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Exemptions to the Disclosure Requirements

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I. Introduction

It would be nice, in a program like this, to be able to say what the law in this area is at the moment, to describe what changes the proposed Code would make, and to assess whether the changes are beneficial. Unfortunately, the situation is much more complex. The law is not so simple and does not lend itself to such easy treatment. In order to better understand the impact of the Code on the exemptive provisions, we must first examine the origins and purposes of these exemptions. I will trace the historical development of these exemptions;[1] the drafting of the Code[2] itself has been an important step in this development.

I would like to describe this development as having occurred in several stages: the initial balance struck by the Congress in 1933, the narrowing of the exemptions over the years by the courts and the Securities and Exchange Commission, the Commission's initial response to the suggestion of the Code about thirteen years ago, the changes proposed by the Code, and the current developments aside from the consideration of the Code.

In any scheme of disclosure regulation of securities offer-

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1. The exemptions were originally enacted in 1933. Securities Act of 1933, ch. 38, §§ 3(b), 4(1), 5(c), 48 Stat. 74 (1933) (current version at 15 U.S.C. §§ 77c(b), 77d(2), 77c(a)(11) (1976 & Supp. III 1979)).

2. ALI FED. SEC. CODE (1978)(Proposed Official Draft). References in this speech are to the 1978 proposed draft. Comparison will be made with the ALI FED. SEC. CODE (1980)(Official Draft) where the changes in the latter version are significant. On Sept. 30, 1980, the Securities and Exchange Commission published, in an agency release, changes to the 1980 draft which were agreed upon by Professor Loss and the Commission. SEC Sec. Act Release No. 33-6242, 20 SEC Docket 1485 (1980) [hereinafter referred to and cited as CODE RECOMMENDATION].

ings, one of the most important balances struck is that between the protection of investors, through requiring disclosure of all the relevant information about the issuer and the terms of the offering, and the burden on those attempting to finance a venture who must provide that information.[3] This is a real conflict, an important conflict, and one that is not easy to resolve. It has been at the center of attention at every stage of development.

II. Exemptions in the Securities Act of 1933

The 1933 Act[4] starts with the somewhat startling proposition that every sale of a security by anybody must be registered unless specifically exempted.[5] The principal exemptions provided by Congress in 1933 were the exemption for transactions not involving any public offering,[6] the exemption for intrastate offerings,[7] and the exemption for small offerings.[8] These are ex-

3. *See generally* Benston, *Required Periodic Disclosure under the Securities Acts and the Proposed Federal Securities Code,* 33 U. MIAMI L. REV. 1471 (1979).

4. Securities Act of 1933, §§ 1-26, 15 U.S.C. §§ 77a-77aa (1976).

5. *Id.* § 5(c), 15 U.S.C. §77e(c)(1976). Section 5(c) provides that

> [i]t shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use of medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security. . . .

Section 4 exempts certain regulated transactions from the registration requirements of section 5. *Id.* § 4, 15 U.S.C. § 77(d)(1976). Also, section 3 exempts certain securities from the provisions of the Act. Securities Act of 1933, § 3, 15 U.S.C. § 77c (1976).

6. For the current version of this exemption, *see* Securities Act of 1933, § 4(2), 15 U.S.C. § 77d(2)(1976).

7. For the current version of this exemption, *see* Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11)(1976). This section provides that the Act shall not apply to a security

> which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.

8. For the current version of this exemption, *see* Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b)(1976 & Supp. III 1979), *as amended by* Pub. L. No. 96-477, § 301, 94 Stat. 2291 (1980). This section provides that

> [t]he 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

emptions for the issuer itself or for the promoters of a company. I am not going to focus on the exemptions for secondary trading at this point.[9]

There are important differences among the three exemptions. Unlike the exemptions for private offerings and intrastate offerings, which are set forth in the 1933 Act itself and which are self-executing, the exemption authorized by section 3(b) for small offerings is administered by the Commission. The small offerings exemption, then, is available only to the extent allowed by the Commission's rules.

In 1933, Congress enacted these exemptions in the belief that they provided appropriate relief to promoters of an enterprise who needed to raise money without going through the process of disclosure with its attendant liabilities.[10] It is interesting that with the benefit of thirty-five years of experience the draftsmen of the Code seem to have found these same three exemptions to be appropriate today.[11]

> securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000.

