REGULATION D: A PRIMER FOR THE PRACTITIONER

By Mark F. Donahue*

In March of 1982, the Securities and Exchange Commission (SEC) adopted Regulation D,¹ a set of six rules which provide exemptions from the registration requirements of the Securities Act of 1933 (1933 Act).² This regulation constitutes the SEC's response to public concern that prior rules and regulations had imposed disproportionate financial and administrative burdens on small issuers of securities,³ thereby impairing the ability of small businesses to raise capital.⁴

According to the SEC, its reworking of major portions of the 1933 Act's exemptive scheme was primarily designed to accomplish three goals: (1) to simplify and to clarify the existing limited offering rules and regulations; (2) to eliminate unnecessary restrictions and regulations placed on issuers, particularly small businesses, and thereby to enhance the attraction of the exemptions; and (3) to achieve uniformity between state and federal exemptions in order to facilitate capital formation in a way consistent with the protection of investors under

* Mr. Donahue is an investment banker with Merrill Lynch's Capital Markets Group. He practiced corporate and securities law at Simpson Thacher & Bartlett and at Holtzmann, Wise & Shepard, both in New York City, and was law clerk to the Hon. Robert W. Sweet, United States District Court for the Southern District of New York.


Regulation D is the product of the Commission's evaluation of the impact of its rules and regulations on the ability of small businesses to raise capital. This study has revealed a particular concern that the registration requirements and the exemptive scheme of the Securities Act impose disproportionate restraints on small issuers.

Id. at 84,907-08 (footnote omitted).

the 1933 Act.5

The six rules comprising the regulation set forth definitions, terms, and conditions which apply throughout the regulation, and provide three separate exemptions from the registration requirements of the 1933 Act. While the new rules were primarily adopted to facilitate capital growth by small businesses, larger businesses may take advantage of its benefits by making offerings of securities which meet the Regulation D’s requirements.6

The purpose of this article is to outline and to characterize the current requirements for obtaining the Regulation D exemptions, to compare the present exemptions with their more restrictive predecessor regulations, and to identify some of the problems and ambiguities presented by Regulation D.

I. A PERSPECTIVE

Regulation D is the latest in a series of legislative and administrative efforts to limit the burden otherwise imposed by the 1933 Act on small businesses seeking to raise capital.7 As a general rule, the 1933 Act makes it unlawful to sell a security which has not been registered with the SEC.8 Registration involves filing a registration statement and disclosing required information regarding the issuer, the issuer’s business, and the security being offered for sale.9 A corollary provision requires that any security delivered for sale be accompanied or preceded by a prospectus10 which contains most of the information disclosed in the registration statement.11 Fulfilling these requirements frequently involves substantial planning, preparation, and financial commitment by the issuer. In recognition of this fact, in the 1933 Act Congress exempted certain classes of securities and certain transactions from the registration obligations. Specifically, section 3(a) exempts certain classes of securities from the registration requirements12

5. See supra note 3.
6. The new regulation defines “issuer” by reference to the 1933 Act, which draws no distinction based upon size. See 15 U.S.C. § 77b(2)(4) (1982). Thus, no matter how large the offeror, it can still utilize of Regulation D.
12. Id. § 3(a), 15 U.S.C. § 77c(a).
and section 4 exempts nonpublic offerings\textsuperscript{13} and certain other types of transactions, including transactions by persons not involved in the distribution process.\textsuperscript{14} Additionally, Congress empowered the SEC to adopt additional limited exemptions consistent with public interest and investor protection.\textsuperscript{15}

Pursuant to this delegated authority and its general rule-making authority, the SEC promulgated several rules aimed at providing further relief for small issuers.\textsuperscript{16} In 1974, the SEC adopted Rule 146 in order to clarify the disclosure requirements which had been judicially imposed on nonpublic offerings under section 4(2) of the 1933 Act\textsuperscript{17} and to provide a "safe harbor" for nonpublic issuers.\textsuperscript{18} Rule 146 provided that an issuer could meet its disclosure obligation in a nonpublic offering by professing a disclosure statement to offerees determined in advance by the issuer to be neither "sophisticated" nor able to bear the risk of the investment.\textsuperscript{19} One year later, the SEC adopted Rule 240, creating a new exemption for offerings of less than $100,000

\begin{itemize}
\item \textsuperscript{13} Id. § 4(2), 15 U.S.C. § 77d(2).
\item \textsuperscript{14} Id. § 4(1), (4), 15 U.S.C. § 77d.
\item \textsuperscript{15} Id. § 3(b), 15 U.S.C. § 77c(b).
\item \textsuperscript{16} See supra note 7.
\item \textsuperscript{17} Id. § 4(2), 15 U.S.C. § 77d(2). Section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1982), dictates that transactions by an issuer which do not involve any public offering do not have to meet the registration requirements of § 5 of the 1933 Act. The characteristics of a nonpublic offering, however, have been unclear. In 1953, the Supreme Court of the United States attempted to clarify the prerequisites to the utilization of this exemption. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953). There, the Supreme Court based its decision on the need to protect investors by assuring the availability of relevant information. The Court held that even in a nonpublic offering, each offeree must have "access to the same kind of information that the Act would make available in the form of a registration statement." Id. at 125-26. Since the Ralston Purina decision, courts and the SEC have maintained that the availability of the nonpublic offering exemption depends on whether every offeree has available the same information as in a registration statement. See, e.g., Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977).
\item \textsuperscript{18} Rule 146, 17 C.F.R. § 230.146 (1981) (rescinded), was adopted by the SEC as a nonexclusive "safe harbor" under the private offering exemption provided by § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1982). Under this rule, an issuer could meet its disclosure obligation in a nonpublic offering by providing offerees with a disclosure document. 17 C.F.R. § 230.146(e) (1981). There were certain built-in risks. Prior to making an offer, the issuer had to determine that every offeree either was "sophisticated," i.e., knowledgeable in financial and business matters either by himself or together with an "offeree representative," or able to bear the risk of investment. 17 C.F.R. § 230.146(d)(1) (1981). If an offer was made to even a single unqualified offeree, then the Rule 146 exemption was lost. 17 C.F.R. § 230.146 (Preliminary Note 3)(1981). In that event the entire offering was in violation of § 5, and every purchaser of securities had a right to return them to the issuer for a refund of the issue price. Securities Act of 1933, § 12(1), 15 U.S.C. § 77l(1) (1976).
\item \textsuperscript{19} 17 C.F.R. § 230.146(d)(1) (1981) (rescinded).
\end{itemize}
by issuers in closely held businesses.20 In 1980 the SEC adopted Rule 242, which exempted transactions of up to $2 million from full 1933 Act disclosure requirements.21 During this period the SEC also amended Rule 14422 to increase the subsequent liquidity of securities purchased in an exempt offering. In addition, the SEC issued a short-form registration statement to be utilized in initial public offerings of $5 million or less.23

In 1980 Congress provided further impetus for the formulation of Regulation D by passing the Small Business Investment Incentive Act.24 This Act, inter alia, amended the 1933 Act in three ways: (1) it added a section 4(6) exemption, which allows issuers to sell up to $5 million in securities to accredited investors without incurring specific disclosure obligations;25 (2) it raised the section 3(b) ceiling under which the SEC can create exemptions from $2 million to $5 million;26 and

20. 17 C.F.R. § 230.240 (1981) (superseded). Rule 240 provided an exemption from the registration requirements for offerings of up to $100,000 to 100 investors. The offering had to be completed within a twelve-month period.
21. 17 C.F.R. § 230.242 (1981) (superseded). Rule 242 provided a $2 million exemption with limited disclosure requirements. Certain American and Canadian corporations were allowed to raise up to this amount every six months by using a short-form registration statement, Form S-18, as a disclosure document. Id. at §§ 230.242(c), 230.242(f)(1)(i). Rule 242 also introduced the concept of "accredited persons," comprised of investors who were sufficiently sophisticated or had the financial resources to take intelligent action without need for the benefits afforded by registration. Accredited persons included commercial banks, insurance companies, certain employee benefit plans, registered investment companies, licensed small business investment companies, anyone purchasing $100,000 or more of the offered securities within a 60-day period, and directors and executive officer of the issuer. 17 C.F.R. § 230.242(a)(1) (1981).
26. Id. § 3(b), 15 U.S.C. § 77. Section 3(b) of the 1933 Act provides: The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.
(3) it directed the SEC to work with state securities administrators to develop a uniform scheme of securities regulations.27

Thus, prior to the promulgation of Regulation D the statutory and regulatory exemptions from the registration requirements of the 1933 Act were neither consistent nor uniform. Regulation D seeks to remedy these problems and to expand prior exemptions.

