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DARK CLOUDS IN A BLUE SKY: AN ANALYSIS OF THE LIMITED OFFERING EXEMPTION

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I. INTRODUCTION

It is the purpose of this paper to set forth and explain how the various Blue Sky laws through their limited offering exemptions[1] affect the financing of small businesses. The paper will primarily be focused upon the limited offering exemption, with reference being made to other Blue Sky provisions. Moreover, emphasis will be made, where appropriate, upon the close corporation.

It is becoming more and more apparent that small business is playing a greater role in the economy of our society. Moreover, many businessmen are employing various statutory devices in their efforts to incorporate their small tightly knit, and often family businesses. More likely than not these individuals will have felt either an initial need for capital or a post-incorporation desire for working capital or expansion funds. At any rate, such individuals may have success in obtaining post-incorporation funds from the traditional sources of financing, to wit: the individual's own savings, or perhaps funds available from banks, small loan companies, or the insurance industry. It is suggested, however, that such efforts will generally fail to generate sufficient capital. Consequently, businessmen are often forced to explore the possibility of obtaining funds

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1. The limited offering exemption, or as it is sometimes referred to the private offering exemption, is a transaction exemption which enables an issuer to avoid registration of securities issued, upon the rationale that a public offering is not involved.

from members of the public. Here they discover that their efforts, their manner and method of solicitation, are severely restricted by the terms of what the authors consider to be unreasonably encumbering state statutes—the Blue Sky laws which are found in forty-six states. It is our opinion that these statutes unnecessarily hinder the financing of the small business.

In order to advance this thesis, the paper has been divided into several sections: general commentary on the Blue Sky laws, analysis of the federal private offering exemption, discussion of the pre-incorporation subscription exemption, analysis of the various state private offering exemption provisions, commentary on the inability of the close corporation to obtain funds from the "traditional" sources, and a discussion of various other factors which affect the financing of the small business. In addition to the above analysis, the authors propose a model limited offering statute which would permit greater financing success without sacrificing investor protection.

It is interesting to note that there is a general lack of authority on the specific areas covered in this paper. Moreover, it appears that this is the first published article which attempts to relate the economic effect this specific statutory regulation—the private offering exemption—has upon the financing of the close corporation.

The states were the first governmental units which undertook the difficult task of regulating the sale of securities. Constitutionally, such legislation is based on the state's police power to prevent fraud and to provide for the general welfare of its citizens.[2] Kansas, in 1911, was the first state to enact legislation for the express purpose of regulating and supervising the activities of investment companies. Since then all of the states except Delaware have enacted a mass of security regulations which stand ready to entangle the unwary corporation.

Compliance with the federal security statutes does not generally exempt an offering from the shadow of the Blue Sky regulations. In order for a security to be sold, state Blue Sky laws must also be adhered to by the issuing corporation. Therefore, Blue Sky legislation has the potential of giving a nationwide offering "an Alice-in-Wonderland quality."[3]

Just as the avowed purpose of federal security legislation is to afford "full-disclosure," the general purpose which is evident throughout the web of state legislation is the paternalistic attitude that the investor must be protected. Thus it has been stated that: "At one extreme is the universal state paternalistic policy of stressing regulation and at the other

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2. The general validity of the Blue Sky laws is beyond question. *See* Merrick v. North West Halsey & Co., 242 U.S. 568 (1917); Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559 (1917); Hall v. Geiger-Jones Co., 242 U.S. 539 (1917).

3. Brainin & Davis, *State Regulation of the Sale of Securities*, 14 BUS. LAW 456 (1959).

extreme is the federal policy of stressing disclosure."[4] Unfortunately, the corporation is often caught in the middle.

According to the leading case of *Hall v. Geiger-Jones Co.*,[5] the purpose of Blue Sky laws is "to protect the public against the imposition of unsubstantial schemes and the securities based upon them . . . which have no more basis than so many feet of Blue Sky." In essence, Blue Sky laws are allegedly supposed "to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures. . . ."[6]

Forty-six[7] states have enacted some form of limited offering exemption. Generally exempt from the state registration requirements are those transactions made by an issuer which do not result in a public offering within the state. Therefore, to avoid costly registration, a close corporation which is seeking expansion capital must turn to this exemption in order to legally raise funds in these states. Because of the direct regulatory nature of the Blue Sky laws and the economic importance of the limited offering exemption, there exists the potential to "seal off a most likely avenue for fund raising by small promoters. . . ."[8]

II. WHAT IS SMALL BUSINESS?

This article is only pertinent if in fact the small business plays an important role in our economy. It appears necessary, therefore, to define what is meant by the term "small business" and to devote some time to an explanation of the role of the small business in our economy.

At the beginning it should be noted that what is desired is a definition which is simple and which will remain meaningful over time. It seems unlikely, however, that such a definition exists,[9] for the reason that business size may well need to be measured differently while attempting to isolate and study any particular factor as, for example, the financing of the firm.

One possible definition suggests that a small business is one which involves:

4. Krakover & Mehler, *State and Federal Securities Surveillance*, 27 ROCKY MT. L. REV. 496, 502 (1955).

5. 242 U.S. 539, 550 (1917).

6. Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 815, 361 P.2d 906, 908, 13 Cal. Rptr. 186, 188 (1961).

7. Connecticut, Delaware, New Hampshire and Vermont do not have limited offering exemptions. But Connecticut and Delaware do not require the registration of securities, so the exemption is not needed. New York does not expressly provide for such an exemption, but its Blue Sky law does exempt offerings with respect to which a registration statement is not required to be filed under the Securities Act of 1933 for reasons other than the intra-state exemption.

8. Manne & Mofsky, *What Price Blue-Sky?*, Barron's, August 5, 1968 at 5, col. 1.

9. FEDERAL RESERVE SYSTEM, 85TH CONG., 2D SESS., REPORT ON FINANCING SMALL BUSINESS 151 (Comm. Print 1958) [hereinafter cited as REPORTS ON FINANCING SMALL BUSINESS].

> (1) . . . all or most of the business functions and decisions concerning production, marketing, financing, and management; and (2) does not exceed a size which, considering the nature of the business, permits personalized management in the hands of one or a few executives, as opposed to institutionalized mânagement characteristics of larger enterprise.[10]

Other definitions suggest that a small business is any business which cannot afford a lobbyist in Washintgon, while a Department of Labor definition focuses upon the number of employees.[11]

For our purposes, however, it seems sufficient to employ an "average man" definition of small business:

> [A]ny type of business locally owned and operated in which the owner is the "boss" and actually is in charge of operations; he may be in business for himself or he may have a few employees associated with him.[12]

The utility of this definition lies in the fact that it recognizes that small business is self-initiated, self-financed, and self-managed. Included within the scope of this definition of small business is the close corporation.