In the original legislation, offers could be exempted if they did not exceed $100,000. Securities Act of 1933, Ch. 38, § 3(b), 48 Stat. 76 (1933) (current version at 15 U.S.C. § 77c(b)(1976 & Supp. III 1979)). The figure was raised by Congress several times; the current figure, $5,000,000, was adopted by Congress on Oct. 21, 1980. An Act to Amend the Federal securities laws to provide incentives for small business investment and other purposes. Pub. L. No. 96-477, § 301, 94 Stat. 2291 (1980).

9. Spencer, *Issuer Registration and Distributions,* 1 PACE L. REV. 299, 314 (1981).

10. For a discussion of the historical background of the 1933 Act exemptions, *see generally* 1 L. LOSS, SECURITIES REGULATION, 56-105 (1951).

11. The same three exemptions are found in the proposed Code. ALI FED. SEC. CODE §§ 242, 512(e), 514(c)(1978). Section 514 exempts local distributions; a local distribution is one which

> (1) results in sales substantially restricted to persons who are residents of or have their primary employment in a single State, or an area in contiguous States (or a State and a contiguous foreign country) as that area is defined by rule or order on consideration of its population and economic characteristics, and (2) involves securities of an issuer that does business or proposes to do business primarily in that State or area, regardless of where it is organized. Section 514(a)(1) is not satisfied unless at least 95 percent of all the buyers holding of record at least 80 percent of the securities distributed are persons there described.

Id. § 514(a). Section 514(c) provides that "local distributions" are exempted from the filing requirements applicable to offering statements except when the security is issued by an investment corporation. *Id.* § 514(c).

The CODE RECOMMENDATION changes § 514(a) by substituting 95 percent for the present 80 percent figure. CODE RECOMMENDATION, *supra* note 2, at 1492. *See* Casper, *Foreword,* 1 PACE L. REV. 279, 288 (1981).

III. Narrowing the Exemptions

After 1933, there was a long period of interpretation and elaboration of the exemptions. This process primarily occurred in the 1950s and early 1960s as the securities markets and public offerings became more active. The process of interpretation of these three exemptions, by the courts[12] and by the Commis-

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A limited offering is not a "distribution" within the meaning of section 242(a) and is therefore not subject to filing requirements. ALI FED. SEC. CODE § 242(a)(1978). A limited offering is defined as

> one in which the following conditions are satisfied: (A) the initial buyers of the securities are institutional investors or not more than thirty-five other persons or both, or the seller reasonably so believes; (B) resales of any of the securities to persons other than institutional investors within three years after the last sale (in the sense of contract to sell) to any of the initial buyers other than institutional investors do not result in more than thirty-five owners of those securities (apart from any institutional investors and persons who become owners otherwise than by purchase) at any one time, unless any such excess results from resales pursuant to an offering statement or an exemption; and (C) the seller and all resellers comply with any rules adopted under section 242(b)(4).

ALI FED. SEC. CODE § 242(b)(1978).

Section 512(e) exempts small offerings from registration as follows:

> a transaction incident to an offering of not more than $100,000 [is exempt], except that (1) the Commission, by rule with respect to any class of issuers, securities, or offerings, may (A) reduce the amount to not less than $50,000 in any twelve-month period or (B) impose conditions or withdraw this exemption when the offering exceeds $50,000, and (2) this exemption does not apply to a transaction in a security that was the subject of a limited offering within the one-year or three-year period, as the case may be, specified in section 242(b).

Id. § 512(e). This section remains substantially the same in the 1980 draft except that § 512(e)(2) of the 1978 proposed Code was expanded in the 1980 draft to include resales as well as limited offerings. ALI FED. SEC. CODE § 512(5) (1980).

The CODE RECOMMENDATION increases the small offering exemption from $100,000 to $200,000, and from $50,000 to $100,000. CODE RECOMMENDATION, *supra* note 2, at 1492.

