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Regulation A: Small Businesses’ Search for “A Moderate Capital”

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REGULATION A: SMALL BUSINESSES' SEARCH FOR "A MODERATE CAPITAL"

BY RUTHEFORD B CAMPBELL, JR.*

ABSTRACT

Small businesses are an important part of our national economy, accounting for as much as 40% of our total economic activity and providing society with important services and products.

Small businesses face daunting economic, structural, and legal impediments when they attempt to acquire external capital. The absence of financial intermediation services means that they are almost always on their own to find investors. Their small capital needs mean that their relative offering costs are often sky high. Federal and state securities rules significantly exacerbate these economic and structural disadvantages by imposing onerous and unwarranted conditions on their search for external capital.

While, initially, one may view these rules as a matter of unfairness to small entrepreneurs, more broadly, and perhaps more importantly, society is a loser when small businesses are denied the right to compete fairly for capital.

Regulation A appears on its face to offer small businesses a way out of this dilemma. It provides an exemption from the registration requirements of the Securities Act of 1933 for small issuers who offer their securities publicly. The exemption is conditioned upon the issuer's disclosure to investors of prescribed investment information.

Regulation A, however, is almost never used by small entrepreneurs, even though it is the only federal exemption generally available that allows a broad, efficient search for investors.

The SEC and state securities regulators are to blame for the impotency of Regulation A. For their part, the SEC seems never to have understood small businesses, their capital needs, their importance to our economy, and the special circumstances they face when they attempt to access external capital. States, on their side, seem always to resist attempts to formulate exemptions that allow small issuers to search widely

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"He was not of a mercenary spirit, but he had an immense desire for success, and he had more than once reflected that a moderate capital was an aid to achievement." HENRY JAMES, THE BOSTONIANS 15 (Vintage Books 1985) (original publication date 1886).

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and efficiently for capital.

The irony is that the Commission's current iteration of Regulation A provides a framework upon which to construct a sensible and appropriate exemption for public offerings by small issuers. The Commission has the power to transform Regulation A from its present fallow state into a usable tool that promotes efficient capital formation by small businesses and appropriately protects investors.

In this article the author offers data demonstrating the non-use of Regulation A and makes the case for a revision of Regulation A. His data show the importance of small businesses to the national economy, small businesses' need for external capital and the underuse of Regulation A. He explains the economic, structural and legal impediments that small businesses face in their capital formation and the reasons why Regulation A is so underutilized today. The author concludes by expressing faith in the fundamental theory of Regulation A and explaining steps the Commission could take to make Regulation A an effective tool for small business capital formation, benefitting both small entrepreneurs and society.

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I. INTRODUCTION

America's small business owners and potential entrepreneurs often have the ideas, the energy, and the willingness to work hard, but face an almost insurmountable challenge in finding the capital they need. . . . Financing can be especially costly or more difficult for small firms to find.  

Regulation A\(^2\) provides an exemption from the registration requirements of the Securities Act of 1933\(^3\) for small issuers who offer their

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\(^2\)Regulation A, 17 C.F.R §§ 230.251-230.263 (2005), was enacted by the Securities and Exchange Commission under the authority of Section 3(b) of the Securities Act of 1933, 15 U.S.C.A. § 77c(b) (West 2005).

securities publicly. The exemption is conditioned upon the issuer's disclosure to investors of investment information prescribed by Securities and Exchange Commission (SEC or the Commission) rules.\(^4\) Regulation A permits the issuer to solicit widely for investors, imposes no offeree-purchaser qualification or suitability requirements, and permits unlimited resales by persons acquiring shares in a Regulation A offering.

This brief description might suggest that the exemption provided by Regulation A is not only philosophically sound\(^5\) but also popular with small companies searching for capital. One might anticipate that the Commission, in crafting the disclosures that are a predicate for the availability of the Regulation A exemption, carefully and expertly strikes a balance between reasonable protection of investors and capital formation.\(^6\) Further, one might expect the Commission constantly to monitor the workings of the exemption, adjusting the disclosure and other requirements of the exemption to ensure a full and appropriate use of the exemption by small issuers. From the issuers' point of view, one might expect small entrepreneurs to flock to an exemption that has as its only significant condition of availability the disclosure of closely crafted, reasonable amounts of clearly described investment information, especially considering the fact that in most cases Regulation A is the only exemption from registration that permits small businesses to engage in efficient, broad searches for capital.\(^7\)

Regulation A, however, has fallen into nearly total disuse.\(^8\) Contrary to the picture just suggested, the empirical data in Part II of this article demonstrate that the exemption has never reached its potential and, indeed, reveal that today small businesses almost never rely on Regulation A for capital formation.

The SEC and state securities regulators are to blame for the utter failure of Regulation A. For its part, the SEC seems never to have understood small businesses, their capital needs, their importance to our economy, and the special circumstances they face when they attempt to

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\(^4\)See infra Part IV.B.4.


\(^6\)See 15 U.S.C.A. § 77b(b) (West 2005) (obligating the Commission in its rulemaking to "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation").

\(^7\)Except for the intrastate exemption, 15 U.S.C.A. § 77c(a)(11) (West 2005), and Rule 147, 17 C.F.R. § 230.147 (2005), Regulation A is the only broadly available exemption the permits a public solicitation of investors. See infra note 112 and accompanying text. The exemptions provided by § 77c(a)(11) and Rule 147, however, are available only if the issuer and all offerees and purchasers are in the same state. See id.

\(^8\)See infra Part II.
access external capital; as a corollary, the SEC has never seemed interested or able to craft Regulation A into a functional exemption for small businesses. State regulators, on their side, have a long history of actions that are deleterious to the legitimate capital formation needs of small issuers. State regulators generally have resisted attempts to formulate exemptions that allow small issuers to make unregistered public offerings and have fought to protect their turf from any federally initiated intrusion.

The failure by regulators to provide a workable Regulation A exemption may be considered in terms of its unfairness to small entrepreneurs, who are unable to access external capital in a cost effective way. More broadly, and perhaps more importantly, society and the economy suffer when small businesses are denied a way to compete fairly for external capital.

Society needs small businesses. They are vital to our national economy, both qualitatively and quantitatively. They account for as much as 40% of our total economic activity and provide consumers with many of the services and products that are essential in our day-to-day lives.

Small businesses, however, cannot compete effectively in their product markets without access to competitively priced, external capital. Even without the added burden of regulatory oppression, small businesses face daunting economic and structural conditions when they enter the capital markets. External capital for them is hard to find and expensive to acquire. The absence of financial intermediation services for small businesses means that they are almost always on their own to find investors; their small capital needs mean that their relative offering costs are often sky high.

By practically denying small companies access to a workable Regulation A, the SEC and state regulators have exacerbated the structural and economic disadvantages that small businesses encounter in their search for external capital. Society and the national economy are the losers in all this.

The irony here is that the Commission's current iteration of Regulation A provides a sound framework upon which to construct a

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10See Rutheford B Campbell, Jr., The Impact of NSMIA on Small Issuers, 53 BUS. LAW. 575, 582-85 (1998) (offering a public choice analysis for the actions of state securities administrators and others in connection with the enactment of the National Securities Markets Improvement Act of 1996).

11See infra Part III.A.
sensible and appropriate exemption for public offerings by small issuers. With attention from the Commission, Regulation A can be transformed from its present, fallow state into a useable tool that promotes efficient capital formation by small businesses.

The purpose of this article is to present the case for a revision of Regulation A and to suggest steps the SEC should take in order to transform Regulation A into a workable, sound and balanced exemption available for small businesses as they search for external capital.

Part II of this article offers data that show that Regulation A is essentially unused in recent times. Part III presents data demonstrating the importance of small businesses to our economy and describes the impediments—both structural and regulatory—small businesses encounter when they enter the capital market. Part IV focuses on today's iteration of Regulation A and the state securities laws applicable to Regulation A offerings. The discussion demonstrates that together Regulation A and state securities laws amount to an unwarranted regulatory burden, which contributes significantly to the underuse of Regulation A. Finally, in Part V, the article proposes that Regulation A be refocused on offerings by truly small businesses and proposes revisions to Regulation A and state blue sky laws necessary to transform Regulation A into an efficient regime for small business capital formation.

II. THE NON-USE OF REGULATION A

Data show that small businesses almost never utilize Regulation A as a way to raise external capital. The last year the SEC collected and reported data on Regulation A filings, which was calendar year 1988, only seventy Regulation A offerings were filed with the Commission. Taking


13 48 SEC MONTHLY STAT. REV. 15 (Feb. 1989). An Explanatory Note states: Generally excluded from the series are: debt securities with maturities of less than one year; secondary offerings; non-cash offerings; issues exempt under Section 2(1) of the Securities Act of 1933; domestic government securities; offerings of non-profit and/or charitable groups; securities offered only on an intrastate basis; employee stock plans; open-end investment company issues; intracorporate securities transactions and sales to foreign purchasers. Issues registered for offering and later withdrawn are excluded from these offerings data.
a longer view, from 1981 through 1988 inclusive, the Commission reported an average of 140 Regulation A fillings annually.\textsuperscript{14}

Since 1988, data and reports show that Regulation A as continued to be rarely used by small issuers. For example, a footnote to a Securities Act Release suggests that the Commission received a total of only 177 Regulation A filings during the three year period from 1989-1992.\textsuperscript{15}

More current information about Regulation A filings is available on the Commission's EDGAR system and provides evidence of an even further decline in the use of Regulation A. A search of the EDGAR system reveals that during the ten year period from 1995 through 2004, a total of only seventy-eight Form 1-A's were filed with the Commission.\textsuperscript{16} This amounts, on average, to only about eight Regulation A filings per year.\textsuperscript{17}

These data dramatically demonstrate that Regulation A is essentially unused by small businesses. The data become even more powerful when interpreted in light of the discussion in Part III of this article, which suggests that hundreds of thousands of small businesses were in search of external capital during these years.

III. THE CASE FOR A REVISED REGULATION A

Many feel that Regulation A has outlived its usefulness, that the Commission's most prudent course of action is simply to preside over its orderly demise. I do not


\textsuperscript{15}Small Business Initiatives, Securities Act Release No. 33-6949, 57 Fed. Reg. 36,442 (Aug. 13, 1992) ("In the past three years, only 6 of the 177 Regulation A filings made with the Commission were pursuant to the terms of Rule 257.").


\textsuperscript{17}One way to evaluate these data is by reference to the number of registered offerings the Commission processed during the same period. During 1988, for example, the Commission reported that issuers filed 3,860 registration statements. 48 SEC MONTHLY STAT. REV. 15 (Feb. 1989). Over the eight year period from 1981 through 1988, the Commission reported an annual average of 3,334 registered offerings. See 44 SEC MONTHLY STAT. REV. 14 (Feb. 1985); 44 SEC MONTHLY STAT. REV. 13 (Mar. 1985); 48 SEC MONTHLY STAT. REV. 15 (Feb. 1989).
agree. . . . I shall not easily preside over its burial.18

The compelling case for a revised Regulation A is based on three simple and apparent facts. First, small businesses are very important to our national economy. Second, in order to compete and generate efficiencies, small businesses need (and deserve) a fair shot at acquiring external capital under conditions that are competitive. Finally, under today's combined state and federal securities regimes, small businesses are unable to conduct efficient searches for external capital.

A. The Importance of Small Businesses

Small businesses are an important part of our national economy. However one looks at the matter—whether in terms of the number or percentage of business units, the types of goods and services provided, employment or innovation—small businesses are significant in our everyday lives and vital to the economy of our nation.

Perhaps better than any other source, data compiled by the Small Business Administration (SBA data)19 show the economic importance of small businesses.20 These data show, for example, that there are about five million businesses in the United States that employ fewer than twenty


19See, e.g., U.S. SMALL BUSINESS ADMINISTRATION, THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 2000 (2001) [hereinafter THE STATE OF SMALL BUSINESS 2000]. In a previous article, the author used SBA data from U.S. SMALL BUSINESS ADMINISTRATION, THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1994 (1995) [hereinafter THE STATE OF SMALL BUSINESS 1994]. Campbell, supra note 10, at 575-77. Similar data from the 1994 Report and the 2000 Report do not differ materially, although they show, for example, a slight increase in the number of small businesses with twenty or less employees and a slight decrease in the percentage of total employment by such firms. Data from later SBA Reports are also generally consistent with these prior data and are utilized in this article. See, e.g., infra note 21 (utilizing data from 2004 THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT (2004) [hereinafter THE SMALL BUSINESS ECONOMY].