In order to fully appreciate the effect of a particular regulation on our economy, a few statistics seem appropriate. In 1939, 92% of our business establishments were classified as "small," thus indicating the fallacy of the notion that "the man with a little capital has no place in our society."[13] In that same year, for every forty-four individuals there was one business concern. The aggregate of small business constituted over 90% of all industry, employed 45% of the work force and produced 34% of the value of the products and services.

In 1958 the Federal Reserve Systems, in a report to the Congressional Committees on Banking and Currency,[14] indicated that each year as many as 380,000 new firms are started, the overwhelming majority of which are small businesses.[15] Taking into consideration the number of business failures a year, our economy can report, since 1948, a net increase of 50,000 firms a year, of which 99% qualify as small concerns.[16] Moreover, it is suggested that a majority of these businesses are incorporated pursuant to close corporation statutes or would at least be susceptible to this form of incorporation.[17] In addition to the obvious—that

10. E. HOLLANDER, THE FUTURE OF SMALL BUSINESS 4 (1967) [hereinafter cited as HOLLANDER].

11. Schmidt, *The Role and Problems of Small Business*, 11 LAW & CONTEMP. PROB. 205 (1945).

12. *Id.* at 205.

13. *Id.* at 206.

14. Report on Financing Small Business, *supra* note 9.

15. *Id.* at 4.

16. *Id.* at 5.

17. *See* FLA. STAT. § 608.0100 (1967).

the small business, in terms of the number of its firms, its employment capabilities, and its production value plays an important economic role—it should be noted that the development and promotion of the small business is directly related to the number and types of services and commodities available for consumption.[18] Finally, the small business is both socially and politically important:

> If business were confined to a few large companies in every community, the opportunities for self-employment, self-direction, and self-realization would be reduced. The man with ideas, ambition, and small capital would not have an opportunity to use his capital, try out his ideas, and satisfy his ambition.[19]

Clearly, our society has economic, social, and political reasons for seeing to it that the development of the small business is fostered.

III. TRADITIONAL SOURCES OF FINANCING AND THE SMALL BUSINESS

"Everybody agrees that small business should have adequate loan and equity capital on reasonable terms and conditions."[20] As one might expect, however, disagreement existed, and still exists, as to whether or not small business has ready access to the capital markets. Some have expressed the opinion that commercial banks satisfy the needs of small borrowers in the fields of business and personal finance.[21] Others are of the opinion that the solvent borrower in need for expansion, start-up, or working capital is often unable to satisfy his credit demands. A Department of Commerce survey of 600 firms with high credit ratings reports that 75% of the interviewed companies were unable to secure permanent financing in the regular markets. A smaller percentage indicated inability to secure long term and working capital funds.

Since the depression, the various sources of small business credit have not undergone significant changes. Generally the sources of financing include commercial and industrial banks, small loan companies, various manufacturers, trade credit, private sources, and the public capital markets, to name a few.

Our analysis of the above sources of financing indicates that the capital requirements of businesses too new to have accumulated internal resources or too small to tap the organized markets present a perpetual problem to business.[22] This is primarily because the "money and credit system and the capital market of the United States operates in specific

18. Schmidt, *supra* note 11 at 210.
19. *Id.*
20. Wilhelm, *How Small Business Competes for Funds*, 11 LAW & CONTEMP. PROB. 220 (1945).
21. SBA MANAGEMENT RESEARCH SUMMARY, FACTS ABOUT SMALL BUSINESS FINANCING (1967) [hereinafter cited as SBA MANAGEMENT RESEARCH SUMMARY].
22. HOLLANDER at 126.

and characteristic ways which impinge differently on large and small businesses."[23]

The commercial bank is[24] and has been[25] the largest single institutional supplier of funds to the small firm. Though the attitude of bankers toward small business financings is favorable—reflected in the often used phrase "a desire to meet the legitimate needs of all creditworthy borrowers"—there are many factors which force the banking industry to approach loans to small business with caution. For example, the nature of a bank's liabilities imposes restrictions on liquidity which have an effect on lending policies. Additionally, banks must respect and obey the myriad of banking laws and regulations which impose standards for loans in an effort to protect depositors.[26] Finally, and perhaps most important, there is the common sense recognition of risk; a loan to a firm which is either new or unproven, which does not have a record of borrowing and repayment, which has not demonstrated an ability to compete, and which may be controlled by unknown or uninterested management is a loan which involves more unnecessary risk to the lending institution than does the alternative of employment of funds with the established concern.[27] These factors have operated, and justifiably so, to the benefit of the larger firms, enabling them to obtain more money on easier terms with lower rates of interest. The small firm, on the other hand, if able to secure a loan at all, is generally confined to the use of the short term, secured, and high interest instrument.[28]

It appears obvious that the small business, the growth firm, or even the new venture will encounter problems in securing proper financing from the commercial bank. To a small business, the questionable management talents of its executives, its inadequate equity position, and the absence of a "track record" are like the Sword of Damocles crashing down upon it with the filing of the first loan application.

In a smiliar manner the other "traditional" sources of credit are incapable of providing the small business with adequate funding. In addition to recognition of the risk factor, various state laws restrict the disposition of funds in the coffers of the insurance and small loan companies. And in the isolated instance, where money is available from such sources, the terms of the lending instrument call for high rates of interest, are generally restrictive in duration,[29] and often call upon the promoters to supply collateral in the form of their personal assets.

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23. *Id.* at 127.

24. REPORT ON FINANCING SMALL BUSINESS, *supra* note 9, at 396.

25. Wilhelm, *supra* note 20, at 222.

26. REPORT ON FINANCING SMALL BUSINESS, *supra* note 9, at 402, 416.

27. *Id.*

28. HOLLANDER, *supra* note 22, at 129; REPORT ON FINANCING SMALL BUSINESS, *supra* note 9, at 402-03; Wilhelm, *supra* note 20, at 220, 225.

29. It has been observed, and it appears to be generally recognized, that the small business encounters its greatest financing obstacles when it is in need for long term, as opposed to short-term, funds. *See* SBA MANAGEMENT RESEARCH SUMMARY, *supra* note 21.