12. *See, e.g.*, Hillsborough Invest. Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960); Hill York Corp. v. American Int'l Franchises, 448 F.2d 680 (5th Cir. 1971); and Tabby's Int'l, Inc. v. SEC, 479 F.2d 1080 (5th Cir. 1973). The court in *Hillsborough* held that the intrastate exemption does not apply to securities which, though proposed to be sold intrastate, are merely substitutes for unregistered securities sold earlier in violation of the Securities Act. In *Hill York*, the court interpreted the private offering exemption in light of the statutory purpose and concluded that since the Act, as remedial legislation, is entitled to a broad construction, the exemptions must be narrowly viewed. The court disavowed the use of arbitrary numerical tests in determining whether an offer is public and stated agreement with the factors the Commission relies on: facts, circumstances and policies embodied in the Act. In *Tabby's Int'l*, the court, in interpreting the monetary ceiling of § 3(b) exemptions, found the permanent suspension of the exemption to be proper where the offering was carried out by the underwriter in a fraudulent manner, even though there was no evidence of wrongdoing on the part of the issuer. The court emphasized that the suspension was not punitive in nature but rather served the reme-

sion,[13] was essentially as Professor Sowards has described in his opening remarks.[14] Various assumptions that had been made—that certain offerings were private or intrastate or were exempt because they were small—gradually became eroded.

This erosion resulted from the Commission's shift in position on disclosure. I suppose it is a fact of administrative momentum or inertia that a certain mood takes hold of an agency. In the case of the Commission, the balance between the need for disclosure to protect investors and the need for some flexibility to let people raise small amounts of money without the imposition of inordinate expenses and burdens was gradually moved further and further toward the side of protection.[15]

This change came about in two ways. First, the actual disclosure requirements became more and more elaborate. Form S-1,[16] the basic form for registration, grew longer and longer. Each amendment of the form added new categories of information. One chairman of the Commission who had been a venture capitalist[17] expanded this form during his tenure to require information that he decided a venture capitalist would need before investing.[18] Ideas of corporate responsibility took hold and found their way into the disclosure requirements under the 1933 and 1934 Acts. Environmental disclosures have been incorporated

dial purpose of protecting investors.

13. These exemptions were all refined by the Commission, pursuant to its rule-making authority, to provide more objective criteria in assessing claims for exemptions. Rule 146 was specifically tailored for businessmen raising capital under a section 4(2) exemption. 17 C.F.R. § 230.146 (1980). Rule 147 deals with issues that involve local offerors seeking to obtain financing for local enterprises through local offerees. 17 C.F.R. § 230.147 (1980). Rule 242 allows corporate issuers to raise small amounts of capital under a section 3(b) exemption of the 1933 Act. 17 C.F.R. § 230.242 (1980).

14. *See* Sowards, *A Symposium on the Proposed Federal Securities Code: An Introduction,* 1 PACE L. REV. 291, 294-97 (1981).

15. *See generally* Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions from Registrations for the Sale of Securities,* 74 COLUM. L. REV. 622 (1974); Note, 82 YALE L.J. 1512 (1973).

16. The current text of the Form S-1 registration statement can be found at [1980] 2 FED. SEC. L. REP. (CCH) ¶¶ 7121-29.

17. William J. Casey was Chairman of the Securities and Exchange Commission from 1971-1973.

18. Testimony in Commission proceedings revealed that venture capitalists consider studies of market penetration, as well as facts about management performance, to be important to their investment decisions. SEC Sec. Act Release Nos. 33-5313 & 34-9801, 37 Fed. Reg. 21,445 (1972).

into the requirements.[19]

This expansion of disclosure requirements was combined with a narrowing of the exemptions by the courts and the Commission.[20] The Commission concluded, after a number of fraudulent offerings were uncovered, that exemptions which permitted the sale of securities without adequate disclosure were dangerous because innocent investors could be hurt. The courts also saw the most egregious cases, and in a series of decisions in the early 1970s,[21] narrowed the exemption for private offerings to the point where many lawyers concluded that there really was no longer any such exemption for private transactions. The only private offerings which continued to enjoy the exemption were either the standard debt offering to large institutions or an offering directly to the promoters of the venture.

This intrastate exemption,[22] drafted in 1933, probably was

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19. Disclosure of this type is meant not only to indicate the future profitability of an enterprise, but also to reveal the willingness of management to comply with legislation. For example, Regulation S-K requires, among other things, the disclosure of a registrant's efforts to comply with environmental regulations.

