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Venture Capital Financings and Exemptions from Registration under the Securities Act of 1933: Section 4(2), Rule 146, and Rule 242

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VENTURE CAPITAL FINANCINGS AND EXEMPTIONS FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933: SECTION 4(2), RULE 146, AND RULE 242

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I. INTRODUCTION

Few—if any—venture capital financings involve securities registered under the Securities Act of 1933 (the "Act"). Registered offerings are expensive and very time-consuming.[1] Moreover, the information disclosed in a registration statement and the related prospectus is not oriented towards the informational needs of the venture capitalist. In addition, in a registered offering confidentiality relating to a company's proposed products, markets, and plans may be lost, to the extent that such information is disclosed. As a result, venture capital financings are almost invariably made pursuant to an exemption from the Act's registration requirement.

Of the various available exemptions from registration, the nonpublic offering or private placement exemption embodied in section 4(2) of the Act and rule 146 promulgated under the Act, and the exemption made available by rule 242, promulgated under the small-issue exemption contained in section 3(b) of the Act, are—or are expected to be—the most useful and most used exemptions for venture capital financings.[2]

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1. "Aggregate expenses for a first public offering . . . are typically in the $175,000 to $225,000 range." M. HALLORAN, GOING PUBLIC 28-29 (3d ed. 1979).

2. Regulation A, promulgated under the Act's small-issue exemption, is another means of exempting securities transactions from registration (or at least full-fledged registration) under the Act. The dollar amount of securities that may be offered pursuant to Regulation A was in 1978 increased from $0.5 million to $1.5 million. Securities Act Release No. 5977 (Sept. 11, 1978). As a result, use of Regulation A is growing.

This article begins with a discussion of the nonpublic offering exemption under section 4(2) and under rule 146 (the statutory and the rule-based exemptions); it then turns to a discussion of rule 242; it concludes with a comparison of these different approaches to exempting securities transactions from registration under the Act.

I. SECTION 4(2) AND THE ORIGINS OF RULE 146

Section 4(2) of the Act exempts from the Act's registration requirement "transactions by an issuer not involving any public offering."[3] Legislative history provides little guidance

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Gross proceeds from primary securities offerings pursuant to Regulation A in the years 1975 through 1978 averaged $49.75 million per year. SECURITIES AND EXCHANGE COMMISSION, STATISTICAL BULLETIN 18 (June 1980). In 1979 this figure increased to $182 million. *Id.* (There were approximately 135 Regulation A offerings per year during the 1975-78 period; in 1979 there were 235 Regulation A offerings.) Regulation A requires that an offering circular containing information specified in Schedule I of Form 1-A be used in connection with offerings pursuant to its provisions. The offering circular is filed with and reviewed by an SEC regional office. Because of the attendant time and expense involved, Regulation A is little used as an exemption for venture capital financings.

In addition, section 4(6) was recently added to the Act by the Small Business Investment Incentive Act of 1980. Section 4(6) exempts:

> transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issuer of securities offered in reliance on this paragraph does not exceed the amount allowed under section 3(b) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe.

Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 602, 94 Stat. 2275 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 94 Stat. 2294 (to be codified in 15 U.S.C. § 77d (6)). Section 2(15) of the Act defines "accredited investor" to include the types of entities (such as banks, insurance companies, and small business investment companies) presently specified in the definition of "accredited person" under Rule 242 (*see* text at note 56 *infra*), business development companies as defined by section 2(a)(48) of the Investment Company Act of 1940, *as amended by* Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 101, 94 Stat. 2275 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 94 Stat. 2275 (to be codified in 15 U.S.C. § 80a-2(a)(48)), and "any person who on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 603, 94 Stat. 2275 (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS, 94 Stat. 2294 (to be codified in 15 U.S.C. 77b (15)).

For a short discussion of the potential implication of section 4(6), *see* text accompanying notes 119-23 *infra*.

3. 15 U.S.C. § 77d(2) (1976).

regarding congressional intent underlying the nonpublic offering exemption.[4] A 1935 release issued by the SEC's general counsel provided the first major interpretation of the exemption.[5] The 1935 release identified four principal factors to be examined in determining whether an offering was nonpublic: (1) the number of offerees and their relationship to each other and to the issuer; (2) the number of units offered; (3) the size of the offering; and (4) the manner of the offering.[6] In addition, the release also stated that "under ordinary circumstances an offering to not more than approximately twenty-five persons . . . presumably does not involve a public offering."[7] This latter statement gave rise to the widespread view that any offering to less than twenty-five offerees was exempt from registration as a nonpublic offering.[8]

The 1935 release remained authoritative until the 1953 Supreme Court decision in the well-known *SEC v. Ralston Purina Co.* case.[9] At issue in *Ralston Purina* was whether Ralston Purina's offer and sale of its stock to some four hundred "key" employees was exempt from registration as a nonpublic offering. The Supreme Court, in holding that the offering was not nonpublic, rejected the use of any numerical test or guideline in defining the nonpublic offering exemption: "[T]he statute would seem to apply to a 'public offering' whether to few or many."[10] Instead, the Court concluded that "the focus of inquiry should be on the need of the offerees for the protections afforded by registration,"[11] thus shifting the focus of analysis away from the nature and manner of the offering to the offeree. According to the *Ralston Purina* Court: "An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.' "[12]

Despite the Supreme Court's avowed purpose in granting

4. *See* 1 L. Loss, Securities Regulation 653 (2d ed. 1961).

5. Securities Act Release No. 285 (Jan. 24, 1935), *reprinted in* 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2740-44 (1980).

6. *Id.*

7. *Id.* ¶ 2740.

8. *See* R. Jennings & H. Marsh, Securities Regulation (4th ed. 1977). "As a practical matter, this was the test which many lawyers used to mark the zone of danger. Offers to 25 persons were regarded as safe." *Id.* at 339.

9. 346 U.S. 119 (1953).

10. *Id.* at 125.

11. *Id.* at 127.

12. *Id.* at 125.

certiorari in *Ralston Purina* "to define the scope of the private offering exemption,"[13] the offeree-based test enunciated by the Court in that case has engendered a high degree of uncertainty about the availability and the contours of the nonpublic offering exemption.[14] What it means for an offeree to be able to "fend for himself" has never been absolutely clear.[15] The uncertainty surrounding the nonpublic offering exemption reached its zenith in the early 1970's in a series of Fifth Circuit cases culminating in *SEC v. Continental Tobacco Co. of South Carolina, Inc.*[16] At the time, some commentators read the *Continental Tobacco* case to require that each offeree have a relationship to the issuer tantamount to that of an "insider."[17] Although in retrospect this reading appears to have been overbroad,[18] at the time these cases were decided, there was undeniably considerable confusion about the availability and scope of the nonpublic offering exemption.