At this point it should be evident that the needs and objectives of the small businessman are likely to be inconsistent or incompatible with the terms and objectives of the potential investor or lender.[30] It should be realized that what the small firm, perhaps the close corporation, desires is a "partner"—the person or institution with the money necessary to promote the ideas and products of the firm. However, the suppliers of funds are not anxious to become partners in an unproven enterprise when they, too, are forced to respond to depositors and stockholders while additionally obeying the laws of their states. Perhaps, in part, it is this general inability to obtain funds from the traditional sources of financing which has resulted in the demise of from 325,000 to 340,000 businesses a year.[31]

With respect to government supported financing, it has recently been noted that the federal government, through SBA loans, has managed to make a noticeable impact in aiding the financing efforts of the new concern.[32] The SBA, however, has not managed to close the gap between the needs of the typical small business and the supply of available funds. Hollander points out that even though the SBA will only make loans which banks do not make, its program is essentially an "extension of the commercial banking system, with somewhat easier requirements and longer maturities."[33]

Moreover, the SBA's requirement for "matching funds" and its emphasis on "bankable" loans are further indications that the SBA will not depart, to any great measure, from traditional banking standards.

An excellent summary of the foregoing comments is presented by Hollander:

> It has been said of small business that they want venture capital on a loan basis meaning that they want long-term money not fully secured, without surrendering or diluting their equity or their freedom to make policies and decisions in their personal interest. On such terms, organized capital markets are normally beyond reach; and long term loans are hard to come by and require secure collateral.[34]

The single greatest need of the small business is its desire for long term funds. While the large firm can make use of the existing security markets and the other sources of financing, its small counterpart can neither qualify nor afford such funding. For all practical purposes the security markets are closed to the small business. And even in the situation where the firm can afford an issue it may encounter difficulty in finding an adequate market.

30. HOLLANDER, *supra* note 22, at 128.
31. REPORT ON FINANCING SMALL BUSINESS, *supra* note 9, at 5.
32. HOLLANDER, *supra* note 22, at 132.
33. *Id.*
34. *Id.* at 128.

The effect of the general inability of small business to obtain capital has been that, by and large, such enterprise has been the product of personal investment. A recent study of 689 small businesses reports that 70% of the firms interviewed increased their equity capital through the devices of retained earnings or personal investment.[35] And obviously the ability of such sources to provide proper financing for our firms is limited by our tax laws.[36] It is suggested that of firms reporting an increase in capital through personal investment, a high percentage turned to their own pockets upon finding the other sources generally unavailable.

Notwithstanding the foregoing, there are those who would undoubtedly argue that small business does not need funds or that present needs are adequately satisfied by the traditional sources. Moreover, even if it is admitted that the needs of the small business are not satisfied by the traditional sources, individuals would argue that a solution to the problem lies in correctional efforts with respect to such traditional sources, and consequently little or no emphasis should be placed upon the private offering exemption. That position, however, is shortsighted; the small business does need funds, the traditional sources do not satisfy that need, and those sources, unlike the private offering exemptions, are not susceptible to easy change. And, as shown later, many of the typical private offering exemption statutes are rooted in something other than logic and sense, unnecessarily interfere with the financing of the small business, and *are* susceptible to easy change.

IV. Limited Offering Exemption—Federal Position

Commentary upon the federal private offering exemption is included for several reasons: first, the various state limited offering exemption provisions have not yet undergone judicial interpretation; second, the spirit of the federal law will necessarily influence later judicial interpretation of the state statutes; and third, in certain respects the shortcomings of the state statutes are common to the federal position.

Section 4(2) of the Securities Act of 1933, as amended, exempts from the registration requirements of the act "transactions by an issuer not involving any public offering." This exemption was, and is, frequently relied upon by the promoters of ventures desiring additional expansion or working capital. Overuse of the exemption has led, however, to abuse, with the consequent result that the exemption has experienced more than a fair share of judicial interpretation.

Basically, the private offering exemptions are of two types, the statute which focuses upon the "needs" of the offerees and the statute which focuses upon the "number" of offerees. The federal exemption can be

35. SBA Management Research Summary, *supra* note 21.

36. Hollander, *supra* note 22, at 135; Report on Financing Small Business, *supra* note 9, at 128.

classified as a "needs" statute and the proper inquiry is, therefore, whether the offeree needs the protection of the registration provisions of the act. The primary advantage of the "needs" statute, at least in theory, is that it enables an issuer to offer his securities without registration only to those individuals who do not need the protection of the act. However, registration is required where the offerees are unable to "fend" for themselves. A disadvantage stemming from such a statute is that the issuer can never be sure of just which offerees are in need of "protection," at least not until the event fixing liability has occurred.

Whether or not a distribution of securities is a private offering is still regarded as a question of fact. Nevertheless, after 30 years of judicial and commission interpretation involving no less than two dozen leading cases and two Security Act Releases, the law is relatively clear.

In *Securities Exchange Commission v. Sunbeam Gold Mines*,[37] the court first drew the distinction between a public and private offering, pointing out that a public offering has a meaning which does not preclude a finding that an offer to a restricted group is a public offering. Thus, the court rejected the issuer's contention that an offering to a restricted group, in this case 530 stockholders, was a private offering. In addition, the court recognized that the offerees involved (stockholders) were in as much need for information as were the members of the general public.

Though the court in *Sunbeam* failed to make specific reference to the 1935 Securities Act Rulings of the General Counsel, the error was later rectified in *Campbell v. Degenther*.[38] There the court held that a private offering was effected where the defendant sold 32 shares in the cost of drilling an oil well *to persons with whom he was associated in drilling other wells*. The court adopted the suggestions of the General Counsel in pointing out that the character of the offering could best be determined through analysis of:

1) The number of offerees and their relationship to each other and to the issuer.
2) The number of units involved.
3) The size of the offering.
4) The manner of the offering.

Today, however, guidelines for the availability of the private offerings exemption are set forth by the case of *S.E.C. v. Ralston Purina Co.*[39] and by Securities Exchange Act Release #4552 in 1962.

The importance of *Ralston Purina* lies in the fact that it constitutes an expression by the Supreme Court that "the statute [the exemption] would seem to apply to a 'public offering' whether to few or many."[40]

37. 95 F.2d 699 (9th Cir. 1938).
38. 97 F. Supp. 975 (W.D. Pa. 1951).
39. 346 U.S. 119 (1953).
40. *Id.* at 125.