> Appropriate disclosure shall also be made as to the material effects that compliance with Federal, State and local provisions which have been enacted or adopted regulating the discharge of materials into the environment, or otherwise relating to the protection of the environment, may have upon the capital expenditures, earnings and competitive position of the registrant and its subsidiaries. The registrant shall disclose any material estimated capital expenditures for environmental control facilities for the remainder of its current fiscal year and its succeeding fiscal year and for such further periods as the registrant may deem material.

17 C.F.R. § 229.20(c)(2)(iii) (1980).

20. *See* notes 12 & 13 *supra*.

21. *See, e.g.*, SEC v. Continental Tobacco Co. of S.C., 463 F.2d 137 (5th Cir. 1972). The court in this case narrowly interpreted the private offering exemptive provisions and held the issuer to a strict burden of proof. The issuer must sustain a burden of showing affirmatively that there is no practical need for registration requirements and that the public benefits to be derived from such requirements would be too remote. *Id.* at 157-61. *See also* Hill York Corp. v. American Int'l Franchises, 448 F.2d 680 (5th Cir. 1971). The court held that the private offering exemption must be construed narrowly. *See generally* Rediker, *The Fifth Circuit Cracks Down on Not-So-Private Offerings*, 25 ALA. L. REV. 289 (1973).

22. Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11)(1976). This section provides an exemption for:

> any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State or Territory.

The exemption was designed to apply only to a local offering capable of being entirely prompted more by concern about whether Congress could regulate purely intrastate dealings than by a desire to provide a needed exemption. This exemption has unique problems because of the way it is drafted. Its principal problem is that a single offer made to a person who in fact is a nonresident of the state technically destroys the entire exemption. As a result of this single inadvertent offer, the issuer has civil liability to all purchasers, including all those who are in fact residents of the state.[23]

The small offering exemption, which started off as a relatively simple exemption for offerings of under $100,000, was rewritten during the 1950s by the Commission, with the encouragement of the National Association of Securities Dealers,[24] into what is now Regulation A.[25] That regulation is not so much an exemption as a somewhat simplified form of registration for small offerings.[26]

Over the years, then, there was a narrowing of all of these exemptions to the point that the exemptions virtually disappeared. Knowledgeable people were either uncertain as to whether the law permitted an offering without registration, or, to the extent that they knew the law to be certain, knew that it always said no.

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effected within a single state or territory. To qualify for a section 77c(a)(11) exemption the issuer (1) must offer and sell the securities only to persons resident within a single state, and the issuer must also be resident within that state; (2) must conduct the predominant amount of his business within this same state; and (3) the business so conducted must refer to the income producing operations of the business of which the securities are being sold. SEC Sec. Act Release No. 33-4434, 26 Fed. Reg. 11,896 (1961).

Rule 147 clarified the "doing business" requirement. The issuer is deemed to be "doing business" in a state only if it is deriving at least 80% of its gross revenues from the state; has at least 80% of its assets in the state; intends to use at least 80% of the proceeds of the offering in the state; and has its principal office in the state. 17 C.F.R. § 230.147 (1980).

23. *See, e.g.*, SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225 (E.D.N.Y. 1976), *aff'd mem.*, 556 F.2d 559 (2d Cir. 1977). The court found that offers to sell franchises in a grocery delivery service were sales of investment contracts under the federal securities laws. The defendant's attempt to use the intrastate exemption of § 3(a)(11) was rejected because the franchise offers were not limited to New York state residents and at least one had been sold to a New Jersey resident. *Id.* at 1243.

24. The National Association of Securities Dealers is an association that regulates brokers and dealers.

25. Regulation A encompasses rules 251-264. 17 C.F.R. §§ 230.251-.264 (1980).

26. 17 C.F.R. § 230.255(c)(1980).

IV. Administrative Response to the Code's Objectives

A project as ambitious and as complex as the Code obviously incorporates many different objectives. One important objective of the Code was to expand the area in which promoters could make limited offerings to provide initial financing for a new venture without going through the full disclosure procedure.[27] Another objective was to increase certainty as to the applicability of exemptions.[28] These were some of the objectives conveyed to the Commission in 1967 at a meeting which I was privileged to attend. I was serving as Manuel Cohen's executive assistant at the Securities and Exchange Commission when Ray Garrett,[29] Louis Loss[30] and Milton Cohen[31] came in to tell him about the Code project.

