

Washington University Law Quarterly

VOLUME 68

NUMBER 2

1990

THE NEW REGULATION D: DEREGULATION, FEDERALISM AND THE DYNAMICS OF REGULATORY REFORM

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I. INTRODUCTION

Over the course of 1987-1989 the Securities and Exchange Commission (SEC) created a new Regulation D.¹ While the basic structure of this important set of exemptions from securities registration under the Securities Act of 1933² (the 1933 Act) remains essentially unchanged, the combined force of numerous revisions of existing rules and the introduction of the novel "substantial compliance" concept³ has shaped a distinctly different legal environment for exempt transactions. We now need a guide to that unsettled environment, one that explains the points

1. 17 C.F.R. §§ 230.501-.508 (1989).

2. 15 U.S.C. §§ 77a-77aa (1988). For explanation of the operation of the registration and exemption provisions of the Securities Act of 1933, see *infra* text accompanying notes 10-20.

3. For discussion of the "substantial compliance" concept of 17 C.F.R. § 230.508 (1989), see *infra* text accompanying notes 257-82.

of departure, the changes of direction and the still uncharted territory. This Article will try to provide such a guide.

The urgency of the need for a guide to the changes in Regulation D should not be underestimated; any major changes in a set of rules as important as Regulation D will have great practical consequences.⁴ The importance of these rules is manifest in their history. The SEC promulgated Regulation D in 1982 as part of a major effort to reduce regulatory constraints on capital formation—particularly by small business—to the greatest extent compatible with investor protection.⁵ Through that comprehensive set of exemptions, the SEC attempted to reduce issuers' compliance costs by simplifying and consolidating disparate exemptive concepts and devices while liberalizing limits on the size and nature of exempt transactions.⁶

This deregulatory effort succeeded. Regulation D became a major channel for the flow of securities, as issuers large and small raised billions of dollars through transactions exempt thereunder.⁷ This "success," however, did not end controversy over the Regulation or the federal exemptive scheme as a whole. The securities bar continued to press for liberalization of the Regulation D exemptions, while critics—principally state securities administrators—claimed that Regulation D was serving less as a relief measure for small business than as a conduit for securities fraud.⁸ These critics urged that the Regulation be cut back, interpreted

4. For empirical analysis of the use of Regulation D by securities issuers, see Directorate of Economic and Policy Analysis, Securities and Exchange Commission, *An Analysis of Regulation D* (May, 1984) [hereinafter SEC, Analysis].

5. For discussion of the background to the original promulgation of Regulation D, see *infra* text accompanying notes 73-113.

6. *Id.*

7. According to the SEC, the amount of intended sales using Regulation D during the first full year of its availability (April 15, 1982 through April 14, 1983) amounted to approximately \$15.5 billion. SEC, Analysis, *supra* note 4, table 2, at 14. While there was surely some gap between the "intended sales" figure, derived from the amounts reported on notice filings with the SEC prior to the commencement of offerings, and actual sales, the actual sales figures surely can be presumed substantial. No published data for the years after 1983 is available, but the amount of securities offered and sold under Regulation D can safely be presumed to be at least comparable.

8. For analysis of the disparate views of the securities bar and the state securities administrators on this issue, see *infra* text accompanying notes 156-223. The state securities administrators are charged with administration of the state securities acts, virtually all of which require registration or exemption of securities offerings made within the state. For detailed discussion of the state administrators' role in the regulation of securities offerings, see 1 L. LOSS & J. SELIGMAN, *SECURITIES REGULATION* 29-152 (1989); *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986) (report of Ad Hoc Subcommittee on Merit Regulation of the ABA State Regulation of Securities Committee) [hereinafter *ABA Merit Report*].

narrowly, or at least not expanded.

These conflicting opinions were evident in the revision process⁹ that led to the development of the new Regulation D. The resulting changes, however, not only failed to resolve the old controversy, but created new controversies. Regulation D thus continues to present important questions of policy as well as practical difficulties and opportunities. Our guide, therefore, must operate at two levels. It must identify the specific interpretive and practical problems posed by individual changes to the rules, but it must also provide a more distant perspective, one that shows the broad contours of the terrain, revealing the fundamental assumptions and goals of current regulatory policy. Only this type of multidimensional perspective will make the guide genuinely useful.

This Article will try to provide that comprehensive perspective. Part II creates a basis for further analysis by briefly describing Regulation D as it stood prior to the 1987-1989 revisions. This description of the setting for change will provide a working vocabulary of the exemptive concepts used under the Regulation. Part III examines the background to change by tracing the evolution of Regulation D and showing how conflicting attitudes about the need for reform and the appropriate mechanisms of reform shaped the revision process. In particular, Part III argues that the central dynamic shaping the new Regulation D was a dialectical conflict between the securities bar and the state securities administrators, with the SEC playing a crucial mediating and synthesizing function. This argument will show the pervasive impact of questions of federalism on regulatory policy toward exempt transactions. Part IV explains the basic principles applied in revising the rules and identifies new interpretive problems. Part V contends that both the recent revisions and the basic structure of Regulation D make sense as positive attempts to balance the costs and benefits of securities regulation and to achieve a rational allocation of regulatory responsibilities between the states and the SEC. This Article concludes in Part VI by identifying the unfinished agenda and recommending solutions to those problems left unresolved by the 1987-1989 revisions to Regulation D.

9. That revision process is discussed in detail *infra* in the text accompanying notes 156-223.

II. THE SETTING FOR CHANGE: AN OVERVIEW OF THE ORIGINAL REGULATION D

Section 5¹⁰ of the 1933 Act requires all offers and sales of securities in interstate commerce either to be registered with the SEC or exempted from registration. Sections 3¹¹ and 4¹² of the 1933 Act set out numerous exemptions from registration, some of very broad applicability and others applicable only to a narrow spectrum of securities or transactions. Two of the most important exemptions for issuers of securities are sections 3(b)¹³ and 4(2).¹⁴

Section 3(b) exempts offerings with an aggregate offering price not in excess of \$5 million made in accordance with rules prescribed by the SEC.¹⁵ The SEC has adopted several rules under the section 3(b) limited offering exemption, including Regulation A,¹⁶ one of the earliest of the exemptive rules.¹⁷

10. 15 U.S.C. § 77e (1988).

11. *Id.* § 77c.

12. *Id.* § 77d.

13. *Id.* § 77c(b).

14. *Id.* § 77d(2).

15. *Id.* § 77c(b). Section 3(b) provides that the SEC may add any class of securities to the securities exempted as provided in this section, if it finds that [registration] 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.

Id. As stated in the text, however, the maximum size of offerings that may be exempted by the SEC under § 3(b) is \$5 million. *Id.*

16. 17 C.F.R. §§ 230.251-264 (1989). Regulation A provides an exemption from registration for offerings with an aggregate offering price not in excess of \$1.5 million. *Id.* § 230.255(a)(1)(A). While Regulation A is in fact a type of exemption, it requires an issuer to file a detailed Offering Statement with an SEC regional office. *Id.* § 230.255. Regulation A thus shares some of the characteristics of registration under § 5 of the 1933 Act, 15 U.S.C. § 77e (1988). For further discussion of Regulation A, see Sonsini, *Regulation A*, 16 REV. SEC. REG. 781 (1983).

17. Regulation A was adopted in 1936. Securities Act Release No. 627-632 (Jan. 21, 1936). For discussion of the history of Regulation A, see 3 L. LOSS & J. SELIGMAN, *supra* note 8, at 1322-27.

Other important § 3(b) rules include those that immediately preceded the § 3(b) rules adopted in Regulation D. Those rules were rule 240, 17 C.F.R. § 230.240 (rescinded 1982), and rule 242, 17 C.F.R. § 230.242 (rescinded 1982). Rule 240 exempted offerings not in excess of \$100,000 within a twelve-month period, provided that no more than 100 persons held the issuer's securities at the conclusion of the offering. For discussion of rule 240, see Securities Act Release No. 5560 (Jan. 24, 1975), 40 Fed. Reg. 6484 (1975). Rule 242 exempted offerings not in excess of \$2 million within a six-month period, provided that the offering was sold to no more than 35 purchasers. Rule 242 also introduced the concept of "accredited investor" that Regulation D inherited. For discussion of the accredited investor concept under Regulation D, see *infra* text accompanying notes 284-319. For discussion of rule 242, see Securities Act Release No. 6180 (Jan. 17, 1980), 45 Fed. Reg. 6362 (1980).

Section 4(2) exempts issuer transactions not involving any public offering, without any limit on the aggregate offering price. Unlike section 3(b), section 4(2) does not require SEC rulemaking for implementation of its "private offering" exemption.¹⁸ The SEC, however, has adopted safe harbor rules implementing section 4(2), including former Rule 146.¹⁹

The section 4(2) nonpublic offering and section 3(b) limited offering exemptions represent separate, concurrent bases for exemption. Although the exemptive conditions developed under these sections often have been similar, distinct approaches did evolve as case law and SEC rulemaking developed.²⁰

The original Regulation D, as adopted in 1982,²¹ was a set of six rules

18. There is thus a statutory § 4(2) exemption outside of any safe harbor rule adopted by the SEC to implement § 4(2). An offering that fails to meet all of the many highly specific requirements of the current § 4(2) safe harbor rule, rule 506 of Regulation D, 17 C.F.R. § 230.506 (1989), still may be exempt under the statutory exemption if it meets the less technical but more amorphous criteria established under the § 4(2) case law. For discussion of some of this case law, see *infra* text accompanying notes 284-93. This is not to suggest that the statutory exemption is more liberal or easier to establish than the rule 506 safe harbor exemption. Rather, it means that the statutory exemption may be available in cases in which relatively technical problems such as a failure to file the appropriate form or to deliver specified information make rule 506 unavailable. The statutory exemption also may prove useful in transactions involving only small numbers of sophisticated offerees such as institutional investors. For further discussion of the statutory § 4(2) exemption, see *Institutional Private Placements Under the Section 4(2) Exemption of the Securities Act of 1933*, 31 BUS. LAW. 515 (1975) (report of ABA Committee on Developments in Business Financing) [hereinafter *ABA Institutional Private Placements Report*]; *Section 4(2) and Statutory Law*, 31 BUS. LAW. 485 (1975) (report of ABA Federal Regulation of Securities Committee) [hereinafter *ABA Section 4(2) Report*].

19. 17 C.F.R. § 230.146 (rescinded 1982). For discussion of rule 146, see Securities Act Release No. 5487 (Apr. 23, 1974), 39 Fed. Reg. 15,261 (1974).

20. For example, § 3(b) and § 4(2) exemptive rules both typically have included bans on general solicitation of prospective purchasers, limitations on the number of purchasers, and a requirement that all offerings that are part of the same issue be integrated for purposes of determining the availability of the exemption. In contrast, the concept of offeree or purchaser sophistication was peculiar to § 4(2), while the concepts of issuer disqualification and aggregation were peculiar to § 3(b) rules. For explanation of how these different concepts operated in the rules that preceded Regulation D, see Benton & Gunderson, *Venture Capital Financings and Exemptions from Registration Under the Securities Act of 1933: Section 4(2), Rule 242, and Rule 142*, 21 SANTA CLARA L. REV. 23 (1981); Carney, *Exemptions from Securities Registration for Small Issuers: Shifting from Full Disclosure—Part III: The Small Offering Exemption and Rule 240*, 11 LAND & WATER L. REV. 483 (1976); Thomforde, *Relief for Small Businesses: Two New Exemptions from SEC Registration*, 48 TENN. L. REV. 323 (1981).

21. The SEC first proposed Regulation D in Securities Act Release No. 6339 (Aug. 7, 1981), 46 Fed. Reg. 41,791 (1981). The SEC adopted a substantially revised version in Securities Act Release No. 6389 (March 8, 1982), 47 Fed. Reg. 11,251 (1982). The following discussion in the text of Regulation D will use the past tense, but this is not intended to suggest that the provisions of Regulation D discussed therein are merely of historical interest. To the contrary, virtually all of these

designed for use under both sections 3(b) and 4(2). The Regulation represented an attempt to harmonize the inconsistencies that had developed among the various section 3(b) and 4(2) exemptions.²² The SEC's solution was to define separate exemptions with distinct statutory bases, while providing a common set of definitions and conditions.

Three separate exemptions were set out in rules 504,²³ 505²⁴ and 506.²⁵ Rules 504 and 505 were limited offering exemptions under section 3(b); rule 506 was a safe harbor rule under section 4(2). Rule 501²⁶ contained definitions common to all three exemptions and rule 502²⁷ established conditions necessary to varying degrees for all three. Rule 503²⁸ imposed a notice filing requirement for all Regulation D transactions, requiring an initial filing on Form D²⁹ soon after the commencement of the offering, periodic filings during the offering and a final filing after termination of the offering.³⁰

provisions are still largely in effect, and the Regulation's basic structure is still largely as described in this Part II, despite the many changes made from 1987 through 1989. The past tense simply emphasizes that there are many important differences between the Regulation originally promulgated in 1982 and the "new" Regulation D. Those differences will be described at length in Part IV. See *infra* text accompanying notes 224-360. In order to distinguish Regulation D as originally promulgated in 1982 from the current version of the Regulation, citations to the original version will be to the text published in Securities Act Release No. 6389, *supra*, in 1982. Citations to the current version will be to 17 C.F.R. § 230.501-.508 (1989).

22. For the SEC's statement of this purpose in connection with Regulation D, see Securities Act Release No. 6389, 47 Fed. Reg. at 11,252. See also Warren, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U.L. REV. 355, 358-59 (1984). The SEC's other goal was to use Regulation D to improve coordination between federal and state exemptions. 47 Fed. Reg. at 11,252-53. As explained below, that goal was more difficult to achieve. See *infra* text accompanying notes 114-54.

23. Rule 504, Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of amendments to rule 504, see *infra* text accompanying notes 321-32.

24. Rule 505, Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of amendments affecting rule 505, see *infra* text accompanying notes 231-319.

25. Rule 506, Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of amendments affecting rule 506, see *infra* text accompanying notes 231-319.

26. Rule 501, Securities Act Release No. 6389, 47 Fed. Reg. at 11,262. For discussion of amendments to rule 501, see *infra* text accompanying notes 283-319.

27. Rule 502, Securities Act Release No. 6389, 47 Fed. Reg. at 11,264-65. For discussion of amendments to rule 502, see *infra* text accompanying notes 239-56, 353-60.

28. Rule 503, Securities Act Release No. 6389, 47 Fed. Reg. at 11,265. For discussion of amendments affecting rule 503, see *infra* text accompanying notes 231-38.

29. Form D, Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of revisions of Form D, see *infra* text accompanying notes 142-54.

30. Rule 503, as originally promulgated, required the issuer to file Form D no later than 15 days after the first sale of securities under any of the Regulation D exemptions, every six months after the first sale, and no later than 30 days after the last sale in the offering. Rule 503(a)-(b),

Rule 504 established an exemption for offerings not in excess of \$500,000,³¹ provided the issuer was not a company reporting under the Securities Exchange Act of 1934³² (the 1934 Act) or an investment company,³³ and that the issuer met certain specified conditions.³⁴ Those conditions included compliance with the rule 503 filing requirements, the rule 502(c)³⁵ prohibitions on general solicitation and public advertising, and the rule 502(d)³⁶ restrictions on resale. Rule 504 did not require any specific disclosure as a condition of the exemption³⁷ and did not limit the number of investors permitted to purchase securities offered under the exemption.³⁸ The rule also did not require investors to possess any particular status or suitability to qualify as rule 504 purchasers.³⁹

Issuers willing to register a rule 504 offering in every state in which it was offered, furthermore, were relieved of the manner of sale limitations and the resale restrictions, leaving them subject only to the filing requirement and the \$500,000 aggregate offering price ceiling.⁴⁰

In contrast to rule 504, rule 505 was intended to permit much larger

Securities Act Release No. 6389, 47 Fed. Reg. at 11,265. For discussion of SEC's later elimination of the periodic and final filing requirements, see *infra* text accompanying notes 142-54.

31. Rule 504(b)(2)(i), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of amendments changing the amount of securities that can be sold under rule 504, see *infra* text accompanying notes 321-32.

The actual amount of securities permitted to be sold under rule 504 was limited by the principle of "aggregation." Rule 504(b)(2)(i), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. This principle required inclusion within the aggregate offering price of any rule 504 offering of the aggregate offering price of all securities sold within 12 months before and during the rule 504 offering, if sold in reliance on any exemption under § 3(b), 15 U.S.C. § 77c(b) (1988) or in violation of § 5(a) of the Securities Act of 1933, 15 U.S.C. § 77e(a) (1988).

32. 15 U.S.C. §§ 78a-78kk (1988). The reporting requirements are contained in 15 U.S.C. §§ 78m, 78o(d) (1988).

33. Rule 504(a), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

34. For more detailed discussion of rule 504 as originally adopted, see Parnall, Kohl & Huff, *Private and Limited Offerings After a Decade of Experimentation: The Evolution of Regulation D*, 12 N.M.L. REV. 633, 673-84 (1982); Warren, *supra* note 22, at 361-67; Note, *Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933*, 24 WM. & MARY L. REV. 121, 139 (1982).

35. Rule 502(c), Securities Act Release No. 6389, 47 Fed. Reg. at 11,265. For discussion and critique of this prohibition, see *infra* text accompanying notes 412-21.

36. Rule 502(d), Securities Act Release No. 6389, 47 Fed. Reg. at 11,265. For discussion of these restrictions and changes therein, see *infra* text accompanying notes 246-56.

37. Warren, *supra* note 22, at 363.

38. *Id.*

39. *Id.* at 365.

40. Rule 504(b)(1)-(2), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of amendments relating to the effect of state registration on rule 504 offerings, see *infra* text accompanying notes 321-32.

offerings;⁴¹ its limit on the aggregate offering price was \$5 million.⁴² Rule 505 also imposed, however, a far greater set of conditions and restrictions than rule 504. In addition to complying with the filing, manner of sale and resale requirements also applicable to rule 504, issuers relying upon rule 505 had to take into account the number and nature of the purchasers and provide, under some circumstances, specified types of disclosure. Rule 505 expressly limited the number of purchasers to thirty-five⁴³ and required delivery of a disclosure document⁴⁴ containing much of the same information that a 1933 Act prospectus would require.⁴⁵

Rule 501(e) provided significant relief from the rule 505 purchaser limitation, however, by allowing issuers to exclude "accredited investors"⁴⁶ from the thirty-five purchaser total—the so-called "body count."⁴⁷ This exclusion allowed issuers to sell to an unlimited number of accredited investors under rule 505 as well as thirty-five non-accredited investors, although the ban on general solicitation at least theoretically placed a de facto outer limit on the number of purchasers.

The accredited investor concept also played an important role with respect to the issuer's disclosure obligations under rule 505. If the issuer sold exclusively to accredited investors, no specific disclosure was re-

41. For discussion of rule 505 as originally promulgated, see Parnall, Kohl & Huff, *supra* note 34, at 673-84; Warren, *supra* note 22, at 367-74; Note, *supra* note 34, at 143-45.

42. Rule 505(b)(2)(i), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. As under rule 504, determination of the aggregate offering price under rule 505 required application of the aggregation principle. *Id.*

43. Rule 505(b)(2)(ii), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

44. Rule 505(b)(1), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of amendments affecting the disclosure obligations under rule 505, see *infra* text accompanying notes 353-60.

45. The disclosures required in connection with rule 505 offerings were specified in rule 502(b), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264-65.

46. The term "accredited investor" was defined in rule 501(a), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262-63, by means of a list of specifically defined institutional and individual investors. For discussion of the theory and function of the accredited investor concept, see *infra* text accompanying notes 283-302. For discussion of amendments to the accredited investor definition of Rule 501(a), see *infra* text accompanying notes 305-19.

For discussion of the role of the accredited investor concept under § 2(15), 15 U.S.C. § 77b(15) (1988), and § 4(6), 15 U.S.C. § 77d(6) (1988), of the 1933 Act, see Warren, *supra* note 22, at 356 n.8, 368 n.84.

47. Rule 501(e)(1)(iv), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263. Also excluded from the body count were relatives of the purchaser who have the same principal residence as the purchaser; trusts or estates in which the purchaser, or relatives living with the purchaser, collectively own 50% of the beneficial interest; and corporations or other organizations in which the purchaser, or relatives living with the purchaser, collectively own 50% of the equity. Rule 501(e)(1)(i-iii), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263.

quired as a condition of the exemption.⁴⁸ The issuer might decide to produce a disclosure document anyway, as protection against antifraud liability, but that document did not have to comply with the many highly specific disclosure requirements of rule 502(b).⁴⁹ If the issuer sold to a single non-accredited investor, however, a disclosure document containing the information specified by rule 502(b) had to be delivered prior to sale not only to the non-accredited investor, but also to each accredited investor.⁵⁰

The accredited investor concept obviously was central to the operation of rule 505. Rule 501(a),⁵¹ which defined the term, did not contain a generic definition; rather, it provided simply that an accredited investor meant any person who came within a list of categories of investors, or any person the issuer reasonably believed to come within those categories. The rule 501(a) categories included a series of institutional investors;⁵² private business development companies;⁵³ tax-exempt organizations with assets in excess of \$5 million;⁵⁴ the issuer's directors, officers, partners and similar insiders;⁵⁵ entities whose owners were all accredited investors;⁵⁶ purchasers who invested at least \$150,000 and met certain net worth criteria;⁵⁷ and individuals ("natural persons") who met specified net worth⁵⁸ or annual income criteria.⁵⁹

48. Rule 502(b)(1)(i), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264.

49. Rule 502(b), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264. For discussion of amendments to rule 502(b), see *infra* text accompanying notes 239-56.

50. Rule 502(b)(1)(ii), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264. For discussion of amendments to rule 502(b), see *infra* text accompanying notes 239-56.

51. Rule 501(a), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262-63. For discussion of amendments to rule 501(a) and the subsections thereof cited *infra* in notes 52-59, see *infra* text accompanying notes 305-19.

52. Rule 501(a)(1), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262.

53. Rule 501(a)(2), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262.

54. Rule 501(a)(3), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262.

55. Rule 501(a)(4), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262-63.

56. Rule 501(a)(8), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263.

57. Rule 501(a)(5), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263. For an investor to qualify as an accredited investor under this category, the purchase price could not exceed 20% of the investor's net worth at the time of sale, and had to be paid within 5 years. *Id.*

58. Rule 501(a)(6), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263. This category included natural persons who, either individually or jointly with their spouses, had a net worth at the time of sale in excess of \$1 million. *Id.*

59. Rule 501(a)(7), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263. This category included natural persons who had individual income exceeding \$200,000 per year for the 2 immediately preceding years and who reasonably expected to have that income during the year of the sale. *Id.*

Rule 505 also differed from rule 504 in that it contained a set of disqualification or "bad boy" provisions, which prevented an issuer from using rule 505 if the issuer or any of a broad variety of its affiliates had been subject to specified types of judicial or administrative action for misconduct in the securities business.⁶⁰ These disqualifiers were unique to rule 505.