Moreover, "there is no warrant for superimposing a quantity limit on private offerings as a matter of stautory interpretation."[41] In this case the court focused on the factual inquiry of whether the offerees, who were employees of the defendant corporation and who included an artist, a foreman, an office clerk, a stenographer and the like, were in *need* of the protection of the registration requirements of the act. The court stated:

> Absent such a showing of *special circumstances*, employees are just as much members of the investing "public" as any of their neighbors in the community. . . .
>
> The focus of the inquiry should be on the need of the offerees for the protections afforded by registration.

and concluded:

> The employees here were not shown to have access to the kind of information which registration would disclose.[42]

Thus, in this one decision the Supreme Court indicated that the focus of the federal statute was on "need" rather than "numbers."

The 1962 release was a response to what the commission found to be a tendency of many issuers to rely upon the exemption for the offerings of speculative issues to uninformed and unrelated investors. The reasoning supporting the "needs" type of private offering exemption is that an adequate substitute for the protection of the investor can be found in the relationship between himself and the issuer as examined within the framework of the particular issue. The release, therefore, adopted the position that the question of character of an issue is a question of fact which "necessitates a consideration of all surrounding circumstances,"[43] including those contained in the 1935 report set forth above. The Commission, moreover, indicated its support of the "need" classification placed upon the exemption in *Ralston Purina* and reemphasized that the numbers problem is only relevant to the question of whether the offerees have the requisite association with and knowledge of the issuer which make the exemption available. Specifically, the proper inquiry is whether the offeree has obtained from the above relationship the type of information usually disseminated through registration.

In addition, the release also mentioned the problem of investment; the purchasers must hold the securities for a length of time consistent with an investment, as opposed to a secondary and public distribution intent. The Commission was additionally concerned with the problem of integration of offerings—*i.e.*, whether what appears to be a private offering to a limited group is actually one of a series of offerings which amount to a non-exempt public offering.

41. *Id.*
42. *Id.* at 126, 127 (emphasis added).
43. Sec. Act Rel. 4552 (1962).

Though the federal position on this exemption is in some respects an improvement over many of the Blue Sky laws, it too operates as a detriment to the financing of small business. Specifically it suffers from the basic disadvantage of a "need" statute, the requisite investment intent, and the warning in the release on the use of the investment banker as a means of placing the private offering. At the conclusion of this paper it is hoped that the reader will understand why it has been stated that section 4(2) and its state counterparts are inadequate as a means for the general financing of small business[44] and why reliance upon the exemption is, at best, hazardous.[45]

V. The Blue Sky Limited Offering Exemption

Since the underlying philosophy of the Blue Sky laws is to protect the public, then any such "protection" must take into consideration the economic effect of the regulation on the close corporation. The limited offering exemption possibly affords the close corporation an opportunity to raise capital without the prohibitive cost of registering the offered security. To explore this possibility it is necessary to inquire into the practicality of such exemptions and into whether or not these exemptions are truly supplying adequate amounts of capital to the small corporation.

To expedite such an evaluation of the limited offering exemption, this paper has categorized the forty-six state limited offering exemptions into seven categories. The categories serve as a catalyst to foster the economic evaluation of the various types of limited offering exemptions which have been adopted. The state exemptions lend themselves to the following categorization: (A) those which limit the number of offerees; (B) those which limit the number of buyers; (C) states which limit the number of security holders; (D) those which apply the dual test of limiting the number of security holders and of establishing a maximum amount of capital which is permitted to be raised; (E) states which afford issuers the use of an isolated transaction exemption; (F) the twenty-four states and the District of Columbia which have adopted the Uniform Securities Act; and finally (G) those states which employ some other type of limited offering exemption.

A. *States Which Limit the Number of Offerees*

Of the twenty-one states which have limited offering exemptions and have not adopted the Uniform Securities Act, Florida, Georgia, Louisiana and North Carolina have a type of limited offering exemption which permits an issuer to offer stock to a specified number of offerees without registering the securities.

44. Margraf, *Does Securities Regulation Hinder Financing Small Business*, 11 Law & Contemp. Prob. 301 (1945).

45. Coll, *Corporate Financing and the Federal Securities Laws*, 6 Mercer L. Rev. 264, 272 (1955).

Florida's statute exempts:

> [t]he sale of its securities by a corporation or trust organized and existing under the laws of this state during any period of twelve (12) consecutive months to not more than *fifteen* (15) persons other than those designated in subsection (5) and including sales made pursuant to subsection (10), and provided that each purchaser prior to the consummation of the sale has been furnished adequate information concerning the true financial condition of the issuer, its business operations and the use of the proceeds from the sale. Provided further that sales made pursuant to this subsection shall be made without any public solicitation or advertisement, and no commission or other remuneration is paid or given, directly or indirectly, in connection with the sale and that sales are made only to persons who purchase for investment purposes only.[46]

The majority of the Florida Securities Commission interprets this section as allowing a maximum of fifteen offerees within the state, regardless of the number of offers made out of state. It is also interesting to note that the issuer must be a Florida corporation and that each purchaser must be given financial information prior to the sale.

The Georgia statute[47] exempts the sale of securities if the security is offered to no more than twenty-five persons, provided that the securities are purchased for investment,[48] that no commission or other remuneration is paid or given for or in connection with such sale, and that no other exemptions are afforded by the issuer under the subsection within the preceding period of twelve months.

North Carolina[49] exempts the transaction if a single class of securities of a domestic corporation is offered to not more than twenty-five persons in the state, provided that no expenses are incurred and no commission or remuneration is paid in connection with the sale.[50]

Louisiana's Blue Sky law[51] exempts the sale of securities if offers are directed to no more than ten persons in the state during twelve consecutive months. The seller must reasonably believe that all buyers in the state are purchasing for investment. No commission or remuneration may be paid in connection with the sale. Furthermore, the Commissioner is given the authority to withdraw or further condition this exemption or change the offeree and remuneration provisions.

The problem with an offeree-oriented exemption is that it is very difficult for the small corporation to raise additional capital and avoid offering the security to more than the prescribed number of offerees. For

46. FLA. STAT. § 517.06(11) (1967) (emphasis added).

47. GA. CODE ANN. § 97-107(j) (1968).

48. The statute provides that it is prima facie presumed to be purchased for investment if the stock purchased under this exemption was held by the original purchaser for a period of twelve months after issuance.

49. N.C. GEN. STAT. § 78-4(7) (1965).

example, under the Florida provision,[52] if the corporation offers the security to fifteen people in Florida and no one is interested in purchasing the stock, the corporation is prevented from offering the security to anyone else in Florida (under this exemption) for another twelve months.