The reaction of some of us at the Commission at that time was that much of what the draftsmen of the Code were trying to accomplish could be done administratively. Eventually, a committee under the chairmanship of Frank Wheat, who was then a member of the Securities and Exchange Commission, produced the rules in the 140 series,[32] which were designed to meet some of the Code objectives; in particular, the committee intended to expand the exemptions for offerings without registration and to provide more certainty in these areas. I think it is fair to say that rule 144,[33] dealing with secondary transactions, and rule 145,[34] dealing with mergers, have been relatively useful and effective in dealing with the uncertainties in those two areas. Rule 146,[35] dealing with private placements, and rule 147,[36] dealing

27. *See generally* Loss, *Keynote Address: The Federal Securities Code,* 33 U. Miami L. Rev. 1431, 1437-40 (1979).

28. *Id.* at 1440-43.

29. Ray Garrett, Jr., who was Chairman of the Securities and Exchange Commission from 1973 to 1975 and Associate Executive Director of the Commission from 1954 to 1958, served as a consultant to the Federal Securities Code project.

30. Louis Loss, William Nelson Cromwell Professor of Law, Harvard University, served as the Reporter for the Federal Securities Code.

31. Milton H. Cohen was a member of the Advisory Committee of the Institutional Investor Study for the Securities and Exchange Commission from 1969 to 1971, Director of Special Study of the Securities Markets from 1961 to 1963, and also served as a consultant to the Federal Securities Code project.

32. 17 C.F.R. §§ 230.144-.147 (1980).

33. 17 C.F.R. § 230.144 (1980).

34. 17 C.F.R. § 230.145 (1980).

35. 17 C.F.R. § 230.146 (1980).

with intrastate offerings, which were both adopted in the early 1970s, have not been nearly as useful and effective.

The private offering exemption has always caused difficulties. Rule 146 is an attempt to provide objective standards and certainty in place of the very vague rules as to what constituted a private placement.[37] The rule managed to achieve the worst of both worlds. It created new levels of complexity and, at the same time, left areas of imprecision such as degrees of sophistication, ability to bear the loss, reasonable grounds for belief, and so forth.[38] The rule is a lengthy series of traps. Unfortunately, unlike some areas of securities law where it does not matter how complex the law is because the people dealing with it are all specialists, this particular part of the law is designed for the people who don't know anything about securities law, the ones who simply want to know whether they can raise some money without complying with all the Commission's requirements. Rule 146 will not enlighten them.

In the intrastate offering area, rule 147 simply added some numerical tests to an exemption with which it was already difficult to comply;[39] I don't believe it enlarged the scope of the exemption in any way. The rule did, however, add some certainty by defining the "doing business standard" and clarifying the in-

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36. 17 C.F.R. § 230.147 (1980).

37. In Release No. 5487, Apr. 23, 1974, the Commission announced the adoption of Rule 146. SEC Sec. Act Release No. 33-5487, 4 SEC Docket 154 (1974).

> The Rule is designed to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act and thus would be exempt from the registration provisions of the Act.

Id. at 155. *See also* the preliminary notes to the rule which state:

> Rule 146 is designed to provide, to the extent feasible, objective standards upon which responsible businessmen may rely in raising capital under claim of the Section 4(2) exemption and also to deter reliance on that exemption for offerings of securities to persons who need the protections afforded by the registration process.

17 C.F.R. Preliminary Note 3, § 230.146 (1980).

38. *See generally* Soraghan, *Private Offerings: Determining "Access," "Investment Sophistication," and "Ability to Bear Economic Risk,"* 8 SEC. REG. L.J. 3 (1980); Schwartz, *Rule 146; The Private Offering Exemption—Historical Perspective and Analysis*, 35 OHIO STATE L.J. 738 (1974).

39. 17 C.F.R. § 230.147 (1980). The stated intention of rule 147 is to provide "more objective standards" upon which businessmen may rely in claiming an exemption for an intrastate offering. 17 C.F.R. Preliminary Note 3 § 230.147 (1980). *See also* note 23 and accompanying text *supra*.

trastate resale limitation.[40]

Does the Code provide more reasonable standards? Does the Code provide a degree of certainty that will be useful to people trying to raise money without prohibitive disclosure burdens? Strangely enough, the Code very much follows the present patterns.

