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In this, the final section of a three-part article on exemptions from registration requirements for issuers of securities, Professor Carney examines the small offering exemption of Rule 240.

EXEMPTIONS FROM SECURITIES REGISTRATION FOR SMALL ISSUERS: SHIFTING FROM FULL DISCLOSURE -- PART III: THE SMALL OFFERING EXEMPTION AND RULE 240.

*William J. Carney**

INTRODUCTION

THE first two parts of this article examined the availability of the private offering exemption and the intrastate offering exemption, and concluded that for small issuers, the intrastate offering had become relatively more attractive with the adoption of Rules 146[1] and 147,[2] although neither exemption represented a satisfactory "safe harbor".[3] This final part will examine the small offering exemption

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1. 17 C.F.R. § 230.146 (1975).
2. 17 C.F.R. § 230.147 (1975).
3. Carney, *Exemptions From Securities Registration for Small Issuers: Shifting From Full Disclosure—Part I: The Private Offering Exemption, Rule 146 and an End to Access for Small Issuers*, 10 LAND & WATER L. REV. 507 (1975); Carney, *Exemptions From Securities Registration for Small Issuers: Shifting From Full Disclosure—Part II: The Intrastate Offering Exemption and Rule 147*, 11 LAND & WATER L. REV. 161 (1976). *But see* the forceful argument that the private offering exemption is still alive, and can be made well with reasonable interpretation, in *Section 4(2) and Statutory Law—A Position Paper of the Federal Regulation of Securities Committee, Section of Corporation, Banking and Business Law of the American Bar Association*, 31 BUS. LAW. 485 (1975).

now provided by Rule 240,[4] which, like Rule 147, may be characterized as a nondisclosure transactional exemption from registration.

Rule 240 is a mixture of features from the private offering exemption, the intrastate offering exemption, and Regulation A, and is designed to provide a "safe harbor" for those issuers which do not need to raise substantial amounts of capital at any one time. The rule appears to focus more on the needs of small business to raise capital than on protection of investors through elaborate disclosure requirements. In that respect it represents a welcome balancing of the interests of the two groups. Rule 240 requires neither provision of information nor any assurance that offerees and buyers will be able to obtain information in some other way.

SMALL OFFERINGS

In addition to the specific exemptions set out in the Securities Act, Congress, in Section 3(b) of the Act,[5] authorized the Commission to adopt additional exemptions, originally in an amount not to exceed $100,000; this figure was later raised to $300,000 and finally to $500,000.

A series of Commission rules exempts various securities from registration under the authority granted by Section 3(b). The most important exemption is Regulation A,[6] which exempts certain offerings up to the full statutory limit of

4. 17 C.F.R. § 230.240 (1975).

5. Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) (1970), provides:

> The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities 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; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $500,000.

6. Regulation A covers Rules 251 through 263, 17 C.F.R. § 230.251—.263 (1975). For a brief history of the regulation, *see* BLOOMENTHAL, 3 SECURITIES AND FEDERAL CORPORATE LAW § 5.02 (1975).

$500,000.[7] The other exemptions adopted under this section are not generally relevant here.[8]

Regulation A involves a simplified registration-type process. Over the years it has become sufficiently complex and costly so that it is little used for very small offerings.[9] This article will not treat these problems, which are fully discussed elsewhere.[10]

Rule 257 of Regulation A[11] contains an exemption for offerings of $50,000 or less which requires no formal disclosure to investors. This provision was criticized in *The Wheat Report* as being inconsistent with good disclosure pol-

7. Rule 254(a)(1), 17 C.F.R. § 230.254(a)(1) (1975). $500,000 is the amount available to the issuer within any one year. Under certain circumstances nonaffiliated persons of the issuer can each offer or sell up to $100,000 worth of such securities, aggregating not in excess of $300,000, in addition to the amount available for the issuer. Rule 254 (a)(1)(ii), 17 C.F.R. § 230.254(a)(1)(ii) (1975).

8. Rule 234, 17 C.F.R. § 230.234 (1975), exempts certain first lien notes secured by real property not in excess of $100,000; Rule 235, 17 C.F.R. § 230.235 (1975), exempts certain securities of cooperative housing corporations not in excess of $300,000; Rule 236, 17 C.F.R. § 230.236 (1975), exempts shares of stock offered to provide funds to pay shareholders in lieu of fractional shares in connection with stock splits, conversions, mergers and similar transactions, not to exceed $100,000; Rule 237, 17 C.F.R. § 230.237 (1975), exempts securities of nonreporting issuers being sold by persons other than controlling persons, where the shares have been held at least five years and the amount does not exceed the lesser of $50,000 or 1 percent of the securities of the class outstanding—a corollary to Rule 144, 17 C.F.R. § 230.144 (1975), for nonreporting companies; Regulation B, covering Rules 300 through 346, 17 C.F.R. §§ 230.300—.346 (1975), exempts small offerings of fractional undivided interests in oil or gas rights, not exceeding $250,000; Regulation F, Rules 651 through 656, 17 C.F.R. §§ 230.651—.656 (1975), exempts assessments on assessable stock not exceeding $300,000. The Commission has also proposed Rule 238, CCH FED. SEC. L. REP. ¶ 2358B, which would exempt certain options involving securities of companies already reporting under the Securities Exchange Act of 1934, where issued by persons unrelated to the issuer.

9. The decline in the proportion of smaller offerings under Regulation A can be seen from the following table. Sources: 1973 SEC ANNUAL REP. 166; 1974 SEC ANNUAL REP. 171:

	1961-70 Annual Average		Fiscal Year 1974		1973		1972		1971	
Size:	% of Total	No.	% of Total	No.	% of Total	No.	% of Total	No.	% of Total	No.
$100,000 or less	17	120	10	40	8	69	5	52	6	54
$100,000 to $200,000	17	120	18	79	13	107	4	46	14	116
$200,000 to $300,000	65	455	15	66	12	96	11	118	51	429
$300,000 to $400,000		0	9	39	11	86	17	182	14	114
$400,000 to $500,000		0	48	214	56	459	63	689	15	123
Total	100	695	100	438	100	817	100	1,087	100	836

10. A comprehensive discussion of Regulation A can be found in Weiss, *Regulation A Under The Securities Act of 1933—Highways and Byways*, 8 N.Y.L.F. 3 (1962), and Weiss, *Highways and Byways Revisited*, 15 N.Y.L.F. 218 (1969). *See also* BLOOMENTHAL, 3 SECURITIES AND FEDERAL CORPORATE LAW ch. 5 (1975), and Loss, 1 SECURITIES REGULATION 605-34 (2d ed. 1961).

11. 17 C.F.R. § 230.257 (1975).

icy, with the suggestion that Rule 257 be rescinded.[12] The rule is actually of little use, since the information required for an offering circular, including financial statements establishing that the issuer is not unseasoned, must be filed with the SEC.[13] Despite the recommendations of *The Wheat Report*, Rule 257 has not been rescinded, and Rule 240, which also provides an exemption with no assurance of formal disclosure, has been added to the list of exemptions under Section 3(b).

RULE 240

On June 3, 1974, the Commission first proposed Rule 240.[14] It was finally adopted on January 24, 1975, and became effective March 15, 1975.[15] Like Rules 146 and 147, it is a conditional exemption, requiring compliance with a series of conditions before the exemption is available. Unlike those rules, it treats each sale separately, so that a failure to comply with all of the conditions with respect to one sale does not jeopardize the exemption for previously exempt sales. This is a major departure from the concept of "integration" of offerings into an "issue" found in interpretations of both the intrastate and private offering exemptions.[16]

12. DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS; THE WHEAT REPORT 306 (1969).
13. Rule 257, 17 C.F.R. § 230.257 (1975), provides that it is available "except as to issues specified in paragraph (a) of Rule 253" which covers both newly organized issuers and those which have not had profits from operations during at least one of the past two years. This requires delivery of financial statements to the Commission to establish that this requirement has been met by the issuer. WHEAT REPORT, *supra* note 12, at 307. Having excused qualified issuers from delivery of an offering circular, Rule 257(a) then requires the issuer to file with the Commission the information required by the provisions of Regulation A relating to the offering circular. The process is described briefly in the WHEAT REPORT, *supra* note 12, and in BLOOMENTHAL, 3 SECURITIES AND FEDERAL CORPORATE LAW § 5.13 [1] (1975).
14. SEC Securities Act Release No. 5499 (June 3, 1974), [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,804.
15. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP ¶ 80,066, adopted Rule 240, 17 C.F.R. § 230.240 (1975), CCH FED. SEC. L. REP ¶ 2358D.
16. Note 1 to Rule 240(b), 17 C.F.R. § 230.240(b) (1975), states:

> Each individual transaction effected in reliance on the rule must meet all the terms and conditions of the rule; the availability of the rule will not be affected by other transactions effected in reliance upon the rule but which do not meet all its terms and conditions.

A discussion of the integration problem can be found in Part II of this article, Carney, *supra* note 3, at 166-73; and *see* Shapiro & Sachs, Finally, like Rule 147, Rule 240 does not require any formal disclosure as a condition of the exemption, but relies on the antifraud provisions of the Act to protect investors.[17]

In the release introducing the proposed rule, the Commission expressly recognized two important factors: first, that state securities laws have a place to play in the protection of investors, and second, that even in small offerings by small issuers, the private offering exemption (with or without Rule 146) may not be available to the issuer.[18] The release also noted that the intrastate offering might not be available for some small offerings.

The release also stated that in cases covered by Rule 240 full registration is both uneconomical and unnecessary, which implied that the Regulation A process was also too costly and burdensome in such small offerings.[19] By its total absence of any formal disclosure requirements, where such offerings are also exempt from state regulation, the implication seemed to be that the rigorous disclosure standards which have developed have become "overkill" for small offerings.

A. *Issuer Exemption*

Like Rules 146 and 147, Rule 240 is available only for issuers; shareholders attempting a secondary offering will

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Integration Under the Securities Act: Once an Exemption, Not Always . . . ., 31 MD. L. REV. 3 (1971); Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 WEST. RES. L. REV. 110 (1964); and BLOOMENTHAL, 3 SECURITIES AND FEDERAL CORPORATE LAW § 4.14[5] (1975).

17. Preliminary Note 1 to Rule 240, 17 C.F.R. § 230.240 (1975), states:

> Rule 240 relates to transactions exempted only from section 5 of the Act by section 3 (b) of the Act. It does not provide an exemption from the anti-fraud provisions of the federal securities laws or from the civil liability provisions of section 12(2) of the Act or other provisions of the federal securities laws.

18. SEC Securities Act Release No. 5499 (June 3, 1974), [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,804, at 84,179—84,180. While Rule 240 appears to rely to some extent on state securities laws to require disclosure, noting in the rule assures that such disclosure will take place. For example, the Wyoming Blue Sky Law provides for registration by coordination of offerings for which a filing has been made under Section 3(b) of the Securities Act of 1933, obviously contemplating Regulation A filings. Wyoming Uniform Securities Act, WYO. STAT. § 17-117.9(a) (1957). Further, some Rule 240 offerings may be small enough to fit within various limited or private offering exemptions available under state law. *See, e.g.*, Wyoming Uniform Securities Act, WYO. STAT. § 17-117.14(b) (9) (1957). Thus offerees may be left with the anti-fraud provisions of both state and federal law as their only protection. *See also* Preliminary Note 1 to Rule 240, *supra* note 17.