20Data demonstrating the significance of small business to our economy can also be found in U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 1999 (119th ed 1999). Particularly relevant to this article and supportive of the SBA data are the data found at id. tbl. 861, at 545 (84.6% of all business tax returns filed for 1980 were filed by entities with less than $1 million in receipts; 7.4% of all business receipts during that year were generated by entities with less than $1 million in receipts), and at id. tbl. 874, at 555 (in 1980, 22.3% of total national payroll came from firms with less than twenty employees, and 47.5% of total national payroll that year came from firms with less than 100 employees).
employees.\textsuperscript{21} Firms in this smallest of size categories—less than twenty employees—account, therefore, for almost 90\% of the total business units in the United States.\textsuperscript{22} Continuing to focus on absolute numbers of small businesses, the SBA data report about five and one-half million business firms have less than 100 employees. Thus, this somewhat larger version of a small firm accounts for slightly over 98\% of the total businesses units in the United States.\textsuperscript{23}

Another, perhaps even more revealing, measure of the importance of small businesses is employment. Here one finds that the smallest firms, those with less than twenty employees, provide nearly 18\% of all the jobs in the United States,\textsuperscript{24} while firms with less than 100 workers provide approximately 36\% of all jobs.\textsuperscript{25} In absolute numbers, firms employing less than twenty employees provide work for slightly more than twenty million people,\textsuperscript{26} and all firms employing less than 100 workers provide employment for nearly forty-one million people.\textsuperscript{27}

Small businesses also provide dynamic energy for our economy that is not properly impounded in the foregoing data.\textsuperscript{28} Small entrepreneurs


\textsuperscript{22}See \textit{The Small Business Economy}, supra note 19, at 178 tbl. A-5 (in 2001, 89.0\% of all firms in America had less than twenty employees); see also \textit{The State of Small Business 2000}, supra note 19, at 61 tbl. A.4.

\textsuperscript{23}See \textit{The Small Business Economy}, supra note 19, at 178 tbl. A-5 (in 2001, 5,555,103 firms, which is 98.2\% of all firms in America, employed less than 100 persons); see also \textit{The State of Small Business 2000}, supra note 19, at 61 tbl. A.4.


\textsuperscript{28}SBA data show, for example, that during 1996-1997, 95.5\% of all firm births involved firms with less than twenty employees, and 99.9\% of all firm failures were of firms with less than twenty employees \textit{Id.} at 84 tbl. A.9 (during 1996-1997, 564,197 of the total of 590,644 firm births involved firms with less than twenty employees, while 500,014 of the 500,536 firm
appear to generate a disproportionately large amount of job creation, opportunities for historically disadvantaged groups and innovation. In short, they provide much of the entrepreneurial spirit that drives our market economy.

In the area of job creation, small businesses are vital. Various statements regarding the percentage of jobs created by small businesses put the percentage as high as 75%. SBA data, for example, show that in a recent two year period, 50.2% of all new jobs were created by firms of less than twenty employees.29

SBA data also show the increases in women-owned and minority-owned firms.30 Not surprising, the SBA states that "[s]mall business continued to be an important means by which women, minorities, and immigrants entered the American economic mainstream and managed to increase their share in the economy."31

Finally, although hard data regarding innovation are difficult to find, both estimates and opinions suggest the importance of small businesses to innovation. By one estimate, for example, small firms generate 55% of all manufacturing product innovations and more than twice the innovations per employee as large firms.32 In his report to Congress on small business, President Bill Clinton referred to the "key role" of new and small firms "in the experimentation and innovation that leads to technological change and economic growth. They are continual sources of new ideas . . . and their experimental efforts are an essential part of the organic and ever-changing American economy."33

B. The Importance of External Capital for Small Businesses

Data confirm that small businesses need external capital and that their need for external capital increases as they grow in size. Data show that slightly over 85% of firms with ten to nineteen employees utilize some form of credit as a source of financing.34 That number increases to slightly


30Id. at 102 tbl. A.14.
31Id. at 17.
32THE STATE OF SMALL BUSINESS 1994, supra note 19, at 15.
33THE STATE OF SMALL BUSINESS 1998, supra note 1, at 3.
34THE STATE OF SMALL BUSINESS 1994, supra note 19, at 167 tbl. 5.15.
over 90% for firms employing between twenty and ninety-nine persons.\textsuperscript{35} Refocusing on traditional loans only, data suggest that about 75% of firms employing ten to nineteen persons and around 80% of all firms employing between twenty and ninety-nine persons rely on traditional loans as a form of financing.\textsuperscript{36}

Financial institutions are a major source of debt capital utilized by small businesses. SBA data show that about 55% of firms with ten to nineteen employees finance through loans from financial depository institutions. The number goes to around 70% for firms with twenty to ninety-nine employees.\textsuperscript{37} Although somewhat less important, non-depository financial institutions, such as finance companies, provide financing to approximately 35% of small firms with between ten and nineteen employees and nearly the same percentage of all firms with between twenty and ninety-nine employees.\textsuperscript{38}

Economic efficiency provides an explanation for small businesses' reliance on institutional credit. Depository institutions, for example, are able to amass capital relatively easily from deposits and other sources. Financial institutions are also efficient in evaluating and diversifying risk as well as pricing the capital they lend to small businesses. They are engaged in multiple, repeat transactions and as a result are experienced and efficient in credit analysis.

Financial institutions, however, are normally limited in the type of capital they are able or willing to supply small businesses. Regulatory limitations explain part of this problem. Banks, for example, are typically foreclosed from making equity investments in their business customers.\textsuperscript{39}

\textsuperscript{35}Id. (in 1993, for example, 88.7% of firms with ten to nineteen employees and 91.1% of firms employing between twenty and ninety-nine persons utilized some form of credit as a source of financing).

\textsuperscript{36}Id. (in 1993, 75.5% of firms employing ten to nineteen persons and 81.4% of all firms employing between twenty and ninety-nine persons relied on traditional loans as a form of financing).

\textsuperscript{37}Id. at 176 tbl. 5.15 (in 1993, 57.4% of firms employing ten to nineteen persons and 70.7% of all firms employing between twenty and ninety-nine persons relied on loans from depository institutions).

\textsuperscript{38}The State of Small Business 1994, supra note 19, at 167 tbl. 5.15 (in 1993, 35.5% of firms employing ten to nineteen persons and 34.5% of all firms employing between twenty and ninety-nine persons relied on loans from non-depository institutions).

\textsuperscript{39}For example, the Glass-Steagall Act limits national banks and Federal Reserve-member state banks "to purchasing and selling . . . securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account," except "under such limitations and restrictions" as the comptroller may prescribe. 12 U.S.C.A. § 24 (West 2005).
and are limited as to the size of a loan they can make to a single customer. In addition to such regulatory limitations, the culture of banking and perceptions about what amounts to sound banking practices limit significantly the kind of loans that banks are prepared to make to small businesses. For example, banks usually require collateral that is more than sufficient to liquidate the loan in the event of default and, in the case of loans to corporations, require an equity cushion supporting their loan. Such rules, often imposed as a matter of sound business practices, limit the types of business loans that banks are willing and able to make.

The normal progression for a growing small business, therefore, is to exhaust its line of institutional credit and then to seek other sources of external capital. It is here where small businesses encounter some of their most challenging problems.

C. Impediments to Small Businesses' Efficient Search for External Capital

1. Structural and Economic Impediments

Small businesses' difficulties in finding external capital are not caused by a supply inadequacy. There are billions of dollars available in the broad capital market for nearly any risk/reward combination. The problems for small businesses are, instead, the difficulties they face in identifying potential investors and the costs of connecting themselves with the investors' demand. In short, it is the ubiquitous problem of transaction costs.

Two related circumstances are important in that regard. First, financial intermediation is unavailable to small businesses. Second, their

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40A national bank may lend up to 15% of its unimpaired capital and surplus to a single borrower. 12 U.S.C.A. § 84(a)(1) (West 2005). An additional 10% may be lent, if the loan is secured by "readily marketable collateral having a market value, as determined by reliable and continuously available price quotations." Id. § 84(a)(2); see also 12 C.F.R. § 32.2(n) (2005) (providing an expansive definition of "readily marketable collateral"). For an extensive discussion of the exceptions, qualifications, and the penalties for noncompliance with 12 U.S.C.A. § 84(a), see 1 MILTON R. SCHROEDER, THE LAW AND REGULATION OF FINANCIAL INSTITUTIONS ¶ 7.04 (6th ed. 2005).

41Consider, for example, the data prepared by Ibbotson, which track historical returns on various categories of investments from risk free government obligations through small cap companies. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 146 tbl. 7-1 (5th ed. 1996) (average rates of return on various broad types of investments, 1926-1994).
relative offering costs are very high. Reputable, competent underwriting services are not available for offerings by small businesses. The simple reason is that the proceeds from small offerings cannot support the expenses encountered by an underwriting firm, who must learn the company, evaluate the deal, sell the deal, and absorb the residual risk of liability that is generated by the offering, and ultimately earn a reasonable return on its capital.

Professors Gilson and Kraakman have described the value of financial intermediation for firms attempting to access external capital. Reputable professional underwriters, they observe, provide issuers with the "sales force and facilities necessary to sell the securities" and act as "an information and reputational intermediary." Further, underwriters reduce "processing costs," which are "obviously lower for a single investment banker than for a disparate group of individual buyers," and reduce the investors' "verification costs."

Small issuers, who are forced to sell their stock without the assistance of reputable, competent underwriters, therefore, are unable to capture the transactional efficiencies described by Gilson and Kraakman, which drives up their transaction costs. Small businesses do not have trained personnel who are able to sell their securities in an efficient, competitive manner. Usually, company employees do not know where to find potential investors and do not know how to sell them if they are able

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42See, e.g., JAMES D. COX ET AL., SECURITIES REGULATION CASES AND MATERIALS 149 (4th ed. 2004) (reporting a "recent estimate" for the expenses of an IPO as $150,000-$300,000 in fees to counsel; $100,000-$150,000 for the audit; $10,000-$20,000 for underwriter counsel expenses . . . and $50,000-$100,000 for printing costs").

43For example, if one imagines a small offering of $500,000, a 10% underwriting spread would generate only $50,000. This is substantially below a fee sufficient to support the expenses outlined in the text.


45Id. at 616.

46Id. at 618.

47Id. at 619.

48Gilson & Kraakman, supra note 45, at 619. Professor Langevoort also provides thoughtful insights into intermediation, especially in the context of small issuers. See, e.g., Donald C. Langevoort, Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities, 2 J. SMALL & EMERGING Bus. L. 1, 16-18 (1998) (examining "more recent social science-based work outside of conventional economics that also speaks to the role of intermediation in the capital-raising process").

49Also important here are the disinvestment difficulties encountered by investors in small businesses. Since there is no trading market for such shares, their transaction costs when they seek to sell their stock will be high. Rational investors, therefore, will demand more return on their investment in small businesses in order to provide compensation for expected high disinvestment costs.
to find investors. Also, the company itself is unable to provide investors with the same level of verification of facts and credible analysis provided by underwriters. The strong self interest of a company issuing and selling its own securities makes the investors less willing to rely on the company's information and analyses and thus requires that each investor underwrite the expense of its own verification and analysis.

The second, related problem faced by small businesses is that the other offering expenses are very high. For example, small businesses must deal with expenses such as accounting and legal expenses. Moreover, one should appreciate that it is relative, not absolute, offering expenses that are important. To use an extreme example, $500,000 in offering costs on a $50 million offering will certainly not kill the transaction, while $500,000 in offering expenses on a $500,000 deal will kill the transaction.

Accounting, legal and other expenses on small deals can easily exceed $50,000, and such amounts bulk large relative to the total yield from a small offering. When added to the costs due to the lack of financial intermediation services, one is able to appreciate the extreme structural and economic disadvantages that small entrepreneurs encounter when attempting to access external capital.\textsuperscript{50}

The disproportionately high transaction costs that small issuers face when they attempt to access non-institutional capital have important economic effects on society. Inability of small firms to compete effectively in the capital market makes small firms less competitive in their product market. Efficient allocations of productive assets are distorted and in individual, extreme cases, small firms may expire, even though the small firm may otherwise be a very efficient producer. In such cases, larger firms that are less efficient (except for their transaction costs in connection with capital formation) will replace small firms that are more efficient (except for their transaction costs in connection with capital formation).

One might imagine that a society concerned with economic efficiency, fairness, and equal access to business opportunities would move to enhance the competitive opportunities for small businesses to obtain external capital. Unfortunately, as the following discussion shows, society's rules actually exacerbate the structural and economic impediments faced by small businesses searching for external capital.