The final Regulation D exemption, rule 506, differed from rule 505 in three important respects. First, the SEC adopted it under section 4(2), not section 3(b). Second, rule 506 imposed no ceiling on the aggregate offering price.⁶¹ Third, all non-accredited investors in rule 506 transactions were required to be "sophisticated"⁶² or to have a sophisticated "purchaser representative."⁶³ Rule 505, in contrast, did not require the non-accredited investors to meet an individual sophistication standard.⁶⁴

In other respects, rule 506 was quite similar to rule 505. Rule 506 transactions were subject to the same filing,⁶⁵ manner of sale⁶⁶ and restriction on resale requirements.⁶⁷ The number of purchasers was limited to thirty-five⁶⁸ and delivery of a disclosure document was required,⁶⁹ but the accredited investor concept mitigated those requirements in exactly the same manner as under rule 505.⁷⁰

60. Rule 505(b)(2)(iii), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. This subsection incorporated by reference disqualification provisions contained in Regulation A, rule 252(c), 17 C.F.R. § 230.252(c) (1989). Upon a showing of good cause, the SEC could permit an offering to proceed under rule 505 despite the applicability of a disqualification. Rule 505(b)(2)(iii)(C), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

61. Unlike § 3(b), 15 U.S.C. § 77c(b) (1988), which imposes a \$5 million ceiling on offerings that may be exempted thereunder, § 4(2), 15 U.S.C. § 77d(2) (1988), does not impose a dollar ceiling on offerings exempted pursuant thereto. Thus, neither rule 506 nor its predecessor, rule 146, 17 C.F.R. § 230.146 (rescinded 1982), contained such a ceiling.

62. Rule 506(b)(2)(ii), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

63. *Id.* The term "purchaser representative" is defined in rule 501(h), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264.

64. Warren, *supra* note 22, at 376.

65. Rule 503, Securities Act Release No. 6389, 47 Fed. Reg. at 11,265.

66. Rule 502(c), Securities Act Release No. 6389, 47 Fed. Reg. at 11,265.

67. Rule 502(d), Securities Act Release No. 6389, 47 Fed. Reg. at 11,265. Rule 502(d) imposed upon issuers in both rule 505 and rule 506 transactions the obligation to exercise reasonable care to assure that no purchaser is a statutory "underwriter." For explanation of that term, see Warren, *supra* note 22, at 365-66 n.63.

68. Rule 506(b)(2)(i), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

69. Rule 502(b), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264. The lack of a dollar ceiling on the aggregate offering price of rule 506 offerings, however, permitted larger offerings that might become subject to more detailed disclosure requirements under rule 506(b)(2)(ii), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

70. See *supra* notes 47-50.

Taken together, rules 504, 505 and 506 provided a comprehensive set of exemptions. These three exemptions, furthermore, were in no sense exclusive. If the offering complied with more than one exemption it could claim more than one exemption.⁷¹ In addition, an issuer could structure an offering to comply with non-Regulation D exemptions such as rule 147⁷² or the statutory section 4(2) exemption as well as with one or more of the three Regulation D exemptions.

That, in brief, was the basic structure of Regulation D as originally adopted in 1982 and as it stood prior to the 1987-1989 revisions. Those revisions left the basic structure and terminology intact, even though the changes were both pervasive and substantial. This overview thus provides some sense of the setting in which the revision process took place. To fully understand that process, however, it is essential to delve more deeply into the background to the recent changes, beginning with the original development of Regulation D, continuing with the ensuing battle with the state securities administrators, and culminating with an analysis of the dynamics of regulatory reform.

III. THE BACKGROUND TO CHANGE

A. *The Evolution of Regulation D*

The recent revisions of Regulation D were yet another manifestation of the extraordinary fluidity of SEC policy toward the exemptions from 1933 Act registration. The SEC has been in an almost constant state of experimentation in this area.⁷³ The 1987-1989 revisions followed the promulgation of Regulation D in 1982,⁷⁴ which succeeded the SEC's experiments with rules 240⁷⁵ and 242⁷⁶ in 1975 and 1980, respectively. Those rules were themselves sequels to the first major round of experi-

71. See rules 501-506, Securities Act Release No. 6389, 47 Fed. Reg. at 11,262 preliminary note 3 ("Attempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption.")

72. 17 C.F.R. § 230.147 (1989). Rule 147 is a safe harbor rule under § 3(a)(11) of the 1933 Act, 15 U.S.C. § 77c(a)(11) (1982), which exempts intrastate offerings. For discussion of rule 147, see Securities Act Release No. 5450 (Jan. 7, 1974), 39 Fed. Reg. 2353 (1974).

73. For discussion of the SEC's experimentation with its exemptive rules in the 1970s and early 1980s, see Sargent, *State Limited and Private Offering Exemptions: The Maryland Experience in a National Perspective*, 13 U. BALT. L. REV. 496, 505-11 (1984); Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 57-61 (1983).

74. See *supra* note 21.

75. See *supra* note 17.

76. See *supra* note 17.

ments in the early 1970s with the 140 series—rules 144,⁷⁷ 146⁷⁸ and 147.⁷⁹ This state of experimentation reflected the transition from the activist, regulatory-minded SEC of the 1970s⁸⁰ to the more deregulatory SEC of the 1980s.⁸¹

The SEC's adoption of Regulation D in 1982 was not an aberrant act fostered in a sudden deregulatory frenzy, but rather a culmination—albeit an accelerated one—of a preexisting trend toward more workable exemptive rules. This trend, furthermore, was not the result of some new failure of nerve on the part of the SEC. It was actually part of an ongoing process of reevaluation that began in the 1960s with radically revisionist attacks by the economists Stigler,⁸² Benston,⁸³ and Manne⁸⁴ and developed into the 1969 Wheat Report's⁸⁵ much more moderate but still critical reappraisal of the federal mandatory disclosure system. This process of reevaluation persisted into the next decade.⁸⁶ In 1977, the Advisory Committee on Corporate Disclosure⁸⁷ urged the agency to

77. 17 C.F.R. § 230.144 (1989). Rule 144 provides a safe harbor under § 4(1) of the 1933 Act, 15 U.S.C. § 77d(1) (1988), which exempts offers and sales by persons other than issuers, underwriters or dealers. Rule 144 is actually a definitional rule that defines when persons reselling securities will be deemed not to be underwriters. For discussion of rule 144, see Securities Act Release No. 5223 (Jan. 11, 1972), 37 Fed. Reg. 591 (1972); 3 L. LOSS & J. SELIGMAN, *supra* note 8, at 1502-75; Steinberg & Kempler, *The Application and Effectiveness of SEC Rule 144*, 49 OHIO ST. L.J. 473 (1988).

78. *See supra* note 19.

79. *See supra* note 72.

80. For discussion (albeit critical) of the SEC of the 1970s, see R. KARMELE, *REGULATION BY PROSECUTION* (1982).

81. For discussion (albeit critical) of the SEC of the 1980s, see Seligman, *supra* note 73, at 57-61.

82. *See* Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964), *revised and reprinted in* G. STIGLER, *THE CITIZEN AND THE STATE: ESSAYS ON REGULATION* 78 (1975) (questioning the need for the SEC's mandatory disclosure system).

83. *See* Benston, *The Value of the SEC's Accounting Disclosure Requirements*, 44 ACCT. REV. 515 (1969) (critically analyzing those requirements); *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) (criticizing the SEC's mandatory disclosure system).

84. *See* H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) (criticizing prohibition on insider trading).

85. The Wheat Report was an internal study by the SEC of its mandatory disclosure system. SEC, *DISCLOSURE TO INVESTORS: A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS* (1969).

86. Among the most prominent critics during the 1970s of SEC mandatory disclosure policy was Homer Kripke. *See* H. KRIPKE, *THE SEC AND SECURITIES DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* (1979); Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151 (1970).

87. HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., 1ST SESS., RE-

reexamine its approach to the special problems of small business, propelling the SEC into further liberalization of its exemptive regime and abandonment of many of its lingering doubts over expansion of the exemptions for limited and private offerings.⁸⁸

The SEC was given an additional push in the early 1980s by Congress' enactment of the Small Business Issuers' Simplification Act of 1980⁸⁹ and the Small Business Investment Incentive Act of 1980⁹⁰ and by the deregulatory force of the new Reagan administration. The net result was Regulation D.

Regulation D emerged in 1982 as but the latest of several attempts to balance the SEC's traditional concern for investor protection with a perceived need to remove unnecessary restraints on capital formation, particularly by small business. The SEC of the 1980s obviously was willing to go much farther in this direction than the SEC of the 1970s, whose

PORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION (Comm. Print 1977) [hereinafter ADVISORY COMMITTEE REPORT]. For discussion of the public hearings held in connection with preparation of this report, see Securities Act Release No. 6180, 45 Fed. Reg. at 6363. For discussion of the report, see J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION 565-68* (1982).

88. Subsequent to publication of the ADVISORY COMMITTEE REPORT, *supra* note 87, the SEC made four principal changes. First, it raised the ceiling on Regulation A offerings from \$500,000 to \$1.5 million. See 17 C.F.R. § 230.254 (1989); Securities Act Release No. 5977 (Sept. 11, 1978), 43 Fed. Reg. 41,383 (1978). Second, it amended Regulation A to permit the use of a preliminary offering circular prior to the commencement of the offering. 17 C.F.R. § 230.256(h) (1989). Third, it adopted Form S-18. 17 C.F.R. § 239.28 (1989). Form S-18 was a simplified registration statement for certain offerings with an aggregate offering price not in excess of \$5 million. See Securities Act Release No. 6049 (Apr. 3, 1979), 44 Fed. Reg. 21,562 (1979). In 1983, the SEC raised the ceiling on the aggregate offering price to \$7.5 million. Securities Act Release No. 6489 (Sept. 23, 1983), 48 Fed. Reg. 45,386 (1983). Fourth, the SEC adopted rule 242. See *supra* note 17.

89. Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, 94 Stat. 2294 (codified at 15 U.S.C. § 77d(6) (1988)). This Act added a new exemption under § 4(6) of the 1933 Act, 15 U.S.C. § 77d(6), for offers and sales solely to accredited investors. It also added a definition of "accredited investor" to the 1933 Act in a new § 2(15), 15 U.S.C. § 77a(15) (1988). Section 2(15) is supplemented by rule 215, 17 C.F.R. § 230.215 (1989), which defines "accredited investor" in the same manner as Regulation D, rule 501(a), 17 C.F.R. § 230.501(a) (1989).

90. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2292 (codified as amended in scattered sections of 15 U.S.C. (1988)). The most significant contribution of this act was the addition of § 19(c) to the 1933 Act, 15 U.S.C. § 77s(c) (1988). This provision stated the policy "that there should be greater Federal and State cooperation in securities matters," 15 U.S.C. § 77s(c)(2) (1988), and directed the SEC to work with representatives of the states to that end. 15 U.S.C. § 77s(c)(1) (1988). Section 19(c)(3)(C) emphasized, furthermore, that the SEC should work with the state securities administrators to reduce the compliance burden upon small business issuers subject to state and federal exemptive requirements. 15 U.S.C. § 77s(c)(3)(C) (1988).

approach to the 1933 Act exemptions was always somewhat grudging,⁹¹ but the long-term trend was basically consistent. What happened in 1982 was the result of a convergence of a preexisting trend with a new emphasis on removal of regulatory restraints.⁹² Regulation D thus absorbed the prior experiments of the past decade, preserving many of the exemptive concepts developed in rules 146, 240 and 242 and expanding some of them to new dimensions.

The basic structure of Regulation D represented an attempt to make the exemptive system more workable. As explained in Part II,⁹³ Regulation D as originally promulgated consisted of three separate exemptions joined by a set of common definitions and conditions. This structure merged into a common pool the separate streams of exemptive concepts and devices that had been developing independently under sections 3(b) and 4(2). The SEC intended this new approach to reduce the costs associated with an unsystematic, jerry-built exemptive system.⁹⁴ While the attempt to accommodate both section 3(b) and section 4(2) exemptive concepts produced some new anomalies and ambiguities, the overall structure of Regulation D in and of itself brought some measure of relief to securities issuers.

The SEC also intended the substantive provisions of the Regulation to relieve issuers of substantial costs.⁹⁵ The accredited investor concept, for example, was an attempt to define in objective terms categories of investors able to fend for themselves without the protection of registration.

91. A perception of the SEC's attitude as "grudging" is reflected in the intense criticism of rule 146, 17 C.F.R. § 230.146 (rescinded 1982). Some regarded this rule as creating more problems than it solved. See, e.g., Campbell, *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139; Coles, *Has Securities Law Regulation in the Private Capital Market Become a Deterrent to Capital Growth?: A Critical Review*, 58 MARQ. L. REV. 395, 463 (1975); Note, *SEC Rules 144 and 146: Private Placements for the Few*, 59 VA. L. REV. 886, 921-22 (1973); Note, *Revising the Private Placement Exemption*, 82 YALE L.J. 1512, 1519 (1973). Another SEC experiment of the 1970s, rule 240, 17 C.F.R. § 230.240 (rescinded 1982) was criticized for being of little practical use because only offerings of no more than \$100,000 could be exempted thereunder. See Securities Act Release No. 6339, 46 Fed. Reg. at 41,800.

92. The new emphasis obviously had much to do with the change of presidential administrations in 1980. For a critique of the SEC during the early Reagan years, see Seligman, *supra* note 73, at 57-61.

93. See *supra* text accompanying notes 21-30.

94. See Securities Act Release No. 6339, 46 Fed. Reg. at 41,795; Securities Act Release No. 6389, 47 Fed. Reg. at 11,252.

95. See Securities Act Release No. 6339, 46 Fed. Reg. at 41,792; Securities Act Release No. 6389, 47 Fed. Reg. at 11,251-52. The 1977 Advisory Committee Report had made particular note of the disproportionately high cost of securities law compliance for small business issuers. For further discussion of this issue, see *infra* text accompanying notes 370-71.

Use of this concept allowed a substantial expansion of the number of investors who could participate in limited and private offerings,⁹⁶ and reduced the risk of liability.⁹⁷ The objective character of the rule 501(a) "accredited investor" definition, furthermore, helped reduce uncertainty costs. Similarly, the very broad exemption under rule 504 for transactions with an aggregate offering price not in excess of \$500,000⁹⁸ represented a virtually total deferral to state regulation with respect to offerings too small to justify detailed federal regulation.⁹⁹ Rule 504 thus created a flexible means of raising capital by small business. Other substantive aspects of these rules, such as the \$5 million cap on the aggregate offering price under rule 505¹⁰⁰ and the abandonment in rule 506 of offeree suitability requirements,¹⁰¹ had similarly positive effects on the usefulness of the exemptions from registration.

The securities bar largely welcomed Regulation D when it was initially adopted.¹⁰² As experience with the rules unfolded, however, some critics expressed unhappiness with certain aspects of the rules, such as the relatively heavy rule 502(b) disclosure requirements¹⁰³ and the Form D no-

96. Theoretically, an infinite number of accredited investors could be included in an offering under Regulation D, but both the ban on general solicitation and public advertising (*see infra* notes 411-20) and the need to establish the accredited or non-accredited status of each individual investor put some practical limits on the potential number of investors in the transaction. Nevertheless, transactions involving dozens of accredited investors are not uncommon. Unfortunately, no systematic empirical data on the numbers and kinds of investors in Regulation D offerings is available.

97. Regulation D reduced the risk of liability by: (1) eliminating the need to qualify all purchasers as sophisticated in offerings under § 4(2), 15 U.S.C. § 77d(2) (1988), and (2) building great flexibility into limitations on the number of purchasers.

98. Rule 504(b)(2), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266. For discussion of amendments to rule 504(a) affecting the aggregate offering price, *see infra* text accompanying notes 321-32.

99. *See* Securities Act Release No. 6339, 46 Fed. Reg. at 41,793 for discussion of the principle of deferral to state regulation in connection with rule 504 offerings.

100. Rule 505(b)(2), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

101. *Cf.* former rule 146(d)(1), 17 C.F.R. § 230.146(d)(1) (rescinded 1982), which required that the issuer reasonably believe, prior to any offer, that each offeree possessed the sophistication needed to evaluate the merits of the prospective investment, or could bear the economic risk of the investment. This requirement of establishing the subjective suitability of each offeree, and not just each purchaser, was one of the most heavily criticized aspects of rule 146. *See, e.g.,* Warren, *supra* note 22, at 376 n.158.

102. *See, e.g.,* Newman & Goldenberg, *Venture Capital Formation Under the SEC's New Regulation D*, Nat'l L.J., July 5, 1982, at 16, col. 1 (Regulation D a substantial change in regulation of capital formation); Sachs & Attman, *Raising Capital for Small Businesses by the Private Sale of Securities—The New Federal and Maryland Rules*, Md. B.J., June 1982, at 4, 8 ("the SEC seems to have balanced adequately the practical flexibility needed by issuers . . . with sufficient protections").

103. *See, e.g.,* Schneider, *Regulation D—Evaluation and Critique*, 15 REV. SEC. REG. 983, 984-85 (1982) ("the disclosure requirements of Regulation D were excessive"); Note, *Regulation D: Co-*

tice filing requirement.¹⁰⁴ Some also continued to complain about problems that antedated Regulation D but were perpetuated and to some extent exacerbated by these new rules.

Regulation D preserved, for example, the elusive notion that apparently discrete offerings, or even offerings by apparently discrete issuers, might be "integrated" or considered part of the same issue for purposes of determining the availability of an exemption.¹⁰⁵ As Regulation D came to facilitate larger and more complex exempt offerings, some critics perceived the slipperiness and unpredictability of the integration analysis to be more of a problem.¹⁰⁶ Regulation D also continued the ban on "general solicitation" of potential purchasers contained in earlier exemptive rules,¹⁰⁷ thus keeping alive the difficult problem of defining that term.¹⁰⁸ In fact, Regulation D inadvertently complicated matters when its accredited investor concept allowed exempt offerings to be sold to a much larger number of investors than permitted under earlier rules, thereby increasing the risk that a general solicitation might be found to exist.

Critics also complained of the precarious nature of Regulation D com-

herent Exemptions for Small Businesses Under the Securities Act of 1933, 24 WM. & MARY L. REV. 121, 163 (1982) ("[t]he new requirements for audited financial statements . . . could work an undue hardship on certain small issuers").

104. See, e.g., Donahue, *New Exemptions From the Registration Requirements of the Securities Act of 1933: Regulation D*, 10 SEC. REG. L.J. 235, 239 (1982) (criticizing required disclosure in Form D of confidential financial information); Kripke, *Has the SEC Taken All the Dead Wood Out of its Disclosure System?*, 38 BUS. LAW. 833, 851 (1983) ("[t]he notice requirement of rule 503 should be abolished").

105. Rule 502(a) expressly incorporated the "integration" concept into Regulation D. Securities Act Release No. 6389, 47 Fed. Reg. at 11,264. For more detailed discussion of this concept, see *infra* text accompanying notes 398-410.

106. See, e.g., Campbell, *The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems That Need Attention*, 74 KY. L.J. 127, 162-70 (1985-86) (the integration concept should be eradicated); Kripke, *supra* note 104, at 839-43 (present integration rules should be abolished and the concept sharply restricted).

107. Rule 502(c) expressly incorporated the "general solicitation" concept into Regulation D. Securities Act Release No. 6389, 47 Fed. Reg. at 11,265. That rule expressly prohibited "any form of general solicitation or general advertising," except as provided in rule 504(b)(1), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264. Rule 504(b)(1) permitted general solicitation or general advertising under narrowly specified circumstances. For discussion and critique of the "general solicitation" concept, see *infra* text accompanying note 329.

108. For critical analysis of the prohibition on general solicitation and general advertising, see Campbell, *supra* note 106, at 136-43 (criticizing SEC position); Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. FLA. L. REV. 1 (1986) (urging reexamination of the prohibition); Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67 (1989) (urging abolition of the prohibition).

pliance.¹⁰⁹ Even a modest failure to comply with one of many highly specific and technical conditions of the exemption could defeat the exemption with respect to every sale to every investor, and subject the issuer to devastating liability.¹¹⁰ The disproportion between fault and remedy thus shook some of the bloom off the Regulation D rose. Dissatisfaction with these problems lingered, and eventually provided much of the impetus behind the 1987-1989 revisions.¹¹¹

Despite these problems, the bar largely came to regard Regulation D as a workable and relatively flexible means of structuring exempt transactions. A far greater level of dissatisfaction, however, simmered among the state securities administrators. Many administrators still found it difficult to reconcile themselves to Regulation D,¹¹² and at least some resented the Commission's insistence upon establishing such a relatively liberal set of exemptions despite the states' reservations.¹¹³ The states' reservations about Regulation D turned the principal focus of controversy from federal law to state law, as the crucial issue became how the states should or should not revise their limited and private offering exemptions to coordinate with Regulation D.

109. See, e.g., Donahue, *Regulation D: A Primer for the Practitioner*, 8 DEL. J. CORP. L. 495, 520 (1983) (citing risk of liability for failure to comply strictly with the regulation's many complex and technical requirements); Kripke, *supra* note 104, at 852 (complaining that too many of the provisions of the regulation were conditions of exemption); Schneider, *supra* note 103, at 983 ("Regulation D overuses the technique of making every requirement . . . a condition to the availability of the exemption.").

110. For discussion of this phenomenon, see *infra* text accompanying notes 186-89, 224-26.

111. See *infra* text accompanying notes 185-223 for discussion of these issues in the context of the revision process.

112. For a typical critique, see Memorandum from NASAA Enforcement Liaison Committee to NASAA Small Business Finance Committee 3 (Apr. 19, 1983) ("questionable tax shelter deals have been proliferating The encouragement of these offerings through unlimited sales and without full disclosure is counter to every state securities law concept whether the state has merit or full disclosure standards.") [hereinafter Enforcement Memorandum] (on file with the *Washington University Law Quarterly*). One state administrator suggested that "one might anticipate the imminent emergence of questionable offerings" as a result of the SEC's adoption of Regulation D. Parnall, Kohl & Huff, *supra* note 34, at 684 (Kohl was Chief of the New Mexico Securities Bureau); see also Honig, *Massachusetts Securities Regulation: In Search of the Fulcrum*, 13 U. BALT. L. REV. 469, 490-95 (1984) (describing the difficulties of the Massachusetts Securities Division in accommodating itself to Regulation D).

Furthermore, some commentators other than state securities administrators expressed their concerns about Regulation D. See, e.g., Seligman, *supra* note 73, at 57 (criticizing SEC for failing to analyze the potential impact of broader exemptions on investor protection); Warren, *supra* note 22, at 381-82 (criticizing the accredited investor concept as creating a "peculiar reduction of investor protection").

113. See Enforcement Memorandum, *supra* note 112.

B. *The Battle Over the State Coordinating Exemptions*

The debate over the state law consequences of the adoption of Regulation D was but the latest manifestation of a long-standing structural problem in the relation between federal and state securities laws.¹¹⁴ Exemption of a transaction from federal registration under sections 3(b) or 4(2) of the 1933 Act does not exempt the transaction from state registration requirements. Each state securities act has its own version of section 5 of the 1933 Act, requiring all offers and sales within the state to be either registered or exempted from registration.¹¹⁵ Each state act has its own set of exemptive requirements, and the issuer must establish a separate exemption in every state in which the securities are offered. An issuer's ability to sell securities on an exempt basis therefore depends not just on the practicability of the federal exemptive scheme, but on the availability of parallel state exemptions. The lack of such an exemption in one or more states in which an offering must be made will render even the most liberal federal exemption virtually a dead letter because the issuer must structure the transaction to comply with the exemptive requirements, no matter how stingy or idiosyncratic, of every state in which the offering is made. In extreme cases, the lack of parallel exemptions may require registration of the offering in one or more states, possibly subjecting an offering exempt at the federal level to a stringent state "merit" review.¹¹⁶

114. For more detailed discussion of this problem, see Sargent, *supra* note 73, at 498-505.

115. A majority of states has adopted securities acts modeled on the version of the Uniform Securities Act approved by the National Conference of Commissioners on Uniform State Laws (the National Conference) in 1956 and amended in 1958. 1956 UNIF. SECURITIES ACT, 7B U.L.A. 509 (1958) (amended 1985) (the 1956 Act). For a list of jurisdictions that have adopted the 1956 Act, see 7B U.L.A. 115 (Supp. 1989). For thorough discussion of the 1956 Act, see L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976). Section 301 contains the 1956 Act's registration or exemption requirement. 1956 UNIF. SECURITIES ACT § 301, 7B U.L.A. 550 (1958) (amended 1985).