19. SEC Securities Act Release No. 5499 (June 3, 1974), [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,804, at 84,180.

have to look to other exemptions.[20] The rule expressly provides that it applies only to "transactions by an issuer" involving the issuer's own securities.[21] Thus it is a transactional exemption, and does not exempt the securities themselves from the registration obligations of the Act.[22]

Rule 240 defines "securities of the issuer" to include "all securities issued by the issuer and by any affiliate of the issuer."[23] "Affiliate" of the issuer includes persons directly or indirectly, or through intermediaries, which control the issuer, are controlled by the issuer, or are under common control with such person.[24] This broadening of the definition of "securities of the issuer" to include those of affiliates has the

20. Rule 240, 17 C.F.R. § 230.240 (1975), Preliminary Note 4 states:

> The rule is available only to the issuer of the securities and is not available to affiliates or other persons for resales of the issuer's securities. The rule provides an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves. The securities acquired in a transaction effected in reliance on the rule are unregistered securities and are deemed to have the same status as if they were acquired in a transaction pursuant to section 4(2) of the Act.

21. Rule 240(b), 17 C.F.R. § 230.240(b) (1975).
22. Section 3(b) authorizes the Commission to exempt "any class of securities", and thus permits exemptions for classes, not transactions. The result of this approach is that securities offered under Regulation A can be resold freely by purchasers without any registration obligation. In contrast, purchasers under the private offering exemption are treated as underwriters if they resell to the public. Under Rule 240, as will be pointed out *infra*, the securities themselves are not treated as exempt, but as "restricted" securities, in the same manner as securities sold in a private offering transaction. Thus, through its use of conditions, the Commission has converted the Section 3(b) exemption from one for a class of securities to a transactional exemption.
23. Rule 240(a)(1), 17 C.F.R. § 230.240(a)(1) (1975).
24. Rule 240(a)(2), 17 C.F.R. § 230.240(a)(2) (1975). As originally proposed, Rule 240 would have included in the definition of securities of the issuer all securities issued by any predecessor. Proposed Rule 240(a)(1) (June 5, 1974), 255 BNA SEC. REG. & L. REP. D-3. This approach followed the definition of predecessor in Regulation A, Rule 251, 17 C.F.R. § 230.251 (1975). The term has relevance in Regulation A only because of the "worthy offering" provisions of the Regulation, found in Rule 252(c), 17 C.F.R. § 230.252(c) (1975). With respect to limits on the aggregate amount in Regulation A, they are determined only with respect to the issuer and its affiliates. Thus, a person who has sold a business to those now in control and has taken cash or debt obligations as consideration will not be included in determining the aggregate amount to be sold either under Regulation A or Rule 240. In deleting predecessors from those included in determining aggregate amounts, the Commission explained that "inclusion of predecessors . . . would be unduly restrictive in view of the purpose of the rule and the other conditions on the availability of the rule. However, if, for example, an issuer liquidates and forms a new corporation for the purposes of repeated use of the rule, the exemption provided by the rule would be unavailable." SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED SEC. L. REP. ¶ 80,066, at 84,947. The Commission has recognized that it is not necessary to burden general rules with specific provisions designed to prevent the isolated abuse; such abuses can be dealt with on a case-by-case approach.

effect of limiting the availability of the exemption, especially with reference to limited partnerships, which were included in the rule for the first time in the final version. In the accompanying release the Commission explained that it had decided it should not single out one form of business organization for less favorable treatment,[25] but at the same time it provided an automatic integration rule for all securities of limited partnerships with common or affiliated general partners.[26] Thus the rule has the effect of preventing a realtor or any other individual from promoting a series of small limited partnerships for investment in local real estate, where the equity in each is less than $100,000. At the same time, promoters of larger limited partnerships, either in oil and gas or cattle, utilizing other exemptions, such as Rules 146 and 147 will not suffer from the same integration test, since in those cases the limited partnership, once formed, is deemed to be the issuer, and integration will not occur because of a common general partner or promoter.[27] Regulation A also treats the real estate limited partnership as the issuer and expressly allows multiple offerings by affiliated limited partnerships organized for theatrical and real estate ventures.[28]

The result of this integration of offerings of related issuers, at least in the area of tax shelter offerings structured as limited partnerships, may be to cause these offerings, even when small, to use Rule 147, which contains no such integration provision.[29] In view of recent litigation concerning the tax status of limited partnerships, it is possible that limited

25. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066.
26. Rule 240(a)(1), 17 C.F.R. § 230.240(a)(i) (1975), includes in "securities of the issuer", "[s]ecurities issued by partnerships with the same or affiliated general partners and fractional undivided interests in oil or gas rights created by the same or affiliated persons . . . ."
27. *See* the discussion of integration of limited partnership offerings, Carney, *Part II*, *supra* note 3, at 175-77.
28. Rule 254(d)(5), 17 C.F.R. § 230.254(d)(5)(1975), includes in securities which need not be included in computing the maximum amount available under Regulation A:

> In the case of an offering of interests in an unincorporated issuer organized to hold title to, lease, operate or improve specific real property, interests in any affiliated issuer organized to hold title to, lease, operate or improve other specific real property.

Rule 254(d)(4), 17 C.F.R. § 230.254(d)(4) (1975), gives similar treatment to interests in affiliated unincorporated theatrical productions.
29. *See* the discussion of the use of multiple limited partnerships with common sponsorship in Part II of this article. Carney, *supra* note 3, at 175-78.

partnerships may no longer provide an attractive vehicle for this type of offering.[30]

Counsel for the issuer in a Rule 240 transaction must examine all of those who might reasonably be treated as affiliates to determine if they have issued securities in connection with any unrelated transactions during the past twelve months, or whether they are likely to do so in the future. For example, is the company president organizing a small and entirely unrelated real estate syndicate, or is the major stockholder also involved in syndicating a small oil and gas venture? There seems little reason to include unrelated ventures of promoters or principals of a small business in the "securities of the issuer", but that is the approach of the rule, and it seems fair to state that it will prove a trap for some issuers. The purposes of the Securities Act would have been just as well protected by integration of only those securities of affiliates which could be treated as part of a "single plan of financing" by promoters, and thus part of a single related enterprise.

Except for registered investment companies,[31] Rule 240 as adopted contains no limit on the type of issuers which can utilize the exemption—a welcome step away from the "merit" type of approach first proposed, which would have excluded

30. On October 21, 1975, the U.S. Tax Court in an *en banc* decision in the case of *Larson v. Commissioner*, 65 T. C. No. 10 (1975), held that two limited partnerships validly formed under the laws of the State of California constituted associations taxable as corporations. The court subsequently withdrew the opinion for reconsideration. Language in the decision as originally issued may well be relied upon by the Internal Revenue Service as support for the proposition that limited partnerships of the type being currently offered more closely resemble the corporate form of organization and are, therefore, taxable as such.

State of California Commissioner of Corporations, Release No. 44-C (Nov. 13, 1975), 1 CCH BLUE SKY L. REP. ¶ 8691.

The California Commissioner and the Illinois Securities Commissioner, (Nov. 14, 1975), 1A CCH BLUE SKY L. REP. ¶ 16,803, now require a warning to investors concerning this development. The opinion has been withdrawn from the reports of the Tax Court, but a description of the opinion indicates that it contained dicta broad enough to cover all limited partnerships formed under the Uniform Limited Partnership Act as tax shelters in the currently used form, and not just those formed under the peculiar version of the ULPA which now exists in California. *See* 326 BNA SEC. REG. & L. REP. A-4 (Nov. 5, 1975). The California variations on the ULPA are found in CAL. CORP. CODE §§ 15501.1, 15520, 15520.5, 15525.5 and 15532 (West Supp. 1975). After this article went to press, the Tax Court reversed its earlier position and held that the partnership in question should be treated as a partnership. Larson v. Commissioner, 66 T.C. 21 (1976).

31. Rule 240(b), 17 C.F.R. § 230.240(b) (1975), excludes registered investment companies.

limited partnership interests.[32] The explanation for exclusion of limited partnership interests in the release proposing the rule was based on the Commission's belief that the potential for abuse in limited partnership offerings was great.[33] Why fractional undivided interests in oil or gas rights were not also excluded at that time was not explained, since it would seem that they are equally subject to abuse. This exclusion was dropped when the rule was finally adopted.[34] The Commission rejected another "merit" approach when it did not require any minimum offering price for securities sold, a possibility mentioned in the initial release proposing the rule.[35] Unlike Rule 146, there are no suitability requirements imposed on investors, making it possible to utilize Rule 240 to sell all of an offering to a few unsophisticated investors who cannot afford to bear the risk of the investment. Why the Commission has departed so drastically from the approach of Rule 146 is not explained, except in terms of the small size of the offering and a reference to state securities laws.[36] Careful issuers under Rule 240 should assure themselves that the purchasers of any large amount of an offering are either reasonably experienced business or professional people with some investment experience, or are able to bear the risk of the investment. In this way issuers and officers can reduce the possibility of subsequent fraud claims from

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32. Proposed Rule 240(b) provided:

> (b) *Use of the Rule.* The rule is not available for offers or sales of any interests in a limited partnership, whether such interests are offered or sold prior or subsequent to the formation of the partnership.

SEC Securities Act Release No. 5499 (June 3, 1974), 255 BNA SEC. REG. & L. REP. D-3.

33. SEC Securities Act Release No. 5499 (June 3, 1974), [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,804, at 84,180.

34. Proposed Rule 240(b) did not appear in the final rule. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066, at 84,948, explained:

> The Commission has decided that it should not single out this one form of business organization, and therefore has revised the rule to make it available to all issuers of securities other than investment companies . . . .

35. SEC Securities Act Release No. 5499 (June 3, 1974), [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,804, at 84,180, mentioned that "The Commission is also considering the desirability of adding a condition restricting the availability of the proposed rule to securities with a minimum offering price, such as $1 or $5, in order to avoid the possibility of widespread distributions of 'penny stock' sold pursuant to the rule."

36. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066, at 84,946.

inexperienced purchasers likely to be too sanguine about their investment.

B. *Manner of Offering*

Like Rule 146, Rule 240 places certain restrictions on the manner of offering.[37] Rule 240(c) provides that the securities shall not be offered or sold by means of general advertising or general solicitation.[38] The Commission explained that this was designed to limit sales to persons who have some knowledge of or reason to know each other in order to keep the character of the offering limited.[39] In some respects this appears to be a return to the "subjective" approach to private offerings, alluded to in *Ralston Purina*,[40] which looked in part to whether the issuer had made an advance determination to limit the offering to a group which was reasonable in size and the identity of which gave some indication that the offerees could "fend for themselves." Any such approach to Rule 240 will represent a step backward toward the pre-Rule 146 approach to private offerings, not a step toward clarity and certainty for small issuers.

Unlike Rule 146, Rule 240 prohibits the use of compensated intermediaries in an offering. Rule 240(d) provides:

> No commission or similar remuneration shall be paid or given directly or indirectly for soliciting any prospective buyer or in connection with sales of the securities in reliance on this rule.[41]

37. SEC Securities Act Release No. 5499 (June 3, 1974), [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,804, 84,181.