It was against this background that the SEC proposed and ultimately promulgated rule 146.[19] In language reminiscent of that used by the Supreme Court in *Ralston Purina* in describing its decision to grant certiorari in that case, the SEC

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13. *Id.* at 120.

14. "The cases cast at best a faint beacon toward the horizon of decision." Doran v. Petroleum Management Corp., 545 F.2d 893, 908 (5th Cir. 1977). "Notwithstanding the frequent use of th[e] 'private offering' exemption during the forty-six years of its history, the definition of 'public offering' remains elusive, in part because of the few Section 4(2) cases which have been decided . . . and in part because of the confusion in those cases which have been decided." Soraghan, *Private Offerings: Determining "Access," "Investment Sophistication," and "Ability to Bear Economic Risk,"* 8 SEC. REG. L.J. 3, 4 (1980) (footnote omitted).

15. *See, e.g.*, Schneider, *Private Placements*, in SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 40 (R. Mundheim & A. Fleischer eds. 1971). "Quite obviously, the 'fend for himself' or sophistication qualification is an extremely subjective and fuzzy one to apply." *Id.* at 42.

16. 463 F.2d 137 (5th Cir. 1972). *See* Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

17. "[B]road statements in recent cases and by the SEC, if taken literally, impose such stringent standards for qualified offerees that the [nonpublic offering] exemption would seem no longer to exist." Cassidy & Berkowitz, *Proposed Rule 146*, 6 REV. SEC. REG. 949, 950 (1973).

18. *See, e.g.*, Woolf v. S.D. Cohn & Co., 515 F.2d 591, 610 (5th Cir. 1975), *vacated on other grounds*, 426 U.S. 944 (1976).

19. Securities Act Rules and Regulations, 17 C.F.R. § 230.146 (1980). Rule 146 was adopted April 23, 1974, Securities Act Release No. 5487 (April 23, 1974), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2710 (1980), and became effective June 10, 1974.

stated that rule 146 was designed "to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act."[20]

II. RULE 146

A. *An Overview*

Rule 146 is available only to issuers; it is not available to affiliates or other persons for sales of the issuer's securities. The rule provides a "safe harbor": it specifies conditions under which a transaction will be deemed not to require registration under the Act. It does not provide an exemption from the antifraud provisions of the securities laws, from the civil liability provisions of section 12(2) of the Act, or from other federal or state securities laws.

Rule 146 is nonexclusive. Transactions by an issuer that do not satisfy all of its conditions do not raise a presumption that the statutory nonpublic offering exemption is unavailable. In 1978, as a result of continuing concern by commentators that courts would supplant the section 4(2) nonpublic offering exemption with the narrower criteria of rule 146, the SEC added "nonexclusivity" language to the rule itself.[21]

An issuer wishing to claim availability of the rule has the burden of establishing that it has satisfied *each* of the rule's conditions. Noncompliance with any of the rule's conditions renders the rule unavailable. Relevant conditions must be satisfied as to each offeree as well as each purchaser.

B. *Major Conditions of Rule 146*

In order for an issuer to rely upon rule 146, all of the following conditions must be met:

1. *Manner of Offering.* No general advertising or solicitation is permitted.[22]

2. *Nature of Offerees and Purchasers.* Offers may be

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20. Securities Act Release No. 5487 (April 23, 1974), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2710 (1980).

21. Securities Act Rules and Regulations, 17 C.F.R. § 230.146 (1980); Securities Act Release No. 5975 (Sept. 8, 1978), *reprinted in* [Transfer Binder, 1978 Decisions] FED. SEC. L. REP. (CCH) ¶ 81,708.

22. Securities Act Rules and Regulations, 17 C.F.R. § 230.146(c) (1980).

made only to persons the issuer reasonably believes "have such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment or . . . [are] able to bear the economic risk of the investment."[23]

Sales may be made to persons the issuer, after making reasonable inquiry, reasonably believes to have the requisite knowledge and experience.[24] Sales may also be made to persons the issuer reasonably believes meet the economic-risk test (often stated to require an ability (a) to hold the investment for an indefinite period and (b) to bear the risk of total loss of the investment), even though they do not have the requisite knowledge and experience, if they are advised by an offeree representative who alone, or together with the purchaser, has the requisite knowledge and experience.[25]

3. *Access to or Furnishing of Information.* Each offeree must, during the course of the transaction and prior to sale, either have access to information comparable to that elicited through registration or have such information furnished to him by the issuer.[26] "Access" is a relatively narrow concept determined by the offeree's position with respect to the issuer. It seems probable that only directors, executive officers, persons with certain family relationships with a person controlling the issuer, and persons with economic bargaining power have such access.[27]

4. *Additional Disclosures.* Each offeree or his offeree representative must have the opportunity to ask questions of, and to receive answers from, the issuer or any person acting on its behalf concerning the terms and conditions of the offering, and he must have the opportunity to obtain certain additional information.[28] The issuer or any person acting on its behalf must disclose to each offeree in writing, prior to sale, certain information concerning his offeree representative (if applicable)[29] and certain information concerning limitations

23. *Id.* § 230.146(d)(1).

24. *Id.* § 230.146(d)(2)(i). Typically, investor questionnaires are used to make (and support) determinations of sophistication.

25. *Id.* § 230.146(d)(2)(ii).

26. *Id.* § 230.146(e)(1).

27. *Id.* § 230.146(e) ("Note").

28. *Id.* § 230.146(e)(3)(ii), (iii).

29. *Id.* § 230.146(e)(3)(i).

on disposition of the securities being purchased by the offeree and the effect of such limitations.[30]

5. *Number of Purchasers.* The issuer must have reasonable grounds to believe and, after making reasonable inquiry, must believe that there are no more than thirty-five purchasers in the offering.[31] Certain purchasers are excluded from the count, including those who purchase securities in the aggregate amount of $150,000 or more.[32]

6. *Limitations on Disposition.* Reasonable care must be taken to ensure that the purchasers are not, or do not become, statutory underwriters, including, but not limited to: (a) reasonable inquiry to ascertain whether the purchaser is purchasing for his own account or on behalf of others; (b) placing a restrictive legend on the securities; (c) issuing stop transfer orders or, if the issuer transfers its own securities, noting the restriction on transfer in its records; and (d) obtaining a written agreement from the purchaser that he will not resell in the absence of registration or an exemption.[33]

7. *Report of Offering.* The issuer must file Form 146 with the appropriate regional office of the SEC at the time of the first sale of securities in most offerings effected in reliance on the rule.[34] Form 146 requires certain information concerning the issuer and the offering, including the names and addresses of all organizers, promoters, and sponsors of, and all offeree representatives involved in, the offering.