II. PRELIMINARY NOTES

Regulation D is prefaced by seven preliminary notes which serve as notice to issuers that the provisions of the regulation do not preclude other statutory duties or obligations, and do not pertain to all issuers. Note one informs issuers that although Regulation D offerings are exempt from the registration requirements of section 5 of the 1933 Act, such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws.28 Issuers are obliged to disclose any additional material information necessary to make the information required under Regulation D not misleading.29 Note two emphasizes the issuer’s obligation to comply with applicable state securities laws.30 Note three stresses that reliance on Regulation D does not act as an election to preclude other statutory exemptions for small offerings or private placements.31 Thus, the statutory exemptions provided by sections 3(a)(11), 4(2), and 4(6) of the 1933 Act remain available even if the issuer fails to satisfy all of the requirements of Regulation D.32 Note four specifies that Regulation D is available

27. Id. § 19(c), 15 U.S.C. § 17s(c)(1) (Supp. IV 1980).
29. Id.
30. Id. (Preliminary Note 2).
31. Id. (Preliminary Note 3).
32. Id. Section 3(a)(11), together with Rule 147 thereunder, relates to certain intrastate offerings of securities. Because of the strict requirements for obtaining the § 3(a)(11) exemption, that exemption is infrequently used, at least outside of the western part of the United States. Another relevant provision (which, technically, is not an exemption) is Regulation A, which imposes a $1.5 million ceiling on the amount being raised. Although not frequently used after the enactment of Regulation D and the liberalization of Form S-18, Regulation A does offer certain advantages: advertising is permitted; audited financial statements are not required; and securities purchased in a Regulation A offering are not restricted and, therefore, may be freely resold. The § 4(2) exemption is discussed below. The § 4(6) exemption will probably be used infrequently now that Regulation D has been adopted, because § 4(6) is largely redundant and because the requirements of § 4(6), while similar to those of Regulation D, are more stringent. In certain instances, however, the § 4(6) exempt-
only to the issuers of the securities and not to its affiliates or to other persons for resale of the issuer's securities.\textsuperscript{33} Note five states that Regulation D may be used for business combinations.\textsuperscript{34} Note six points out that mere compliance with all of the technicalities of Regulation D will not allow use of the regulation if it is discovered that the compliance was part of a plan or scheme to evade the registration provisions of the 1933 Act.\textsuperscript{35} Note seven states that certain offers and sales of securities to foreign persons made outside the United States need not be registered under the 1933 Act.\textsuperscript{36}

III. **Rule 501—Definitions and Terms**

Rule 501\textsuperscript{37} defines, inter alia, certain terms used in Regulation D. It provides a degree of clarity which was not present under Regulation D's predecessor rules. The most significant defined term is "accredited investor,"\textsuperscript{38} which includes not only institutions but also a number of persons presumed to be sufficiently sophisticated so as not to need the protections that registration affords.\textsuperscript{39} Since its original formulation in Rule 242, the "accredited investor" concept has undergone transformation. Former Rule 146 contained no reference to accredited investors. Former Rule 242 did, although its definition was much narrower, and it was limited to offerings of $2 million or less.\textsuperscript{40} As defined in Regulation D, issuers have been the beneficiaries of an expansion of the term. "Accredited investor" as defined in 501(a) expands upon the Rule 242 definition by including not only business

\begin{itemize}
  \item \textsuperscript{33} 15 C.F.R. §§ 230.501-.506 (Preliminary Note 4) (1983).
  \item \textsuperscript{34} Id. (Preliminary Note 5).
  \item \textsuperscript{35} Id. (Preliminary Note 6).
  \item \textsuperscript{36} Id. (Preliminary Note 7).
  \item \textsuperscript{37} 17 C.F.R. § 230.501 (1983).
  \item \textsuperscript{38} Id. at 230.501(a). The SEC has also adopted this definition of "accredited investor" in Rule 215, 17 C.F.R. § 230.215 (1983), pursuant to § 2(15) of the 1933 Act, 15 U.S.C. § 77b(15) (1982), which pertains to limited offerings in reliance on § 4(6) of the 1933 Act. Section 2(15) of the 1933 Act defines the term to include a number of institutions or "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." 15 U.S.C. § 77b(15) (1982).
  \item \textsuperscript{39} The other terms defined in § 501 include "affiliate"; "aggregate offering price"; "business combination"; "calculation of number of purchasers"; "executive officer"; "issuer"; and "purchaser representative". See generally 17 C.F.R. § 230.501(b)-(h) (1983).
\end{itemize}
development companies and tax-exempt organizations under section 501(c)(3) of the Internal Revenue Code, but also certain classes of individuals who meet either income or investment activity criteria. Because Regulation D excludes accredited investors in determining the number of purchasers in an offering, distribution may be much broader than under former Rules 242 and 146 if accredited investors are involved as purchasers.

The term "accredited investor" covers the following eight categories of investors:

1. **Institutional Investors.** This category basically encompasses those institutional investors which are included in section 2(15)(i) of the 1933 Act. These include banks, insurance companies, investment companies, business development companies, small business

---

41. I.R.C. § 501(c)(3) (1982). This section provides tax-exempt status to: (3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religions, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

Id.


44. Id. at § 230.501(a)(1). The term "bank" is defined in § (3)(a)(2) of the 1933 Act, whether it is acting in its individual or fiduciary capacity. The term "bank" means any national bank, or any banking institution organized under the laws of any state or territorial banking commission or similar official; except that in the case of a common trust fund or similar fund, or a collective trust fund, the term "bank" has the same meaning as in the Investment Company Act of 1940. 15 U.S.C.A. § 80a-2 (West 1981).


The term "insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity if the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner, or a similar official or agency of a State or territory or the District of Columbia; or any receiver or similar official or any liquidating agent for such company, in his capacity as such.


47. Id. "Business development company" is defined in § 2(a)(48) of the Investment Company Act of 1940:
investment companies, and certain employee benefit plans.

(2) "Big Ticket" Purchasers. This category consists of purchasers of at least $150,000 worth of the securities being offered, provided that the total purchase price does not exceed twenty percent of either the purchaser's net worth at the time of sale, or his joint net worth with his spouse at the time of sale. The purchase may be made by one of four specified methods or a combination thereof: cash, securities for which market quotations are readily available, an unconditional obligation to pay cash or securities for which market quotations are readily available within five years of the sale to the purchaser, or cancellation of indebtedness.

"Business development company" means any closed-end company which—
(A) is organized under the laws of, and has its principal place of business in, any State or States; (B) is operated for the purpose of making investments in securities described in sections 55(a)(1) through (3) [15 U.S.C.A. § 80(a)(1)-(3) (West 1981)], and makes available significant managerial assistance with respect to the issuers of such securities, provided that a business development company must make available significant managerial assistance only with respect to the companies which are treated by such business development company as satisfying the 70 per centum of the value of its total assets condition of section 55 [15 U.S.C.A. § 80a-54 (West 1981)]; and (C) has elected pursuant to section 54(a) [15 U.S.C.A. § 80(a)-53(a) (West 1981)] to be subject to the provisions of sections 55 through 65 [15 U.S.C.A. §§ 80(a)-54 to 80a-64 (West 1981)].

48. 17 C.F.R. § 230.501(a)(1) (1983). Small business investment companies must be registered under § 301(c) or (d) of the Small Business Investment Act of 1958 to qualify.

50. Id. § 230.501(a)(5).
51. Although Regulation D does not define "sale," note 13 to Securities Act Release No. 6389 [1981-82 Transfer Binder] Fed. Sec. L. REP. (CCH) 83,106 (Mar. 8, 1982), indicates that for this purpose a sale occurs "when the purchaser enters into a commitment to pay for the securities." In an interpretive letter, the SEC's staff indicated that a "sale" may be deemed to occur on the closing date of the issue; i.e., the date on which the issuer accepts the purchaser's subscription and on which the funds are delivered by the escrow agent to the issuer. See SEC No-Action Letter re Winthrop Financial Co. (June 25, 1982).