\textsuperscript{50}In light of structural and cost issues, one should not be surprised to find a minuscule number of public offerings by small businesses. Data show, for example, that in 1999, there were only 101 registered initial public offerings by firms with $10 million in assets or less. \textit{The State of Small Business 2000}, supra note 19, at 27 tbl. 1.10. In 1998, such firms made only sixty-two IPOs. \textit{Id.} These data capture the predictable result of the high transaction costs on small businesses' access to capital in the public market.
2. Regulatory Impediments

This part of the article examines, in only the broadest terms, the rules society imposes on the capital formation activities of small businesses. The discussion demonstrates that state and federal regulators have been insensitive to the high capital formation costs faced by small issuers. Instead of capital formation rules that reduce the cost disparity between the capital formation activities of large and small businesses, one finds that state and federal legal regimes actually make the problem worse, most importantly by providing no cost efficient way for small businesses to solicit broadly for their investors.

a. Society's Broad Rules Respecting Capital Formation

Under the Securities Act of 1933, an issuer selling its stock must either register its securities with the SEC or qualify for an exemption from the federal registration requirements.51 State blue sky laws impose similar obligations on issuers.52

The legal obligations imposed by any state respecting capital formation are independent of the obligations imposed by all other states and the federal government. Thus, compliance with the securities laws of one state does not satisfy the issuer's obligations in other states or with the federal government. Similarly, meeting the issuer's federal obligations does not ensure that the issuer has met its obligations in any state. Although these rules apply broadly to small and large businesses alike, the rules disproportionately and adversely impact capital formation activities of small businesses.

b. Registration

Registration has never been a viable way for small businesses to raise capital.53 High transaction costs associated with registered offerings54 inevitably put registration out of the range of small businesses in search of

52 See, e.g., UNIF. SEC. ACT § 301, 7C U.L.A. 158 (2000).
53 See THE STATE OF SMALL BUSINESS 2000, supra note 19, at 27 tbl. 1.10 (in 1999, out of the millions of small businesses in the United States, there were only 101 federally registered offerings by small businesses).
54 See supra note 51.
Thus, the data show that small offerings are very rarely made through SEC registration.\textsuperscript{57}

c. **Exempt Offerings (Except Regulation A)**

Historically, the federal exemptions from registration broadly available to small businesses\textsuperscript{58} have been the intrastate exemption under Section 3(a)(11),\textsuperscript{59} the private place exemption under Section 4(2),\textsuperscript{60} and exemptions for small issuers authorized by Section 3(b).\textsuperscript{61} Under each of these statutory exemptions the Commission has promulgated regulations,

\textsuperscript{55}If registration were an economically viable alternative for small issuers, it would produce a number of attractive benefits. It would ameliorate problems of inadvertent loss of an exemption through the impact of the integration doctrine, see, e.g., Rutheford B Campbell, Jr., *The Overwhelming Case for Elimination of the Integration Doctrine Under the Securities Act of 1933*, 89 KY. L.J. 289 (2000-2001) (hereinafter Campbell, *The Overwhelming Case*) (arguing for elimination of the integration doctrine) or failure to meet the technical requirements of a particular exemption. It would eliminate all resale restrictions that often adversely impact the attractiveness of exemptions. See Rutheford B Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 WASH. & LEE L. REV. 1333, 1351-75 (1995) (hereinafter Campbell, *Resales of Securities*) (describing the restriction of resales of securities taken in exempt transactions). Finally, it would provide some help and comfort regarding antifraud compliance. Scheduled disclosure requirements in registration forms provide a prepackaged checklist regarding matters and events that may be material and thus subject to disclosure obligation under antifraud rules, such as Rule 10b-5. 17 C.F.R. § 240.10b-5 (2005). Compliance with the registration form, therefore, effectively reduces the risk of a material omission of fact that would generate liability under federal antifraud rules.

\textsuperscript{56}See *The State of Small Business 2000*, supra note 19, at 27 tbl. 1.10 (reporting that in 1999 the average size of "small" offerings was $42.4 million). Even going back another ten years to 1989, the average size of an IPO offering by a small issuer was $6.6 million. \textit{Id.}

\textsuperscript{57}It is interesting to look at the number of IPOs by small issuers in relation to the SEC's adoption of its SB Forms, registration forms designed especially for small businesses. The first of the SB Forms was adopted by the Commission in Small Business Initiatives, Securities Act Release No. 6949, 57 Fed. Reg. 36,442 (Aug. 13, 1992). Starting with 1988 and coming through 1991, the SBA reports 83, 89, 86, and 116 IPOs in the respective years. \textit{Id.} In 1992, the year of adopting the SB Forms, 171 IPOs were registered by small issuers. \textit{Id.} In years 1993 through 1996, registered small businesses' IPOs amounted to 203, 202, 193, and 304. \textit{Id.} In 1997, the number of IPOs registered by small businesses dropped back to 154. *The State of Small Business 1998*, supra note 1, at 161 tbl. 5.10. "Small businesses" for this data are issuers with assets of $10 million or less. \textit{Id.}

\textsuperscript{58}Other exemptions under the 1933 Act are not broadly available for small businesses. Examples of more limited exemptions are the exemptions provided for the offer and sale of governmental securities and bank securities, 15 U.S.C.A. § 77c(a)(2) (West 2005), and for certain sales of securities by bank holding companies. \textit{Id.} § 77c(a)(12).

\textsuperscript{59}\textit{Id.} § 77c(a)(11).

\textsuperscript{60}\textit{Id.} § 77(d)(2).

\textsuperscript{61}\textit{Id.} § 77c(b). The exemptions from registration provided by Rules 504 and 505, 17 C.F.R. §§ 230.504-230.505 (2005), are examples of regulatory exemptions enacted under Section 3(b).
and both Section 3(a)(11) and Section 4(2) have generated common law exemptions. 62

States generally have had only two types of broadly available exemptions from their registration requirements. 63 First, most states have some type of a small offering exemption. 64 For example, the Uniform Securities Act exempts from registration offers to less than ten persons within a twelve-month period, provided the issuer pays no brokerage fees in connection with the offer and reasonably believes that the purchasers are taking for investment. 65 Second, states also often have some form of the Uniform Limited Offering Exemption (ULOE), 66 which provides for an exemption from state registration for offers made in compliance with federal Rules 505 67 and 506, 68 provided that certain other conditions are met. 69 In 1996, Congress passed the National Securities Markets Improvement Act (NSMIA), 70 which preempted part of state control over securities matters. NSMIA, however, had virtually no impact on state rules governing

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62 Section 3(b), on the other hand, is not self-executing and thus requires Commission rules. 15 U.S.C.A. § 77c(b) (West 2005).

63 States statutes and regulations provide other exemptions from the state registration requirements. None, however, is broadly available to small businesses. For example, some exemptions are limited to certain industries, such as the exemption provided by the Uniform Securities Act for securities issues by some regulated, financial institutions and some regulated, non-financial institutions, such as public utilities. UNIF. SEC. ACT § 402(a), 7C U.L.A. 218-19 (2000). Other exemptions, such as the exemption from registration for shares traded on certain national securities markets, are available only for securities issued by larger companies. See, e.g., id. § 402(a)(8) (exempting from registration shares trades on the New York, American or Midwest Stock Exchange). For a discussion of the so-called marketplace exemption, see Rutheford B Campbell, Jr., Blue Sky Laws and the Recent Congressional Preemption Failure, 22 J. CORP. LAW 176 (1997).


66 Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101 (May 1989). The ULEO was promulgated by the North American Securities Administrators Association for adoption by state securities' regulators.


68 Id. § 230.506.

69 Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101 (May 1989). Additional requirements imposed by the ULOE include a suitability requirement and a requirement that non-accredited investors be sophisticated. Id. at 6103. State regulatory agencies, when they adopt the ULOE for their state, often impose additional or different criteria as a condition for the available of the exemption. See, e.g., Therese H. Maynard, The Uniform Limited Offering Exemption: How "Uniform" is "Uniform?"—An Evaluation and Critique of the ULOE, 36 EMORY L.J. 357, 504 (1987) (arguing that ULOE has not provided uniformity among states).

capital formation by small businesses.\footnote{See Campbell, supra note 10, at 581 (arguing that NSMIA had no impact on small issuers).}

The following brief discussions are organized around federal exemptions, but each discussion also explains the impact of state securities rules on small business capital formation. The discussions show how the combined effects of state and federal rules governing capital formation make it even more difficult for small businesses to raise capital and thus widen significantly the cost disparity between large and small businesses when they attempt to raise external capital.

1. Intrastate Offerings

Small businesses may use the federal intrastate exemption provided by Rule 147 for offering their securities.\footnote{17 C.F.R. § 230.147 (2005). The Commission enacted Rule 147 under Section 3(a)(11) of the 1933 Act. 15 U.S.C.A. § 77c(a)(11) (West 2005). Although Rule 147 is not the exclusive manner in which an issuer may qualify for an exemption under Section 3(a)(11), see 17 C.F.R. § 230.147, Preliminary Note 1 (2005), the common law under that Section is so unsettled and undeveloped that it does not provide a workable vehicle for the sale of securities. The Commission's enactment of Rule 147 eliminated these problems to a large degree. See Rutheford B Campbell, Jr., The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market, 1977 DUKEL.J. 1139, 1167-72 (describing the advantages of Rule 147 over the common law of Section 3(a)(11)).}

To qualify for the Rule 147 exemption, all offerees and purchasers must be residents of the same state in which the issuer is incorporated and doing business.\footnote{7 C.F.R. § 230.147 (2005). Section 3(a)(11) provides an exemption from registration if securities are "offered and sold only to persons resident within... [the state] where the issuer of such security is... incorporated... and doing business." 15 U.S.C.A. § 77c(a)(11) (West 2005).}

Resales of securities taken in a Rule 147 offering are subject to a relatively modest nine-month holding period.\footnote{7See Campbell, Resales of Securities, supra note 56, at 1351-55.}

On its face, Rule 147 appears attractive to small businesses. The rule permits small businesses to make broad, intrastate, public solicitations of investors and to solicit and sell their securities to unsophisticated or non-wealthy investors.\footnote{7 The position of the SEC is that a public advertisement may be used in an intrastate offering, even if such advertisement reaches an interstate audience, so long as the advertisement makes it explicitly clear that the offering is limited to residents of the state in which the offering is being made. See, e.g., Securities Act Release No. 33-4434, Fed. Sec. L. Rep. (CCH) ¶ 2270, at 2609 (Dec. 6, 1961) (stating that offers under Section 3(a)(11) "may be made the subject of general newspaper advertisement [provided the advertisement is appropriately limited to indicate that offers to purchase are solicited only from, and sales will be made only to, residents of the particular State involved]"). See also Maryland Inn, SEC No-Action Letter, 1977 SEC No-Act.} While the rule does impose some requirements that
limit its use by small issuers—such as limitations on the issuer's interstate activities and residency requirements for offerees and purchasers—the ability in a Rule 147 offering to solicit broadly for investors without regard to offeree qualifications would seem in many instances to make the rule attractive for small businesses in search of capital.

Unfortunately, these benefits of Rule 147 to a small business are negated by state blue sky laws. As stated above, Congress, when it enacted NSMIA, did not preempt the applicability of state blue sky laws to offerings made under the intrastate exemption and, as a result, small businesses utilizing Rule 147 are subject to state registration requirements. The only state exemption from registration that typically is broadly available for small businesses utilizing Rule 147 is the small offering

LEXIS 97 (Jan. 21, 1976) (noting that newspaper advertisements for a Maryland intrastate offering did render Rule 147 unavailable even though some of the advertisements were in newspapers published in states other than Maryland); Master Financial, Inc., SEC No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,560 (May 27, 1999) (stating the fact that an out-of-state resident reads or listens to the advertisement for the intrastate offering does not disqualify the use of Rule 147).

Rule 147 requires that 80% of the issuer's revenues be generated by activities conducted in the same state as is the residence of all offerees and purchasers. Additionally, 80% of the issuer's assets must be located in, and 80% of the proceeds from the offering must be used in connection with, the issuer's business within that state. 17 C.F.R. § 230.147(c) (2005).

All offerees and purchasers must have their "principal residence" in the same state as the one in which the issuer is incorporated and doing business. Id. § 230.147(d). The Rule contains other requirements that make the exemption somewhat less attractive. For example, interstate resales are prohibited for nine months, although intrastate resales are permissible during that time period. Id. § 230.147(e). For a discussion of the resale restrictions under Rule 147, see Campbell, Resales of Securities, supra note 56, at 1351-55. The rule also has a complicated integration provisions, which make it somewhat less attractive as a vehicle for capital formation. See Campbell, The Overwhelming Case, supra note 56, at 311-18.