C. *Other Aspects of Rule 146*

1. *Integration.* Rule 146(b)(1) contains a special six-month rule on integration. Offers and sales of securities of the issuer issued under exemptions provided by section 3 or section 4(2) of the Act or under a registration statement filed under the Act that took place more than six months preceding commencement of the rule 146 offering or more than six months following completion of the rule 146 offering will not be included in a rule 146 offering if there are no offers or sales

30. *Id.* § 230.146(e)(3)(ii), (iii).
31. *Id.* § 230.146(g)(1). Certain entities that would otherwise be counted as one purchaser under the rule are not treated as a single purchaser if they were organized "for the specific purpose of acquiring the securities offered." *Id.* § 230.146(g)(2)(ii).
32. *Id.* § 230.146(g)(2).
33. *Id.* § 230.146(h).
34. *Id.* § 230.146(i).

of the same or similar securities by or for the issuer during those six-month periods.

If an issuer does not qualify for the integration safe harbor afforded by rule 146(b)(1), it must use traditional factors in determining whether the offering in question is part of a larger offering and thus should be integrated. These factors include the following:

> (a) Whether the offerings are part of a single plan of financing;
> (b) Whether the offerings involve issuance of the same class of security;
> (c) Whether the offerings are made at or about the same time;
> (d) Whether the same type of consideration is to be received; and
> (e) Whether the offerings are made for the same general purpose.[35]

2. *Offeree Representatives.* One of the most potentially useful aspects of rule 146 is its formalization of the concept of an "offeree representative," through whom an offeree can satisfy the *Ralston Purina* requirement that offerees be able to fend for themselves. In order to utilize an offeree representative, however, an offeree must be able to bear the economic risk of the investment.[36]

Except in narrow sets of circumstances, an offeree representative cannot be affiliated with, or be an employee of, the issuer.[37] Either alone, or together with other offeree representatives or the offeree, the offeree representative must be capable of evaluating the risks and merits of the prospective investment. An issuer must make certain written disclosures to each offeree concerning the issuer's relationships with offeree representatives.[38]

The scope of an offeree representative's duties and responsibilities is nowhere delineated. It is plain, however, that he must act in the interest of the offeree, even if compensated by the issuer.[39]

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35. *Id.* § 230.146 (Preliminary Note 3). *See generally* Wigder, *Integration,* 10 REV. SEC. REG. 933 (1977).
36. Securities Act Rules and Regulations, 17 C.F.R. § 230.146(d)(2)(ii) (1980).
37. *Id.* § 230.146(a)(1).
38. *Id.* § 230.146(e)(3)(i).
39. Potential conflicts of interest when an offeree representative receives com-

III. The Origins of Rule 242

Rule 242 is a direct outgrowth of the SEC's reexamination of the impact of federal securities regulation on small business and the widespread dissatisfaction with and problems encountered in using other exemptions from registration under the Act,[40] particularly rule 146. As such, it represents but one of several initiatives that the SEC has taken to reduce the regulatory burden on small business.[41] The SEC has called the rule "an important step" in easing "the impact of the federal securities laws on small business consistent with the protection of investors"[42] and has promised to monitor closely the operation of the rule "to determine whether the Rule has functioned as an effective means for issuers, particularly small issuers, to raise limited amounts of capital through unregistered offerings to the public."[43]

Rule 242 reflects a diversity of influences. Elements of rules 146 and 240, Regulation A, and the American Law Institute's Federal Securities Code are all identifiable in one or more of its provisions. In terms of philosophical underpinnings, perhaps the strongest influence on the drafting of rule 242 was former section 242 of the American Law Institute (ALI) Federal Securities Code,[44] which defined "limited offering." Under the ALI Federal Securities Code, a "limited offering," which is exempt from the Code's filing requirement, is one in which "the initial buyers of the securities are institutional investors or not more than thirty-five other persons or both, or the seller reasonably so believes" and in which the securities sold are subject to certain restrictions.[45] Rule 242 may be viewed as the SEC's attempt to bring the "limited of-

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pensation from the issuer were the focus of a proposed amendment to the rule banning such compensation. Securities Act Release No. 5913 (Mar. 6, 1978). The proposed amendment was subsequently withdrawn, however. Securities Act Release No. 5976 (Sept. 8, 1978).

40. Securities Act Release No. 6180, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362, 6363 ("Discussion") (1980).

41. Other initiatives include adoption of Form S-18, Securities Act Release No. 6049 (April 3, 1979), 17 S.E.C. Docket 153, 153 (1979), and establishment of the SEC Office of Small Business Policy.

42. 45 Fed. Reg. 6362, 6363 ("Background") (1980).

43. *Id.* at 6362 ("Supplementary Information").

44. ALI Federal Securities Code § 242(b) (Proposed Official Draft) (1978). Former section 242(b) is now section 202(41) of the Federal Securities Code as adopted by the ALI. 1 ALI Federal Securities Code § 202(41) (1980).

45. 1 ALI Federal Securities Code § 202(41) (1980).

fering concept" of the Federal Securities Code within the Act's statutory small-issue exemption.

IV. Rule 242

A. *An Overview*

Rule 242, promulgated under the Act's small-issue exemption, is, according to the SEC, "in the nature of an experiment."[46] Issued on January 17, 1980, and effective as to offers or sales of securities issues commenced on or after February 25, 1980, the rule provides an exemption from the Act's registration requirement for certain limited offers and sales of securities by "qualified issuers." A "qualified issuer" is defined to encompass only corporations, and then only corporations incorporated under the laws of the United States or Canada (or a political subdivision thereof) that has its principal business operations in its respective country of incorporation, that is neither an investment company nor a company engaged in significant oil and gas or mining operations, and that is "worthy" of the exemption provided by the rule.[47]

The rule currently allows a qualified issuer to sell up to $2 million of its securities in any six-month period. An unlimited number of "accredited persons," satisfying certain requirements, and up to thirty-five other persons may be purchasers of an issue of securities offered pursuant to the rule. The rule is nonexclusive; the issuer may, for example, rely on the nonpublic offering exemption in addition to relying on rule 242. An issuer wishing to claim availability of the rule has the burden of establishing that it has satisfied all of the rule's conditions. The rule does not provide an exemption from the antifraud provisions of the securities laws, from the civil liability provisions of section 12(2) of the Act, or from other federal or state securities laws.