In addition, each of these exemptions prohibits the payment of any commission or remuneration in connection with the sale. This effectively prevents the small corporation from availing itself of the services of an investment banker who could possibly offer the stock to the prescribed number of offerees and be virtually assured of buyers. Therefore, the economic consequences of this type of exemption do not tend to stimulate corporate growth.

Is there any "magic" in a specified number of offerees which the Blue Sky law exempts? Do the residents of one state require less protection than the residents of another state? Disregarding any sophistication of the offeree, the numbers test only establishes an arbitrary number of offerees which are thought not to need the protection of registration. Unfortunately, no one arbitrary number can serve the economic needs of the small corporation, nor can it offer the investing public the desired measure of protection. Certainly thirty financiers do not need the protection of registration, whereas fifteen unsophisticated widows do.

Another problem with the offeree-oriented exemption lies in the administration of the provision. Unless the issuer publicly advertises, it is extremely difficult for the securities commission to determine whether or not more than the specified number of offerees were contacted. A law which cannot be realistically enforced should be amended to insure compliance with the purpose of the provision.

B. *States Which Limit the Number of Buyers*

Two states, Iowa and Illinois, determine a limited offering by the number of buyers involved in the offering. An offering which involves more than the specified number of buyers must comply with the registration requirements of the Blue Sky law.

The Iowa statute[53] exempts the sale of securities by an issuer if within a twelve-month period not more than twenty persons[54] purchase such securities. No commission or other remuneration may be paid on account of such sale. In addition, the provision requires the issuer to file with the Commission the names and addresses of the purchasers along with the total amount of stock sold under the exemption.

50. The provision also states that the exemption is available for the offering of only two classes of securities issued by the same corporation.

51. LA. REV. STAT. § 51.705(12) (1968).

52. FLA. STAT. § 517.06(11) (1967).

53. IOWA CODE ANN. § 502.5(15) (Supp. 1968).

54. The number permitted excludes by statute persons otherwise exempt under different provisions of the Blue Sky law. This is a common feature found in most limited offering exemptions.

Illinois[55] exempts the sale of securities by an issuer to fifteen people[56] within a period of twelve consecutive months. No commission or other remuneration exceeding fifteen percent of the initial offering price of such securities is permitted. Furthermore, the issuer must file a report of sale with the commission.

This type of exemption appears to offer more certainty to the issuance of securities by a small corporation because regardless of the number of offerees the corporation is entitled to sell to the specified number of people. The limiting feature is whether or not the corporation can raise sufficient funds within the number of buyers allowed. Because of the general risk features of a small corporation it might not be possible to get fifteen or twenty people to invest large enough sums of money to satisfy the capital requirements of the corporation.

The built-in restriction of the use of investment bankers by limiting the payment of commisions or remunerations also deprives the issuer of an experienced financier who could lend his expertise to the issuer. In general, the buyer approach would be more useful if the corporation could use an investment banker and the number of buyers would be reasonable enough to allow sufficient sums of capital to be raised.

C. *States Which Limit the Number of Security Holders*

Six states exempt an offering so long as the holders of the security of the issuer does not exceed a specified number at the end of the transaction. The most restrictive states are California[57] and Ohio,[58] which limit the number of holders to five, followed by Maine[59] which limits them to ten, by West Virginia[60] and Wisconsin,[61] which limit the number to fifteen, and finally by Texas,[62] which is the most liberal, limiting the total number of security holders to thirty-five.

California's exemption applies to the sale of the voting common stock of a California corporation if, after the sale, there is only one class of stock which is owned beneficially by no more than five persons. No promotional consideration may be paid nor selling expenses incurred. Ohio allows the initial sale of voting stock to no more than five security holders.

Maine adopted a limited offering exemption directed to a maximum of ten shareholders. Therefore, a domestic corporation is permitted to sell its securities to no more than ten shareholders.

Both West Virginia and Wisconsin exempt the sale of stock by a

55. ILL. REV. STAT. ch. 121½ § 137.4(G) (Supp. 1967).
56. *See* note 51 *supra.*
57. CALIF. CORP. CODE § 25102(h) (Deering's Supp. 1968).
58. OHIO REV. CODE ANN. § 1707.03(o) (1964).
59. ME. REV. STAT. ANN. tit. 32, § 874(9) (Supp. 1968).
60. W. VA. CODE ANN. § 32-1-4(h) (1966).
61. WISC. STAT. ANN. § 189.07(1)(a) (Supp. 1968).
62. TEX. REV. CIV. STAT. ANN. art. 581-5(I) (1964).

domestic corporation if after the issuance the security holders do not exceed fifteen. The total organizational and promotional expenses connected with the issue, including attorney's fees but excluding statutory fees, is not permitted to exceed the greater of either three percent of the aggregate sales price, or two-hundred dollars in West Virginia and three hundred and fifty dollars in Wisconsin.

Texas exempts a sale which is made without public solicitation so long as the total number of security holders of the issuer does not exceed thirty-five, provided such persons purchase for their own account and not for distribution. The section goes on to exempt the sale by an issuer of its securities during a twelve-month period ending with the date of the sale in question to not more than fifteen persons. Because of the construction of the exemption it is difficult to determine whether or not both of these tests are mutually exclusive or whether both are applicable to an issuer.

This type of security holder test is most restrictive, in that after one limited offering the corporation could easily reach the aggregate number of security holders allowed. Thereafter, offerings would have to be registered. Thus, the aggregation of security holders tends to make the exemption available only once, and the number of shareholders is restrictive enough to prevent adequate capital expansion.

Another difficulty is whether or not note-, bond-, mortgage-, and other debt-holders would be included within the authorized number of security holders. The Texas statute[63] defines "security" as including any note, bond, debenture, mortgage certificate or other evidence of indebtedness, as do the Wisconsin,[64] West Virginia,[65] Ohio[66] and California[67] statutes. Maine's[68] statute excludes from the definition of "security" commercial paper or other evidence of a debt running not more than nine months. Therefore, the definitions of the term "security" lead to the conclusion that both debt holders and stockholders would be included in the limited number of security holders allowed, which further demonstrates the highly restrictive results of the security holders test.

D. *States Which Apply the Dual Test of Limiting the Number of Security Holders and of Establishing a Maximum Amount of Capital Permitted to Be Raised*

Massachusetts, Mississippi, Pennsylvania and Tennessee combine the security holder test with a limitation on the aggregate amount of money which may be raised by an exempt limited offering. A corporation,

63. TEX. REV. CIV. STAT. ANN. art. 581-4(A) (1964).
64. WISC. STAT. ANN. § 189.02(1) (1957).
65. W. VA. CODE ANN. § 32-1-2(a) (1966).
66. OHIO REV. CODE ANN. § 1707-01(B) (1964).
67. CALIF. CORP. CODE § 25008(b) (Deering's Supp. 1951).
68. ME. REV. STAT. ANN. tit. 32 § 751 (1964).

in these states, must therefore be aware of the two-fold restriction imposed by the limited offering exemption.