V. The Code Exemptions

I don't know whether the draftsmen actually concluded that private offerings, intrastate offerings and small offerings were the three appropriate types of exemptions, but these are the exemptions we find in the proposed Code.[41]

A. *The Limited Offering Exemption*

The successor to the private offering, the exemption for the so-called limited offering, and the most important exemption in the Code, is found in section 242.[42] The Code proposal does provide an objective test which will ease the burden of compliance. It exempts an offering made to thirty-five or fewer purchasers, exclusive of institutions. An offering can be made to any number of institutions (a term defined to include banks, insurance companies, pension funds and others)[43] and up to thirty-five other people without encountering disclosure requirements. This section of the Code tilts the balance sharply in the direction of nondisclosure.

I think, however, that there is a real question about the wis-

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40. An issuer will be found to be "doing business" within a particular state or territory where it "derived at least 80% of its gross revenues and those of its subsidiaries on a consolidated basis" from that state or territory. The issuer, however, must have had "gross revenues in excess of $5,000 from the sale of products or services or other conduct of its business for its most recent twelve month fiscal period" or the provision will not apply. Also, "at least 80% of [the issuer's] assets and those of its subsidiaries on a consolidated basis [must be] located within such state or territory," and "the issuer [must] intend to use and uses at least 80% of the net proceeds to [itself] from sales made pursuant to this rule in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory." 17 C.F.R. § 230.147 (c)(2)(i)-(iii) (1980).

41. For the complete text of these three exemptions, *see* note 11 *supra*.

42. ALI FED. SEC. CODE § 242 (1978). For the comparison with CODE RECOMMENDATION, *see* note 11 *supra*. *See also* Casper, *supra* note 11, at 283.

43. ALI FED. SEC. CODE § 275 (1978).

dom of the numerical test the Code uses in this section. True, a numerical test is easy. But, is it really responsive to the balancing of objectives to provide that an offering to not more than thirty-five people should be exempt? Is it fair to cheat people so long as you don't cheat more than thirty-five? It may be that a somewhat more flexible approach may work better. A standard that is flexible but provides certainty would be the optimum solution.

B. *The Intrastate Offering Exemption*

At the beginning of their work, the draftsmen of the Code eliminated the intrastate offering exemption completely on the theory that it had too many traps in it to be worth keeping.[44] The exemption, however, has now reappeared as the exemption for local distributions in section 514.[45] This, in effect, is the old intrastate offering exemption with fringes. Instead of all offerees having to be in the same state, the Code provides that as long as 95 percent of the purchasers buying at least 80 percent of the securities are within a single state or within a geographical area (which the Commission would have power to define), an offering can be made without any disclosure or registration.[46]

I am not sure the rationale for this change makes sense. With a completely intrastate offering, at least you can justify the exemption because the state will worry about regulating the offer. The state can control the issuer and presumably protect its own investors. Once you start crossing state lines, however, particularly if you are in an area like the New York metropolitan area, you must ask if any state can effectively regulate such an offering. If people can avoid disclosure requirements simply by confining their offer to an area like this, where there are many potential customers, there will presumably be a lot of offerings of this type. In addition to all the difficulties just discussed, there will continue to be questions of the residence of a particular purchaser and questions of defining the area.

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44. *See* Sowards, *supra* note 14, at 296.

45. ALI FED. SEC. CODE § 514 (1978). For the text of this section and the comparisons with the 1980 draft and the CODE RECOMMENDATION, *see* note 11 *supra*. *See also* Casper, *supra* note 11, at 288.

46. *Id.*

C. *The Small Offering Exemption*

The third of these exemptions, the small offering exemption, reappears in section 512(e)[47] and, lo and behold, is down to $100,000 again. This time, however, it is not by an act of grace on the part of the Commission; under the Code, any offering under $100,000 would be exempt by statute. I am not sure how much use that is going to be to anybody. It will certainly exempt really *de minimi* transactions. But you can't finance much of an operation with $100,000 these days, so I don't think it has much practical significance.