B. *Major Conditions of Rule 242*

Rule 242 contains six conditions, all of which must be satisfied for the exemption provided by the rule to be available:

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46. Securities Act Release No. 6180, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362 (1980).

47. Securities Act Rules and Regulations, 17 C.F.R. § 230.242(a)(5) (1980). For a discussion of the "worthy" issuer, see notes 71-74 and accompanying text *infra*.

1. *Limitations on Aggregate Offering Price per Each Issue.* The "aggregate offering price of an *issue* of *securities of the issuer* by a qualified issuer [must] not exceed $2,000,000 less the aggregate gross proceeds from all securities sold pursuant to any section 3(b) exemption" (other than pursuant to certain employee benefit plans) "six months prior to the commencement and during the offering of the issue of securities pursuant to [rule 242]."[48] The term "securities of the issuer" is defined in the rule to include all securities issued by the qualified issuer, by a predecessor of the qualified issuer, and by an affiliate of the qualified issuer which was organized or became affiliated with the issuer within the preceding twelve months.[49] The issuer's predecessors are those persons, the major portion of the assets of which have been acquired directly or indirectly by the issuer, and those persons from which the issuer acquired directly or indirectly the major portion of its assets.[50] An "affiliate of the issuer" is a "person that directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with" the issuer.[51] The term "issue" is not defined in the rule. A preliminary note to the rule points to traditional integration factors as the means of determining whether "separate sales of securities are part of the same issue."[52]

2. *Manner of Offering.* As is the case with rule 146 distributions, no general solicitation or advertising is permitted.[53]

3. *Number of Purchasers.* The issuer must, upon reasonable inquiry, reasonably believe that there are no more than 35 purchasers of each issue of the securities.[54] Excluded from the count of purchasers are certain relatives of a purchaser, certain related trusts and corporations, and, most importantly, any purchaser that is an "accredited person" as that term is defined in the rule.[55] "Accredited persons" are

48. *Id.* § 230.242(c) (emphasis added), *as amended by* Securities Act Release No. 6250 (Oct. 23, 1980), *reprinted in* [Current Binder] FED. SEC. L. REP. (CCH) ¶ 82,671 (1980).

49. *Id.* § 230.242(a)(6).

50. *Id.* § 230.242(a)(4).

51. *Id.* § 230.242(a)(2).

52. *Id.* § 230.242 (Preliminary Note 6). *See* note 35 and accompanying text *supra*.

53. *Id.* § 230.242(d).

54. *Id.* § 230.242(c)(1).

55. *Id.* § 230.242(e)(2)(iv).

those which, upon reasonable inquiry, the issuer reasonably believes are banks, insurance companies, certain employee benefit plans, investment companies registered under the Investment Company Act of 1940, small business investment companies, directors and executive officers of the issuer, and persons purchasing at least $100,000 of the securities and paying for such securities with cash, full-recourse promissory notes due within sixty days of the first issuance of the securities, or cancellation of indebtedness.[56]

4. *Furnishing of Information.* If an issuer sells its securities only to accredited persons in a rule 242 offering, the rule imposes no specific requirements with regard to furnishing information in connection with that offering.[57]

If nonaccredited persons or accredited and nonaccredited persons purchase securities from an issuer pursuant to the rule, the issuer must give each purchaser the same kind of information as specified in Part I of Form S-18 *"to the extent material* to an understanding of the issuer, its business, and the securities being offered."[58] Only the financial statements for the issuer's most recent fiscal year need be certified, however.[59] In addition, if the issuer is a reporting company under the 1934 Act, the issuer may simply furnish purchasers with copies of its most recent annual report, definitive proxy statement, and any other reports or documents required to be filed with the SEC, and, to the extent applicable, the information required by items 1, 2, 3, and 14 of Part I of Form S-18.[60]

Each purchaser must be given the opportunity to inquire of and receive answers from the issuer or its representative concerning the terms and conditions of the offering. Each purchaser must be furnished with any additional information, to the extent that the issuer possesses such or can acquire it without unreasonable effort or expense, necessary to verify the accuracy of the disclosed information.[61]

Finally, the issuer is required to furnish each nonaccredited purchaser with a written description of any written information given by the issuer to an accredited purchaser in

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56. *Id.* § 230.242(a)(1).
57. *Id.* § 230.242(f)(1).
58. *Id.* § 230.242(f)(1)(i) (emphasis added).
59. *Id.*
60. *Id.* § 230.242(f)(1)(iii).
61. *Id.* § 230.242(f)(2).

connection with the transaction in question.[62] The nonaccredited purchaser is then entitled to receive any such information prior to the date he purchases the issuer's securities if he so requests in writing.[63]

5. *Limitations on Disposition.* The issuer must "exercise reasonable care to assure that the purchasers of the securities are not underwriters."[64] Securities acquired in rule 242 transactions are restricted securities and may not be sold or transferred in the absence of registration or an exemption from registration under the Act.[65]

6. *Report of Offering.* The issuer who intends to rely on rule 242 must file Form 242 with the SEC in Washington, D.C. no later than ten days after the first sale of securities issued under the rule; in certain circumstances, subsequent filings are also required.[66] The SEC may request that an issuer filing Form 242 submit disclosure documents used by the issuer in connection with the transaction.[67] These requests will be made, according to the SEC, in order to monitor the use of the rule and to determine whether modification of the rule is necessary.[68]

C. *Other Aspects of Rule 242*

1. *Integration.* Rule 242 contains a special safe harbor integration rule. Securities issued more than six months before a rule 242 offering are not included in the aggregate offering price calculation.[69] Securities that are part of the same issue must be counted against the rule 242 aggregate offering price limitation regardless of the exemption from registration relied upon in their sale if such securities were sold within the six-month period preceding the rule 242 offering. If an issuer does not qualify for the integration safe harbor afforded by the rule, then it must use traditional integration factors in determining whether the offering in question com-

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62. *Id.* § 230.242(f)(3).

63. *Id.*

64. *Id.* § 230.242(g).

65. *Id.*

66. *Id.* § 230.242(h)(1).