Massachusetts[69] employs an alternative requirement in its limited offering exemption. A Massachusetts corporation may issue and sell shares under the exemption if, as a result of the sale, the number of security holders does not exceed twenty-five *or* the aggregate amount raised by the sale and all prior sales does not exceed twenty-five thousand dollars. This limited offering exemption allows up to twenty-five security holders to contribute an unlimited amount of money or an unlimited number of security holders (over twenty-five) to contribute an aggregate of twenty-five thousand dollars.

The Mississippi statute[70] authorizes a domestic investment company[71] to offer its securities for sale if the total number of shareholders after such sale does not exceed ten. Furthermore, the shares must be purchased for investment and no commission or other remuneration is permitted to be paid. When the sale or offer exceeds an aggregate of fifty thousand dollars or the authorized capital of such company exceeds fifty thousand dollars, the Secretary of State requires certain affidavits from issuer signed by each proposed purchaser.

Pennsylvania does not require the registration of securities under its Blue Sky law. But it is necessary to register "dealers" in the state.[72] The act defines "dealers" as those who sell securities of another, and also those who sell securities issued by such person.[73] To avoid the "dealer" registration requirement, the act affords two provisions which, if followed, prevent the "dealer" status from becoming attached to the transaction. The first exemption[74] avoids dealer registration if the Pennsylvania corporation issuer's financial condition reflects that its authorized capital stock, when added to its other outstanding securities, does not exceed twenty-five thousand dollars.[75] The second provision[76] exempts the original issuance and sale by a domestic corporation so long as the number of stockholders does not exceed twenty-five and the securities are issued without the use of advertisements, agents, salesmen or any form of public solicitation.

Tennessee[77] exempts from registration subscriptions for or sales of shares of the capital stock of a domestic corporation or of a corporation

69. MASS. GEN. LAWS ANN. ch. 110A, § 3(f) (1958).

70. MISS. CODE ANN. § 5384.5(9) (Supp. 1966).

71. *Id.* Section 5361(a) of the Mississippi Blue Sky law defines a "Domestic Investment Company" as a corporation, copartnership, limited partnership or association organized in Mississippi.

72. PA. STAT. ANN. tit. 70 § 33 (1965).

73. *Id.* tit. 70 § 32(f).

74. *Id.* tit. 70 § 32-f-9.

75. For the purpose of the act, shares without nominal or par value are considered to be worth one hundred dollars each.

76. PA. STAT. ANN. tit. 70 § 32-f-10 (1965).

77. TENN. CODE ANN. § 48-1632(f) (1964).

domiciled in Tennessee. The securities must be issued prior to or in connection with the incorporation of the issuer and the number of subscriptions or sales must not exceed thirty. Furthermore, the amount raised must not exceed one hundred thousand dollars. No commission or other remuneration may be paid or given in connection with the transaction.

When the security holder test is combined with an aggregate monetary test, the result is a severe economic restriction on the size of the small corporation. The test does not distinguish between the economic needs of various corporations when it establishes a flat dollar amount. As stated in a discussion of this type of limited offering exemption:[78]

> The dollar limit alone has nothing to do with the policy of exempting essentially private transactions while regulating issues offered to the general public. Since most states are concerned primarily with regulating the number of transactions and the number of people involved rather than the amount of money involved, the dollar limit exception does not further the policy of the blue sky laws.

The Massachusetts alternative approach appears more desirable than the combined dual test. But the dollar limitation in any form is an economic inhibitor which tends to keep a corporation small without at the same time protecting the public.

E. *States Which Afford Issuers the Use of an Isolated Transaction Exemption*

Minnesota, North Dakota, Rhode Island and South Dakota allow corporate issuers the use of an isolated transaction exemption which most states only afford to non-issuers. These states permit use of the exemption if the corporation meets the same isolated transaction requirements that apply to non-issuers. An isolated sale is one which is not made in the course of successive and repeated transactions of a similar nature which are integrated with previous or subsequent sales.

Minnesota[79] allows a corporation to raise additional capital from the public without registering only if an isolated transaction exemption is used. Likewise Rhode Island[80] affords an issuer the use of the isolated transaction exemption only to offer securities and to still be able to avoid registration. The Rhode Island exemption uses the word "owner," but the state securities commission interprets the exemption to apply to issuers.

North Dakota[81] exempts an isolated transaction by an issuer only if there have not been more than two other sales of securities of the

78. Dillman, Mango, Sistare and Crean, *The Connecticut Security Act's Limited Offering exemption—A Proposal*, 39 Conn. Bar. J. 253, 286 (1965).

79. Minn. Stat. Ann. § 80.06(2) (1968).

80. R.I. Gen. Laws § 7-11-8(a) (1956).

81. N.D. Cent. Code § 10-04-06(3) (Supp. 1967).

same issue by the issuer in the state within twelve months prior to the date of such sale. The state also has an applicable provision for the sale of pre-incorporation subscriptions.[82]

South Dakota[83] affords the issuer use of the isolated transaction exemption. In addition, the Blue Sky law[84] also enables the domestic issuer to sell its securities to fifteen original incorporators and subscribers who purchase for investment.

Because of the importance of maintaining the singular transaction characteristic which is representative of the isolated transaction exemption, this type of exemption is of minor benefit to the small corporation. By its very nature, this exemption precludes the offer and sale of securities to any realistically sized market.

F. *States Which Have Adopted the Uniform Securities Act*

Twenty-four states,[85] along with the District of Columbia and Puerto Rico, have adopted the Uniform Securities Act.[86] Section 402(b)(9) of the Act contains a limited offering exemption as follows:[87]

> any transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in paragraph (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 paragraph 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 paragraph 8)); but the [Administrator] 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, Waive the conditions in clauses (A) and (B) with or without the substitution of a limitation or remuneration.

The official Code Comment to Sec. 402(b)(9) states that the "figure ten is in substance only a *prima facie* figure." Of the twenty-four states

82. *Id.* Section 10-04-06(9) allows for the sale of preorganization subscriptions to fifteen offerees or when the amount raised by such subscription does not exceed an aggregate of twenty-five thousand dollars.

