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A PROPOSED WEST VIRGINIA RESPONSE TO THE INITIATIVE OF REGULATION D

JAMES A. RUSSELL*

In the words of William S. Casey, a former Chairman of the Securities and Exchange Commission ("SEC":)

From the time of Pericles through Elizabeth I down to Polaroid, the cutting edge of dynamic societies has been the innovator, risking his own savings and those of others having confidence in him, whether on the waves of the high seas and new horizons or those of high technology and new services. Almost every new technology that has given a lift to the American economy has come from a new company, struggling in a garage or venturing out to obtain needed capital from the public.1

Whether one is moved to prose to the same extent as Mr. Casey, one cannot deny the impact on the American economy of people like Alexander Graham Bell, Thomas Edison and Henry Ford. In terms of jobs, revenues, and technological development, promoters of small, growing enterprises have contributed more than their share to the well-being of all of us.2

Many, if not most, entrepreneurs have sprung from a common background — a new idea, worthy of development, a shortage of funds to develop the idea on their own and a shortage of assets to secure a lender. Due to the inappropriateness or unavailability of other forms of financing,3 these promoters4 have often looked to the public for venture capital. Of course, when one obtains money from others, he has to give something in return. When that return is a share of the enterprise, the thing given is called a security,5 and the transaction

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1 Casey, SEC Rules 144 and 146 Revisited, 43 BROOKLYN L. REV. 571, 572 (Spring 1977) [hereinafter cited as Casey].
3 Debt financing is often unavailable due to the lack of collateral to adequately secure a lender or because of the venture's poor cash flow prospects to service debt payments in the early stages of the project. An outright sale of a patentable idea or a sale coupled with a reservation of a percentage of the profits realized from marketing the resulting product or service is often not a realistic possibility due to the unrealistically high value placed on the idea by the creator or the lack of purchasers who share the creator's belief in the ultimate profitability of the venture. Mofsky, Blue Sky Restrictions on New Business Promotions, 1969 DUKE L.J. 273, 275 [hereinafter cited as Mofsky].
4 The term "promoter" suffers from excessive usage in securities jargon and, thus, lacks meaning due to overdefinition. As used herein, a promoter is the person or entity sponsoring the sale of equity interests in the enterprise or investment vehicle used to raise funds for the particular venture.
5 The term "security" is defined in securities laws, e.g., 15 U.S.C. § 77b.(1) (1976), and typically includes such common securities as stocks, bonds, and the like. Statutory definitions of "security" are not limited to such conventional securities, however, and include such things as an "investment contract" and a "certificate of interest or participation in an oil, gas, or mining title or lease..." W. VA. CODE § 32-4-401(1) (1982).
is subject to regulation.

The stock market crash of 1929 was perceived at the time as the major cause of the Great Depression. The ensuing political and economic turmoil resulted in the election of Franklin D. Roosevelt, which in turn, brought on an unprecedented intrusion of the federal government into the affairs of private enterprise. Due to President Roosevelt’s desire to restore a degree of confidence in the securities market,8 his first significant act as President was to recommend to Congress the bill which, in short order, became the Securities Act of 19337 (hereinafter “the Securities Act”).

The principal function of the Securities Act is to regulate new offerings of securities through registration.8 Registration, it was felt, would protect the investor by requiring the disclosure of specified information about the issuer9 — the entity which proposes to sell the securities — and the security, so that an informed investment decision can be made. Section 5 of the Securities Act10 contains the basic provision and requires all securities offered or sold in interstate commerce to be registered with the SEC.11

Other sections of the Securities Act specify the contents of the registration statement12 and proscribe the use of false or misleading information therein.13 The consequence of errors is devastating — return of all funds received from the sales, plus interest, less income received in respect of the investment.14

A highly specialized segment of the legal and accounting professions emerged to assist issuers in dealing with the rigors of registration. Of course, the cost of the process is substantial. An analysis of six smaller registered public offerings made in 1976, each of which was made by a company with assets of less than $5 million, reveals that the average cost of registering the offerings was $122,350.15

The cost of registration forces promoters in need of venture capital to seek alternatives. However, due to the unavailability of other forms of financing, the promoter has only two realistic options: abandon the venture or try to fit within one of the exemptions from registration under the Securities Act. In its wisdom, Congress provided two categories of exemptions from registration: exempted securities and exempt transactions.16

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8 D. Ratner, SECURTIES REGULATION 6 (1975).
11 Id.
15 Casey, supra note 1, at 576.
An exempted security is primarily characterized by the nature of the issuer, the extent of regulation by some other federal agency, or the jurisdictional limitations of the Securities Act. Examples are obligations issued or guaranteed by governmental bodies, securities issued by common carriers regulated by the Interstate Commerce Commission, and securities offered or sold in purely intrastate transactions. Section 3(a) of the Securities Act lists the exempted securities.

Because most promoters cannot issue exempted securities, the transactional exemptions have to be used. The transactional exemption relied upon most often has been the section 4(2) exemption for transactions “not involving any public offering.” Despite the vagaries of the so-called “private offering” exemption as developed by the courts and the SEC, the private placement of securities to raise venture capital has long been a common financing technique. However, the burden of compliance with the subjective conditions of the exemption has been less than the burden of registration only in relative terms.

If the promoter can qualify under, or more appropriately, is willing to risk reliance upon the private placement exemption as an alternative to registration under the Federal Securities Act, then he must also comply with the requirements of state securities laws. Almost all of the states have “blue sky” laws which also require the registration of securities offered or sold within their borders. The promoter has to register with each of those states or qualify for an exemption if one is available. State registration is not cheap, and many state exemptions are quite restrictive and incompatible with the federal exemptions.

The promoter of the business seeking venture capital has a dual burden of complying with the regulatory schemes of the federal government and with each of the states in which his offering is made. The burden of compliance has often been unrealistically related to the needs of the investing public for protection.

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23 See, e.g., W. VA. CODE § 32-3-301(1) (1982).
Effective April 15, 1982, the SEC adopted a new series of six rules, collectively designated Regulation D. The rules implement three tiers of exemptions from registration under the Securities Act, based upon the dollar amount of the offering. Regulation D was designed to clarify, simplify, and expand the availability of prior exemptions under section 4(2) and under section 3(b) of the Securities Act and to serve as the basic framework for compatible federal and state regulation of new offerings of unregistered securities. In conjunction with its re-evaluation of the impact of its rules and regulations on capital formation by small businesses, which resulted in Regulation D, the SEC collaborated with the Small Business Financing Subcommittee of the North America Securities Administrators Association ("NASAA") to develop a compatible and, it was hoped, uniform federal-state exemption. The process resulted in NASAA's adoption of an official policy guideline recommending to its members a "Uniform Limited Offering Exemption." Thus, the SEC and NASAA have produced an initiative for improving or eliminating one of the chief problems heretofore encountered by the issuer of unregistered securities — the existence of multiplicitious, incompatible regulation of the primary offering.

The purpose of this Article is to examine the changes made in the federal law by Regulation D and the changes which need to be made in the present "limited offering" exemption from registration under the West Virginia Uniform Securities Act. Part I narrates the history of the statutory exemptions from registration which underlay Regulation D and points out some of the problems those exemptions posed for issuers. Part II examines Regulation D itself and Part III examines and criticizes the present status of the limited offering exemption in West Virginia. Part IV identifies a proper scope of securities regulation at the state level and recommends the adoption of three exemptions from registration under the West Virginia Uniform Securities Act, consistent with the tiered scheme of Regulation D.

I.

Regulation D replaces three prior exemptive rules of the SEC: Rules 146, 504, and 505.

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51 The tiered levels are: (a) offerings up to $500,000 (Rule 504); (b) offerings up to $5 million (Rule 505); and (c) offerings with no dollar limitation (Rule 506).
55 Resolution of NASAA Endorsement of Revised Uniform Limited Offering Exemption (approved April 30, 1982) and NASAA Uniform Limited Offering Exemption, reprinted in 1 BLUE SKY L. REP. (CCH) ¶ 5294, 5294A (1982). See also 1 PRIVATE PLACEMENTS IN OIL UNDER SEC REGULATION D 453-62 (L. Mosburg ed. 1982) [hereinafter cited as Mosburg].
An understanding of the workings of these rules and the statutory underpinning of the rules is necessary to gain a working knowledge of Regulation D.

A. Rule 146

Section 4(2) of the Securities Act exempts from the registration requirement of section 5 "transactions by an issuer not involving any public offering." The operative terms, "public offering," is not defined in the Securities Act, but the sparse legislative history concerning the scope of the exemption indicates that it was intended to apply when there is "no practical need" for registration or when the "public benefits [of registration] are too remote." A reference to the exemption in the Conference Committee Report suggests that a sale of securities would not involve a public offering when the purchasers are "small in number."

Shortly after the enactment of the Securities Act, the SEC announced certain factors which, in its view, are relevant to whether an offering is "public," including: the number of offerees, their relationship to the issuer and to each other; the number of shares or units offered; and the size and manner of the offering. Thus, the nature of the offering was initially felt to be primarily determinative of the availability of the exemption. Due to the imprecision of the other factors, judicial decisions, and hence issuers, tended to place the most weight on the one measurable criterion, the number of offerees. The so-called "Rule of 25" was informally adopted, and a degree of predictability developed.

Predictability began to decrease, however, with the Supreme Court's decision in SEC v. Ralston Purina Company. Ralston Purina involved the unregistered sale of treasury stock to a large number of employees of the corporate defendant. Although no solicitation of the purchasers occurred, between 1947 and 1951 nearly $2 million of stock was sold to employees of Ralston Purina whose positions ranged from stock clerk to stenographer to veterinarian and whose residences were scattered from California to Texas to New Hampshire.
The company claimed the section 4(2) exemption based on their position that the only purchasers were employees who took the initiative to invest in the company and were, therefore, "key employees" in the organization. The Court rejected Ralston Purina's contention and also rejected the "number of offerees" test urged by the SEC. Noting that "[t]he design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions," the Court saw the availability of the private offering exemption as turning on "the knowledge of the offerees." The Court explained: "[t]he focus of inquiry should be on the need of the offerees for the protection afforded by registration." Language elsewhere in the opinion disclosed that "[a]n offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'" The claimed exemption in Ralston Purina failed because "[t]he employees here were not shown to have access to the kind of information which registration would disclose."

Despite the Court's awareness of the pertinent legislative history, it examined only the perceived needs of investors. Its failure to examine the interests of others affected by an offering of securities in reliance upon the exemption — the particular issuer and the business community in general — effectively shifted the focus in private placements from the nature of the offering to the nature of the offerees.