52. Several examples may serve to illustrate how this rule works. An investor whose net worth at the time of sale is $750,000 and who makes a cash purchase of $150,000 worth of the offered securities on the day of sale is accredited. The investor maintains accredited status if his payment is spread out over five years, so long as on the date of purchase he enters into an unconditional obligation to pay within that period. If, however, the investor agrees to purchase $200,000 of securities, with $150,000 to be paid on the date of sale and the balance to be paid in installments over four years, he will not qualify under this category of accredited investor because his $200,000 purchase constitutes more than 20% of his $750,000 net worth. A final example involves an investor with a net worth of $4,900,000 who agrees to purchase $180,000 of securities over six years, the first $150,000 of that purchase coming in the first five years. That investor is accredited because he is purchasing at least $150,000
§1 Million Net Worth Test. This category includes a natural person whose net worth (either alone or jointly with his spouse) at the time of purchase exceeds $1 million.

§200,000 Income Test. This category includes natural persons who had individual income (exclusive of spouse's income) in excess of $200,000 in each of the two most recent years and who reasonably expect an income in excess of $200,000 in the current year.

Private Business Development Companies.

Tax Exempt Organizations with total assets in excess of $5 million.

Directors, Executors Officers, and General Partners.

within a five-year period and because the total purchase price of $180,000 does not exceed 20% of his net worth. Securities Act Release No. 6389 [1981-82 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 83,106 (Mar. 8, 1982). For additional explanation and interpretations, see Smith Barney, Harris Upham & Co., [Current Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 77,340 (Aug. 13, 1982) (where an investment general partnership is purchasing securities in a Regulation D offering, the issuer may consider the aggregate net worth of the general partners in calculating the net worth of the partnership, as long as the partnership was not formed for the specific purpose of acquiring the securities being offered); Lola M. Hale, Esq. [Current Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 77,339 (Aug. 2, 1982) (for purposes of the 20% net worth limitation, non-recourse debt is not includable in the total purchase price); Winthrop Financial Co. [1982 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 77,235 (June 25, 1982) (where formation of a partnership is conditioned upon the sale of a specified number of interests, the five-year period begins on the date the minimum level of sales has been reached); Federated Financial Corp. [1982 Transfer Binder] Fed. Sec. L. REP. (CCH) ¶ 77,236 (June 14, 1982) (A totally held subsidiary [defined at 17 C.F.R. § 230.405 (1983)] may use the consolidated net worth of its parent in determining the 20% net worth test).

53. 17 C.F.R. § 230.501(a)(6) (1983). The rule makes no mention of excluding homes, furnishings, or automobiles. Because this rule is limited to “natural persons,” a corporation is not an accredited investor under Rule 501(a)(6).


56. 17 C.F.R. § 230.501(a)(3) (1983). This category applies to any organization which is described in § 501(c)(3) of the Internal Revenue Code, 26 U.S.C. § 501(c)(3) (1981), and which has total assets in excess of $5 million.

57. 17 C.F.R. § 230.501(a)(4) (1983). This category provides that certain insiders of the issuer are accredited investors. This group includes general partners of issuers, as well as directors, executive officers, and general partners of those general partners. The rationale is that these insiders do not need the protection that a registration statement would provide for them since their insider status gives them access to information about the issuer and the securities being offered.
(8) **Entities Made Up of Certain Accredited Investors.**

This category extends accredited investor status to those entities in which all of the equity owners are accredited investors under Rule 501(a), except for the "Big Ticket" Purchaser.

As used in Regulation D, "accredited investor" encompasses not only persons who, in fact, fit into one of the specified categories, but also persons who the issuer "reasonably believes" fit within any such category. To establish such a reasonable belief, the careful Regulation D issuer will, at a minimum, require potential purchasers to complete purchaser questionnaires with specific questions, e.g., "What are your sources of income and how much of your income is attributable to each source?" and by requesting copies of the potential purchaser's income tax returns. The issuer should also keep in mind that the relevant states may define "accredited investor" in a manner inconsistent with Regulation D.

IV. **Rule 502—General Conditions to be Met**

Rule 502 contains general provisions which apply to virtually all offers and sales under Regulation D's three exemptive provisions, Rules 504, 505, and 506. Rule 502 permits an issuer of securities to sell the securities pursuant to Rule 504 (regardless of whether the purchasers are accredited or nonaccredited) or pursuant to Rules 505 or 506 when all purchasers are accredited, without first providing specific

---

58. 17 C.F.R. § 230.501(a)(8) (1983). If all but one of the shareholders of a purchasing corporation are accredited investors under the net worth or income test and the unaccredited shareholder is a director who bought one share of stock in order to comply with a requirement that all directors be shareholders of the corporation, the corporation is not an accredited investor under Rule 501(a)(8). The rule requires all of the equity owners to be accredited investors. The director is an equity owner and is not accredited. The director cannot be accredited under Rule 501(a)(4) because that category grants accreditation status to a director of the issuer, not a director of a purchaser corporation. See Securities Act Release No., 6455 Fed. Sec. L. Rep. (CCH) ¶ 2380 (Mar. 3, 1983).

59. Because the SEC takes the position that the phrase "equity owners" does not encompass beneficiaries of a conventional trust, trusts generally will not be considered accredited investors under Rule 501(a)(8), even where each beneficiary of the trust is an accredited investor. See Securities Act Release No. 6455 (Mar. 3, 1983), question 30. The SEC's staff, however, has indicated that if each grantor of a revocable grantor trust is an accredited investor under Rule 501(a)(1)-(4), (6), or (7), then the revocable trust may be considered an accredited investor under Rule 501(a)(8). See SEC No-Action Letter re Lawrence B. Rabkin (Aug. 16, 1982).


information to purchasers.⁶² Even in such transactions, however, either
the antifraud provisions of the federal securities laws or applicable state
law may require that some information be furnished to purchasers.⁶³
Furthermore, some issuers, in particular start-up companies, may volun-
tarily provide information in such transactions. One reason for pro-
viding this information is that gathering and reporting information
which is material to prospective investors can prove helpful in the ini-
tiation of subsequent offerings. Furthermore, gathering this informa-
tion may assist the issuer in the formulation of a business plan.⁶⁴ To
the placement agent,⁶⁵ the disclosure document, even when not re-
quired by Regulation D, may be beneficial because it summarizes the
terms of the deal for potential investors, memorializes the issuer's represen-
tations and warranties, and serves as a vehicle for organizing
the placement agent's due diligence investigation.

In other Regulation D sales (i.e., sales under Rule 505 or Rule
506, where at least one of the purchasers is not accredited), Rule 502
requires that certain information be provided to all purchasers during
the course of the offering and prior to the "sale."⁶⁶ The type of infor-
mation which must be furnished depends upon: (1) the size of the
offering; (2) whether the investor participating in the offering is ac-
credited or nonaccredited; and (3) whether the issuer is a reporting
or nonreporting company under the Securities Exchange Act of 1934
(Exchange Act).⁶⁷ One inconsistency in Rule 502(b)'s information re-
quirements is that if the issuer is a nonreporting company under the
Exchange Act, the issuer need disclose the specified information only
"to the extent material to an understanding of the issuer, its business,
and the securities being offered."⁶⁸ For some reason, this important
language does not appear in that part of Rule 502(b) which sets forth
the informational requirements imposed on Exchange Act reporting
companies.⁶⁹ The inconsistency is probably inadvertent and, hopefully,
will be remedied by the SEC or the courts.