83. S.D. CODE § 55.1904(1) (1939).

84. S.D. CODE § 55.1904(11) (1967).

85. Alabama, Alaska, Arkansas, Colorado, Hawaii, Idaho, Indiana, Kansas, Kentucky, Maryland, Michigan, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, Oklahoma, Oregon, South Carolina, Utah, Virginia, Washington and Wyoming.

86. The act was approved by the National Conference of Commissioners on Uniform State Laws on August 25, 1956. Amendments to the act were approved by the Conference on August 23, 1958.

87. The section exempts the transaction from the registration requirements of § 301 and the filing of sales and advertising literature in accord with § 403.

which have adopted the Act, only Alabama,[88] New Jersey,[89] Oklahoma[90] and South Carolina[91] have adopted section 402(b)(9) without any material changes. Therefore, in reality the Act is far from a "uniform" limited offering exemption.

Idaho,[92] Kentucky,[93] Montana[94] and Nebraska[95] use the "ten offerees" test but they do not give the commissioner the authority to withdraw or further condition the exemption. Nor can he increase or decrease the number of offerees permitted, nor waive the conditions in Clauses (A) and (B) with or without the subsection of a limitation or remuneration.

Oregon[96] combines the "ten offerees" test with alternative provisions of (1) filing notice with the commissioner at least five business days before the offer is made, or (2) the offerees must be holders of securities previously issued by the offeror, and the number of security holders must not exceed twenty-five.

Michigan,[97] Wyoming[98] and Missouri[99] all allow the corporation to offer its securities to not more than fifteen persons[100] during any period of twelve consecutive months. The commissioner may by rule or order alter the conditions of the exemption and decrease or increase the number of offerees or alter the no remuneration provision. All purchasers must buy for investment, and not with a view towards distribution.

Kansas[101] conditions its limited offering exemption by allowing only a domestic corporation to offer and sell its securities to the issuer's incorporators, who must not exceed fifteen in number.

Alaska,[102] Indiana[103] and Washington[104] use a "twenty offerees" test whereby the issuer may offer to twenty people within twelve consecutive months. No commission or remuneration is permitted and the purchaser must buy for investment. Both Alaska and Indiana permit the commissioner to further condition the exemption, or increase or decrease the number of offerees and adjust the limitation or remuneration.

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88. ALA. CODE ANN. tit. 53 § 38(i) (Supp. 1967).
89. N.J. STAT. ANN. § 49:3-50(b)(9) (Supp. 1967).
90. OKLA. STAT. ANN. tit. 71 § 401(b)(9) (1965).
91. S.C. CODE ANN. § 62-52(9) (1962).
92. IDAHO CODE ANN. § 30-1435(8) (1967).
93. KY. REV. STAT. § 292.410(9) (1962).
94. MONT. REV. CODE ANN. § 15-2014(8) (1967).
95. NEB. REV. STAT. § 8-1111(9) (Supp. 1965). Under its limited offering exemption a registered broker-dealer is permitted to receive remuneration.
96. OREGON REV. STAT. § 59.035(12) (1967).
97. MICH. STAT. ANN. § 451.802(6)(9) (1967).
98. WYO. STAT. ANN. 17-117.14(b)(9) (1965).
99. MO. ANN. STAT. § 409.402(b)(9) (Supp. 1968).
100. *See* note 51 *supra*.
101. KAN. STAT. ANN. § 17-1262(h) (1963).
102. ALASKA STAT. ANN. § 45.55.140(b)(5) (Supp. 1966).
103. IND. STAT. ANN. § 25-855(b)(10) (Supp. 1968).
104. WASH. REV. CODE ANN. § 21.20.320(9) (1961).

In Nevada,[105] a corporation may offer its securities to twenty-four people without having to comply with the state's intra-state security registration provisions.

Arkansas,[106] Colorado,[107] Hawaii[108] and Maryland[109] have established a "twenty-five offerees" test, which enables a corporation to offer its securities to twenty-four people within a twelve-month period. With the exception of Hawaii, these states also give the Commissioner the power to further condition the exemption or adjust the offeree number and the remuneration provisions. Only Maryland allows the corporations to pay commissions or remunerations in respect to the sale of its securities without having to obtain special authorization. Maryland is also exceptional in that it allows the commissioner to waive the condition relating to investment intent.

New Mexico[110] has adopted a security holder type of limited offering exemption. A domestic corporation may offer and sell its securities without registration if the number of security holders does not, and will not as a consequence of the sale, exceed twenty-four. The purchaser must buy for investment and no remunerations or commissions are permitted.

Virginia[111] allows a sales of securities by a corporation if after the sales the corporation does not have more than thirty security holders.

The remaining Uniform Securities Act state is Utah. It has no specific limited offering exemption available to post-incorporation capital expansion. The Blue Sky law[112] does provide for an isolated transaction exemption, but it is not certain whether or not this exemption is available to in issuer.

It is apparent from an evaluation of the various limited offering provisions which have been adopted by the Uniform Securities Act states that the Act has not brought uniformity to the problem. The one improvement which the Act does make, which the majority of states have adopted, is the provision giving the commissioner the authority to vary the number of offerees and adjust the remuneration prohibitions in a given instance. The difficulty with such an individual approach is that it lends uncertainty and results in additional cost to a small corporation seeking the commissioner's approval to change some of the conditions. The lack of promulgated rules and regulations dealing with this exemption prohibits an evaluation of the number of times a change has been effected and what guidelines have been employed.

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105. NEV. REV. STAT. § 90.075 (1965).
106. ARK. STAT. ANN. § 67-1248(b)(9) (1966).
107. COLO. REV. STAT. § 125-1-13(2)(a)(j) (1963).
108. HAWAII REV. LAWS § 199-5(i) (Supp. 1965).
109. MD. CODE ANN. 32A § 26(b)(9) (1967).
110. N.M. STAT. ANN. § 48-18-22(J) (1965).
111. VA. CODE ANN. § 13.1-514(b)(8) (1968).
112. UTAH CODE ANN. § 61-1-14(2)(a) (1967).

G. *States Which Employ Some Other Type of Limited Offering Exemption*

There are four non-Uniform Security Act states which use different standards to allow post-incorporation security sales without registration. Arizona[113] permits the sale of securities only to ten original incorporators who purchase for investment. Connecticut[114] does not require the registration of securities at all, but only of broker-dealers. Likewise, Delaware does not require the registration of securities.

