1985

The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention

Rutheford B. Campbell Jr.
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Securities Law Commons

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation

Available at: https://uknowledge.uky.edu/klj/vol74/iss1/3

This Article is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledge@lsv.uky.edu.
The Plight of Small Issuers*  
(And Others) Under Regulation D:  
Those Nagging Problems  
That Need Attention  

RUTHERFORD B CAMPBELL, JR.**

INTRODUCTION

Regulation D1 traces its roots to section 4(2)2 and section 3(b)3 of the Securities Act of 1933 (hereinafter referred to as the "1933 Act"). Both of these sections are designed to relieve an issuer from the pains of registration under the 1933 Act in situations where Congress deemed such registration inappropriate. Therefore, under section 4(2), no registration is required for "transactions by an issuer not involving any public offering."4 Section 3(b) is not a self-executing exemption but instead permits the Securities and Exchange Commission (hereinafter referred to as the "Commission") to enact rules and regulations exempting issuers from registration requirements "if it finds that ... [registration] is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering. . ."5

* "Small issuer" as used in this Article means a company or other business entity (e.g., a limited partnership) that is relatively small in size (i.e., has a relatively small dollar amount of assets) and that has no active market for its stock (i.e., stock is not traded on the NASDAQ system or some national exchange).

** Professor of Law, University of Kentucky. B.A. 1966, Centre College; J.D. 1969, University of Kentucky; LL.M. 1971, Harvard University.

The author thanks Jane Ellen Broadwater for her help in the preparation of this Article.

3 Id. § 77c(b) (1982).
4 Id. § 77d(2).
5 Presently, § 3(b) is limited to offerings of $5 million or less. Id. § 77c(b) (1982).
Section 4(2) has a long, rich\(^6\) and often confusing history\(^7\) and has played an important role in the sales of securities outside the registration process.\(^8\) Notwithstanding the significance of this statutory exemption, the popularity of and interest in this exemption over the years has been subject to an apparent ebb and flow. The exemption's nadir, at least in modern times, must have been in the early 1970's, when a series of cases from the Fifth Circuit\(^9\) were read (or perhaps feared)\(^10\) by some to say that the section exempts only sales to insiders.\(^11\)

At about that time,\(^12\) the Commission, partially in response to the confusion and apprehension generated by such cases,\(^13\) promulgated Rule 146. Under the provisions of that rule, an offering under section 4(2) was considered exempt from the registration requirements if certain criteria were met. More specifically, Rule 146 prohibited general advertising,\(^14\) required generally that the offerees and purchasers be sophisticated,\(^15\) required

---

\(^{\text{6}}\) See Section 4(2) and Statutory Law, 31 Bus. Law. 485, 505-II (1975) for a list of the writings regarding section 4(2) up to the date of that Article.


\(^{\text{10}}\) See, e.g., Kripke, Wrap-up in Revolution in Securities Regulation, 29 Bus. Law. 185, 187 (Special Issue Mar. 1974).

\(^{\text{11}}\) The Fifth Circuit later attempted to explain these cases. Doran v. Petroleum Corp., 545 F.2d 893 (5th Cir. 1977); Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975), cert. denied, 434 U.S. 831 (1977).


\(^{\text{13}}\) "The Rule is designed to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed to be transactions not involving any public offering within the meaning of Section 4(2). . . ." Id.

\(^{\text{14}}\) 17 C.F.R. § 230.146(c) (1981). In addition to newspaper and magazine advertisements, general advertising was defined to include seminars and letters, unless all persons attending the seminars and all persons receiving the letters were qualified offerees.

\(^{\text{15}}\) Id. § 230.146(d). Rule 146 required that all offerees and all purchasers be qualified. To be a qualified offeree, one had to be either wealthy or sophisticated. To be a qualified purchaser, one either had to be sophisticated or had to be wealthy and have an offeree representative who was sophisticated.
that purchasers have access to information about the offering,\footnote{Id. § 230.146(c). Under Rule 146, each purchaser was required to have access to all material information about the issuer or to be supplied with all material information about the issuer.} limited the number of purchasers to thirty-five\footnote{Id. § 230.146(g).} and imposed restrictions on the resale of the securities.\footnote{Id. § 231.146(h). Because securities purchased in a Rule 146 transaction were within the exemption of section 4(2), the resale of those securities was subject to the same resale restrictions as securities purchased under a traditional section 4(2) offering. Therefore, for example, such securities would be included within the definition of "restricted securities" under Rule 144 and thus could be resold within the terms of that rule. \textit{Id.} § 230.144(a)(3) (1984).}

Unfortunately, Rule 146 was an ill-conceived exemption,\footnote{Commentators were often quite harsh in the assessment of rule 146. \textit{See} Kripke, \textit{SEC Rule 146: A "Major Blunder"}, N.Y.L.J., July 5, 1974, at 1, col. 2; Kesseler, \textit{Private Placement Rules 146 and 240 — Safe Harbor?}, 44 FORDHAM L. REV. 37 (1975); Kinderman, \textit{The Private Offering Exemption: An Examination of its Availability Under and Outside Rule 146}, 30 BUS. LAW. 921 (1975); Weinberg & McManus, \textit{The Private Placement Exemption Under the Securities and Exchange Act of 1933 [sic] Revisited and Rule 146, 27 BAYLOR L. REV. 201 (1975); Heumann, \textit{Is Rule 146 Too Subjective to Provide the Needed Predictability in Private Offerings?}, 55 NEB. L. REV. 1, 9 (1975).} and its flaws were apparent from the beginning. The rule was unnecessarily technical, cumbersome, out of balance and contained some requirements that were nearly bizarre. With regard to small issuers, the rule was literally unavailable in most instances. A combination of costs, unnecessary technicalities and impossible resale provisions usually foreclosed small issuers from using the rule.\footnote{See Campbell, \textit{The Plight of Small Issuers under the Securities Act of 1933: Practical Foreclosure From the Capital Market}, 1977 DUKE L.J. 1139 (1977).}

Unlike section 4(2), section 3(b) lay fallow for decades. Prior to 1975, the Commission's only implementation of the section was Regulation A,\footnote{17 C.F.R. §§ 230.251-.264 (1984).} which essentially allowed small public offerings of securities pursuant to somewhat abbreviated disclosure documents, and Rule 237,\footnote{Id. § 230.237 (1983). Rule 237 was rescinded effective October 31, 1983. Securities Act Release No. 6488 (September 23, 1983), [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,429, at 86,249.} which permitted very limited resales of restricted securities after the purchaser held the securities for five years. Both of these provisions, however, had only limited significance for issuers attempting to sell securities outside the registration provisions of the 1933 Act.\footnote{Generally, Regulation A is unattractive to small issuers because of the inability to access information about the offering, as required by Rule 146.}
The Commission’s adoption of Rule 240\textsuperscript{24} in 1975 was a significant development under section 3(b). That rule, the spiritual predecessor of Rule 504 of Regulation D,\textsuperscript{25} provided an exemption from registration if the sale did not involve any general advertising, no solicitation fees were paid to brokers or others, the aggregate offering did not exceed $100,000 in any twelve month period, the issuer had one hundred or fewer shareholders and certain restrictions on resales were observed.\textsuperscript{26}

In 1978, the Commission used section 3(b) as a basis for another rule, Rule 242.\textsuperscript{27} That rule, the predecessor of Rule 505 of Regulation D,\textsuperscript{28} provided an exemption from registration for sales of securities up to the maximum amount permitted by section 3(b) if there were no general advertising, there were a maximum of thirty-five purchasers, S-18 information were furnished to the purchasers and certain resale limitations were observed.\textsuperscript{29}

At about the same time, the Commission apparently realized that it needed to take a hard look at the special problems of small issuers under the federal securities laws. As a result, the Commission held a series of hearings during 1978 to solicit comments from interested parties.\textsuperscript{30} This author, as well as numerous other commentators, presented the Commission with a variety of views and information concerning the problems of small issuers. Thereafter, the Commission made several adjustments in the rules under which issuers (and particularly small issuers) could sell their securities.
Regulation D became effective on April 15, 1982 and was the most obvious rule change that occurred after the Small Business Hearings. By repealing Rules 146, 240 and 242 and adopting Regulation D, the Commission attempted to address many of the problems that rankled commentators and perplexed practitioners. Although one must certainly concede the improvements of Regulation D, small issuers (and others) still face unnecessary obstacles under Regulation D.

This Article describes certain areas in which Regulation D continues to subject small issuers and, to some extent, larger issuers to indefensible standards and requirements. The Commission should address these areas and, where necessary, should petition Congress to lend its assistance.

I. AN OVERVIEW OF REGULATION D

Rule 504 provides an exemption from registration under the 1933 Act for offerings of up to $500,000. Rule 505 exempts offerings of up to $5 million, and Rule 506 exempts offerings without any amount limitation. Rules 501, 502 and 503 provide the definitions, general conditions and filing requirements for the three exemptions. If the requirements of Rule 504 or Rule 505 are met, the offering is exempt pursuant to section 3(b) of the 1933 Act. By complying with the conditions of Rule 506, an offering is exempt pursuant to section 4(2).

A. Rule 504

Rule 504 exempts from registration offerings up to $500,000, if the issuer meets certain conditions. The exemption, which is

---

32 The release adopting Regulation D announced the repeal of Rules 146, 240 and 242. Id.
34 Id. § 230.505(b)(2)(i).
35 Id. § 230.506.
36 Id. § 230.501.
37 Id. § 230.502.
38 Id. § 230.503.
39 Id. § 230.504(a); Id. § 230.505(a).
40 Id. § 230.506(a).
41 In addition to the rule itself, the Commission has, through its no-action letters,
not available to companies that are subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (the "1934 Act"), prohibits general advertising, restricts the resale of the securities purchased in a Rule 504 transaction, obligates the issuer to take certain steps to insure that resales are limited and requires the issuer to file a notice with the Commission on Form D.

Equally important are the "non-requirements" of Rule 504 (i.e., those factors that are not prerequisites to the rule's availability). There are no purchaser qualifications, which means that the offering does not have to be limited to sophisticated or wealthy individuals. Also, there are no disclosure requirements and no limitations on the number of purchasers that can acquire securities pursuant to Rule 504, and the exemption is available to limited partnerships and other noncorporate entities. Finally, provided some guidance concerning the calculations of the maximum offering under Rules 504 and 505. See id. § 230.505(c); 12 C.F.R. § 230.504(b)(2), Notes 1 and 2 (1983); Niles Federal Savings & Loan Association, SEC No-Action letter (Aug. 30, 1982) (available on Lexis, Fedsec library, No act file); In re Kim R. Clark, Esq., SEC No-Action letter (Nov. 8, 1982) (available on Lexis, Fedsec library, No act file).