Consider the basic example we have used before—that of a small business that needs to raise a modest $250,000 in equity capital. One could imagine that the CEO of the company could make a broad, general solicitation of investors within the state through advertisements in newspapers, trade journals and even the Internet. See supra discussion note 76. Perhaps even more importantly and realistically, the CEO could develop a list of 100 potential investors and, inexpensively, pitch the stock to these potential investors. The CEO could do this without regard to the number or qualifications of the offerees. The sales effort would be limited only by the requirement that offers and sales be made only to residents of the appropriate state and, of course, the antifraud provisions of Rule 10b-5. 17 C.F.R. § 240.10b-5 (2005). While this flexibility certainly cannot completely overcome small businesses' high offering transaction costs, it is a significant step in the right direction.

15 U.S.C.A. § 77t (West 2005). NSMIA preempted only with regard to "covered securities," and securities issued under Rule 147 are not within that definition.

The ULOE is typically only available to exempt securities issued under Rule 505 and 506. Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101 (May 1989). For exhaustive and thoughtful discussions of ULOE, see Maynard, supra note 70; Ronald L. Fein et al., ULOE: Comprehending the Confusion, 43 BUS. L. 737 (1988); Mark A. Sargent & Hugh H. Makens, ULOE: New Hope, New Challenge, 45 BUS. LAW. 1319 (1990).
exemption, which imposes severe limitations on the number of offers or sales the issuer is allowed.\textsuperscript{81} State blue sky laws, therefore, effectively foreclose a broad intrastate solicitation in a Rule 147 offering, thereby eliminating the most attractive aspect of the Rule for small businesses.

2. Private Placements under Section 4(2)

Section 4(2) of the 1933 Act provides an exemption from federal registration for "transactions by an issuer not involving any public offering."\textsuperscript{82} There is broad agreement that the exemption prohibits any general advertising for investors\textsuperscript{83} and imposes significant resale restrictions.\textsuperscript{84} Most also interpret the exemption as requiring sophisticated offerees and purchasers\textsuperscript{85} who have access to the same information that is contained in a registration statement.\textsuperscript{86}

Again, state blue sky laws apply to Section 4(2) transactions.\textsuperscript{87} Typically, state requirements are met through the state small offering exemption, which, as described above, severely limits the number of offerees or purchasers and forbids any selling commissions.\textsuperscript{88}

In combination, therefore, the conditions for Section 4(2) and state


\textsuperscript{82}15 U.S.C.A. § 77d(2) (West 2005).

\textsuperscript{83}See, \textit{e.g.}, John C. Coffee, Jr. & Joel Seligman, \textit{Securities Regulation Cases and Materials} 396 (9th ed. 2003) ("The concept of a private offering precludes general advertising or general solicitation through which offers are made."). This notion goes back to the very beginning of the 1933 Act itself. \textit{See, e.g.}, Securities Act Release No. 33-285, Fed. Sec. L. Rep. (CCH) ¶ 2740, at 2911-12 (Jan. 24, 1935) (listing among the factors of importance to the availability of the private placement exemption the manner of offering).

\textsuperscript{84}See Campbell, \textit{Resales of Securities}, \textit{supra} note 56, at 1341-46.

\textsuperscript{85}See, \textit{e.g.}, the discussion in Cox \textit{et al.}, \textit{supra} note 43, at 395-98 (discussing the issue of sophistication). The authors observe that "differences of opinion" exist regarding the sophistication requirement. \textit{Id.} at 395. They conclude, nonetheless, that issuers who fail to ensure the quality of their offerees "proceed at their [own] peril." \textit{Id.} at 396.

\textsuperscript{86}In the seminal case, \textit{SEC v. Ralston Purina Co.}, 346 U.S. 119 (1953), the Supreme Court stated that an offering limited to employees who "have access to the same kind of information . . . available in . . . a registration statement" may come within the Section 4(2) exemption. \textit{Id.} at 125-26.

\textsuperscript{87}NSMIA preempted only with regard to "covered securities," and securities issued under Section 4(2) are not within that definition. 15 U.S.C.A. § 77r (West 2005).

\textsuperscript{88}See \textit{supra} notes 79-81 and accompanying text.
blue sky laws make it impossible for small businesses that have exhausted their institutional line of credit to conduct a wide, efficient search for external capital. Once again, small businesses face rules that compound their natural disadvantage in capital formation.

3. Regulation D Offerings

Regulation D is made up of three basic offering rules that provide exemptions from registration for increasingly large offerings: Rule 504 provides an exemption for offerings up to $1 million,89 Rule 505 provides an exemption for offerings up to $5 million,90 and Rule 506 provides an exemption for offerings in unlimited amounts.91

All three of the exemptions, however, impose conditions that significantly limit the access of small businesses to potential investors. All three prohibit any general advertising,92 once again severely restricting the

90 Id. § 230.505(b)(2)(i).
91 Id. § 230.506.
92 The prohibition against general advertising, which is found in Rule 502(c), id. § 230.502(c), is incorporated into the general conditions of Rule 504, id. § 230.504(b)(1), Rule 505, id. § 230.505(b)(1), and Rule 506, id. § 230.506(b)(1).

The history of the prohibition on general advertising in Rule 504 offerings merits at least brief mention here because it highlights, unfortunately, the Commission's failure to understand the impact of combined state and federal regulation on capital formation by small issuers and suggests a Commission bias against small businesses.

As originally adopted, Rule 504 prohibited general advertising, unless offers and sales were made pursuant to state registration and disclosure requirements, an exception which rarely was used. 17 C.F.R. §§ 230.504(b)(1) and 502(c) (1983), adopted in Securities Act Release No. 33-6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106, at 84,917-18 (Mar. 8, 1982). In 1992, however, the Commission amended the Rule to permit the use of general advertising in a Rule 504 offering. 17 C.F.R. §§ 230.504(b)(1) and 502(c) (1993). In 1999, the Commission reversed itself and reimposed a prohibition against general advertising in Rule 504. Revision of Rule 504 of Regulation D, Securities Act Release No. 7644, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,114 (Apr. 7, 1999). The basis to reinstate the prohibition on general advertising in Rule 504 offerings was a perception of fraudulent conduct by small businesses utilizing Rule 504. The Commission referenced cases of "manipulation of the over-the-counter markets" and other "illegal practices," although citing only five cases involving problems with solicitations. Id. at 81,771 n.14.

All of this suggests a failure of the Commission to understand the reality of small business financing and a bias against small businesses. The original lifting of the prohibition against general advertising was entirely ineffectual because states continued to enforce rules that prohibited such activities by issuers utilizing Rule 504. See infra notes 94-98 and accompanying text. The decision to reimpose a prohibition on general advertising was seemingly made on the thinnest of evidence concerning fraudulent Rule 504 offerings and failed to give proper consideration to the facts that the Commission has a broad array of antifraud weapons in its arsenal.
search strategies small businesses may use to find investors. All three rules further limit the investor pool by imposing resale restrictions on Regulation D securities. Both Rule 505 and Rule 506 reduce the investor pool even more by limiting the number of unaccredited investors to thirty-five. Finally, Rule 506 also requires all investors to be accredited or sophisticated.

State requirements further complicate the matters for small businesses relying on Regulation D. Normally, a Rule 504 offering will be coordinated with the state small offering exemption, which may include

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*The definition of "general advertising" is less than entirely clear. But, certainly broad solicitations—even if the ultimate number of purchasers is quite limited—would not be permissible. Thus this would include media advertising of any kind, Internet announcements, and generally any broad blind solicitation of interested investors. See, e.g., Stuart R. Cohn, The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten Off the Ground?, 3 J. SMALL & EMERGING BUS. L. 315, 359 (1999) ("No limitation characterizes the phobia of securities regulators more than the prohibitions against general advertising and solicitation.").

*The limitation of resales found in Rule 502(d), 17 C.F.R. § 230.502(d) (2005), is incorporated into the general conditions of Rule 504, id. § 230.504(b)(1), Rule 505, id. § 230.505(b)(1), and Rule 506, id. § 230.506(b)(1).

Shares acquired in a Regulation D offering are considered to have been acquired in a non-public transaction under Section 4(2). Id. § 230.502(d) ("shall have the status of securities acquired in a transaction under Section 4(2) of the Act"). Resales of the securities of small businesses acquired in a Regulation D offering, therefore, would most likely require at least a two-year holding period, if the resales are made under Rule 144(k) or the common law, or require that the resales be made privately under the so-called "Section 4(1½) exemption." See discussion at Campbell, Resales of Securities, supra note 56, at 1341-46.


*Id. § 230.506(b)(2)(ii) (stating that each purchaser must either be "accredited" or "alone or with his purchaser representative(s) . . . [possess] such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment").

*Unif. Sec. Act § 402(b)(9), 7C U.L.A. 220 (2000). Another way that a small issuer may meet state requirements in a Rule 504 offering is through registration with the state on a registration statement, referred to as "SCOR," which is especially designed for small unregistered offerings. Because of its complexity and costs, SCOR has never been a popular way for most small issuers to coordinate state compliance with a Rule 504 offering. Thus, although in 1997 the Commission reported that thirty-six states had adopted the SCOR form and four additional states informally permitted use of the form, small businesses have rarely used the form, SEC, Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not "Covered Securities" (Oct. 11, 1997), available at http://www.sec.gov/news/studies/uniformity. htm, sampling from particular states that show how little SCOR registrations are used. In an article published in 2000, the author surveyed ten sample states regarding the number of SCOR filings received.

According to information gathered from ten sample states, Iowa reports that only four SCOR registration statements became effective in that state during each of the calendar years 1997, 1998, and 1999. Indiana reports that only two SCOR registration statements became effective between January, 1997 and August 1999. Information gathered from other sample states reflects similarly
an additional severe limitation on the number of offerees or purchasers. Coordination of a Rule 505 offering with state rules will typically involve meeting the ULOE requirements, which impose additional conditions, such as sophistication and suitability for all unaccredited investors.

Regulation D, therefore, does not offer small businesses competitive access to a broad pool of investors.

3. Summary

Small businesses face formidable structural and economic impediments when they attempt to acquire external capital. Regulators significantly exacerbate these problems by imposing rules that foreclose a broad and efficient search for capital by small businesses.

IV. REGULATION A

A. Historical Overview of Section 3(b) and Regulation A

To facilitate an understanding of today's Regulation A and the reasons for its extreme underuse, this part offers a brief overview of the evolution of Section 3(b) and Regulation A.

1. Section 3(b)

Section 3(b), which is not self-executing, provides the statutory basis

modest utilization of SCOR.


In most states, Rule 504 offerings cannot be made under the ULOE because, as promulgated by NASAA and adopted by most states, the ULOE offers state exemptions only for offerings under Rule 505 and Rule 506. See Uniform Limited Offering Exemption, NASAA Rep. (CCH) ¶ 6201, at 6101 (May 1989). A few states, however, have adopted a form of the ULOE that permits Rule 504 offerings to be coordinated with the state's ULOE. See, e.g., Campbell, supra, at 422 (out of a ten state sample, one state had not adopted the ULOE, two states permitted coordination with Rule 504, and seven states have limited coordination under the ULOE to offerings made under Rule 505 and Rule 506).

98Rule 504 contains no limitation on the number of offerees or purchasers, except the prohibition against general advertising. 17 C.F.R. § 230.504 (2005). State small offering exemptions, however, typically severely limit the number of offerees or purchasers. The Uniform Securities Act, for example, limits the offering to ten offerees within a twelve-month period. UNIF. SEC. ACT § 402(b)(9), 7C U.L.A. 220 (2000). The Uniform Act's small offering exemption also prohibits selling commissions. Id.

99Uniform Limited Offering Exemptions, Section 1, D, 1 & 2, NASAA Rep. (CCH) ¶ 6201, at 6103 (May 1989).
for Regulation A. Over the last seventy years, there have been relatively few changes in the statute, itself, although Congress has from time to time raised the limit of Section 3(b). As originally adopted in the 1933 Act, the limit of the Commission's authority to adopt exemptions "in the public interest" was $100,000. Twelve years later, in 1945, Congress tripled the limit, raising it to $300,000. The limit remained stuck there for twenty-five years, until Congress modestly raised the limit to $500,000 in 1970. In May of 1978, Congress tripled that limit, raising it to $1.5 million, and then raised the limit to $2 million five months later in the year. Finally in 1980, Congress raised the Section 3(b) limit to its present level of $5 million.