A substantially revised version of the 1956 Act was approved by the National Conference in 1985 and has been adopted in a few states. 1985 UNIF. SECURITIES ACT, 7B U.L.A. 50 (Supp. 1989) (the 1985 Act). For a list of jurisdictions that have adopted the 1985 Act, see 7B U.L.A. 50 (Supp. 1989). For discussion of the 1985 Act, which is also referred to as the Revised Uniform Securities Act or RUSA, see Sargent, *Some Thoughts on the Revised Uniform Securities Act*, 14 SEC. REG. L.J. 62 (1986); Sargent, *RUSA Revisited*, 17 SEC. REG. L.J. 79 (1989). The 1985 Uniform Act also contains a § 301 that imposes a registration or exemption requirement. 1985 UNIF. SECURITIES ACT § 301, 7B U.L.A. 70 (Supp. 1989).

116. State merit regulation has been defined in the following terms:

In essence, merit regulation is a paternalistic system of securities regulation permitting the administrator to deny effectiveness to a registration statement if the terms of the offering, the structure of the issuer, or any associated transactions do not (i) ensure a fair relation-

This structural problem created serious practical difficulties in the 1970s as the SEC began to experiment with its exemptive scheme. The then-existing state exemptions were based largely on variants of a Uniform Securities Act model¹¹⁷ that did not incorporate the private offering concept of section 4(2) and rule 146.¹¹⁸ These state exemptions also tended to restrict exempt offerings to very small numbers of purchasers, to impose narrow limits on the number of offerees, and to apply exemptive conditions alien to federal law, such as prohibitions on remuneration of salespersons.¹¹⁹ Some state administrators, furthermore, resisted pressure for compatible changes in state law.¹²⁰ In addition, there was substantial state-to-state variation in exemptive requirements, a phenomenon that exacerbated the difficulties already created by the restrictive or peculiar requirements of the individual state exemptions.¹²¹ For much of the 1970s, therefore, the federal and state exemptive systems were ships passing in the night, largely unresponsive to each other, and creating great practical problems for issuers with few compensating benefits to investors.¹²²

ship between promoters and public investors, and (ii) provide public investors with a reasonable relation between risk and return.

Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities*, 46 MD. L. REV. 1027, 1039 (1987). This definition was derived from *ABA Merit Report*, *supra* note 8, at 829. The author of this Article was the principal author of that report, and hence of the definition contained therein. *Id.* at 785. For discussion of the difficulties of producing a consensus definition of merit regulation, see *id.* at 795.

117. 1956 UNIF. SECURITIES ACT § 402(b)(9), 7B U.L.A. 509, 601-02 (1958) (amended 1985). This provision exempts offers and sales of securities to a specified, limited number of investors, exclusive of institutional investors, in a twelve-month period, if the issuer reasonably believes that all purchasers are purchasing for investment, and if no remuneration is paid directly or indirectly for soliciting a prospective buyer.

118. Some states, however, did make an attempt to accommodate themselves to rule 146. For discussion of Maryland's attempt, see Sargent, *supra* note 73, at 516-22; Comment, *Maryland Blue Sky Reform: One State's Experiment with the Private Offering Exemption*, 32 MD. L. REV. 273 (1972). For discussion of other state efforts, see Note, *State Exemptions from Securities Regulation Coextensive with SEC Rule 146*, 61 CORNELL L. REV. 157 (1975).

119. See Sargent, *supra* note 73, at 501-05.

120. See *id.* Illinois, for example, created serious practical problems by insisting on a report of sales in connection with exempt transactions, despite the absence of such a requirement in federal law. See Fein & Bright, *Private Offerings of Securities Under the Illinois Securities Law—Judicial Changes and the Need for Further Amendment*, 31 DEPAUL L. REV. 307, 315-17 (1982). Massachusetts required precommencement merit review of exempt offerings, a concept alien to federal securities laws. See Honig, *supra* note 112, at 486-88.

121. See Sargent, *supra* note 73, at 501-05.

122. For critical accounts of the practical problems created by this state of affairs, see J. MOFSKY, *BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS* 11, 19-30 (1971); Garcia & Kantor, *Dark Clouds in a Blue Sky: An Analysis of the Limited Offering Exemption*, 23 U. MIAMI L.

The SEC and the state administrators attempted to create a more cooperative spirit during the original development of Regulation D. Largely as a result of the 1980 congressional mandate to the SEC to cooperate with the states expressed in section 19(c)(3)(C) of the 1933 Act,¹²³ the SEC made a serious effort to involve the states in its attack on the problem of regulatory restraints on small business capital formation. Acting through the North American Securities Administrators Association (NASAA),¹²⁴ an organization of state securities administrators, representatives of the states participated fully in the Regulation D drafting process,¹²⁵ and used this opportunity to express their reservations about the expansion of existing exemptions from federal registration.¹²⁶

The state administrators' influence on the drafting process appeared most clearly in the version of Regulation D originally proposed by the SEC in Securities Act Release No. 6339 in 1981.¹²⁷ This version of the rules proposed at least two conditions clearly reflecting state influence: a restriction on remuneration of sales agents¹²⁸ and a disqualification pro-

REV. 568 (1969); Royalty & Jones, *The Private Placement Exemption and the Blue Sky Laws—Shoals in the Safe Harbor*, 33 WASH. & LEE L. REV. 877 (1976).

123. 15 U.S.C. § 77s(c)(3)(C) (1988). For discussion, see *supra* note 90.

124. The North American Securities Administrators Association (NASAA) is an organization comprised of securities regulators from 65 jurisdictions located in the United States, Puerto Rico, Canada and Mexico. NASAA Reports (CCH) ¶ 1 (1986). NASAA is not a regulatory entity; all regulatory authority resides with each of its members. *Id.* NASAA is of enormous importance, however, in defining statements of policy and guidelines for use by its members. See Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435, 443-47 (1984) (analysis of the impact of NASAA guidelines on the regulation of real estate securities offerings). NASAA also functions as the "voice" of the state securities regulators by commenting on proposed federal legislation and rules, filing amicus curiae briefs, and disseminating "investor alerts." Many of such NASAA documents are published in NASAA Reports (CCH).

125. For discussion of NASAA's role in the drafting process, see Securities Act Release No. 6339, 46 Fed. Reg. at 41,793-94; Securities Act Release No. 6389, 47 Fed. Reg. at 11,252-53.

126. See Memorandum from E.C. Mackey, Chairman of NASAA Subcommittee on Small Business Financing, to NASAA Members (Mar. 11, 1982) [hereinafter Mackey Memorandum] (on file with the *Washington University Law Quarterly*). Mackey described how the final version of Regulation D "in large measure adopted the NASAA proposals for change" from the proposed version of the regulation. *Id.* Mackey added:

In summary, it is fair to say that while your subcommittee is not totally satisfied with the final product, we were certainly given the opportunity to influence the outcome and where our ideas and suggestions were not adopted, the SEC had sound reasons and rationale, from their perspective, for not doing so.

Id. at 1-2. As mentioned above, however, not all state administrators were so sanguine about Regulation D. See Enforcement Memorandum, *supra* note 112.

127. Securities Act Release No. 6339, 46 Fed. Reg. at 41,791-809.

128. *Id.* at 41,799.

vision based on prior violations of state law.¹²⁹ Bar groups strongly criticized these proposals,¹³⁰ and they did not survive the next set of revisions.¹³¹ The states' influence on the drafting process, however, cannot be measured solely in terms of these failed proposals. The state administrators' strong, critical voice provided a consistent counterweight to the forces exerted by the securities bar in favor of even broader expansion of the federal exemptions.¹³² Although some state administrators may have felt aggrieved by the SEC's decision to promulgate Regulation D without their proposed constraints, they should have drawn consolation from their relative success in helping to forestall the adoption of even more extreme changes.

Some of the state administrators did not see the result in those terms, so they carried the battle to their own turf—the individual state exemptions that would have to be coordinated with Regulation D in order for the federal exemptions to be truly effective.¹³³ Here the state administrators enjoyed a better bargaining position than they had held in the Regulation D drafting process. The battles lost at the federal level could be won at the state level, or at least refought on more even terms, because the state administrators had ultimate control over the shape of their own states' exemptions. This control was far from complete, because the ad-

129. *Id.* at 41,801.

130. See ABA Section of Corporation, Banking and Business Law, Comment Letter on Securities Act Release No. 6339 at 42-49, 54 (SEC File No. S7-891) (Nov. 11, 1981) [hereinafter ABA Comment Letter on Release No. 6339].

131. See Securities Act Release No. 6389, 47 Fed. Reg. at 11,256, 11,258.

132. NASAA's representatives in the drafting process were apparently successful in persuading the SEC to tighten, rather than loosen, some of the Regulation D requirements. According to the Mackey Memorandum, *supra* note 126, which was drafted by the chairman of the NASAA subcommittee that participated in the process, NASAA exerted considerable influence over the formulation of the accredited investor definition:

Not only did SEC agree with our net worth limitation on the "big ticket" purchaser, but in fact increased the minimum purchase standard from \$100,000 to \$150,000. The "net worth" accredited investor standard was increased from \$750,000 to NASAA's proposed level of \$1.0 million and they agreed with NASAA's three year income requirement for the "large income" accredited investor. In fact, SEC went a step further and increased the income standard from \$100,000 to \$200,000.

Mackey Memorandum, *supra* note 126, at 1.

133. Even those state administrators who were more or less resigned to Regulation D may have been mollified by the realization that they would indeed have the last word in the form of their state coordinating exemptions. This sentiment is even expressed in the Mackey Memorandum, which is otherwise quite positive about Regulation D. See *supra* note 126. After explaining that the SEC did not accept all of NASAA's suggestions, the author of the memorandum stated that "[a]ctually, what has happened is some of the things we would like to have seen dealt with at a federal level will simply have to be implemented as a state initiative." Mackey Memorandum, *supra* note 126, at 2.

ministrators were subject to political pressures from the securities industry and the bars within their own states,¹³⁴ but, as a practical matter, most administrators had the legal and political authority to carve out their own approaches to exempt transactions.

The willingness of many administrators to use that authority to establish coordinating exemptions more consistent with their vision of investors' needs¹³⁵ immediately shifted the focus of attention away from Regulation D to the question of state coordination. The ensuing debate was not only of great practical importance but of great interest as a matter of public policy, because it demonstrated the enormous tension implicit in the joint state-federal system of securities regulation. From the states' perspective, the SEC's virtually unilateral action in liberalizing its own exemptive rules subjected the states to enormous pressure to abandon their own policies toward exempt transactions. From the SEC's perspective, the states' insistence on pursuing their own more restrictive and idiosyncratic paths was inimical to the cause of state-federal uniformity in a market context that needed uniformity. From the practitioner's perspective, the result was a nightmarish morass of inconsistent or contradictory state requirements superimposed upon the new structure of federal exemptions.

The fundamental debate over the substantive and philosophical bases of exemption from registration thus became entangled in disputes over the relative importance of state-federal uniformity, the degree of deference that the state administrators and the SEC owed to each other, and the proper allocation of securities regulatory responsibilities between the

134. For description of the kinds of tensions that can arise at the state level over this and related issues, see Honig, *supra* note 112. Battles at the state level over state exemptions coordinating with Regulation D were often tied to battles over merit regulation, an even more controversial aspect of state securities law. For descriptions of some of those battles, see Sargent, *The Challenge to Merit Regulation* (pts. 1 & 2), 12 SEC. REG. L.J. 276, 367 (1984-85).

135. For thorough description and analysis of the complex and confusing pattern of exemptions that states adopted to "coordinate" with Regulation D, but which largely reflected many state administrators' insistence on applying additional or inconsistent exemptive conditions, see Maynard, *The Uniform Limited Offering Exemption: How "Uniform" is "Uniform?"—an Evaluation and Critique of the ULOE*, 36 EMORY L.J. 357 (1987). Other commentators exploring the same territory include Hainsfurther, *Summary of Blue Sky Exemptions Corresponding to Regulation D*, 38 SW. L.J. 989 (1984); Halloran & Linderman, *Coordinating State Securities Laws with Regulation D and Federal Integration Policy: State Limited Offering Exemptions and Integration Standards*, in STATE REGULATION OF CAPITAL FORMATION AND SECURITIES TRANSACTIONS 155 (D. Goldwasser & H. Makens ed. 1983); Sargent, *supra* note 73, at 522-57.

state and federal governments.¹³⁶ In other words, this battle became another example of the tendency of disputes over substantive questions of corporate and securities law to transform themselves into questions of federalism.¹³⁷

The intertwining of serious substantive questions with these intractable federalism issues made this debate difficult to resolve. Additional complexity, furthermore, resulted from the need to resolve these problems at two levels. First, NASAA had to determine whether it should adopt a uniform exemption that would coordinate substantially with Regulation D. NASAA and the bar devoted great efforts to the development of a model Uniform Limited Offering Exemption (ULOE), which NASAA finally adopted in 1983.¹³⁸ NASAA's adoption of ULOE, however, simply moved the debate to a different level. Because NASAA uniform provisions and statements of policy do not have the force of law and are not binding on its individual state members, the state administrators had to decide whether they should adopt in their own states either the NASAA ULOE, a more restrictive alternative, or a more liberal alternative. The debate over these coordinating exemptions thus had a peculiarly indeterminate quality. Battles won or lost at the NASAA level could be refought at the individual state level, where the particular constellation of political forces within the state would determine the degree of coordination with ULOE and Regulation D.

The results of these debates can be described either optimistically or pessimistically, depending on one's perspective. From an optimistic per-

136. For detailed consideration of this issue in the context of state regulation of registered public offerings, see Sargent, *supra* note 116, at 1060-70.

137. For a cogent analysis of this phenomenon in other contexts, see Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813 (1984). Anderson argues that "issues about the appropriate roles for the courts and for Congress in resolving questions about the federal-state allocation of power often become confusingly entangled with questions about the appropriate substantive federal-state balance." *Id.* at 816.

138. NASAA adopted the present Uniform Limited Offering Exemption on September 21, 1983. *Uniform Limited Offering Exemption*, NASAA Reports (CCH) ¶ 6201 (May 1989) (with amendments adopted through April 29, 1989) (hereinafter referred to as ULOE or the ULOE). The ULOE drafting process, which included the participation of the ABA State Regulation of Securities Committee, actually began before Regulation D was proposed, and continued throughout the Regulation D drafting and review process. See ABA State Regulation of Securities Committee, Comment Letter on Proposed ULOE 3 (Oct. 9, 1981) [hereinafter ABA ULOE Letter (1981)]. A pre-Regulation D predecessor of the current ULOE was adopted by NASAA in 1981 and revised in 1982. It remained in effect until superceded by the present version of ULOE. See Maynard, *supra* note 135, at 378-79. For discussion of the development of ULOE, see Halloran & Linderman, *supra* note 135, at 165-74; ABA ULOE Letter (1981), *supra* at 3-4.

spective, progress seemed to have been made in the mid-1980s through NASAA's adoption of ULOE and the eventual adoption by a substantial number of states of coordinating exemptions consistent with or more liberal than ULOE.¹³⁹ These developments allowed many Regulation D transactions to be "blue-skied" with some predictability. From a pessimistic perspective, the situation seemed little improved. The NASAA ULOE in some respects appeared a begrudging form of coordination.¹⁴⁰ Some states, furthermore, refused to adopt ULOE-type exemptions, while others that did adopt such exemptions superimposed additional and often inconsistent exemptive conditions, requiring extremely careful and expensive blue-sky compliance efforts.¹⁴¹ Whether one regards the outcome of these debates optimistically or pessimistically, the situation

139. Counting the number of states that have adopted ULOE-type exemptions is no easy matter. According to NASAA's count in 1984, 13 states had adopted coordinating exemptions less restrictive than ULOE, and 16 other states had adopted coordinating exemptions more or less consistent with ULOE. *Periodic ULOE Adoption Update*, NASAA Reports (CCH) ¶ 6401, at 6202-04 (Sept. 10, 1984). According to Professor Maynard, by 1987 27 states had "implemented" ULOE. Maynard, *supra* note 135, at 361 n.10. This figure includes some of the "less restrictive" states included within the 1984 NASAA count. Other commentators report, however, that by 1988 only 23 states had "adopted ULOE in some form." Fein, Makens & Cahalan, *ULOEO: Comprehending the Confusion*, 43 BUS. LAW. 737, 738 (1988). The difficulty here is created by inconsistencies in defining when a state has implemented or adopted ULOE. Those definitions are inconsistent because many states have insisted on substantially modifying their version of ULOE, thus making it hard to say whether they have truly adopted ULOE or not. For comprehensive analysis of this bewildering array of modifications, see Maynard, *supra* note 135. It is probably fair to say, however, that about half of the states have adopted coordinating exemptions recognizable as some form of ULOE.

140. In other words, difficulties at the state level have been created not only by individual state modification of the ULOE, but by the fact that ULOE itself is not entirely consistent with crucial aspects of Regulation D, and thus has not truly served as an adequate model for state-federal coordination. For discussion of the inconsistencies between Regulation D and ULOE, see Maynard, *supra* note 135, at 386-89. For analysis of the conceptual and practical consequences of the inconsistencies between the disqualification provisions of Regulation D and ULOE, see Crespi, *The Uniform Limited Offering Exemption: The Need for Amendment of its Disqualification Provisions*, 16 SEC. REG. L. J. 370 (1989).

141. One group of commentators has painted a dismal picture of the resulting situation:

[M]any states have hesitated to adopt ULOE. Some simply refused to act, while others adopted only a portion of ULOE. Many purported to adopt ULOE but substantially varied its terms, and very few adopted a truly conforming ULOE. Unfortunately, to some degree the lack of uniformity arises from the parochial perceptions of state administrators who in some circumstances view their changes to ULOE solely from the perspective of offerings conducted only in their own state, not comprehending the chaos produced by the profligation [sic] of ULOE variations for multistate limited offerings. . . . [T]o us it appears incomprehensible that all states should not have acted by this time to adopt ULOE if they considered both the favorable experience of other NASAA members who have so acted and the need for national uniformity.

Fein, Makens & Cahalan, *supra* note 139, at 739.

demonstrated a fundamental and still-unresolved tension within the regulatory framework.

NASAA, individual state administrators and the bar were the principal combatants in the battle over ULOE. The SEC seemed to encourage a greater degree of state-federal coordination, but remained largely on the sidelines. The SEC's only amendment of Regulation D prior to the 1987-1989 revisions, however, demonstrated that it really was interested in developing a more coordinated state-federal exemptive regime for limited and private offerings.

Late in 1986, the SEC announced in Securities Act Release No. 6663¹⁴² the adoption of a set of revisions to Form D.¹⁴³ Some of these revisions were intended to reduce the amount of information required by the Form D notice filing, and had no impact on the state coordination question.¹⁴⁴ The principal change, however, was creation of a uniform notice form that could be filed with both the SEC and states, ending the need to file separate forms with the SEC and each of the different states.¹⁴⁵ The SEC also intended the revised Form D to facilitate state enforcement efforts by requiring disclosure in its appendix of the type and aggregate offering price of all securities sold in each state.¹⁴⁶ In addition, the revisions added a special state signature page that elicited specific information about persons subject to either state or federal disqualifiers and that required issuer consent to certain undertakings and representations of interest to the states.¹⁴⁷

The changes announced in Release No. 6663 established a greater degree of procedural coordination between Regulation D and parallel state exemptions. The drafting of the revised Form D, furthermore, was a welcome example of state-federal cooperation,¹⁴⁸ as NASAA representatives participated in the revision process.¹⁴⁹ The persistence of different state-federal points of view, however, became manifest in the objections

142. Securities Act Release No. 6663 (Oct. 2, 1986), 51 Fed. Reg. 36,385 (1986).

143. The current version of Form D is published at 17 C.F.R. § 239.500 (1989).

144. These changes are explained in Securities Act Release No. 6650 (June 5, 1986), 51 Fed. Reg. 21,378, 21,379 (1986), the release in which the changes to Form D were proposed.

145. *Id.* at 21,378-79

146. *Id.* at 21,379.

147. *Id.*

148. The goal of cooperation was stated clearly in Securities Act Release No. 6650, 51 Fed. Reg. at 21,378: "The proposal to structure Form D as a uniform federal/state notification form is intended to further encourage states to adopt ULOE."

149. *Id.*; Securities Act Release No. 6663, 51 Fed. Reg. at 36,386.

of some individual state administrators to the other key change accomplished by Release No. 6663: elimination of the periodic notice filings required during the course of Regulation D offerings and the final filing required after the completion of the offering.¹⁵⁰

In its earlier Securities Act Release No. 6650, in which the SEC originally had proposed these changes, the agency acknowledged that the periodic and final filing requirements imposed significant costs on both issuers and the agency itself, and conceded that these filings could be eliminated with little disadvantage to investors.¹⁵¹ Implicit in this conclusion was the SEC's recognition that issuers' risk of losing the entire exemption because of inadvertent failures to comply with the filing requirements was disproportionate to any harm done to investors by issuers' failures to file. Some state administrators opposed this proposal, however, arguing that elimination of these requirements would impair their monitoring capabilities and compromise their enforcement efforts because it would create pressure upon them to adopt similar changes in state coordinating rules.¹⁵² The SEC adopted the proposed changes over these objections, but the theme sounded in the state administrators' comments reappeared in their comments on the SEC's more recent proposals: the SEC was achieving its goal of removing impediments to capital formation at the expense of the state administrators' enforcement capability.¹⁵³ For some state administrators, the SEC's various attempts throughout the 1980s to strike a regulatory balance facilitating small business capital formation actually struck an imbalance that facilitated fraud, not capital formation.¹⁵⁴

The continuing battle over state-federal coordination thus provided the backdrop as the SEC turned its attention to the substance of Regulation D. In 1987, the SEC issued a series of proposals addressing the problems that had emerged during the five years since the Regulation's promulgation.

C. Creating the New Regulation D: Dynamics of the Revision Process

The shape of the new Regulation D was determined by a dialectical conflict between the bar pressing for relief from burdens perceived as

150. *See supra* note 30.

151. Securities Act Release No. 6650, 51 Fed. Reg. at 21,379-80.

152. Securities Act Release No. 6663, 51 Fed. Reg. at 36,386.

153. *See infra* text accompanying notes 206-15.

154. *Id.*

unjustifiable and state securities administrators committed to limiting the impact of ULOE and Regulation D on their enforcement efforts. As this conflict intensified, the SEC assumed the role of mediator, and tried to produce a synthesis acceptable to both sides. The agency's ability to play that role, however, was constrained by a tension between the Commission and the SEC staff over the scope and direction of the 1987-1989 revisions. The complex interplay of these dynamics produced a long period of uncertainty, no little acrimony, and, finally, compromise solutions. The exquisite difficulty of balancing these different dynamics, furthermore, probably contributed to the SEC's decision to leave untouched long-standing problems such as the definition of "general solicitation" and the exact scope of the "integration" concept.¹⁵⁵ These dynamics of regulatory reform thus permitted substantial change but, almost inevitably, left an unfinished agenda.

As discussed in Part III B,¹⁵⁶ the 1986 revisions to Form D reflected the kind of balancing act that the SEC would undertake on a larger scale in 1987-1989. The same balancing technique appears in the major set of revisions to Regulation D proposed in Securities Act Release No. 6683¹⁵⁷ in January 1987.