Id. § 230.502(c).

Id. § 230.502(d).

Under Rule 502(d), the issuer is required to exercise "reasonable care to assure that the purchasers of the securities are not underwriters ...," including making "reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons ...," providing written disclosures to purchasers explaining the restrictions on resales and placing a legend on the securities disclosing the restrictions on resales. 17 C.F.R. § 230.502(d) (1984).

Id. § 230.503. Although the filing requirements of Rule 503 are not major obstacles to the availability of the exemption provided by Regulation D, one aspect of the rule deserves comment. Failure to file the Form D in a timely manner causes the exemption to be lost. That is an excessive and inappropriate remedy. It robs the issuer of the exemption and, accordingly, subjects the issuer to liability for its lawyer's mistake. The need to ensure the filing of Form D does not justify such an extreme remedy. Rather, a fine or late charge should be assessed in those situations. Although one should not overdramatize the significance of Rule 503, it is an example of the lack of balance that the Commission too often manifests.


Rule 240 provided that after the sale under the rule, the stock of the issuer could not be owned by more than 100 persons. Id. § 230.240(l) (1981). This limitation was omitted from Rule 504, although, as indicated in the text, companies reporting under section 13 or 15(d) of the 1934 Act cannot utilize Rule 504. 17 C.F.R. § 230.504(a) (1984).

Rule 242, for example, was not available for offerings of limited partnership interests. 17 C.F.R. § 230.242(b) (1981).
there are no prohibitions against paying selling commissions in connection with a Rule 504 offering.\(^50\)

**B. Rule 505**

Rule 505 exempts offerings up to $5 million from the registration requirements if certain conditions are met.\(^51\) As with Rule 504, there is a prohibition against general advertising, a limitation on the resale of securities purchased pursuant to a Rule 505 offering and a requirement to file a Form D with the Commission.\(^52\)

Qualification under Rule 505, however, requires two additional, significant conditions. First, an issuer is normally required to disclose certain prescribed information as a prerequisite to the availability of the exemption. This criterion typically requires disclosure of the information that would be required by Form S-18.\(^53\) Second, the maximum number of purchasers in a Rule 505 transaction is normally limited to approximately thirty-five.\(^54\)

Again, the nonrequirements of Rule 505 are as significant as its requirements. Specifically, there is no offeree or purchaser qualification requirement and the exemption is available to limited partnerships and other noncorporate issuers. The disclosure requirements are suspended if the offering is limited to "accredited investors,"\(^55\) and in calculating the maximum number of investors, accredited investors are not included.\(^56\)


\(^{51}\) 17 C.F.R. § 230.505(b) (1984). For certain Commission no-action letters regarding calculations of the maximum offering price, see note 41 supra.

\(^{52}\) See notes 43-46 supra.

\(^{53}\) The rule requires only the most recent fiscal year's financial statements to be certified. Also, the right to disclose only S-18 information depends on whether the form would be available if the offering were registered. Thus, for example, if the transaction involves a merger, one would be required to use Form S-4. Finally, issuers reporting under the 1934 Act can meet the disclosure requirements by using annual reports, proxy statements and periodic reports filed with the Commission. 17 C.F.R. § 502(b) (1984).

\(^{54}\) Rule 505 limits the number of purchasers to thirty-five, but in calculating the number, "accredited investors" are excluded. 17 C.F.R. § 230.502(b)(1)(i) (1984).

\(^{55}\) Id. § 230.502(b)(1)(i).

\(^{56}\) Id. § 230.502(e)(1)(iv).
C. Rule 506

Rule 506 provides an exemption from registration without imposing any limitation on the dollar amount of the offering. Essentially, the exemption requires disclosure of the same kind of information contained in a registration statement and limits the sale either to persons that are sophisticated or to accredited investors. As with Rule 505, Rule 506 also prohibits general advertising, limits resales of the securities, requires filings of a Form D and limits the number of purchasers to approximately thirty-five.

From an issuer's point of view, Rule 506 is the most burdensome of the Regulation D rules. The most important of these added burdens are the more extensive disclosure requirement and the requirement that all purchasers either be capable of evaluating the merits and risks of the investment or be accredited investors. Because of these added burdens, issuers normally will not rely on Rule 506 for offerings of less than $5 million but, instead, will utilize either Rule 505 or Rule 504. Rule 506, therefore, is not as significant for small issuers, since their capital requirements usually do not require a $5 million offering.

II. A Commendable Attempt at Balance

The Commission, within the structure of Regulation D, apparently attempted to balance the need for investor protection with the need to provide cost efficient access to the capital markets. As a result, there are fewer disclosure requirements under Regulation D as the size of the offering decreases. Thus, for offerings over $5 million, an issuer not reporting under the

---

57 More precisely, the level of disclosure by an issuer not reporting under the 1934 Act is determined by the size of the offering rather than the rule involved. Realistically, Rule 506 will usually be confined to offerings in excess of $5 million, and, in that instance, Rule 502(b)(2)(i)(B) requires the "same kind of information as would be required in Part I of a registration statement filed under the Act on the form that the issuer would be entitled to use." Issuers reporting under the 1934 Act can effect disclosure by providing purchasers with certain 1934 Act disclosure documents (e.g., annual reports, periodic reports filed with the Commission and proxy statements). 17 C.F.R. § 230.502(b) (1984).
58 Id. § 230.506(b)(2)(ii).
59 17 C.F.R. § 230.506(b)(l) requires that all conditions of Rules 501-03 be met. The referenced requirements are contained in those rules, except the limitation on the number of purchasers, which is found in Rule 506(b)(2)(l). Id. § 230.506(b)(2)(l).
1934 Act is often required to provide the disclosures mandated in Form S-1. For offerings between $5 million and $500,000, the issuer is usually required to disclose essentially the information required by the less extensive Form S-18. For offerings below $500,000, no disclosures are required as a prerequisite to the exemption's availability, although the antifraud provisions necessitate disclosures. Similarly, there usually are no purchaser qualification requirements for offerings of less than $5 million. Only offerings under Rule 506 contain any purchaser qualifications, and normally offerings under that Rule are in excess of $5 million.

Requiring less disclosure and fewer purchaser qualifications as the offering decreases accommodates the realities faced by an issuer utilizing Regulation D. Providing extensive disclosure and ensuring compliance with purchaser or offeree qualifications are expensive to an issuer, and the indiscriminate use of these mechanisms by the Commission can practically foreclose an issuer from using a particular exemption.

The problem with Regulation D, therefore, is not the underlying fundamental philosophy of the rules but, instead, is the implementation of that philosophy. Issuers attempting to qualify for an exemption under Regulation D are required to meet a number of requirements that significantly add to the cost of compliance without any corresponding increase in investor protection. These problems are especially difficult for small issuers.

III. SMALL ISSUERS UNDER REGULATION D: A CRITIQUE

The Commission needs to address the problems of Regulation D. With some attention, Regulation D can become a fair, clear and well-balanced set of rules.

Specifically, the Commission should undertake the following:
1. Eliminate Regulation D's prohibition against general advertising.
2. Adjust the disclosure requirements of Regulation D.
3. Modify the resale restrictions of Rule 144.
4. Eliminate the integration concept.

---

60 Id. § 230.502(b)(1).
61 See notes 96-106 infra and accompanying text.
Understandably, some may consider the foregoing suggestions extreme. A careful analysis, however, reveals that the proposals would maintain investor protection while effectively broadening the availability of Regulation D to small issuers.

A. The Prohibition Against Advertising

1. The Special Problems of Small Issuers

For a number of reasons, it is difficult for small issuers to raise capital by the sale of stock. Initially, professional underwriting services are practically unavailable, since small deals do not generate sufficient underwriting profits to justify participation by investment bankers. Even if the small issuer has larger capital needs, however, it is difficult to persuade an investment banker to underwrite an offering. After all, investment bankers are not much different from automobile dealers, at least in some respects. They both make money by selling a quality product in an efficient manner and must, therefore, avoid situations in which the selling effort is expensive or the product is inferior. Investment bankers consider offerings by small issuers to be hard, expensive sales that involve high risk to their customers. As a result, investment bankers tend to limit their underwriting activities to larger, more seasoned companies.

The issuer and its officers, directors and owners are, therefore, often forced to bear the burden of selling the issuer’s securities. This is a difficult task, since a small issuer’s management typically has neither the skills, time nor experience necessary to sell securities.

This is not to say that small issuers are unable to sell their own securities in all instances. Each of us who practice in this area has examples of situations in which issuers marketed their

---

63 In the fall of 1984, this writer acted as counsel to a company in the public offering of $4 million in common stock. In selecting an underwriter, the company talked to four investment bankers. Two of those houses rejected the company as a client in substantial part because the deal was too small.

64 Not only is it hard for the salesman at the retail level to interest customers in new offerings from unseasoned companies, it is also very expensive for the investment banker’s department of corporate finance to evaluate and educate itself regarding such a company. This means less profit for the investment banking firm and is one reason investment banking firms are reluctant to take on small companies as clients.
own stock, and in certain instances issuers raised substantial amounts of capital without the aid of underwriters.

Unfortunately, the prohibition against general advertising places an unnecessary obstacle in the path of a small issuer trying to offer securities pursuant to Regulation D. The prohibition provides no protection to investors but does make it more difficult for a small issuer to attract investment bankers or to sell securities on its own behalf.