The references in the Ralston Purina decision to "those who are shown to be able to fend for themselves," "the knowledge of the offerees," and "access to the kind of information which registration would disclose" led, over time, to judicial decisions which were difficult to digest. For example, a fair reading of Ralston Purina suggests that the requisite "access" to information could be demonstrated by either the offeree's position with the issuer or, alternatively, by disclosure. However, the Fifth Circuit case of SEC v. Continental Tobacco Co. effectively required a cumulative showing of both position and disclosure.
And, although the Court strongly hinted that disclosure of appropriate information to such presumably ordinary persons as the clerical assistants, stock clerks, and stenographers who bought Ralston Purina’s stock would have entitled the company to the exemption, the Tenth Circuit in Lively v. Hirschfeld held that a showing of “investment sophistication” is required. Given the imprecision of the concepts of “access” and “sophistication,” and the arguable lack of sufficiency of full disclosure, it is little wonder that the most active of the courts of appeals, in the areas of section 4(2) exemption, noted that “the cases cast at best a faint beacon toward the horizon of decision.”

In 1974, the SEC adopted Rule 146 for the stated purpose of providing more objective standards for determining when offers and 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 Securities Act. In general, Rule 146 established certain conditions relative to an offer or sale of securities and provided that transactions by an issuer made in accordance with all of the conditions of the rule “shall be deemed to be transactions not involving any public offering.” Rule 146 was expressly nonexclusive, and the issuers who were unable to demonstrate total compliance could still claim the statutory exemption if they had complied with applicable section 4(2) judicial and administrative interpretations.

In very general fashion, the Rule 146 requirements, except those applicable to business combinations, were as follows:

1. Limitation on Manner of Offering

No general solicitation or advertising could be used, except that letters could be sent to “qualified” offerees and private meetings could be arranged for “qualified” offerees.

2. Nature of Offerees

Before any offer was made, the issuer and its salesman had to actually believe, upon reasonable grounds, that (a) each offeree had sufficient knowledge and experience in financial and business matters to enable him to evaluate the merits and risks of the prospective investment — i.e., the offeree was

448 F.2d 680 (5th Cir. 1971).
440 F.2d 631 (10th Cir. 1971).
Id. at 663.
Doran v. Petroleum Management Corp., 545 F.2d 893, 908 (5th Cir. 1977).

Rule 146, supra note 65, at preliminary note 3.
Id. at § 230.146(b).
Id. at preliminary note 1.
Id. at § 230.146(e).
Id. at § 230.146(d)(1)(i).
sophisticated - or (b) each offeree was able to bear the economic risk of the investment\textsuperscript{72} - an unprecedented standard.

3. Nature of Purchasers

Before making any sales, and after making reasonable inquiry, the issuer and its salesman had to actually believe, upon reasonable grounds, that either (a) the offeree was sophisticated,\textsuperscript{73} or (b) the offeree and an offeree representative - another new element - together were sophisticated, and the offeree was able to bear the economic risk.\textsuperscript{74}

4. Access to or Furnishing of Information

Each offeree either had to have access, throughout the transaction and prior to the sale, to certain specified information or, alternatively, be furnished the pertinent information.\textsuperscript{75} Access existed under the rule only by reason of the offeree's employment or family relationship with the issuer or by sufficient economic bargaining power to enable the offeree to obtain the relevant information.\textsuperscript{76} For those offerees who did not have access, the informational requirement could be discharged by furnishing the information to the offeree or an offeree representative, if such adviser had been retained.\textsuperscript{77} Additionally, whether or not an offeree had access to or was furnished the required information, the issuer had to afford such offeree the opportunity to ask questions of, and receive answers from, the issuer or its representative concerning the terms and conditions of the offering and to obtain additional information, to the extent reasonably available, to enable verification of the required information.\textsuperscript{78}

5. Information Required

The information which an offeree had to have access to or which had to be furnished to either him or his offeree representative was the "same kind of information that is specified in Schedule A . . . to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense."\textsuperscript{79} In the case of an issuer subject to the reporting requirements of the Securities Exchange Act of 1934\textsuperscript{80} ("the Exchange Act"), the informational requirement could be discharged by providing documents already prepared for other purposes,\textsuperscript{81} and additionally, "[a] brief description of the securities being

\textsuperscript{72} Id. at § 230.146(d)(1)(ii).
\textsuperscript{73} Id. at § 230.146(d)(2)(i).
\textsuperscript{74} Id. at § 230.146(d)(2)(ii).
\textsuperscript{75} Id. at § 230.146(e)(1).
\textsuperscript{76} Id. at § 230.146(e) Norm.
\textsuperscript{77} Id. at § 230.146(e)(1)(ii).
\textsuperscript{78} Id. at § 230.146(e)(2).
\textsuperscript{79} Id. at § 230.146(e)(1)(i), (ii).
\textsuperscript{80} 15 U.S.C. §§ 78a to 78kk (1976).
\textsuperscript{81} Rule 146, supra note 65, at § 230.146(e)(1)(a)(1), required an issuer subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act to furnish offerees or offeree representatives with:

The information contained in the annual report required to be filed under the Ex-
offered, the use of the proceeds from the offering, and any material changes in
the issuer's affairs which are not disclosed in the documents furnished.\textsuperscript{23} All
other issuers, which included most users of Rule 146, had to provide the informa-
tion that would be required to be included in a public registration state-
ment on the form which the issuer would be entitled to use;\textsuperscript{23} however, imma-
terial details could be omitted, and information could be condensed so long as
the information provided was not rendered misleading.\textsuperscript{24} Also, the issuer not
subject to the reporting requirements of the Exchange Act could furnish
unaudited financial statements if the audited financial statements required by
the applicable registration form were not available without unreasonable effort
or expense.\textsuperscript{25} If unaudited financial statements were not available without
unreasonable effort or expense, Regulation A financial statements could be fur-
nished.\textsuperscript{28} Moreover, if the aggregate sales price of all securities offered under
the rule did not exceed $1.5 million, the informational requirements could be
satisfied by furnishing the disclosure required by Schedule 1 of Regulation A.\textsuperscript{27}

6. Number of Purchasers

Under Rule 146, the issuer had to have reasonable grounds to believe, and,
after making reasonable inquiry, had to actually believe that there were no
more than 35 purchasers of the issuer's security from the issuer in any offer-
ing.\textsuperscript{26} There were special rules for counting the number of purchasers,\textsuperscript{26} and,
Rule 146 had its own "safe harbor" from integration\textsuperscript{26} of the offering made in
change Act or a registration statement on Form S-1 under the Act or on Form 10 under
the Exchange Act, whichever filing is the most recent required to be filed, and the infor-
mation contained in any definitive proxy statement required to be filed pursuant to sec-
tion 14 of the Exchange Act and in any reports or documents required to be filed by
the issuer pursuant to section 13(a) or 15(d) of the Exchange Act, since the filing of such
annual report or registration statement.

\textsuperscript{23} Id. at § 230.146(e)(1)(a)(2).
\textsuperscript{24} Id. at § 230.146(e)(1)(b).
\textsuperscript{25} Id. at § 230.146(e)(1)(b)(1).
\textsuperscript{26} Id. at § 230.146(e)(1)(b)(2).
\textsuperscript{27} Id.
\textsuperscript{28} Id. at § 230.146(e)(1)(d).
\textsuperscript{29} Id. at 230.146(g)(1).

Rule 146, supra note 65, at § 230.146(e)(1)(a)(1), excluded from the computation of pur-
chasers: (a) a purchaser's relative, spouse, or relative of the purchaser's spouse who had the same
home as the purchaser, (b) any trust or estate 100 percent beneficially owned by a purchaser or
excluded spouse, relative or spouse's relative, (c) any corporation or other organization wholly
owned by a purchaser or related person, and (d) any person who purchased, or agreed in writing to
purchase, for cash, whether in a single payment or in installments, securities of the issuer in the
aggregate amount of $150,000 or more.

Rule 146, supra note 65, at § 230.146(e)(1)(a)(2), provided that a corporation, partnership,
association, joint stock company, trust or unincorporated organization was to be counted as one
purchaser, unless the entity was organized for the specific purpose of acquiring the securities of-
fered. If so, then each beneficial owner of equity interests or equity securities in the entity was
counted as a separate purchaser.

The doctrine of integration arose from the notion that an issuer should not be allowed to
circumvent registration requirements by stringing together a number of supposedly separate or
discrete transactions and claiming an exemption for each of the separate offerings. Thus, integra-
reliance upon the rule with other securities offerings.91

7. Limitations on Resale

The issuer, and each of its representatives, had to exercise reasonable care to assure that each purchaser in the offering was not an underwriter within the meaning of section 2(11) of the Securities Act.92 Such reasonable care included, without limitation: (a) making reasonable inquiry to determine whether the purchaser was acquiring the securities for his own account or for others,93 (b) placing a legend on the certificate indicating that the securities were unregistered and setting forth or referring to the restrictions on transferability and sale,94 (c) issuing stop transfer instructions to the transfer agent or, if the issuer transferred its own securities, annotating the transfer records,95 and (d) obtaining a signed written agreement from each purchaser that the securities would not be resold by the purchaser without registration or an appropriate exemption.96 Additionally, although more in the nature of required information, the issuer or its representative had to disclose to each purchaser in writing, before sale, that the economic risk of the investment had to be borne for an indefinite period because the securities had not been registered and, therefore, could not be sold unless subsequently registered or unless an exemption was available.97

91 Rule 146, supra note 65, at § 230.146(b)(1) provided:
   For purposes of this rule only, an offering shall be deemed not to include offers, offers to
sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided
by section 3 or section 4(2) of the Act or pursuant to a registration statement filed under
the Act, that take place prior to the six-month period immediately preceding or after the
six-month period immediately following any offers, offers for sale, or sales pursuant to
this rule. Provided, That there are during neither of said six month periods any offers,
offers for sale or sales of securities by or for the issuer of the same or similar class as
those offered, offered for sale or sold pursuant to the rule.

92 Id. at § 230.146(h).
93 Id. at § 230.146(h)(1).
94 Id. at § 230.146(h)(2).
95 Id. at § 230.146(h)(3).
96 Id. at § 230.146(h)(4).
97 Id. at § 230.146(e)(3)(ii).
8. Report of Offering

At the time of the first sale under the rule, the issuer had to file three copies of a report (Form 146) at the appropriate SEC regional office, unless the cumulative proceeds of all Rule 146 offerings during a twelve-month period were less than $50,000. Amended reports had to be filed when any material change occurred in the reported information.

Three primary points emerged from experience under Rule 146: (1) compliance with the exemptive conditions was disproportionately burdensome upon small issuers, (2) the subjective nature of certain of the determinative factors, e.g., sophistication and economic ability to bear the risk, rendered qualification for the exemption uncertain, and (3) despite the express non-exclusivity of the rule, the effect of certain judicial decisions was to make the Rule 146 exemptive criteria virtually determinative of the availability of the underlying statutory exemption.

B. Rule 240

Section 3(b) of the Securities Act vests in the SEC the authority to create exemptions from registration “by reason of the small amount involved or the limited character of the public offering.” As originally enacted, the specific dollar limitation was $100,000; however, the amount was raised from time to time over the years.