67. Securities Act Forms, 17 C.F.R. § 239.242 ("Undertaking") (1980).

68. Securities Act Release No. 6180, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362, 6363 (1980).

69. Securities Act Rules and Regulations, 17 C.F.R. § 230.242(c) (1980).

prises part of a larger offering and thus should be integrated.[70]

2. *The Unworthy Issuer.*[71] An issuer is not a qualified issuer within the meaning of rule 242 if the issuer, or other persons having certain relationships to the issuer, has engaged in certain proscribed activities or has been or is subject to certain orders, judgments, or decrees.[72] Persons whose activities may bring an issuer within the unworthy issuer doctrine include predecessors and affiliates of the issuer; directors, officers, and principal securities holders of the issuer; promoters of the issuer who are presently associated with the issuer in some capacity; and underwriters or partners, directors, or officers of underwriters, to be used in connection with the offering.[73] For example, rule 242 would be unavailable if, within five years of its intended use, an affiliate of the issuer (defined as a person controlling, controlled by, or under common control with the issuer) had filed a registration statement that had been the subject of a stop order under section 8 of the Act.[74]

70. Securities Act Release No. 6180, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362, 6365 (1980). *See* note 35 and accompanying text *supra*.

71. The SEC has recently adopted certain amendments to the unworthy issuer doctrine contained in rules 242 and 252. Securities Act Release No. 6289 (Feb. 13, 1981), *reprinted in* [Current Binder] FED. SEC. L. REP. (CCH) ¶ 82,855. Both rule 252 and rule 242 contained a proviso that the unworthy issuer doctrine would not apply if, upon a showing of good cause, the SEC determined that under the circumstances its application was unnecessary. A principal purpose of the recent amendments was to reduce the growing number of requests for relief from the unworthy issuer doctrine being received by the SEC in connection with Regulation A. In addition, a new disqualifying provision was added to rule 252 and incorporated into rule 242: an issuer that is a 1934 Act reporting company is disqualified for failure during the preceding year to file reports required by the SEC.

72. Rule 242(a)(5)(v) provides that an issuer is not a "qualified" issuer within the meaning of the rule if it is an issuer "described in Rule 252(c), (d), or (e)." Paragraphs (c), (d), and (e) of rule 252, which is one of the rules comprising Regulation A, set forth what has come to be known as the unworthy issuer doctrine: these paragraphs enumerate certain events or conditions that disqualify an issuer from using Regulation A, and hence rule 242. Securities Act Rules and Regulations, 17 C.F.R. §§ 230.242(a)(5)(v), .252(c), (d), (e) (1980).

73. *Id.* §§ 230.242(a)(5)(v), .252(d).

74. *Id.* §§ 230.242(a)(5)(v), .252(c)(1).

V. SECTION 4(2) AND RULES 146 AND 242 IN THE VENTURE CAPITAL CONTEXT: SIMILARITIES AND DIFFERENCES

A. *Similarities*

1. *Manner of Offering.* No general solicitation or advertising is permitted under rule 146, rule 242, or section 4(2).[75]

2. *Limitations on Disposal.* The issuer must exercise reasonable care to ensure that the purchasers of its securities pursuant to rule 146, rule 242, or section 4(2) are not underwriters within the meaning of the Act.[76]

3. *Applicability of Antifraud and Other Provisions of the State and Federal Securities Laws.* The applicability of the antifraud provisions of the securities laws, section 12(2) of the Act, and other federal and state securities laws is unaffected by an exemption from registration under the Act pursuant to rule 146, rule 242, or section 4(2).[77]

4. *Number of Offerees.* Within reason, the number of offerees is immaterial to the availability of the rule 146 and rule 242 exemptions so long as all conditions of each rule (and, in particular, the no general solicitation or advertising condition) are met.[78] So long as there is no general advertising or solicitation and each offeree is able to "fend for himself," the number of offerees (within reason) should also be inconsequential to the availability of the section 4(2) exemption.[79]

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75. *Id.* §§ 230.146(c), .242(d) (the language of which is substantially the same as that of rule 146(c)(1)). It is clear that the concept of a private offering is inconsistent with general solicitation and advertising by an issuer. *See* Hill York Corp. v. American Int'l Franchises, Inc., 449 F.2d 680, 689 (5th Cir. 1971); Securities Act Release No. 4552 (Nov. 6, 1962), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶¶ 2770, 2776 ("Public advertising of the offerings would, of course, be incompatible with a claim of a private offering.").

76. Securities Act Rules and Regulations, 17 C.F.R. §§ 230.146(h), .242(g) (1980) (the language of which is substantially equivalent to that of rule 146(h)(1)-(3)); Securities Act Release No. 3825 (Aug. 12, 1957), *reprinted in* [Transfer Binder, '57-'61 Decisions] FED. SEC. L. REP. (CCH) ¶ 73,539. *See also* Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

77. Securities Act Rules and Regulations, 17 C.F.R. § 230.146 (1980) (Preliminary Notes 2 & 4); *id.* § 230.242 (Preliminary Notes 1 & 2); 15 U.S.C. § 77d(2) (1976).

78. *See* Securities Act Rules and Regulations, 17 C.F.R. § 230.146(g) (1980) (number of purchasers is relevant; number of offerees is not); *id.* § 230.242(e) (same).

79. There is some indication that the number of offerees under section 4(2) is still important. *See* Securities Act Release No. 4552, *supra* note 75. *See also* SEC no-action letter to Secured Options Strategies, Inc. (Nov. 14, 1979) ("Whether or not a public offering is involved is essentially a question of fact and depends on such factors as the number of offerees."). But by analogy with rule 146, it should be clear that the number of offerees is not determinative, Securities Act Release No. 4552 notwith-

B. *Principal Differences*

1. *Nature of the Issuer.* There are no restrictions on the nature of the issuer entitled to use rule 146 or section 4(2). The availability of the rule 242 exemption, in contrast, is limited to corporations that meet certain incorporation and type and place-of-business standards[80] and are "worthy" of the section 3(b) exemption. Theoretically, the restrictions on the nature of the issuer entitled to use rule 242 do not greatly limit the availability of the rule in the venture capital context. As a practical matter, however, inclusion of the unworthy issuer doctrine in the rule may serve to diminish its usefulness both in and outside the venture capital field. That doctrine forces an issuer wishing to rely upon the rule to undertake an extensive inquiry of its affiliates, directors, principal security holders, officers, and any promoters still associated with it. In the venture capital context, if one interprets the definition of "affiliate" cautiously,[81] the necessary inquiry may be particularly burdensome since the issuer may have numerous portfolio affiliates[82] that must be polled. The time and expense associated with such an inquiry may discourage issuers from using, and counsel from relying upon, the rule.

2. *Aggregate Offering Price Limitation.* There is no limit on the dollar amount of securities that may be sold pursuant to rule 146 or section 4(2). In contrast, rule 242 sets an aggregate offering price limitation on issues of securities pursuant to the rule equal to $2 million less all section 3(b) issues of securities within the preceding six months.[83]

The ramifications of this difference are obvious. Issues of securities in excess of $2 million in any six-month period must be made in reliance on an exemption other than rule 242. A cautious reading of the definition of "affiliate" under the rule

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standing. *See* Woolf v. S.D. Cohn & Co., 515 F.2d 591, 612 (5th Cir. 1975), *vacated on other grounds*, 426 U.S. 944 (1976) (rule 146 "does supply a useful frame of reference to an appellate court in assessing the validity of § 4(2) exemptions").