2. The Commission's View and Its Impact on Selling Deals

The prohibition against general advertising contained in Rule 502(c) is incorporated into the requirements of Rules 504, 505 and 506. As a result, an "issuer" or "any person acting on its behalf" cannot use any "general solicitation or general advertising" in connection with an offering pursuant to Regulation D. The definition of general solicitation or general advertising includes "but is not limited to. . . . (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising." 66

In order for an issuer's conduct to violate the prohibition against general solicitation or general advertising, there must be a "solicitation" or an "advertising," and it must be "general." The notion of a solicitation or an advertising is apparently coextensive with that of an "offer" under section 2(3) of the 1933 Act. 67 As a result, the Commission, in deciding whether the conduct of an issuer involves a solicitation or an advertising, is often faced with questions similar to ones it has faced in other contexts, such as "gun jumping" in public offerings. 68 For example, one no-action request asked whether an issuer would be engaged in a general advertising under Regulation D if it continued to "promote its products and services through newspaper, radio and television media at the same time as it [was] conduct-

---

5 Id. § 230.502(c).
6 Id.
ing an offering of securities in reliance on Regulation D."69 Another inquiry raised the question of whether a tombstone ad announcing the completion of a Regulation D offering could be considered general advertising.70 The real issue in these cases, of course, was whether the activity involved an "offer" of the issuer's securities.71

By examining the Commission's releases and no-action letters interpreting Regulation D and the concept of an "offer" under section 2(3) of the 1933 Act, one can glean an insight into how the Commission defines "solicitation" or "advertising." For example, in a no-action response to Alaska Company, the Commission concluded without much difficulty that an offer would be involved where a "finder" acting on behalf of an issuer in a Regulation D offering contacted potential investors, briefed them "on the nature of the offering, the minimum amount that they would be required to purchase and the total amount of the offering" and referred interested persons to the issuer.72 On the other hand, in an earlier release, the Commission advised issuers "in registration"74 that no offer would be involved if an issuer

---

70 A "tombstone ad" is a "notice, circular, advertisement, letter or communication in respect of a security" that is excepted from the definition of a prospectus and therefore does not have to meet the requirements of a prospectus embodied in section 10 (Securities Act of 1933 § 10 (codified at 15 U.S.C. § 77j (1982)). A tombstone ad must contain information on "from whom a written prospectus meeting the requirements of section 10 may be obtained." The ad must do no more than "identify the security, state the price thereof, state by whom orders will be executed" and contain any other information deemed necessary by the Commission. Securities Act of 1933 § 2(10)(b) (codified at 15 U.S.C. § 77b(10)(b) (1982)). "Because of the format which advertisements took under the pre-1954 language—and still do for the most part—they are universally if somewhat lugubriously known as 'tombstone ads.'" L. Loss, supra note 68, at 227.
72 In its response to Alma Securities Corporation, the Commission stated, "The relevant questions under Regulation D . . . is whether or not the tombstone advertisement is used to offer or sell securities." Id.
73 Alaska Co., SEC No-Action Letter (Oct. 10, 1978) (available on Lexis, Fedsec library, No act file). This no-action response was issued under Rule 146. The language in Rule 146 was similar to Regulation D regarding the general advertising prohibition.
74 "In registration" is defined by the Commission as "the entire process of registration, at least from the time an issuer reaches an understanding with the broker-dealer which is to act as managing underwriter prior to the filing of a registration statement and the period of 40 to 90 days during which dealers must deliver a prospectus." Securities Act of 1933, Release No. 5180 n.1 (Aug. 16, 1971) (available on Lexis, Fedsec library, Release file).
continued to advertise its products and services, sent customary periodic reports and proxy statements to its shareholders, announced factual business and financial developments to the press and responded to unsolicited inquiries regarding factual information.

In a no-action response to Alma Securities Corporation, a securities firm involved in the placement of interests in drilling programs asked the Commission whether publication of tombstone ads announcing the completion of a Regulation D offering would constitute a general solicitation or advertising. Again, the real question was whether such tombstone ads would constitute an "offer," since the publication of these advertisements would certainly be "general." The Commission refused to opine in that situation, concluding that it did not have enough facts to respond. The response did state, however, that a tombstone ad might be permissible "following the completion of an isolated Regulation D offering where the advertisement would have no immediate or direct bearing on contemporaneous or subsequent offers or sales of securities." The Commission indicated that a tombstone ad would constitute an offer, however, if an issuer involved in ongoing programs of private placements employed tombstone ads to announce the completion of each individual program. The apparent concern of the Commission was that the advertisement for the completed deals could be an advertisement for contemporaneous or future deals.

All of these releases and responses indicate that the Commission utilizes an intent or purpose test in determining whether the conduct of an issuer involves a solicitation, advertisement or offer. Thus, a solicitation, advertisement or offer will be involved if the conduct of the issuer is intended "to awaken an interest which later would be focused on the specific financ-

---

75 In a no-action letter regarding Regulation D, however, the Commission indicated that product advertising could in some instances be considered a solicitation or an advertising. See Printing Enterprises Management Science, Inc., SEC No-Action Letter, supra note 69, at 78,517-2.


77 Alma Securities Corporation, SEC No-Action Letter, supra note 71.

78 Id.
On the other hand, if the issuer's conduct has independent significance and purpose, it will not be deemed a solicitation, advertisement or offer, even though it may have a positive impact on the issuer's ability to market its securities. This is the reason an issuer can normally continue to advertise its products and solicit proxies during a Regulation D offering. Either of these activities, however, could constitute a solicitation or advertising, if the facts indicate that the real purpose of the conduct were to promote the Regulation D offering by the issuer.

Although it is difficult in some instances to decide whether a particular course of conduct involves a solicitation, advertising or offer, the determination of whether the conduct is "general" typically is a more perplexing and prevalent problem. Invariably, issuers ask "How many offers can I make?". Just as invariably, the issuer's counsel is unable to provide a clear answer to this question.

Nevertheless, one is able to draw certain general conclusions about the Commission's interpretation of the meaning of "general." First, an offer obviously will be "general" if it is made through a vehicle that reaches an undetermined number of persons. Thus, an offer in an airline's in-flight magazine or an offer in a thoroughbred horse trade magazine would be "general."

Second, offers may still be considered "general", even though limited to persons who are sophisticated or "accredited". In its response to the Texas Investment Newsletter, the Commission concluded that an offer to two thousand accredited investors would be general. In a response to Tax Information Corporation, the Commission concluded that a general advertising would be involved if an offer went to an undetermined number of persons.

---

79 Securities Act Release 3844, supra note 76, at example 1.
81 In Damson Oil Corporation, SEC No-Action Letter (July 5, 1974) (available on Lexis, Fedsec library, No act file), the staff concluded that this raised "serious questions" concerning the availability of Rule 146.
83 But see Woodtrails-Seattle Ltd., SEC No-Action Letter (August 9, 1982) (available on Lexis, Fedsec library, No act file), where the Commission issued a no-action letter involving 330 sophisticated offerees.
accountants and lawyers in Louisiana. Finally, in a proposed Regulation D offering involving thoroughbred horses, the Commission concluded that the issuer could not offer the securities to an undefined number of members of the Thoroughbred Owners and Breeders Association.

Third, indiscriminate offers, even if the actual number of offers is not excessive, are more likely to run afoul of the prohibition against general advertising than are offers to the same number of persons who have been screened and evaluated by the issuer. Thus, the Commission did not allow the apparently indiscriminate distribution of offering materials at a thoroughbred horse sale, nor did the Commission permit apparently indiscriminate offers to the lawyers and accountants in a particular state. But, in the Woodtrails no-action letter, the fact that the offerees had been evaluated and carefully selected by the issuer apparently was important to the Commission's approval of an offer to 330 persons.

Finally, the number of offerees obviously is important in determining whether the offer is general, although one must be wary of the nearly overwhelming temptation to rely exclusively on such quantification. Two no-action responses are instructive in this regard. In the Woodtrails no-action response, the Commission concluded that no general advertising would be involved if offers were made to approximately 330 persons. The Commission, however, reached an opposite result where an issuer proposed to make an offer to two thousand persons.

Although the Woodtrails letter may well represent the limit of the Commission's tolerance for large offerings, one should not assume, for example, that an indiscriminate offer to approximately 330 persons randomly selected from the telephone


Aspen Grove, SEC No-Action Letter, supra note 82.


See Aspen Grove, SEC No-Action Letter, supra note 82.

See Tax Investment Information Corporation, SEC No-Action Letter, supra note 85.


Id.

See The Texas Investor Newsletter, SEC No-Action Letter, supra note 84.
book would pass muster. In its response in Woodtrails, the Commission emphasized that the offerees had a preexisting relationship with the issuer, were sophisticated and met certain financial suitability standards. Without such facts, Commission approval of an offering to such a large number of offerees is unlikely.

Thus, as a practical matter, an issuer attempting to complete a Regulation D offering may be unwilling to press to the limit outlined in the Woodtrails response. Concerns for safety may cause issuers and their counsel to limit their offers to a number well below the 330 approved in Woodtrails.

For example, this writer, in advising clients, usually starts by asking the client for the least number of offerees necessary to complete the deal. Sometimes this question resolves the matter, if the client, for example, indicates that he can live with forty or fifty offerees. Often, however, an issuer indicates that he would like to make an offer to one hundred or more persons, and, at that point, the analysis becomes more complex.

This writer thinks that one should feel fairly comfortable in making one hundred discriminate offers. Thus, while one should not make offers to one hundred unknown persons selected from the telephone book, one hundred offers to persons who have been determined by the issuer to be potentially interested investors should not violate the prohibition against general advertising. This does not imply any need to impose suitability or sophistication requirements, unless otherwise required under Regulation D. Further, if those offers do not result in the deal's being sold out, offers to additional persons, similarly screened and selected, should not cause the offering to become general.

3. The Case for Eliminating the Prohibition Against General Advertising

Imposing a general advertising prohibition on issuers (especially small issuers) is unnecessary and illogical and, thus, is impossible to justify under any cost-benefit analysis. The prohibition makes location of investors significantly more difficult for small issuers, while providing no protection to investors.

Two points are significant in this regard. First, it is exceedingly difficult for small issuers to sell their securities. As described earlier, brokers typically are unavailable to assist these small issuers, and, as a result, the issuer and its management
must bear the burden of selling the company's securities. Even if the small issuer is able to find a broker to help, the broker will face substantial difficulty in marketing the securities. To restrict the issuer and broker further by limiting their ability to place advertisements in newspapers or magazines, for example, removes an effective technique for locating investors. This prohibition may eliminate the issuer's only real chance at attracting outside investors, especially if the issuer must go it alone.

Second, one must keep in mind what the removal of the prohibition against general advertising would not do. It would not eliminate any sophistication or disclosure requirements under Regulation D. Rather, these requirements would still be imposed, to the extent they presently are, prior to the sale of the security. Under Rule 502(b)(1)(ii), therefore, issuers would still be obligated to furnish "to any purchaser that is not an accredited investor the . . . [required information] during the course of the offering and prior to sale."[93] Similarly, in a Rule 506 offering, the issuer would still be subject to the requirement that it "reasonably believe immediately prior to making any sale that each purchaser . . ."[94] is either accredited or sophisticated.[95]

This is the reason that the removal of the general advertising prohibition would not harm investors. So long as the protective provisions of Regulation D, such as disclosure and offeree qualification requirements, are imposed at the purchaser level, investors are adequately protected. Since the protective provisions would still be in place when the investor makes his investment judgment, it seems impossible to conclude that allowing general advertising harms investors.