These proposals, at first glance, seemed largely responsive to the bar's concerns. The release proposed expanding the definition of "accredited investor" to cover several gaps left in the original definition,¹⁵⁸ raising the limit on the aggregate offering price for rule 504 offerings from \$500,000 to \$1 million under certain circumstances,¹⁵⁹ and creating a new exemption separate from Regulation D under proposed rules 701-702 for certain employee benefit plan offerings.¹⁶⁰ This release also invited comment on the desirability of reducing mandatory disclosure under Regulation D for issuers engaged in relatively small offerings, conceding that "experience over the past four years suggests that there may be benefits to providing a reduced level of disclosure for such small offerings."¹⁶¹ Other aspects of Release No. 6683, however, showed that the SEC was not entirely in thrall to the bar.

155. For discussion of the continuing need for reexamination of these problems, see *infra* text accompanying notes 398-421.

156. See *supra* text accompanying notes 148-54.

157. Securities Act Release No. 6683 (Jan. 16, 1987), 52 Fed. Reg. 3015 (1987).

158. *Id.* at 3017-18.

159. *Id.* at 3018-19.

160. *Id.* at 3020-21.

161. *Id.* at 3019.

For example, the release invited comment on the question of whether "a substantial or good faith compliance standard should be instituted for purposes of Regulation D."¹⁶² This standard would have created a defense from liability for violation of Regulation D when the failure to comply with some provision of the regulation was "inadvertent" and "in a manner that is immaterial to the offering as a whole."¹⁶³ While it was remarkable that the SEC had announced its willingness to consider a concept that had been in the air for almost fifteen years,¹⁶⁴ the release took a completely neutral position with respect to the concept, and did not state any proposed language. This tentative approach to the issue surely reflected the SEC staff's reservations about the concept¹⁶⁵ as well as some trepidation about the state administrators' possible reaction.

An even clearer example of the SEC's sensitivity to concerns other than those of the bar was the request in Release No. 6683 for comment on the desirability of applying the disqualifiers contained in rule 505 to rule 506.¹⁶⁶ Rule 505(b)(2)(iii) prohibits the use of the exemption if certain persons involved in the offering, such as the issuer, its affiliates or the underwriter, have been subject to legal action for specified types of conduct.¹⁶⁷ In floating the suggestion that it might extend such disqualifiers to rule 506, the SEC referred specifically to "[r]epresentatives of the state securities regulators" who believed that the extension of disqualifiers to rule 506 was appropriate, because exemptions from registration were "privileges, rather than rights," and thus could "be withheld for certain persons and should not be automatically available to persons who have exhibited a disregard for the law."¹⁶⁸ The release contains no SEC statement for or against the suggested expansion, but it is significant that the agency was willing to consider broader applicability for a concept whose practical complications had been one of the most controversial aspects of the original Regulation D.¹⁶⁹

162. *Id.* at 3020.

163. *Id.*

164. The source of the concept was Schneider & Zall, *Section 12(I) and the Imperfect Exempt Transaction: The Proposed I & I Defense*, 28 BUS. LAW. 1011 (1973). See also Schneider, *supra* note 103, at 987-88. Other commentators have urged SEC adoption of a substantial compliance approach over the years. See, e.g., Kripke, *supra* note 104 at 852-53 (proposing adoption of defense for inadvertent and immaterial errors—the "I & I" defense).

165. See *infra* text accompanying notes 190-93.

166. Securities Act Release No. 6683, 52 Fed. Reg. at 3018-19.

167. 17 C.F.R. § 230.505(b)(2)(iii) (1989).

168. Securities Act Release No. 6683, 52 Fed. Reg. at 3018-19.

169. For criticism of the Regulation D disqualifiers, see ABA Comment Letter on Release No.

The fate of some of the proposals set out in Release No. 6683 showed the precariousness of the SEC's balancing act. Even the agency's attempt to reduce some of the burdens on small business encountered complaints from the new rules' intended beneficiaries. For example, while the SEC's attempt to provide substantial relief to smaller companies issuing securities under employee benefit plans¹⁷⁰ was clearly appreciated, commentators so thoroughly criticized the details of the agency's proposal on both technical and substantive grounds¹⁷¹ that the SEC was forced to rewrite the initial proposal. In mid-1987, the SEC issued Release No. 6726, proposing a less restrictive set of exemptive conditions for employee benefit plan offerings under proposed rules 701-703.¹⁷² Most notably, the SEC agreed to eliminate compliance with the rule 702 notice filing requirement as a condition of the exemption, and proposed instead that issuers who violate the filing requirement be prohibited under rule 703 from using the rule 701 exemption in the future.¹⁷³ Even this major concession, however, did not entirely satisfy the critics,¹⁷⁴ and nearly another year would pass before the SEC was able to resolve lingering disputes over the method of determining the limit on the aggregate offering price of securities to be offered under rule 701.¹⁷⁵ The SEC did not announce the final adoption of rules 701-703 until April 1988 in Securities Act Release No. 6768.¹⁷⁶

Some of the other proposals from Release No. 6683 met a kinder fate.

6339, *supra* note 130, at 53 ("We most strongly urge the Commission to remove all disqualification provisions in Rule 505 . . ."). For analysis of the difficulties created by incorporation of Regulation D disqualifiers into ULOE, see Crespi, *supra* note 140, at 375-85 (urging amendment of ULOE disqualification provisions).

170. Securities Act Release No. 6683, 52 Fed. Reg. at 3020-21 (proposing Rule 701).

171. See *ABA Panel's Comment on Proposed Employee Benefit Plan Exemptions*, 19 Sec. Reg. & L. Rep. (BNA) 451 (Mar. 27, 1987) (commentators identify numerous problems with proposed rules 701-702).

172. Securities Act Release No. 6726 (July 30, 1987), 52 Fed. Reg. 29,033 (1987).

173. *Id.* at 29,034-35.

174. See *ABA Members Applaud SEC Proposals on Employee Benefit Plan Exemption*, 19 Sec. Reg. & L. Rep. (BNA) 1494 (Oct. 2, 1987) (commentators express appreciation for revision of the proposal while reiterating several criticisms).

175. See Securities Act Release No. 6768 (Apr. 14, 1988), 53 Fed. Reg. 12,918, 12,919 (1988) for discussion of these disputes.

176. *Id.* Rules 701-703 are now codified at 17 C.F.R. § 230.701-703(T) (1989). These rules are not technically part of Regulation D, but the SEC proposed and adopted them in connection with changes to Regulation D, and they obviously serve the same goal of reducing compliance costs for small business issuers. They thus deserve consideration in connection with the revisions to Regulation D itself. For more detailed discussion of rules 701-703(T), see *infra* text accompanying notes 333-51.

The additions to the list of accredited investors engendered little controversy, and their final adoption was announced in March 1988 in Securities Act Release No. 6758.¹⁷⁷ The same release announced the approval of amendments to rule 504, including an increase of the aggregate offering price ceiling from \$500,000 to \$1 million—so long as the issuer offers and sells no more than \$500,000 of securities without registration under state securities laws¹⁷⁸—and the removal under some circumstances of the restrictions on general solicitation and resales.¹⁷⁹ A reduction in the level of mandatory disclosure for rule 505 and 506 offerings not in excess of \$2 million also was approved without any major opposition.¹⁸⁰

The SEC also disposed of the suggestion made in Release No. 6683 that it add “bad boy” disqualifiers to rule 506.¹⁸¹ Virtually all commentators objected to the proposal, and the state administrators did not push for it,¹⁸² probably because they felt that the proposal had little chance of success, and because many state coordinating exemptions already superimposed disqualifiers upon rule 506 offerings.¹⁸³ Release No. 6758 thus announced that the SEC had abandoned the notion.¹⁸⁴

All was not sweetness and light, however, as demonstrated by the controversy over the proposed employee benefit plan exemption. That controversy, furthermore, was dwarfed by the conflict over the substantial compliance issue. With respect to this issue, the SEC faced more criticism for what it did not propose in Release No. 6683 than for what it did propose. While the SEC requested comments on the desirability of a substantial compliance defense, it did not recommend adoption of the defense and did not set out any proposed language for an appropriate amendment of the rules.¹⁸⁵ The SEC’s apparently neutral position on the issue made the agency a target for attack.

A comment letter provided by a group of several American Bar Association (ABA) committees described the lack of a substantial compliance

177. Securities Act Release No. 6758 (Mar. 3, 1988), 53 Fed. Reg. 7866 (1988).

178. *Id.* at 7867, 7869.

179. *Id.*

180. *Id.* at 7867-69.

181. Securities Act Release No. 6683, 52 Fed. Reg. at 3018-19.

182. See Securities Act Release No. 6758, 53 Fed. Reg. at 7867. (“The commentators were almost unanimously opposed to the suggestion. No state commented on this issue.”)

183. See Maynard, *supra* note 135, at 461.

184. Securities Act Release No. 6758, 53 Fed. Reg. at 7867.

185. Securities Act Release No. 6683, 52 Fed. Reg. at 3019-20. See *supra* text accompanying notes 162-64.

defense as a "fundamental defect," and urged SEC adoption of such a defense under Regulation D.¹⁸⁶ A New York State Bar Association committee took a similar position in another strongly worded letter.¹⁸⁷ These representatives of the organized bar thus took an unequivocal position on what they regarded as the most significant issue raised by Release No. 6683. According to the drafters of the ABA comment letter, "Regulation D simply contains too many detailed conditions, many of which are not susceptible to objective analysis, for an 'all or none' compliance requirement,"¹⁸⁸ and "investors as a whole [do not] benefit from the 'all or none' approach sufficiently to justify the considerable extra expense and uncertainty it creates."¹⁸⁹

The SEC's immediate response was to do essentially nothing. The issue languished for over a year until a confrontation at a January 1988 meeting of the Commission exposed the conflict between the SEC staff and some Commission members over the substantial compliance concept.¹⁹⁰ Some members of the staff apparently felt that the defense would broaden the exemption unacceptably, and that unpredictable judicial interpretations of the relatively vague substantial compliance standard would pose a threat to the SEC's goal of investor protection.¹⁹¹ Some of the commissioners were far more sympathetic to the concept, and expressed impatience with the staff's reluctance to propose a substantial compliance rule.¹⁹² After an airing of both views, the Commission directed the staff to draft language for an appropriate rule within sixty days.¹⁹³ The proposed substantial compliance defense that resulted from this directive therefore emerged from a policy struggle within the SEC as well as from the struggle between the state administrators and the bar. The key to the final adoption of the defense can be found in the Commis-

186. ABA Section of Corporation, Banking and Business Law, Comment Letter on Securities Act Release No. 6683 at 4 (SEC File No. S7-1-87) (Mar. 13, 1987) [hereinafter as ABA Comment Letter on Release No. 6683].

187. See *Bar Group Urges Support for Proposed Reg D. Amendments*, 19 Sec. Reg. & L. Rep. (BNA) 481 (Apr. 3, 1987).

188. ABA Comment Letter on Release No. 6683, *supra* note 186, at 6.

189. *Id.* at 5.

190. For a description of this confrontation, see *SEC Defers Action on Expanding Reg. D to Consider Possible Violations Defense*, 20 Sec. Reg. & L. Rep (BNA) 128 (Jan. 29, 1988).

191. *Id.* at 129.

192. *Id.* The principal supporter of the substantial compliance concept on the Commission was apparently Commissioner Edward Fleischman. *Id.*

193. *Id.*

sion's ability to impose upon the law its skeptical vision of the costs and benefits of Regulation D over the objections of the staff.

The SEC proposed the new substantial compliance concept in March 1988 in Securities Act Release No. 6759.¹⁹⁴ This release also suggested two minor additions to the list of accredited investors,¹⁹⁵ but the heart of the release was the substantial compliance proposal contained in a new Rule 508¹⁹⁶ and a related proposal set out in a new rule 507.¹⁹⁷

Release No. 6759's version of proposed rule 508 was short and at least apparently simple. It stated that

[a] failure to comply with a condition or requirement of . . . Regulation D that is insignificant with respect to the offering as a whole will not result in the loss of the exemption . . . if the issuer can show a good faith and reasonable attempt to comply with all provisions of the Regulation.¹⁹⁸

With respect to offers or sales to particular persons, however, the issuer would have to show that "the failure to comply was insignificant with respect to that offer or sale, as well as to the offering as a whole."¹⁹⁹ The crucial term "insignificant" was defined as "an isolated and minor deviation from [the] requirements."²⁰⁰ Proposed rule 508 thus presented for the first time the possibility of avoiding, or at least limiting, liability for registration violations in cases in which those liabilities were the most difficult to justify. The proposed language was rife with potential interpretive problems, but it nevertheless represented a conceptual breakthrough.

Proposed rule 507 also represented a breakthrough, while serving much of the same purpose as proposed rule 508 through different and more specific means. One of the major pitfalls under Regulation D was the issuer's risk of incurring section 12(1)²⁰¹ liability in connection with even the most carefully structured Regulation D transaction by failing to comply with the rule 503 filing requirement.²⁰² Because the filing re-

194. Securities Act Release No. 6759 (Mar. 3, 1988), 53 Fed. Reg. 7870 (1988).

195. *Id.* at 7870-72.

196. *Id.* at 7871, 7873. Rule 508 is codified at 17 C.F.R. § 230.508 (1989).

197. Securities Act Release No. 6759, 53 Fed. Reg. at 7871, 7873. Rule 507 is codified at 17 C.F.R. § 230.507 (1989).

198. Securities Act Release No. 6759, 53 Fed. Reg. at 7873.

199. *Id.*

200. *Id.*

201. 15 U.S.C. § 77L(1) (1988).

202. Liability would result under § 12(1), 15 U.S.C. § 77L(1) (1988), because a failure to comply with the filing requirement under rule 503, Securities Act Release No. 6389, 47 Fed. Reg. at 11,265, constituted a failure to comply with one of the conditions of exemption under Regulation D. If the

quirement was a condition of the exemption, even an inadvertent failure to file could result in loss of the exemption with respect to the entire offering.

Over the years, the SEC had grown more sensitive to the imbalance between wrong and remedy inherent in the potentially devastating consequences of a failure to file a notice form that would never be reviewed by the SEC. As explained above in Part III B,²⁰³ this sensitivity was implicit in the SEC's 1986 decision to eliminate the periodic and final reporting requirements that created traps for the unwary issuer while producing few benefits for investors. With proposed rule 507, the SEC went a major step further.

The SEC proposed maintaining the rule 503 filing requirement, but eliminating it as a condition of exemption under rules 504, 505 and 506.²⁰⁴ An incentive to comply with the filing requirement would remain, however, because proposed rule 507 would disqualify from future use of Regulation D any issuer found to have violated the rule 503 filing requirement.²⁰⁵ Thus, the net effect of proposed rule 507 would be to preserve an incentive to comply while reducing the risk of liability for one of the more trivial violations of Regulation D.

Release No. 6759 thereby placated the critics of SEC exemption policy both within the bar²⁰⁶ and on the Commission itself. It started an uproar, however, among those at the opposite end of the philosophical spectrum—the state securities administrators. The state administrators' reaction to proposed rules 507 and 508 was negative, to say the least. Some administrators not only objected vehemently to the substance of the proposed rules, but also insisted that the SEC's decision to adopt such rules violated the spirit of compromise and cooperation prerequisite to the administrators' adoption and support of ULOE. The president of

sale of securities failed to qualify for an exemption under Regulation D (or some other exemption) and was not registered with the SEC, a violation under § 5, 15 U.S.C. § 77e (1988) would result. Potential liability under § 12(l), 15 U.S.C. § 77L(1) (1988) would then arise.

203. See *supra* text accompanying notes 142-54.

204. Securities Act Release No. 6759, 53 Fed. Reg. at 7871.

205. *Id.*

206. See ABA Section of Corporation, Banking and Business Law, Comment Letter on Securities Act Release No. 6759 at 2 (SEC file S7-4-88) (June 3, 1988)[hereinafter ABA Comment Letter on Release No. 6759] ("We strongly support the Commission's effort to address the issue of substantial compliance We agree with the elimination of the Form D filing requirement as a condition of the exemption")

NASAA made these points clear in that organization's comment letter on Release No. 6759:

There is a deeply felt concern by some state securities administrators that by unilaterally proposing significant changes in what is designed as a federal-state regulatory scheme, the Commission is abandoning its commitment to cooperate with the states for the benefit of small business. Equally disturbing is the possibility that adoption of these rules will produce such wide differences in the regulatory schemes that uniformity will come to be viewed as an unattainable goal.²⁰⁷

These proposals thus brought to the surface the old tensions and resentments that had made the battle over ULOE so intense, and threatened to destroy the fragile consensus that had emerged around that coordinating rule.²⁰⁸

The administrators' specific substantive objections echoed a theme that they first had sounded with respect to the earlier changes in the Form D filing requirements.²⁰⁹ In essence, they regarded proposed rule 508 as a potential obstacle to their enforcement efforts because this change to federal law probably would be introduced into their own exemptive rules by means of ULOE or otherwise. According to the NASAA comment letter, proposed rule 508 would "inevitably complicate enforcement efforts by introducing such vague and debatable concepts as 'insignificant with respect to the offering as a whole' and 'good faith and reasonable attempt to comply' into all but the clearest enforcement cases."²¹⁰ The negative impact of the substantive compliance defense, the NASAA letter added, would be "aggravated by the fact that, whether by design or otherwise, the policing of Regulation D offerings has fallen almost entirely to the states."²¹¹ The letter appended to this line of reasoning the barbed comment that "it may be reasonable for the Commission to expect the states to bear the lion's share of the enforcement role," but that "this separation

207. *NASAA Comment Letter on Securities Act Release No. 6759* (SEC File No. S7-4-88), NASAA Reports (CCH) ¶ 9317, at 9271 (May 10, 1988)[hereinafter *NASAA Comment Letter on Release No. 6759*]. Representatives of NASAA previously had expressed their opposition to the substantial compliance concept in an earlier comment letter. *NASAA Comment Letter on Securities Act Release No. 6683* (SEC File No. S7-1-87), NASAA Reports (CCH) ¶ 9310, at 9245 (Apr. 15, 1987) ("A 'substantial compliance' standard for Reg D filings is not warranted. No party has produced evidence of any hardship (absent hypotheticals) caused by strict compliance with the provisions of Reg. D or ULOE.")

208. See *supra* text accompanying notes 114-54.

209. See *supra* text accompanying notes 152-54.

210. *NASAA Comment Letter on Release No. 6759*, *supra* note 207, at 9269.

211. *Id.* at 9267.

of responsibilities may make it somewhat too easy for the Commission to propose rules which have the unintended effect of impeding enforcement."²¹²

NASAA's response to proposed rule 507 was equally vehement: "When coupled with the provisions of Rule 508, the elimination of the form as a condition of the exemption will invite the dishonest and the unethical to hide behind the shield of Regulation D after their activities have been discovered."²¹³ More specifically, the administrators feared that their ability to take action against registration violations under their own laws would be seriously compromised by elimination of the enforcement leverage that the issuer's failure to make the requisite filing creates. One state administrator explained in a comment letter on Release No. 6759 that

the filing requirement is critical to allocation of our thinly-spread enforcement resources: when we begin to receive investor complaints with regard to an offering, and are able to determine that no filing was made as required, we can move immediately to issue inquiry letters, and subpoenas if necessary. Frankly, in our experience, the failure to file a Form D is often a "proxy" for much more serious violations of federal and state securities laws.²¹⁴

The state administrators' opposition to proposed rules 507 and 508 thus counterbalanced the bar's support, and the SEC once again remained in the middle.

A suggestion contained within NASAA's comment letter on Release No. 6759, however, laid the groundwork for the compromise that eventually emerged from this imbroglio. In that letter, NASAA suggested that the substantial compliance defense be available to defendants facing suits brought by private plaintiffs, "but never as to federal and state regulators."²¹⁵ Sellers could thus use the substantial compliance defense in private litigation with purchasers, but not in enforcement actions. NASAA's suggested distinction provided a starting point for development of a compromise.

The compromise resulted from the formation of a working group consisting of representatives of NASAA, various committees of the ABA

212. *Id.* at 9271 n.1.

213. *Id.* at 9269.

214. Ellyn L. Brown, Maryland Securities Commissioner, Comment Letter on Securities Act Release No. 6759 at 1 (SEC File No. S7-4-88)(May 12, 1988).

215. *NASAA Comment Letter on Release No. 6759, supra* note 207, at 9269-70.

and the SEC staff.²¹⁶ The working group eventually produced a solution to the substantial compliance problem. The solution had three basic elements: (1) reformulation of the substantial compliance standard itself; (2) elimination of the defense with respect to violations of the general solicitation ban and the aggregate offering price and purchaser limitations; and (3) exclusion of the defense from SEC enforcement actions.²¹⁷ These elements of the compromise gave the bar much of what it wanted while assuaging many of NASAA's concerns. The SEC thus was able in Securities Act Release No. 6812 to repropose rule 508 in accordance with the working group's recommendations.²¹⁸ This December 1988 release also repropose rule 507 without change.²¹⁹ The compromise solution to the substantive compliance problem quelled all serious opposition. The SEC announced the final adoption of rules 507 and 508 in March 1989 in Securities Act Release No. 6825.²²⁰ Perhaps the best indication of the strength of the political rapprochement over the substantial compliance defense was the speed with which the bar and NASAA were able to work out coordinating language with ULOE²²¹ and to secure approval of those

216. For discussion of the background to the activities of this working group by a member thereof, see Schneider, *A Substantial Compliance ("I & I") Defense and Other Changes are Added to SEC Regulation D*, 44 Bus. Law. 1207, 1208-10 (1989). See also Summary of the Recommendations of a Working Group Comprised of Representatives of NASAA, Committees of the ABA and the SEC Staff (Oct. 4, 1988) [hereinafter Working Group Summary] (on file with the *Washington University Law Quarterly*); *Resolution of the North American Securities Administrators Association, Inc. Regarding Proposed Amendments to Regulation D*, NASAA Reports (CCH) ¶ 11,121 (Oct. 12, 1988) (expressing support of working group's proposals and recommending parallel changes to the ULOE).

217. Working Group Summary, *supra* note 216, at 2.

218. Securities Act Release No. 6812 (Dec. 20, 1988), 54 Fed. Reg. 309, 312, 314 (1989).

219. *Id.*

220. Securities Act Release No. 6825 (Mar. 14, 1989), 54 Fed. Reg. 11,369 (1989).

221. See *Uniform Limited Offering Exemption*, NASAA Reports (CCH) ¶ 6201, at 6103 (May 1989). It must be emphasized, however, that ULOE does not entirely coordinate with the approach taken by the SEC in rules 507 and 508. There is, in particular, no direct parallel to rule 507 with respect to state filing requirements. Instead, § 2 of ULOE includes a bracketed reference to § 1.C of ULOE, which sets out the exemption's filing requirement, and in footnote 6 states that in those jurisdictions that have adopted Regulation D-type postsale notice requirements, "it would not be inconsistent with the regulatory objectives of this exemption to include the notice filing requirements of section 1.C within the substantial compliance provisions of section 2 or to eliminate the filing as a condition and adopt a rule similar to Rule 230.507." *Uniform Limited Offering Exemption*, footnote 6, NASAA Reports (CCH) ¶ 6201, at 6103, 6105 (May 1989). This approach to the filing problem reflects not only NASAA's continuing reservations about eliminating the filing requirements as an absolute condition to the exemption, but the difficulty in accommodating a rule 507 or 508 approach to state exemptions with a precommencement filing requirement. For discussion of such exemptions, see Maynard, *supra* note 135, at 395-405. For additional critical discussion, see Keller, *The*

changes by the NASAA membership in April 1989.²²²

The true measure of the compromise's strength, however, will come not at the NASAA level but in the individual states, as the battle over the actual extent of coordination of individual state rules with rules 507 and 508 begins.²²³ The continuing disagreement over the complex relation of capital formation and investor protection in limited and private offerings should make this battle almost as intense as the initial battle over ULOE. It remains to be seen whether the states' ability to impose their own requirements and limitations on exempt transactions will undermine the impact of rules 507 and 508.