2. Regulation A

The Commission adopted the original version of Regulation A in 1936, although that original version looked almost nothing like the Regulation A of today. In 1941, the Commission substantially revised Regulation A, but it was not until 1953 that the Commission established

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102 Ch. 122, 59 Stat. 167 (1946).
108 For a description of the original Regulation A and an excellent history of Regulation A, see Hicks, supra note 14, §§ 6.2-6.4; 3 Louis Loss & Joel Seligman, Securities Regulation 1322-27 (3d ed. 1989).
Professor Hicks provides an interesting overview of these 1941 amendments and the shape of Regulation A until the 1953 Amendments. Under the 1941 amendments, Professor Hicks reports that "the SEC abandoned completely the need for an issuer to use an offering document with prescribed information or to subject its offering materials to the Commission's examination procedures." Hicks, supra note 14, § 6.3, at 6-20. He continues in a footnote to outline the administrative requirements for the Regulation A exemption during that period:
To use the simplified Regulation A, a domestic issuer was only required to send to the nearest SEC regional office a letter notifying the Commission of its intention to sell, together with any selling literature it planned to use. The letter of notification required a minimum of information, i.e., the name of the company, the name of the underwriter, the name of the issue to be sold, and a
the regulatory model for Regulation A that essentially survives today.\textsuperscript{110}

The last significant revision of Regulation A occurred in 1992, when the Commission, as part of its small business initiatives, raised the limit of the regulatory exemption to $5 million and adopted its much debated "test the waters" mechanism through which issuers are able to solicit indications of interest from potential investors before preparing and distributing an offering circular.\textsuperscript{111}

Little noticed in these 1992 amendments was the elimination of Rule 257, which had authorized a Regulation A offering of up to $100,000\textsuperscript{112} without filing or distributing an offering circular.\textsuperscript{113} The logic of eliminating Rule 257 was based on the fact that the Commission in the same release eliminated the prohibition against general advertising for Rule 504 offerings.\textsuperscript{114} Rule 504, therefore, became more attractive than Rule 257 for small public offerings.

When, however, the Commission reversed itself regarding Rule 504 and once again prohibited general advertising in most Rule 504 offerings,\textsuperscript{115} the Commission did not restore to Regulation A any mechanism allowing small Regulation A offerings with no disclosure requirements or diminished requirements. Today, therefore, small issuers are able to meet the requirements of Regulation A only through filing an offering statement with the Commission and supplying investors with an offering circular.

\textbf{B. Present Iteration of Section 3(b) and Regulation A}

Regulation A has received extensive attention from scholars,\textsuperscript{116} including Professor William Hicks, whose treatise on exempt securities

\textsuperscript{110}Securities Act Release No. 3466, 1953 WL 5669 (Mar. 6, 1953). According to Professor Hicks, the rules and forms adopted in Release 3466 for Regulation A "formed the basis for their counterparts under the present form of Regulation A." Hicks, supra note 14, at 6-20 n.24.


\textsuperscript{112}In 1978 the Commission amended Rule 257, raising its limit from $50,000 to $100,000. Increase in Amount of Small Offering Exemption, Securities Act Release No. 33-5977, Fed. Sec. L. Rep. (CCH) ¶ 81,710 (Sept. 11, 1978).

\textsuperscript{113}17 C.F.R. § 230.257 (1991). A condition of Rule 257, however, required the issuer to file as an exhibit to its notification much of the information required in the offering circular, except financial statements. Id. § 230.257(a).


\textsuperscript{115}17 C.F.R. § 230.504(b)(1), 502(c) (2005).

\textsuperscript{116}See, e.g., HAZEN, supra note 12, at 203-10; LOSS & SELIGMAN, supra note 109, at 1319-38.
transactions devotes over 200 pages to a fine and exhaustive discussion of Regulation A.\(^{117}\) The purpose in this section, therefore, is not to restate the work of these scholars but, instead, to explain and discuss Regulation A only to the extent necessary to understand the bases for its failures and underuse and to provide a springboard for a discussion of the author's prescription for this fallow but potentially significant exemption.

1. Section 3(b)

Today, Section 3(b) authorizes the Commission to enact exemptions from the registration requirements for offerings of up to $5 million dollars, subject only to the requirement that the Commission finds that the 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."\(^{118}\)

The National Securities Markets Improvement Act of 1996 (NISMA) provides an important, mandatory gloss to Section 3(b). NISMA directs that when the Commission is required in its rulemaking to act "in the public interest," it must "consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."\(^{119}\) NISMA, therefore, amounts to a clear directive for the Commission to give enhanced consideration to efficiency, competition and capital formation in connection with rules it promulgates under Regulation A.

2. Regulation A—Maximum Offering Size

Turning to Regulation A itself, since 1992 the Commission\(^{120}\) has exercised its maximum authority concerning the size of Regulation A offerings, permitting use of the exemption for offerings of up to $5 million in any twelve-month period.\(^{121}\) If one focuses on smaller businesses, such as those with less than twenty employees, this $5 million ceiling seems more than adequate to meet the needs or capital raising abilities of most small issuers.

\(^{117}\) Hicks, supra note 14, at 6-1 to 6-204.

\(^{118}\) 15 U.S.C.A. § 77c(b) (West 2005).

\(^{119}\) Id. § 77b(b).


\(^{121}\) 17 C.F.R. § 230.251(b) (2005) ("$5,000,000 . . ., less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities in reliance upon Regulation A").

The availability of Regulation A is predicated on a number of conditions involving the issuer and persons associated with the issuer in its securities offering.

To be eligible for Regulation A, an issuer cannot be a reporting company under the 1934 Act. The point of this requirement is apparently to force public offerings by larger, 1934 Act companies onto either S Forms or SB Forms, with their more extensive disclosure requirements.

Regulation A also is unavailable for offerings by "a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company." While this preclusion on its face seems somewhat ambiguous and thus possibly subject to a broad interpretation, the Commission in the release adopting the latest version of this requirement suggested a narrow reading of the preclusion. The Commission indicated that it applies only to offerings by a "blank check" company, which is defined in the Release as a company "that has no specific business or plan except to locate and acquire a presently unknown business or opportunity."

Of the other factors that exclude the availability of Regulation A, the most notorious are the so-called "bad boy" provisions, which preclude the use of Regulation A if either the issuer or certain persons affiliated with the issuer have committed any one of a number of enumerated bad acts. Thus, for example, Regulation A is unavailable for an offering if a stop order has been issued against any offering of the issuer within the last five years.

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122 The exemption is available only to an issuer that "[i]s not subject to section 13 or 15(d) of the Securities Exchange Act of 1934 . . . immediately before the offering." Id. § 230.251(a)(2).

123 Forms S-1, S-2, and S-3 are the general forms available for registration of public offerings of securities. See, e.g., id. §§ 239.11-239.13.

124 The SB forms are forms to be used by a "small business issuer" for registration of their securities offered to the public. See, e.g., id. § 239.9 (discussing Form SB-1).

125 17 C.F.R. § 230.251(a)(3) (2005). In his treatise, Professor Hicks offers an exhaustive history of this provision. HICKS, supra note 14, §§ 6.27-6.38.


127 In addition to the limitations on availability discussed in the text, the issuer must be either a U.S. or Canadian company, 17 C.F.R. § 230.251(a)(1) (2005), and cannot be an investment company. Id. § 230.251(a)(4). Regulation A also is not available for the issuance of fractional undivided interests in oil and gas rights. Id. § 230.251(a)(5). In his treatise, Professor Hicks offers a discussion of these issues. See, e.g., HICKS, supra note 14, § 6.8 (discussing requirement of issuer's residence).

128 Once again, Professor Hicks provides an extensive discussion of these "bad boy" provisions. HICKS, supra note 14, §§ 6.10-6.26.
years\textsuperscript{129} or if any director, officer or 10% shareholder of the issuer or any underwriter of the Regulation A offering has, within ten years, been convicted of certain felonies as a result of securities transactions.\textsuperscript{130}

While one may wish to argue about the wisdom of some of these predicates, none of these requirements broadly eliminates the availability of Regulation A for the types of small businesses that are the focus of this article, and none limits a broad search for investors by small businesses in search of capital.

4. Regulation A—Filing and Disclosure Requirements

The heart of Regulation A is the obligation of the issuer to file an offering statement with the SEC\textsuperscript{131} and the obligation to provide investors with an offering circular.\textsuperscript{132} These documents—the offering statement and the offering circular—are roughly analogous to the registration statement and prospectus in registered offerings.

The offering statement filed with the Commission is made up of four components—the notification, the offering circular, the exhibits and a signature page.\textsuperscript{133} The notification contains nine rather simple informational items that are deemed relevant only for the Commission and its processing of the Form 1-A.\textsuperscript{134} The exhibits, which also normally are not provided to investors, are made up of only nine items.\textsuperscript{135} The exhibits required in Form 1-A are similar to those required by SK 601 for registered offerings.\textsuperscript{136} Normally, compiling and supplying the Commission with the necessary exhibits should not run up costs in ways that are troublesome for a small issuer.

\textsuperscript{130}17 C.F.R. § 230.262(b)(1) (2005). In his treatise, Professor Hicks offers an extensive discussion of the acts by entities other than the issuer that eliminate the availability of Regulation A. \textit{See}, e.g., Hicks, supra note 14, §§ 6.17-6.26.
\textsuperscript{131}17 C.F.R. § 230.251(d)(i) (2005).
\textsuperscript{132}Id. § 230.251(d)(2).
\textsuperscript{133}See Form 1-A, 57 Fed. Reg. at 36,476.
\textsuperscript{134}See Part I—Form 1-A, Notification of Form 1-A, \textit{id.} (includes, for example, requirements to disclose names and addresses of directors, officers, counsel and underwriters and disclosure as to whether any of the foregoing are subject to disqualification under the "bad boy" provisions of Rule 262).
\textsuperscript{135}See Form I-A, Part III—Exhibits of Form 1-A, \textit{id.} at 36,492 (includes underwriting agreement, articles of incorporation, bylaws, and material contracts).
\textsuperscript{136}S-K 601, which establishes exhibit requirements for registered offering, contains twenty-six items, although not all items are required as exhibits in any registered offering). 17 C.F.R. § 229.601 (2005).
The offering circular is the part of the offering statement that contains the essential investment information and is the document that most fundamentally underpins the policy basis for Regulation A. Drafting the offering circular also generates the most costs associated with a Regulation A offering for the issuer.

Presently, the SEC permits corporate issuers utilizing Regulation A to pick from among three formats for the offering circular. All three require that the issuer supply each investor with substantial investment information about the issuer and the offering. Model A, for example, which is in a question and answer format, has forty-nine matters (plus the financial statements requirement) that must be addressed. Model B requires the issuer to disclose information concerning twelve broad items, which look much like the information required by the S Forms and Regulation S-K.

The narrative disclosures required in the offering circular include information about the issuer's business, properties, pending and threatened litigation, risk factors, officers and directors (including experience and compensation paid to them by the issuer), stock ownership, and use of proceeds. Although less extensive than the corresponding disclosures required in a prospectus in a registered offering, the narrative disclosures in an offering circular are substantial. In fact, the disclosures may be made even more substantial by the natural tendency of counsel to rely on the S Forms, Regulation S-X and counsel's general experiences from registered offerings for guidance in writing an offering circular.

138 Id.
141 See Form 1-A, Offering Circular Model B, Items 3-10, 57 Fed. Reg. at 36,488. Interestingly, Offering Circular Model A has a requirement for disclosing material litigation, see Form 1-A, Offering Circular Model A, Item 43, Id. at 36,487, while Model B has no express litigation provision. Nonetheless, it seems likely that counsel would insist that the issuer disclose all material litigation.
142 See, e.g., Hicks, supra note 14, § 6.63 ("offering circular is often thought of as a smaller version of the prospectus used in registered offerings").
143 Thus in his treatise, under his heading of "Some practical suggestions," Professor Hicks suggests that the sensible approach for counsel preparing an offering circular is to rely on Regulation S-K and "standard instructions for preparing a prospectus." Id. at 6-100. One example relevant to Professor Hicks' "practical suggestion" jumps out at anyone with experience in drafting registration statements and proxy statements and makes Professor Hicks' point vividly. Item 9 in Model B requires disclosure of the latest "aggregate annual remuneration" paid certain senior officers and proposed future remuneration to be paid to the officers under any plan. Form 1-A, Offering Circular Model B, Item 9, 57 Fed. Reg. at 36,490. The Item appears to be simple and certainly is brief, taking up less than one-half a page in the CCH Federal Securities Law
An offering circular also must contain prescribed financial information, which includes a one year balance sheet and income information for two years, plus any interim period necessary to bring the latest annual income information down to the date of the balance sheet. All financial statements must be prepared according to generally accepted accounting principles (GAAP) but do not have to conform to Regulation S-X and usually do not have to be audited.