B. The Disclosure Requirements

In constructing its rules regarding exemptions from the registration requirements, the Commission must maintain a delicate balance between the need to protect investors and the need to foster capital formation.[96] Nowhere is this balance more difficult

[95] Id.
[96] Evidence indicates that the Commission was late in recognizing or accepting this idea. In enacting Rule 146, for example, the Commission made no attempt to fashion disclosure requirements that were reasonable for small offerings. See Campbell, supra note 20, at 1144-46.
to maintain than in setting the appropriate level of disclosure in exempt transactions. Although the Commission, to its credit, attempted to accommodate these competing needs in Regulation D, at least one adjustment is needed. The Commission should raise the threshold for requiring Form S-18 information from $500,000 to $1 million.

Under Regulation D, offerings of up to $500,000 typically are made under Rule 504. There are no disclosure requirements prerequisite to the availability of that exemption. Offerings of $500,000 to $5 million are usually made under Rule 505, and small issuers normally are required to provide investors with basically the same information that is contained in a registration statement filed on Form S-18. The cost of this disclosure imposes a significant and usually unacceptable burden on small issuers attempting to raise between $500,000 and $1 million.

Generalization about the costs of complying with SEC disclosure requirements is always difficult. As people who work in the area can attest, the legal and accounting expenses of one S-18 offering literally can be three times as much as the costs of another S-18 offering, even though the two companies and the two offerings are roughly the same size. Nonetheless, experience indicates that legal and accounting expenses may exceed $30,000 for an offering with Form S-18 disclosures. These ex-

---

97 The basic scheme of Regulation D is to require more extensive disclosures as the deals get bigger. Typically, therefore, deals of less than $500,000 do not require disclosure as a prerequisite to the availability of Regulation D. Deals between $500,000 and $5 million require the information that would be required in Form S-18, and deals in excess of $5 million require the same information that would be required if the deal were registered. 17 C.F.R. § 230.502(b) (1984).

98 Id. § 230.502(b)(i)(i).

99 In certain situations, Form S-18 is not the appropriate form for the disclosure requirements in a Rule 505 offering. If the sales are made only to "accredited investors" no disclosure is required. See id. § 230.502(b)(1)(i). If Form S-18 is not available to the issuer, the otherwise applicable form must be used. Id. § 230.502(b)(2)(i)(A). Further, certain deviations from Form S-18 are permitted. Financial statements are required only for two years, and only one year is required to be audited. Id. The Form S-18 information is required to be furnished "to the extent material to an understanding of the issuer, its business and the securities being offered." Id. § 230.502(b)(2)(i). Finally, companies reporting under the 1934 Act can fulfill the disclosure requirements by furnishing certain of their periodic reports, annual reports and proxy statements. Id. § 230.502(b)(2)(ii).

100 One of the major factors in this regard is the sophistication of the issuer's in-house staff. Some issuers have people in-house who can bear the major burden in gathering information and writing the disclosure document. In other instances, outside counsel may have to do everything.
penses, amounting to 6% of a $500,000 offering, may drive the issuer's cost of capital to an unacceptable level. Regulation D, therefore, may be practically unavailable for small issuers wishing to sell $500,000 to $1 million in securities.\(^{101}\)

To determine whether it is sensible to raise the threshold of S-18 disclosure to $1 million, however, one must also consider whether investors would thereby be denied access to meaningful information about the issuer. This writer is convinced that they would not.

In the first place, investors would be protected by market forces.\(^{102}\) Investors today are accustomed to seeing disclosure documents when they lay out their cash. As a result, issuers who want to sell their stock feel some market pressure to provide information to investors through offering circulars, even when not required by the 1933 Act. Although one may be unwilling to rely entirely on market forces to insure disclosure, one certainly should not dismiss these pressures as irrelevant.

The antifraud provisions of the 1933 Act and the 1934 Act, however, generate additional significant investor protection.\(^{103}\) Presently, these provisions provide appropriate protection for investors in deals of less than $500,000, and it would be entirely sensible to rely on the antifraud rules for Regulation D offerings up to $1 million.

One must understand that these antifraud provisions provide more than after-the-fact relief for fraud. The practical in terrorem effects of these provisions cause issuers to provide formalized disclosures to investors (i.e., some sort of offering circular or memorandum), even in instances where such disclosures are not a prerequisite to the availability of an exemption. Offering circulars are used in these situations to try to insulate the issuer

\(^{101}\) This writer's rule of thumb is that issuers should not tolerate or, indeed, be asked to tolerate legal and accounting expenses in excess of five percent of an offering. That amount, actually, is exorbitant. One must never forget that these expenses do not go to purchase the productive assets of the company.

\(^{102}\) There is a body of scholarship that argues in favor of eliminating required disclosures and thereby relying exclusively on market forces to generate sufficient disclosure. See, e.g., R. Posner, ECONOMIC ANALYSIS OF LAW 332 (2d ed. 1977).

\(^{103}\) The most significant of these provisions are section 12(2) under the 1933 Act, 15 U.S.C. § 77l(2) (1982), and § 10(b), 15 U.S.C. § 78j(10) (1982), and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984), under the 1934 Act.
from claims that it failed to disclose all material facts to the investors and thereby violated the antifraud provisions.

As a result, issuers normally are willing to underwrite the expense of these offering circulars. In fact, only in unusual situations has this writer been involved in exempt offerings that did not use an offering circular.\(^{104}\) This seems to be the common practice with other securities attorneys as well.

Typically, these antifraud disclosure documents are more concise than and omit much of the material contained in disclosure documents based on registration forms. Likewise, requirements such as audited financial statements are no longer applicable.\(^{105}\) This allows the issuer to recognize even more savings.

These factors, however, do not necessarily result in a poor-quality disclosure document. In fact, this writer would argue that such antifraud documents may result in better disclosure than those that slavishly follow the boiler-plate-ridden documents of seventy pages or more. These latter documents tend to be poorly organized, excessive in length and riddled with irrelevant, repetitive and confusing information, much of which is in the document solely to ensure compliance with a particular registration form. It is not hard to argue that better disclosure may be effected through a twenty page disclosure document written by an experienced attorney who is charged only with providing all material information.\(^{106}\)

---

\(^{104}\) The one situation in which this writer feels fairly comfortable in not using an offering circular is where a corporation is started by five people, for example, each of whom has had some participation in the formation of the company and will be involved, at least to some extent, in the operation of the business.

\(^{105}\) Form S-18 requires the submission of an audited balance sheet for one year and an audited income statement for two years. Form S-18, Item 21(b) and (c), 2 Fed. Sec. L. Rep. (CCH) ¶ 7303, at 6451-12 (June 19, 1985). Regulation D provides, however, that if the Form S-18 information is applicable for offerings of less than $5 million, "only the financial statements for the issuer's most recent fiscal year must be certified. . . ." 17 C.F.R. § 230.502(b)(2)(i)(A) (1984).

\(^{106}\) A personal experience supports this argument. While engaged in practice, this writer did a significant amount of work in the horse industry. The firm with which he was associated developed a disclosure document that it used in horse deals (i.e., the sale of securities by partnerships, limited partnerships, syndicates and corporations engaged in the horse business) where disclosure was not a prerequisite to the availability of the particular securities exemption. That document would usually consist of approximately twenty-five pages, and this writer believes that it provided better disclosure to the average investor than the seventy to one hundred page documents used in larger deals.
The Commission should become comfortable with allowing the antifraud rules to protect investors in small deals. This writer is convinced that the theory works well. Allowing counsel to make judgments about disclosure based on a materiality standard allows the person closest to the deal to fashion an appropriate level of disclosure in light of all relevant factors, including just how much cost the issuer can bear.

C. Resale of Securities Purchased in a Regulation D Offering

For any exemption from registration to work, investors must be able to resell their securities in some reasonable manner. Without such a resale opportunity, investors will be unwilling to invest in an enterprise and, as a result, issuers will encounter difficulty raising capital for particular projects.

Securities purchased under Regulation D are restricted as to resale, having "the status of securities acquired in a transaction under 4(2)..."107 (securities purchased under Regulation D are hereinafter referred to as "restricted securities"). As a result, there are three ways that investors can practically resell these restricted securities (persons purchasing securities from an issuer in a private placement under section 4(2) or in a Regulation D offering are hereinafter sometimes referred to as "holders"). First, holders can resell in private transactions pursuant to the "section 4(1 1/2)" exemption;108 second, holders can publicly resell restricted securities pursuant to a section 4(1) transaction;109 finally, holders can resell pursuant to Rule 144.110 It is, however, often unnecessarily difficult and sometimes practically impossible for holders of securities in small issuers to resell restricted securities pursuant to these provisions.