38. 17 C.F.R. § 230.240(c) (1975). Contrast these restrictions with those of Rule 257 under Regulation A, which also allows sales without use of any disclosure documents, and allows general advertising of a "tombstone" type. 17 C.F.R. § 230.257(b) (1975). Would it be possible for an issuer to rely on Rule 257 for the first $50,000 of an offering and engage in such advertising, and rely on Rule 240 for the balance? How much of a waiting period would be required before beginning the latter half of the offering? Presumably the Commission would regard such an attempt as a "transaction . . . which, although in technical compliance with the rule, [is] part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration is required." Preliminary Note 5, Rule 240, 17 C.F.R. § 230.240 (1975).

39. SEC Securities Act Release No. 5499 (June 3, 1974), [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,804, 84,181.

40. SEC v. Ralston Purina Co., 346 U.S. 119, 123-25 (1953).

41. 17 C.F.R. § 230.240(d) (1975).

The Commission noted that this was similar to the prohibition contained in many state limited or private offering exemptions and that it was intended to assure that securities are not sold using high pressure tactics through organized distribution media.[42] Obviously the Commission is concerned that some "boiler room" operations might develop which would specalize in small issues.

The appropriate place to deal with fraudulent sales techniques by brokers is in regulations dealing with brokers rather than issuers. Responsible broker-dealers can be extremely useful in placing investments with suitable investors, but may be precluded from doing so in cases where Rule 240, rather than Rule 146, is relied upon. The prohibition will probably cause little concern for most small issuers utilizing Rule 240 since few underwriters will be interested in offerings of this size. It is only in the case of preliminary financing of enterprises which may go public in the future that this restriction may cause problems, and it may be that interested underwriters will forego commissions on the first $100,000 which they may place for such issuers in anticipation of the larger financing they hope will follow. The only question in such cases will be whether the various sweeteners which underwriters might obtain at this stage will be considered as commissions—cheap stock, options, commitments to use the underwriter in the future, etc. There seems little justification for prohibiting such forms of compensation, since they are not forms likely to be used by boiler room operations attempting to flood the market with worthless securities, but forms which would be used by reputable underwriters interested in the longer term future of their relationship with the issuer.

Other than such prohibitions on the use of marketing techniques designed for public offerings, the Commission has imposed no constraints on the manner in which securities may be offered under the rule. One observer describes Rule 240 as authorizing the "almost-public offering", since no

42. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066, at 84,948.

limits are placed on the number of offerees or their qualifications.[43] In this respect the offering will be more like a limited offering under state law than the type of private offering envisaged by the Supreme Court in *Ralston Purina.*[44] The limited offering exemption of Section 227(b) of the ALI Federal Securities Code may have served as a pattern for Rule 240, in part, since it too contains no requirements concerning offerees other than a numerical limit of 35 on buyers other than institutions.[45] However, Rule 240 departs from the pattern of Section 227(b) in prohibiting general solicitations.

C. *Limit on Amount Sold*

By limiting the aggregate amount which can be sold in reliance on Rule 240 to not more than $100,000 in the preceding twelve months,[46] the rule assures that any transactions undertaken under its provisions will be relatively small. The rule, like Rule 146, is phrased in terms of sales, not offers, thereby eliminating much of the uncertainty which formerly existed under the private offering exemption and which still exists under the intrastate offering exemption, even after adoption of Rule 147.[47] Whether, like Rule 146,

43. Kessler, *Private Placement Rules 146 and 240—Safe Harbor?* 44 FORD. L. REV. 37, 70 (1975). This is confirmed in Ovation Cosmetics, Inc., [Transfer Binder 1975-76 Decisions] CCH FED. SEC. L. REP. ¶ 80,450 (SEC Div. Corp. Fin. Feb. 6, 1976).

44. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

45. ALI FED. SEC. CODE § 227(b) (Reporter's Revision of Tent. Drafts Nos. 1-3, Oct. 1, 1974), defines a limited offering as follows:

> (1) A "limited offering" is one in which the following conditions are satisfied: (A) the initial buyers of the securities are institutional investors or not more than thirty-five other persons or both; (B) resales of any of the securities to persons other than institutional investors within three years after the last sale to any of the initial buyers other than institutional investors do not result in more than thirty-five owners of those securities (apart from any institutional investors and persons who become owners otherwise than by purchase) at any one time, unless the resales are pursuant to an offering statement, a distribution statement, or an exemption; and (C) the original offeror and all sellers in such resales comply with any rules adopted under paragraph (4).

Subparagraph (4) gives the Commission the authority to require precautions against resales of the type required by Rule 240(g), discussed hereinafter.

46. Rule 240(e), 17 C.F.R. § 230.240(e) (1975).

47. *See* the discussion of offers in Part I of this article, Carney, *supra* note 3, at 541 n.111. The difficulties with an "offer" approach to the intrastate offering exemption under Rule 147 are discussed in Carney, *Part II*, *supra* note 3, at 202-04. A question could arise concerning the validity of a limit only on dollars of sales, rather than offers, as provided in Section 3(b), but this should cause no serious concern to issuers, which will be protected from liability by the provisions of Section 19(a) of the Securities Act, 15 U.S.C. § 77(s)(a) (1970).

Rule 240 will allow offers to the public depends on how restrictively the Commission interprets its requirement of no general solicitation, which could create a trap for the unwary in this area.[48] Leaving this question aside, counsel for issuers must focus on which securities will be included and excluded in making calculations of amounts sold, and at what price securities are sold in transactions other than for cash.

1. Securities To Be Included in the Amount

The approach of Rule 240 is roughly the opposite of that of Rules 146 and 147, since Rule 240 requires inclusion of all securities of the issuer issued within the relevant time period.[49] In contrast, Rules 146 and 147 allow the sale of different classes of securities at the same time without impairing the exempt nature of the transaction.[50]

The amount of securities which may be sold under the exemption includes all sales within the twelve months preceding the point in time immediately after the last sale under the rule.[51] This includes not only amounts sold under Rule 240, but sales "otherwise without registration under the Act."[52] The rule excludes from the calculation sales to certain classes of purchasers, such as promoters, and sales of purchase money mortgages and other sales to financial institutions.

The exclusion for promoters is phrased in terms of sales, many of which will probably be made without registration under the private offering exemption, to any promoter, director, executive officer or full-time employee. The danger is not that integration of these sales will destroy the Rule 240 exemption, but that sales made under Rule 240 will destroy

48. *See* the discussion of this problem in the text accompanying note 38.
49. Rule 240(a)(1), 17 C.F.R. § 230.240(a)(1)(1975), defines "securities of the issuer" as including "all securities issued by the issuer and by any affiliate of the issuer." Specific exceptions are then made for other sales, as discussed in the text which follows.
50. Rule 146(b)(1), 17 C.F.R. § 230.146(b)(1)(1975), applies the integration rules only to sales of "securities by or for the issuer of the same or similar class as those offered." Rule 147(b)(2), 17 C.F.R. § 230.147(b)(2) (1975), contains the same language. Rule 240(e), 17 C.F.R. § 230.240(e) (1975), refers to the "aggregate sales price of *all* sales of securities of the issuer . . . ." (Emphasis added).
51. Rule 240(e), 17 C.F.R. § 230.240(e) (1975).
52. Rule 240(e), 17 C.F.R. § 230.240(e) (1975). Registered securities are excluded under Rule 240(e)(1).

the exempt nature of the earlier sales. The safest course for an issuer selling to the promoter group is to carefully utilize Rule 146 or Rule 147 for such sales and to wait the six-month "safe harbor" provided by paragraph (b) of Rules 146 or 147 before making any sales to outsiders under Rule 240.[53]

If the issuer cannot wait, the Commission will apply the traditional integration tests to determine whether the prior offering remains exempt in the light of the Rule 240 offering.[54] Where the prior sales were to a promoter group for consideration other than cash, such as assets and services, the issuer may be able to risk not waiting for the six month period to expire, since this will assist in separating the promoter sales from Rule 240 sales for cash. Indeed, a well-planned transaction might involve having the promoter group enter into a pre-incorporation agreement by which it utilizes the cash which it might otherwise have used to purchase shares for the purpose of acquiring assets which will be exchanged for stock. In addition, the issuer should consider the use of common stock solely for the promoter group and some other and distinct class of securities for the outsiders purchasing in the Rule 240 transactions. If convertible securities are used, they should not be immediately converti-

53. Rule 146(b)(1), 17 C.F.R. § 230.146(b)(1) (1975), provides that:

> For the purposes of this rule only, an offering shall be deemed not to include offers . . . that take place prior to the six-month period immediately preceding or after the six-month period immediately following any offers, offers for sale or sales pursuant to this rule, *provided*, that there are during neither of said six month periods any offers . . . of securities by or for the issuer of the same or similar class as those offered . . . pursuant to the rule.

Rule 147(b)(2) is substantially identical. 17 C.F.R. § 230.147(b)(2) (1975).

54. Preliminary Note 6 to Rule 240, 17 C.F.R. § 230.240 (1975), states:

> While a transaction may be exempt pursuant to Rule 240, the same transaction may be part of a larger issue of securities and may affect the availability of a different exemption for other transactions which are a part of such larger issue. See Securities Act Release No. 4552 (November 6, 1962) concerning the integration of transactions.

In recent correspondence concerning the exclusion of sales to the promoter group from Rule 240 and the warning about integration to destroy another presumably exempt sale to promoters, the inquiring party suggested that the Commission could not intend to integrate with a previous "private" offering, since to do so would effectively destroy or drastically limit the availability of Rule 240. The staff response stated the contrary: "In order to determine the availability of an exemption under Sections 3(a)(11) or 4(2), consideration must be directed to whether the transaction is an integral part of the offering purporting to rely on Sections 3(a)(11) or 4(2)." The reply specifically excluded Rules 146 and 147 from its discussion. Morrison & Foerster (July 30, 1975), CCH FED. SEC. L. REP. ¶ 80,265.

ble; if preferred stock is used, care should be taken that its rights are sufficiently distinct from those of the common stock.[55]

In calculating the aggregate sales price, all sales made within the preceding twelve months must be included.[56] The note to the rule illustrates the operation of the limitation by assuming an initial sale on June 1, 1975, of $50,000 of the issuer's securities, followed by an additional sale of $25,000 on September 1, 1975. Thereafter the issuer could only sell an additional $25,000 up to and including May 31, 1976. But on June 1, 1976, the sale on the prior June 1 would be excluded from the calculation, and if no sales had taken place since September 1, the issuer could sell $75,000 of its securities.[57] For an issuer continuing to rely on Rule 240 for exempt sales, this approach is little different from the approach of the proposed rule, which limited sales to $100,000 during any consecutive twelve month period.[58] But if the issuer should wish to raise larger amounts of capital under Rule 146 or 147 offerings, the consecutive twelve month approach would have required a twelve month wait after the last sale under Rule 240 before the first sale under either Rule 146 or 147, while use of the preceding twelve month approach means an issuer must only abstain from sales and offers for the six months required by those rules.[59] If an issuer should decide to make a Regulation A offering, all sales in the preceding twelve months will be integrated with the Regulation A offering, since Regulation A requires inclusion of all sales made under Rule 240 within the past year.[60]

55. Securities which are convertible into another security are deemed continuing offers of the security into which they are convertible at all times while the conversion rights exist, but not prior to such time. Great Western United Corp., [Transfer Binder 1971-72 Decisions] CCH FED. SEC. L. REP. ¶ 78,425 (SEC. Div. Corp. Fin. Sept. 8, 1971). *See also* H. R. REP. No. 85, 73d Cong., 1st Sess. 11 (1933).
56. Rule 240(e), 17 C.F.R. § 230.240(e) (1975).
57. Note 1, Rule 240(e), 17 C.F.R. § 230.240(e) (1975).
58. Proposed Rule 240(f), SEC Securities Act Release No. 5499 (June 3, 1974), 255 BNA SEC. REG. & L. REP. D-1, D-3.
59. 17 C.F.R. §§ 230.146(b)(1), 230.147(b)(2) (1975).
60. Securities Act Rule 254, 17 C.F.R. § 230.254 (1975). Rule 254(a)(1) provides that the aggregate offering price of all securities of the issuer sold pursuant to Regulation A "and any other securites offered or sold within one year prior to the commencement of the proposed offering pursuant to any other exemption under Section 3(b) of the Act" shall be counted toward the limits under the Regulation. This automatic integration of all offerings

Perhaps the most helpful feature of the rule with respect to the securities to be included in the determination of the amount is the fact that subsequent transactions will not destroy the exemption, once available. The aggregate amount is determined with reference to past sales, and there will be no integration with future sales which will destroy the exemption. In this respect the rule is somewhat similar to the exclusion of registered public offerings in Rule 152, except that Rule 240 excludes any kind of subsequent transaction.[61] This renders it an attractive route for financing preliminary to a public offering.[62]

Once the issuer is past the organizational stage and the exclusions from the aggregate amount which are permissible have been determined by an attorney, the limitations on the amount sold should be understandable by most corporate officials; these officials should then be able to comply with the rule without constant supervision of an attorney—a significant advantage over Rules 146 and 147. For small issuers, it is appropriate that legal costs be kept to a minimum during the period when relatively small amounts of capital are needed, although planning for future capital needs may require considerable legal effort at an early stage.