---

⁶³. See Preliminary Notes 1 and 2 to Regulation D; see also supra note 61.
⁶⁵. A placement agent acts as the issuer's representative for purposes of selling
the securities. Its role is largely that of providing contacts with the pool of potential
Regulation D purchasers (e.g., pension funds and insurance companies with whom
the placement agent typically has developed ongoing business relationships).
⁶⁸. Id.
Rule 502(a) deals with the principle of integration\textsuperscript{70} and provides that all sales that are deemed to be part of the same Regulation D offering must be integrated. The rule establishes an exception to this doctrine, however, by offering a safe harbor for offers or sales of unregistered securities made more than six months before or after a Regulation D offering.\textsuperscript{71} Whether separate sales of securities are part of the same offering, and are therefore considered "integrated," depends on the specific facts of each situation. In making this determination, the SEC has listed five factors which should be considered.\textsuperscript{72} These are: (1) whether the sales are part of a single plan of financing; (2) whether the sales involve issuance of the same class of securities; (3) whether the sales have been made at or about the same time; (4) whether the same type of consideration is received; and (5) whether the sales are made for the same general purpose.\textsuperscript{73} However, as mentioned above, a Regulation D offering will not be integrated with offers or sales that occur more than six months prior to the start of the offering or more than six months after completion of the offering. The safe harbor only applies if there are no offers or sales of securities either by or for the issuer, which are of the same or a similar class of securities as the unregistered securities during the six-month periods.\textsuperscript{74} Although under generally applicable integration principles other transactions such as securities issued upon exercise of outstanding warrants or upon conversion of outstanding convertible securities may be exempt from integration during the six-month periods, care should be taken to determine precisely when the offering commences and when the offering is completed, in order to avoid inadvertent integration. If the safe harbor provisions of Rule 502(a) are not utilized, the issuer is forced to rely on the vague integration standards otherwise set forth by the SEC.\textsuperscript{75}

\textsuperscript{70} 17 C.F.R. § 230.502(a) (1983). When securities offered in two purportedly separate transactions have sufficiently similar characteristics, the doctrine of integration requires that the "two" sales be treated as if they were one.

\textsuperscript{71} "A 'safe harbor' is a rule clarifying a statute. Compliance with the rule is deemed compliance with the statute, and the issuer is safe from future interpretations that otherwise would expose him to liability." Note, Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933, 24 WM. & MARY L. REV. 121, 126 n.37 (1982).


\textsuperscript{73} See note following Rule 502(a), 17 C.F.R. § 230.502(a).

\textsuperscript{74} Rule 502(a), 17 C.F.R. § 230.502(a) (1983). There is an exception for offers and sales during the six-month period pursuant to an employee benefit plan as defined in Rule 405. See 17 C.F.R. § 230.405 (1983).

\textsuperscript{75} See supra note 72.
Rule 502(b)\textsuperscript{76} describes the type of information which must be furnished to the offerees in order for a sale to qualify for the exemptions contained in Rules 504, 505, and 506. The required information varies, depending upon the nature of the offeree, the nature of the issuer, the amount of the offering, and the rule under which the exemption is taken.

When securities are sold only to accredited investors, or the sale is pursuant to Rule 504 (not exceeding $500,000), no specific information is required to be furnished to the purchasers.\textsuperscript{77} The absence of particularized disclosure requirements for sales only to accredited investors reflects the SEC's belief that accredited investors can fend for themselves. As for Rule 504, the lack of any particularized disclosure requirement reflects the policy underlying former Rule 240, i.e., that there is no federal interest in requiring specific disclosure for offerings of a de minimis nature. The primary underlying concern of these Regulation D rules is to facilitate the acquisition of capital by small businesses. The SEC relies on state registration provisions and the general, federal antifraud statutes to protect investors in small issue transactions.\textsuperscript{78}

For offerings under Rules 505 and 506 which include investors who are not accredited, disclosure is required for all purchasers.\textsuperscript{79} The degree of disclosure depends on the size of the offering and the nature of the issuer. Regulation D divides disclosure into two categories—information which needs to be provided by nonreporting companies and information which is required for reporting companies.\textsuperscript{80}

If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act,\textsuperscript{81} it must provide the specified information "to the extent material to an understanding of the issuer,

\begin{itemize}
\item \textsuperscript{76} Rule 502(b), 17 C.F.R. § 230.502(b) (1983).
\item \textsuperscript{77} 17 C.F.R. § 230.502(b)(2) (1983).
\item \textsuperscript{78} See supra note 35 and accompanying text.
\item \textsuperscript{79} 17 C.F.R. § 230.502(b)(1)(ii) (1983).
\item \textsuperscript{80} See 17 C.F.R. § 230.502(b)(2)(i)(ii) (1983).
\item \textsuperscript{81} When an issuer has a class of securities registered under § 12 of the Exchange Act, it is subject to § 13 reporting obligations. Section 15(d) reporting obligations come into play when an issuer's 1933 Act registration statement becomes effective in the same year that the report is due. Additionally, in any year after the year of effectiveness, if the issuer has at least 300 holders of the class of securities to which the registration statement applied, it is subject to § 15(d) reporting obligations. Note, however, that the issuer may be exempt from this obligation if, at the beginning of its fiscal year, it had less than 500 shareholders of record and on the last day of each of the issuer's last three fiscal years it had assets not exceeding $3 million. See Rule 15d-6, 17 C.F.R. § 240.15d-6 (1983).
\end{itemize}
its business, and the securities being offered."82 For offerings up to $5 million, the same type of information is required as would be disclosed in Part I of Form S-18,83 except that only the financial statements for the most recent fiscal year need be certified.84 If the offering is for over $5 million, the disclosure would be the same as required by Part I of a registration statement filed under the 1933 Act on the form the issuer would be entitled to use.85

If the issuer is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, Regulation D gives the issuer two disclosure alternatives.86 Under the first alternative, an issuer can furnish an annual report to shareholders for the most recent fiscal year,87 the definitive proxy statement88 filed in connection with that report

82. Rule 502(b)(2)(i), 17 C.F.R. § 230.502(b)(2)(i) (1983). "Materiality" is not defined in Regulation D. However, the SEC has defined the term in Rule 405, 17 C.F.R. § 230.405 (1983). There, materiality is defined as referring to "those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." See also TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976).

83. Rule 502(b)(2)(1)(A), 17 C.F.R. § 230.502(b)(2)(i)(A) (1983). Form S-18 is a short registration form available for certain offerings of up to $7.5 million. This form cannot be utilized by issuers which are reporting companies under the Exchange Act. See 17 C.F.R. § 239.28 (1983). At the time it was adopted, Form S-18 was not available to an issuer which was offering limited partnership interests, which was an investment company, or which was engaging or would engage in oil and gas related operations. Form S-18 was amended to permit its use by limited partnerships and issuers engaged in oil and gas operations. See Securities Act Release No. 6406 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,228 (June 4, 1982).

84. Rule 502(b)(2)(j)(A), 17 C.F.R. § 230.502(b)(2)(j)(A) (1983). This certification must be made by an independent public or certified accountant. If the issuer cannot utilize Form S-18, then the issuer is to provide the same kind of information as would be required in Part I of a registration statement filed under the 1933 Act, on the form the issuer would be entitled to use. In such case, only the financial statements for the two most recent fiscal years, prepared in accordance with generally accepted accounting principles, are to be provided and only the financial statements for the issuer's most recent fiscal year have to be certified by an independent public or certified accountant. If an issuer, other than a limited partnership, could obtain these audited financial statements only by going to unreasonable effort or expense, then only the issuer’s balance sheet, which must be dated within 120 days of the start of the offering, must be audited. Limited partnerships may furnish federal income tax basis financial statements if the basic requirements result in an unreasonable effort or expense. Id.


88. Proxy solicitations dealing with securities registered under § 12 of the Exchange Act (§ 12(g)(1) requires registration of securities by issuers if there are 500 or more holders of record of a class of the issuer's equity securities, and the issuer
and, if requested in writing by the purchaser, a copy of the issuer's most recent Form 10-K. This alternative requires the publication of the annual report and the proxy statement virtually in their original form, and prohibits a rewording or reprint of the reports. Under the second alternative, the issuer must disclose the information contained in the most recent of its Form 10-K or Form 10 under the Exchange Act or Form S-1 under the 1933 Act. This alternative pertains to the information contained therein and thus the information may be a reprint or a restatement of the required information.

Under either alternative, the issuer must also disclose the information contained in any Exchange Act report or proxy filing since the filing or distribution of the material pursuant to the preceding alternatives. In addition, the issuer must provide the offeree with a brief description of the securities being offered, the proposed use of the proceeds, and any material changes in the issuer's affairs which are not contained in the furnished documents.

The balance of Rule 502(b)(2) contains four general provisions which are applicable to all classes of issuers in all offerings where specified disclosure is required. These provisions cover exhibits, has more than $1 million in assets) are governed by § 14(a) of the Exchange Act, 15 U.S.C. § 78h(a) (1982). The proxy statement must also meet the requirements of 17 C.F.R. § 240.14a (1983).