VI. Current Administrative Response to the Code

What overall effect has the Code had in this area? I would suggest that the Code has already had a very important effect on Commission rulemaking. Two areas I particularly want to focus on are the changes in the disclosure requirements and the adoption of rule 242.

A. *Changes in the Disclosure Requirements*

The Commission has recently begun to realize that practical limitations must be placed on disclosure requirements.[48] This realization has led to the adoption of simplified forms in some instances. One of the earliest simplified forms was form S-7,[49] adopted quite a few years ago for very large companies, which reflects the view that if a company is sufficiently large, very few things are material enough to require special disclosure. It greatly simplifies the disclosure required of large companies. That was followed by another simplified form, S-16,[50] which is

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47. ALI FED. SEC. CODE § 512(c) (1978). The CODE RECOMMENDATION increases the exemption from $100,000 to $200,000. For the text of this section and the comparisons with the 1980 draft and CODE RECOMMENDATION, *see* note 11 *supra*.

48. *See, e.g.*, SEC Sec. Act Release No. 6176, 19 SEC Docket 186 (1980); [Current] FED. SEC. L. REP. (CCH) ¶ 82,422. The Commission has proposed "major changes" intended to "reduce disclosure burdens" and to create the integrated disclosure system "long advocated by many commentators and to reduce current impediments to combining informal shareholder communications, such as annual reports to shareholders, with official Commission filings." *Id.*

49. The text of form S-7 can be found at [1980] 2 FED. SEC. L. REP. (CCH) ¶¶ 7191-96A.

50. The text of form S-16 can be found at [1980] 2 FED. SEC. L. REP. (CCH) ¶¶ 7291-

now available to many large companies, even further reducing the amount of required information. But the large companies are not the problem here. They have plenty of money and can pass the cost of registration statements along to their customers. What about the little fellows who are trying to raise money? Form S-18 now exists for companies at that end of the scale:[51] a small nonreporting company, offering up to $5,000,000, can disclose on a simplified form and can file in a regional office. But even though there has been simplification for large and small companies, we now have a category of companies in the middle who are still saddled with the full panoply of disclosure requirements under form S-1. I assume at some point it is going to occur to the Commission that, if form S-18 is adequate for offerings up to $5,000,000 by small companies, it may also be adequate for larger offerings.

B. *Changes in the Small Offering Exemption*

Another change is the expanded use by the Commission of its rule-making authority under section 3(b) to exempt small offerings. Rule 240,[52] which was adopted by the Commission in 1975, gives a complete exemption for an offering of up to $100,000 as long as the securities don't wind up being held by more than 100 people. This rule contains no sophistication requirements and no requirements as to information to be supplied. This was a significant step, but, because limited to $100,000, it was one that will not be of use in most cases.

The really significant change is rule 242,[53] adopted by the Commission in 1980. The rule, in effect, enacts, with modifications, section 242[54] of the proposed Code for offerings up to

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51. The text of form S-18 can be found at [1980] 2 FED. SEC. L. REP. CCH ¶¶ 7301-07. The SECOND ANNUAL SECURITIES UPDATE summarized the findings of the Securities and Exchange Commission's Monitoring Report on the use of Form S-18 in 1979 which found that Form S-18 "has substantially displaced Form S-1 as a means of registering smaller initial public offerings of common stock." The monitoring report also found that issuers who filed in regional offices were able to file with shorter processing times than those who filed at the Commission's Headquarters office. Beach, *Form S-18—A Monitoring Report on its Use in 1979,* in SECOND ANNUAL SECURITIES UPDATE 213 (1980).

52. 17 C.F.R. § 230.240 (1980)

53. 17 C.F.R. § 230.242 (1980).