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within one year is not required by Section 3(b), which only requires that "no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $500,000." Nothing would preclude the Commission from adopting a six month test for integration, as it has in Rules 146 and 147.

61. Securities Act Rule 152, 17 C.F.R. § 230.152 (1975), provides:

> The phrase "transactions by an issuer not involving any public offering" in section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement.

One article points out that this protection may not be available for preliminary financing where the issuer already contemplates the later registered public offering, since the two offerings will then be treated as a "single plan of financing" and the first offering will not be exempt when made. Shapiro & Sachs, *supra* note 16, at 17-18. In contrast, Rule 240(e) looks backward to determine the availability of the exemption based on past sales, and Note 2 to paragraph (e) makes clear that a subsequent transaction in violation of the rule does not jeopardize the exempt nature of the earlier transactions. The note contains no reference to whether separate transactions are part of the same "issue" or plan of financing.

62. The staff approved use of Rule 240 as a preliminary financing device, to be followed by a Regulation A offering of the remainder of the $500,000 available, in DCOM Indust., Inc., 335 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Jan. 5, 1976).

Even where the Rule 240 transactions themselves seem manageable for corporate officials after initial guidance, they may affect the availability of other exemptions for subsequent transactions, as was pointed out by one of the preliminary notes to the rule.[63] For example, if a private offering is later made under Rule 146 before the passage of six months from the last Rule 240 sale, sales which are exempt under Rule 240 may be integrated with the Rule 146 sales, and may destroy the Rule 146 exemption for the subsequent sales. A similar result can occur for subsequent intrastate offerings under Rule 147.[64]

A problem which may occur with even greater frequency involves an exempt private offering, not pursuant to Rule 146, to the promoters of the company, who may take their shares either for assets, cash or past services, followed by a Rule 240 transaction to raise additional cash. While the sales to promoters will be excluded in calculating amounts of sales under Rule 240(e)(2)(ii), this will not prevent the integration of the Rule 240 sales with the earlier sales to the promoters and the destruction of the exempt nature of the sale to the promoters; this would allow the promoters to rescind, using the funds of the Rule 240 investors to bail themselves out, if the enterprise fails quickly and some funds are left. Such a result would obviously be absurd, but it is at least theoretically possible under present law.[65] Hopefully courts would avoid such an absurdity by refusing to integrate the transactions, even though some of the integration tests described in Part II of this article are met, on the theory that on balance they are not part of the same issue.[66]

Another difficult problem could arise in the case of issuers planning preliminary financing under the rule or a

63. Preliminary Note 6, 17 C.F.R. § 230.240 (1975).
64. John J. Hentschell, 304 BNA SEC. REG. & L. REP. C-2 (SEC Div. Corp. Fin. May 28, 1975).
65. This analysis assumes that the defense of *in pari delictu* would not be available to the company, either because the promoter requesting rescission was not culpable at the time he took his shares, since he believed in good faith at the time that the transaction was exempt, or because the courts will decline to allow an issuer who violates the registration requirements of Section 5 to assert the defense, as suggested in Woolf v. S. D. Cohn & Co., CCH FED. SEC. L. REP. ¶ 95,223 (5th Cir. 1975), at 98,158—98,159.
66. *See* Carney, *Part II*, *supra* note 3, at 164-73.

series of Rule 240 offerings in successive years. The rule provides that its exemption is not available for offerings which constitute part of a plan or scheme to evade registration.[67] The examples given are of little assistance, since they involve successive use of the rule by a single general partner forming a series of limited partnerships, by a single promoter selling separate offerings of fractional undivided interests in oil and gas rights,[68] or an issuer which liquidates and forms a new corporation for repeated use of the rule.[69] All but the last of these examples are covered by the specific provisions of the rule governing which securities are to be treated as "securities of the issuer".[70] Recent no-action correspondence by the Commission Staff indicates that the rule will not be applied narrowly to exclude offerings which are planned to be a preliminary financing for a subsequent public offering.[71]

2. Securities To Be Excluded From the Amount

Rule 240 departs from the general approach of regulations under the Securities Act to integrate a series of transactions into one "issue" whenever those transactions bear a relationship to each other.[72] Rule 240 expressly allows exclusion of a number of types of sales of securities in calculat-

67. Preliminary Note 5, 17 C.F.R. § 230.240 (1975), provides:

> In view of the objectives of the rule and the purpose and policies underlying the Act, the rule is not available to any issuer with respect to any transactions which, although in technical compliance with the rule, are part of a plan or scheme to evade the registration provisions of the Act. In such cases registration pursuant to the Act is required.

68. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066, at 84,948.

69. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066, at 84,947.

70. Rule 240(a)(1) defines "securities of the issuer" to include "all securities issued by the issuer and by any affiliate of the issuer." It goes on to include "[s]ecurities issued by partnerships with the same or affiliated general partners", as discussed in the text accompanying note 26, *supra*. Where an individual sells fractional undivided interests in oil and gas rights, the individual is considered the issuer, if the individual creates the fractional interests, or, if not the landowner, if he plans to acquire the interests in a specific tract and convey out fractional interests. *SEC Statement in Compilation of Rules, Regulations, Forms and Opinions Applicable to Oil and Gas Interests, July 1, 1935*, CCH FED. SEC. L. REP. ¶ 1252.

71. *See* DCOM Indust., Inc., 335 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Jan. 5, 1976), in which the staff approved the issuance of promissory notes under Rule 240, to be followed by a Regulation A offering of similar notes within twelve months of the offering.

72. *See* the discussion in Part II of this article, Carney, *supra* note 3, at 166-73, and articles cited *supra* note 16.

ing the aggregate amount.[73] Why the Commission chose to depart from this method (also used in Regulation A, which includes all securities sold within the preceding twelve months, except pursuant to a registration statement[74]) is not explained.

The exclusions are basically transactional in nature. All securities sold prior to the effective date of the rule, March 15, 1975, are excluded if the sales were either registered or exempt from registration.[75] In many instances this may bring the integration rules into play to determine whether the exempt nature of the previous offering will be destroyed by the subsequent Rule 240 transactions. This problem will rapidly disappear, and, in the future, all sales within the previous twelve months must be included if not made in a registered offering, unless otherwise excluded.

a. *Institutional investors in debt instruments.* The next exclusion shows the influence of the proposed Federal Securities Code on recent regulations. The rule excludes from the calculations of the aggregate amount nonconvertible debt instruments either representing a purchase money mortgage or sold to specified financial institutions.[76] The exclusion bears a resemblance but is not identical to the provisions of Section 227(b) of the Federal Securities Code, which permits sales to institutional investors in addition to the 35 permissible buyers.[77] Rule 240 thus gives some hint of the kinds of modifications the Commission might make by regulation in the institutional investor provisions of the Code.[78]

73. 17 C.F.R. §§ 230.240(e)(1) and (2)(1975).
74. Rule 254(a)(1), 17 C.F.R. § 230.254(a)(1) (1975), requires inclusion of all unregistered securities sold within the preceding year for purposes of calculating the amount which can be sold under Regulation A.
75. Rule 240(e)(1), 17 C.F.R. § 230.240(e)(i) (1975).
76. Rule 240(e)(2)(i), 17 C.F.R. § 230.240(e)(2)(i) (1975).
77. ALI FED. SEC. CODE § 227(b) (Reporter's Revision of Tent. Drafts Nos. 1-3, Oct. 1, 1974). *See supra* note 45.
78. Section 227(b)(3) of the Federal Securities Code, *supra* note 77, provides that the Commission may, by rule, modify the conditions or impose additional conditions on Section 227(b)(1), describing limited offerings. Professor Loss, the Reporter for the Code project, recognized that not all institutions of the same type are equally sophisticated, giving the example of large banks versus country banks. He further pointed out that the drafters of the Code expected the "Commission will make an ungrudging use of its rule-making authority." Loss, *The "Limited Offering" Under the American Law Institute's Federal Securities Code,* FOURTH ANNUAL INST. ON SEC. REG. 35, 41-42 (Mundheim, Fleisher & Schupper, eds. 1973).

One wonders why the exclusion is limited to nonconvertible debt instruments, although it could be argued that these constitute a different class of security from those typically sold by small promotional issuers. This provision is somewhat similar to, or at least not inconsistent with, the provisions of Rules 146 and 147, which apply the integration doctrine only where the same class of security is involved.[79] On the other hand, if institutional investors are sophisticated enough to be excluded, it is difficult to see why they could not also protect themselves if they purchased convertible or equity securities. Indeed, they may be better equipped to do so than the buyers of equity securities in Rule 240 transactions.[79a]

Does this provision allow institutional investors to purchase for the accounts of others who do not qualify as institutional investors? In such circumstances the rule might provide a significant opportunity to broaden the amount sold, provided another exemption were available. A bank might well serve as a trustee or agent for a group of individuals in a Rule 146 transaction. The exception in the Federal Securities Code was apparently designed to allow such sales.[80] Thus an issuer might complete a Rule 146 transaction with an institution purchasing for the account of others, wait six months for the Rule 146 safe harbor, and then begin sales under Rule 240, without counting the earlier sales in the

79. 17 C.F.R. §§ 230.146(b)(1), 230.147(b)(2) (1975).

79a. After this article went to the printer the National Venture Capital Association took the same position as the author. That association has submitted a proposal to the SEC to amend Rule 240(e)(2) and 240(f)(3) to eliminate the list of institutional investors which will be excluded in determining aggregate sales and shareholders, and replace it with the defined term "professional investor". The association's proposal would define a professional investor as any person or entity engaged wholly or partly in the business of investing in restricted securities, as defined in Rule 144. The proposal also calls for elimination of the limitation of such purchases to nonconvertible debt securities and for a non-integration rule so that such offerings to professional investors would not be integrated with Rule 240 offerings. This goes beyond the approach of the Federal Securities Code, *supra* note 77, which requires that offerings be of different classes of securities in order to avoid integration. 350 BNA SEC. REG. & L. REP. A-3 (Apr. 28, 1976).