80. Securities Act Rules and Regulations, 17 C.F.R. § 230.242(a)(5) (1980).

81. *Id.* § 230.242(a)(2).

82. As used in this article, portfolio affiliates (a term not used in rule 242) are companies that are unrelated to the issuer but that are, with the issuer, under the common control of some third person, such as a venture capital company or one of its partners or officers.

83. Securities Act Rules and Regulations, 17 C.F.R. § 230.242(c) (1980), *as amended by* Securities Act Release No. 6250 (Oct. 23, 1980) *reprinted in* [Current Binder] FED. SEC. L. REP. (CCH) ¶82,671 (1980).

requires that the $2 million ceiling be reduced by the amount of all section 3(b) offerings of unrelated "portfolio affiliates." This, in turn, requires a determination of the existence of portfolio affiliates and whether they have made any section 3(b) offerings.

3. *Nature of Offerees; Nature of Purchasers.* Rule 242 imposes no restriction on the nature of offeree or purchaser permitted under the rule. Section 4(2), in contrast, has been interpreted by the courts to require that offerees and purchasers be able to "fend for themselves."[84] This is generally understood to mean that offerees and purchasers in section 4(2) transactions must meet a "sophistication" requirement.[85] Rule 146 adopts a bifurcated approach to permissible offerees and purchasers. In line with *Ralston Purina*, a person who has "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment" (*i.e.*, a person who is sophisticated) is both a permissible offeree and purchaser under rule 146.[86] But the rule goes a step beyond *Ralston Purina* by permitting "a person who is able to bear the economic risk of the investment" (*i.e.*, a person who is wealthy) to be a qualified offeree under the rule, even if he is not sophisticated.[87] In order to qualify as a purchaser under rule 146, however, the wealthy but unsophisticated person must be advised by an offeree representative.[88] Together, the purchaser and his offeree representative must meet the rule's sophistication standard.[89]

Rule 146 does not define what constitutes sophistication

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84. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

85. *See, e.g.*, Schneider, *supra* note 15, at 41.

86. Securities Act Rules and Regulations, 17 C.F.R. §§ 230.146(d)(1)(i), .146(d)(2)(i) (1980).

87. *Id.* § 230.146(d)(1)(ii).

88. *Id.* § 230.146(d)(2)(ii).

89. *Id.* Although expansion of the class of permissible offerees under rule 146 to include wealthy persons (and the concomitant expansion of the class of permissible purchasers under the rule to include wealthy persons with offeree representatives) is a novel idea, offeree representatives in the formal sense are little used in the venture capital field (although lead investors may informally serve many of the same functions). This is because investors in venture capital transactions typically possess "such knowledge and experience in financial and business matters" that they are "capable of evaluating the merits and risks of" prospective investments. In addition, the offeree representative device is of no use in the situation in which there is some doubt about the sophistication of an offeree who plainly does not meet the rule's wealth standard.

or wealth.[90] Similarly, no definition of the ability to "fend for oneself" and its constituent components has gained wide acceptance. Judicial precedent on point may best be described as chaotic.[91] As a result, determining sophistication and wealth for rule 146 purposes remains an essentially subjective process.

In many venture capital transactions, however, determining sophistication or wealth will pose little difficulty. If only venture capital firms, professional venture capitalists, and officers and directors of the issuer are involved, there is little doubt that the offerees are sophisticated. If other persons are offerees, however, difficult subjective factual judgments may be required. Two important consequences result. First, as the necessary subjective factual determinations become more difficult, it becomes increasingly difficult for counsel to give a legal opinion that the transaction is exempt from registration under the Act by virtue of rule 146 or section 4(2). Second, because subjective judgments are involved, there is always the risk that another party, whether the SEC, a court, or a finder of fact, will reach a contrary conclusion. In those instances in which difficult subjective judgments are necessary, the attendant risk of error may lead to reliance on exemptions from registration other than those made available by section 4(2) or rule 146.

4. *Information: Access and Availability.* When information is required to be disclosed in conjunction with rule 146, rule 242, or section 4(2), the type of information that must be disclosed is the sort that would be found in a registration statement under the Act. Disclosure of this information in writing is an expensive and time-consuming task.

Information that venture capital investors consider important is often of a different sort than that disclosed in a registration statement, and is obtained by means other than reading the issuer's offering memorandum or other disclosure documents. Accordingly, because preparation of a registration statement form of disclosure document in the venture capital context has high costs but relatively low benefits, venture cap-

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90. The SEC recently stated that the rule did not set forth a procedure for determining whether offerees are qualified offerees "because the Commission was of the view that flexibility would be desirable in this part of the rule." SEC no-action letter to Michael J. Schneider (July 16, 1979).

91. *See* note 14 *supra*.

ital investors and issuers will generally choose to rely upon the exemption from registration that requires the least burdensome disclosure document.

In this regard, rule 242 may be significantly less burdensome than rule 146 or section 4(2). If only accredited persons are purchasing securities, rule 242 imposes no written disclosure requirements on the issuer.[92] This requires the venture capital investor to bargain for the type and amount of information it wishes to receive.

If nonaccredited persons are among the offerees, then rule 242 requires that the offerees be furnished with a disclosure document based upon Part I of Form S-18, but only to the extent that Form S-18 disclosures would be *material* to an understanding of the issuer or its business or securities.[93] Although preparation of such a document is still a time-consuming and expensive undertaking, incorporation of a materiality standard and use of Form S-18 as the basis for the disclosure document represent important steps in reducing the costs and risks associated with the preparation of a nonpublic-offering disclosure document.

Rule 146 requires that each offeree shall either have access to or be furnished with the same kind of information specified in Schedule A, to the extent that the issuer either possesses such information or can acquire it without unreasonable effort or expense.[94] Both the courts and the SEC have given the concept of "access" a very restrictive interpretation.[95] Offerees are likely to be found to possess the requisite access only if: (a) they are key employees of the issuer, (b) they have a family relationship with a person controlling the issuer, or (c) they possess economic bargaining power by which they may obtain Schedule A type information from the issuer.[96] If not all offerees are in "access" relationships with the issuer, then a disclosure document, based on Schedule A of the Act, is required. Rule 146, in contrast to rule 242, has

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92. Securities Act Rules and Regulations, 17 C.F.R. § 230.242(f)(1) (1980).