54. ALI FED. SEC. CODE § 242 (1978). For the text of this section and the compari-

$2,000,000 (which of course is the Congressionally imposed limit under section 3(b) as currently in effect).[55] Essentially, it follows the pattern of section 242, but is more liberal in one respect. Under rule 242, up to $2,000,000 of securities can be offered to any number of institutions, to any number of people who purchase $100,000 or more, and to as many as thirty-five other people. There are no requirements for supplying information to institutions or to other purchasers of over $100,000. Any other purchasers must be given the offeror's most recent annual report or definitive proxy statement or other comparable material if the offeror is a reporting company; if it is a nonreporting company, the offeror must supply the information required by part 1 of form S-18. This looks to me like a flexible way of distinguishing between sophisticated and nonsophisticated offerees: if you choose to include, as offerees, noninstitutional investors or people who do not have $100,000, then you must furnish them with certain information. This is very close to section 242 of the Code, but it preserves more flexibility because it is a Commission rule. The Commission can see what happens and can loosen or tighten the rule in light of future experience. The most serious problem of the Code approach, in this as in other areas, is that specific tests would be written into the statute. Congress can strike a general balance. It can determine to require full disclosure, so that people won't buy things that they don't understand; on the other hand, it can decide to provide some leeway for people to offer without going through incredible difficulties. Congress can make that judgment. But for Congress to draw the precise line, and to keep changing that line as conditions change, is very difficult. Congress simply does not have the ability to keep up in that way. Congress could simply give the Commission power to adjust the dollar limit in accordance with inflation, which would make adjustment automatic. But if they write provisions like section 242 and section 514 into the law, there they will sit, and the Commission will wind up, just as it did under the 1933 Act, writing a lot of rules and interpretations just to get around obstacles imposed by the statute.

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sons with the 1980 draft and CODE RECOMMENDATION, *see* note 11 *supra*.

55. Sowards, *supra* note 14, at 295-96.

VII. Conclusion

To summarize, I would agree with Professor Sowards that the prospects for adoption of the Code in anything like its present form are dubious and far off in the distance. But perhaps that does not matter too much. It may be that the drafting of the Code, the distribution of the Code, and the discussions of the Code with the Commission have had enough of an impact that we have already accomplished more than we would under the new Code which, as I have said, proposes new rigid statutory formulae.

VIII. Discussion

Professor Sowards: Can I just ask you to comment on manners of resale both under rule 242 and proposed section 242? How can you resell securities that you take under rule 242 today?

Professor Ratner: Under rule 242 they are restricted, subject to resale in accordance with rule 144. Rule 144 has now been loosened up to the extent that I think that it provides a pretty broad avenue for the distribution of securities, as long as you meet the current public information test, which might be a problem for companies that are not filing current information. I do not think anybody is willing at this point to permit unregulated distribution of securities of companies that are not filing. Also, you can only resell so long as the offeree group remains limited.

Question: Do you recommend passage of the Code to provide flexibility in the administration of the securities laws?

Professor Ratner: I think flexibility has been probably the best and the worst thing about the Securities and Exchange Commission's administration of the securities laws. In some areas, the flexibility has operated in such a way that the statute makes sense in terms of what is really occurring. This is true in the disclosure area at present. In other areas, the Commission's flexibility has worked very badly. I think Mr. Spencer has quite rightly pointed to a number of areas in which the Commission simply went way beyond their statutory powers because they felt they had to do so to protect the public interest.

One of the problems of the Code, and Professor Loss him-self has said this, is that the drafters are shooting at a moving target. One of the initial reasons for the Code was that Commission and court interpretations had simply gone way beyond the original language of the statutes. That was true from 1967 to 1969, the period of the most expansive interpretations. The Commission had interpreted its rules broadly and had written rules under the anti-fraud sections governing practices that might be considered unfair but could hardly be considered fraud. The Commission had extended its powers under the provisions for acceleration of registration statements to require not only disclosure but the famous "undertakings not to enforce indemnification provisions," which really had no legitimate statutory foundation.

In the intervening ten years, the courts have cut back a lot on the Commission's powers. The Supreme Court has pulled back in many substantive areas, and the Court of Appeals for the District of Columbia has been pulling the Commission in on a tighter rein in terms of the burden of proof and the standards to be applied in administrative proceedings. There has been a tightening all along the line. I have mixed feelings about the trend. I think in some areas the courts have pulled back to the point where they have cut the heart out of some really useful provisions of the securities law.

What started off in 1969 in Professor Loss's proposal as either a codification or a restriction on Commission power, therefore, becomes in the present context a substantial extension of Commission power. That is something more than codification, and you have to look at it on a case-by-case basis to see whether that flexibility is needed. I urged earlier that flexibility is useful in the area of exemptions because the situations change constantly, I think it is a lot more questionable in some of the areas described by Mr. Lowenfels.