Early on, the SEC exercised its rulemaking authority by adopting a loose series of rules designated collectively as Regulation A. These rules were later repealed in favor of a uniform regulation, also termed Regulation A. In publicly announcing its adoption of Regulation A in 1941, the SEC pronounced, “[t]he new regulation shifts the Commission’s administrative emphasis from the disclosure requirements of the Act to the fraud prevention provisions.” Accordingly, the original exemptive conditions for Regulation A were quite simple and did not require the disclosure of any specific information. The administrative screws were progressively tightened over time, however, in re-
Effective January 24, 1975, the SEC adopted Rule 240 pursuant to its rulemaking authority under section 3(b) of the Securities Act. Like Rule 146, Rule 240 was a nonexclusive “safe harbor” exemption from registration available to issuers only. Rule 240 proscribed general solicitation of purchasers and general advertising in marketing securities issued pursuant to the rule, required the issuer to exercise reasonable care to assure that the purchasers were buying for investment instead of distribution, required the filing of a notice of sales form (Form 240), and proscribed the payment of commissions or other remuneration for soliciting purchasers. No specific information had to be disclosed and offerees did not have to be screened for sophistication or wealth. The purchaser limitation was framed in terms of the issuer’s good faith belief about the number of beneficial owners of the issuer’s securities issued pursuant to the rule. The number was 100, which was a potential advantage over Rule 146, assuming the Rule 240 issuer had few security holders before the offering. The great disadvantage of Rule 240 was the limitation upon the aggregate sales price of unregistered securities of the issuer which could be sold in a twelve-month period - $100,000. Thus, despite the reduced burden of compliance and increased certainty of application of the Rule 240 exemption in contrast to Rule 146, Rule 240 was of little use to the small business in need of venture capital due to the niggardly dollar limitation.

C. Rule 242

Rule 242 was adopted by the SEC, effective February 25, 1980, also pursuant to the SEC’s rulemaking authority for small or limited offerings. Rule 242 introduced the concept of an accredited investor, which has been carried over into Regulation D. An “accredited person,” under Rule 242, was any person who the issuer and any person acting on its behalf had reasonable grounds to believe, and did believe, after making reasonable inquiry, came within one of the following three categories at the time of the Rule 242 sale: (a) a bank, an insurance company, or certain other specified institutional investors, (b) a “big ticket” or “fat cat” investor, i.e., one who purchased $100,000

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110 Id. at 610-12.
113 Id. at preliminary note 4.
114 Rule 240, supra note 112, at § 230.240(c).
115 Id. at § 230.240(g).
116 Id. at § 230.240(h).
117 Id. at § 230.240(d).
118 Id. at § 230.240(f).
119 Id.
120 Id. at § 230.240(e).
123 Rule 242, supra note 121, at § 230.242(a)(1).
124 Id. at § 230.242(a)(1)(i).
or more of the securities, and (c) any director or executive officer of the issuer. Rule 242 was a nonexclusive exemption available only to United States or Canadian corporations, with certain specified exclusions, notably including Regulation A "bad boys." The great breakthrough with Rule 242, regarding the SEC's exercise of its section 3(b) rulemaking authority, was setting the aggregate offering price limitation at $2 million. The purchaser limitation was framed in terms of purchasers of the particular offering, rather than an outstanding security holder limitation a la Rule 240, and was based on the issuer's good faith belief that no more than 35 non-accredited persons had purchased securities in the transaction. There was no limit upon the number of accredited investors, nor were there any suitability criteria for non-accredited purchasers. General solicitation and advertising were prohibited.

No specific information had to be disclosed when the only purchasers were accredited persons; however, when the purchasers included non-accredited persons, the issuer had to disclose to all purchasers, in writing, the same kind of information as that specified in Part I of Form S-18 (Form S-18 is used to disclose information about registered securities), to the extent material to an understanding of the issuer, its business and the securities being offered. The issuer must also provide any information necessary to make the expressly required information not misleading - a necessary anti-fraud corollary whether stated in the rule or not. Exchange Act reporting companies utilizing the Rule 242 exemption could satisfy the specific disclosure requirement largely by furnishing documents required to be filed under the Exchange Act, plus certain additional information, if applicable. Additionally, each offeree had to be extended the opportunity to ask questions and receive answers regarding the offering and to obtain additional, reasonably available, information from the issuer to verify the accuracy of the information mandatorily disclosed, all of which had to be done prior to sale. Also, at

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125 Id. at § 230.242(a)(1)(ii).
126 Id.
127 Rule 242, supra note 121, at preliminary note 3.
128 Id. at § 230.242(a)(5).
129 Rule 242 (a)(5), supra note 121, at § 230.242(a)(5), excluded from the definition of a "qualified issuer": (i) an investment company, (ii) an issuer which engaged or intended to engage in oil and gas operations which exceed the criteria for exemption specified in Regulation S-X, and (iii) an issuer which was a majority-owned subsidiary of an issuer which did not qualify to use the rule.
130 17 C.F.R. § 230.252 (c)-(f), denied the Regulation A exemption to an issuer when any of a long list of conditions applied. The conditions, in general terms, related to pending or previous securities proceedings or violations against or by the issuer, its predecessors, affiliates, directors, officers and owners. Hence the term "bad boys" or "bad guys."
131 Id. at § 230.242(a)(2).
132 Id. at § 230.242(e)(1).
133 Id. at § 230.242(d).
134 Id. at § 230.242(f)(1)(i).
135 Id.
136 Id. at § 230.242(f)(1)(ii).
137 Id. at § 230.242(f)(1)(iii).
138 Id.
139 Id. at § 230.242(f)(2).
some reasonable time prior to sale of Rule 242 securities to a non-accredited person, the issuer had to furnish to such prospective purchaser a brief written description of any written information obtained by any accredited person and, if the prospective non-accredited purchaser so requested in writing, the issuer had to actually furnish such information.140

Securities acquired pursuant to a Rule 242 transaction had the same restricted status as securities acquired in a private placement.141 Accordingly, "reasonable care" limitations were imposed on the resale of the securities similar to those applicable to Rule 146.142 Finally, a notice of sales form (Form 242) had to be filed with the SEC within 10 days after the first sale,143 within 10 days after the final sale,144 and periodically throughout the offering.145

In summary, prior to the adoption of Regulation D, the rules which it replaced, in very general terms, permitted the sale of unregistered securities as follows:

1. Rule 240 permitted the sale of up to an aggregate of $100,000 in a twelve-month period to up to 100 security holders, without requiring any specific information to be disclosed, so long as no commissions or the like were paid.146

2. Rule 242 permitted American or Canadian corporations to sell $2 million per transaction to up to 35 persons who were free of suitability criteria and, additionally, an unlimited number of institutional investors, big ticket purchasers, or insiders. When only accredited purchasers were involved, no specific information had to be disclosed; otherwise, material information in the format of Part I of Form S-18 had to be disclosed in writing. In every case prospective investors were entitled to ask questions and get such additional, reasonably available information as they deemed appropriate.147

3. Rule 146 permitted the sale of an unlimited dollar amount of securities to up to 35 purchasers who were either sophisticated—however the issuer dared interpret that concept—or were able to achieve sophistication with the help of a representative and were able to bear the economic risk—however, the issuer dared interpret that. Big ticket purchasers and family members or subsidiaries of other purchasers did not count against the limit. Offerees had to be either sophisticated or able to bear the risk, irrespective of whether they purchased. The manner of offering was limited. Information similar to that required in a registration statement had to be disclosed to each offeree, or else the offeree had to have a special relationship with the issuer.148

140 Id. at § 230.242(f)(3).
141 Id. at § 230.242(g).
142 Id.
143 Id. at § 230.242(b)(1)(i).
144 Id. at § 230.242(b)(1)(ii).
145 Id. at § 230.242(b)(1)(iii).
146 See supra text accompanying notes 111-20.
147 See supra text accompanying notes 121-45.
148 See supra text accompanying notes 65-99.
Conditions common to all three exemptions were that (a) the exemptions were not exclusive, (b) no general solicitation of purchasers was allowed, (c) subsequent disposition of the securities was restricted, and (d) notice of sales forms had to be filed.\textsuperscript{149}

II.

Regulation D consists of six rules, 501 through 506.\textsuperscript{150} The first three contain definitions and general conditions applicable to the exemptive rules.\textsuperscript{151} The last three contain specific exemptive conditions which vary according to the aggregate size of the offering.\textsuperscript{152} Like the rules which it replaced, the safe harbor of Regulation D as an exemption from registration is available only to issuers\textsuperscript{153} and only when each of the relevant conditions is satisfied.\textsuperscript{154}

Rule 501\textsuperscript{155} sets forth an expanded definition of accredited investor,\textsuperscript{156} es-

\textsuperscript{149} See supra text accompanying notes 65-99, 111-45.


\textsuperscript{151} Rules supra note 150, at § 230.501-.503.

\textsuperscript{152} Id. at § 230.504-.506.

\textsuperscript{153} 47 Fed. Reg. 11,251 (1982). Preliminary Note 4 to Regulation D.

\textsuperscript{154} Rules, supra note 150, at §§ 230.501(b), 230.505(b), 230.506(b).

\textsuperscript{155} Id. at § 230.501.

\textsuperscript{156} Rule 501(a) defines an "accredited investor" as any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

1. Any bank as defined in section 3(a)(2) of the Act whether acting in its individual or fiduciary capacity; insurance company as defined in section 2(13) of the Act; investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; Small Business Investment Company licensed by the U. S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000;

2. Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

3. Any organization described in section 501(c)(3) of the Internal Revenue Code with total assets in excess of $5,000,000;

4. Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

5. Any person who purchases at least $150,000 of the securities being offered, where the purchaser's total purchase price does not exceed 20 percent of the purchaser's net worth at the time of sale, or joint net worth with that person's spouse, for one or any combination of the following: (i) cash, (ii) securities for which market quotations are readily available, (iii) an unconditional obligation to pay cash or securities for which market quotations are readily available which obligation is to be discharged within five years of the sale of the securities to the purchaser, or (iv) the cancellation of any indebtedness owed by the issuer to the purchaser;

6. Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;

7. Any natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 orally upon the same statement of the applicability of Regulation D, and the adequacy of the basis for the exemption.
establishes rules for computing the aggregate offering price and for calculating the number of purchasers, and contains other relevant definitions. Rule 502 contains the integration rules for a Regulation D offering, sets forth when and what information is required to be disclosed, and establishes limitations upon the manner of offering and resale. Rule 503 provides for the

in the current year; and

(8) Any entity in which all of the equity owners are accredited investors under paragraph (a)(1), (2), (3), (4), (6), or (7) of this § 230.501.

Id. at § 230.501(a).

Rule 501(c) defines “aggregate offering price” as the sum of all cash, services, property, notes, cancellation of debt, or other consideration received by an issuer for issuance of its securities. The rule then provides that where securities are being offered for both cash and non-cash consideration, the aggregate offering price shall be based on the price at which the securities are offered for cash; but, if securities are not offered for cash, the aggregate offering price shall be based on the value of the consideration as established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard. Id. at § 230.501(c).