93. *Id.* § 230.242(f)(1)(i).

94. *Id.* § 230.146(e)(1).

95. *Id.* § 230.146(e) ("Note"); SEC v. Continental Tobacco Co. of S.C., Inc., 463 F.2d 137 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

96. Securities Act Rules and Regulations, 17 C.F.R. § 230.146(e) ("Note") (1980).

only a circumscribed materiality standard: all information required by Schedule A must be furnished (to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense) except that an issuer "may omit details or employ condensation of information if, under the circumstances, the omitted information is not material or the condensation of information does not render the statements made misleading."[97]

The requirements of section 4(2) regarding access to and availability of information are somewhat unclear. The view has long been taken by some courts and the SEC that availability alone is insufficient.[98] As the SEC recently put it:

> An offering is not a nonpublic offering merely because it is made to persons who are voluntarily furnished information when such persons are not in a position with respect to the company as would give them access to such information about the company that would make compliance with section 5 of the 1933 Act unnecessary.[99]

In a 1977 case, however, the Fifth Circuit, which played a central role in the narrowing of the section 4(2) exemption, rejected the view that both availability of and access to information were necessary for purposes of the section 4(2) exemption: the "disjunctive requirement . . . expresses a sound view."[100]

It is also unclear whether the concept of "access" contained in rule 146, which is based upon the Fifth Circuit *Hill York* and *Continental Tobacco* cases, controls in section 4(2) offerings or whether a broader concept of access might apply. Furthermore, most practitioners read a more meaningful materiality standard into the informational requirements of section 4(2) than is provided by rule 146.[101] As a result, section

97. *Id.* § 230.146(e)(1)(ii)(*b*)(*1*). The burden of proof as to the materiality of the omission of the "detail" or the condensation rests with the issuer. *Id.* § 230.146(e)(1)(ii)(*b*)(*1*) ("Note").

98. *See, e.g.*, Securities Act Release No. 4552 (Nov. 6, 1962), *reprinted in* 1 FED. SEC. L. REP. (CCH) ¶ 2770 (1980); SEC v. Continental Tobacco Co. of S.C., Inc., 463 F.2d 137 (5th Cir. 1972).

99. SEC no-action letter to Secured Option Strategies, Inc. (Nov. 14, 1979).

100. Doran v. Petroleum Management Corp., 545 F.2d 893, 906 (5th Cir. 1977).

101. Rule 146 provides only for the omission of details and the condensation of information. Securities Act Rules and Regulations, 17 C.F.R. § 230.146(e)(1)(ii)(*b*)(*1*). *See* note 97 and accompanying text *supra*. The SEC is considering amending rule 146 "to add to Rule 146(e) an express materiality standard with respect to the informa-

4(2) is preferred over rule 146 in most venture capital transactions.

C. *Other Differences*

1. *Number of Purchasers.* Rule 146 permits sales of securities to as many as thirty-five persons, with purchasers of at least $150,000 of securities being excluded from the count.[102] Rule 242 permits sales of securities to as many as thirty-five nonaccredited persons and to an unlimited number of accredited persons.[103] Under section 4(2), the permissible number of purchasers is not subject to precise specification.[104] It does seem likely, however, that the permissible number of purchasers under section 4(2), as currently interpreted by the courts and the SEC, is at least as large as the number of purchasers permitted by rule 146.[105]

Venture capital financings generally involve a relatively small group of investors that will seldom approach the permissible limits under any of these three exemptions. Thus, the differences among the three exemptions with respect to permissible numbers of purchasers are likely to be of little significance in determining which exemption to rely upon in a venture capital transaction.

2. *Reports.* It is a condition of both rule 146 and rule 242 that an issuer file a report (on Form 146 or Form 242 respectively) with the SEC indicating that an offering of securities has been made pursuant to one of those rules.[106] The rule 242 filing, in addition to reporting that a rule 242 offering has been made, contains an undertaking that requires the issuer, upon SEC request, to submit to the SEC the information fur-

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tion which must be received by . . . each offeree." Securities Act Release No. 6219 (June 30, 1980).

102. Securities Act Rules and Regulations, 17 C.F.R. § 230.146(g) (1980). Rule 146(g) also provides for some attribution with regard to the number of purchasers. *Id.* § 230.146(g)(2).

103. *Id.* § 230.242(e).

104. This follows from the Supreme Court's observation in *Ralston Purina* that "the statute would seem to apply to a 'public offering' whether to few or many." SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1952) (footnote omitted).

105. "[N]othing prevents the Commission . . . from using some kind of numerical test . . . . But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation." *Id.*

106. Securities Act Rules and Regulations, 17 C.F.R. §§ 230.146(i) and 230.242(h) (1980).

nished by it to nonaccredited persons.[107] The SEC has indicated that such materials will be requested only for purposes of evaluating the rule's use and determining whether the rule should be amended or rescinded.[108] By contrast, there is no reporting requirement for offerings made pursuant to section 4(2).

In the venture capital context, the possibility that an issuer may be required to file its disclosure documents with the SEC may result in somewhat diminished use of rule 242 if the issuer fears that, through the Freedom of Information Act or some other means, confidential information contained in its disclosure documents might become publicly available.[109] In the typical venture capital transaction, however, this is unlikely to be a significant factor in the choice of an exemption from registration.

3. *Effect Upon Other Exemptions.* In general, use of rule 146 or section 4(2) does not affect the availability of other exemptions from registration under the Act.[110] Use of rule 242, on the other hand, does (within certain time limitations) reduce or eliminate the ability of the issuer to rely upon the Act's small-issue exemption, including Regulation A.[111] For the typical venture capital transaction, however, this difference is likely to be of little consequence.

VI. Conclusion

Rule 146 is seldom relied upon in venture capital transactions.[112] Its conception of "access" to information is too limited, its condition relating to furnishing of information contains a circumscribed materiality standard, it makes no

107. Securities Act Forms, 17 C.F.R. § 239.242 ("Undertaking") (1980).

108. Securities Act Release No. 6180, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362, 6367 (1980).

109. *See, e.g.*, 5 U.S.C. § 552 (1980).

110. *But cf.* rule 240 (sales of unregistered securities by an issuer within the preceding twelve months directly reduce the amount of securities that may be sold pursuant to rule 240). Securities Act Rules and Regulations, 17 C.F.R. § 230.240 (1980).

111. *Id.* § 230.254(a)(1).