This discussion suggests that the costs involved in preparing and distributing the offering statement and the offering circular are significant relative to the yields from a smaller offering. These relative costs are an important reason why small businesses seeking small amounts of capital so rarely rely on Regulation A. Related to these relatively high offering costs is a fear that small issuers and their counsel may have of getting tangled up in administrative actions as a result of filing an offering statement with the Commission. Issuers may fear that a Commission review of their offering statement will expose the company to the risk of delays in their financing, extended staff conferences, and costly and protracted adjustments to their filings required by the Commission's staff. These matters may be especially daunting to issuers relying on counsel who are less experienced in financings and matters of securities regulation.

C. The Impact of State Blue Sky Laws on the Availability of Regulation A

While the costs and complexities of complying with federal requirements make Regulation A substantially less attractive for small businesses, the costs exacted by state blue sky regulation may be an even more significant factor in the underuse of Regulation A by small businesses.
businesses.

In the legislative process that led to the enactment of NSMIA, Congress considered but ultimately failed to preempt the authority of state securities regulators over offerings made under Regulation A. As a result, a small business making a Regulation A offering is still obliged in each state in which it offers its securities either to register the securities with the state or qualify for a state exemption to the state registration obligation.

State exemptions from registration almost never work well with a Regulation A offering, principally because the only state exemption broadly available for a Regulation A offering is the state small offering exemption. That exemption severely limits the number of offerees or purchasers and thus destroys the principal benefit of a Regulation A offering, which is the right to offer securities publicly.

Various states have enacted up to three different methods for registering a Regulation A offering. The first of these adopted by states was the traditional, registration by qualification. Later, a number of states adopted a new registration form—the SCOR form—for registering

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146An earlier House version of the legislation that became NSMIA would have preempted state control over nearly all securities offerings, except offerings made under the intrastate exemption. Capital Markets Deregulation and Liberalization Act of 1995, H.R. 2131, 104th Cong. (1995). If this version had been adopted, the Commission would have had exclusive authority in all Regulation A offerings.

14715 U.S.C.A. § 77r(b)(4) (West 2005). See Campbell, supra note 64, at 198-99 ("Glaringly absent from . . . [preemption] are securities issued in transactions exempt under Section 3(a)(11), which includes Rule 147, under Section 3(b), which includes Rule 504, Rule 505 and Regulation A, and under the common law of Section 4(2). ").

148For a basic description of the registration requirements under state blue sky laws, see supra notes 64-72 and accompanying text.


150See supra note 81 and accompanying text.

151See supra note 81 and accompanying text.

152The SCOR (Small Corporate Offering Registration) form—Form U-7—was developed jointly by NASAA and a committee of the American Bar Association. Small Corporate Offerings Registration Form (Form U-7), NASAA Rep. (CCH) ¶ 5057, at 5197 (Dec. 1999). At least forty-three states have, officially or unofficially, adopted SCOR. Small Corporate Offering Registration Program and Form U-7, 1 Blue Sky L. Rep. (CCH) ¶ 6461 (Apr. 2005).
offerings of up to $1 million, including Regulation A offerings. The SCOR form was specifically tailored for small issuers and was supposed to be simpler and less costly than a registration by qualification.

Neither of these registration methods has ever worked for Regulation A offerings. Although both registration by qualification and registration through the SCOR form preserve the right of the issuer to make an unlimited number of offers and sales, the additional costs and complexities added to a Regulation A offering apparently overwhelm any benefits to the issuer. Perhaps most disappointingly, the SCOR form, which was designed to ameliorate the complexity and costs of a qualification registration, is rarely used by the thousands of small issuers searching for capital.

More recently, some states have begun to permit registration through coordination with a Regulation A offering. Essentially, this method allows issuers relying on Regulation A to meet their state obligations by filing their Form 1-A with the state. Obviously, permitting a state registration of a Regulation A offering by coordination significantly reduces state compliance costs.

Not all states have adopted registration by coordination with a Regulation A offering. From a sample of ten states, three of the states permit registration by coordination with Regulation A, and another three states, although technically not permitting registration of a Regulation A offering by coordination, have adopted regimes that are essentially


154 An examination of the SCOR form as adopted by states and the accompanying rules regarding its use in those states suggests that the initiative may not have met these objectives. See Campbell, supra note 98, at 423-24.

155 Id., at 424. The data reported in that article include SCOR filings for offerings under Regulation A and other exemptions as well.

156 E.g., KY. REV. STAT. ANN. § 292.360 (West 2004).

157 The author used a sample of 20% of the state jurisdictions, consisting of his home state, Kentucky, and nine states that lie closest to Kentucky in the alphabet. Thus the states considered were: Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, and Michigan.

158 States from the sample with either statutory or regulatory authority for registration of a Regulation A offering by coordination include: Iowa, IOWA CODE ANN. § 502.206 (West 1999); Kentucky, KY. REV. STAT. ANN. § 292.360 (West 2004), and Maryland, MD. CODE ANN., CORPS. & ASS'NS § 11-503(d)(1) (1999) (Maryland, however, requires the issuer to petition the Commissioner for an order permitting registration by coordination. Id. § 11-206(e) (issuance of interpretive opinions, $100 fee required)).

equivalent to registration by coordination.¹⁵⁹ Four of the states in the ten state sample, however, do not have a coordination or coordination-equivalent regime available for Regulation A offerings.¹⁶⁰

This data suggests, then, that a substantial number of states still do not allow Regulation A offerings to be registered by coordination. In such states, a Regulation A offering would typically require that the issuer either file a qualification registration or meet the requirements of some small or limited offering exemption that does not permit general advertising.¹⁶¹ Either of these options effectively destroy Regulation A as a vehicle for small businesses to use in raising capital.

Even in states that provide a coordination or coordination-equivalent regime, meeting state requirements in a Regulation A offering may not be as smooth as one might imagine. States have a way of imposing idiosyncratic conditions on their securities laws¹⁶² and reserving administrative discretion to the securities staff processing registration statements.¹⁶³ To

¹⁵⁹The states are: Louisiana, L.A. REV. STAT. ANN. § 51:709 (5)(a) (West 2003) (Regulation A offerings can qualify as exempt transactions, provided the issuer meets certain filing requirements and pays prescribed fees); Massachusetts, MASS. GEN. LAWS ch. 110A, § 302 (West 1999) (permits registration by coordination only for registered offerings) and 950 MASS. CODE REGS. 13.303(A)(2) (2005) (issuer can meet qualification registration requirements by filing its federal Form 1-A with state); and Michigan, MICH. COMP. LAWS. § 451.703 (2001) (coordination only with registered offerings) and Use of Form U-7 for Regulation A Offerings, 2 Blue Sky L. Rep. (CCH) 32,639, at 27,624 (Sept. 1997) ("The Bureau will accept Form 1-A ... as a recognized disclosure document for Regulation A offerings that are filed under ... the Michigan Uniform Securities Act ... ").

¹⁶⁰The states are: Illinois, Indiana, Kansas, and Maine.

¹⁶¹For example, in Maine, registration of a Regulation A offering would be by qualification. ME. REV. STAT. ANN. tit. 32, § 10,404 (West 1999 & Supp. 2004). If the offering were not more than $1 million, the offering could be registered on the SCOR form. 02-032-525 ME. CODE R. § 9 (Weil 2005). Alternatively, the issuer could use one of Maine's small offering exemptions. ME. REV. STAT. ANN. tit. 32, § 10,502,2.J (West 1999) (providing that an exempt transaction includes "[a]ny offer or sale of a preorganization certificate ... if no commission ... is paid ... for soliciting any prospective customer, no public advertising or general solicitation is used in connection with the offer or sale, the number of subscribers does not exceed 10 and no payment is made by any subscriber"); ME. REV. STAT. ANN. tit. 32, § 10,502.2.P (Supp. 2004) (exemption conditioned on no more than ten holders after offering and no general advertising); and id. § 10,502.2.Q (permitting offers without general advertising [and meeting other conditions], provided no more than 25 holders after the offering).

¹⁶²See, e.g., Maynard, supra note 70 (discussing differences in the Uniform Limited Offering Exemption as adopted by various states).

¹⁶³For example, Maryland, which the author classifies as a coordination registration state, allows a Regulation A offering to be registered by coordination "in the manner the Commissioner by rule or order may prescribe." Md. CODE ANN., CORPS. & ASS'N § 11-503(d)(1) (1999). This means that one wishing to register a Regulation A offering by coordination must petition the Commissioner for an order. The Commissioner has outlined what is required in such a petition:

In order to meet the requirements of § 11-503, [the issuer] should submit to the
the extent states do not provide uniform rules respecting registration by coordination or impose regulatory hurdles to the availability of their particular coordination registration, transaction costs increase, making Regulation A less attractive. These problems, obviously, become more significant when an offering involves a number of states.

Finally, permitting state registration by coordination for Regulation A offerings does not necessarily protect the issuer from the loss of Regulation A benefits. Consider the "test the waters" provision of Regulation A. Under that rule, issuers are able to solicit indications of interest in a Regulation A offering before writing the Form 1-A, even though the activity otherwise would amount to an unauthorized "offer" of a security in violation of the provisions of the 1933 Act. The benefit to the issuer, of course, is that it can better gauge the demand for its securities, before investing the significant amount of money necessary to put together a Regulation A offering. Adopting a rule permitting a Regulation A offering to be registered by coordination does not necessarily affect the determination of whether prefiling testing of the water activity amounts to an illegal offer under state law. Thus, a state permitting registration by coordination could take the position that prefiling testing of the water activity amounts to illegal gun jumping under state law. The small business using Regulation A in such a case would have to forego the benefits of testing the waters in order meet state blue sky law requirements.

State blue sky laws continue to impose substantial costs on small businesses attempting to utilize Regulation A and thus amount to a continuing, material impediment to its use.

D. The Underuse of Regulation A—An Exemption Without a Niche

Today, Regulation A is essentially unused because it does not have

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Division of Securities three copies of your Reg A filing; a form U-1 or the Maryland Application for Registration of Securities by Coordination . . . , a form U-2, Consent to Service of Process, naming the "Commissioner of Securities," and a filing fee representing 1/10th of one percent of the aggregate offering price of securities to be offered in Maryland, with a minimum fee of $100.00 and a maximum fee of $500.00.


165 Id.

166 Two noted commentators reported the opposition of state securities administrators to the "test the waters" provision. See Sargent, supra note 9, at 477-79; Steinberg, supra note 9, at 408-11. This may suggest that states, even if they adopted registration of Regulation A offerings by coordination, would be reluctant to permit such registered offering to be offered through the federal "test the waters" technique.
a niche. No matter the size or nature of the offering, the exemption does not provide small issuers with an attractive alternative for capital formation.

On the small offering end of the Regulation A spectrum, which is the principal concern in this article, issuers are discouraged from using Regulation A by the complexities of the filing, disclosure and other requirements and by the difficulties in many instances of meeting state blue sky requirements. Together, the costs of meeting these federal and state requirements overwhelm any benefit a small business would attain from utilizing Regulation A.

As offerings get larger, one might imagine that Regulation A becomes more attractive to businesses in search of capital. The all-important relative offering costs—the costs of the offering in relation to the yield from the offering—decrease as the size of the offering goes up, and because the narrative and financial disclosures required in Regulation A are less onerous than those required in a registration statement, it may at first seem surprising that so few Regulation A offerings are made, for example, around the $5 million area.

It appears, however, that the advantages of a Regulation A offering at such higher levels still do not make up for lingering difficulties. State law compliance problems are probably the most apparent among these problems. For example, a Regulation A offering of $5 million in twenty-five states would likely present problems with state securities laws so overwhelmingly complex that they would swamp any benefit from reduced disclosure costs. Based on the previous ten state sample, one surely would expect to encounter extreme difficulties coordinating such an offer with twenty-five sets of differing state blue sky laws. On the other hand, if the $5 million offer were registered on a Form SB with the Commission, state blue sky requirements could be met through registration by coordination, which is an enormous advantage for the issuer.

It is unlikely, therefore, that Regulation A as presently constituted, or even if increased in its limit, will have a significant role in the capital formation activities of small businesses. The shame in all this is that the

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167 Another, perhaps more practical, problem in the use of Regulation A in larger offers is the unfamiliarity that professionals and investors have with Regulation A offerings. The very small number of Regulation A offers suggest that Regulation A has an underdeveloped body of de facto protocols and traditions and surely means that the SEC staff is less experienced in this area. Experienced SEC lawyers, therefore, face more uncertainty in outcomes in operating in such an environment, which encourages them to favor registration. Registered offerings also are more familiar to the investing public and the investment professionals, who may either be involved in placing the offering or at least advising investors. Considered together, these factors may help account for the underuse of Regulation A at higher offering levels.