80. Comment 3 to Section 242(a), defining institutional investors, states:

> It is implicit in § 242(a) that banks and insurance companies are institutional investors whether buying for their own accounts or for accounts under their investment management.

ALI FED. SEC. CODE § 242(a), Comment 3 (Tent. Draft No. 1, Apr. 25, 1972). Under Rule 146(g)(2)(ii), 17 C.F.R. § 230.146(g)(2)(ii) (1975), in some cases the individual beneficiaries of such a trust would have to be counted as separate purchasers.

aggregate amount. As a practical matter there is no reason why the rule should not allow such a procedure, since Rule 146 provides amply for protection of the earlier investors; however, the rule is not clear in this respect and should be clarified. Another aspect of this problem is whether the bank or other institution could assign the debt instruments which it had purchased in a "private offering" transaction to another noninstitutional investor without forcing the issuer to include those notes in the aggregate amount under the rule.

In the case of many small new issuers this exclusion will be of little assistance, absent inducements such as warrants or conversion rights, since lenders are normally not eager to extend large amounts of credit to new corporate enterprises, unless guaranteed by various individuals in the enterprise.[81] The exclusion may provide the opportunity for small real estate syndicates to utilize the rule. If a syndicate is able to obtain 80 or 90 percent mortgage financing on income property, as is often the case, syndicates may be able to finance the purchase of properties worth up to $1,000,000 relying on the exemption. This assumes that the promoters are not investing substantial amounts of their own; if they are, the size of the syndicate may be increased by an amount equal to the promoters' investment plus the amount of debt financing which can be obtained because of it. This represents a conscious shift from the proposed version of the rule, which excluded only notes issued to commercial banks, which are not necessarily the most important real estate lenders.[82]

b. *Promoters, directors, officers and employees.* Rule 240(e)(2)(ii) excludes from the computation of the dollar amount "Securities sold to any promoter, director, executive officer, or full-time employee."[83] This exclusion solves one

81. A note to Rule 240(e)(2)(i) provides that:
> The exclusion set forth in this subparagraph does not apply to arrangements where nonconvertible notes are issued with warrants or other rights enabling the purchaser to acquire an equity interest in the issuer.

82. Proposed Rule 240(f)(1), SEC Securities Act Release No. 5499 (June 3, 1974), 255 BNA SEC. REG. & L. REP. D-4, allowed exclusion only of "Notes or similar evidences of indebtedness issued to a commercial bank."

83. These purchasers are excluded only for purposes of calculating dollar amounts, but must be included in determining whether the issuer complies with the limitation of subparagraph (f) of the Rule. Note, 17 C.F.R. § 230.240(e)(2)(ii) (1975).

potential problem which has created difficulties both under Regulation A and under the antidilution provisions of many blue sky laws—the valuation of promoters' securities issued for services or assets.[84] No explanation is given why the approach of Regulation A was not followed. Regulation A includes all securities sold within the preceding twelve months in the calculation, whether or not sold to promoters.[85] Where unseasoned companies are involved in a Regulation A offering, all promoters' securities issued for assets or services are included in the amount offered unless placed in escrow.[86] No such restrictions are imposed as a condition to the use of Rule 240, which will also be used by unseasoned companies.

One ambiguity has crept into the drafting of the exclusion for promoters' shares. While it is clear that shares issued to promoters are to be excluded, the definition of "promoter" has been somewhat confused in the rule, possibly through a typographical error. Rule 240(a)(4) defines promoter to include, in addition to those who take the initiative in founding and organizing the issuer,

> (ii) any person who, in connection with the founding or organizing of the business or enter-

84. Section 306(a)(2)(F) of the Uniform Securities Act, CCH BLUE SKY L. REP. ¶ 4926, authorizes state securities commissioners to deny registration where the offering would be made with unreasonable amounts of promoters' profits or participation. *See* WYO. STAT. § 17-117.12(a)(2)(F)(1957). *See also Statements of General Policy of Midwest Securities Commissioners Association on Cheap Stock and on Promoters' Investment*, CCH BLUE SKY L. REP. ¶ 4761 and ¶4771.

85. Rule 254(a)(1), 17 C.F.R. § 230.254(a)(1) (1975), requires inclusion of all securities sold within the preceding year for purposes of calculating the amount which can be sold under Regulation A. Rule 254(b) and (c) contains provisions for calculating the value of securities sold. Promoters' securities are to be valued at the public offering price, where market value of the securities is not determinable, and where the securities are not issued for cash.

86. Rule 253, 17 C.F.R. § 230.253 (1975), applies to issuers which either (1) have been incorporated or organized within the past year and have not had income from operations, or (2) have been incorporated or organized more than one year, and have not had net income from operations of the type in which the issuer intends to engage for at least one of the past two fiscal years. In such cases, in computing the amount available under Regulation A, which normally covers only the past twelve months under Rule 254, there must be added to such securities, all securities issued for consideration other than cash to persons still holding them, and all securities issued to any director, officer or promoter of the issuer, or to any underwriter, dealer or security salesman, regardless of the date on which such securities were issued, unless the holders agree to place these securities in escrow for a period of one year after the commencement of the Regulation A offering. Rule 253(c), 17 C.F.R. § 230.253(c) (1975).

> prise of the issuer, directly or indirectly receives in consideration of services or property, 10 percent or more of the *proceeds* from the sale of any class of securities.[87]

The unusual feature of this definition is that it does not include as promoters those who actually receive shares, but only those who receive proceeds from shares. In this context, it has omitted the principal form of compensation which promoters usually take, and thus has omitted from the definition many persons normally regarded as promoters of the enterprise. Indeed, receipt of cash at the organizational stage is fairly unusual, and this definition seems aimed more at underwriters than at typical promoters of small new enterprises.

The matter is further confused by the synopsis of the rule provided in Release 5560, which states that:

> A definition of "promoter" based on that in Rule 251 of Regulation A under the Act has been added to the rule since the term "promoter" is now used in paragraph (e) in identifying persons whose transactions are excludable from the calculation of the aggregate sales price of securities sold if such transactions are made in reliance on an exemption other than the rule.[88]

The definition of a promoter in Rule 251 includes not only persons receiving proceeds from the sale of any class of securities, but also any person who receives "10 percent or more of any class of securities of the issuer."[89] This definition, aside from fitting traditional notions of a promoter, would have the virtue, if applied to Rule 240, of being logically more consistent and of simplifying the calculations of the aggregate amount of the issue. One can only hope that the SEC will amend Rule 240 to bring it into line with the definition in Rule 251.

87. Rule 240(a)(4), 17 C.F.R. § 230.240(a)(4) (1975) [emphasis added].
88. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066.
89. Rule 251, 17 C.F.R. § 230.251 (1975).

If securities are sold for consideration other than cash, such as assets or services, to one who does not qualify as a promoter, the shares must be included in calculating the aggregate amount, presumably at the fair market value of the consideration.[90] Under the rule an issuer's interest lies in minimizing this figure, while under the antidilution provisions of some blue sky laws, the issuer's interest lies in the other direction.[91]

The definitions of the other persons to whom sales may be made outside the dollar limitations of the rule also present some problems. While there can be little doubt about the identity of directors, can sales to their functional equivalents in unincorporated enterprises also be excluded? If an enterprise is structured as a limited partnership and has general partners who are not clearly promoters, can sales of interests to them be excluded? The term "executive officer" is defined in the rule to include "the president, secretary, treasurer, any vice president in charge of a principal business function (such as sales, administration or finance) and any other person who performs similar policy-making functions for the issuer."[92] This definition may resolve the problem of whether individual general partners in a limited partnership need be counted, since such persons should fit the definition of executive officer, if not that of a director. The rule does not define a full-time employee, although one author suggests a reasonable approach would be that of the Internal Revenue Code to pension and profit-sharing plans, which defines such employees as those working more than twenty hours a week, and not otherwise on a seasonal or part-time basis.[93]

90. Note 3, Rule 240(e). The presumption is based on the approach of Rule 254(c), 17 C.F.R. § 230.254(c) (1975), which looks to fair market value of the assets, securities, or services received by the issuer, in the absence of any direct measure of value of the issuer's securities. *See* the discussion in the text accompanying note 98, *infra*.

91. *See, e.g.*, WYO. STAT. § 17-117.12(a)(2)(F) (1957).

92. 17 C.F.R. § 230.240(a)(3) (1975). *See also* 17 C.F.R. § 240.3b-2 (1975), and Hurley, *Who Is An "Officer" for Purposes of the Securities Exchange Act of 1934—Colby v. Klune Revisited,* 44 FORD. L. REV. 498 (1975).

93. Butler, *Is It Malpractice When Counsel Fails to Rely on New SEC Rule 240 For Security Issues?* 50 L. A. BAR BULL. 291, 298 (1975).

The more difficult problem with the rule is whether offerees need occupy such positions at the time a solicitation begins, or whether they can be granted such a position in return for a large investment, and thus have the sale excluded from the computations under the rule. There is no comparable exclusion under Regulation A, other conditional exemptions from registration under the Securities Act, or the Uniform Securities Act, so little guidance exists in the area. The general categories of purchasers excluded from the computation are persons who can "fend for themselves" in purchasing securities, and who should have "access" to all the information about the issuer they require, indicating that the Commission had in mind excluding only those persons who could qualify in a private offering transaction (although nothing is said in Rule 240 about excluded securities being offered or sold pursuant to this exemption).[94] If this is the intent of the Commission, it should be clear that a person does not necessarily occupy a relationship to the issuer guaranteeing "access" merely by virtue of the fact that he obtained a directorship, a position as an officer, or full-time employment as part of the transaction in which he invested in the issuer.[95] A related problem exists where the purchaser occupied one of the specified positions at the time of his purchase, but no longer holds it at the time of the later Rule 240 offering. Such persons should be treated as being excluded from the dollar calculations under the rule, since they occupied the appropriate position and had access to information at the time they needed it—at the purchase.[96]

c. *Price calculations.* In calculating the aggregate sales price of securities which must be included in the computations under Rule 240, Note 3 to subsection (e) points out that price "would include all consideration received for the issu-

94. Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2) (1970).

95. *Contra,* Butler, *supra* note 93, who states at 298: "Attaining such a position subsequent to the purchase is evidence of a pre-existing relationship not enjoyed by many persons." For a discussion of the requisite relationship under Section 4(2) of the Act, *see* Part I of this Article, *supra* note 3. The author's position is that the employment or position as an officer or director may be part of the inducement to an outsider to purchase securities, and does not necessarily indicate any special relationship at the time the investment decision is made.

96. *Accord,* Butler, *supra* note 93, at 298.

ance of securities of the issuer, including cash, services, property, notes, or other consideration."[97] It seems likely that many of the sales involving consideration other than cash will involve promoters, so that the sales will not be counted toward the $100,000 ceiling, but the problem of valuation of noncash consideration persists. It is particularly acute with appreciated property and services. Nothing in the releases, the notes to the rule, or Commission interpretative correspondence gives any hint about the method for calculating the price in such cases.