89. 17 C.F.R. § 249.310 (1983). Reporting companies are required to file annual reports on Form 10-K.


91. 17 C.F.R. § 249.210 (1983). Registration under §§ 12(b) or 12(g) of the Exchange Act is usually achieved by using Form 10. Disclosure under Form 10 is similar to disclosure under Form S-1 under the 1933 Act, and includes standardized financial statements, the basic information package, in-depth disclosures, appropriate exhibits, and certain other disclosures. H. Bloomenthal, 1983 Securities Law Handbook 181 (1983).

92. 17 C.F.R. § 239.11 (1983). When an issuer is not authorized or eligible to use any other prescribed form, registration under the 1933 Act is to be accomplished by using Form S-1. This form is not to be used, however, for securities of a foreign government or political subdivision thereof.


The SEC's staff has approved the use of a two-step offering, whereby a "fair and adequate summary" of the document is delivered first, and an expanded disclosure document is later (but prior to the sale) delivered to the investor. See Securities Act Release No. 6455 (Mar. 3, 1983), question 40.


disclosure of additional information to nonaccredited investors,98 the opportunity to ask questions and to receive answers concerning the offering,99 and disclosure of additional information in the case of business combinations.100

Rule 502(c) limits the manner in which securities issued pursuant to Regulation D are offered. This section is generally comparable to former Rule 146(c).101 With the exception of state-regulated securities offerings,102 neither the issuer nor any person acting on the issuer’s behalf is permitted to offer or sell securities through general solicitation or general advertising.103 Rule 502(c) requires a two-step analysis. First, it must be determined whether the communication involved is a form of general solicitation or general advertising. If so, the second step is to determine whether the communication is being used by the issuer or by someone acting on the issuer’s behalf to offer or sell securities. A negative response to either inquiry will result in no breach of the Rule 502(c). Problems in this regard have centered around the definitions of general solicitation and general advertising.104 These problems were recognized by the SEC when it proposed Regulation to be filed with the SEC as part of a registration or report, other than an annual report to shareholders or parts of that report incorporated by reference in a form 10-K report, need not be furnished to each purchaser if the contents are identified and made available to the purchaser, on his written request, prior to purchase. Id.

98. Rule 502(b)(2)(iv), 17 C.F.R. § 230.502(b)(2)(iv) (1983). In a Rule 505 or 506 transaction, if a nonaccredited investor makes a written request, prior to his purchase the issuer is to furnish him a brief description in writing of any written information concerning the offering that has been provided by the issuer to any accredited investor.

99. Rule 502(b)(2)(v), 17 C.F.R. § 230.502(b)(2)(v) (1983). In a Rule 505 or 506 transaction, each purchaser is to be given the opportunity to inquire as to the terms and conditions of the offering. In addition, purchasers may obtain additional necessary information so as to verify the accuracy of information furnished under § 502(b)(2)(i) or (ii) if the issuer possesses or can acquire such information without unreasonable effort or expense.

100. Rule 502(b)(2)(vi), 17 C.F.R. § 230.502(b)(2)(vi) (1983). For business combinations, the purchaser is to be furnished by the issuer written information about any terms or arrangements of the proposed transaction that are materially different from those for all other security holders.

101. See supra note 18 and accompanying text.


103. 17 C.F.R. § 230.502(c) (1983). General solicitation or general advertising includes, but is not limited to, any advertisement, article, notice, or other communication in any newspaper, magazine, or similar media, or broadcast over television or radio, and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. Id. at § 230.502(c)(1) & .502(c)(2).

104. When considering what constitutes a "general solicitation," the SEC excluded a solicitation by the general partner of a limited partnership to limited partners in other active programs sponsored by the same general partner. The SEC based
D, as the SEC offered a caveat stating that if the offering is made to a significantly large number of offerees, a general solicitation might be presumed. The SEC was silent, however, on the point when it actually adopted Regulation D. While the SEC has been able to address some questions under this rule, many questions present issues of fact and circumstances that the SEC is not in a position to resolve. Thus, prudent issuers and placement agents acting on behalf of issuers would be well advised to solicit offers only from persons with whom the issuer or placement agent is familiar.

Rule 502(d) contains limitations on resale of the unregistered securities issued under Regulation D. With the exception of offers and sales of securities made exclusively in states which require registration and delivery of a disclosure document prior to a sale, securities acquired in a Regulation D transaction have the same status as securities acquired in a section 4(2) transaction, i.e., they cannot be resold without

---


106. In practice, a number of "limited" offerings have been made under Regulation D involving 2,000 or more offerees. Counsel representing such offerees appear to have taken the position that what is important for Regulation D purposes is not the number of offerees, but how the offering is made and whether the offerees in large-scale offerings can fend for themselves. These large-scale offerings should not run afoul of Regulation D's "general solicitation" prohibition so long as appropriate controls are imposed (for example, the issuer's employees should be given strict instructions regarding persons with whom they may speak and only persons with whom the issuer has a pre-existing relationship should be offered securities). In a no-action letter re Woodtrails-Seattle, Ltd. (Aug. 9, 1982), the SEC's staff indicated its opinion that written offers to approximately 300 prior investors would not violate the general solicitation or general advertising prohibitions of Rule 502(e) where: (i) each offeree had a pre-existing relationship with the general partner, and (ii) the general partner had previously determined that the offerees met certain suitability standards and were sophisticated investors.

107. See supra note 104. For example, Regulation D does not explicitly proscribe advertising intended to promote an issuer's products. Depending upon the nature of the advertising campaign, however, a close question may arise concerning whether that product promotion constitutes general solicitation or general advertising in connection with the Regulation D sale of securities. See SEC No-Action Letter re Printing Enterprise Management Science, Inc. (Apr. 25, 1983).

1933 Act registration or an exemption therefrom. The issuer must exercise reasonable care to ascertain that the purchasers are not underwriters within the meaning of section 2(11) of the 1933 Act and are not involved in impermissible resales to the public. Three nonexclusive measures for complying with this reasonable care standard are as follows:

1. A reasonable inquiry must be made to ascertain whether the purchaser is buying for himself or on behalf of others. The issuer does not have to investigate the purchaser's "intent," but should ascertain whether other participants would be involved so as to violate the thirty-five purchaser limit.

2. Written disclosure must be made to each purchaser advising that the securities are unregistered and that, therefore, their resale is restricted.

3. A statement on the face of the certificate evidencing the security must explain that the securities are unregistered and must set forth the conditions of sale and transferability.

V. Rule 503—Filing of Notice of Sales

To qualify for the exemptions provided by Regulation D, under Rule 503 the issuer must file with the SEC five copies of a notice on Form D within fifteen days after the first sale of securities. The issuer must continue to file Form D every six months while the offering continues, and no later than thirty days after the last sale of securities in the offering. If the initial Form D is filed within fifteen days after the first sale of securities, and the offering has been completed by the time of such filing, no additional Form D filing is required.

112. Id. at § 230.502(d)(2).
113. Id. at § 230.502(d)(3).
114. Id. at § 230.503.
115. Form D is found at id § 239.500.
116. 17 C.F.R. § 230.503(a)(1) (1983). Form D is a uniform notice of sales form which is to be used for all exempt offerings pursuant to Regulation D and Section 4(6) of the 1933 Act. Form D is similar to the form previously utilized in connection with Rule 242. It requires more extensive disclosure than did prior Forms 146 and 240.
117. Id. at § 230.503(a)(2).
118. Id. at § 230.503(a)(3).
119. Id. at § 230.503(b). Because Regulation D does not define "sale," the careful issuer will file its initial Form D as soon as practical. Note, however, that Release
If the issuer is using the Rule 505 exemption, Form D further requires the issuer to provide the SEC, upon written request by the SEC's staff, with the information which the issuer is required to give nonaccredited purchasers under Rule 502(b)(2).\textsuperscript{120}

VI. Rule 504—Exemption for Offerings Not Exceeding $500,000

Rules 504 to 506 of Regulation D set forth three different exemptions from the 1933 Act's registration requirements.