IV. PRINCIPLES OF REFORM: AN ANALYSIS OF THE NEW REGULATION D

The new Regulation D was shaped by the rivalry between the organized securities bar and the state securities administrators, with the SEC (despite its own internal rivalries) mediating between the two and trying to forge consensus solutions. The resulting changes thus bear the marks of compromise between the bar's desire for changes that would allow them to complete Regulation D transactions more easily and the state administrators' desire to avoid changes in federal law that would diminish their ability to enforce their own laws. The SEC loosened many existing constraints on exempt financing in response to arguments from the bar and its allies on the Commission, but slowed the deregulatory momentum in response to expressions of concern by state administrators and their sympathizers on the SEC staff. Despite these necessary compromises, however, the revisions will make it easier and less expensive for issuers to raise capital under Regulation D.

A closer look at the 1987-1989 revisions will show how this result was achieved. In particular, an analysis of the basic principles by which Regulation D was reformed will demonstrate the cumulative effect of the many specific revisions. This analysis also will reveal the new interpretive problems generated by these revisions.

Saga of a Substantial Compliance Defense, INSIGHTS, Aug. 1989, at 11, 15-16. See also *infra* text accompanying notes 392-95.

222. See *Uniform Limited Offering Exemption*, NASAA Reports (CCH) ¶ 6201, at 6101 (May 1989).

223. For expressions of concern over this issue, see Halloran & Mendelson, *Revisions to Regulation D*, INSIGHTS, May 1988, at 3, 10; Keller, *supra* note 221, at 15-16. See also *infra* text accompanying notes 392-95.

A. *Reduction of the Risk of Liability for Noncompliance*

As the bar's comments on the SEC's substantial compliance proposals made clear,²²⁴ reliance on the original version of Regulation D often was very dangerous. Any careful securities practitioner asked to give a formal opinion on the exempt status of a Regulation D transaction would have been aware of the precarious nature of the exemption, and would tend to give a highly conditioned opinion.²²⁵ This sense of danger derived from three basic problems.

First, Regulation D contained many specific requirements, all of which were considered conditions of the exemption.²²⁶ Many of these conditions were highly technical in nature and easily overlooked, such as some of the specific disclosure requirements and the periodic and final filing requirements. As a result, the possibility of noncompliance—and hence loss of the exemption—was relatively high.

Second, Regulation D absorbed the principle established in the case law under section 4(2)²²⁷ that a compliance failure with respect to one purchaser—for example, a failure to establish that purchaser's accredited or sophisticated status or to deliver a disclosure document—would result in loss of the exemption not just for that purchaser but for the entire offering. Purchasers with no connection to the act or acts of noncompliance thus would obtain the windfall of a right of rescission, and the issuer would face enormous potential liability.

Third, some of the key exemptive concepts used under Regulation D

224. See ABA Comment Letter on Release No. 6683, *supra* note 186, at 5:

The exposure to potential rescission requests [in connection with Regulation D offerings] is magnified by the likelihood that some insubstantial or inadvertent error exists, for Regulation D has not been drafted with objective precision We believe uncertainty is affecting decisions regarding methods of financing and is resulting in unnecessary expense.

225. The ABA stated: "Lawyers and accountants who must make professional judgments as to the adequacy of compliance are bound by the rigidity of Regulation D. Conclusions are often based on time-consuming and expensive procedures and yet still are qualified as to potential inadvertent and insubstantial matters." *Id.* See also Halloran & Mendelsen, *supra* note 223, at 7:

The lack of a substantial or good faith compliance standard subjects an issuer using Regulation D to the endless uncertainty and fear that a dissatisfied investor will seek to overturn the entire offering. This uncertainty also affects lawyers, who often must render an opinion in connection with a private placement . . . and accountants, who must account for contingent liabilities.

226. For criticism of this feature of Regulation D, see Kripke, *supra* note 104, at 852; Schneider, *supra* note 103, at 983.

227. 15 U.S.C. § 77d(2) (1988). See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125-26 (1953); *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 903 (5th Cir. 1977); *SEC v. Continental Tobacco Co.*, 463 F.2d 137, 158-61 (5th Cir. 1972).

were inherited from the amorphous and inconsistent body of case law and SEC rulemaking under section 4(2) and proved very difficult to apply. The most notable examples were the integration,²²⁸ general solicitation²²⁹ and sophistication²³⁰ concepts that played various roles under the different Regulation D exemptions.

The net result of these structural problems was persistent risk of liability. Conscientious practitioners could mitigate that risk for their clients, but the sense of uncertainty remained. As concern over this problem grew, the SEC revised Regulation D to provide a twofold solution: reduction of occasions for noncompliance and application of the concept of substantial compliance.

1. Reduction of Occasions for Noncompliance

(a) Rule 507

One of the major occasions for noncompliance under Regulation D was the rule 503 notice filing requirement. In one sense, this filing requirement was quite trivial. The SEC did not review filings on Form D to ensure compliance with the exemption, and apparently did not use it widely in connection with enforcement actions. The requirement served primarily as a means for the SEC to gather data about the use of Regulation D.²³¹ In another sense, however, this requirement was very important. It was a condition of the three exemptions, and a failure to file in a timely manner could result in loss of the exemption for the entire offering. The risk of liability was exacerbated, as we have seen, by the need to make not only an initial filing, but also periodic filings during the course of the offering and a postcompletion final filing.²³² Even careful attorneys all too often overlooked these additional filing requirements.

The SEC's first attempt to mitigate the filing problem came in 1986 with the elimination of the periodic and final filing requirements.²³³ The initial filing requirement, however, remained a condition of the exemption, leaving much of the problem intact. That requirement was perhaps the prime example of a relatively unimportant condition whose violation was both easy and potentially disastrous.

228. *See infra* text accompanying notes 398-410.

229. *See infra* text accompanying notes 411-20.

230. *See infra* text accompanying notes 283-302.

231. Securities Act Release No. 6650, 51 Fed. Reg. at 21,378.

232. *See supra* text accompanying notes 151-54.

233. *Id.*

The SEC addressed the problem by removing the filing requirement as a condition of the three Regulation D exemptions.²³⁴ That is the net result of rule 507 and related amendments to the rules, although the nature of the change is more complex than that description might suggest. Rule 503(a)²³⁵ still directs an issuer offering or selling securities under rules 504, 505 or 506 to file Form D no later than fifteen days after the first sale; rule 507 simply redefines the consequences of failure to make that filing. No longer will the exemption be lost for the present offering. Instead, the issuer will be disqualified from using Regulation D in connection with any *future* offering if a court has enjoined the issuer or any predecessor or affiliate for violation of the filing requirement.²³⁶ This approach leaves an incentive to comply with rule 503, while mitigating the immediate consequences of failing to do so. Rule 507(b)²³⁷ carries this mitigation even further by authorizing the Commission to waive the rule 507(a) disqualification “upon a showing of good cause,”²³⁸ thus allowing some past violators of rule 503 to rely on the Regulation D exemptions for new offerings. The circumstances under which the Commission will waive the disqualification remain to be defined.

(b) Rule 502(b)

With respect to the filing requirement, the SEC's strategy for reducing the risk of liability under Regulation D was elimination of one of the most easily violated conditions of the exemption. Changes to rule 502(b) reflect the same strategy. Rule 502(b)(1)(i) previously provided that no specific information need be furnished as a condition of the rule 505 or rule 506 exemptions if the issuer intended to sell securities only to accredited investors.²³⁹ Rule 502(b)(1)(ii) provided, however, that if the securities were sold to any non-accredited investor the issuer would have to furnish information specified by the rule to all investors, including the accredited investors.²⁴⁰ In other words, a requirement of disclosure to *all*

234. The SEC eliminated the filing as a condition of the exemptions amending rules 504(b), 505(b) and 506(b) to delete references to compliance with the rule 503 Form D filing requirement as a condition to the exemption. See Securities Act Release No. 6812, 54 Fed. Reg. at 314; Securities Act Release No. 6825, 54 Fed. Reg. at 11,373.

235. 17 C.F.R. § 230.503(a) (1989).

236. *Id.* § 230.507(a).

237. *Id.* § 230.507(b).

238. *Id.*

239. Rule 502(b)(1)(i), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264.

240. Rule 502(b)(1)(ii), *id.* at 11,264.

investors materialized as soon as one non-accredited investor entered the transaction. Any failure, inadvertent or otherwise, to deliver the specified information to even a single accredited investor would jeopardize the entire exemption.

In addition, rule 502(b)(2)(iv) required that all non-accredited investors receive "a brief description in writing of any written information concerning the offering that has been provided by the issuer to any accredited investor."²⁴¹ This affirmative disclosure obligation was not limited to material information, and had to be satisfied prior to purchase.²⁴² Compliance with this requirement proved very tricky, as large, complex transactions involving many accredited investors inevitably produced substantial amounts of correspondence and other types of written communication among the parties. It was a real trap for the unwary.

Revised rule 502(b) deals with these two problems very directly. Rule 502(b)(1) no longer requires disclosure to accredited investors whenever a non-accredited investor purchases part of the offering; the disclosure obligation runs only to the non-accredited investor or investors.²⁴³ As the SEC explained in proposing this change, "the accredited investors are in the same position they undoubtedly believed they were in from the start, *i.e.*, not entitled to any mandated disclosure."²⁴⁴ Issuers may wish to deliver a disclosure document to accredited investors for protection from fraud liability, but they no longer will run the risk of liability for a registration violation because one or more accredited investors fail to receive a disclosure document.

Revised rule 502(b)(2)(iv) solves the other problem by requiring description only of *material* written information delivered to accredited investors.²⁴⁵ This change makes the requirement more meaningful, and eliminates a potential source of anxiety for the issuer.

(c) *Rule 502(d)*

One of the basic principles of Regulation D is that securities purchased in rule 505 and 506 transactions and in some rule 504 transactions are restricted securities that a purchaser cannot resell without a separate exemption from registration. In addition to stating this basic principle, rule

241. Rule 502(b)(2)(iv), *id.* at 11,265.

242. *Id.*

243. 17 C.F.R. § 230.502(b)(1) (1989).

244. Securities Act Release No. 6812, 54 Fed. Reg. at 311.

245. 17 C.F.R. § 230.502(b)(2)(iv) (1989).

502(d)²⁴⁶ requires the issuer to exercise reasonable care to ensure that the purchasers of the securities are not “underwriters” within the meaning of section 2(11)²⁴⁷ of the 1933 Act. The original version of rule 502(d) also provided that such “reasonable care shall include, but not be limited to” three specific steps: inquiry as to investment intent, written disclosure of the security’s restricted status, and legending of the stock certificate or other document evidencing the security.²⁴⁸ This language had been read as requiring that issuers take those specific steps as a condition of the exemption.²⁴⁹

Revised rule 502(d) dispels this impression by adding the following disclaimer: “While taking these actions will establish the requisite reasonable care, it is not the exclusive method to demonstrate such care. Other actions by the issuer may satisfy this provision.”²⁵⁰ A failure to place the appropriate legend on a stock certificate thus will not imperil the exemption, so long as the issuer can otherwise establish that it took reasonable care.

A failure to disclose the restricted status of the securities, however, may produce a problem under other new provisions of the regulation. Under rule 502(b)(2)(vii), the issuer now must advise all non-accredited investors in rule 505 or 506 offerings of the restricted nature of the securities.²⁵¹ Similarly, rule 504(b)(2)(ii) now requires all investors in rule 504 offerings to receive such advice from the issuer except in specified circumstances.²⁵² These new requirements—added at the insistence of NASAA representatives²⁵³—seem to undercut rule 502(d)’s attempt to diminish, rather than increase, the burden created by the issuer’s obligation to police redistributions. As a practical matter, however, these requirements should not cause much of a problem, at least with respect to rule 505 or 506 offerings. Non-accredited investors in such offerings must receive a full-blown disclosure document in any event,²⁵⁴ so this additional disclosure requirement will not be burdensome. In rule 504

246. *Id.* § 230.502(d).

247. 15 U.S.C. § 77b(11) (1988).

248. Rule 502(d), Securities Act Release No. 6389, 47 Fed. Reg. at 11,265.

249. See ABA Comment Letter on Release No. 6759, *supra* note 206, at 3.

250. 17 C.F.R. § 230.502(d) (1989).

251. *Id.* § 230.502(b)(2)(vii).

252. *Id.* § 230.504(b)(2)(ii).

253. Securities Act Release No. 6825, 54 Fed. Reg. at 11,371.

254. 17 C.F.R. § 230.502(b)(1) (1989).

offerings, however, it may create a trap,²⁵⁵ because that exemption requires very few affirmative steps by the issuer. The issuer easily may overlook this relatively minor requirement and therefore face potentially serious problems.²⁵⁶

2. *Substantial Compliance*

As suggested in Part III C,²⁵⁷ the most dramatic change to Regulation D was the addition of a substantial compliance concept in new rule 508.²⁵⁸ The operation of rule 508 requires careful description.

Rule 508 allows an issuer to establish the existence of an exemption under Regulation D despite a failure to comply with one or more of the conditions of the exemption. Rule 508(a) provides that a failure to comply with one or more of the exemptions will not result in loss of the exemption for any offer or sale to a particular individual or entity if the person relying on the exemption makes three required showings: (1) that the term, condition or requirement was not "directly intended to protect that particular individual";²⁵⁹ (2) that the failure to comply was "insignificant with respect to the offering as a whole;"²⁶⁰ and (3) that a "good faith and reasonable attempt was made to comply" with all of the Regulation's terms, conditions and requirements.²⁶¹

The net effect of rule 508 is to cut off liability to purchasers who had

255. See Keller, *supra* note 221, at 13 (explaining how this disclosure requirement might be overlooked). Apparently the SEC and NASAA are considering some kind of exception from this disclosure requirement for smaller issuers. See *id.*; Securities Act Release No. 6825, 54 Fed. Reg. at 11,371 (describing continuing SEC-NASAA review of the problem).

256. One other way in which the new Regulation D has reduced opportunities for noncompliance deserves mention. Keller explains that the revisions to Regulation D overcome a technical drafting problem by allowing the existence of facts to be an alternative way to satisfy requirements without regard to whether the issuer had a "reasonable belief" about a fact. For example, before the revision one could theorize that the exemption would not be available if the issuer did not have a reasonable belief as to the sophistication and number of non-accredited investors even if they were sophisticated and limited to 35. Now the existence of these facts alone will satisfy the requirement.

Keller, *supra* note 221, at 13. See 17 C.F.R. § 230.505(b)(2)(ii) (1989) ("There are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities"); *id.* § 230.506(b)(2)(i) (similar language with respect to the number of purchasers). See also *id.* § 230.506(b)(2)(ii), where the alternative between reasonable belief and the actual existence of the facts is created with respect to the nature of the non-accredited investors.

257. See *supra* text accompanying notes 185-200.

258. 17 C.F.R. § 230.508 (1989).

259. *Id.* § 230.508(a)(1).

260. *Id.* § 230.508(a)(2).

261. *Id.* § 230.508(a)(3).

no connection to the violation, provided that the violation was “insignificant with respect to the offering as a whole” and a “good faith and reasonable attempt” to comply was made. In other words, rule 508 reduces the risk of liability for inadvertent violations and denies the right of rescission to purchasers who were not directly victimized by the noncompliance. Two examples will show how rule 508 works.

Rule 506(b)(2)(ii) requires all non-accredited investors in rule 506 transactions to be sophisticated or to have a sophisticated purchaser representative.²⁶² Assume that purchasers *A-F* are accredited investors. Purchaser *G* is a non-accredited investor who also turns out not to be sophisticated, despite the issuer’s efforts to establish sophistication on the part of all the non-accredited investors. Under rule 508, the issuer will lose the rule 506 exemption with respect to purchaser *G*. Purchaser *G* will have a right of rescission because the sophistication requirement was “directly intended to protect that particular individual.” Purchasers *A-F*, however, will not have rights of rescission because the sophistication requirement is not “directly intended” to protect accredited investors. This conclusion, however, assumes that the violation is “insignificant with respect to the offering as a whole,” and the issuer made a “good faith and reasonable attempt” to comply.

Another example will show a similar result. Rule 502(b)(1) requires delivery of specified information to non-accredited investors in rule 505 and rule 506 transactions.²⁶³ Assume that Purchasers *A* and *B* are non-accredited investors in a rule 505 transaction. Purchaser *A* receives the information specified by the rule, while purchaser *B* does not. Purchaser *B* has a right of rescission because of the issuer’s failure to comply with a requirement “directly intended” to protect that investor. Purchaser *A*, however, cannot rescind on the basis of the non-disclosure to purchaser *B*, assuming that the failure to comply was “insignificant with respect to the offering as a whole,” and a “good faith and reasonable attempt” to comply was made.²⁶⁴

These examples demonstrate the basic operation of rule 508, but they also suggest that some important interpretive problems remain. For instance, it is by no means clear when a failure to comply will be deemed “insignificant with respect to the offering as a whole.” Rule 508(a)(1)

262. *Id.* § 230.506(b)(2)(ii).

263. *Id.* § 230.502(b)(1). See *supra* text accompanying notes 250-55.

264. Accord Keller, *supra* note 221, at 14 (same conclusion on basis of similar hypothetical).

states expressly²⁶⁵ that violations of the rule 502(c) prohibition on general solicitation,²⁶⁶ the rule 504²⁶⁷ and rule 505²⁶⁸ limitations on aggregate offering price and the rule 505²⁶⁹ and rule 506²⁷⁰ limitations on the number of purchasers shall always be deemed to be "significant to the offering as a whole," but the rule does not similarly categorize other types of violations²⁷¹ or attempt a generic definition of "significant" or "insignificant." The relation of these terms to the traditional securities law concept of materiality remains to be determined, as does the relevance of the number or scale of the acts of non-compliance.

A distinction may evolve between violations that are merely investor-specific, such as failures to qualify an individual investor as sophisticated or to deliver a disclosure document to a particular non-accredited investor, and violations of provisions that seem to touch the offering as a whole, such as the general solicitation ban and the aggregate offering price and purchaser limitations. This distinction, however, may not be a true touchstone. What about disqualifier provisions, for example? When will the presence of a person subject to disqualification be considered significant to the offering as whole? In all cases? Only when the issuer itself is subject to disqualification? Will the result depend upon who the disqualified person was and what that person's role in the offering might have been?²⁷² The answers to these questions are not clear.

265. 17 C.F.R. § 230.508(a)(2) (1989).

266. *Id.* § 230.502(c).

267. *Id.* § 230.504(b)(2)(i).

268. *Id.* § 230.505(b)(2)(i).

269. *Id.*

270. *Id.* § 230.506(b)(2)(i).

271. One may ask why the SEC decided to carve these particular violations out of the coverage of rule 508. A prominent member of the working group that drafted the final version of rule 508 (*see supra* note 216) explains that

[w]ith respect to the carve-outs, the SEC staff and NASAA believed that the underlying provisions were so integral to the essence of the statutory exemptions that any I & I-type defense would be inappropriate without the carve-outs. While the bar representatives argued vigorously for their elimination, it became clear that the political and practical realities precluded adoption of any workable compromise without these carve-outs.

Schneider, *supra* note 216, at 1213.

The practical impact of these carve-outs is debatable. If the SEC continues to take a somewhat more relaxed approach to the general solicitation prohibition (*see infra* text accompanying notes 417-18), the carve-out may not be of great significance. Similarly, the availability of both a reasonable belief and actual existence standard with respect to the number of purchasers (*see supra* note 256) mitigates the impact of the carve-out with respect to violation of the purchaser limitations. *Accord* Keller, *supra* note 221, at 15.

272. It is also not entirely clear when the presence of a disqualified person will be considered a

Even clearly investor-specific violations, furthermore, may be significant with respect to the offering as a whole if the purchaser or purchasers who gain a right to rescission have purchased a substantial percentage of the offering. If their right to withdraw their investment will jeopardize the success of the entire offering or even the ultimate fate of the issuer, the question of significance may turn on quantitative as well as qualitative factors.²⁷³ The SEC and the courts presumably will develop much-needed interpretations of these questions.

Similarly, the elements of a "good faith and reasonable attempt" to comply with the regulation remain to be defined. The SEC, however, clearly does not intend to countenance a "close is good enough" attitude toward Regulation D compliance. The agency's position is implicit in rule 508(b), which states flatly that a transaction made in reliance on rules 504, 505 or 506 "shall comply with all applicable terms, conditions and requirements of Regulation D."²⁷⁴ Strict compliance apparently will be regarded as the norm, and substantial compliance the exception. Presumably, the lack of compliance must be somehow "innocent" or "inadvertent"—to use the words of earlier formulations of the substantial compliance concept²⁷⁵—because the "good faith" language would seem to eliminate anyone who intentionally disregards any aspect of the Regulation's requirements.²⁷⁶ Furthermore, there must be some *attempt* to comply. A person ignorant of the requirements of the regulations and who does not even try to comply with them cannot claim substantial compliance.²⁷⁷

Issuers probably will have to show that they established an appropriate procedure or mechanism for compliance, and that some carelessness or slip-up (preferably at a clerical level) caused the violation.²⁷⁸ The rule

violation of a term intended to protect a particular investor. Will it be so considered in all cases? For an argument to the contrary, see Keller, *supra* note 221, at 14.

273. For arguments to this effect, see Keller, *supra* note 221, at 15; Schneider, *supra* note 216, at 1211.

274. 17 C.F.R. § 230.508(b) (1989).

275. See *supra* notes 198-200.

276. Accord Keller, *supra* note 221, at 15 (a person who does not act in good faith may not claim substantial compliance).

277. Accord *id.* (the "attempt to comply" requirement excludes persons ignorant of the rule); Schneider, *supra* note 216, at 1211 ("In effect, there can be no such thing as inadvertent substantial compliance with regulation D by a person unmindful of the requirements.").

278. Accord Schneider, *supra* note 216, at 1211 ("The prototypical circumstances to which rule 508 should apply is where the issuer has adopted a reasonable plan to assure compliance, and some accidental or careless oversight occurred.").

506 issuer with the unexpectedly unsophisticated, non-accredited investor on its hands, for example, might need to establish that it had developed an appropriate purchaser questionnaire, that a means of delivering, gathering and evaluating the questionnaires had been in place, and that the investor in question somehow had just had been "missed." Similarly, the rule 505 issuer who failed to deliver the required disclosure document to a non-accredited investor might have to show that the documents had been numbered and cross-indexed with the names of the recipients and the sales personnel, and that a messenger or someone in the back office had mislaid the copy to be delivered to the investor in question. In any event, interpretation on a case-by-case basis is needed here as well, but it is unlikely that the present uncertainty will encourage a more casual approach to Regulation D compliance, especially in light of the additional disincentive created by rule 508(b).

Rule 508(b) reflects the basic compromise with the state securities administrators.²⁷⁹ It provides²⁸⁰ that when an exemption is established only through reliance on rule 508, the failure to comply shall nonetheless be actionable by the SEC in an enforcement action under section 20²⁸¹ of the 1933 Act. The combined force of this reserved enforcement authority and the "good faith and reasonable attempt" condition should prevent undue reliance on substantial compliance and erosion of the level of care devoted to Regulation D transactions by securities counsel. The states also are likely to retain their enforcement powers with respect to offerings seeking exemption under equivalent state substantial compliance concepts.²⁸² That will provide yet another good reason for continued adherence to the straight and narrow.