Regulation A offers a possible approach to these problems. In view of the fact that the language of Regulation A is slightly different, referring to "aggregate offering price", while Rule 240 deals with "aggregate sales price", it may not provide conclusive guidance.[98] Nevertheless, Rule 254(c) provides guidelines: (1) where securities are being offered for cash, securities sold for other consideration will be valued at the cash offering price; (2) in the absence of cash sales of the issuer's securities, then the value of the securities shall be determined on the basis of the cash price obtained in bona fide sales of the assets or services within a reasonable time; and (3) absent any such sales, the value shall be the fair value of the non-cash consideration received.[99] Presumably the "fair value" is to be determined at the time the assets or services are transferred to the issuer, rather than at the time they came into the hands of the stock purchaser, in the case of appreciated assets, even though for tax purposes some such transferors may not recognize taxable gain on the transaction.[100] The only remaining question is the treatment of duplication. The Regulation A approach has been to eliminate duplication, as where pre-organization subscriptions are filled with the issuer's common stock, or where conversion rights are exercised. Under Regulation A,

97. Note 3, 17 C.F.R. § 230.240(e) (1975).

98. 17 C.F.R. §§ 230.254(a)(1), 230.240(e) (1975). The departure of Rule 240(e) from the statutory language, which allows the Commission to exempt issues "where the aggregate amount . . . offered" does not exceed $500,000, is discussed *supra* note 47.

99. 17 C.F.R. § 230.254(c) (1975).

100. *E.g.*, Internal Revenue Code of 1954, as amended, § 351, 26 U.S.C. § 351 (1970).

the Commission has eliminated the double charge against the ceiling.[101] The difficulty with this approach is that under Regulation A the Commission apparently treats convertible securities with immediate conversion rights as involving a concurrent offer, while Rule 240 deals with sales, and it is possible to argue that exercise of conversion rights is a separate sale.

D. *Limitation on Number of Beneficial Owners*

Paragraph (f) of the rule requires that both immediately before and after any sale in reliance on the rule, the issuer shall, after reasonable inquiry, have reasonable grounds to believe, and shall believe, that the securities of the issuer are beneficially owned by 100 or fewer persons.[102] This approach represents a substantial change from the proposed version of the rule, which also limited the number of purchasers to 25 in any twelve month period.[103] Since small issuers utilizing Rule 240 are less likely to be capable of making the kinds of disclosure contemplated under Rule 146, there was some logic in keeping the purchaser group even smaller than that allowed in Rule 146 transactions. In eliminating the limit on purchasers the Commission merely stated that with a limit on the number of owners of securities of the issuer, the limitation on number of purchasers was not necessary.[104] This paved the way for an offering and for sales to a larger group than is permitted under Rule 146, a result questioned by Professor Kessler.[105]

The change seems to indicate two new directions in SEC thinking on exempt offerings. The first is a softening of Commission attitudes about exempt offerings, and an attempt to make them more useful, perhaps in recognition of the volumes of critical comment directed at the post-*Wheat*

101. *See* Weiss, *Regulation A Under The Securities Act of 1933—Highways and Byways*, *supra* note 10, at 41-42, and Weiss, *Highways and Byways Revisited*, *supra* note 10, at 249-50.
102. 17 C.F.R. § 230.240(f) (1975).
103. Proposed Rule 240(g), SEC Securities Act Release No. 5499 (June 3, 1974), 255 BNA SEC. REG. & L. REP. D-1, D-4.
104. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066, at 84,949.
105. Kessler, *supra* note 43, at 70.

Report rules.[106] This is evidenced by the addition, through amendment in May, 1975,[107] of a "good faith" excuse for failure to comply with some of the requirements of Rule 146. That "good faith" excuse also applies to Rule 240 in the limited area of the number of beneficial owners.[108] Rule 240 has been made more workable than Rule 146 in other respects, such as qualifications of purchasers (none) and the required amount of disclosure needed to qualify for the exemption (none). While this may be logically inconsistent, it represents a welcome touch of realism for small issuers.

The second new direction which appears in Rule 240 is a trend toward the "limited offering" approach of the Federal Securities Code.[109] While the private offering exemption was concerned with the investment intent of purchasers almost exclusively prior to Rule 144, the code focuses on whether the purchasers might collectively engage in a distribution. For this reason the code looks to the ultimate number of owners of an issue, rather than to holding periods or particular resales.

Rule 240 might fairly be described as something of a compromise between the old private offering notion and the new limited offering concept of a distribution. Consistent with this approach, the staff has taken the position that once an issuer has "distributed" its securities to more than 100 persons, and has once had more than 100 beneficial owners, it cannot qualify for Rule 240 transactions at any time in the future, even if it reduces the number of beneficial owners

106. WHEAT REPORT, *supra* note 12.
107. 17 C.F.R. § 230.146(g)(1)(1975) was amended to read:

> The issuer shall have reasonable grounds to believe, and after making reasonable inquiry shall believe, that there are no more than thirty-five purchasers of the securities of the issuer from the issuer in any offering pursuant to the rule.

SEC Securities Act Release No. 5585 (May 7, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,168.
108. 17 C.F.R. § 230.240(f) (1975).
109. ALI FED. SEC. CODE § 227(b) (Reporter's Revision of Tent. Drafts Nos. 1-3, Oct. 1, 1974), *supra* note 45. Section 227(b) defines limited offerings as those involving no more than 35 initial purchasers, excluding certain institutions, where resales do not result in more than 35 owners of those securities at any one time for a period of three years, absent the filing of an offering statement, a distribution statement. or an exemption. The Code focuses on the distribution of the particular securities sold, while Rule 240 focuses on the distribution of all securities of the issuer, whether sold pursuant to Rule 240 or some other exemption.

below 100 through repurchases or some other means.[110] In the same release the staff conceded the obvious, that a later increase in the number of beneficial owners above 100 would not jeopardize a previous transaction which qualified under the rule at the time it took place.[111] While there is a logical consistency in this approach, it provides a trap for counsel advising an issuer on a Rule 240 offering, since he will have to assure himself that the issuer has never had more than 100 beneficial owners of its securities. Traps such as this are inconsistent with the apparent purpose of the rule to provide a "safe harbor" for small and unsophisticated issuers raising modest amounts of capital.

The provisions concerning the permissible number of owners of "securities of the issuer" are less liberal than those concerning the sales which will be included in determining the aggregate dollar amount sold.[112] Thus persons, such as promoters, purchasers of purchase money mortgages, officers and directors, and full-time employees whose purchases are excluded from the dollar calculations, must be included in the count of owners of the issuer's securities, as a general rule.[113] Only institutional purchasers in the categories specified by the rule are excluded, on the same grounds that their original purchases were excluded in the aggregate dollar volume of sales.[114]

The provisions relating to calculation of the number of beneficial owners are identical to the provisions of Rule 146 (g)(2) and allow exclusion from the count of relatives, spouses, and relatives of spouses of beneficial owners who have the same home as a beneficial owner; trusts and estates in which beneficial owners, their relatives, spouses or in-laws living with them have 100 percent of the interests, or in which corporations 100 percent owned by such persons have such 100 percent interest, and corporations or other organizations

110. John J. Hentschell, 304 BNA SEC. REG. & L. REP. C-2 (SEC Div. Corp. Fin. May 14, 1975).
111. *Id.*
112. Note, 17 C.F.R. § 230.240(e)(2)(ii) (1975).
113. 17 C.F.R. § 230.240(e)(1) and (2) (1975).
114. 17 C.F.R. § 230.240(f)(3) (1975).

100 percent owned by the persons named above.[115] The rule goes on to count as one beneficial owner corporations and other organizations with multiple owners, provided they were not organized as conduits for the specific purpose of acquiring the securities offered.[116] These provisions, like the similar provisions of Rule 146,[117] are liberal in their approach to the number of owners of securities and should cause no real problems, since the unadvised issuer will probably tend to err on the side of conservatism and count each securities holder of record. Forms can be used to obtain representations from purchasers concerning beneficial ownership, which should form a basis for a good faith defense in case of error. Thus the chances of inadvertent error seem relatively small in this area, making the exemption an attractive one for small issuers.

E. *Limitations on Resale*

When it turns to resales, Rule 240(g) shifts from a "limited offering" approach concerned with the number of holders of the securities involved in a particular offering to an approach much more like that of a private offering. The rule specifically provides that securities acquired in Rule 240 transactions "shall be deemed to have the same status as if they had been acquired in a transaction pursuant to Section 4(2) of the Act. . . ."[118] The rule goes on to note that such securities cannot be resold without registration under the Act or exemption therefrom, which places them in the same position as Rule 146 securities. The rule then requires the issuer to exercise reasonable care to assure that purchasers are not underwriters, thus requiring an investigation of their investment intent. As part of the "reasonable care", the rule requires a reasonable inquiry to determine that the purchaser is acquiring shares for his own account. It also requires the issuer to inform the purchaser of restrictions on resale and to place a legend on the certificate evidencing the

115. Rule 240(f)(1), 17 C.F.R. § 230.240(f)(1) (1975).
116. Rule 240(f)(2), 17 C.F.R. § 230.240(f)(2) (1975). The approach to conduits reflects existing law. *See* United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967).
117. Rule 146(g)(2), 17 C.F.R. § 230.146(g)(2) (1975).
118. Rule 240(g), 17 C.F.R. § 230.240(g) (1975).

lack of registration and referring to restrictions on resale.[119] This procedure is somewhat simpler than that required under Rule 146, which requires, in addition to the steps described, a written agreement from each purchaser that the securities will not be resold without registration or exemption and issuance of stop transfer instructions to a transfer agent or placing a notation on the issuer's own transfer records.[120] Regardless of the minimum requirements imposed by Rule 240, the further precautions imposed by Rule 146 seem appropriate in all cases. It will be necessary to obtain a letter containing investment representations as evidence of disclosure of the restrictions on resale, and it takes little more to secure an agreement that the securities will not be resold except in a lawful manner; furthermore, the practice of placing notations of the restrictions on transfer records is always prudent.[121]

The Commission has amended Rule 144 to make it clear that Rule 240 securities are "restricted securities" for which Rule 144 is available.[122] For the issuer undertaking preliminary financing prior to a public offering, Rule 144, with its two year waiting period and its relative certainty about resale, may be useful. For the small issuer which expects to stay small—the local merchant, or other "mom and pop" enterprises—Rule 144 will be of little help, since it requires either registration under the 1934 Act or making publicly

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119. Rule 240(g)(1)-(3), 17 C.F.R. §§ 230.240(g)(1)-(3) (1975). It is significant that compliance with the steps required by the rule does not conclusively establish "reasonable care", since the rule expressly states that "reasonable care shall include, but not necessarily be limited to" the steps described. Thus the issuer may not know in any individual case whether it has exercised reasonable care until the matter is litigated. The author suggests that taking the additional step required by Rule 146, obtaining a written agreement from each shareholder about resales, issuing of stop transfer instructions to a transfer agent or placing a notation on the issuer's own stock transfer records, should be sufficient to establish reasonable care conclusively, in the absence of evidence of bad faith.