Rule 504\textsuperscript{121} exempts certain limited offerings and sales of securities that comply with the requirements of Rules 501 through 503\textsuperscript{122} and in which the aggregate offering price does not exceed $500,000.\textsuperscript{123}

---

Note 1 to Rule 504, 17 C.F.R. § 230.504 n.1 (1983), states:

The calculation of the aggregate offering price is illustrated as follows:

Example 1. If an issuer sold $200,000 of its securities on June 1, 1982 under this Rule 504 and an additional $100,000 on September 1, 1982, the issuer would be permitted to sell only $200,000 more under this Rule 504 until June 1, 1983. Until that date the issuer must count both prior sales toward the $500,000 limit. However, if the issuer made its third sale on June 1, 1983, the issuer could then sell $400,000 of its securities because the June 1, 1982 sale would not be within the preceding twelve months under this Rule 504.

Example 2. If an issuer sold $100,000 of its securities on June 1, 1982 and an additional $4,500,000 on December 1, 1982 under Rule 505, the issuer could not sell any of its securities under this Rule 504 until December 1, 1983. Until then the issuer must count the December 1, 1982 sale towards the limit of $500,000 within the preceding twelve months.

Rule 504's offset provisions apply not only to securities of the same class as the Regulation D securities, but to all securities, 17 C.F.R. § 230.504 (1983). Thus, for example, an issuer which offers common stock pursuant to Rule 504 must offset
504's exemption was enacted to provide small businesses with an opportunity to acquire start-up financing. This exemption enhances the ability of small businesses to compete in capital markets. Previously, compliance with the 1933 Act's registration requirements was prohibitive for issuers who would typically make an offering of less than $500,000. Thus, the SEC adopted Rule 504 in order to encourage small businesses to utilize the capital markets and to aid them in avoiding the costly registration requirements of the 1933 Act. However, Rule 504 is not available to two types of issuers. Neither an investment company nor an issuer which must file reports under the Exchange Act may take advantage of the exemption provided by Rule 504.

There are several noticeable differences between Rule 504 and its predecessor, Rule 240. First, Rule 504 increases the dollar value of exempt issues from the Rule 240 limitation of $100,000 during a

against Rule 504's $500,000 ceiling the aggregate offering price of debt securities offered in reliance upon a § 3(b), 15 U.S.C. § 77c(b) (1981), exemption within the prior twelve months.

The offset provision includes only sales prior to and including the present sale. See 17 C.F.R. § 230.504(b)(2) (1983).

Note 2 to Rule 504 states that a subsequent transaction in excess of Rule 504's ceiling amount will not affect the exemption for earlier sales made pursuant to Rule 504.

124. Wertheimer, Small Issuers: Update on Regulation D; Installment Payments and Assessments as New Securities; Extension of Credit, in 1 FIFTEENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 377, 394 (Practising Law Institute ed. 1983).


126. 17 C.F.R. § 230.504(a) (1983). An investment company is one which: (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Investment Company Act of 1940, § 3(a), 15 U.S.C. § 80(a)-3(a) (1976). Because investment companies are excluded, private venture capital funds cannot use Rule 504.


six-month period\textsuperscript{129} to $500,000 during a twelve-month period.\textsuperscript{130} Second, Rule 504 permits an unlimited number of shareholders, purchasers, and offerees to take advantage of the exemption,\textsuperscript{131} while Rule 240 was limited to issuers with fewer than 100 shareholders.\textsuperscript{132} Finally, Rule 504, unlike Rule 240, places no restrictions on brokerage commissions from sales of Regulation D offerings. This enables small companies to seek the aid of professional brokers and, in turn, encourages professional brokers with expertise to sell small offerings.\textsuperscript{133}

VII. Rule 505—Exemption for Offerings Not Exceeding $5,000,000

Rule 505,\textsuperscript{134} the successor to Rule 242,\textsuperscript{135} exempts certain limited offerings and sales of securities which comply with Rules 501 through 503 and which do not exceed $5 million.\textsuperscript{136} The $5 million ceiling is reduced by the aggregate offering price of all securities sold by the issuer within the twelve months before the start of and during the offering in reliance upon any exemption under section 3(b) of the 1933 Act or in violation of section 5 of the 1933 Act.\textsuperscript{137}

The same integration rules which apply to Rule 504 apply to Rule 505.\textsuperscript{138} That is, where nominally separate issues of securities are deemed to be a single issue because of factual similarities, the issuer is put on notice as to the possibility that other, non-Rule 505, offerings may be deemed to be part of the Rule 505 offering, thereby possibly taking the total offering price over the $5 million ceiling, and preventing the issuer from taking advantage of the Rule 505 exemption. The same six-month safe harbor provision available in Rule 504 sales is available for Rule 505 sales. Therefore, offers and sales made more than six

\textsuperscript{129} 17 C.F.R. § 230.240(e) (1983).
\textsuperscript{130} 17 C.F.R. § 230.504(b)(2)(i) (1983); see supra note 123.
\textsuperscript{131} 17 C.F.R. § 230.504 (1983).
\textsuperscript{132} However, the Rule 504 issuer must not be subject to the reporting requirements of the Exchange Act, 15 U.S.C. § 78a-kk (1976 & Supp. IV 1980).
\textsuperscript{133} See infra Exhibit A for a summary of the conditions required for obtaining an exemption under Rule 504.
\textsuperscript{134} 17 C.F.R. § 230.505 (1983).
\textsuperscript{136} 17 C.F.R. § 230.505(b)(2)(i) (1983). This was increased from Rule 242's ceiling of $2 million during a six-month period.
\textsuperscript{137} See supra notes 26 & 72. Sales pursuant to § 4(2) of the 1933 Act, 15 U.S.C. § 77(d)(2) (1981), or pursuant to the Rule 506 exemption will not reduce the $5 million ceiling under Rule 505. Rule 505's offset provision applies not only to securities of the same class as the Regulation D securities, but to all securities. See supra note 123.
\textsuperscript{138} 17 C.F.R. § 230.502(a) (1983). See supra notes 70-75 and accompanying text.
months prior to commencement of, or more than six months after the conclusion of, the Rule 505 offering are not considered to be part of that offering.\textsuperscript{139} The safe harbor, however, applies only so long as no offers or sales of securities are made during those six-month periods by or for the issuer that are of the same or a similar class as those in Regulation D offering.\textsuperscript{140}

Moreover, although Rule 504 has no express limitations on the number of persons to whom offers may be extended, Rule 505 states that the issuers must reasonably believe that there are no more than thirty-five purchasers.\textsuperscript{141} In arriving at the thirty-five purchaser limit, however, investors who are related to a purchaser\textsuperscript{142} and in persons deemed accredited investors\textsuperscript{143} are not taken into consideration. Thus, although Rule 505 is limited to thirty-five nonaccredited investors, an unlimited number of accredited investors may participate in the offering.\textsuperscript{144}

There are no disclosure requirements under Rule 505 if offers are made only to accredited investors. If the issuer sells securities to both accredited investors and nonaccredited investors, however, the issuer must provide both classes of investors with the information\textsuperscript{145} required by Rule 502.\textsuperscript{146} Furthermore, the issuer must provide nonaccredited investors with a description of information given to any accredited investor.\textsuperscript{147} The cost of meeting these disclosure requirements may be burdensome to a small issuer.\textsuperscript{148} Therefore, it may be advan-

\textsuperscript{139} 17 C.F.R. § 230.502(a) (1983).
\textsuperscript{140} Id. There is an exception, however, for offers or sales of securities under an employee benefit plan as defined in Rule 405 under the 1933 Act.
\textsuperscript{141} Id. at § 230.505(b)(2)(ii).
\textsuperscript{142} Id. at § 230.501(e). The following persons are excluded: any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser; any trust or estate in which a purchaser, and certain other specified persons who are related to the person collectively own more than 50% of the beneficial interest; or any corporation, or other organization of which the purchaser, and certain other specified persons who are related to the purchaser collectively own more than 50% of the equity securities.
\textsuperscript{143} Id. at § 230.501(c)(1)(iv).
\textsuperscript{144} The SEC's staff has indicated that non-United States citizens and residents may also be excluded from the calculation of the number of purchasers under Rule 501(e). See SEC No-Action Letter re American Real Estate Fund 82-A (Aug. 13, 1982).
\textsuperscript{145} 17 C.F.R. § 230.502(b)(2)(iv), (v) (1983). See supra notes 76-100 and accompanying text for the information the issuer must disclose.
\textsuperscript{146} See generally 17 C.F.R. § 230.502(b) (1983).
\textsuperscript{147} 17 C.F.R. § 230.502(b)(2)(iv) (1983). To obtain this information, the nonaccredited purchaser must submit a written request to the issuer prior to his purchase.
\textsuperscript{148} See supra note 125. In light of this burden and in consideration of the purposes and goals of Regulation D, see supra notes 3-6 and accompanying text, strict
tageous for the issuer to offer its securities only to accredited investors.\textsuperscript{149}