Rule 501(e)(1) excludes from the computation of the number of purchasers: (i) any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser; (ii) any trust or estate more than 50 per cent beneficially owned by a purchaser or related person; (iii) any corporation or other organization of which a purchaser and related persons are beneficial owners of more than 50 per cent of the equity securities or equity interests; and (iv) any accredited investor. Rule 501(e)(2) counts as one purchaser a corporation, partnership or other entity unless the entity is organized for the specific purpose of acquiring the securities being offered and all equity owners are not accredited investors, in which case each beneficial owner of equity securities or equity interests in the entity counts as a separate purchaser. Id. at § 230.501(e)(1) - .501(e)(2).

I.e., “Affiliate,” id. at § 230.501(b); “Business combination,” id. at § 230.501(d); “Executive officer,” id. at § 230.501(f); “Issuer,” id. at § 230.501(g); and “Purchaser representative,” id. at § 230.501(g).

Id. at § 230.502.

Rule 502(a) provides that offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers and sales of securities under an employee benefit plan as defined in Rule 405 under the Securities Act. Id. at § 230.502(a).

Id. at § 230.502(b).

Rule 502(c) proscribes offering or selling the securities by any form of general solicitation or general advertising, including, but not limited to (1) any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio; and (2) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. An exception is made for a Rule 504 offering made exclusively in states requiring registration of the securities and delivery of a disclosure document before sale. Id. at § 230.502(c).

Rule 502(d) provides that securities acquired in a Regulation D transaction have the same restricted status of securities acquired in a private placement under section 4(2) of the Securities Act. Accordingly, the rule proscribes the resale of the securities without registration or an available exemption, and mandates that the issuer exercise reasonable care to assure that the purchasers are not underwriters (i.e., are not buying with a view toward distribution), including (1) a reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons, (2) written pre-sale disclosure to each purchaser that the securities have not been registered under the Securities Act and, therefore, cannot be resold unless they are so registered or an exemption from registration is available, and (3) legending the certificate to the effect that the securities are unre-
filing of a notice of sales form (Form D) initially and periodically thereafter until the offering is completed.\textsuperscript{165} and, with respect to Rule 505 offerings only, Rule 503 requires that the notice contain an undertaking by the issuer to furnish to the SEC, upon request, the information furnished to non-accredited investors.\textsuperscript{166}

Rule 504\textsuperscript{167} contains the specific exemptive conditions for "limited offers and sales of securities not exceeding $500,000."\textsuperscript{168} Investment companies and Exchange Act reporting companies cannot use Rule 504.\textsuperscript{169} Otherwise, to qualify for the exemption, the issuer must satisfy only the general conditions of Rules 501 through 503.\textsuperscript{170} But, if the securities are offered and sold exclusively in states which require registration and pre-sale delivery of a disclosure document, the limitations upon the manner of the offering and resale are not applicable.\textsuperscript{171} No specific informational disclosure requirement exists under a Rule 504 offering; there is no limitation upon the number of purchasers and no purchaser suitability standards. However, there is to be aggregated with the sales price of the offering the total offering price for all securities sold in reliance upon any section 3(b) exemption or in violation of section 5(a) of the Securities Act within twelve months preceding the commencement and completion of the Rule 504 offering.\textsuperscript{172}

Rule 505,\textsuperscript{173} entitled "Exemption for limited offers and sales of securities not exceeding $5,000,000,"\textsuperscript{174} is available to all issuers except investment companies.\textsuperscript{175} The $5,000,000 aggregate offering price\textsuperscript{176} is the subject of an aggregation rule like that applicable to Rule 504.\textsuperscript{177} Rule 505 is limited to no more than 35 non-accredited purchasers, who do not have to meet any express suitability standards.\textsuperscript{178} An unlimited number of accredited investors can participate in a Rule 505 offering. The information which must be disclosed is spelled

\textsuperscript{165} Id. at § 230.503.
\textsuperscript{166} Rule 503(a) requires the issuer to file with the SEC five copies of a notice on Form D (1) no later than 15 days after the first sale, (2) every six months after the first sale, unless the final notice has been filed, and (3) no later than 30 days after the last sale. Id. at § 230.503(a).
\textsuperscript{167} Id. at § 230.503(d).
\textsuperscript{168} Id. at § 230.504.
\textsuperscript{169} Id.
\textsuperscript{161} Id. at § 230.504(a).
\textsuperscript{170} Id. at § 230.504(b)(1).
\textsuperscript{171} Id.
\textsuperscript{172} Id. at § 230.504(b)(2)(i).
\textsuperscript{173} Id. at § 230.505.
\textsuperscript{174} Id.
\textsuperscript{175} Id. at § 230.505(a).
\textsuperscript{176} Id.
\textsuperscript{177} Compare 17 C.F.R. § 230.505(b)(2)(i) (1982) with 17 C.F.R. § 230.504(b)(2)(i) (1982). (Both rules require that the aggregate offering price be below a specified amount in order for the exemption to be valid; $5,000,000 in Rule 505, and $500,000 in Rule 504).
\textsuperscript{178} Rules, supra note 150, at § 230.505(b)(2)(ii).
out in Rule 502(b)\textsuperscript{179} in detail. Essentially, the Rule 505 non-accredited investor must receive the same information as would be required in Form S-18, if that form can be used by the issuer, or Part I of an applicable registration statement;\textsuperscript{180} however, some leeway is provided to delete immaterial information.\textsuperscript{181}

Rule 506,\textsuperscript{182} which replaces Rule 146, is available to any issuer.\textsuperscript{183} Like Rule 505, there is a "good faith" limitation to 35 non-accredited purchasers,\textsuperscript{184} however, there is an additional requirement, carried over from Rule 146,\textsuperscript{185} that the Rule 506 non-accredited investor, either alone or with his purchaser representative, be sophisticated.\textsuperscript{186} The "ability to bear the economic risk" test of Rule 146 has been deleted. Consistent with the tiered informational scheme of Regulation D, the Rule 506 issuer must furnish to each non-accredited investor the same kind of information as would be required in Part I of a registration statement filed under the Securities Act on the form which the issuer would be entitled to use.\textsuperscript{187}

The informational requirements for Exchange Act reporting companies are the same for both Rule 505 and Rule 506\textsuperscript{188} and are similar to those for reporting companies under old Rule 146.\textsuperscript{189} Further, under both Rules 505 and 506, any issuer must furnish to non-accredited investors, prior to sale, a written description of any written information provided to any accredited investor and,

\textsuperscript{179} Id. at § 230.502(b).
\textsuperscript{180} Id. at § 230.502(b)(2)(i)(A).
\textsuperscript{181} Rule 502(b)(2)(i), which controls the type of information to be furnished by an issuer not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, requires the specified information be furnished "to the extent material to an understanding of the issuer, its business and the securities being offered." Id. at § 230.502(b)(2)(i).
\textsuperscript{182} Id. at § 230.506.
\textsuperscript{183} Id. at § 230.506(a).
\textsuperscript{184} Id. at § 506(b)(2)(i).
\textsuperscript{185} See supra text accompanying note 73.
\textsuperscript{186} Rule 505(b)(2)(ii) requires the issuer to "reasonably believe immediately prior to making any sale that each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." Rule, supra note 150 at § 230.506(b)(2)(ii).
\textsuperscript{187} Id. at § 230.502(b)(2)(i)(B).
\textsuperscript{188} Rule 502(b)(2)(ii) requires the issuer subject to the reporting requirements of section 13 or 15(d) of the Exchange Act to furnish either (A) the issuer's annual report to the shareholders for the most recent fiscal year (if the annual report meets certain conditions), the definitive proxy statement filed in connection with that annual report, and, if requested by the purchaser in writing, a copy of the issuer's most recent Form 10-K under the Exchange Act; or (B) the information contained in an annual report on Form 10-K or in a registration statement on Form S-1, whichever filing is the most recent required to be filed; and, in either event, (C) the information contained in any reports or documents required to be filed by the issuer under sections 13(a), 14(a), 14(c), and 15(d) of the Exchange Act since the distribution or filing of the report or registration statement specified in (A) or (B), and a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs that are not disclosed in the documents furnished. Id. at § 230.506(b)(2)(ii).
\textsuperscript{189} Compare Rule 502(b)(2)(ii) with Rule 146(e)(1)(a)(1), supra note 81. (See supra text accompanying notes 81, 82).
if requested in writing, must actually furnish that information to the non-accredited investor. Moreover, under both rules, the issuer must extend to each purchaser, whether accredited or non-accredited, at a reasonable time prior to sale, the opportunity to ask questions, receive answers and obtain additional information, to the extent such additional information is reasonably available to the issuer.

Although definitive commentary upon the extent to which the SEC accomplished its goals with Regulation D must await the workings of the courts and administrative interpretations, certain initial observations are in order. The Rule 504 exemption should prove to be salutary in that it results in simplified disclosure requirements, imposes no specific suitability standards and contains no limitation upon the number of purchasers. The aggregation rules potentially limit Rule 504's usefulness but the aggregate sales price limitation under Rule 504 is nevertheless five times greater than that of its immediate predecessor, Rule 240. The absence of any specific disclosure requirement may actually create a quandary for the promoter, however, because Rule 504 is an exemption from registration only, it is not an exemption from the anti-fraud provisions. The marketing of any security these days requires some disclosure, and, in order to avoid having the disclosed information found to be misleading due to the absence of other information, the diligent promoter must always consider "spilling his guts." Thus, the simplified disclosure requirement may not be so simple. Nonetheless, the SEC seems to have enhanced the process of capital formation for the small venture via Rule 504, however, the response of the states to the initiative will determine the extent to which simplification is achieved in reality.

The general nature of the tiered informational requirements of Rules 505 and 506, conceptually at least, evidence an attempt by the SEC to balance the needs of investors and issuers. Such a cost-benefit approach seems true to the wishes of Congress. The absence of a sophistication test for non-accred-

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190 Rules, supra note 150, at § 230.502(b)(2)(ii).
191 Id. at § 230.502(b)(2)(v).
192 47 Fed. Reg. 11,251 (1982). Preliminary Note 1 to Regulation D.
193 See generally Mosburg, supra note 35, at 84-103.
194 Because Regulation D provides an exemption from registration under the federal Securities Act only, state registration or exemption-qualification requirements, to the extent incompatible with the Regulation D exemption, will negate the advantages achieved under Regulation D.
195 "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. Securities Act Release No. 6389, 47 Fed. Reg. 11,251 (1982) (footnote omitted). The new regulation is designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions in order to facilitate capital formation consistent with the protection of investors." Id.
ited investors in Rule 505 enables the issuer to avoid federal problems with purchasers of marginal investment acumen. Likewise, the comparatively less stringent informational requirements of Rule 505 affords the issuer an alternative to the more stringent requirements of Rule 506; however, state disclosure requirements could dilute the advantage. The dollar limitation of Rule 505 is a disadvantage in comparison to Rule 506, but, then again, $4,999,999.99 is not chicken feed, even in these inflationary times. A possible hidden disadvantage of Rule 505 is that, because it is based on section 3(b) rather than section 4(2), it is presumably subject to the Federal Reserve Board's Regulation T restrictions upon the use of leveraging techniques. Due to the extreme significance of leverage in real estate offerings, this potential disadvantage is significant.