120. Rule 146(h)(3) and (4), 17 C.F.R. §§ 230.146(h)(3) and (4) (1975).

121. The evolution of this practice is discussed in Part I of this article, Carney, *supra* note 3, at 521-22.

122. SEC Securities Act Release No. 5560 (Jan. 24, 1975), [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,066, amended Rule 144(a)(3) by adding the definition of "restricted securities" securities acquired "from the issuer in a transaction in reliance on Rule 240 under the Act or which were issued by an issuer in a transaction in reliance on Rule 240 and were acquired in a transaction or chain of transactions not involving any public offering."

available information equivalent to that provided in 1934 Act reports.[123]

Securities holders unable to utilize Rule 144 for resales may look to Rule 237, another exemption available under Section 3(b) of the Act,[124] which requires a five-year holding period before the securities can be resold freely.[125] Obviously some shareholdrs will wish to resell before the expiration of five years, and they will, aside from registration and Regulation A secondary offerings, have two choices available. First, and most attractive, they may resell under the pre-Rule 144 judicial and administrative interpretations of who is not an underwriter, which involves holding for a sufficiently long period to satisfy the requirements of investment intent—something over the two year holding period of Rule 144 and possibly as long as three years.[126] Second, shareholders may themselves utilize the private offering exemption for their resales and require their purchasers to take for investment, in much the same manner that they did initially.[127] The latter approach normally reduces the price

123. Rule 144(c), 17 C.F.R. § 230.144(c) (1975).
124. SEC Securities Act Release No. 5224 (Jan. 10, 1972), [Transfer Binder 1971-72 Decisions] CCH FED. SEC. L. REP. ¶ 78,484.
125. Rule 237, 17 C.F.R. § 230.237 (1975). Obviously such a long holding period is designed to encourage issuers to register under the 1934 Act to make Rule 144 available to shareholders, but smaller issuers simply will not find this a viable alternative.
126. In an attempt to discourage use of this approach and to encourage issuers to become reporting companies under the 1934 Act, the Commission, in adopting Rule 144 as a non-exclusive rule, discouraged use of resales outside the rule. In SEC Securities Act Release No. 5223 (Jan. 11, 1972), [Transfer Binder 1971-72 Decisions] CCH FED. SEC. L. REP. ¶ 78,487, at 81,050-81,051, the Commission stated: 1) persons selling in non-Rule 144 transactions will have a "substantial" burden of proof in establishing the exemption under Section 4(1) of the Act and proceed at their own risk; 2) the staff would no longer issue "no-action" letters with respect to such sales; 3) the "change in circumstances" concept should no longer be considered; and 4) the length of time the securities had been held would be considered, but no particular holding period would by itself assure the exemption. *The Wheat Report* noted in 1969 that holding periods of two to three years had been accepted by practitioners, although some staff advice was to the effect that sales could safely be made after five years. The SEC's official position appears always to have been that no specific holding was sufficient by itself to establish that shares could be resold freely. WHEAT REPORT, *supra* note 12, at 164-66. A recent article discusses current Commission treatment of resales made outside Rule 144, and indicates that the volume of such resales is substantial. *See* Goldwasser, *Resale Exemption Developments*, 8 REV. SEC. REG. 860 (1975).
127. *c.f.* United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967). That opinion points out that such purchasers must have access to information about the issuer, and presumably must also be able to fend for themselves in a manner which allows the selling shareholder to satisfy the criteria set out in Part I of this article, Carney, *supra* note 3.

which the shareholder can obtain for his shares because of reduced liquidity, but where a truly small business is concerned, that may not result, since the purchaser will have already taken into account the lack of a market for the securities.

This article will not deal with the problems of resales by controlling shareholders of corporations unable to utilize Rule 144, other than to note that Rule 237 is not available to them, although Rule 257 under Regulation A may be available to such persons for offerings not in excess of $50,000.[128] Professor Kessler regards these retrictions on resale as the "principal drafting defect" of Rule 240, since they place severe restrictions on "innocuous transfers" such as the sale of all of the stock of a business by the sole shareholder to a single buyer.[129] As a practical matter these formal restrictions do not seem as onerous as that author suggests, since in nearly all such cases the buyer will demand sufficient information about the business to readily qualify the transaction as a private offering under Section 4(2).[130] Thus it is only the controlling shareholder of the nonreporting company which has a growing and substantial number of shareholders who cannot take advantage of what may be a developing over-the-counter market for his securities without some formal disclosure, probably under Regulation A.

F. *Notice of Sales*

Consistent with the other exemptions adopted by the Commission under Section 3(b), Rule 240 requires filing of a notice of sales as a condition of the availability of the

128. Rule 257, 17 C.F.R. § 230.257 (1975), provides that exempt offerings may be made without use of the Regulation A offering circular, provided the Regulation A notification is filed with the regional office of the SEC, along with four copies of a statement setting forth the information (other than the financial statements) which would be required by Schedule I of Form 1-A (the offering circular). This rule is only available for a "seasoned" company which is exempt from the requirements of Rule 253, 17 C.F.R. § 230.253 (1975). Thus the issuer must have net income from operations, if it has not yet been incorporated for a year, or must have had net income from operations for at least one of the past two years, if incorporated more than one year prior to the date of the offering. A comprehensive treatment of sales by corporate insiders will be found in FROME & ROSENZWEIG, SALES OF SECURITIES BY CORPORATE INSIDERS (PLI, 2d ed. 1975).
129. Kessler, *supra* note 43, at 72-73.
130. 15 U.S.C. § 77d (2) (1970).

exemption.[131] Illustrative of the relatively sympathetic approach to the problems of small issuers is the change made from the proposed version of the rule. The proposed version of the rule required that Form 240, "Notice of Sales of Securities Pursuant to Rule 240", be filed before the first sale as a condition of the exemption.[132] As finally adopted, the rule still requires a notice to be filed in each year in which sales are made, but nevertheless contains several significant changes. First, the filing is only required to be made within ten days after the close of the first month in which a sale is made in each calendar year,[133] and second, relief from liability is provided in the event the issuer fails to file, at least with respect to the first $100,000 of securities of the issuer sold pursuant to the exemption.[134] Filings are to be made with the appropriate regional office of the SEC on a simple form which issuers should be able to complete by themselves.[135]

It is likely that many small issuers will still manage to violate the filing requirements, especially where they do not regularly consult counsel. Precautions such as having the attorney keep the stock certificate book and placing on the book's cover a prominent legend reminding the person in possession of the Rule 240 filing requirement may help in many cases involving small and inexperienced issuers. But the rule is unusually forgiving and limits the number of sales for which the exemption will be lost if the issuer fails to make the appropriate filing. Rather than integrate all sales, the rule treats each sale separately, and allows an issuer to cure its failure to file the Notice of Sales. For example, assuming an issuer which has sold more than the first $100,000

131. Rule 240(h), 17 C.F.R. § 230.240(h) (1975). For other filing requirements under Section 3(b), *see* Rule 236(c) (offerings to fund purchases of fractional shares); Rule 237(c) (secondary offerings of less than $50,000); Rules 255 and 257(a) (Regulation A); Rule 310 (Regulation B); Rule 652 (Regulation F).

132. Proposed Rule 240(j), SEC Securities Act Release No. 5499 (June 3, 1974), 255 BNA SEC. REG. & L. REP. D-4.

133. Rule 240(h)(1), 17 C.F.R. § 230.240(h)(1) (1975).

134. Rule 240(h)(2), 17 C.F.R. § 230.240(h)(2) (1975), provides in part:

> Notwithstanding the foregoing, the exemption provided by this rule will be available for the first $100,000 of the securities of the issuer as defined in subparagraph (a)(1) sold by the issuer if the sale of such securities complied with all the conditions of this rule other than the notice requirement.

135. SEC Form 240, CCH FED. SEC. L. REP. ¶ 7427.

of its securities under Rule 240, and which issues securities in a subsequent transaction in a new calendar year, that issuer would have the obligation to file the Notice within ten days after the month in which such sale is made. Failure to file would cause the sale in question to be nonexempt under the rule.[136] But if the issuer's attorney should discover the error prior to the next sale, he could cure the mistake, at least as to subsequent sales, by filing a Form 240 prior to the sale, covering the prior sale of all securities, and after such sale, by filing a new Form 240 covering the subsequent sale.[137] Failure to take either step would render that sale nonexempt, but would not prevent the issuer from taking the same curative action before and after the next attempted sale under the rule.

G. *Compliance Procedures*

For the issuer carefully and regularly supervised by counsel, compliance with the requirements of Rule 240 should impose no insuperable problems, other than the integration problems mentioned hereinafter. Unfortunately, when dealing with the securities laws, many practitioners are aware of the tendency of corporate clients to run their business as a personal enterprise, without regular legal supervision and review, at least until legal problems arise in the form of a crisis. It is with this type of issuer that the risk of failure to comply wth the notice requirements is highest. Where the attorney retains possession of the corporate stock book, supervision is possible, since a regular review of the need to file Form 240 can be undertaken each time stock is issued. A notation on the stock book itself that Rule 240 has been relied on and that subsequent notices must be filed to continue to rely on the rule will assist the attorney, and may even assist the client who insists on possession of the stock records. In the case of the client who retains possession of the stock book, it appears that an annual filing in January of each year may

136. Rule 240(h)(1), 17 C.F.R. § 230.240(h)(1) (1975). But the rule is non-exclusive, and another exemption may be available. *See* Preliminary Note 3, 17 C.F.R. § 230.240 (1975).

137. Rule 240(h)(2) 17 C.F.R. § 280.240(h)(2) (1975). SEC Securities Act Release No. 5560 (Jan. 24, 1975), CCH FED. SEC. L. REP. ¶ 80,066, at 84,950.

meet the requirements of the rule. The rule requires the filing of Form 240 in each calendar year after the first $100,000 in sales "within ten days after the close of the first month in which a sale in reliance on the rule is made."[138] Thus the rule sets the latest date at which the filing can be made; it does not limit the earliest date at which an issuer can file to a date after the first sale. This approach is confirmed by Form 240, which only requires, in item 4, the aggregate sales price of unregistered securities sold within the preceding twelve months,[139] and says nothing about intended sales during the present calendar year. Thus prudent counsel should question all small corporate clients during January of each year to obtain the information needed to file Form 240 by February 10. The form must be signed by an officer of the corporation, but it may be dangerous to rely on some corporate officials to complete and file the form.

For the general practitioner dealing largely with smaller corporations, use of Rule 240 may well become routine. Indeed, the rule is so simple and understandable that its use seems as advisable as the use of Section 1244 plans for small business corporations.[140] Like such plans, there is no way the use of the rule can harm the issuer, and it gives some assurance that the complexities of the securities laws can be solved in a relatively inexpensive way for most corporate clients of the general practitioner. Indeed, one author has questioned whether it may not be malpractice for an attorney to fail to utilize Rule 240 when representing small issuers in the sale of securities.[141]

It is interesting to note that, as first proposed, Rule 146 contained a requirement that a notice of sales be filed with the SEC within 45 days after the close of any quarter in which

138. Rule 240(h)(1), 17 C.F.R. § 230.240(h)(1) (1975).

139. SEC Form 240, item 4, CCH FED. SEC. L. REP. ¶ 7427.

140. Section 1244 of the Internal Revenue Code of 1954, 26 U.S.C. § 1244 (1970), allows certain small business corporations to adopt a plan to offer common stock ("§ 1244 Plan"), and then allows purchasers of stock sold under the plan to take an ordinary loss, rather than a capital loss, in the event of a loss realized on the sale of the stock or the insolvency of the corporation.