1. Resales Under Section 4(1 1/2)

To effect a resale pursuant to the section 4(1 1/2) exemption, the restricted securities must be sold in a transaction not involv-

108 There is, of course, no section 4(1 1/2) under the 1933 Act. It is called a section 4(1 1/2) transaction because the original issuer of the securities relies on its exemption under section 4(2), and the reselling investor relies on the exemption in section 4(1) of the 1933 Act. The theory of the exemption is more fully explained at notes 111-23 infra and accompanying text.
ing any public offering. In that event, the issuer's original private placement exemption pursuant to section 4(2) is maintained, since all of the sales and resales meet the requirements of section 4(2) (i.e., constitute "transactions by an issuer not involving any public offering"[111]). The holder's resale is exempt under section 4(1), since it involves "transactions by any person other than an issuer, underwriter, or dealer."[112] Obviously, the reselling holder is not an "issuer"[113] or, it is assumed, a "dealer."[114] The holder is not an "underwriter" unless he purchased his securities from the issuer "with a view to . . . distribution."[115] Private resales by a holder (i.e., sales not involving any public offering) do not constitute a "distribution," since the Commission regards the terms "distribution" and "public offering" as synonymous.[116] Because these private resales do not constitute a "distribution," the holder is not considered to have purchased "with a view to distribution" and, thus, would not be considered an underwriter.[117]

The foregoing analysis suggests that resales pursuant to the section 4(1 1/2) exemption must meet the same criteria applied to sales by an issuer under the private placement exemption of section 4(2).[118] Such resales, therefore, should be made only to

---

[112] Id. § 77d(1).
[113] Id. § 77b(4).
[114] Id. § 77b(12). Regarding the definition of a "dealer" and the regulation generally of brokers and dealers under federal law, see N. Wolfson, R. Phillips & T. Russo, Regulation of Brokers, Dealers and Securities Markets (1977).
[117] For an excellent discussion of Section 4(1 1/2), see The Section "4(1 1/2)" Phenomenon, Private Resales of "Restricted Securities", 34 Bus. Law. 195 (1979) (hereinafter cited as Section 4 (1 1/2) Phenomenon).
[118] At least one set of commentators seem to reject the idea that resales under section 4(1 1/2) must comply strictly to the informational disclosure requirements of section 4(2). See Section 4(1 1/2) Phenomenon, supra note 117, at 1976 ("[W]e consider the better view to be that only the manner of sale and the number of purchasers are relevant. . . . We find no basis . . . to impose the requirements that the Purchaser be sophisticated or have access to registration-type information."). It is this writer's opinion, however, that resales of restricted securities without disclosure of or access to the same
sophisticated purchasers, and each purchaser must be supplied with or have access to the same information about the issuer that would be contained in a registration statement.\textsuperscript{119}

information that would be required in a section 4(2) offering creates a significant risk that such resales would not be exempt under a section 4(1/2) exemption. See, e.g., Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466-67 (2d Cir.), cert. denied, 361 U.S. 896 (1959). In fact, the commentators cited in this note concluded, after reviewing the major cases in the area: "The Purchasers' sophistication and access to information appear to have been viewed as essential in five of the six decisions." \textit{Section 4 (1/2) Phenomenon, supra} note 117, at 1971.

\textsuperscript{119} Although the exact requirements of a private offering pursuant to section 4(2) have been the subject of controversy over the years, there seems to be general consensus that the offerees and purchasers must be supplied with or have access to the same information that would be contained in a registration statement and must be sufficiently sophisticated to evaluate the merits and risks of the proposed deal. See, e.g., Schwartz, \textit{Private Offering Exemption: Recent Developments}, 37 \textit{Ohio St. L.J.} 1, 17 (1976). See Schneider, \textit{The Statutory Law of Private Placements}, 14 \textit{Review of Securities Regulation} 869 (1981), for a somewhat different approach.

Regarding the private resale of restricted securities, one author has stated:

All resale of securities in reliance upon this exemption must satisfy all of the following general requirements:

1. \textit{The Purchaser} The purchaser must be financially responsible and therefore able to bear the economic risks of his purchase should that investment prove unsatisfactory. The purchaser must also be a "sophisticated investor" capable of discerning the merits and risks of his investment. . . .

2. \textit{Information Regarding the Issuer} The purchaser must be given all the relevant information (i.e., that which would be contained in a registration statement) regarding the issuer . . . or at least given access to this information. . . .

3. \textit{Manner of Sale} [A] seller relying on this exemption cannot publicly solicit purchasers through brokers or by means of advertisements offering circulars and the like. . . .

4. \textit{Acquisition for Investment} [T]he purchaser in a private sale must agree to acquire his shares for investment and not with a view to resell or distribute them.


In summarizing the case law regarding resales pursuant to section 4(1/2), one group of commentators concluded:

1. The appropriate exemptive provision is section 4(l) and not 4(2).
2. No particular holding period is required.
3. The Purchasers' sophistication and access to information appear to have been viewed as essential in five of the six decisions.
4. The number of purchasers, viewed alone, is not dispositive of the availability of an exemption.
5. Restrictions on resales by a Purchaser generally have not been required.
6. No decision has articulated an affirmative duty on a Holder to provide registration-type information to a Purchaser.

The applicability of these criteria often makes it difficult for investors in small issuers to resell restricted securities in section 4(1 1/2) transactions. In this regard, the burden imposed by the access to information requirement is the most onerous, since it may be impractical, or actually impossible, for investors holding restricted securities to acquire and provide the purchasers with the same information that would be contained in a registration statement.

In some instances, of course, the information requirement may be met without unreasonable burden or expense. For example, if the issuer originally utilized Rule 505 and provided the investors with an offering circular pursuant to Rule 502(b), the holder might be able to supply information to the new purchasers by merely updating that offering circular. This is a perfectly sensible use of the section 4(1 1/2) exemption and provides an efficient mechanism for the resale of restricted securities.

Problems arise, however, if the original offering circular becomes dated. If the issuer's original offering were eighteen months ago, for example, the expense of updating the offering circular would become more significant. New financial statements and updated narrative information would be required, and the entire offering circular would have to comply with the registration form applicable at the time of resale.

The problem is even more difficult if the issuer's original Regulation D offering were made either without any offering circular or pursuant to an offering circular designed only to meet the antifraud provisions of the securities laws. In those

---

120 Under Rule 502(b), the availability of Rule 505 normally depends upon supplying each purchaser with "[t]he same kind of information as would be required in Part I of Form S-18..." 17 C.F.R. § 230.502(b)(2)(i)(A) (1984).

121 There are a number of technical problems generated by such an update. Probably the most important would be the question of whether the updated financial information would have to be audited. Form S-18, which may be the applicable form, requires audited statements and unaudited interim statements current within 135 days of the offering. See item 21 of Form S-18, Registration Statement Under the Securities Act of 1933, Fed. Sec. L. Rep. (CCH) ¶ 7303, at 6431-12 to 6431-17 (June 19, 1985).

122 Under Regulation D, no information is required for offerings made under Rule 504 (involving amounts of $500,000 or less) or made only to accredited investors. 17 C.F.R. § 230.502(b)(1)(i) (1984).

123 For a discussion of the use and content of an offering circular in an offering not requiring disclosure as a prerequisite to the availability of Regulation D, see text
situations, it is especially burdensome and expensive for holders to provide purchasers of restricted securities with the same information contained in a registration statement (a requirement for the section 4(1 1/2) exemption). Because no such information was gathered and rendered at the time of the original offering, it is impossible merely to update existing information. If the total proposed sale of the restricted securities is only $10,000, for example, the size of the resale will not support the expenses necessary to prepare such disclosure documents.

The foregoing problems are especially likely to occur when holders of restricted securities in a small issuer attempt to resell under section 4(1 1/2). First, a small issuer is more likely to utilize Rule 504 for the initial offering, and Rule 504, as previously noted, does not require disclosure as a prerequisite to its availability. A reselling holder, therefore, may be faced with a de novo preparation of the disclosure document. In addition, holders of restricted securities in a small issuer are more likely to have relatively small investments in the issuer. Thus, they need to resell less stock, making it economically unfeasible to provide the extensive disclosures that may be required under section 4(1 1/2).

One should not conclude from this discussion that investors in small issuers can never rely on section 4(1 1/2) as a way to resell restricted securities taken in a Regulation D offering. Rather, one should be aware that section 4(1 1/2) is not a panacea for all resale problems faced by investors in small issuers and that in a significant percentage of situations the expense and difficulty in meeting its apparent requirements may foreclose section 4(1 1/2) from being a practical resale alternative.

2. Public Resales of Restricted Securities Outside Rule 144

Section 4(l) of the 1933 Act provides an exemption from registration for offers and sales by persons other than issuers,
underwriters or dealers. Concerning securities purchased in private placements under section 4(2), the theory developed that a holder at some point can resell his securities in a public transaction pursuant to section 4(1). To avoid characterization as an "underwriter," which is the key issue in such resales, the holder selling in a public transaction must establish that he has a proper "investment intent" at the time he purchased the restricted securities. This investment intent removes the holder from the definition of "underwriter," since it means that the holder did not purchase his securities from the issuer "with a view to distribution." Although in such an instance the holder may have purchased his securities from the issuer and may make a "distribution," his investment intent establishes that, at the time he purchased the securities, he did not have a "view" to distribute.

As a corollary, such a resale by a holder that purchased with an investment intent will not destroy the issuer's original section 4(2) exemption. The issuer's original private placement is considered complete when the restricted securities come to rest in the hands of holders who possess an investment intent.

The most important factor in establishing investment intent is the period of time between the holder's original purchase and his resale. The longer that period of time, the easier it is to conclude that the subsequent public resale is not inconsistent with the holder's initial investment intent. The "change in circumstances" doctrine may also be relevant in this regard. That doctrine provides that a subsequent public resale can be reconciled with an initial investment intent by a change in the holder's circumstances that causes the holder to change his original investment intent.


126 See generally note 124 supra.


128 Section 4(f 1/2) Phenomenon, supra note 117, at 1972 (1979) ("[T]he existence of a relatively long holding period serves a dual function, both sustaining the seller's original investment intent and evidence that any 'distribution' by the seller is not 'for the issuer.'").

Because the holding period and the existence of changed circumstances are mere evidence that the holder possessed no intent or view to distribute at the time he purchased, it is generally believed that there can be some trade-off between the two factors. Thus, the longer the holding period, the less dramatic the required change in circumstances. On the other hand, if the holding period is short, a more significant change is required.\(^1\)

Although the application of these concepts in concrete instances may be difficult, public resales of restricted securities were, prior to the adoption of Rule 144, regularly undertaken pursuant to the foregoing analysis.\(^1\) In 1972, however, in a not too subtle piece of *in terrorem* administrative action, the Commission attempted to overrule this common law of resales and force all public resales of restricted securities into Rule 144 transactions. This was accomplished by the release adopting Rule 144, in which the Commission stated:

(1) "the 'change in circumstances' concept should no longer be considered as one of the factors in determining whether a person is an underwriter"; (2) "the fact that securities have been held for a particular period of time does not by itself establish the availability of an exemption"; (3) "the staff will not issue no-action letters relating to resales of such [restricted] securities"; and (4) persons making sales of restricted securities outside Rule 144 "will have a substantial burden of proof in establishing" the legality of the resales.\(^2\)

Notwithstanding the uncertainty created by the Commission's pronouncements, there is obvious support for the conclusion that public resales of restricted securities can be undertaken outside Rule 144 after a three year holding period. Indeed, there is authority that a two year holding period is adequate.

The Commission itself is one source of authority for the legitimacy of resales after a three year holding period, since the last word from the staff was that three years is sufficient.\(^3\)

\(^{1}\) D. Goldwasser, *supra* note 119, at 374-75.