112. In the period from May 1978 through January 1979, the SEC received a total of 1,047 Form 146's, covering offerings totalling approximately $1.3 billion. Of the 1,047 offerings, 667, or nearly two-thirds, were either real estate syndications or oil and gas offerings. Fass & Wittner, *Real Estate Securities*, 12 Rev. Sec. Reg. 921, 924 (1979).

provision for the lead investor phenomenon often encountered in venture capital transactions,[113] and its availability is governed by a standard of strict, rather than substantial, compliance.[114]

Rule 146 has served an important function in connection with venture capital transactions, nonetheless. It has provided a more objective means of interpreting section 4(2) and resolved a number of previously unsettled issues.[115] As the Fifth Circuit noted in the *Doran* case, it offers "some rays of sunlight into the limbos and uncertain depths of § 4(2)."[116]

Section 4(2), the contours of which have been uncertain ever since the *Ralston Purina* case, remains the most important exemption from registration for venture capital transactions, principally because it lacks the rigidity of rule 146, particularly with respect to access to information. With rule 146 as a guideline, practitioners may with some confidence structure venture capital transactions to fall within the boundaries of section 4(2).

Rule 242 represents a promising development for venture

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113. In many venture capital transactions there will be a group of investors with some investing more than others. In such situations it is common to find a "lead investor" who handles the bulk of the negotiations with and investigation of the issuer. In such instances, the lower-tier investors rely primarily upon the lead investor in making decisions regarding their investment. Accordingly, the implicit assumption in rule 146 that investment transactions pursuant to the rule will be handled on a fact-to-face basis, and the consequent tailoring of the rule's provisions to fit such situations, makes it difficult for all of the conditions of the rule to be met when a lead investor is relied upon. Rather than forego reliance upon a lead investor, the investor group is likely to choose to rely upon section 4(2) rather than rule 146.

Interestingly enough, the SEC did consider structuring rule 146 to cover more satisfactorily transactions in which there are only "two genuine sides to the bargaining table"; in such cases "the lead purchaser [would] . . . be considered to have negotiated on behalf of the second and third tier of purchasers." Whitman, *Private Placements and Rule 146*, in THE SEC SPEAKS AGAIN 131, 133 (A.A. Sommer, A. Levenson & H. Enberg eds. 1973). The proposal was never adopted.

114. SEC Chairman Harold Williams, in testimony before the United States Senate, commented that witnesses at the SEC's 1978 small business capital formation hearings "[w]ith very few exceptions . . . indicated that Rule 146 should either be amended, or a separate rule promulgated, in order to be of benefit to small business seeking to raise capital. Compliance with the rule was described as unduly complex, costly, and subjective, with an unacceptable level of risk that the exemption may be lost inadvertently." *Hearings on Capital Formation Before the Select Comm. on Small Business of the U.S. Senate*, 95th Cong., 2d Sess. (pt. 3) 584 (1978).

115. The rule made clear that, at least for its own purposes, the information "access" and "availability" tests are *alternative* tests. It also made clear that use of a disclosure document does not signal lack of sophistication of the offerees.

116. Doran v. Petroleum Management Corp., 454 F.2d 893, 908 (5th Cir. 1977).

capital transactions. The rule suffers from three principal shortcomings, however. First, it imposes an aggregate offering price limitation equal to $2 million that may be inadequate for a number of venture capital financings. Second, especially in the venture capital context, the fact that its definition of "affiliate" may cover what we have referred to as "portfolio affiliates" may create untoward problems in complying with the rule. Third, the rule's failure to include venture capital companies within the definition of "accredited persons" may require the issuer to make extensive written disclosures that might otherwise have been unnecessary, thus reducing the rule's attractiveness for venture capital transactions.[117] It may be hoped that with experience the SEC will modify the rule to remedy at least the latter two shortcomings.

The SEC has indicated that it may revise rule 146 to bring it more into line with the approach taken in rule 242.[118] For venture capital transactions, this would represent a promising development: it would reduce the costs of compliance with the Act without a corresponding reduction in the protections afforded by the Act to those in need of such protections.

Finally, the recent adoption of section 4(6) of the Act represents a promising development for venture capital financings because of the potential advantages of section 4(6) over rule 242.[119] The exemption afforded by section 4(6) is not lim-

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117. A number of commentators recommended to the SEC that venture capital firms be included within the definition of "accredited person." Securities Act Release No. 6180, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362, 6363 (1980). The SEC did not adopt this recommendation, noting that it believed "it appropriate to defer consideration of 'accredited person' treatment for venture capital companies until it has defined 'business development company' in the current rulemaking proceeding under the [Investment] Advisers Act [of 1940]." *Id.* at 6363-64. Congress, in recently enacting the Small Business Investment Incentive Act of 1980, has codified a definition of "business development company." That same Act also added section 2(15) and section 4(6) to the Securities Act of 1933. *See* note 2 *supra*; note 122 *infra*.

118. Securities Act Release No. 6219 (June 30, 1980) *reprinted in* [Current Binder] FED. SEC. L. REP. (CCH) ¶ 82,619. "The Office of Small Business Policy is considering amendments to Rule 146 . . . which would more closely conform that provision to Rule 242 . . . . Among the questions under review are whether to add to Rule 146(e) an express materiality standard with respect to the information which must be received by, or be accessible to, each offeree or this representative, The staff also is considering whether to exclude defined institutional investors from the 35-purchaser limitation in Rule 146." *Id.*

119. *See* note 2 *supra*.

ited to "qualified issuers."[120] The aggregate offering price limitation under section 4(6) is $5 million rather than $2 million. There are no specific information requirements imposed by section 4(6).[121] On the other hand, offers and sales under section 4(6) are limited to "accredited investors."

Any assessment of section 4(6) as an exemption for use in venture capital transactions must await SEC promulgation of rules and regulations completing the definition of "accredited investor" under section 2(15)(ii) of the Act. Of particular significance is whether the SEC's definition of accredited investor will be broad enough to include most venture capitalists.[122] If it is, the SEC will have made an appropriate response to the clear intent of Congress to ease the regulatory burdens that now hinder small business capital formation.[123]

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120. *See* text accompanying notes 47 & 71-74 *supra*.

121. There are no specific informational requirements in a rule 242 offering so long as sales are limited to "accredited persons" under the rule. *See* note 57 *supra*.

122. The definition of "business development company" in section 2(a)(48) of the Investment Company Act of 1940, *as amended by* Small Business Investments Incentive Act of 1980, Pub. L. No. 96-477, §101, 94 Stat. 2275, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 94 Stat. 2276 (to be codified in 15 U.S.C. § 80a-2(a)(48)), is too restrictive to be of use to most venture capitalists.

123. *See, e.g.*, H.R. Rep. No. 1341, 96th Cong., 2d Sess. 20-22 (1980).