Rule 506, the new section 4(2) exemption, has retained the exemptive criteria of Rule 146, except for the "ability to bear the economic risk" test with respect to non-accredited investors and the express need to qualify offerees; however, the cautious promoter will appreciate the foolhardiness of totally disregarding the investment acumen and financial ability of every potential investor. Accordingly, the supposed simplification of qualification under Rule 506 in contrast to former Rule 146 is relative only, but, by the same token, the "needs of the issuer" argument begins to break down when more than $5,000,000 is being raised. The major advantages of Rule 506 are the absence of a dollar limitation and the absence of the aggregation rules applicable to Rule 504 and 506.

The chief importance of Regulation D in the context of an analysis of the West Virginia Uniform Securities Act is the background of cooperation between the SEC and the Small Business Financing Subcommittee of NASAA in the development of Regulation D and NASAA's proposed Uniform Limited Offering Exemption and, especially, the assumptions of those bodies with respect

198 Regulation T essentially provides that unregistered securities have no loan value; consequently, a federal bank or other lending institution subject to the rules and regulations of the Federal Reserve Board cannot extend credit to a limited partnership or other tax-shelter program for the purpose of enabling the limited partners or investors to purchase or carry the securities. That limitation does not apply, however, when the security transaction is exempt from the registration requirements of the Securities Act by virtue of section 4(2) of the Act. 12 C.F.R. §§ 220.7(a)(2), 220.8, 220.124 (1982).
199 Leverage, in a tax-shelter real estate program, is the use of debt to achieve tax benefits in excess of an investor's initial cash contribution. For example, if a limited partner of a real estate limited partnership purchases a $100 limited partnership unit for $1 cash and a $99 promissory note, he may be able to claim and achieve tax benefits (e.g., investment tax credit, depreciation, deduction of losses, etc.) upon the basis of $100, which could yield current writeoffs several times in excess of his actual cash contribution. The "at risk" provisions of the Tax Reform Act of 1976 and the Economic Recovery Tax Act of 1981 have somewhat tempered the benefits of leverage, however, by limiting the investor's current deductibility of losses and current use of the investment tax credit to the extent to which he is "at risk" on his contribution, e.g., the holder of the note has recourse against the personal assets of the investor. Weller, The "At Risk" Rules: A New Consideration for Tax Shelter Investments and Partnership, NYU Thirty-Sixth Annual Institute on Federal Taxation 1351, 1356 (1978); Messinger, Developments and Anomalies in the At-Risk Rules, NYU Fortieth Annual Institute on Federal Taxation 18-1 (1992).
to the future of relevant regulation. The Uniform Limited Offering Exemption recommended by NASAA to its members, in terms, relates only to Rule 505. It is silent with respect to Rules 504 and 506. The assumption behind the scheme was that offerings below $500,000 would be primarily regulated by the states upon the premise that offerings below that amount represent local financings. In that regard, SEC Rule 504 exists to establish minimal investor protections in the event an issuer is able to evade state regulation. Rule 505 and the NASAA proposed Uniform Limited Offering Exemption are designed to subject intermediate-size offerings to compatible federal and state regulation and, if the uniform exemption is implemented in a substantial number of states, nearly uniform state exemptions. The proposed uniform exemption contains optional conditions so as to accommodate differing regulatory philosophies of the various states, but subject to those conditions, the design is to achieve a fully coordinated state and federal exemption for intermediate offerings. The Uniform Limited Offering Exemption contains no provisions for offerings in excess of $5,000,000. Earlier drafts of the uniform exemption did cover Rule 506, as initially proposed, but the relevant provisions were deleted "not because of any flaws in the exemption or negative judgments by the committee, but merely that . . . it seemed beyond the small business scope of the committee." Thus, the clear assumption of NASAA was that large offerings would be principally federally regulated. Given the proliferation of exemptive rules promulgated by a federal agency and forty-nine states, it is clearly appropriate and hopefully beneficial for small offerings to be regulated locally, for intermediate offerings to be regulated in a compatible manner by state and federal governments, and for large offerings to be federally regulated.

III.

State "blue sky" laws predated the enactment of the Securities Act in 1933. Unlike other examples of significant federal regulation pursuant to the Commerce Clause, state regulation of securities transactions was not preempted by the Securities Act. Perhaps that was a mistake because a major feature of securities regulation in the United States since then has been the

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201 Mosburg, supra note 35, at 457.
203 Id.
204 Id.; Mosburg, supra note 35, at 453.
205 Mosburg, supra note 35, at 455.
208 E.g., the Motor Carrier Act of 1940 was held to preclude states from suspending an interstate carrier's right to use their highways for violations of state highway regulations in Castle v. Hayes Freight Lines, 348 U.S. 61 (1954). See generally Note, Pre-Emption As A Preferential Ground: A New Canon of Construction, 12 STAN. L. REV. 208 (1959).
redundancy of multiple regulatory regimes. The “blue sky” laws also require securities to be registered before they are offered for sale, unless an exemption from registration is available.210 In this context, an offering made only in one state may qualify for the federal exemption of section 3(a)(11) of the Securities Act; however, the courts and the SEC have rendered reliance on the intrastate exemption an extremely risky proposition.211 The difficulties with the intrastate exemption are particularly applicable in West Virginia, where most of the metropolitan areas from which securities offerings are likely to emanate are located at or relatively near the borders of adjoining states.212

There is some form of exemption from registration for a limited offering in the vast majority of the states.213 These exemptions are generally of the following varieties: (1) exemptions framed by the number of offerees214 or the number of buyers,215 (2) exemptions framed by the number of outstanding security holders of the issuer,216 (3) exemptions dually framed by the number of buyers and/or a dollar amount,217 and (4) an “isolated transaction” exemption.218 Some state statutes have more than one of these variants.219 Additionally, the statutes of many states proscribe220 or limit221 the payment of commissions or other remuneration in connection with an exempted offering.

The present West Virginia statute (“the Act”) is a version of the Uniform Securities Act222 and was enacted in 1974223 without substantial modification from the draft approved by the Conference of Commissioners on Uniform State Laws and the American Bar Association in 1956. The Act is divided into four principal parts:224 Article 1225 dealing with fraudulent and other prohibited practices; Article 2228 dealing with the registration of broker-dealers, agents and investment advisers; Article 3227 dealing with the registration of se-

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210 E.g., W. VA. CODE § 32-3-301 (1982).
212 Several of the metropolitan areas of West Virginia are within five minutes of other states, e.g., Huntington, Parkersburg, Wheeling, Morgantown, Martinsburg and Bluefield. Others are within one hour of other states, e.g., Charleston, Beckley, Clarksburg and Fairmont. Thus, the problem of controlling where an offering comes to rest is particularly acute.
213 Mofsky, supra note 3, at 276.
215 Id. at 125.
216 Id. at 126.
217 Id.
218 Id. at 127.
219 Mofsky, supra note 3, at 278.
220 E.g., W. VA. CODE § 32-4-402(b)(9) (1982).
221 See infra notes 269-70.
223 Id. at 15 n.2.
224 Id. at 19.
227 W. VA. CODE §§ 32-3-301 to -306 (1982).
Section 301 of the Act is the conceptual counterpart of section 5 of the Federal Securities Act and established the general rule that it is unlawful "for any person to offer or sell any security in this State unless (1) it is registered under this chapter or (2) the security or transaction is exempted under section 402." Section 301 provides three methods of registration: registration by notification, registration by coordination, and registration by qualification. Registration by qualification, or "full-blown" registration, is the only method which is always available. Registration by coordination is available for any security, the offering of which is being contemporaneously registered under the Federal Securities Act. Registration by notification is of limited usefulness for the primary issuance of securities by the fledgling enterprise, however, the apparent availability of this procedure for secondary transactions in non-mineral securities potentially offers the purchaser of unregistered securities a means of liquidating his investment under state law, albeit at some expense. Registration by qualification is not effective until the commissioner of securities so orders and, a registration statement pursuant to any of the methods remains effective for one year, unless the offering continues for a longer period.

Section 402 of the Act grants exemptions from registration to twelve types of securities and to twelve types of transactions. As is the case with

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228 W. VA. CODE §§ 32-4-401 to -418 (1982).
229 W. VA. CODE § 32-4-402 (1982).
230 W. VA. CODE § 32-4-409 (1982).
231 W. VA. CODE § 32-4-410 (1982).
233 W. VA. CODE § 32-3-301 (1982).
234 W. VA. CODE § 32-3-302 (1982).
236 W. VA. CODE § 32-3-304 (1982).
237 W. VA. CODE § 32-3-304(a) (1982), provides: "Any security may be registered by qualification."
238 W. VA. CODE § 32-3-303(a) (1982).
239 Issuer registration by notification is limited to securities, other than a security with a fixed maturity or a fixed interest or dividend provision, whose issuer and any predecessors have been in continuous operation for at least five years if certain additional conditions are satisfied. W. VA. CODE § 32-3-302(a)(1) (1982).
240 W. VA. CODE § 32-3-302(a)(2) (1982), authorizes registration by notification for: Any security (other than a certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease) registered for non-issuer distribution if (A) any security of the same class has ever been registered under this chapter or a predecessor act, or (B) the security being registered was originally issued pursuant to an exemption under this chapter or a predecessor act.
241 The Auditor is the ex officio Commissioner of Securities. W. VA. CODE § 32-4-406(a) (1982).
242 W. VA. CODE §§ 32-3-304(e), -305(i) (1982).
243 W. VA. CODE § 32-4-402 (1982).
244 W. VA. CODE § 32-4-402(a) (1982); see generally, Tompkins, supra note 222, at 34-35.
245 W. VA. CODE § 32-4-402(b) (1982); Tompkins, supra note 222, at 35-37.
the Federal Securities Act, an exemption from registration does not constitute an exemption from the anti-fraud provisions and the broker-dealer registration provisions of the Act.246

The West Virginia limited offering exemption is found in section 402(b)(9)247 and is the literal duplicate of the version approved for adoption by the states in 1956.248 As the draftsmen's commentary discloses, the approved version of the limited offering exemption was the product of a substantial number of redrafts and a great deal of discussion, with the result being a compromise palatable to those states which had no analogous exemption at all.249 The draftsmen, who felt that "some exemption along these lines is essential in any well-ordered blue sky law . . .",250 rationalized the end result aptly: "half . . . of a uniform loaf is better than none."251 Notwithstanding the existence of an arguably broader exemption under the previous West Virginia statute252 and the fact that a substantial number of other states which adopted a variant of the Uniform Securities Act saw fit to increase the offeree limitation above the number provided in the draft,253 West Virginia adopted the provision as written.