\(^{13}\) D. Goldwasser, *supra* note 119, at 364-65.
Interestingly, both Sommer and Loss have recalled that the Commission earlier seemed willing to permit such resales after only a one year holding period. Later, the Commission apparently increased the holding period to two years and finally settled on a three year holding period, which it generally applied in its no-action letters until the adoption of Rule 144. Commentators invariably agreed that a three year holding period met the Commission's informal holding period requirements, and one writer emphatically stated that it was "firmly established through literally hundreds of letters that the staff requires a three year holding period . . ." for such resales.

Although the case law on the subject certainly is not overwhelming, it does support the adequacy of a three year holding period. In fact, the case law supports an even shorter holding period.

In United States v. Sherwood, one of the few cases dealing with this matter, and certainly the most cited on this issue, the court faced the question of whether Sherwood, who had held his restricted securities for two years, could resell those securities without filing a registration statement. Although Sherwood involved a charge of a criminal contempt and thus required the prosecution to demonstrate its case "beyond a reasonable doubt," the court's language on the particular issue of the two year holding period was clear and strong:

The passage of two years before the commencement of distribution of any of these shares is an insuperable obstacle to my finding that Sherwood took these shares with a view to distribution thereof, in the absence of any relevant evidence from

---

134 Sommer, Considerations Leading to the Adoption of Rule 144, 67 Nw. U.L. Rev. 65, 69 (Supp. 1972); 1 L. Loss, supra note 68, at 671-72.
136 D. Goldwasser, supra note 119, at § 12.02.
138 See id. at 484. In his treatise, Professor Hazen makes the following statement about Sherwood: "Since this arose in a criminal case with higher standards of proof, a longer holding period might arguably apply in a civil or SEC enforcement proceeding." T. Hazen, supra note 129, at l45.
which I could conclude he did not take the shares for investment. 140

This writer is convinced, therefore, that the case law, commentators and even the Commission's own statements support the conclusion that holders of restricted securities can, except under unusual circumstances, 141 resell after a three year holding period. 142

Notwithstanding this view, however, it seems clear that the Commission has had its way regarding public resales outside Rule 144, because the confusion and terror created by the Commission's pronouncements have effectively throttled these public resales. Although there have been some attempts by commentators to remedy this situation, 143 individuals continue to believe the Commission's 1972 Release. Attorneys, therefore, are generally willing to render favorable opinions regarding such resales only "in very limited situations," 144 and public resales outside

---

140 175 F. Supp. at 483. In another case, the Second Circuit held that ten months was an insufficient holding period for the resale of restricted securities. See Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), cert. denied, 371 U.S. 896 (1959).

141 These "unusual circumstances" should indeed be unusual and should be limited to instances where there is an attempt to circumvent the non-public requirement of the initial offering by the issuer. For example, the issuer may sell securities to a holder in a section 4(2) transaction, with the holder paying for the securities with notes. The holder, after retaining the securities for three years, might resell the securities publicly and repay the debt to the issuer with the proceeds from the public offering. Such a scheme, if the result of collusion between the issuer and the holder, and if undertaken to evade the impact of the 1933 Act, should not meet the holding period requirements.

142 One can find statements indicating that a three year holding period is not necessarily determinative. See Section 4(11/2) Phenomenon, supra note 117, at 1972 ("generally three or more years"); Sommer, supra note 134, at 69 ("SEC staff refused to say unequivocally that if a purchaser held his securities for three years he could dispose of them in a public offering without any restraints."). On the other hand, one can find statements indicating that a two year holding period may be sufficient to establish one's investment intent. T. Hazen, supra note 129, at 145 (indicating that the Sherwood case was "the basis of a two year rule of thumb for the holding period."); Schneider, supra note 136, at 1337 ("probably two to three years").

143 See T. Hazen, supra note 129, at 145-47; Volk & Schneider, supra note 124.

144 See Lipton, Fogelson & Warnken, Rule 144—A Summary Review After Two Years, 29 BUS. LAW. 1183, 1198 (1973-74), where the authors state:

In view of the strong policy statement of the SEC in Release No. 5223 . . ., it would appear that counsel may render favorable opinions as to sales outside the Rule of post-144 restricted securities only in very limited situations—those where the issuer is a major listed company, the amount can be sold readily without material effect on the market . . . and there has been a holding period substantially more than two years (probably in
Rule 144 continues to involve levels of risk that are considered unacceptably high to holders and issuers of restricted securities.

3. Resales Under Rule 144

Because of the difficulty of reselling restricted securities privately under section 4(1 1/2) or publicly under the common law of section 4(l), holders often must utilize Rule 144.145 Needlessly restrictive provisions, however, may cause the rule to be unavailable for the holders of restricted securities of small issuers.

Prior to the adoption of Rule 144, commentators often criticized the common law regarding public resales, pointing out that conditioning the right to resell restricted securities on the investment intent of the holder made no sense on any policy basis. Commentators argued that the holder's state of mind at the time he purchased the particular securities had little to do with the need for disclosures upon resale.146

To address these problems, the Commission, in 1972, promulgated Rule 144.147 As originally adopted, the Rule permitted the resale of up to one percent of the issuer's outstanding securities every six months if information about the issuer was currently available, the holder had owned the securities for two years and the sales were effected only in brokers' transactions.148 The rule was designed to allow the resale of restricted securities only where information about the issuer is available and the transaction itself is not the type that historically has been a source of abusive selling tactics.149

the area of three to five years). Substantially the same standards are applicable to pre-144 restricted securities, except that the current three-year holding period is generally considered adequate. Most lawyers will not give an opinion in either situation where the company is marginal or the amount of securities cannot be readily absorbed by the normal trading market, no matter what the holding period. See also Fogelson, Rule 144-A Summary Review, 37 Bus. Law. 1519 (1981-82); Note, Rule 144: SEC Regulation of Dispositions of Securities by Controlling Persons and Private Placements, 25 Vand. L. Rev. 845, 883 (1972).

149 Over the years, commentators have generally concluded that Rule 144 has been a success. See, e.g., Lipton, Fogelson & Warnken, supra note 144, at 1183.
Rule 144, as originally adopted, was unavailable to holders of restricted securities of small issuers. This glaring flaw, which somehow escaped the notice or concern of the Commission, was caused by the requirement that all Rule 144 sales be made in “brokers’ transactions.”\(^{150}\) Holders of securities in small issuers simply could not meet this requirement.

The “brokers’ transaction” requirement prohibits a holder’s using any “solicitation of orders to buy” his securities.\(^{151}\) The only way holders of securities in small issuers can sell their securities is by soliciting a buy order. Unlike holders of securities that are traded on NASDAQ,\(^{152}\) for example, investors in small issuers cannot execute sales on the market by merely responding to the bids of market makers. Instead, they (or someone on their behalf) must make inquiries of potential purchasers, and that action is inconsistent with the prohibition against the “solicitation of orders to buy.”\(^{153}\)

In 1981, after some firm prodding by commentators,\(^{154}\) the Commission amended Rule 144, making it more available to investors in small issuers.\(^{155}\) Pursuant to the new section (k), nonaffiliate investors holding restricted securities for at least three years are no longer required to comply with the current public information requirement, the amount limitation or, more importantly, the broker’s transaction requirement of Rule 144.\(^{156}\)

Although the addition of section (k) is certainly laudable, Rule 144 still is often and unnecessarily unavailable for holders of securities in small issuers. Additionally, the rule continues to discriminate unfairly against small issuers and their investors.

The difficulty partially stems from a restriction in Rule 144 that makes the special provisions of section (k) unavailable for sales of restricted securities by “affiliates.”\(^{157}\) “Affiliate” is

---


\(^{151}\) See id. § 230.144(g).

\(^{152}\) The National Association of Securities Dealers Automated Quotation system facilitates trading in over-the-counter securities.

\(^{153}\) See Campbell, supra note 20, at II52-53.

\(^{154}\) Id. at II50-56 & II75-76.

\(^{155}\) The amendments to Rule 144 were adopted in Securities Act Release No. 6286 (February 6, 1981) (available on Lexis, Fedsec library, Release file).


\(^{157}\) Id.
defined to include one who "controls" the particular issuer.\textsuperscript{158} As a result, control persons selling restricted securities cannot utilize the provisions of section (k) but, instead, must meet all of the requirements of Rule 144, including the brokers' transaction requirements. As previously noted, it is impossible for holders of securities in a small issuer to meet the brokers' transaction requirements. Because of this, control persons holding restricted securities in a small issuer are entirely foreclosed from using Rule 144.

To understand the impact of this exclusion on small issuers and their investors, one must appreciate the inherent ambiguity and the apparent breadth of the concept of "control." Even the proper formulation of the definition is uncertain. The Commission has defined "control" in Rule 405 as "the power to direct ... the management and policies" of the issuer.\textsuperscript{159} Commentators, on the other hand, have suggested that a better test of control is one's power or ability to cause the issuer to file a registration statement in the event such person desires to make a public distribution of his stock.\textsuperscript{160} Commentators argue that this latter standard is more consistent with the legislative history of and the purpose for requiring such shareholders to comply with the registration requirements under the 1933 Act.\textsuperscript{161}

An analysis of the case law reveals that courts typically look at three factors in determining whether a shareholder is a control person. These factors are the ownership of voting stock in the

\textsuperscript{158} Rule 144 defines "affiliate" of an issuer as "a person that directly, or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1) (1984).


issuer (ten percent is usually considered significant), significant management positions with the issuer and relationships with such owners or persons in management positions. These standards, however, are difficult to apply in concrete situations.

This author previously wrote on the definition of control under the 1933 Act. In attempting to arrive at some rough rules of thumb, he concluded:

If . . . one of . . . [the above] factors is present, there is a substantial risk that a selling shareholder will be declared a control person. The presence of two or more factors usually results in a determination that a particular individual is a control person. . . .

While numerous cases support these conclusions, a rational analysis of whether a selling shareholder is a control person cannot be limited to a quantification of the control factors present. The intensity of any one factor is an important additional consideration. For example, if a shareholder's only basis for control is voting securities, the probability of his being a control person increases as his percentage of ownership increases. Thus, if he owns thirty-five percent, he is more likely to be declared a control person than if he owns only ten percent.

Because it is impossible to pinpoint what quantity and intensity of factors will cause a court or the Commission to treat a selling shareholder as a control person, a quantification-intensity analysis leaves the status of many shareholders uncertain. To alleviate this uncertainty, it is urged that the control analysis utilize one final touchstone—the ability to obtain registration.