Rule 505 significantly broadens the exemptions that were available to an issuer under Rule 242 in that, with a few exceptions,\textsuperscript{150} the Rule 505 exemption may be used by all issuers, including oil and gas companies and limited partnerships.\textsuperscript{151} These exceptions include investment companies\textsuperscript{152} and issuers subject to certain disqualifications.\textsuperscript{153} Upon a showing of "good cause,"\textsuperscript{154} however, the SEC may allow an issuer to proceed with a Rule 505 offering despite these disqualifications.\textsuperscript{155}

VIII. RULE 506—EXEMPTION WITHOUT REGARD TO DOLLAR AMOUNT

The Rule 506\textsuperscript{156} exemption supersedes Rule 146\textsuperscript{157} and can be used for an offering of any size, provided that the offering complies with Rules 501 through 503,\textsuperscript{158} and that certain other conditions are met.\textsuperscript{159} Rule 506 is the only Regulation D rule which places no ceiling on the amount of proceeds that may be raised through an offering under Regulation D.

compliance with Regulation D's requirements is arguably inappropriate. Rather, this author suggests that substantial compliance by the issuer with Regulation D's requirements should be considered sufficient. See infra text accompanying note 177.

149. Combining this cost factor with the fact that accredited investors are not considered part of the 35 purchaser limit makes restricting the offering to accredited investors an even more attractive option.

150. See infra notes 152-53.

151. 17 C.F.R. § 230.505(a) (1983). By comparison, the exemptions under Rule 242 were not available to noncorporate issuers; foreign issuers, other than Canadian issuers; and oil companies. In addition Rule 505 eliminated two other restrictions contained in Rule 242 which excluded companies which had been Exchange Act reporting companies for three or more years and Exchange Act reporting companies which were delinquent in filing reports with the SEC. 17 C.F.R. § 230.242(c)-(f) (1983).

152. See infra note 126; therefore, private venture capital funds may not use Rule 505.

153. 17 C.F.R. § 230.505(b)(2)(iii) (1983). These so-called "bad guy" disqualifications are set forth in Regulation A under the 1933 Act. They exclude, for example, issuers who have engaged in questionable securities practices within the preceding five years, and issuers whose directors, officers general partners, or 10\% shareholders have engaged in questionable securities practices within the preceding ten years. These questionable practices include being temporarily or permanently enjoined from violating the securities laws, or being the subject of pending proceedings or orders of the SEC. They also include being convicted of a crime concerning the sale of securities or false filing with SEC. 17 C.F.R. § 230.252(c)-(f) (1983).

154. See infra Exhibit A for a summary of the conditions required for obtaining an exemption under Rule 505.


159. See infra notes 161-70 and accompanying text.
on the dollar amount of the offering.\textsuperscript{160} Rule 506, like Rule 505, limits the number of purchasers. Although the issuer must reasonably believe there are no more than thirty-five nonaccredited investors,\textsuperscript{161} the issuer may sell to an unlimited number of accredited investors.\textsuperscript{162}

Rule 506 differs from Rules 504 and 505 in that it has qualification requirements with respect to nonaccredited purchasers.\textsuperscript{163} Qualification of a nonaccredited purchaser is based on the issuer's reasonable belief\textsuperscript{164} that each nonaccredited purchaser has such knowledge and experience in financial and business matters that he is able to evaluate the merits and risks of the prospective investment.\textsuperscript{165} This subjective determination need be made, however, only as to nonaccredited investors.\textsuperscript{166} Therefore, the burden on a Rule 506 issuer, with respect to nonaccredited investors, may be more onerous than the burden under other Regulation D rules.\textsuperscript{167} The requirement of purchaser qualification may discourage otherwise eligible issuers from utilizing Rule 506. However, an issuer may avoid the burden of having to determine whether or not the purchaser is a "sophisticated investor" by selling securities only to accredited investors.

Finally, Rule 506 requires that if sales are made to any nonac-

\textsuperscript{160} 17 C.F.R. § 230.506(b) (1983).
\textsuperscript{161} Id. at § 230.506(b)(2)(i). There actually need not be 35 or fewer nonaccredited investors; Rule 506 only requires that the issuer reasonably believe that there are no more than 35.
\textsuperscript{162} See supra note 143 and accompanying text.
\textsuperscript{163} 17 C.F.R. § 230.506(b)(2)(ii) (1983). This discrepancy probably exists because Rule 506, unlike Rules 504 and 505, was promulgated pursuant to § 4(2) of the 1933 Act, 15 U.S.C. § 77(d)(2) (1981). Courts construing § 4(2) have traditionally focused on offeree sophistication. See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119 (1953). On the positive side, the Rule 146 requirement that unsophisticated purchasers be able to bear the economic risk of the investment has been eliminated in Rule 506.
\textsuperscript{164} This reasonable belief is measured immediately prior to the relevant sale. 17 C.F.R. § 230.506(b)(2)(ii) (1983). The SEC's staff has generally been unwilling to issue no-action letters concerning whether or not a person is "sophisticated." Thus, no-action letters concerning this issue in the context of requests for § 4(2) exemptions usually indicate that the Staff will not give guidance concerning "whether the offerees come within the types of persons described in SEC v. Ralston Purina . . . ." See, e.g., SEC No-Action Letter In re House of Shoes, Inc. (Sept. 11, 1978).
\textsuperscript{165} Id. Either the purchaser alone, or together with his "purchaser representative," must meet this "sophistication" requirement.
\textsuperscript{166} See supra text accompanying note 163. Rule 506 states that this subjective qualification must be made as to purchasers, 17 C.F.R. § 230.506(b)(2)(ii) (1983), and Rule 501 excludes accredited investors from the group of purchasers. Id. at § 230.501(e)(1)(iv) (1983).
\textsuperscript{167} However, the burden is significantly less than that of Rule 146, which required the issuer to determine the sophistication and wealth of each offeree. 17 C.F.R. § 230.146(d)(2) (1983).
credited purchaser, the issuer must provide both accredited and nonaccredited investors with the information required by Rule 502. Furthermore, the issuer must provide nonaccredited investors with a description of any information which was given to any accredited investor.

IX. Section 4(2) Statutory Exemption—An Alternative to Regulation D

A failure to fulfill the requirements of Regulation D does not preclude the offering from qualifying under another exemption. If an offering does fail to qualify for an exemption under Regulation D, the issuer may attempt to utilize the statutory exemption provided by section 4(2) of the 1933 Act for "transactions by an issuer not involving any public offering."

Section 4(2) may not be the safety net it appears to be, however. The discrepancies between the requirements for Regulation D's exemptions and for the section 4(2) exemption may cause problems for the unwary issuer. For example, courts construing section 4(2) have typically indicated that an important consideration is the sophistication of the offerees. By contrast, Rule 506 of Regulation D focuses on the sophistication of the purchasers, not the offerees, and the Rule 504 and 505 exemptions contain no sophistication requirement at all. Thus, in making a Regulation D offering, the issuer may not have prescreened offerees because such prescreening is not required by

---

168. Whether the securities are sold to only nonaccredited investors or to both nonaccredited and accredited investors, the same information must be supplied. 17 C.F.R. § 230.502(b)(1)(ii) (1983).


171. See infra Exhibit A for a summary of the conditions required for obtaining an exemption under Rule 506.

172. Preliminary note 3 to Regulation D states: 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. For instance, an issuer's failure to satisfy all the terms and conditions of Rule 506 shall not raise any presumption that the exemption provided by section 4(2) of the Act if not available.


175. See supra notes 163-67 and accompanying text. Even in a Rule 506 transaction if the purchasers are all accredited investors, the issuer need not consider their sophistication at all. Id.
Regulation D. This failure to consider offeree sophistication may come back to haunt the issuer by rendering it impossible for the issuer to utilize the section 4(2) exemption. The careful issuer will take into consideration the discrepancies between the requirements for Regulation D exemptions and for the section 4(2) exemption.