168 See supra notes 158-69 and infra notes 170-72 and accompanying text.
fundamental concepts of Regulation A—providing an exemption from registration through a disclosure tailored to meet the tension between capital formation and investor protection—makes perfect sense.

V. PRESCRIPTION FOR REGULATION A

The SEC has never understood or appreciated small businesses.\(^\text{169}\) Over the years, the actions of the Commission suggest a suspicion about the integrity of small business managers and manifest a failure to understand the importance of small businesses to our national economy and the importance of accessible capital to small businesses.\(^\text{170}\) These misunderstandings have shaped today's misdirected and unused Regulation A.

The offered proposals are intended to refocus Regulation A on the capital needs of truly small issuers and thus to reshape Regulation A into a vehicle that can be used effectively and efficiently by these small businesses to access external, non-institutional capital.

A. Broad Public Offering; Disclosure Predicate

The Regulation A proposed in this article would continue the essential nature of today's Regulation A regime, which permits broad, public solicitation of investors, conditioned on meaningful, mandatory disclosure of prescribed investment information prior to sale.

B. Amount Limitations

Concerning the amount limitations for Regulation A, the Commission must be mindful that both the top and bottom ends of the Regulation A range are important.

Consider first the appropriate upper limits of a Regulation A offering. The Commission should approach this as an integrated matter, with Regulation A as the vehicle through which truly small businesses can sell small amounts of securities publicly and registration as the vehicle for selling larger amounts of securities publicly. This stair-stepped approach, which would be similar to the approach the Commission adopted in

\(^{169}\) This is a specific criticism and not part of any general dissatisfaction on my part with the Commission. Indeed, my experience as a securities lawyer assisting clients in capital formation and a professor who has offered opinions and testimony to the Commission leads me to conclude that the SEC is among our very best governmental agencies.

\(^{170}\) For an example of these problems, see supra text accompanying note 93.
Regulation D,\textsuperscript{171} amounts to an appropriate accommodation of the tension between capital formation and investor protection. It would permit smaller offerings to be sold by meeting the less burdensome disclosure requirements of Regulation A, while requiring larger offerings with lower relative offering costs\textsuperscript{172} to be registered.

Assuming, therefore, that a Form S-B would be the first registration form an issuer would face as it increased its offering size above the Regulation A level, the Commission should estimate the minimum offering size that can practically be made on a Form S-B. The Commission might conclude that an offering on a Form S-B must be at least $2$ million before the relative offering costs fall to an acceptable, competitive level. That would then become the maximum amount that could be offered under Regulation A.

More critical to the discussion in this article, however, is the lower limit of Regulation A offerings, because of the concern over foreclosure of small businesses from an efficient hunt for capital. While it is unlikely that the Commission would ever, as a regulatory matter, establish a lower limit to the availability of the exemption, the lower limit will be practically and effectively set primarily by the relative offering costs of Regulation A, and the bulk of those costs will be generated by the level of disclosures required by the exemption.

C. Nature and Content of Disclosures

If the Commission refocuses Regulation A on public offerings by small businesses, its task then becomes that of establishing a Regulation A disclosure regime that offers small businesses of the type described in Part II of this article reasonable and realistic access to the exemption when they raise capital. The revised Regulation A should be designed in a way that makes it practically available for offerings of $250,000 or more. With $250,000 as the defacto threshold for Regulation A offerings, and indulging an assumption that offering expenses in excess of 10\% create substantial difficulties for small businesses, the Commission's goal should be to design

\textsuperscript{171} 17 C.F.R. § 230.501-.508 (2005). The maximum offering amount under Rule 504, id. § 230.504, is $1$ million, and the Rule does not mandate any particular disclosure as a prerequisite to its availability. Rule 505, id. § 230.505, and Rule 506, id. § 230.506, which allow, respectively, offerings of up to $5$ million and offerings of unlimited amounts, require enhanced disclosures as the offerings increase in size. Id. § 230.502(b).

\textsuperscript{172} It is relative, not absolute, offering costs that are critical. To use a simplified example, an offering of $100,000 would not be feasible if the offering costs were $100,000, but an offering of $100 million would be feasible if offering costs were $100,000.
a compliance regime that can be met for not more than $25,000.\textsuperscript{173}

While these numbers appear precise, the exact implementation of all this should be subject to the Commission's expertise and good judgment. It is the principle, however, that is critical. The compliance (principally, disclosure) regime for Regulation A must be set at a level that makes the exemption reasonably and realistically available for small businesses, and this requires close attention to the relative offering costs that small businesses face when making their smallest sized offerings under Regulation A.

Form 1-A, the notification that must be filed with the Commission and that contains the offering circular, will need to be reevaluated and revised in order to get the offering costs down to a level that will not swamp a $250,000 offering. In that regard, the following observations and suggestions are offered.

On the accounting side, stated in general terms, today's Form 1-A requires the issuer to provide a balance sheet for one year and two years of income information.\textsuperscript{174} The financial information must be consistent with GAAP,\textsuperscript{175} but the financial statements do not have to be audited\textsuperscript{176} and do not have to conform to the requirements of the Commission's Regulation S-X.\textsuperscript{177}

To make Regulation A workable for small businesses, the Commission should reduce the mandatory financial disclosure obligation\textsuperscript{178} to a

\textsuperscript{173}Quantifications of this nature, although clearly estimates based on less than perfect empirical evidence, are the very kind the Commission, utilizing its collective experience and expertise, must make. Indeed, one is put in mind of Keynes' famous statement, revived by Warren Buffett in one of his letters to shareholders: "I would rather be vaguely right than precisely wrong." Warren Buffett, The Essays of Warren Buffett: Lessons for Corporate America, 19 CARDOZO L. REV. 1, 185 (1997).

For example, such estimated quantifications might lead the Commission into the following analysis. The Commission might conclude that about 3/4 of the offering expenses of a Regulation A offering would be consumed by legal costs. If the Commission estimates that the average hourly rate for lawyers doing this work is $250 per hour, the compliance should be designed to require no more than about 75 hours of legal assistance ($250,000 \times 3/4 = $18,750; $18,750 divided by $250 per hour = 75 hours). Such a target—75 hours of legal time—will be very helpful, as the Commission considers revisions of the Form 1-A, for example. Such quantified analyses may be essential if the Commission is not to repeat its past mistakes.

\textsuperscript{174}Form 1-A, Part F/S, 57 Fed. Reg. at 36,491.

\textsuperscript{175}Id. ("financial statements shall be prepared in accordance with generally accepted accounting principles").

\textsuperscript{176}Id. ("financial statements need not be audited").

\textsuperscript{177}Id. ("Regulation S-X . . . shall not apply").

\textsuperscript{178}The Commission should take some comfort in the ability of the parties to bargain for more investment information, if it suits their preferences. See Frank H. Easterbrook & Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 VA. L. REV. 669, 680-85 (1984) (discussing arguments for and against mandatory disclosure).
balance sheet and one year of income information. Otherwise, the present requirements for financial statements in a Regulation A offering circular strike a sensible balance. Imposing GAAP requirements on the financial statements is essential to ensuring a common financial language. Equally appropriate is the omission of a requirement for an audit or Regulation S-X compliance, which in many cases would add substantial expenses to an offering circular. Undoubtedly, an audit would enhance investor protection. But disclosure that the statements are unaudited allows investors to price the additional risk generated by the absence of an audit, and antifraud provisions provide the issuer a strong incentive not to misstate its financial condition. In short, this is a sensible cost-benefit judgment on the part of the Commission, especially for a Regulation A refocused on smaller deals.

On the narrative disclosure side, today’s requirements for a Regulation A offering circular—especially those for Offering Circular Model B, which is the offering circular model that the author believes most experienced securities lawyers would choose—go a long way toward establishing the proper level of disclosure for revised Regulation A.

Some adjustments are needed, however, as the exemption is refocused on small public offerings. An example of one such adjustment involves the

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179 The risk in limiting income information to a single year (or even two years, as is presently required) is that a single year may fail adequately to disclose earnings volatility from year to year. One way for the Commission to deal with this is to require summary financial information, perhaps modeled on SK 301, see 17 C.F.R. § 229.301, Note 2 (2005), in the event that within the trailing three years net profits varied more than some predetermined percentage in any two successive years.

Another idea is to require only one year income information for offerings of less than $500,000 and two years for offerings above $500,000.


182 The intent here is not to provide a detailed list of suggestions for how the SEC could appropriately adjust the disclosure requirements for the offering circular, in light of the refocusing of the exemption on public offerings of less than $2 million. Nonetheless, in addition to revising obligations about the disclosure of risk factors, the obligation for segment reporting, see Form I-A, Offering Circular Model B, Item 6(b), 57 Fed. Reg. at 36,489, seems inappropriate for such smaller issues. Another item that merits reconsideration is the obligation regarding the disclosure of the purchase of cheap stock. While it is entirely appropriate to disclose cheap purchases of stock by insiders, disclosing that matter through references to book value, as is presently required, seems overly technical and, indeed, confusing. Id. at 36,488, Item 3(b).
requirement to include a discussion of risk factors in the offering circular. While there is some sense to a section on risk factors in a small public offering under Regulation A, the instructions should expressly state that disclosure is required only for risks that are material, not reasonably apparent from the offering circular, and not otherwise known to a reasonably informed citizen.\textsuperscript{183}

Finally, the Commission's instructions for the offering circular for revised Regulation A must be reasonable and intelligible, and the Regulation A exemption should be available if the offering circular complies "in all material respects" with the Commission's instructions. In short, immaterial disclosure failures should not result in the loss of the Regulation A exemption. The pressure from the possible loss of the exemption for materially inadequate disclosures provides the correct balance for society and the small issuers using revised Regulation A. This also is similar to the position taken with regard to registered offerings, where courts have found a violation of Section 5 of the 1933 Act in instances where prospectuses filed as part of a registration statement are materially inadequate.\textsuperscript{184}

D. Offering Flexibility and Meaningful Disclosure

The provisions of a revised Regulation A should offer small issuers all reasonable flexibility as they set about the very difficult task of identifying their potential investors. At the same time, the requirements of the revised exemption should ensure meaningful disclosure to investors before they make their investment decisions.

To facilitate the proper balance in this regard, revised Regulation A should retain some effective and efficient form of the "test the waters"

\textsuperscript{183}The whole idea of disclosing risk factors has gotten somewhat out of hand. For example, I recently assisted a small regulated gas utility company in a public offering of $12 million of its common stock. This company's entire business consisted of purchasing natural gas and reselling it to retail customers, nearly all of whom used the gas to heat their homes. The state's public service commission sets the rates the company charged. The prospectus for this offering had three pages of risk factors, including a statement that "[w]eather conditions may cause our revenues to vary from year to year," and "[v]olatility in the price of natural gas could reduce our profits" and "[t]errorist attacks and threats, escalation of military activity in response to such attacks or acts of war may negatively affect our earnings and financial condition." See Delta Natural Gas Co. Prospectus (2003) available at http://sec.gov/Archives/edgar/data277375/000106880003000284/0001068800-03-000284.txt.

\textsuperscript{184}A.J. White & Co. v. SEC, 556 F.2d 619, 622 (1st Cir. 1977) (affirming SEC order based on a finding that a material misstatement in a prospectus regarding method and nature of securities distribution violated Section 5 of the 1933 Act); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1098 (2d Cir. 1972) (a materially misleading prospectus violates Section 5 of the 1933 Act).
This provision permits issuers relying on Regulation A to make written or oral offers prior to filing disclosure documents with the Commission or providing a full-blown offering circular to investors. The clear benefit of the provision for small issuers is that they are able to search broadly for investors prior to paying the hefty expenses and enduring the delay that attends the preparation and filing of a notification and offering circular.

At the same time, no sales under revised Regulation A should be permitted until the offering circular has been in the hands of offerees for a period sufficient for them to read and digest the information. Three days should be a minimum amount of time to meet this goal.

Putting these provisions together, a small business operating under the revised Regulation A could begin a serious and wide search for investors before underwriting the significant expense of the offering circular. This selling effort could involve written or oral efforts and could involve the use of any medium—newspapers, the Internet, radio, etc. Interested investors discovered as a result of such a public search could not be sold securities, however, until an offering circular that is consistent with the mandated disclosure requirements of revised Regulation A is furnished to each investor, and the investor has had at least three days to read and evaluate the investment information. Investors, therefore, would be protected both by the antifraud provisions under the 1933 Act\(^8\) and 1934 Act\(^8\) and by the obligation to deliver the offering circular three days prior to sale.