The exemption is as follows:

Any transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in subdivision (8)) in this State during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this State, if (A) the seller reasonably believes that all the buyers in this State (other than those designated in subdivision (8)) are purchasing for investment, and (B) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this State (other than those designated in subdivision (8)); but the commissioner may by rule or order, as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in clauses (A) and (B) with or without the substitution of a limitation on remuneration.254

The exemption has not yet been judicially construed in West Virginia. Likewise, the Commissioner has not promulgated any rules related to the ex-

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246 In terms, the exempted securities and exempt transactions relate only to the registration requirement of section 301 of the Act and the requirement of section 403 of the Act to file with the Commissioner, before use, any prospectus, circular or like sales literature intended for distribution to prospective investors. W. VA. CODE § 32-4-402(a), (b) (1982).
250 Id.
251 Id.
252 See Tompkins, supra note 222, at 36 & n.68.
254 W. VA. CODE § 32-4-402(b)(9) (1982).
emtion, despite the statute's invitation for him to do so. Consequently, a search for the precise scope of the exemption must begin and end with the naked words of the statute and the few judicial decisions of other jurisdictions construing similar exemptions.

The exemption is clearly conditioned upon the seller's reasonable belief regarding the investment intent of the buyers and upon the absence of commissions or other payments for soliciting buyers; however, those conditions do not apply if the buyer is a bank, savings institution, insurance company or any of the other specified institutional investors, or if the buyer is a broker-dealer. The limitation upon the number of persons clearly seems to focus upon the number of oferees, including those who decide not to buy the security, rather than the number of buyers. The "offeree" orientation is difficult to digest in the absence of limitations upon the manner of the offering. If the legislature intended to create a state counterpart to the private offering exemption of section 4(2) of the Federal Securities Act, it could have more clearly expressed itself on the point.

Neither the offeror nor any of the oferees need be present in the State for the exemptive conditions to apply, so long as the "transaction pursuant to any offer," i.e., the offering, is "directed . . . in this State." A reading of Upton v. Trinidad Petroleum Corp. will quickly dispel any notions that the exemption necessarily applies when no more than ten offers are made in West Virginia. The occasion for constructional difficulty in this regard arises from the location in the statute of the words "in this State." The Upton court, which relied heavily on input from the Director of the Alabama Securities Commission, effectively construed the identical Alabama exemption such that the antecedent for "in this State" is "transaction," rather than "ten persons." Another court has implicitly construed the statute in the contrary manner, which seems more consistent with the expectations of the draftsmen.

W. Va. Code § 32-4-402(b)(9) (1982) says, in part, "[t]he commissioner may by rule or order . . . withdraw or further condition this exemption, or increase or decrease the number of oferees permitted, or waive the conditions in clause (A) and (B). . . ." Id. at § 32-4-402(b)(9).

The "persons" designated in subdivision (8) are "a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or . . . a broker-dealer. . . ." W. Va. Code § 32-4-402(b)(9) (1982).

W. Va. Code § 32-4-401(c) (1982) defines a "broker-dealer" as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account."

Indeed, the statute expresses that it is the "number of oferees" on which the exemption turns. W. Va. Code § 32-4-402(b)(9) (1982).

Although the term "offeror" is not defined, it presumably embraces more than the issuer and probably would be held to include anyone who acted on behalf of the issuer in effecting an offer or sale of the issuer's securities. Cf. Hippensteel v. Karol, 159 Ind. App. 146, 304 N.E.2d 796 (1973).


Id. at 335.


"[T]here is no limit on the total number of oferees as long as it does not exceed ten 'in this state'. . . ." L. Loss, COMMENTARY ON THE UNIFORM SECURITIES ACT 129 (1976).
Nevertheless, because of *Upton*, the cautious promoter who desires to raise venture capital via the primary issuance of unregistered securities will rely upon the 402(b)(9) exemption at his peril when the offering is directed to more than ten persons and any one of those offers occurs in West Virginia.\(^{265}\) *Upton* cannot be dismissed lightly as aberrant authority in the absence of action by the legislature, the Commissioner or the courts. The resulting uncertainty renders the exemption unworkable.

The section 402(b)(9) proscription against the payment of commissions or other remuneration for soliciting buyers is not unusual.\(^{266}\) The apparent purpose of such prohibitions in “blue sky” laws is to prevent a dilution of the investors’ equity\(^{267}\) - a salutary purpose - but, in the absence of definitional content in the West Virginia statute regarding who cannot be paid for what, the wisdom of the prohibition is questionable if it purports to prevent the payment of commissions to registered broker-dealers or investment bankers. Given the manifest complexities inherent in effecting an unregistered offering of securities under federal and state regulation, securities professionals are eminently better qualified than the typical promoter of a business venture to engineer the offering and place the securities with suitable investors from among their clients or contacts. Moreover, the investment industry’s suitability rules tend to deter an ill-matching of investor with investment when broker-dealers subject to the various rule-making bodies are involved.\(^{268}\)

An alternative exists. Other states such as Ohio\(^{269}\) and Virginia\(^{270}\) permit the payment of brokerage commissions but control the amount and limit the payment to broker-dealers who are registered in the state. Presumably, disclosure of the fact of participation of a broker-dealer or an investment banker and the amount of his fee is deemed to be adequate protection for investors in those states and, it is submitted, such practice could indirectly lead to competitive fees with consequent benefit to the investor and the issuer.\(^{271}\) In any event, the dilution of the investor’s equity which results from the compensation of a securities professional for his services should be less detrimental to the public in the long-run than the potential consequences of denying his services to the promoter. There is no societal benefit in forcing the promoter of a fledgling enterprise to grope in the dark for investors once he has exhausted his friends and acquaintances, when the supervening law imposes devastating liability upon innocent mistakes. Consequently, either by administrative rule

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\(^{265}\) As W. VA. Code § 32-4-414(a) (1982) clearly discloses, the registration requirement of the Act does not turn on whether an investor or an issuer is a resident of this state. Rather, the registration requirement applies when an offer to sell is made, or an offer to buy is made and accepted, in West Virginia. Hence, the availability of an exemption from registration should turn on the number of offers to sell that are made, and offers to buy that are made and accepted, in West Virginia; and, as W. VA. Code § 32-4-414(c) (1982) discloses, neither party must be physically located in West Virginia when the offer occurs.

\(^{266}\) Mofsky, *supra* note 3, at 278.

\(^{267}\) Id.

\(^{268}\) See Soraghan, *supra* note 47, at 22, 23.

\(^{269}\) OHIO REV. CODE ANN. §§ 1707.03(O)(5) and (6), (Q) (2) and (3) (Page Supp. 1981).


\(^{271}\) Mofsky, *supra* note 3, at 279.
or by amendment to the statute, it should be made clear that brokerage commissions paid to registered broker-dealers are permissible.

The most deplorable aspect of the West Virginia limited offering exemption is that the Commissioner has not clarified the application of the exemption or sought to make it more workable by administrative rule. The statute clearly gives him the authority to do so, and the draftsmen of the Uniform Securities Act expected that the authority would be utilized. For example, the Official Comment to section 402(b)(9) of the Uniform Securities Act states that "[t]he figure ten is in substance only a prima facie figure." If the Commissioner's purpose in leaving the scope of the exemption uncertain and unworkable is to prompt the diligent promoter to register, he has missed the mark. The function of registration is the disclosure of information deemed appropriate to an informed investment decision. As the federal experience clearly discloses, securities administrators can require the disclosure of information by conditioning an exemption in that manner. Moreover, the Commissioner would not lose his influence or his ability to protect the public by making an exemption from registration more certain and more workable because, unlike the SEC, he has the express power to regulate the merits of an offering, whether registered or exempt, irrespective of the sufficiency of compliance with disclosure requirements. Therefore, the Commissioner's abrogation of his authority to clarify and make more workable the exact application of the limited offering exemption by interpretative rules is particularly disappointing.

IV.

The SEC's invitation to the states to principally regulate small offerings of securities and NASAA's proposed Uniform Limited Offering Exemption for intermediate size offerings provide an initiative to improve the present West Virginia limited offering exemption. Given the uncertain and restrictive nature of the West Virginia exemption, the need to do so is clear. The substantial policy question is how to proceed. The answer to that question can be found in the principal distinction between the federal Securities Act and state blue sky laws. State securities administrators have substantive authority to regulate the merits of securities offered for sale in their states, notwithstanding compliance with the disclosure requirements of a registration statement or an available exemption. Federal administrators have no such authority.

State blue sky laws were, in essence, the first consumer protection statutes. Early definitions of the word "security" in state securities laws were generally limited to the traditional forms of securities, such as stocks and bonds. In response to the questionable investment schemes which arose during World War I and thereafter, the definition of a security was expanded to fash-

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272 L. Loss, COMMENTARY ON THE UNIFORM SECURITIES ACT 128-29 (1976).
273 Id. at 124.
274 See, e.g., supra note 188.
275 W. VA. CODE § 32-3-306(a)(E), (F) (1982).
276 Long, supra note 207, at 548.
277 Id. at 543.
ion a remedy. As a result of this evolutionary process, state securities laws were able to squelch such schemes as the fraudulent sale of commodity option contracts, the Glenn Turner “Ponzi” schemes, pyramid arrangements in the sale of memberships in discount department stores, and worm farms. Indeed, with the SEC’s focus on the national securities markets and the narrowing scope of jurisdiction in the federal courts, the substantive regulation of exotic securities has been effectively delegated to the states. Such allocation of responsibility fashions a proper, efficient role for both levels of government in an otherwise redundant system of securities regulation. Fraudulent investment schemes are best regulated, however, through broadly interpreting the definition of a security and through enforcing the anti-fraud and merit regulation provisions of the Act, rather than through registration.

Recognition of a proper scope of state securities regulation does not negate the public benefit of disclosure of information, which function is served through registration or through conditioning an exemption upon an appropriate disclosure requirement. What is appropriate, however, depends upon a balancing of the needs of business and the needs of the investing public. The SEC implicitly acknowledged the point via the tiered informational requirements of Regulation D. The new Rule 504 has no specific disclosure requirement because, in the SEC’s view, equity financings of less than $500,000 are local in nature and, accordingly, should be regulated by the states in accordance with their regulatory philosophies.

The best statement of West Virginia’s regulatory philosophy is found in section 415 of the Act which embodies the Legislature’s intent to make the securities laws of West Virginia uniform with the laws of other states which enact the Uniform Securities Act and compatible with related federal regulation. In other words, the Legislature realized that, securities-wise, the Free State of West Virginia does not exist.