While the foregoing discussion indicates the inherent ambiguity in the definition of control, it also suggests the breadth of the concept, especially as it relates to small issuers. Because shareholders of small issuers often have a management position

---

162 Id. at 41-44; Enstam & Kamen, Control and the Institutional Investor, 23 Bus. Law. 289, 315 (1967-68). One commentator, however, has suggested that five percent may be the critical figure. S.E.C. PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITING 19 (1962).

163 See Campbell, supra note 161, at 44-46.

164 Id. at 46-49.

165 Id. at 49-52 (footnotes omitted).
with the company, a relatively higher percentage of stock ownership and personal, family and business relationships with other shareholders and managers, they are more likely to be considered control persons.

Consider the following hypothetical. Assume X corporation has assets of $2 million, equity of $500,000, and thirty-five shareholders. Out of those thirty-five shareholders, a certain number may own ten percent or more of X's voting stock. Ten of the shareholders, perhaps, may be involved in the management of X, either as officers or directors. Another ten or fifteen shareholders may be members of the same family (or families). Others may have close business and personal relationships with other shareholders. The point is that in small corporations it often may be hard to find a shareholder that clearly falls outside the definition of control person.

It is difficult to understand why the Commission chose to prohibit control persons from using section (k). There seems to be no policy reason for the exclusion.6 Further, this prohibition has an unfortunate effect on small issuers and their investors, since it often eliminates the availability of Rule 144 for resales by holders of stock in small issuers. To make matters worse, control persons who hold restricted securities in a small issuer literally may have no other way to sell their stock. Public resales under section 4(l) may be unavailable.167 As described earlier, the costs and difficulty of making the required disclosures may practically foreclose resales under section 4(l 1/2). Similarly, the costs involved in registration of the restricted securities held by

---

6 One reason for excluding control persons from Rule 144(k) may be because the section also removes the rule's amount limitation. Thus, a control person, who presumably owns a large block of the issuer, might be able to make large distributions without disclosures. That concern, however, could be met by imposing an amount limitation on control person's selling under section (k).

167 Restricted securities held by control persons are actually doubly "restricted." First, such securities are restricted in the sense described in this Article, because they have been purchased in a private placement, and resales must avoid the destruction of that private placement exemption. In addition, however, sales by control persons are limited pursuant to section 2(ll) of the 1933 Act. 15 U.S.C. § 77b(ll) (1982). That provision defines a control person as an "issuer" if the control person utilizes the services of an "underwriter" in connection with a "distribution" of his securities. Thus, even though a public resale under section 4(l) may be consistent with the initial private placement, the reselling shareholder may not utilize the services of an underwriter in connection with such a distribution of his stock, unless the transaction is otherwise exempt or registered.
a control person in a small issuer make that alternative entirely impractical as well.

The Commission should, therefore, amend Rule 144 to make the special provisions of section (k) available for resales of restricted securities by control persons. Without such an amendment, Rule 144 is not an effective resale mechanism for the securities of small issuers.

Even with this amendment, however, Rule 144 would still discriminate against small issuers and their investors. The reason is that holders of securities in small issuers could sell only under section (k), which has a three year holding period, while holders of securities of larger issuers could typically sell outside section (k) after a two year holding period.

The Commission should not allow this discrimination to continue. Instead, a new rule should be adopted that allows holders$^{168}$ of securities of small issuers to resell a limited amount of restricted securities after a two year holding period. Although such a new rule may appropriately contain provisions to protect the purchasers of these restricted securities, such provisions must be realistic and fair to small issuers and their investors.

At a minimum, the new rule should allow such holders, after a two year holding period, to sell up to $50,000 in restricted securities every six months. To protect the purchasers of such restricted securities, it might be sensible to limit resales to face-to-face, negotiated transactions$^{169}$ and to prohibit commissions or brokers' fees in connection with the resales. These restrictions would be an analogue to the brokers' transaction requirements of Rule 144, since the provisions might help contain heroic selling tactics by paid agents. Such requirements would also ensure that the purchaser has direct access to the selling holder, who, in turn, may have access to information about the issuer.

An additional requirement could be imposed if the issuer were a reporting company under the 1934 Act. In such a case, the selling holder could be required to provide the purchaser with current information about the issuer. Specifically, the holder

$^{168}$ The new rule should be available to control persons holding restricted securities.

$^{169}$ This requirement should not prohibit general advertising by the holder. Instead, the rule should require only that the selling holder provide the purchaser with an opportunity to discuss the transaction with the holder, obtain information about the issuer from the holder and ask questions of the holder.
should furnish the purchaser with a copy of the issuer’s latest annual report required to be delivered to shareholders pursuant to Rule 14a-3 of the 1934 Act\(^\text{170}\) and a copy of the issuer’s latest Form 10-Q.\(^\text{171}\) This requirement would ensure access to information without imposing overly onerous restrictions on the selling holder or the issuer.

Finally, there probably is no need to make such a new rule available to investors in larger issuers. Thus, issuers that are traded on NASDAQ or on a national exchange should be ineligible for the rule and should, instead, be relegated to Rule 144.

4. An Overview of the Proposed Changes

The changes proposed in this Article would provide holders with a fair and sensible array of alternatives for the resale of restricted securities of small issuers. For the first two years after purchasing restricted securities of small issuers, holders could rely upon the section 4(l 1/2) exemption as a basis for resales. After two years have elapsed, holders of restricted securities of small issuers could rely on the new rule, proposed above, as a basis for limited resales. Coincidentally, holders of restricted securities in larger issuers could also sell a limited amount of securities under Rule 144 after the two year holding period. Finally, after a three year holding period, holders of restricted securities in both small and large corporations could use the provisions of Rule 144(k) and resell without any amount limitations.

These changes would help end the discrimination against small issuers and persons investing in them. This would be accomplished without any significant sacrifice of investor protection. The proposed changes represent, it is suggested, a sensible balance between the need to protect purchasers and the need to treat small issuers and their investors fairly.

D. The Integration Doctrine

The perniciousness of the integration doctrine affects both large and small issuers. This writer is convinced, however, that


\(^{171}\) For an example of the use of these documents as the basis for disclosure in the sale of securities, see item 12, Form S-4, FED. SEC. L. REP. (CCH) ¶ 7163, at 6267-68 (May 1, 1985).
the tangles and snares of the doctrine generally are less troublesome to larger issuers. Such companies are more likely to have an array of financing alternatives, including banks and institutional and public investors, each of which may be willing to take debt, preferred stock, or common stock. The loss of one financing alternative through the impact of integration may not, therefore, be as significant for such an issuer. Small issuers, on the other hand, may not have this financing flexibility, so the loss of a single financing alternative through the impact of integration might be significantly more harmful.

The purpose of this section, however, is not to argue the relative harms to large and small issuers caused by the integration concept. Instead, the thesis promulgated here is that the integration concept should be eradicated. The concept makes no sense. It has no defensible policy basis, limits the availability of legitimate exemptions from registration and, as a result, unnecessarily restricts the availability of capital for small (and large) issuers.

The integration doctrine seems to rest on the notion that it is somehow improper for a single "issue" of securities to be offered and sold under two separate exemptions from registration or under an exemption and a registration statement. As a result, a corporation cannot, for example, sell one-half of an issue under section 4(2) as a private transaction and one-half of the issue as an intrastate offering pursuant to section 3(a)(11). The offering would not qualify as a section 4(2) transaction, since part of the issue (the part sold pursuant to section 3(a)(11)) presumably does not meet the requirements of section 4(2), and part of the issue (the part sold under section 4(2)) presumably does not meet the requirements of Section 3(a)(11).

The pivotal issue in integration questions, therefore, is whether the two (or more) offerings are to be considered part of a single issue (i.e., integrated) or are to be considered separate. To address this question, the Commission developed criteria that it applies to the facts of particular situations. These criteria, which originated

---

with the *Unity Gold*¹⁷³ case in 1938, are also often utilized by courts considering integration questions.¹⁷⁴ Specifically, the Commission considers the following factors:

(1) are the offerings part of a single plan of financing;

(2) do the offerings involve issuance of the same class of security;

(3) are the offerings made at or about the same time;

(4) is the same type of consideration to be received; and

(5) are the offerings made for the same general purpose?¹⁷⁵

Everyone seems to agree that these criteria are nearly impossible to apply,¹⁷⁶ principally because neither the Commission nor the courts have ever adequately articulated how these factors are to be weighed or how many factors must be present in order for integration to occur. As a result, the area remains confusing and dangerous.

The Commission especially has been criticized in this regard, as commentators have uncovered what appear to be glaring inconsistencies in no-action letters from the staff.¹⁷⁷ Perhaps the clearest indication of the confusion is that a few years ago the Commission ceased issuing no-action letters on integration questions, stating, "[B]ecause of the complexity of the proposed arrangements and the possibility that staff positions in the integration concept may be misconstrued and misapplied in other situations, we will not be issuing interpretations in this area any longer."¹⁷⁸

¹⁷³ *In re Unity Gold Corp.*, 3 S.E.C. 618 (1938).


¹⁷⁶ See, e.g., *Partnership Integration*, *supra* note 172, at 1592; Deaktor, *supra* note 172, at 474.

¹⁷⁷ See, e.g., *Partnership Integration*, *supra* note 172, at 1592.

In an effort to combat these difficulties, the Commission adopted a basic safe harbor provision, which is included as a part of Regulation D.\textsuperscript{177} Rule 502(a) provides:

Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D.\ldots\textsuperscript{180}

Even with these safe harbor provisions, the integration concept in Regulation D continues to be fraught with confusion and needless complexity. In addition, the irrationality of the doctrine itself often leads to results that are inconsistent and entirely indefensible. This can best be demonstrated by an example.

Assume that on January 1, 1984, X Corporation offered and sold stock pursuant to Rule 505. On April 1, 1984, X Corporation sold more stock pursuant to the intrastate exemption under section 3(a)(ll). On December 1, 1984, X Corporation sold additional stock pursuant to Rule 506.

In this example it appears that the safe harbor provisions of Regulation D are not available to protect the January offering from integration with the April offering, since the April sale was within six months of the January sale.\textsuperscript{181} Similarly, it is clear that safe harbor is not available for the April offering, since the safe harbor provisions of Regulation D protect only the Regulation D part of the transaction, i.e., the January transaction.\textsuperscript{182}

So, the safe harbor provisions are often unavailable to answer integration questions related to Regulation D offerings. Instead, one is with some frequency forced back into the common law analysis, with all the confusion and complexities previously discussed.