141. Butler, *supra* note 93.

sales were made in reliance on the rule.[142] In the final version of Rule 146, this requirement was dropped, with an accompanying explanation "that requiring the filing of such a Form as a condition of the Rule would unnecessarily increase the difficulty of complying with the Rule for many small issuers."[143] One can only wonder why this filing requirement was too difficult for issuers attempting to comply with a rule that demands close supervision of counsel, but not too difficult in Rule 240 offerings, where an issuer will nearly always be small, and may well attempt the offering without close supervision of an attorney. The Commission has not attempted to explain this matter to date.

H. *Disclosure to Investors*

Rule 146, with its elaborate precautions and conditions, represents the administrative and judicial idealization of the exempt offering—that is, an offering in which able and sophisticated entrepreneurs, bargaining at arms' length, make full disclosure to financiers capable of extracting all relevant information and evaluating it once received. Such transactions may occur in institutional private placements, but the truly small issuer is rarely a participant in such placements.[144] The costs of such transactions are sufficiently high that it seems the rule was drafted without any regard for the economic impact of such costs—as if protection of investors were a goal to be pursued regardless of costs.[145]

142. Proposed Rule 146(h) (Nov. 29, 1972), 179 BNA SEC. REG. & L. REP. F-5. The report requirement was criticized not only because of the difficulties presented for small issuers, but on the ground of lack of SEC authority to require reports from companies not required to register and report under the Exchange Act, and as an invasion of privacy for a company not publicly owned. *See* Schneider & Zall, *Comment Letter on Proposed Rule 146*, RULE 146, 48-49 (Cohen & Schneider, eds. 1974).

143. SEC Securities Act Release No. 5487 (April 23, 1974), CCH FED. SEC. L. REP. ¶ 2710, at 2907-10.

144. For a description of private institutional placements and the law applicable under Section 4(2), *see Institutional Private Placements Under the Section 4(2) Exemption of the Securities Act of 1933—A Paper of the Committee on Developments in Business Financing*, 31 BUS. LAW. 515 (1975).

145. Note the statement of the purposes of the securities laws in SEC Securities Act Release No. 5487 (April 23, 1974), CCH FED. SEC. L. REP. ¶ 2710, at 2907-02, adopting Rule 146:

> Congress, in enacting the federal securities laws, created a continuous disclosure system designed to protect investors and to assure the maintenance of fair and honest securities markets.

Contrast the later statement of the Commission when considering whether

Rule 146 may also represent the culmination of the 40 year drive toward perfection in disclosure, and a turning point of sorts in attitudes toward the efficacy of the regulatory process. The essence of the criticism of Rule 146 has been that it is an unworkable rule, which imposes excessive costs and is filled with pitfalls, and that the result of rules like 146 will be erection of additional barriers to access to the capital markets for small issuers.[146] Rule 146 was followed by two rules, 147[147] and 240,[148] which seem to represent a turning point in Commission attitudes about requiring full and formal disclosures as a condition to the use of exemptions from registration. These rules are perhaps the first recognition by the Commission that the existence of fraud in an offering is not always proof, post hoc, that the offering should have been registered.[149]

If Rule 147 represented the beginning of a trend away from onerous formal disclosure requirements as a condition of obtaining a "safe harbor" from registration, Rule 240 appears to be a continuation of that trend. But like Rule 147,

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to require additional disclosures in connection with matters of environmental and social concern:

> Those Acts confer upon the Commission broad discretion to determine what matters, in addition to those specifically enumerated in the Acts, are appropriate for disclosure. That broad discretion is limited, as set forth immediately below, by the requirement that the Commission determine disclosure of such matters is either necessary to discharge the Commission's obligations under the Acts or is necessary or appropriate in the public interest or for the protection of investors. In addition, Congress desired that disclosure be fair as well as full.

SEC Securities Act Release No. 5627 (Oct. 14, 1975), CCH FED. SEC. L. REP. ¶ 80,310, at 85,709.

In rejecting the suggestion that company disclosure documents be required to cover nonmaterial matters of social concern, judged on the basis of the economic concept of a security, the Commission stated that such disclosure would, in addition to making disclosure documents wholly unmanageable, "significantly increase the costs to all involved without, in our view, corresponding benefits to investors generally." *Id.* at 85,725. Thus the public interest, as the Commission now views it, appears to include consideration of the cost of disclosure to issuers, as well as protection of investors.

146. *See* Coles, *Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review*, 58 MARQ. L. REV. 395 (1975).
147. 17 C.F.R. § 230.147 (1975).
148. 17 C.F.R. § 230.240 (1975).
149. *See* the criticism of this tendency in *Section 4(2) and Statutory Law—A Position Paper of the Federal Regulation of Securities Committee*, 31 BUS. LAW. 483, 488 (1975). The tendency is best illustrated by such cases as Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971), and Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973).

Rule 240 is an exemption from registration only, and not from the antifraud provisions of the Act.[150]

The lack of a formal disclosure requirement does not mean that the issuer can simply ignore the need for disclosure to prospective investors. The antifraud provisions of Section 12(2) of the Securities Act[151] and Section 10(b) of the 1934 Act should provide a sufficient incentive to disclose.[152] While there is no requirement that purchasers be told anything at all in connection with a securities sale, the risk is that in selling the securities the issuer's representatives will in fact tell the bright side of the story and omit to fill in the gloomier details or prospects. This will invoke the antifraud provisions in nearly all cases, whether the negligence standard of Section 12(2) of the Securities Act is ap-

150. *See* Preliminary Note 1 to Rule 240, quoted, *supra* note 17.

151. Section 12(2), 15 U.S.C. § 77 (2) (1970), provides in part:

> Any person who—
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> * * *
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such securities from him . . . .

Section 17 (a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970), prohibits the offer or sale of securities using the jurisdictional means by means of any untrue statement of a material fact or omission to state such a fact, and provides a basis for injunctive relief by the Commission. LOSS, 3 SECURITIES REGULATION 1784 (2d ed. 1961). The courts are divided on whether it provides a basis for a civil action for damages for a defrauded purchaser. For a holding that a private right of action exists, *see, e.g.*, Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1095 (E.D. Pa. 1972); *contra*, Russell v. Travel Concepts Corp., CCH FED. SEC. L. REP. ¶ 95,230 (M.D. Tenn. 1975), citing Loss. *See also* Doty, *Application of the Antifraud Provisions of the Federal Securities Laws to Exempt Offerings: Duties of Underwriters and Counsel*, 16 B.C. IND. & COM. L. REV. 393 (1975).

152. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

plied,[153] or the scienter standard of Section 10(b) of the 1934 Act is used.[154] Where, as in many Rule 240 transactions, small issuers are involved with inexperienced promoters, who, in turn, are dealing with small and inexperienced investors, the risk may be as high that the antifraud provisions will be violated as it formerly was that the conditions for a successful private offering exemption would not be satisfied. In the long run, with a relaxation of the rules concerning exemptions from registration, the antifraud rules may assume primacy in the consciousness of the general practitioner dealing with small issuers.

Regardless of the fraud standard applied, consideration should be given to the ability of the promoters of the issuer to appreciate the need for particular types of information and to obtain it. Inexperienced corporate officers should not be expected to live up to the same standard of care which can reasonably be imposed on officials with more experience and ability to develop the information required for informed investment decisions.

CONCLUSION

There is an obvious inconsistency between Rule 146, which allows sales to only 35 purchasers who are able to bear the risk of loss or are able to evaluate that risk for themselves, and Rule 240, which allows sales to as many as

153. Ernst & Ernst v. Hochfelder, ... U.S. ......, 96 S.Ct. 1375, 1388 (1976), describes the standard of Section 12(2) as one of negligence. Cases decided under Section 10(b) prior to *Hochfelder* applying a negligence standard raise a question whether the duty of care is a flexible one, varying with the particular investors involved. In White v. Abrams, 495 F.2d 724, 735-36 (9th Cir. 1975), the court stated that the following factors should be considered in instructing a jury on a defendant's duty of care in a 10b-5 case:

> the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transacton in question.

While *Hochfelder* rejects this approach under Section 10(b), where questions of negligence arise under Section 12(2), this analysis may still have some vitality.

154. Ernst & Ernst v. Hochfelder, *supra* note 153, held that Section 10(b) and Rule 10b-5 will not support "a private cause of action for damages . . . in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud." 96 S.Ct. at 1381.

100 purchasers, with no assurance that they can either evaluate the investment or bear the risk. Professor Kessler concludes that this results from "the SEC's failure to recognize and distinguish among the widely different types of transactions subsumed under the 'nonpublic' offering."[155] A more charitable reading might be that the SEC is in a period of transition, recognizing that for certain types of transactions the antifraud rules should be the primary protection for investors, and that any attempt to regulate all securities transactions under a Rule 146 type approach will impose such burdens on the Commission that it will be unable to deal with the major problems of the capital markets. Assuming that offerings are limited to no more than $100,000 per year, it seems unlikely that any single investor will have a large stake in any issuer utilizing Rule 240.

It seems doubtful that Rule 240 is either "a do-it-yourself type rule in that an intelligent layman could probably comply with its provisions," as suggested by Bloomenthal,[156] at least without careful initial review and guidance from counsel, or the "disaster" initially suggested by Professor Kripke.[157] While it may not solve the problems of resale of securities in a closely held corporation as effectively as the limited offering provisions of the Federal Securities Code, it was not intended to serve primarily as a rule governing resales.[158] It does nothing to worsen the situation of the seller of a control block of shares in a closely held enterprise, and forcing such sellers to rely on the Section 4(2) statutory private offering exemption seems appropriate.

The Commission could relieve purchasers of noncontrolling shares in a Rule 240 transaction from some of the limitations now imposed on them by allowing resales in the manner contemplated by the Federal Securities Code—that is, by

155. Kessler, *supra* note 43, at 40.
156. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 4.05A, at 4-42.24 (1975).
157. Kripke, *SEC Rule 146: A "Major Blunder"*, 172 N.Y.L.J. 1, 6 (July 5, 1974), *quoted in* Kessler, *supra* note 43, at 72.
158. ALI FED. SEC. CODE § 227(b) (Reporter's Revision of Tent. Drafts Nos. 1-3, Oct. 1, 1974), *supra* note 45, allows resales as long as they "do not result in more than thirty-five owners of those securities," apart from institutional investors, which are excluded from the count in any event.

allowing resales as long as the number of shareholders resulting from the particular offering does not increase past the number of initial purchasers. There is no reason why such an approach could not also be applied to purchasers in Rule 146 offerings. At the present purchasers in Rule 147 transactions are free from these strict resale provisions, since they can sell within the state, and can complete a "distribution" to persons with no knowledge of or contact with the issuer. If it is the distribution which is to be avoided, the present rules overkill in some cases and are extremely lenient in others, creating an inconsistent patchwork. New rules governing resale could remedy this most serious defect.

Rule 240 should at least eliminate for issuers' counsel many of the uncertainties which arose in the past because of the lack of assurance that corporate officers could successfully follow advice given concerning the requirements for private offerings and intrastate offerings. Questions of sophistication and residence are generally determined for small issuers not by counsel, but by inexperienced and eager entrepreneurs. Sending such persons out to comply with previous interpretations of the securities laws was an invitation to disaster, and many counsel contented themselves with giving the advice concerning compliance in written form, to assure against later recriminations. Securities practice in such instances degenerates into a process of going through motions with the knowledge that any resulting litigation will have to be settled, since the likelihood of a successful defense is so small. Rule 240 offers a realistic opportunity for small issuers to comply with the Securities Act, which may ultimately mean that it will be taken more seriously by such issuers and their counsel.