The distinction between private actions in which substantial compliance relief is available and enforcement actions in which it is not may make sense as a matter of both policy and politics, but it raises the legal question of whether the SEC has the authority to adopt a rule making such a distinction. The SEC has, in effect, waved a magic wand turning a violation of section 5 into a nonviolation for all purposes other than its own. None of the SEC's releases concerning rule 508 provided any real discussion of this issue.

279. See *supra* text accompanying notes 215-22.

280. 17 C.F.R. § 230.508(b)(1) (1989).

281. 15 U.S.C. § 77t (1988).

282. Indeed, they have under ULOE. See *Uniform Limited Offering Exemption*, NASAA Reports (CCH) ¶ 6201, at 6104 (May 1989).

The problem, however, may be more technical than substantive. Although rule 508 is part of a set of rules defining conditions for exemption under sections 3(b) and 4(2), it does not define additional exemptive conditions; instead it limits the private purchaser's right of action under section 12(1) for failure to meet certain of those conditions. Technically, it perhaps should be regarded as a definitional or interpretive rule under section 12(1), one that the SEC has authority to adopt. Some clarification of this issue by the SEC, however, would be helpful.

The novel character of rule 508 thus creates numerous interpretive problems. It is nevertheless fair to say that the substantial compliance concept is the most useful attempt to mitigate the difficulties of Regulation D financing yet encountered.

B. Expansion of the Class of Investors Deemed Able to Fend for Themselves

Among the most important of the 1987-1989 changes to Regulation D was the expansion of the categories of accredited investors.²⁸³ To understand why these changes are important—indeed, to understand why the base concept of accredited investor is so important—it is necessary to return to the source of this approach to investor suitability.

In his famous 1953 opinion in *Securities and Exchange Commission v. Ralston Purina Co.*,²⁸⁴ Justice Clark held that the difference between a public and private offering under section 4(2) lies in the private offering being made only to those "able to fend for themselves."²⁸⁵ Justice Clark reached this conclusion, eschewing simpler formulations of the public/private distinction, through an analysis of the purpose of the registration provisions of the 1933 Act. Their purpose, according to Justice Clark, was to protect investors through mandatory disclosure of information necessary to investment decisions.²⁸⁶ In contrast, offerings to persons who do not need that protection—that is, persons able to fend for themselves—should be exempt from registration. The key to a private offering, therefore, is the nature of the offerees.

Ralston Purina established the basic parameters of section 4(2) analysis. Less subtle means of drawing the line between public and private

283. See *infra* text accompanying notes 303-19.

284. 346 U.S. 119 (1953).

285. *Id.* at 124-25.

286. *Id.*

transactions such as numerical offeree or purchaser limitations²⁸⁷ and the general solicitation concept²⁸⁸ remained relevant, but the crucial task for issuers structuring private offerings became that of determining the ability of the investors to fend for themselves.

As the law under section 4(2) developed, the courts applied a subtle exegesis to this concept, and began to distinguish between the investor's ability to assess the merits of the investment opportunity—sophistication²⁸⁹—and the ability to obtain the information needed for a sophisticated assessment—access.²⁹⁰ The conventional wisdom soon reflected the notion that both sophistication and access were required before investors would be deemed able to fend for themselves,²⁹¹ and the “suitability” concept was eventually codified in rule 146,²⁹² the first section 4(2) safe harbor rule.

This approach to section 4(2) spawned a series of practical questions about how one could establish investor suitability. A complex body of law and lore crystallized around investor suitability as financing under the 1933 Act exemptions expanded during the 1970s.²⁹³ The practical

287. The *Ralston Purina* decision in fact stated expressly that “nothing prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims.” *Id.* at 125. For discussion of the extent to which the Commission applied an informal numerical limitation under § 4(2), 15 U.S.C. § 77d(2) (1988), prior to its promulgation of rule 146, 17 C.F.R. § 230.146 (rescinded 1982) and rule 506, 17 C.F.R. § 230.506 (1989), both of which contained numerical limitations, see 3 L. LOSS & J. SELIGMAN, *supra* note 8, at 1364-70.

288. See *ABA Section 4(2) Report*, *supra* note 18, at 497.

289. For discussion of the evolution of the sophistication concept, see 3 L. LOSS & J. SELIGMAN, *supra* note 8, at 1370-77. For criticism of the notion that offeree sophistication is necessary under § 4(2), 15 U.S.C. § 77d(2) (1988), see Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869, 873-76 (1981).

290. The leading case defining “access” is *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977), which stated a disjunctive requirement, *i.e.*, the offeree must have access to information either by virtue of an insider position or bargaining power or through actual disclosure of the material information. *Id.* at 905-06.

291. For detailed discussion of the role of the sophistication and access concepts under the statutory exemption created by § 4(2), 15 U.S.C. § 77d(2) (1988), see *ABA Section 4(2) Report*, *supra* note 18, at 489-95.

292. Rule 146(d), 17 C.F.R. § 230.146(d) (rescinded 1982) imposed an offeree suitability requirement that required consideration not only of the offeree's sophistication but also of the offeree's ability to bear the economic risk of the transaction. Rule 146(e), 17 C.F.R. § 230.146(e) (rescinded 1982), employed the *Doran* disjunctive approach to disclosure. For discussion of these aspects of rule 146, see 3 L. LOSS & J. SELIGMAN, *supra* note 8, at 1395-1400.

293. For a synthesis of this law and lore, see generally *ABA Section 4(2) Report*, *supra* note 18. For discussion of the practical difficulties created by this legal framework, see Soraghan, *Private Offerings: Determining “Access,” “Investment Sophistication,” and “Ability to Bear Economic Risk,”*

difficulty of establishing the suitability of each investor on a case-by-case basis, however, generated a need for a more objective means of determining suitability. Recognizing this need, the SEC developed the accredited investor device, which consisted of objectively defined categories of investors deemed capable of fending for themselves. This device first surfaced in 1980 in rule 242, discussed above,²⁹⁴ and was carried over into Regulation D under rules 505 and 506.

The accredited investor concept simplified exempt financing. Under the statutory section 4(2) exemption and its rule 146 safe harbor, the issuer had to establish its reasonable belief in the suitability of each investor. Under rules 505 and 506, on the other hand, the issuer's first inquiry is into the accredited or non-accredited status of the investors—a far more objective determination. Sophistication is totally irrelevant under rule 505. Under rule 506, which requires non-accredited investors to be sophisticated,²⁹⁵ the issuer need not establish investor sophistication if all of the investors in the transaction are accredited. Once the accredited status of an investor is established, furthermore, that investor may be excluded from the number of investors who must be counted under the purchaser limitations of rule 505²⁹⁶ and rule 506.²⁹⁷ In addition, issuers selling only to accredited investors under these rules will not have to provide any specific disclosure document as a condition of the exemption.²⁹⁸

Issuers engaged in rule 505 or rule 506 transactions, therefore, tend to concern themselves with individual investor sophistication only if they must include some non-accredited investors in a rule 506 transaction, or if they want to establish a fallback exemption under the statutory section 4(2) exemption.²⁹⁹ The determination of whether investors can fend for

8 SEC. REG. L.J. 3 (1980). For criticism of the courts' approach to these issues, see Marsh, *Who Killed the Private Offering Exemption? A Legal Whodunit*, 71 NW. U.L. REV. 470 (1976).

294. See *supra* text accompanying notes 76 and 92. The definition of accredited investor was set out in rule 242(a)(1), 17 C.F.R. § 230.242(a)(1) (rescinded 1982).

295. Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (1989).

296. Rule 505(b)(2)(i), *id.* § 230.505(b)(2)(i).

297. Rule 506(b)(2)(i), *id.* § 230.506(b)(2)(i).

298. Rule 502(b)(1), *id.* § 230.502(b)(1).

299. For discussion of the need to establish a fall-back statutory exemption in offerings under the rule 506 safe harbor, see Nimkin, *Offeree Sophistication in Private Offering*, 15 REV. SEC. REG. 863, 869-70 (1982) (explaining the need to establish *offeree* sophistication in connection with a fall-back statutory § 4(2) exemption); Seldin, *Who Cares About Accredited Investors?*, 15 REV. SEC. REG. 810, 813 (1982) (expressing belief that reliance on a fall-back statutory § 4(2) exemption will remain important).

themselves is thus now primarily a matter of deciding whether they fit into the objective categories of accredited investor defined in rule 501(a).³⁰⁰ One can challenge the assumption that investors who fall into these categories are able to fend for themselves, as Part V of this Article will discuss,³⁰¹ but the accredited investor concept has become central to private and limited offerings under the 1933 Act. The SEC's continued faith in the validity of this approach was reflected in its expansion of the list of accredited investor categories during the 1987-1989 revisions.

Rule 501(a) defines an accredited investor as any person who fits, or who the issuer reasonably believes to fit, within any of the categories set out in that subsection.³⁰² Many of these categories were expanded or otherwise revised as a result of the 1987-1989 revisions.

1. Rule 501(a)(1)—Institutional Investors

Rule 501(a)(1) previously included³⁰³ certain institutional investors, such as banks, insurance companies, registered investment companies, and certain employee benefit plans covered by the Employee Retirement Income Security Act (ERISA).³⁰⁴ The SEC has expanded this list in several ways. Savings and loan associations and credit unions are now included.³⁰⁵ Brokers and dealers registered under the 1934 Act have been added, provided that they are purchasing for their own account. The most significant changes, however, concern employee benefit plans. Public employee benefit plans not covered by ERISA are now included, so long as they have total assets in excess of \$5 million. Specified private employee benefit plans under ERISA continue to be covered by this subsection, but the eligibility requirements have been liberalized to include plans whose plan fiduciary is a savings and loan association, and self-directed plans whose investment decisions are made solely by accredited investors.

2. Rule 501(a)(3)—Corporations and Other Business Entities

Perhaps the most important additions to the list of accredited investors

300. Rule 501(a)(1)-(8), 17 C.F.R. § 230.501(a)(1)-(8) (1989).

301. See *infra* text accompanying notes 377-80.

302. Rule 501(a), 17 C.F.R. § 230.501(a) (1989).

303. Rule 501(a)(1), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262.

304. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended at 29 U.S.C. §§ 1001-1461 (1982 & Supp. V 1987)).

305. 17 C.F.R. § 230.501(a)(1) (1989).

can be found in rule 501(a)(3).³⁰⁶ That subsection previously included³⁰⁷ only nonprofit organizations qualified under section 501(c)(3) of the Internal Revenue Code³⁰⁸ with total assets in excess of \$5 million. Added to those nonprofit organizations are corporations, business trusts and partnerships with total assets in excess of \$5 million, provided that the entity was not formed for the specific purpose of acquiring the securities offered under Regulation D.³⁰⁹ These additions fill a major gap in the "accredited investor" definition. Previously, a corporation, business trust or partnership that was not a financial institution such as those specified in rule 501(a)(1) would not qualify as an accredited investor even if it had an enormous annual income or net worth. Accredited investor status under the so-called "fat cat" net worth and annual income categories was available only to natural persons.³¹⁰ A large business corporation could qualify as an accredited investor only if, under former rule 501(a)(5),³¹¹ it purchased at least \$150,000 of the securities being offered. The additions to rule 501(a)(3) eliminate this anomaly, and provide ordinary business entities of sufficient size with their own accredited investor category. This change also allowed the SEC to eliminate the former rule 501(a)(5) "heavy hitter" or "big ticket" purchaser category,³¹² which had been used mostly by those entities.

3. Rule 501(a)(6)—Annual Income Accredited Investors

This category of accredited investors previously included only natural persons with an individual income in excess of \$200,000 in each of the two most recent years who reasonably expected an income in excess of that amount in the current year.³¹³ Added to this category is a person who had a joint income of \$300,000 with a spouse and who has a reasonable expectation of reaching the same income level in the current year.³¹⁴ Presumably, each spouse who has such a joint income will be considered a separate accredited investor. The SEC thus expanded the annual in-

306. *Id.* § 230.501(a)(3).

307. Rule 501(a)(3), Securities Act Release No. 6389, 47 Fed. Reg. at 11,262.

308. 26 U.S.C. § 501(c)(3) (Supp. V. 1987).

309. 17 C.F.R. § 230.501(a)(3) (1989).

310. Rule 501(a)(6)-(7), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263. These categories are now included in subsections 5-6 of rule 501(a). 17 C.F.R. § 230.501(a)(5)-(6) (1989).

311. Rule 501(a)(5), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263 (rescinded 1988).

312. *See* Securities Act Release No. 6758, 53 Fed. Reg. at 7867.

313. Rule 501(a)(7), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263 (now rule 501(a)(6)).

314. 17 C.F.R. § 230.501(a)(6) (1989).

come "fat cat" category by adding the so-called "yuppie" subcategory. The net worth "fat cat" category, which characterizes persons with a net worth of \$1 million as accredited investors, was not revised because it already allowed spouses' joint net worth to be taken into account.³¹⁵

4. Rule 501(a)(7)—Trusts

This new provision allows a trust to be accredited if it has \$5 million in total assets and its investment decisions are made by a sophisticated investor, provided that the trust was not formed solely for purposes of the investment.³¹⁶ The provision is a parallel to rule 501(a)(3), which includes nonprofit organizations, corporations, partnerships and business trusts that meet the \$5 million asset test.³¹⁷ The parallel is not complete, however, because rule 501(a)(7) also requires that the trust's investment decisions be made by a "sophisticated person."³¹⁸ A sophisticated person is defined by a cross-reference to rule 506(b)(2)(ii), which requires non-accredited investors in rule 506 transactions to be sophisticated, and defines such a person as one possessing "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."³¹⁹

This express incorporation of the section 4(2) and rule 506 sophistication concept into an "accredited investor" definition is notable as the first departure from the strictly objective approach of the other "accredited investor" definitions. This departure is troublesome. It will require the type of subjective, case-by-case analysis of individual sophistication that the accredited investor concept was intended to avoid. It also is by no means clear whether the sophistication required of a trust fiduciary under rule 501(a)(7) will be the same as that required of a mere purchaser of securities under section 4(2) or rule 506, despite the cross-reference to rule 506(b)(2)(ii). Arguably, rule 501(a)(7) might require a higher threshold of sophistication on the part of a plan fiduciary than an ordinary individual investor.

315. *Id.* § 230.501(a)(5). It was, however, renumbered. This subsection was formerly rule 501(a)(6), Securities Act Release No. 6389, 47 Fed. Reg. at 11,263.

316. 17 C.F.R. § 230.501(a)(7) (1989).

317. *Id.* § 230.501(a)(3).

318. *Id.* § 230.501(a)(7).

319. *Id.* § 230.506(b)(2)(ii).

C. *Reduction of Compliance Costs for Small Business Issuers*

As discussed in Part II,³²⁰ one of the principal goals of the original Regulation D was the reduction of the regulatory burden on small business issuers. A desire to make Regulation D even more useful to small business issuers was one of the key principles by which Regulation D was reformed in 1987-1989. In one sense, this principle informed all of the revisions, because anything that made the exemptions easier and cheaper to use would be of particular value to smaller issuers. Certain revisions, however, were more directly intended to benefit small business issuers.

1. *A More Useful Rule 504*

Rule 504 was the aspect of the original Regulation D most clearly intended to reduce small business issuers' compliance costs. The rule was, in essence, an exemption for a class of relatively small offerings in which the federal interest was too slight to justify detailed federal regulation.³²¹ Regulation of such transactions could be left to the states, who would have a greater interest in what tended to be highly localized transactions. This deferral to state regulation generated its own problems, because state treatment of rule 504 transactions was neither uniform nor necessarily flexible,³²² but rule 504 reduced compliance costs by eliminating most federal exemptive conditions for transactions under the rule.

As experience under rule 504 evolved, however, some practical difficulties emerged. Rule 504 originally limited the aggregate offering price of securities sold under the rule to \$500,000.³²³ This amount was an improvement over the \$100,000 permitted under rule 240,³²⁴ rule 504's predecessor, but it soon proved inadequate as the costs of new business formation continued to increase.³²⁵ In the recent revisions, the SEC attempted to balance the demand for a higher aggregate offering price with its own reluctance to permit larger offerings under rule 504 by tying an

320. See *supra* text accompanying notes 89-92.

321. See *supra* note 99.

322. For discussion of the difficulties in coordinating rule 504 with parallel state exemptions (and of a possible solution), see Harris, Keller, Stakias & Liles, *Financing the "American Dream"—Small Business and the ULOR Project*, 43 BUS. LAW. 757 (1988); Harris, Keller, Stakias and Liles, *Financing the "American Dream": A Beginning*, 44 BUS. LAW. 625 (1989).

323. Rule 504(b)(2), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

324. See *id.* at 11,257-58 (discussing change from the \$100,000 ceiling under rule 240).

325. See Securities Act Release No. 6339, 46 Fed. Reg. at 41,800 (citing criticism of the rule 240 \$100,000 ceiling).

increase in the aggregate offering price to a higher level of state regulation.

Rule 504(b)(2)(i) now permits an aggregate offering price of up to \$1 million in a twelve-month period, so long as no more than \$500,000 of that amount is "attributable" to offers and sales of securities without registration under a state's securities laws.³²⁶ The operation of this limit is fairly simple.

Assume that an issuer sells on January 1 \$250,000 of its securities pursuant to a state registration in Massachusetts and another \$250,000 pursuant to a registration in Maine. Assume further the January offering is exempt on the federal level under rule 504. The issuer may sell another \$500,000 of its securities under rule 504 during the next twelve-month period without state registration, because no more than \$500,000 of the offering would have been sold without state registration.³²⁷ If, however, the issuer had registered \$250,000 of its securities in Massachusetts, but had sold the \$250,000 Maine portion of the offering pursuant to a state exemption, then the issuer could sell no more than an additional \$250,000 under rule 504 without state registration, for a total of \$750,000. Otherwise, the issuer would have sold more than \$500,000 of securities without state registration.

This mechanism should prove practicable. It probably will be smaller offerings that will rely on state exemptions rather than state registration and hence will not need the higher ceiling on the aggregate offering price. Conversely, issuers that need to raise \$1 million should be able to afford the additional cost of state registration, especially in nonmerit jurisdictions or jurisdictions with a simplified registration mechanism tailored to offerings of that size.³²⁸

Another liberalization of rule 504 also shows the linkage of federal deregulation to compliance with state securities laws. Rule 504(b)(1) previously provided that the rule 502(c) ban on general solicitation and the rule 502(d) resale restrictions would not apply to rule 504 transactions made exclusively in states requiring registration of the securities and delivery of a disclosure document.³²⁹ Issues not registered in every state in which they were offered remained subject to rules 502(c) and (d).

326. 17 C.F.R. § 230.504(b)(2)(i) (1989).

327. For a similar example, see *id.* note 1, example 1.

328. For discussion of NASAA's recent development of such a mechanism, see *infra* text accompanying notes 394-97.

329. Rule 504(b)(1), Securities Act Release No. 6389, 47 Fed. Reg. at 11,266.

The SEC amended rule 504(b)(1)³³⁰ to take into account the lack of a securities registration procedure in some jurisdictions, notably New York and the District of Columbia.³³¹ The following example illustrates the effect of the amendment. Under the original version of rule 504(b)(1), a rule 504 offering registered in Maryland and Virginia would remain subject to the rule 502(c) and (d) restrictions if the offering were also made in the District of Columbia, which does not register securities. Under new rule 504(b)(1)(i), the restrictions will not apply even if the securities are offered in a jurisdiction without a registration procedure, if the following conditions are met: (1) the securities are registered in at least one state that provides for registration and delivery of a disclosure document; (2) offers and sales are made in the state of registration in compliance with that state's requirements; and (3) the disclosure document is delivered to all purchasers prior to sale in the jurisdictions without a registration procedure.³³²

In this example, transactions in the District of Columbia would not create a problem so long as the conditions listed above are met. Presumably, however, the offering would still have to be registered in each of the other two states that have a registration procedure. The offering could not be registered in Virginia and sold under an exemption in Maryland and still qualify for the exclusion from the general solicitation and resale restrictions. The relief provided by rule 504(b)(1)(ii) extends only to offerings that are registered in every jurisdiction except those without registration mechanisms.

2. *A New Exemption for Small Issuer Employee Benefit Plans*

As discussed in Part II,³³³ one of the controversial aspects of the 1987-1989 rulemaking was the new exemption for certain employee benefit plans.³³⁴ This exemption, which is technically not part of Regulation D but is functionally and historically related to it,³³⁵ permits the offer and sale of securities by issuers not reporting under the 1934 Act if pursuant to "compensatory benefit plans" or written contracts between the issuer

330. 17 C.F.R. § 230.504(b)(1) (1989).

331. See Securities Act Release No. 6758, 53 Fed. Reg. at 7867 (the rule "is intended to accommodate offerings in large metropolitan areas where the central jurisdiction has no registration process but the surrounding jurisdictions do, e.g., New York and the District of Columbia").

332. 17 C.F.R. § 230.504(b)(1)(ii) (1989).

333. See *supra* text accompanying notes 170-76.

334. 17 C.F.R. §§ 230.701-.703(T) (1989).

335. See *supra* note 176.

or its affiliates and its employees, directors, general partners, trustees (if a business trust), officers, and consultants and advisers.³³⁶ The sole purpose of the exemption is to facilitate smaller issuers' use of securities for compensation by reducing securities compliance costs. A preliminary note to these rules states expressly that rule 701 does not exempt offers and sales designed to raise capital.³³⁷ An issuer thus may use the exemption only for compensatory purposes.

Determining the amount of securities that may be sold under rule 701 requires consideration of two numbers: (1) the aggregate offering price of securities of the issuer subject to outstanding *offers* made in reliance on rule 701, plus (2) the amount of securities of the issuer *sold* in reliance on rule 701 in the preceding twelve months.³³⁸ The combined amount of securities subject to offers or already sold may not exceed the greater of \$500,000 or an amount determined under two different formulas.³³⁹ The first formula limits the amount of securities subject to offers and the amount of securities sold to fifteen percent of the total assets of the issuer, measured at the end of the issuer's last fiscal year.³⁴⁰ The second formula provides that the amount shall not exceed fifteen percent of the outstanding securities of the class being offered.³⁴¹ Whichever of these two formulas is used, however, the aggregate offering price of securities subject to outstanding offers and sold in the preceding twelve months under rule 701 may not exceed \$5 million.³⁴²

In view of the special nature of the employee benefit plan offerings covered by rule 701, unique aggregation and integration rules apply to the exemption. Even though rule 701 is a section 3(b) limited offering exemption, offerings under other section 3(b) rules such as rule 504 or rule 505 need not be aggregated with rule 701 transactions for purposes of determining the aggregate offering price of a rule 701 offering.³⁴³ Only the amount of other offerings under rule 701 within the preceding twelve-

336. 17 C.F.R. § 230.701(b)(1) (1989). "Compensatory benefit plan" is defined as "any purchase, savings, option, bonus, stock appreciation, profit sharing, thrift, incentive, pension or similar plan." *Id.* § 230.701(b)(2).

337. *Id.* § 230.701 preliminary note 5. *See also* Securities Act Release No. 6768, 53 Fed. Reg. at 12,919 ("the purpose of the rule is to facilitate the use of securities for compensation").

338. 17 C.F.R. § 230.701(b)(5) (1989).