A. Proposed Small Offering Exemption

The Uniform Securities Act has been adopted by at least thirty-three

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278 Id.
279 Id.
283 Long, supra note 207, at 543, 545.
285 Long, supra note 207, at 545.
287 W. VA. CODE § 32-4-415 (1982).
288 Id.
states, the District of Columbia and Puerto Rico. A number of jurisdictions have tinkered with the draft of the limited offering exemption of section 402(b)(9), including every state which borders West Virginia which has adopted some variant of the act. Kentucky raised the prima facie figure from 10 to 25, and, by administrative regulation, the Kentucky administrator supplemented the statute with Rule 146-like requirements. The Pennsylvania statute limits offerees to fifty and purchasers to twenty-five and requires a written investment representation from each purchaser. The Pennsylvania statute also exempts securities sold by Exchange Act reporting companies pursuant to transactions which would be exempt under section 3(b) of the federal Securities Act. The Maryland statute permits up to thirty-five purchasers, but only when the administrator permits the same by rule or order, which he has done with a Rule 146-like rule. The Virginia exemption is framed in terms of the number of outstanding security holders (thirty-five) following the sale, which can be made by the issuer or a broker-dealer registered in Virginia. Ohio is the only bordering state which has not adopted some version of the Uniform Securities Act but nevertheless exempts transactions which would be exempt under section 4(2) of the federal Securities Act so long as brokerage commissions are paid only to broker-dealers registered in Ohio and do not exceed ten percent of the aggregate sales price. Thus, the West Virginia limited offering exemption is more restrictive than those of surrounding states. The statutory policy of uniformity calls for an increase in the number of permissible investors under the section 402(b)(9) exemption and, given the prevalence of the number twenty-five, that number emerges as appropriate. Moreover, given the inapplicability of the private offering concept to the state act, the fact that the more analogous federal exemption turns on purchasers, not offerees, and the fact that present section 402(b)(9) does not purport to regulate the manner of the offering, the exemption would be more workable for issuers, without diluting public protection, if the limitation is imposed upon the number of purchasers, rather than the number of offerees. Finally, the frightening holding of Upton should be obviated by clarifying that the numerical limitation of the exemption turns upon the number of persons who are residents of this state, rather than are prospective investors or purchasers, wherever located. The State of West Virginia should not be unduly concerned

291 Id. at § 1-203(e) (Purdon 1972).
292 Id. at § 1-203(d).
293 Id. at § 1-203(i).
294 Id. at § 1-203(j).
298 Id.
300 Id. at § 1707.03(Q)(3).
301 Id. at § 1707.03(Q)(2).
302 See supra text accompanying note 178.
with protecting investors from Alabama.

The proposed increase in the number of permissible investors does not undercut the Commissioner's administrative authority to further condition the exemption. NASAA has promulgated a number of policy statements for particular types of offerings which are generally either tax-shelter oriented or speculative in nature. These NASAA policy statements generally control organizational and offering expenses, establish net worth requirements for sponsors and suitability criteria for investors and limit the compensation

304 E.g., real estate investment programs, oil and gas drilling programs, and cattle-feeding programs.

305 NASAA's Guidelines for the Registration of Oil and Gas Programs, adopted September 22, 1976, and subsequently amended on October 12, 1977, and October 31, 1979, provides, at paragraph V.A.1, that "...organization and offering expenses incurred in order to sell program units shall be reasonable, and the total of those organization and offering expenses, which may be charged to the program, plus any management fee, which may be charged by the sponsor, shall not exceed 15% of the initial subscriptions." 1 BLUE SKY L. REP. (CCH) ¶ 5226 (1981).

306 NASAA's Statement of Policy for Real Estate Programs, adopted April 15, 1980, and amended effective March 30, 1982, provides, at paragraph II.B.: The financial condition of the SPONSOR liable for the debts of the PROGRAM must be commensurate with any financial obligations assumed in the offering and in operation of the PROGRAM. As a minimum, such SPONSOR shall have an aggregate financial NET WORTH, exclusive of home, automobile and home furnishings, of the greater of either $50,000 or an amount at least equal to 5% of the gross amount of all offerings sold within the prior 12 months plus 5% of the gross amount of the current offering, to an aggregate maximum NET WORTH of such SPONSOR of one million dollars. 1 BLUE SKY L. REP. (CCH) ¶ 5362 (1982).

307 NASAA's Guidelines for the Registration of Oil and Gas Programs provides, at paragraph IV.B.(2): The sponsor and/or his representatives shall make every reasonable effort to ascertain that the participant can reasonably benefit from the program, and the following shall be evidence thereof:

(a) The participant has the capacity of understanding the fundamental aspects of the program, which capacity may be evidenced by the following:
(1) The nature of employment experience;
(2) Educational level achieved;
(3) Access to advice from qualified sources, such as attorney, accountant and tax adviser; and
(4) Prior experience with investments of a similar nature.

(b) The participant has apparent understanding:
(1) of the fundamental risks and possible financial hazards of the investment; and
(2) the lack of liquidity of the investment.

(c) The participant is able to bear the economic risk of the investment and can reasonably benefit from the program, on the basis of his net worth and taxable income. For purposes of determining the ability to bear the economic risk and to reasonably benefit from the program, unless circumstances warrant and the Administrator allows another standard, a participant shall have:
(1) a net worth of $225,000 or more (exclusive of home, furnishings and automobiles), or
(2) a net worth of $60,000 or more (exclusive of home, furnishings and automobiles) and had during the last tax year, or estimates that he will have during the current tax year, 'taxable income' as defined in Section 63 of the Internal Revenue Code of 1954, as amended, of $60,000 or more, without regard to the investment in the program. 1 BLUE SKY L. REP. (CCH) ¶ 5225 (1981).
of insiders. Such policy statements provide tools for regulating speculative securities, without affecting the general exemptive criteria applicable to all issuers.

As to the disclosure of information, it seems clear that summary disclosure, coupled with the right to verify the information provided, should suffice for the small offering. The predicate of the Regulation D informational requirements - "to the extent material to an understanding of the issuer, its business, and the securities being offered" provides an appropriate scope of required disclosure. Thus, a small offering disclosure statement should include such things as the type of business entity, the issuer's principal place of business, its key personnel, the types of business it has conducted, its present financial condition, the particular purpose or goals of the financing (i.e., the venture), the amount of the financing, the intended use of the proceeds (including commissions and the like), the nature of the security being offered, the rights which will inure to the security holders, the limitations, if any, upon those rights, the obligations, if any, of the security holder, and the restrictions imposed upon the liquidity of the investment. For the burden upon the issuer to be realistic in the small offering situation, financial statements should not have to be audited; erroneous or misleading information can be remedied via the anti-fraud provisions. Additionally, to the extent that the required information can be furnished by a specimen or by an exhibit, such practice should be allowed.

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309 NASAA's Guidelines for the Registration of Oil and Gas Programs requires that the sponsor's participation in program revenues be "reasonable" and sets forth detailed standards for determining what is reasonable. 1 Blue Sky L. REP. (CCH) ¶ 5226 (1981). NASAA's Statement of Policy for Real Estate Programs contains detailed constraints on sponsors' compensation in the forms of program management fees, promotional interests, and property management fees. 1 Blue Sky L. REP. (CCH) ¶ 5364 (1982).
310 See supra note 181.
311 E.g., corporation, partnership, joint venture, investment trust.
312 E.g., directors, officers, partners, managers.
313 I.e., current balance sheet.
314 E.g., common or preferred stock, partnership interest.
315 E.g., right to vote, right to preferential receipt of dividends, right to prorata share of net profits.
316 E.g., dividends declared only at discretion of board of directors, no right to manage or control.
317 See, e.g., supra note 163.

   It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly
   * * *

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading;

W. Va. Code § 32-4-410(a)(2) (1982) creates a civil right of action in a purchaser to remedy an offer or sale of a security by means of an untrue or misleading statement of material fact.
319 E.g., a copy of the stock offering resolution or a copy of the limited partnership agreement.
320 E.g., a map, a balance sheet, a copy of the issuer's contract for distribution of the resulting product, etc.
One final point should be made with respect to the disclosure of information. The present exemption does not require any disclosure; the proposal recommends the summary disclosure of minimal information. In theory, at least, the increased protection of investors occasioned by such a requirement should have the additional advantage of prompting the disclosure of still more information not expressly required because the anti-fraud provision of the Act\textsuperscript{321} proscribes the omission of a material fact necessary to make the statements actually made not misleading. Thus, given the fraud prevention function of state securities regulation, the efficient thrust of a disclosure requirement should be to assure that one exists. Once a minimally sufficient disclosure requirement is in place, the anti-fraud provisions should take over and the precise scope of the express requirement is largely a matter of trivial detail.

Finally, the present prohibition upon the payment of brokerage commissions, if the statute was intended to be so construed, should be deleted. The valuable function served by a securities professional should not be denied to the promoter. Instead, if the Legislature or the Commissioner feels that the security holders' equity should be protected, then diversion of the offering proceeds to solicitors of investors should be limited to broker-dealers and other securities professionals registered in West Virginia and, if necessary, the commission could be limited to a specified percentage of the aggregate sales price. The State should view securities professionals as revenue-generating persons, not pariahs.

Thus, an appropriately refashioned "small offering" exemption for West Virginia could be framed as follows:

(1) Sales of securities of the issuer pursuant to the transaction should be limited to not more than twenty-five persons who are residents of this State;

(2) Information regarding the issuer, its business and the securities should be furnished in summary form, without any requirement for audited or certified financial statements, before the sale to each investor, and each investor should have the opportunity to ask questions and inspect records so as to verify the information furnished;

(3) Brokerage commissions should be allowed with respect to sales to West Virginia residents, but could be limited as to amount and be payable only to broker-dealers or other professionals registered in West Virginia; and

(4) The Commissioner should have the authority to promulgate additional exemptive criteria for speculative securities.

In this manner, the exemption can be made more certain and more workable without creating an undue burden of compliance for promoters of small equity financings, while, at the same time, enhancing the protection of investors. Moreover, the Commissioner's substantive authority to regulate the merits of an offering is always available to squelch the fraudulent schemes.

\textsuperscript{321} W. VA. CODE § 32-1-101 (1982).
B. Proposed Intermediate Offering Exemption

The Uniform Limited Offering Exemption ("ULOE") recommended to the states by NASAA is designed to achieve the twin objectives of uniformity among the states and compatibility with the federal Rule 505 exemption from registration for intermediate size offerings.\textsuperscript{322} Like Regulation D, ULOE manifests a balancing of the needs of the business community to facilitate capital formation with the needs of the investing public for protection. Notably, NASAA apparently perceived the role of ULOE in investor protection as one of protecting against fraud, rather than uninformed investment decisions,\textsuperscript{323} which perception presumably arises from the recognition that qualification for the compatible federal exemption - Rule 505 - requires disclosure of the kind of information contained in Form S-18 or Part I of an applicable registration statement.\textsuperscript{324} In any event, NASAA seems to accept fraud prevention as the proper scope of securities regulation at the state level, which is consistent with the theme of this article.

The implementation of ULOE would require both legislative action and administrative action. The proposed legislative action is the grant of authority to the securities administrator to create a "limited offering transactional exemption. . . ."\textsuperscript{325} Thereafter, NASAA proposes, the securities administrator is to take over and promulgate a rule exempting from registration "[a]ny offer or sale of securities offered or sold in compliance with. . . Regulation D, Rules [501-503] and [505]. . . ."\textsuperscript{326} and which satisfies certain further conditions and limitations.