It is worth noting that this proposed Regulation A regime would ensure earlier disclosures of mandatory information than is currently guaranteed in a registered offering. Under Section 5 of the 1933 Act, once a registration is filed with the Commission, issuers or underwriters or their brokers may make oral offers to potential investors without any obligation to supply a prospectus.\(^8\) Indeed, once the registration becomes effective, it is permissible for the issuer or underwriter to actually sell the registered security to an investor without ever having supplied the investor with a

\(^{185}\) 17 C.F.R. § 230.254(a) (2005).

\(^{186}\) Id.

\(^{187}\) Section 12(a)(2) of the 1933 Act, 15 U.S.C.A. § 77l (West 2005), which is a strong antifraud provision, would apply to a Regulation A offering. See Gustafson v. Alloyd Co., 513 U.S. 561 (1995) (Section 12(a)(1) applicable only to non-private offerings by issuers and control persons).

\(^{188}\) 17 C.F.R. § 240.10b-5 (2005).

\(^{189}\) Section 5(c) of the 1933 Act prohibits offers before the registration statement is filed. 15 U.S.C.A. § 77e(c) (West 2005). Once the registration statement is filed, offers are, by negative implication, permitted, and Section 5 nowhere prohibits such offers.
prospectus. The regime proposed here for a revised Regulation A, therefore, would provide a cost effective way for small issuers to identify potential investors, while at the same time ensuring that investors receive and have time to evaluate the information that the Commission has determined to be essential to an informed investment decision by investors in small businesses.

E. Eliminate Needless Federal Bureaucracy

Revised Regulation A should remove all unwarranted federal administrative interference with small issuers using the exemption. First, any Commission review of Regulation A offerings should be eliminated. Such administrative reviews, especially if Regulation A is re-directed as a vehicle for truly small issuers to use to make public offerings, are not cost efficient for society. These reviews add to offering costs of small issues—both out of pocket expenses and costs associated with delay and loss of control over the timing of the offering—while it is difficult to find any equal benefit from such administrative oversight. Instead of a formal review and comment procedure, issuers utilizing the revised Regulation A should be obligated to send the Commission copies of their offering circular (and other appropriate information) no later than the time they first distribute the materials to investors.

A similar philosophy should be employed with any "test the waters" documents. For the same reasons articulated above, the administrative intrusion into activities of small businesses attempting to identify potential investors through the "test the waters" mechanism should be limited to

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190Section 5(a)(1) of the 1933 Act prohibits sales of securities, "[u]nless a registration statement is in effect." Id. § 77e(a)(1). By negative implication sales after the effective date are permitted, and such sales do not themselves trigger an obligation to precede the sale with the delivery of a prospectus.

191Under the present regime for Regulation A, no offer can be made until the Form 1-A is filed, and no sale can be made until the Form 1-A has been "qualified." 17 C.F.R. § 230.251(d) (2005).

192It would also be helpful if the Commission would post on its website all offering circulars that it receives in connection with Regulation A offerings. It should not, however, require filings to be made consistent with the EDGAR filing regime. Although it would be too expensive to require filings to be "EDGARized," easy access to previous Regulation A offering circulars will facilitate and reduce costs for future filers.

193Although confusingly written, today's rules appear not to require filing of the "test the waters" documents as a predicate to the availability of the Regulation A exemption. Filing of the "test the waters" documents does appear to be a predicate for permissible oral offers prior to the time of filing the Form 1-A. Id. § 230.254(a).
filing any written documents no later than the first use of those documents.

F. Eliminate State Control Over Regulation A Offerings

Regulation A can never work as an effective, efficient vehicle for small business capital formation until state control over these offerings is eliminated. While states themselves have made some progress on this matter,\textsuperscript{194} state blue sky laws still represent the most important and troubling bureaucratic interference with appropriate use of Regulation A by small businesses. Unfortunately, this is also the most difficult problem to eliminate.

The best way to eliminate state interference is for Congress to expand the preemption of NSMIA to include securities issued under Section 3(b) of the 1933 Act.\textsuperscript{195} Unfortunately, operating in the wake of Enron, Congress will be reluctant to take any action—such as further preemption of state authority over securities regulations—which might appear to eliminate any protection for investors and society from the excesses of corrupt management or sharp practices of securities traders. One also should recall, when considering whether Congress may be willing to expand the preemption of NSMIA, that the act as originally proposed preempted authority over Section 3(b) offerings, but that provision was eliminated during the legislative process.\textsuperscript{196}

While one may be pessimistic about the probability of convincing Congress to revisit this matter, it is important enough to justify a Commission-led legislative initiative. Although, admittedly, the Commission is vulnerable to similar pressures, such as not wanting to seem soft on investor protection, if it is serious about providing a meaningful opportunity for small businesses to have a realistic chance to find external capital, states must be taken completely out of Regulation A offerings.\textsuperscript{197}

\textsuperscript{194}See supra notes 167-71 and accompanying text.

\textsuperscript{195}See 15 U.S.C.A. § 77r(b)(4)(c) (West 2005) (defining "covered securities," which are preempted by exclusive federal control, to include most securities issued under exemptions provided by Section 3(a) of the 1933 Act but not securities issued under Section 3(b)).

\textsuperscript{196}As originally introduced, NSMIA was called the Capital Markets Deregulation and Liberalization Act of 1995 (the Capital Markets Bill). H.R. 2131, 104th Cong. (1995). That bill would have preempted essentially all state control over the registration of securities, except state control over securities issued under the intrastate exemption. See Campbell, supra note 98, at 411-14 (providing a description and analysis of the legislative process leading to the adoption of NSMIA).

\textsuperscript{197}This statement applies only to registration matters and not to state antifraud rules. See Rutheford B Campbell, Jr., An Open Attack on the Nonsense of State Blue Sky Regulation, 10 J. CORP. L. 553, 575-77 (1985) (discussing the case for federal preemption of state antifraud rules).
Otherwise, misdirected, albeit usually well-meaning, state bureaucrats will retain the power to impose state conditions on Regulation A offerings. These conditions may well destroy the gains achieved by a revised and refocused Regulation A.

Even without congressional action, the Commission could on its own limit the excessive state control over Regulation A offerings in at least two ways. The Commission's most effective strategy would be to use its delegated authority under NSMIA to expand the federal preemption of state securities laws. NSMIA preempts state control over securities offered to "qualified purchasers" and specifically delegates to the Commission the obligation to define "qualified purchaser." The Commission, therefore, could define "qualified purchaser" to include any investor who is offered and sold securities under the exemption provided by Regulation A.

In a previous article, I proposed this solution and offered arguments supporting the appropriateness of this solution, both as a matter of sound policy and the proper use of legislatively delegated authority. The Commission, however, seems disinclined to follow any such proposal. Indeed, to date, not only has the Commission failed to adopt this article's view of "qualified purchasers," but also it has, during the more than nine years since the enactment of NSMIA, failed to establish any definition of "qualified purchaser."

The other path for the Commission would be to abandon Regulation A as a Section 3(b) exemption and move the regime into a registration format. The Commission could adopt a new registration form along the lines discussed above for the Regulation A offering circular, making the form available for small company offerings of up to $2 million. This would then make offerings under this re-formatted structure eligible for registration by coordination with the states and would appear to eliminate much of the expensive and excessive state oversight of these offerings.

Changing to a registration regime, however, is not as attractive as congressional or Commission preemption because states would retain the

199 See Campbell, supra note 64, at 207-10.
200 Late in 2001, the Commission proposed to amend Rule 146, 17 C.F.R. § 230.146 (2005), to define "qualified purchaser" as "any accredited investor" under Regulation D. Defining the term "qualified purchasers" under the Securities Act of 1933, Securities Act Release No. 8041, 2001-2002 Transfer Binder Fed. Sec. L. Rep. (CCH) ¶ 86,610, at 85,098 (Dec. 19, 2001). It was reported that, predictably, NASAA objected to the proposal. NASAA and States Oppose Proposed Definition of Qualified Purchaser, 202-63 SEC TODAY 1-2 (Apr. 2, 2002) ("NASAA ... expressed concerns that the preemption will increase the risk of fraud. States frequently use violations of their registration provisions as the basis for stopping fraud, NASAA explained."). The Commission did not adopt the amendment and to date has not defined "qualified purchasers."
power to neutralize the benefits of such a regime.\textsuperscript{201} As an extreme example, a state could amend its statutes and eliminate state registration by coordination for offerings registered under such a new federal regime. A more likely source of mischief, however, is the power each state would retain to construct rules regarding offering strategies for such registered offerings. For example, if the Commission were to adopt rules at the federal level allowing generous "testing of the waters" actions by the offering registered under this new regime, states would be entirely free to determine that testing the waters amounts to illegal "offers" under state laws.

The importance of the fundamental point should not get lost, however. To the extent that states exercise hegemony over Regulation A, it is unlikely that Regulation A can ever be an effective exemption for small businesses. Congressional or regulatory preemption, therefore, is the way to ensure a single, uniform regime that is sensible and fair to small businesses involved in capital formation.

\textbf{G. Summary of the Prescription}

Under a revised Regulation A, as described above, small businesses could offer up to $2 million of their securities predicated on providing investors a reasonable amount of closely tailored investment information a reasonable time prior to sale. Small businesses could solicit broadly and efficiently for investors without inappropriate interference or review from state or federal bureaucrats. Moreover, small businesses would subject to only one set of offering and disclosure rules, those of Regulation A.

\textbf{VI. CONCLUSION}

Small businesses are important to our national economy. Yet, they find it difficult to compete for external capital, an essential component to the growth or, perhaps, even the survival of many small businesses. The small size of their capital needs and the absence of financial intermediaries

\textsuperscript{201}Another issue that would make this approach less attractive is the impact of the Sarbanes-Oxley Act. The requirement to comply with Sarbanes-Oxley is generally predicated on the company's having a class of securities registered under Section 12 of the 1934 Act, 15 U.S.C.A. § 78l (West 2005), or being subject to the periodic reporting requirements under Section 15(d) of the 1934 Act, 15 U.S.C.A. § 78o(d) (West 2005). See, e.g., Section 2(a)(7) of Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2(a)(7), 116 Stat. 745 (2002) (defining "issuer" for the purposes of applicability of Sarbanes-Oxley as a company with shares registered under Section 12 or reporting pursuant to Section 15(d)). A small issuer filing a registration statement under the 1933 Act would become subject to Section 15(d) of the 1934 Act and thus subject to the provisions of Sarbanes-Oxley. This would add significant expenses to the small issuer's costs of doing business.
inevitably put small businesses at a big disadvantage when they attempt to raise capital.

Federal and state securities laws exacerbate these problems. Instead of enacting laws and regulations that level the playing field for small businesses, federal and state securities laws impose severe limitations on the manner in which small businesses are permitted to search for their external capital. In short, small businesses, already suffering under substantial structural impediments, are further disadvantaged by federal and state rules that make an efficient search for external capital essentially impossible.

Although it has fallen into nearly complete disuse, Regulation A offers a sensible structure through which these problems can be addressed. For Regulation A to work for small businesses, however, it must be significantly revised and protected from state hegemony.

The revised Regulation A proposed in this article would provide an exemption for public offerings of securities by small businesses, conditioned principally on the disclosure of prescribed investment information to all purchasers a reasonable time before the sale of the securities. The disclosure and the regulatory obligations of revised Regulation A would be closely tailored by the Commission to ensure that the small issuer's compliance expenses do no overwhelm an offering of $250,000. To facilitate a wide, economical search for investors, the restructured Regulation A would continue a generous "test the waters" provision, and it would eliminate unwarranted federal bureaucratic interference by no longer requiring any Commission review of the offering statement. Finally, to be effective, these changes must be accompanied by the elimination of state control over Regulation A offerings.

Operating under such a regime, a small business in search of capital could freely use the media in its solicitation and essentially would be limited only by antifraud provisions as it went about the difficult task of identifying potential investors. A small business could, for example, put together a one page term sheet and use that to offer its securities through newspaper, radio, or television advertisements, on the Internet, or directly to friends or business associates or potential investors it is able to identify through other means. Three days before any contract for the sale of the investment, however, the small issuer would have to deliver an offering circular to investors, a document that would contain information closely tailored by the Commission to properly balance capital formation with investor protection.

The result would be an important change in the way small issuers are able to acquire their external capital. While these revisions of Regulation A would not cure all disadvantages of small businesses, they would amount
to a step in the right direction—a step toward eliminating the discriminatory rules that society has placed on the capital formation activities of small businesses.