339. *Id.*

340. *Id.* § 230.701(b)(5)(i).

341. *Id.* § 230.701(b)(5)(ii).

342. *Id.* § 230.701(b)(5).

343. *Id.* § 230.701(b)(4)(ii).

month period need be considered for aggregation purposes.³⁴⁴ Similarly, no transactions under any other exemption will be integrated into a rule 701 offering, and rule 701 transactions will not be integrated into offerings under other exemptions.³⁴⁵

Rule 701 imposes no other exemptive conditions except for a restriction on resale.³⁴⁶ Rule 702, however, requires a simple postcommencement notice filing on Form 701 and an annual report.³⁴⁷ While the rule 702 filing is technically mandatory, rule 703³⁴⁸ takes the same approach to failures to file as rule 507.³⁴⁹ The exemption is not lost for the present offering. Rather, rule 703 disqualifies from future use of the exemption any issuer who has been subject to specified judicial action for failure to comply with the rule 702 filing requirement, unless the Commission waives the disqualification upon a showing of good cause.³⁵⁰ The SEC intends rules 702 and 703, however, to be only temporary rules.³⁵¹ They may eventually be eliminated if the SEC determines that they are no longer needed.³⁵²

3. *A Lighter Disclosure Burden*

Rule 502(b) defines the circumstances under which specified types of disclosure must be made as a condition of the exemption.³⁵³ The cost of complying with these detailed disclosure requirements has long been a subject of complaint, particularly with respect to smaller offerings.³⁵⁴

Prior to the recent revisions, the only recognition of the disproportionate impact of disclosure requirements on smaller offerings was a distinction between offerings up to \$5 million and those in excess of \$5 million.³⁵⁵ Offerings in excess of that amount had to be made by means

344. *Id.*

345. *Id.* § 230.701(b)(6).

346. *Id.* § 230.701(c). Securities issued pursuant to rule 701 are deemed to be "restricted securities" that cannot be resold without registration or an exemption therefrom. *Id.* § 230.701(c)(1)-(2). A mechanism for resale of securities under rule 144, *id.* § 230.144 is provided by *id.* § 230.701(c)(3).

347. *Id.* § 230.702(T)(a).

348. *Id.* § 230.703(T).

349. *See supra* text accompanying notes 231-38.

350. 17 C.F.R. § 230.703(T)(a)-(b) (1989).

351. *See id.* § 230.702(T)(e), .703(T)(c) which provide that rules 702 and 703 will remain effective for only five years from the effective date of those rules.

352. Securities Act Release No. 6768, 53 Fed. Reg. at 12,920.

353. 17 C.F.R. § 230.502(b) (1989).

354. *See* the authorities cited *supra* note 103.

355. Rule 502(b)(2)(A)-(B), Securities Act Release No. 6389, 47 Fed. Reg. at 11,264-65.

of a disclosure document containing the information required by Part I of a 1933 Act registration statement.³⁵⁶ Offerings below \$5 million, however, could provide the type of information required by SEC Form S-18, a short-form 1933 Act registration statement that allows somewhat abbreviated disclosures.³⁵⁷

In recognition of the burdens that even Form S-18 type disclosure could impose on smaller offerings, the SEC amended rule 502(b) to provide that offerings of up to \$2 million in aggregate offering price need provide only the type of disclosure required by Regulation A plus an audited balance sheet.³⁵⁸ Regulation A requires a more modest level of disclosure than Form S-18.³⁵⁹ Furthermore, offerings of up to \$7.5 million, rather than \$5 million, may now provide Form S-18 type disclosure; only offerings in excess of \$7.5 million must provide a higher level of disclosure.³⁶⁰

V. A DEFENSE OF THE NEW REGULATION D

A. *Reduced Costs for Small Business Issuers Without Increased Risks for Investors*

Do the many changes to Regulation D make sense? Are they defensible as a matter of public policy? For most securities issuers, the answers to these questions surely must be yes. While the 1987-1989 revisions may not have produced as liberal a Regulation D as some may have wished, they do reflect an expansion of most issuers' ability to offer securities on an exempt basis. Regulation D offerings, in the aggregate, should be less costly, and, from the issuer's perspective, less precarious.

From other perspectives, however, the new Regulation D might appear to worsen an already bad situation. Those who believe that the original Regulation D simply provided a broad conduit for fraud will hardly

356. Rule 502(b)(2)(B), *id.* at 11,264-65.

357. Rule 502(b)(2)(A), *id.* at 11,264. For discussion of the disclosure requirements of Form S-18, see Securities Act Release No. 6049 (Apr. 3, 1979), 44 Fed. Reg. 21,562, 21,567 (1979); Securities Act Release No. 6489 (Sept. 23, 1983), 48 Fed. Reg. 45,386, 45,387-88 (1983).

358. 17 C.F.R. § 230.502(b)(2)(i)(A) (1989). The specific reference in this subsection is to Part II of Form I-A, 17 C.F.R. § 239.90 (1989). The audited balance sheet must be dated within 120 days of the start of the offering. 17 C.F.R. § 230.502(b)(2)(i)(A) (1989).

359. Regulation A, 17 C.F.R. § 230.251-.264 (1989), unlike Form S-18, does not require audited financial statements, and requires less detailed narrative disclosures than does Form S-18. The crucial effect of this change, therefore, was to eliminate the requirement of audited financial statements for offerings under \$2 million, and to require only an audited balance sheet.

360. 17 C.F.R. § 230.502(b)(2)(i)(B)-(C) (1989).

approve the new substantial compliance concept, expanded categories of accredited investors, reduced filing and disclosure requirements or most of the other changes in the rules. Some state administrators already have made their feelings known about these developments,³⁶¹ and can be expected to fight a rear-guard action at the state level.

This Article takes the position that the 1987-1989 revisions do make sense, and are defensible as a matter of public policy. The arguments in support of this position, furthermore, extend not only to the recent revisions, but to all of Regulation D itself.

Both the original Regulation D and the 1987-1989 revisions perhaps can best be justified in terms of a cost-benefit analysis. These rules implicitly recognize that the benefits to investors generated by the 1933 Act registration process are not without costs, and that in at least some contexts the costs outweigh the benefits. Of course, the strongest version of this argument would proceed from the assumption that the 1933 Act registration system generates few if any benefits, either because firms have sufficient private incentives to disclose³⁶² or because the mandated disclosure is useless or not very important to most investors.³⁶³ If that assumption is correct,³⁶⁴ then the cost-benefit equation is totally skewed; the substantial costs of the registration system completely outweigh the few or nonexistent benefits to investors.

Even if one were skeptical about that strong form of the argument,³⁶⁵ and were to assume that the 1933 Act registration process generates at

361. See *supra* text accompanying notes 207-14.

362. Arguments to this effect have been made by W. BEAVER, *FINANCIAL REPORTING: AN ACCOUNTING REVOLUTION* 13 (1981); H. KRIPKE, *supra* note 86, at 119; S. PHILLIPS & J. ZECHER, *THE SEC AND THE PUBLIC INTEREST* 50 (1981); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306, 313, 323, 326 (1976); Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, in *ISSUES IN FINANCIAL REGULATION* 177 (F. Edwards ed. 1979).

363. Kripke has been the principal proponent of this argument. See his works cited *supra* note 86.

364. The argument that the SEC's mandatory disclosure system does not benefit investors has been analyzed in empirical terms by Stigler, *supra* note 82, and Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J. L. & ECON. 613 (1981), who both argued that the SEC's mandatory disclosure rules did not produce benefits observable in the form of returns to investors.

365. For critical analysis of the claim that issuers have sufficient private incentives to disclose, see Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 738-47 (1984); Seligman, *supra* note 73, at 5-8 n.24. For critical discussion of the argument based on empirical analysis of returns to investors, see Friend & Herman, *The SEC Through a Glass Darkly*, 37 J. BUS. 382 (1964); Seligman, *supra* note 73, at 11-45.

least some important benefits, the analysis would still not be complete. It would be crucial to recognize, for example, that the value of those benefits in certain market contexts may be less than in others. The SEC itself appeared to reach such a conclusion when it developed its integrated disclosure³⁶⁶ and shelf registration³⁶⁷ systems. Both of those systems substantially reduce the scale of 1933 Act disclosure and administrative review in connection with offerings by certain widely-followed issuers. The systems expressly recognize that traditional 1933 Act registration provides relatively few investor benefits with respect to offerings by issuers whose securities are traded in efficient markets and who have already generated large amounts of publicly available information under the 1934 Act.³⁶⁸ If traditional 1933 Act mandatory disclosure is largely superfluous in that market context, then its "benefits" are largely illusory and cannot outweigh the costs of full compliance with 1933 Act registration requirements.³⁶⁹ Hence, the integrated disclosure and shelf registration

366. The integrated disclosure system has been explained in the following terms:

The "integrated disclosure system" has two major aspects: (1) It coordinates required disclosures under the 1933 Act and the 1934 Act, in light of an assumption of the efficient market hypothesis that information effectively disseminated to the public will be rapidly reflected in share prices regardless of the source of the data. This aspect of the system is responsible for streamlined registration forms, notably Forms S-2 and S-3, for registrants subject to the 1934 Act's continuous disclosure obligations; (2) The system developed generic disclosure items for both 1933 Act registration and 1934 Act registration Previously required disclosures under the two Acts had been developed independently of each other (citations omitted).

2 L. LOSS & J. SELIGMAN, *supra* note 8, at 604-05.

367. The SEC's "shelf registration" system is the product of rule 415, 17 C.F.R. § 230.415 (1989). In essence,

Rule 415 permits the registration of securities that an issuer intends to "put on the shelf" rather than sell immediately. By having a block of "shelf registered" securities available, an issuer avoids the delay of the registration process once the decision is made to proceed with a sale. Shelf registration also gives an issuer the flexibility to seek bids from a group of competing underwriters and bypasses the traditional method of negotiating a fixed price in advance of sale with just one underwriting syndicate.

Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1005-06 (1984).

368. The SEC's reliance on efficient market theory in adopting the integrated disclosure system was made express in Securities Act Release No. 6235 (Sept. 2, 1980), 45 Fed. Reg. 63,693, 63,694 (1980); Securities Act Release No. 6331 (Aug. 6, 1981), 46 Fed. Reg. 41,902, 41,904-05 (1981); Securities Act Release No. 6383 (Mar. 3, 1982), 47 Fed. Reg. 11,380, 11,382-85 (1982). The importance of the theory to creation of the shelf registration system was equally clear. See Fox, *supra* note 367, at 1008. For a thorough analysis of the efficient market hypothesis and its application to securities regulatory policy, see Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

369. For a debate over the question of whether the shelf registration system deprives investors of the benefits created by underwriter due diligence in traditional nonshelf 1933 Act registration

systems eliminate the need for much of that compliance.

Relaxation of 1933 Act requirements also may be justified when the costs in specific market contexts may be too high to justify the benefits, even if those benefits are substantial. In contrast to securities sold under the integrated disclosure or shelf registration systems, the types of securities exempted under Regulation D tend not to be sold in efficient markets.³⁷⁰ One might assume that purchasers of such securities would benefit from the due diligence process, formalized disclosure and administrative review required by 1933 Act registration. On the other hand, the costs of due diligence, audited financial statements and administrative delays, as well as substantial opportunity costs, are disproportionately high for smaller issuers raising relatively small amounts of money because the costs remain relatively constant.³⁷¹ Those costs also are particularly insupportable for companies who need access to investors other than venture capitalists or banks.

The costs of 1933 Act compliance for small business, therefore, may outweigh the benefits that 1933 Act registration would provide to investors. This is not to suggest that the federal government's interest in investor protection is trivial, or that it should be ignored in this market context. Rather, this interest should be balanced against other legitimate interests and in this particular context the interest in facilitating capital formation justifies substantial exemptions from the 1933 Act registration requirement. This sense of balance has characterized Regulation D since the beginning, and continued to do so in the 1987-1989 revisions. The new exemption for certain employee benefit plans, the increased aggregate offering price ceiling for rule 504 offerings, and the reduced disclosure requirements for smaller offerings are but the clearest examples on point.

Critics of Regulation D might concede that small business needs regulatory relief, while arguing that Regulation D has not served primarily as a small business financing mechanism, but rather as a loophole for tax advantaged oil and gas and real estate limited partnership syndicators

processes, compare Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984), with Fox, *supra* note 367.

370. See Coffee, *supra* note 365, at 731 (arguing that not all securities are sold in "efficient" markets).

371. For discussion of the data supporting this conclusion see Seligman, *supra* note 73, at 57-59. For discussion of the costs of compliance with 1933 Act registration requirements, see S. PHILLIPS & J. ZECHER, *supra* note 362, at 27-51; Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 708-09 (1984).

and, even worse, as an open invitation to fraud.³⁷²

At least three responses might be made to that cluster of assumptions and conclusions. First, the use of Regulation D by some larger issuers does not contradict the fact that small business issuers also routinely rely on it.³⁷³ The Regulation is crucial to small business issuers of every type, ranging from those at the start-up stage relying on rule 504 to more mature small companies needing rules 505 or 506 for an additional round of financing prior to a public offering.³⁷⁴ Regulation D is the key to reduction of their disproportionate compliance burden. To the extent that larger issuers use the Regulation, a separate and additional justification lies in the many conditions and requirements that provide substantial protection to investors. In any event, the use of Regulation D by some non-small business issuers does not obviate the Regulation's usefulness as a means of relieving small business's disproportionate compliance burden.

Second, the assumption that Regulation D is somehow inherently linked with fraud has never been established empirically, and no unique causal relationship has been articulated convincingly. One sometimes hears anecdotal evidence about the depredations of Regulation D issuers, but such stories can be counterbalanced with anecdotal evidence of similar abuses by issuers of registered offerings. For example, penny stock issuers often have perpetrated frauds and other abuses despite apparent compliance with 1933 Act registration requirements.³⁷⁵ The availability

372. The most persuasive proponent of arguments to this effect has been Professor Seligman. See Seligman, *supra* note 73, at 58-60 (criticizing the SEC for failing to recognize that broadened small firm exemptions would increase the likelihood of securities fraud).

373. The SEC's analysis of the first year of use of Regulation D showed that limited partnerships claimed 66% of Regulation D filings and 55% of the aggregate value. Corporations accounted for 32% of the filings and 43% of the value. SEC, Analysis, *supra* note 4, at 17. Assuming, *arguendo*, that limited partnerships should be excluded from the category of small business (a by no means self-evident proposition), it remains that a very large percentage of the users of Regulation D were corporate issuers. The same study found further that most of the corporate issuers were closely held, and many were in the start-up stage. *Id.* at 23. Of particular importance to such smaller corporate issuers was rule 504. *Id.* at 17, 23-24.

374. See *id.* at 24 table 7, showing continued reliance on Regulation D, albeit at lower rates, by emerging companies beyond the start-up stage.

375. Accounts of serious problems of investor abuse in penny stock offerings have become common in the popular press. See Boland, *Confessions of a Penny-Stock Broker*, SYLVIA PORTER'S PERSONAL FINANCE, Sept. 1988, at 65; Quinn, *The War on Penny Stocks*, NEWSWEEK, Apr. 10, 1989, at 52. The SEC has recently acted under the 1934 Act to control penny stock abuses by imposing stringent sales practice requirements on broker-dealers selling such securities. 17 C.F.R. § 240.15c2-6 (1989). For discussion, see Securities Exchange Act Release No. 27,160 (Aug. 22, 1989), 54 Fed. Reg. 35,468 (1989).

of an exemption such as Regulation D may make it cheaper for some issuers to take advantage of investors, but the scale and nature of the correlation between fraud or overreaching and the exempt status of securities offerings remains to be determined.

Third, objections to Regulation D often are really indirect objections to the type of offering exempted under the Regulation. Regulation D may appear suspect to some because it has so well served syndicators of tax-advantaged limited partnerships. This is a case of throwing the proverbial baby out with the bathwater. If there is a problem with abusive tax shelters, the problem should be addressed as a matter of tax policy and not as a matter of securities regulatory policy. Even the subtler version of this critique—that Regulation D facilitates abusive tax shelters by allowing them to be marketed more cheaply—misses or at least undervalues this basic point. The applicability of 1933 Act registration requirements does nothing to prevent economically questionable transactions when markets for those transactions exist. The recent dismal experience with SEC-registered, publicly offered limited partnerships is a case in point.³⁷⁶

These criticisms of Regulation D and its recent expansion also implicitly assume that investors are in fact being left vulnerable to exploitation by the unscrupulous. This assumption is not entirely credible. It fails, in particular, to take into account the crucial role of the accredited investor concept under Regulation D.

In many respects, the accredited investor concept is the heart of Regulation D. As explained above in Part IV,³⁷⁷ accredited investors are persons or entities deemed, according to objective standards, able to fend for themselves. Accredited investors, like sophisticated investors under section 4(2) and rule 506, do not need the protection that registration would provide. They either are capable of evaluating the merits of the offering or have sufficient resources to purchase the expertise needed for that evaluation. In particular, they are able to purchase the advice they need to invest on a diversified basis in accordance with portfolio theory, allowing them to hedge the substantial risks usually associated with Regu-

376. See Bettner, *Investors Continue to Shun Offerings of New Public Limited Partnerships*, Wall St. J., Oct. 13, 1989, § 3, at 9, col. 1 (describing how serious economic problems with existing public limited partnerships have led investors to shun new offerings); Bettner & Power, *Morning After: Limited Partnerships Are Often Faltering, To Investors' Dismay*, Wall St. J., Aug. 17, 1989, § 1, at 1, col. 6 (describing severe difficulties encountered by those who invested billions of dollars in public limited partnerships).

377. See *supra* text accompanying notes 294-302.

lation D-type securities with investments in other types of securities or in nonsecurities investments.³⁷⁸ They also presumably have the ability to bargain for the information they need or to decide when particular types of information are not needed. It is thus difficult to justify regulatory intervention in their decision-making process. In fact, it is difficult to justify either the imposition of additional costs on capital formation or the expenditure of public resources for the purpose of "protecting" such investors.

It may be argued that Regulation D's attempt to objectify the class of persons able to fend for themselves is foolishly optimistic, because a person with a high net worth or annual income may be totally unsophisticated, and some institutional investors—savings and loan associations, for instance—may be even more feckless than individuals.³⁷⁹ It also may be pointed out that there is no empirical evidence establishing that such investors can fend for themselves, and that plenty of at least anecdotal evidence suggests that "widows and orphans" are not the only suckers in the world.³⁸⁰ The fact remains, however, that all individuals or entities who fall within the various accredited investor categories, including the individual annual income and net worth categories, have the financial ability to purchase the advice they need. Some investors in those categories may "need" protection from their own greed, laziness or fecklessness, but do they *deserve* that protection? Should "protecting" such investors be a priority of the regulatory system, especially in light of the costs of providing such protection? A regulatory system that answers these questions affirmatively may be providing an unneeded subsidy to the undeserving. The 1987-1989 additions to the list of accredited investors, therefore, merely improved upon an already sound approach and made it even more workable.

378. This is not to suggest that portfolio theory eliminates the need for some sort of mandatory disclosure system. As both Coffee and Seligman have argued (albeit on different grounds) portfolio theory does not satisfy the ordinary investor's total informational needs. Coffee, *supra* note 365, at 750-51; Seligman, *supra* note 73, at 4-5 n.23. It is to suggest, however, that *accredited* investors, as defined in Regulation D, have greater capacities for extracting and evaluating material information than do ordinary investors, and that these capacities will allow them to diversify their investments more effectively than ordinary investors. Government-mandated disclosure in transactions with accredited investors thus may be relatively superfluous.

379. See Warren, *supra* note 22, at 382 ("Experience indicates that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment").

380. *Id.* ("It is important to note that the categories of 'wealthy' investors frequently include the widows and orphans whose protection traditionally has been the sacred trust of the SEC").

The other changes to Regulation D also make the exemptions more practicable without creating a new window of vulnerability for investors. The reduced disclosure requirements for smaller offerings, for example, relate principally to the form of disclosure and the amounts of audited financial data required. The changes reduce the risk of a registration violation for failure to comply with a technical disclosure requirement, while leaving intact the issuer's incentive to disclose all material information in order to minimize potential antifraud liability.

Similarly, neither rule 507 nor rule 508 create new risks for investors. The SEC never intended the rule 503 filing requirement to have any direct impact on investor protection; the Commission designed it as a means of collecting data about the use of the exemptions. The SEC apparently never used these filings as a market-monitoring mechanism for enforcement purposes.³⁸¹ Investor plaintiffs in civil actions against issuers perhaps may have used violations of the filing requirement as an easy way to gain settlement leverage, but it hardly seems appropriate to protect their litigational edge. Civil liability in private actions should be based on more substantive violations of those requirements that were actually intended to protect investors. The elimination of this element of leverage may worsen the field position of some plaintiffs in litigation arising under Regulation D, but the disproportionate risk to issuers makes this marginal benefit to investors hard to justify.

The new substantial compliance concept is perhaps even more innocuous. First, the operation of the concept is quite narrow and specific. It does not even apply in SEC enforcement actions, thus leaving an entire zone of liability untouched.³⁸² The concept is also totally inapplicable to violations of the general solicitation ban, the rule 504 and rule 505 aggregate offering price limitations, and the rule 505 and rule 506 purchaser limitations.³⁸³ In addition, it does not provide complete protection from liability; it only protects against liability to those persons who were not injured by the violation.³⁸⁴

Second, as explained above in Part IV,³⁸⁵ the SEC did not intend the new rule to encourage a "close is good enough" approach to Regulation D compliance. Both the plain language of rule 508 and the SEC's une-

381. Securities Act Release No. 6650, 51 Fed. Reg. at 21,378-80.

382. See *supra* text accompanying notes 279-82.

383. See *supra* text accompanying notes 265-71.

384. See *supra* text accompanying notes 257-64.

385. See *supra* text accompanying notes 274-78.

quivocal utterances show that reliance on rule 508 should be a last-ditch measure used *ex post* in litigation to protect an issuer against the type of highly disproportionate liability that made Regulation D so risky to use. Rule 508 may inject some uncertainty into litigation over Regulation D, but it should not have any substantial impact on the level of compliance under the rules. Substantial incentives for full compliance remain intact; rule 508 simply will provide some comfort for those whose good faith efforts at full compliance somehow fall short. The only important policy question is whether the SEC has been too restrictive in denying substantial compliance relief to violations of the general solicitation ban and the aggregate offering price and purchaser limitations.

Taken as a whole, the foregoing arguments lead to a simple conclusion: Regulation D substantially reduces the costs of compliance for small business issuers without substantially increasing investors' risk of fraud or overreaching. This conclusion justifies not only the original adoption of Regulation D but its recent expansion. Another key justification, however, should be kept in mind.

B. Superior Allocation of Regulatory Responsibilities

A central dilemma of securities regulation in the United States is that of defining the proper allocation of regulatory responsibilities between the federal government and the states. The state securities administrators and the SEC have overlapping jurisdiction over a vast number of transactions.³⁸⁶ Legal devices have been developed to make this terribly nonsystematic "system" workable,³⁸⁷ but there has been no comprehensive effort to define those segments of the securities markets best regulated by the SEC and those best regulated by the states. Rule 504 of Regulation D, however, is a step in the right direction.