There are five additional conditions of ULOE\textsuperscript{327} which would have to be satisfied to qualify for the proposed state exemption: (1) Commissions, finder's fees or other remuneration cannot be paid or given to any person for soliciting any prospective purchaser unless the recipient of such consideration is registered as a broker-dealer, investment adviser or the like with the state;\textsuperscript{328} (2) disqualification of state "bad boys" from using the exemption;\textsuperscript{329} (3) the issuer

\begin{itemize}
\item Resolution of NASAA Endorsement of Revised Uniform Limited Offering Exemption (approved April 30, 1982), \textit{reprinted in} 1 \textit{Blue Sky L. Rep. (CCH)} \textnumero 5294 (1982) [hereinafter cited as NASAA Resolution].
\item The NASAA Resolution, \textit{supra} note 322, states: "There should be a careful balancing of the need to facilitate capital markets with protection of investors from fraud."
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item The proposed Administrative Rule implementing ULOE provides, at section B:
\begin{itemize}
\item No exemption under this rule shall be available for the securities of any issuer if any of the parties or interest described in Securities Act of 1933, Regulation A, Rule 230.252 sections (c),(d),(e) or (f):
\begin{enumerate}
\item Has filed a registration statement which is subject of a currently effective stop order entered pursuant to any state's law within five years prior to the commencement of the offering.
\item Has been convicted within five years prior to commencement of the offering of any felony or misdemeanor in connection with the purchase or sale of any security or any
\end{enumerate}
\end{itemize}
\end{itemize}
must file a notice of sales with the state securities administrator, either before or after the first sale, on Form D and periodically thereafter throughout the offering, and undertake to furnish to the administrator the information furnished to offerees; (4) the issuer must have reasonable grounds to believe and, after making reasonable inquiry, must actually believe that, in all sales to non-accredited investors, (i) the investment is suitable for the purchaser upon the basis of any facts disclosed by the purchaser regarding his other security holdings and his financial situation and needs and, also, (ii) that the purchaser, either alone or with a purchaser representative, has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment; and (5) in all sales to natural persons, non-insider accredited investors, the issuer must have reasonable grounds to believe and, after making reasonable inquiry, must actually believe that (i) the purchaser, either alone or with a purchaser representative, has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, and (ii) the investment does not exceed 20% of the investor's net worth, excluding principal residence, furnishings therein and personal automobiles. Additionally, ULOE would authorize the securities administrator to increase the num-

felony involving fraud or deceit including but not limited to forgery, embezzlement, obtaining money under false pretenses, larceny or conspiracy to defraud.

3. Is currently subject to any state administrative order or judgment entered by that state's securities administrator within five years prior to the filing of a claim of exemption or is subject to any state's administrative order or judgment in which fraud or deceit was found and the order or judgment was entered within five years of the expected offer and sale of securities in reliance upon this exemption.

4. Is currently subject to any state's administrative order or judgment which prohibits the use of any exemption from registration in connection with the purchase or sale of securities.

5. Is subject to any order, judgment, or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years prior to the commencement of the offering permanently restraining or enjoining, such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with any state;

6. The prohibitions of Section 1-3 & 5 above shall not apply if the party or interest subject to the disqualifying order is duly licensed to conduct securities related business in the state in which the administrative order or judgment was entered against such party or interest.

Any disqualification caused by this section is automatically waived if the state which created the basis for disqualification determines upon a showing of good cause that it is not necessary under the circumstances that the exemption be denied.


330 Id.
331 Id.
332 Id.
333 Id.
334 Id. The term "natural person, non-insider accredited investors" relates to those accredited investors specified in Rule 501(a)(5),(6) and (7). See supra note 156.
335 Id.
336 Id.
ber of purchasers or waive any other conditions of the exemption.\textsuperscript{337}

At least two of the additional conditions of ULOE constitute unnecessary restrictions on Rule 505. Requiring the issuer to make judgmental decisions regarding whether the security being offered is suitable for a given non-accredited investor and whether all investors, save insiders and institutions, are sophisticated enough to evaluate the merits and risks of the prospective investment, when the SEC did not deem these criteria to be necessary for investor protection under Rule 505, interjects unwarranted elements of uncertainty and potential liability in an already complicated process.

NASAA's proposed delegation of authority to securities administrators to increase the number of purchasers or waive exemptive conditions, although perhaps useful to a promoter with friends in the right places, would risk disqualification for the federal exemption which, in the case of Rule 505, exists only by virtue of the SEC's grace. Rule 505 has no statutory underpinning except the SEC's rule-making authority under section 3(b) of the Securities Act.\textsuperscript{338}

The "bad boy" disqualification is a harsh one if all of the circumstances of subsection 1.B. of ULOE are adopted. A stop order against a registration statement or a temporary restraining order against the sale of a security, for example, does not necessarily connote the type of securities law violator who ought to be forced out of business. The provisions of subsections 1.B.6. and 1.B.7. temper the harshness of the disqualification somewhat but, on the whole, subsection 1.B. is too broadly drawn. If such a disqualification provision is necessary as a condition of an exemption from registration, then it should be limited to truly egregious violators such as persons convicted of criminal conduct, or persons who have been the subject of multiple administrative or civil liability actions. On the whole, however, it is submitted that a promoter's track record of securities violations should constitute a factor in the administrator's discretionary exercise of substantive regulation, rather than a condition of an exemption from registration.

One of the proposed additional conditions of ULOE is a particularly sound one, however. The filing under Regulation D is a post-sale filing and is made with the SEC only.\textsuperscript{339} ULOE would optionally require\textsuperscript{340} a pre-sale filing with the Commissioner and would require the issuer to undertake to furnish to the Commissioner the informational disclosure materials furnished to investors.\textsuperscript{341} Given the merit regulation authority and fraud prevention function of a state securities administrator,\textsuperscript{342} this requirement, if adopted, would put him in a better position to fulfill his proper role. Thus, the appropriate response to the present initiative for an exemption for intermediate size offerings compatible with Rule 505 would be to merely implement Rule 505 by amending the Act to

\textsuperscript{337} Id.

\textsuperscript{338} 15 U.S.C. § 77c(b) (1976).

\textsuperscript{339} 17 C.F.R. § 230.503(a). See supra note 165.

\textsuperscript{340} 1 BLUE SKY L. REP. (CCH) ¶ 5294A (1982).

\textsuperscript{341} Id.

\textsuperscript{342} See supra text accompanying notes 276-85.
add a new exemption from registration for securities offered or sold which would be exempt from the registration requirements of the federal Securities Act by virtue of Rules 501, 502, 503 and 505 of Regulation D, with the added provision of pre-sale filing of the Form D notice of sales form with the Commissioner and authority in the Commissioner to require that he be furnished with all information furnished the investors before any sale occurs. Additionally, the ULOE treatment of sales commissions is preferable to the total proscription of section 402(b)(9).

C. Proposed Private Placement Exemption

With respect to the large offering, the clear message from the SEC and NASAA is that equity financings in excess of $5 million should be principally regulated at the federal level. If such a financing is truly local notwithstanding the amount, the issuer can try to fit within the federal intrastate exemption of section 3(a)(11) of the Securities Act or SEC Rule 147, both of which are risky propositions. Otherwise, the issuer will have to comply with new Rule 506 or the underlying statutory exemption, or register with the SEC.

At the state level, the practical burden of complying with Rule 506 will likely exceed the burden of registration under the Uniform Securities Act, however, without belaboring the point, the Legislature should nevertheless give issuers an option by enacting a provision similar to one in Ohio which would exempt from registration in the state any offering exempt from federal registration under section 4(2) of the Securities Act. The informational requirements of Rule 506 are approximately as thorough as those required in a registration statement under the state Act, with the only difference being that Regulation D permits omissions if certain information is not material. Conceptually at least, that difference is immaterial itself because of the anti-fraud provisions. In any event, qualification for the Rule 506 exemption serves the function of disclosure of information approximately as well as, if not better than, registration under the state Act. The other potential benefit of registration - ridding the security of restrictions on transfer - is not affected because the Regulation D restrictions apply, regardless of whether the offering is registered with a state. Thus, the investor is not harmed by implementing a Securities Act section 4(2) counterpart exemption under the state Act and the issuer is given a choice. Moreover, because a private placement of securities qualifies for the federal exemption of Rule 506 only when the investors are accredited,

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347 See supra text accompanying note 300.
349 See supra note 181.
350 The restrictions on transfer inhibit the investor from freely liquidating the investment at whatever time is most opportune for the investor, which runs counter to the desires of professional venture capital investors. Casey, supra note 1, at 572.
i.e., financially able to fend for themselves, or sophisticated, implementing a “section 4(2) exemption” in West Virginia would insulate the “little old widow” investor from the risks of the offering, which cannot be said if the offering was registered.

CONCLUSION

The collaborative effort of the SEC and NASAA has produced an initiative to examine the workability of the limited offering exemption of the West Virginia Uniform Securities Act. The goal is to achieve compatibility with analogous federal exemptions and a semblance of uniformity with the relevant law of other states. The present West Virginia limited offering exemption is clearly unworkable and, thus, impedes capital formation.

The proper function of state securities regulation is to protect the public from fraudulent investment schemes. This function is best served through means other than the registration of securities. Nevertheless, requiring the disclosure of information pertinent to an offering of securities is sound policy, but the extent to which enforcement of that policy should deter legitimate capital formation is relative.

The revisions to the West Virginia Uniform Securities Act limited offering exemption herein suggested should achieve a realistic balancing of the needs of the public and the needs of the business community. Admittedly, the details of the proposal are subject to discussion, but the concept of relating the burden of compliance with the exemptive conditions to the amount of the offering appropriately matches the interests of those affected. Summary disclosure of generalized information, coupled with the right of prospective investors to obtain further information they deem important, should allow the promoter of the small venture to obtain needed capital without diminishing necessary protection of the investor, whose interest is also furthered by the anti-fraud provisions of the Uniform Securities Act and the substantive authority of the Commissioner to regulate the merits of the offering. The proposed revision to section 402(b)(9) of the Act recognizes that result and also achieves a semblance of uniformity with counterpart laws of other states.

When the amount of the offering reaches the intermediate level of the new federal Rule 505, the issuer's burden of federal compliance increases to a level the SEC deems to be appropriate anywhere in the country. West Virginia's response should be to achieve compatibility. The proposed implementation of Rule 505 as an additional exemption from registration under the Act accomplishes that goal. Moreover, by adding the requirements that the federal filing also be made with the Commissioner before any sales occur and that the issuer undertake to furnish the Commissioner with the information disclosed to the investors, the proposal enhances the Commissioner's ability to fulfill his functions of fraud prevention and merit regulation.

Once an offering reaches the unlimited dollar level of federal Rule 506, the

301 See supra text accompanying note 186.
regulatory role of the states should wane. Nevertheless, the proposed “private offering” addition to the Act affords the issuer an election between registration and an uncertain burdensome exemption. Given the absence of any material differences between the disclosure required under either scheme, the degree of investor protection is not adversely affected by the proposal, and, given the practical limitation that a private placement can be made only to investors who are able to fend for themselves, protection of investors may be enhanced.

Regulation D has provided the initiative to make the process of venture capital formation more realistic to the issuer of securities. The changes to the West Virginia Securities Act proposed herein are designed to make the law of West Virginia compatible with that initiative. Realistic venture capital formation should be important to the citizens of West Virginia because the next Thomas Edison may live here. If so, the economy could use the lift.