X. Conclusion

Regulation D is the product of an effort by the SEC to create simplified registration exemptions for small and private offerings in order to facilitate capital acquisition by small businesses. Whether Regulation D will actually produce this result, however, will depend on how the SEC enforces Regulation D and how the courts construe its provisions. If the SEC requires an overly strict compliance with Regulation D, then the primary purpose of the regulation may be thwarted. A small business considering making a limited offering under Regulation D may hesitate when it realizes the potential liability it faces if it fails to comply strictly with the regulation's complex and technical provisions. The issuer may decide that the risk is too great, and therefore may not attempt to utilize Regulation D. For this reason, the SEC should adopt a substantial compliance policy. If that were the case, an issuer could make use of Regulation D with the assurance that if it has made a good faith effort to comply with the regulation and has substantially done so, it will then have available the appropriate exemption even if it has mistakenly failed to meet one of Regulation D’s requirements. The adoption of a substantial compliance test would further the purpose of Regulation D, i.e., allowing small businesses to raise capital through limited offerings without having to comply with needlessly burdensome rules.

176. It is conceivable, however, that in the future courts construing § 4(2) may be influenced by the SEC's approach in Regulation D and may thus shift their focus from offerees to purchasers. Indeed, the SEC appears to want to encourage courts to liberalize their interpretation of § 4(2). For example, the SEC has expressed its view that the sophistication of offerees who ultimately do not become purchasers in an offering which relies exclusively on § 4(2) "is not a fact that in and of itself should determine mechanically the availability of the exemption . . ." Securities Act Release No. 6455 (Mar. 3, 1983), question 73.

177. See supra note 148 and accompanying text.
## EXHIBIT A

### REGULATION D EXEMPTIONS

<table>
<thead>
<tr>
<th>Exemption Available to</th>
<th>Rule 504</th>
<th>Rule 505</th>
<th>Rule 506</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer Qualification</td>
<td>Issuer only (unavailable to secondary sellers)¹</td>
<td>Issuer only (unavailable to secondary sellers)¹</td>
<td>Issuer only (unavailable to secondary sellers)¹</td>
</tr>
<tr>
<td>Dollar Limit²</td>
<td>$500,000 (12 months)</td>
<td>$5 million (12 months)</td>
<td>Unlimited</td>
</tr>
<tr>
<td>Number of Purchasers</td>
<td>Unlimited</td>
<td>35, plus unlimited number of accredited purchasers</td>
<td>35, plus unlimited number of accredited purchasers</td>
</tr>
<tr>
<td>Purchaser Qualification</td>
<td>None</td>
<td>None</td>
<td>Each nonaccredited purchaser must be sophisticated (alone or with purchaser representative); accredited purchasers presumed to be qualified³</td>
</tr>
</tbody>
</table>

---

1. See Preliminary note 4 to Regulation D.
2. The amounts listed in Exhibit A are reduced by the aggregate offering price of all securities sold within twelve months before the start of, and during, the offering of securities in reliance on any exemption under § 3(b) of the 1933 Act or in violation of § 5(a) of the 1933 Act. See 17 C.F.R. § 230.504(b)(2)(i) (1983); id. at § 230.505(b)(2)(i).
3. The issuer must reasonably believe that each nonaccredited purchaser (either alone or with his purchaser representative(s)) has such knowledge and experience in...
<table>
<thead>
<tr>
<th>Brokerage Commissions</th>
<th>Permitted</th>
<th>Permitted</th>
<th>Permitted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manner of Offering</td>
<td>No general solicitation or general advertising (unless offering made exclusively in states which provide for registration and require delivery of a disclosure document before sale)</td>
<td>No general solicitation or general advertising</td>
<td>No general solicitation or general advertising</td>
</tr>
<tr>
<td>Resale of Purchased Securities</td>
<td>Restricted (unless offering made exclusively in states which provide for registration and require delivery of a disclosure document before sale); issuer must exercise reasonable care to assure that purchaser is not purchasing with a view to distribution</td>
<td>Restricted; issuer must exercise reasonable care to assure that purchaser is not purchasing with a view to distribution</td>
<td>Restricted; issuer must exercise reasonable care to assure that purchaser is not purchasing with a view to distribution</td>
</tr>
</tbody>
</table>

financial and business matters that he is capable of evaluating the merits and risks of the prospective investment. See id. at § 230.506(b)(2)(ii).

4. Regulation D permits commissions to be paid to any person, including a person who is not a registered broker-dealer. State securities laws may, however, restrict the payment of commissions.

5. Regulation D sheds no light on the meaning of "general solicitation."

6. If the Rule 504 offering is made exclusively in states which provide for registration and require delivery of a disclosure document before sale, Regulation D's manner of offering and resale restrictions are inapplicable. In effect, Rule 504 allows a mini-public offering under such circumstances. See id. at § 230.504(b)(1).

7. If the Rule 504 offering is made exclusively in states which provide for registration and require delivery of a disclosure document before sale, Regulation D's manner of offering and resale restrictions are inapplicable. In effect, Rule 504 allows a mini-public offering under such circumstances. See id. at § 230.504(b)(1).
reasonable
care to assure
that purchaser
is not purchas-
ing with a
view to dis-
tribution

| Notice of Sale | Form D required—5 copies filed with the SEC within 15 days after first sale, every 6 months after first sale, and within 30 days after last sale | Form D required—5 copies filed with the SEC within 15 days after first sale, every 6 months after first sale, and within 30 days after last sale | Form D required—5 copies filed with the SEC within 15 days after first sale, every 6 months after first sale, and within 30 days after last sale |
| Notice to Nonaccredited Investors | No | Yes | Yes |

8. If the initial Form D filing is timely (i.e., within 15 days after the first sale of securities) and the offering has been completed by the time of such filing, no additional Form D filing is required. See id. at § 230.503(b).

9. The issuer should file its initial Form D as soon as practical, because regulation D does to indicate when a "sale" occurs. Note, however, that footnote 27 to SEC Release No. 33-6389 indicates that, for this purpose, "generally the acceptance of subscription funds into an escrow account pending receipt of minimum subscriptions would trigger the filing requirements." Note also that, pursuant to § 2(3) of the 1933 Act, the execution and delivery of a binding stock purchase agreement constitutes a "sale" even before the related closing occurs.

10. The disclosure requirements of Rules 505 and 506 are identical, except with respect to an issuer which is a non-reporting company under the 1934 Act and which is making an offering of over $5 million (such an issuer could not use Rule 505 in any case because Rule 505 is limited to offers and sales not exceeding $5 million). Disclosure requirements for non-reporting companies under the 1934 Act are described in 17 C.F.R. § 230.502(b)(2)(i) (1982). Subparagraph (A) thereof concerns offerings of up to $5 million; subparagraph (B) thereof concerns offerings in excess of $5 million. Disclosure requirements for 1934 Act reporting companies are described in 17 C.F.R. § 230.502(b)(2)(ii) (1982). For Rule 505 and Rule 506 transactions, if there are both accredited and nonaccredited purchasers, at a reasonable time prior to the relevant purchase the issuer must give each nonaccredited purchaser a brief written description of any written information supplied by the issuer to any accredited investor. The issuer must furnish such information to the nonaccredited purchaser upon written request. See id. at § 230.502(b)(2)(iv). For all Rule 505 and
<table>
<thead>
<tr>
<th>Statutory Basis</th>
<th>Limit on Number of Offerees</th>
<th>Predecessor Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>§ 3(b) of the 1933 Act</td>
<td>None</td>
<td>Rule 240</td>
</tr>
<tr>
<td>§ 3(b) of the 1933 Act</td>
<td>None</td>
<td>Rule 242</td>
</tr>
<tr>
<td>§ 4(2) of the 1933 Act</td>
<td>None</td>
<td>Rule 146</td>
</tr>
</tbody>
</table>

Rule 506 transactions, at a reasonable time prior to the purchase of securities, the issuer must make available to each purchaser the opportunity to ask questions and to obtain certain information. See id. at § 230.502(b)(2)(v). Even if no information need be provided to purchasers by the terms of Regulation D, state law or the federal antifraud laws may mandate disclosure. See Introduction to Regulation D, 15 Rev. Sec. Reg. 990, 991 n.2 (Jan. 13, 1982).