From the beginning, rule 504 represented an attempt to define a class of small offerings in which the federal interest was *de minimis*, and with respect to which deferral to state regulation was appropriate.³⁸⁸ "Deferral to state regulation" in this context meant that the SEC would impose minimal conditions for exemption of certain smaller offerings, on the assumption that those offerings either would comply with more stringent state exemptions or would be registered in every state in which the offer-

386. See *ABA Merit Report*, *supra* note 8, at 791; Sargent, *supra* note 116, at 1029-37.

387. An example is the state "registration by coordination" device. See *ABA Merit Report*, *supra* note 8, at 798-99.

388. See *supra* text accompanying note 99.

ings were made. To encourage state registration, rule 504 provided the incentive of relief from most of the remaining federal exemptive conditions if the offering were in fact state-registered.³⁸⁹ In short, rule 504 created a neat and practicable division of regulatory responsibilities.³⁹⁰

All of the 1987-1989 changes to rule 504 reflect the same philosophy and are directed toward the same end. The SEC increased the ceiling on the aggregate offering price to \$1 million, but tied the availability of the higher ceiling to state registration, and eliminated an anomaly that made it impossible for issuers to take full advantage of rule 504 when selling in jurisdictions without registration mechanisms.³⁹¹ The sole remaining issue is whether the states will develop a simplified registration mechanism appropriate to \$1 million registered offerings.

In any event, rule 504 is a positive attempt to resolve at least one aspect of a persistent problem of federalism. The revisions to rule 504 show that the SEC is continuing to take the type of creative and balanced approach that has characterized the Regulation D enterprise since the beginning and that makes its defense possible. One should not read this Article's defense of the basic approach implicit in Regulation D and its recent revisions, however, as suggesting perfection. Much remains to be done.

VI. THE UNFINISHED AGENDA

There remain three principal problems with Regulation D. Two of those problems are within the SEC's purview; the other is primarily the responsibility of NASAA and the states.

A. Greater Coordination of State and Federal Regulation of Limited and Private Offerings

One of the principal points of this Article is that reform of securities regulatory policy is not just a matter of deciding what makes sense philosophically, but of deciding what will work in the context of a joint state-federal system of securities regulation. Evaluation of regulatory policy, therefore, has to take into account not only the costs of compliance with federal law, but also the costs of compliance with parallel aspects of state law.

389. See *supra* text accompanying note 40.

390. See *supra* text accompanying notes 98-99.

391. See *supra* text accompanying notes 330-32.

Those state-generated costs are more than a matter of paying a few extra filing fees or spending a bit more on legal research.³⁹² The law that determines the structure of an exempt transaction is the law of the most restrictive state in which the offering must be sold. In that sense, the states have had the last word on Regulation D. If the investors in a particular transaction are located in a jurisdiction that imposes more stringent conditions than any of the Regulation D rules, then those conditions will prevail. The advantages provided by Regulation D will go for naught. The persistence of state exemptive conditions more restrictive than those of Regulation D thus causes the aggregate costs of securities compliance to increase.

Even more costly is the lack of uniformity among the state coordinating exemptions. Here the problem is not necessarily that the state coordinating exemptions are more restrictive than the Regulation D exemptions, but that they are different from each other. The Uniform Limited Offering Exemption is uniform in name only. The state administrators have not been able to resist hanging all sorts of bells and whistles on their versions of ULOE, and hence upon Regulation D itself.³⁹³ The net result is that rule 505 and 506 transactions are "doable," but only after expensive and time-consuming efforts to comply with an ever-shifting constellation of idiosyncratic state coordinating exemptions. Compounding the difficulty, and undermining the progress made in the recent revisions of Regulation D, is the omnipresent risk of liability for failing to comply with one or more states' exemptive requirements.

For the states to insist that this is simply a matter of the exercise of sovereign power in the interests of investors is self-indulgent. While the states may possess the constitutional authority to regulate in this manner, their insistence on maintaining a nonuniform hodgepodge of exemptions subverts the SEC's careful and systematic attempt to balance the legitimate needs of capital formation and investor protection, and shows an indifference to essential national concerns.

The solution? Only widespread adoption of a truly uniform state coordinating exemption for rule 505 and 506 transactions will preserve the appropriate regulatory balance. This will require many state administra-

392. There has been no comprehensive theoretical or empirical analysis of the costs generated by state securities regulation. A promising work-in-progress, however, is a study sponsored by the Small Business Administration. Office of Advocacy, United States Small Business Administration, *The Effect of State Securities Laws on Small Business Capital Formation* (Nov. 1, 1988).

393. *See supra* authorities cited note 135.

tors to adopt a far more cooperative spirit than they have demonstrated so far, but progress in that direction is both possible and necessary. The ultimate result should be state rules that do not superimpose additional or inconsistent state requirements upon rule 505 and 506 transactions, but make compliance with those rules the crux of both state and federal exemption. Unfortunately, NASAA's legal incapacity to impose a uniform solution upon its members and its political inability to forge a consensus among them shows the profound weakness of the current purely voluntary approach to state-federal coordination, and does not bode well for the future.

With respect to rule 504 transactions, the issue is more complicated. Unlike rules 505 and 506, rule 504 represents an express deferral to state regulation.³⁹⁴ State exemptions directly coordinated with rule 504 thus would be neither desirable nor consistent with the intent of rule 504. Transactions under this rule should be subjected to a higher degree of regulation at the state level than the minimal regulation applied at the federal level. These transactions are typically too small and localized to justify federal intervention, but the states do have a legitimate interest in regulating them. The goal therefore should not be the development of state rules that hinge state exemption upon compliance with rule 504; something more should be required at the state level.

This is not to say, however, that rule 504 transactions do not need some sort of special treatment by the states. These offerings, after all, are typically the quintessential small business offerings by issuers who cannot afford the cost of an ordinary, full-scale state registration by qualification. The states thus need to develop mechanisms that will regulate rule 504 offerings without burdening them with excessive compliance costs.

Among such mechanisms might be exemptions that limit the number and nature of the purchasers while requiring some type of short-form disclosure as a condition of the exemption. The states could specifically tailor such exemptions to rule 504 offerings. Some states already have developed highly flexible rules of that type.³⁹⁵ A particularly important mechanism would be a simplified registration form. Such a form would limit the amounts and types of required disclosure, thereby making state registration much less expensive and time-consuming. The wide availability of such a form would be particularly valuable under the revised

394. See *supra* text accompanying notes 99, 389-90.

395. An example of such a rule is MD. REGS. CODE tit. 2, § 02.04.09 (1983), 1A Blue Sky L. Rep. (CCH) ¶ 30,435. For discussion, see Sargent, *supra* note 73, at 541-56.

version of rule 504, because it would improve issuers' ability to take advantage of the new \$1 million ceiling on the aggregate offering price. A cooperative drafting effort between NASAA and representatives of the ABA recently resulted in NASAA's adoption of a Small Corporate Offerings Registration Form, popularly known as SCOR.³⁹⁶ The drafters designed this form for use with state registration of rule 504 offerings,³⁹⁷ and it offers a promising start toward resolution of rule 504 problems. The individual states also will have to adopt SCOR, however, before the problem can be deemed solved. Widespread adoption of SCOR and a true uniform limited offering exemption would be crucial steps toward resolving the persistent tensions in this area, and toward achieving a rational allocation of regulatory responsibilities between the states and the SEC.

B. *An Integration Safe Harbor*

The integration doctrine has long been one of the major puzzles of SEC exemptive policy. The doctrine originated under the statutory section 4(2) exemption, and the SEC has expressly incorporated it into virtually all of the sections 3(b) and 4(2) exemptive rules.³⁹⁸ While useful and perhaps necessary from an investor protection standpoint, the integration doctrine historically has injected substantial uncertainty into the planning of exempt transactions.

The key to the doctrine is that all purchases and sales that are part of the same issue should be taken into account for purposes of determining whether the issue as a whole meets the conditions of the applicable exemption.³⁹⁹ The goal of the doctrine is to prevent issuers from chopping offerings into artificially distinct segments to avoid limitations on the number of purchasers or the aggregate offering price.⁴⁰⁰ The doctrine

396. Small Corporate Offerings Registration Form (Form U-7) (adopted Apr. 29, 1989), NASAA Reports (CCH) ¶ 5057 [hereinafter SCOR]. For discussion of the development of SCOR through a joint NASAA-ABA project, see *supra* authorities cited note 322. For critical analysis, see Sargent, *The SCOR Solution*, 18 SEC. REG. L.J. 93 (1990).

397. SCOR, *supra* note 396, at 5197.

398. For a comprehensive survey of the origins and development of this doctrine, see Wallace, *Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses*, 45 WASH. & LEE L. REV. 935, 953-66 (1988).

399. Deaktor, *Integration of Securities Offerings*, 31 U. FLA. L. REV. 465, 492 (1979); Shapiro & Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always . . .*, 31 MD. L. REV. 3, 9-10 (1971); Wallace, *supra* note 398, at 937.

400. Deaktor, *supra* note 399, at 492.

thus makes sense as a way of preventing issuers from elevating form over substance to avoid their obligations under the securities laws.

The exquisite difficulty of determining when apparently discrete offerings are actually part of a single issue, however, has created great practical problems for issuers who are not trying to manipulate the securities laws. To preserve maximum flexibility under the integration doctrine, the SEC has left the basic concept largely undefined, and contented itself with a five factor test⁴⁰¹ that is of relatively little help to transaction planners.

This test, which was expressly incorporated into Regulation D as rule 502(a), requires consideration of whether the sales: (1) are part of a "single plan of financing;" (2) involve the issuance of "the same class of securities;" (3) are made "at or about the same time;" (4) are made for the "same type of consideration;" and (5) are made for "the same general purpose."⁴⁰²

The SEC's and the courts' utterances on this test⁴⁰³ have never clearly established how many of these factors must be present before integration will result or whether some factors are more important than others. It is also not clear whether there is any real difference between the first factor—"single plan of financing"—and the fifth—"same general purpose." In fact, those two factors are so open-ended as to constitute virtual re-statements of the general question of whether an offering is part of the same issue.

The five factor test is particularly useless with respect to the latest wrinkle in integration: issuer integration.⁴⁰⁴ In traditional integration analysis, the question is whether apparently discrete offerings by the same issuer should be regarded as part of the same issue. Under an is-

401. See Securities Act Release No. 4434 (Dec. 6, 1961), 26 Fed. Reg. 11,896 (1961); Securities Act Release No. 4552 (Nov. 6, 1962), 27 Fed. Reg. 11,316, 11,317 (1962). For critical analysis of this formulation, see Deaktor, *supra* note 399, at 502, 505; *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595, 596, 600, 623 (1986) (report of task force of ABA Committee on Federal Regulation of Securities) [hereinafter *ABA Integration Report*]; Wallace, *supra* note 398, at 939-40.

402. 17 C.F.R. § 230.502(a) (1989).

403. For citations to this body of law, see Wallace, *supra* note 398, at 953-66.

404. For discussion of this concept, see *ABA Integration Report*, *supra* note 401, at 621-31; *Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering*, 37 BUS. LAW. 1591, 1610-11 (1982) (report of the ABA Subcommittee on Partnerships, Trusts, and Unincorporated Associations) [hereinafter *ABA Partnership Report*]; Morrissey, *Integration of Securities Offerings—The ABA's "Indiscreet" Proposal*, 26 ARIZ. L. REV. 41, 64-69 (1984); Stevenson, *Integration and Private Placements*, 19 REV. SEC. & COMM. REG. 49, 57 (1986); Wallace, *supra* note 398, at 967-71.

suer integration analysis, the question is whether offerings by apparently discrete *issuers* should be integrated. This question is particularly acute in the limited partnership context, in which a single corporation may act as general partner or otherwise sponsor a series of very similar limited partnership offerings.⁴⁰⁵ Under an issuer integration analysis, that corporation may be regarded as the issuer of all of those limited partnership units, despite the various limited partnerships' legal status as distinct entities.⁴⁰⁶

The five factor test is of very little use in such contexts. The securities are inevitably of the same class, they typically are all sold for the same type of consideration, and they usually are all sold at or about the same time. Whether they are part of a "single plan of financing" or sold for the "same general purpose" depends upon how one interprets those concepts, and different interpretations are certainly possible. Some sort of guidance is needed.

The SEC's reluctance to provide hard and fast rules is understandable, because such rules can simply become a road map for successful evasion. The SEC can meet the need for a higher level of predictability, however, by adopting a substantive safe harbor rule. Such a rule would provide planners with greater certainty by allowing them to identify a specific set of circumstances under which integration definitely will not arise, while allowing the SEC flexibility to determine when other circumstances will give rise to integration. The adoption of a safe harbor rule, furthermore, would not really be a novelty, because the SEC has long applied a temporal safe harbor, deeming transactions more than six months prior to the commencement of an offering and more than six months after the completion of the offering not to be part of the same issue.⁴⁰⁷

What is needed now is a more substantive safe harbor, particularly in the issuer integration context. An ABA task force already has proposed a model safe harbor that would address this problem very effectively.⁴⁰⁸ The ABA's proposal contains several elements, but the crux is that offer-

405. This was precisely the issue in the leading issuer integration case, *SEC v. Murphy*, 626 F.2d 633 (9th Cir. 1980). See also *SEC v. Holschuh*, 694 F.2d 130 (7th Cir. 1982) (following *Murphy*).

406. *Murphy*, 626 F.2d at 644.

407. Such a temporal safe harbor is already included in rules 502(a) and 147(b)(2), 17 C.F.R. § 230.502(a) (1989), 17 C.F.R. § 230.147(b)(2) (1989).

408. *ABA Integration Report*, *supra* note 401, at 631-32. This proposal derived from a proposal set forth in the earlier *ABA Partnership Report*, *supra* note 404, at 1610-11. For a critique, see *Morrissey*, *supra* note 404, at 69-76. For a defense and extension, see *Wallace*, *supra* note 398, at 967-71.

ings by legally distinct issuers should not be integrated if each issuer possesses "economic independence," that is, "an independent opportunity to meet its primary investment objectives."⁴⁰⁹ Under this standard, integration will not result if the offering in question is "designed to fund a separate and independent entity that is not financially dependent upon any entity created through any other offering involving a common sponsor."⁴¹⁰ This standard, of course, creates its own interpretive problems, but it at least eliminates the possibility that all series of limited partnership offerings with common sponsors will be regarded as single issues under the issuer integration doctrine.

The ABA proposal was perhaps too controversial for the SEC to consider seriously during the 1987-1989 revisions, but the proposal may be an idea, like the substantial compliance idea, whose time will come. Once the SEC perceives that it will be able to preserve substantial enforcement flexibility despite the safe harbor, it may be willing to consider its adoption.

C. *Reexamination of the General Solicitation Doctrine*

As explained in Part II,⁴¹¹ rule 502(c) bans any general solicitation in connection with an offering under rule 505 or 506 and, in some circumstances, under rule 504. The history of this ban is too long and complicated to bear retelling here, especially since recent scholarly commentary already has exposed its dubious antecedents and currently confused status.⁴¹² Suffice it to say that this apparently innocuous prohibition began to create serious practical problems after the adoption of Regulation D. Rule 501(e) permitted accredited investors to be excluded for purposes of the "body count" under rules 505 and 506.⁴¹³ Offerings under those rules were thus permitted thirty-five non-accredited investors and an unlimited number of accredited investors. As transactions involving dozens or even scores of accredited investors began to surface, a tension between rule 501(e) and the rule 502(c) general solicitation ban emerged. How, after all, could an issuer assemble so many investors without a general solicitation?

409. *ABA Integration Report*, *supra* note 401, at 631; *ABA Partnership Report*, *supra* note 404, at 1611.

410. *ABA Partnership Report*, *supra* note 404, at 1610.

411. *See supra* text accompanying note 35.

412. *See Daugherty*, *supra* note 108.

413. *See supra* text accompanying notes 46-47.

This tension provoked an outpouring of requests to the SEC for interpretive guidance. The SEC responded with a few no-action letters.⁴¹⁴ One commentator describes the resulting state of the law in the following terms:

These few letters comprise all of the Staff's written interpretations of the "general solicitation" prohibition of rule 502(c). In sum, almost any use of the media to offer securities is said to be prohibited. In the Staff's view, the rule also forbids solicitation (which is broadly construed), in connection with any offering (whether underway or contemplated), of any individual with whom the issuer or other seller lacks a "substantive relationship." The letters support, however, one very important practice that had been suspect while rule 146 was operative and had been presumed illegal before then. They show that, in the Staff's view, a solicitation is not "general," and thus rule 502(c) is not violated, merely because a great number of prospective investors may be approached.⁴¹⁵

In the absence of radical change, concepts such as "substantive relationship"—also called "preexisting relationship"—will provide the framework for analysis of the general solicitation issue.⁴¹⁶ Securities practitioners can be expected to develop the subtlety of scholastic theologians with respect to this issue, or at least the perspicuity of ancient priests attempting to discern the future in the entrails of slaughtered beasts.

The SEC did give some reassurance to the priesthood in Release No. 33-6825, when it stated that

inasmuch as general solicitation is not defined in Regulation D, the question of whether or not particular activities constitute a general solicitation must always be determined in the context of the particular facts and circumstances of each case. Thus, for example, if an offering is structured so that only persons with whom the issuer and its agents have had a prior relationship are solicited, the fact that one potential investor with whom there is no such prior relationship is called may not necessarily result in a general solicitation.⁴¹⁷

414. For citations to and discussion of these letters, see Daugherty, *supra* note 108, at 103-15; Lipson & Scharfman, *General Solicitations in Exempt Offerings*, 20 REV. SEC. & COMM. REG. 8, 9-12 (1987); Martin & Parsons, *The Preexisting Relationship Doctrine Under Regulation D: A Rule Without Reason?*, 45 WASH. & LEE L. REV. 1031, 1040-43 (1989).

415. Daugherty, *supra* note 108, at 113.

416. For critical analysis of this concept, see Martin & Parsons, *supra* note 414, at 1043-47 ("the preexisting relationship criterion has little, if any, bearing on whether the protections of the Securities Act are necessary in particular circumstances").

417. Securities Act Release No. 6825, 54 Fed. Reg. at 11,370.

Practitioners will derive reassurance from this announcement of the SEC's willingness to consider the "particular facts and circumstances of each case" and to forgive minor lapses from the prior or substantive relationship requirement if the issuer had in place an appropriate procedure to avoid general solicitation.⁴¹⁸ The SEC's apparent reasonableness on these questions, however, does not constitute a response to a more fundamental question.

To put that question most simply: What benefit do investors derive from the ban on general solicitation? Investors in rule 506 transactions are either accredited or sophisticated. In rule 505 transactions they are either accredited or the beneficiaries of detailed disclosure requirements. In rule 504 transactions they rely on state law. What, then, does the general solicitation ban accomplish? Does it protect investors from fraud or overreaching? Arguably their own status or the delivery of a disclosure document accomplishes that. Does the ban have a prophylactic effect that somehow keeps Regulation D transactions limited in scale? Arguably the aggregate offering price and purchaser limitations accomplish those goals.

So what is left for the general solicitation ban to accomplish? The SEC either should provide some clear articulation of the beneficial effects of the ban, or should consider removing it as a constraint on capital formation.⁴¹⁹ This may not be possible with respect to rule 506, because section 4(2), which exempts only nonpublic offerings, may require the ban on general solicitation.⁴²⁰ Under its very broad section 3(b) rulemaking authority, however, the SEC could eliminate the prohibition for purposes of rule 505 or 504 offerings, much as it has for state-registered rule 504 offerings. There is thus some room for change.

It may very well be that the other exemptive requirements contained in the Regulation D rules are not sufficient to prevent investor abuse in the absence of a general solicitation ban. The elimination of the constraint might produce a wide-open atmosphere that would generate too much temptation for even well-intentioned issuers and counsel. That worst

418. See Schneider, *supra* note 216, at 1214 ("The SEC sends a clear message to the counsel and the courts that, if there is a reasonable plan to preclude general solicitation and advertising, an insignificant event which exceeds the limits of the plan should not necessarily cause a section 5 violation").

419. For earlier arguments to this effect, see Campbell, *supra* note 106, at 136-43; Cohn, *supra* note 108, at 25-33.

420. *But see* Daugherty, *supra* note 108, at 127-28 (arguing that abolition of the doctrine with respect to section 4(2) and rule 506 might be possible).

case scenario, however, may not come to pass. Perhaps an experiment is in order. The SEC could eliminate the general ban for a two- or three-year period, while continuing to prohibit public advertising through the print and electronic media, or confine the experiment to rule 505 offerings below a specified dollar amount. Whatever the terms of the experiment, some rethinking is in order.⁴²¹

VII. CONCLUSION

The creation of the "new" Regulation D, on one level, was simply a new stage in the SEC's ongoing reassessment of its basic approach to the 1933 Act exemptions for private and limited offerings. This Article's closer look at the way in which the "new" Regulation D was created, however, showed that this reassessment of federal regulatory philosophy exacerbated existing structural tensions with the joint state-federal system of securities regulation. The SEC had to resolve basic questions of regulatory philosophy, therefore, not only—and perhaps not even primarily—on their merits but also in terms of their implications for this curious partnership. It thus was not enough for the SEC simply to decide that the disproportionate burdens imposed upon small business by the 1933 Act required experimentation with different and less restrictive approaches to investor protection. The shape and scale of the experiment was determined by a dialectical struggle in which the SEC was tugged in one direction by an organized securities bar arguing for broader deregulatory change and in another by state securities administrators urging greater SEC deference to their particular conception of the needs of investors.

The changes to Regulation D that emerged from the 1987-1989 revision process bore the marks of this struggle. While the overall tilt of the ultimate synthesis certainly was toward liberalizing Regulation D and making it easier and less dangerous to use, the changes were perhaps more modest than they would have been had the state administrators not interceded.

This result arguably can be defended on the grounds that the state administrators helped make regulatory change proceed at a more cautious, manageable pace, and that they were entitled to influence policy decisions that would effect the allocation of regulatory responsibilities

421. For suggestions of some other incremental reforms that the SEC could consider, see Daugherty, *supra* note 108, at 128-34.

between the states and the SEC. The state administrators' role in the process, however, has not been invariably constructive. ULOE is uniform in name only, and many individual state administrators' insistence on trivial and frequently meaningless variations on the basic ULOE model has increased transactional costs. The state implementation of ULOE thus has undone much of the good achieved by Regulation D without generating clear and convincing evidence of real benefits to investors. SCOR represents a promising attempt to create a special state registration vehicle for transactions exempted under rule 504 from federal registration, but the promise will become reality only if state implementation of SCOR achieves the uniformity that has eluded ULOE.

Continued improvement in the regulation of limited and private offerings of securities, however, does not depend exclusively on the efforts of the state administrators. Now that the SEC has resolved the major problems with the Regulation D filing requirement and the substantial compliance concept, it can turn to the even more controversial and perhaps less tractable integration and general solicitation doctrines. This Article has made the case, at least, for a more fundamental and convincing articulation by the SEC of the rationale for these doctrines. The SEC's demonstrated willingness to experiment with new approaches to balancing the needs of investor protection and capital formation, both in the Regulation D context and elsewhere,⁴²² gives some hope that these troubling doctrines may soon receive a much-needed reexamination.

422. A major example of the SEC's willingness to experiment with novel approaches to balancing these different interests is its recent adoption of rule 144A. Securities Act Release No. 6839, (July 11, 1989), 54 Fed. Reg. 30,076 (1989). This new rule greatly facilitates the resale of restricted securities to certain institutional investors. It will have an indirect impact on Regulation D by making some securities originally sold under that regulation more liquid. The impact may be modest, however, because it will be largely limited to securities sold and traded in purely institutional markets. It should not have much of an impact on smaller corporate or limited partnership financings under Regulation D that primarily involve individual or smaller institutional investors. Rule 144A should have a greater impact on the purely institutional market in which § 4(2) typically exempts primary offerings. For discussion of the use of § 4(2) in that market, see *ABA Institutional Private Placements Report*, *supra* note 18.