\textsuperscript{177} Essentially, the same pattern of safe harbor is present in Rule 147. 17 C.F.R. § 230.147(b)(2) (1984).

\textsuperscript{178} Id. § 230.502(a).

\textsuperscript{180} J. Hicks, 1983 LIMITED OFFERING EXEMPTIONS: REGULATION D 130 (1983). Surprisingly, the language of Rule 502(c) does not answer this question directly.

Continuing the analysis of this hypothetical, one must determine if the December offering is integrated into the January offering, thereby possibly eliminating the availability of Rule 505 for the January offering. The protection of the safe harbor provisions in that instance depends on what can only be considered a strange criterion. It depends on whether the April I offering was the "same or similar class" of securities as the January offering. One should pause to consider why the contractual terms of the securities sold in the April offering should have anything to do with whether the December offering contaminates the January offering. Obviously, one cannot answer the question, since the result is illogical.

In considering whether the January or April offering may be integrated into the December offering, thereby possibly eliminating the availability of Rule 506 for the December offering, one is confronted with a mystic result. The December offering is apparently protected from both the April and the January offerings by the safe harbor provisions of Regulation D. This is true even though the safe harbor provisions protect neither the January nor April offerings from the December offering, unless, of course, the April offering were of a different class of securities than the January offering, in which case the January offering would be protected from the December offering by the safe harbor.

If all of this seems confusing, it is. The confusion, at least in part, is generated by the Commission's attempt to codify a

---

183 If the Rule 505 offering and the Rule 505 offering were integrated, "the issuer would have to evaluate all characteristics of the combined transactions (e.g., number of investors, aggregate offering price, etc.) when determining the availability of an exemption." Securities Act Release No. 6389 (March 8, 1982), [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106, at 84,918 n.31.

184 It is interesting that a sale of a dissimilar class of securities in the April offering ensures that safe harbor will be available to protect the January offering from the December offering, but the dissimilar class does not ensure that the January offering is protected from the April offering by safe harbor. Rather, as stated in the text, the determination of integration of the January and April offerings depends on traditional integration concepts. J. Hicks, supra note 181, at 131.

185 Under the terms of the hypothetical, there were no sales during the six month period prior to the Rule 506 offering (i.e., prior to the December offering). Thus, because the "window period" for the December offering was "clean," the December offering is protected by safe harbor from the April and January offerings. This assumes no sales in the window period following the December offering. See 17 C.F.R. § 230.502(a) (1984).
concept that makes no sense. Not surprisingly, complexity and arbitrariness result and now, as the foregoing example demonstrates, permeate the safe harbor provisions of Regulation D.

The solution to these problems is not to send the staff of the Commission scurrying about to adjust the safe harbor criteria. Instead, the proper solution is to eradicate the concept of integration. To accomplish this, however, the Commission and the courts must fully comprehend the irrationality of the integration doctrine.

It is simple to demonstrate that, at the most fundamental level, integration makes no sense. Indeed, it is so easy that this writer is somewhat at a loss to understand why the concept first developed\(^6\) and is unable to understand how the concept has escaped intense criticism over the years.

Consider, for example, the common law criteria that are applied to solve integration questions. These criteria in no way relate to investor protection. Instead, they are arbitrary criteria developed by the Commission to answer the irrelevant question of whether two (or more) offerings constitute a single issue. The nonsense of these criteria and, indeed, the nonsense of the concept of integration itself, can be vividly demonstrated by the following hypothetical.

Assume that on January 1, 1985, X Corporation offered and sold $100,000 in common stock pursuant to section 4(2). X Corporation proposes to sell another $100,000 in common stock on March 1, 1985, but this second offering will be undertaken as an intrastate offering under section 3(a)(ll). Each offering clearly meets the requirements of the respective exemptions, except to the extent that the exemptions may be fouled by the integration concept.

Applying the integration concept to the foregoing situation, the availability of section 4(2) for the January offering depends either on effectively separating that offering from the proposed March offering or on foregoing the March offering, at least for now. There is no logical reason why the issuer should be forced into either solution. Both solutions penalize the issuer and neither affords any additional protection to investors.

\(^6\) For a discussion of the origin and development of the integration doctrine, see Partnership Integration, supra note 172, at 1593-1607; Deaktor, supra note 172, at 492-525.
Suppose, for example, that the issuer attempts to avoid the integration by separating the offerings. The issuer would probably make the March offering a different class of securities, perhaps debt or preferred stocks, which, by assumption, are not the investment contracts the issuer wants to sell to the March investors. Also, in order to bolster the claim that the offerings were not made at or about the same time, the issuer would try to delay the March offering as long as possible. Again, by assumption, this is not what the issuer wants to do. It, instead, wants its financing in March.

Neither of the foregoing adjustments adds one whit to the protection of the January investors. Clearly, the January investors are not protected either by offering a separate class of securities in March, delaying the March offering or foregoing the March offering altogether. In fact, the January investors are actually harmed by each solution, since each alternative puts X Corporation in a less-than optimum situation and thus increases the risk that X Corporation cannot survive.

Similarly, the March investors, who will purchase under a valid, intrastate exemption, are not afforded additional protection by any of the foregoing solutions. Neither changing the terms of the contract under which they are sold nor delaying the offering date increases the protection of these investors.

This leads to the conclusion that the factors used to determine the separateness of offerings are entirely arbitrary. The presence or absence of those factors have no bearing on any investors’ need for the protection of the 1933 Act. Perhaps one could accept the arbitrariness of these criteria if the concept of integration were itself sensible. Unfortunately, it is not.

Consider again the immediately preceding hypothetical. The assumption of the hypothetical is that the January offering met all of the requirements for a private placement under section 4(2). This means that each investor had access to the same information contained in a registration statement and had the ability to evaluate the merits and risks of the investment.169

---

167 See text accompanying note 175 supra.
168 Id.
169 Today there is probably a general agreement that an exemption pursuant to section 4(2) requires that offerees and purchasers be sophisticated and have access to information about the issue. See Campbell, An Open Attack on the Nonsense of Blue Sky Regulation, 10 J. Corp. Law 553, 560-61 (1985).
Obviously, a subsequent intrastate offering under section 3(a)(ll)
has no impact on the presence of these bases for the section 4(2)
exemption. The January investors are protected by their sophis-
tication and access to information, the prerequisites for a section
4(2) offering, irrespective of whether or when the intrastate
offering occurs.

With regard to the March offering, the assumption is that it
meets the requirements of the intrastate exemption under section
3(a)(ll). In such a case, Congress was apparently willing to rely
on the geographic proximity between the issuer and the investor
to provide the necessary access to information about the issuer.\textsuperscript{190}
Again, the existence of prior offerings obviously has no impact
on whether such proximity exists.

This demonstrates the simple notion that any offer or sale
of securities that meets either the registration requirements or
the exemption requirements should not be contaminated by other
offers or sales. So long as any transaction meets the requirements
of the 1933 Act, investors are adequately protected either by
registration and delivery of a prospectus or by circumstances
and policy bases that Congress has deemed adequate to dispense
with the registration and prospectus requirements.

This line of reasoning is entirely applicable to Regulation D.
Essentially, therefore, if an issuer sells $500,000 in securities
pursuant to Rule 504 on March 1, he should be able to sell
another $2 million in securities on April 1 pursuant to Rule 505
(or any other exemption) without concern that the prior offering
will be integrated into his April offering. Each exemption has
(or should have) sound policy bases, which are unaffected by
subsequent or prior sales.

Admittedly the elimination of the integration concept would
necessitate certain technical adjustments in Regulation D, since
the Commission would have to address matters that presently

\textsuperscript{190} The philosophical bases for section 3(a)(ll) are less than crystal clear. See Hicks,
information due to the geographical proximity between the issuer and the investor,
however, is certainly one of the commonly cited bases for section 3(a)(ll). \textit{Id. See also}
\textit{Rep.} (CCH) \textsuperscript{\textregistered} 79,617, at 83,650 ("[T]he primary purpose of the intrastate exemption
was to allow an essentially local business to raise money within the state where the
investors would be likely to be familiar with the business and with the management
\ldots.").
are resolved by integration. For example, referring back to the hypothetical in the immediately preceding paragraph, the Commission would have to determine if the purchasers under the Rule 504 offering would be counted in determining the thirty-five purchaser limit of Rule 505. At the present time the thirty-five purchaser limitation is with respect to "any offering." The resolution of this and other technical questions involves no unusual difficulty and certainly should not deter the Commission from ridding itself of the irrational integration concept.

IV. CONCLUSION

Small issuers must have room to operate in our society. They are a vital force in our economy and are entitled to fair treatment. This does not require, however, that the Commission abandon its duty to protect investors. It means only that the Commission, in drafting its rules and enforcing and interpreting the relevant laws and regulations, should give due consideration to the general and special needs of small issuers.

Regulation D is a step in that direction. It represents a real attempt by the Commission to balance the need for disclosure against the stifling effect of overregulation, a critical balance that is essential to any sensible implementation of the 1933 Act.

Now, however, the Commission needs to turn its attention to some of the particular requirements of Regulation D and should excise some of the tired, old concepts that unnecessarily throttle capital formation. In that regard, this writer has made four suggestions.

First, the prohibition against general advertising should be removed, to the extent it is possible under existing precedent. Small issuers need the right to engage in general advertising to find potential investors. Investors are not harmed by general advertising, at least so long as the applicable criteria for the exemptions, for example, disclosure and sophistication, are met prior to each purchase.

Second, the requirement to deliver S-18 information to investors should be applicable only when offerings exceed $1 million. The expense and difficulty of complying with the S-18 disclosure

requirements make it unattractive or impossible to do a Regulation D deal in the range of $500,000 to $1 million. The Commission, therefore, should rely on the antifraud rules to ensure disclosure for transactions up to $1 million.

Third, Rule 144, the principal vehicle for resale of securities purchased under Regulation D, should be modified to make section (k) available for resales by control persons. Additionally, the Commission should adopt a new rule that allows investors in small issuers to sell restricted securities after a two year holding period. These changes would extend to investors in small issuers the resale opportunities that are available to investors in larger issuers.

Finally, the integration concept should be eliminated. Each offer and sale of securities should be evaluated to determine whether that particular offer or sale meets either the registration requirements or the requirements for an exemption from registration. If it does, other transactions in the security are irrelevant. Those other transactions in no way compromise the policy bases for the legal sales.