A recent New York statute[115] exempts an offering or sale of securities with respect to which a registration statement has been filed and which has become effective with the United States Securities and Exchange Commission, or with respect to which a federal exemption, other than the intra-state offering, exists for such securities. Thus, compliance with the federal private offering exemption would automatically allow a registration-free sale of securities in New York. There is no restriction on the payment of commissions or remunerations in connection with the sale of such securities. This feature enables a small corporation in New York to take advantage of the services of an investment banker to aid in raising growth capital. Most states prohibit the payment of any commission or remuneration. Because of this situation, New York investment bankers are afforded a virtual monopoly in helping to finance small corporations which come to the state to avail themselves of their services.

Due to the lucrative features of their regulatory statutes, New York, Delaware and Connecticut are considered "free" states. Small corporations selling securities in these states do not have to seek registration exemptions. Because of the absence of an increased number of fraud cases reported in the "free" states, the authors would like to suggest that a comprehensive research project be undertaken to evaluate both the economic and protective effects of security registration, as compared to free sales coupled with fraud legislation.

VI. PRE-INCORPORATION FINANCING

In order to fully appreciate the financing problems encountered by a firm, it is necessary to consider the initial (pre-incorporation) as well as the subsequent (post-incorporation) attempts at capital acquisition.

As previously mentioned, the limited offering exemption serves to enable the firms to raise post-incorporation capital. Additionally, the Blue Sky laws of 34 states contain a transaction exemption—the pre-incorporation exemption—which enables the promoters of a new venture to obtain "start-up" capital.

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113. ARIZ. REV. STAT. § 44-1844(9) (1967).

114. CONN. STAT. ANN. § 36-322(a)(6)(E) (1968).

115. New York Session Laws, ch. 1093 § 359-ff (McKinney 1968) (effective November 1, 1968).

Typically such statutes restrict the number of subscribers or incorporators. The range is from three in Pennsylvania[116] to twenty-five in Rhode Island.[117] Tennessee[118] even provides for a restrictive dollar limit in conjunction with its limit on subscribers. Many statutes place a limit on the expenses which may be incurred in conjunction with the sale of pre-incorporation subscriptions. A few statutes even prohibit the subscribers from paying money for their subscriptions.[119] Of great importance is the fact that the overwhelming majority of the states include within the number of permitted statutory subscribers promoters, attorneys, accountants, and other persons to whom shares may be issued for services or other promotional activities.

This exemption, like the limited offering exemption, places too great a reliance upon the number of permissible subscribers and overlooks the sophistication of the individuals involved. Moreover this number limitation may result in a promoter's loss of control because of demands made by the necessarily small number of subscribers.[120]

VII. Proposed Model Limited Offering Exemption

The following is our proposed statute:

The following transaction is exempted from the registration requirements of the Act:

> The sale or sales of securities, by the issuer thereof to an unlimited number of financially sophisticated buyers, provided that each purchaser prior to the consummation of the sale has been furnished adequate information concerning the true financial condition of the issuer, its business operations, and the use of the proceeds from the sale. Furthermore, the issuer must reasonably believe that the purchaser is buying for investment.

Our proposed exemption statute is designed to accommodate both the philosophy of the Blue Sky laws and the economic realities of the business world. Thus, we have adopted a qualitative as opposed to a quantitative measure. This is in recognition of the fact that a "numbers" test does not fulfill the purpose of the Blue Sky laws. For example, under most statutes it is possible to sell an unlimited amount of securities to a restricted number of unsophisticated investors. Thus the widow, for example, is not afforded the protection allegedly offered by the Blue Sky Law.[121]

116. PA. STAT. ANN. tit. 70 § 32(17) (1965).

117. R.I. GEN. LAWS § 7-11-8(h) (1956).

118. TENN. CODE ANN. § 48-1632(G) (1964).

119. *See* WASH. REV. CODE ANN. § 21.20.320(10) (1961).

120. This is recognition of the fact that the smaller the number of subscribers, the larger the individual's contribution will be, and the demands made by such individuals will necessarily increase. *See* Manne & Mofsky, *supra* note 8.

121. The fraud provisions of the various acts, however, will always apply.

In addition, under the proposed statute it would be permissible to use the services of an investment banker in securing a market for the securities. To restrict the payment of commissions or other remunerations, as the vast majority of states do, is to insure that the firm will not have access to an adequate capital market.

More likely than not this proposed statute will accomplish several goals: 1) It will enable the issuer to come in easy contact with individuals who are looking for investment opportunities; 2) it will insure that the ultimate investors are individuals who are able to fend for themselves; 3) it will result in the investment banker's lending his business acumen to the issuer in order to protect his client. This approach, permitting the use of the investment banker, is patterned after the successful New York statute.

Unlike the majority of state statutes, the model does not limit the exemption to domestic corporations. This is in accord with the character of our national economy. Also, there is no valid reason to prohibit state residents from investing in out-of-state corporations.

Additionally, the proposed statute is consistent with the staff characteristics of the majority of the state securities commissions. That is to say, a buyer-oriented test lends itself to easier enforcement by understaffed commissions.

The authors, moreover, are of the opinion that although the proposed test is buyer-oriented, without restriction on offerees, issuers realistically will not offer to sell securities to an individual ultimately incapable—by virtue of a lack of sophistication—to purchase the securities.

VIII. OTHER FACTORS AFFECTING THE FINANCING OF THE SMALL BUSINESS

It is not the belief of the authors that the Blue Sky laws are solely responsible for the inability of the small business to finance itself. To advance such a position would indeed be naive. Rather, we do recognize that there are several other factors which affect the ability of the small business—the close corporation—to compete in the capital markets.

For example, one principal factor affecting the financing, and thus the future, of the small business is the role of our tax system. Previously it was pointed out that the high rates of personal income taxation have imposed restrictions on personal savings as a source of business capital. Likewise, the high rates of corporate income taxation have slowed the growth of earned surplus as a source of capital for the established firm.[122] In this regard, one author who has recognized the importance of both corporate and personal savings as a source of funds has pointed out that a reduction in taxes would increase and tend to strengthen the financial posture of the small firm.[123]

122. HOLLANDER, *supra* note 22, at 135; REPORT ON FINANCING SMALL BUSINESS, *supra* note 20, at 128.

123. Keith, *Impact of Taxation on Small Business*, 24 LAW & CONTEMP. PROB. 98, 113 (1959).

Moreover, Hollander indicates that though our tax laws are not intended to be discriminatory, they nonetheless operate in favor of big business. The preferential rate treatment afforded capital gains influences the terms of investment by channeling funds toward longer established firms, where the investor may obtain a high rate of return with a concurrently discounted risk factor.[124]

As between amending our tax structure or altering our Blue Sky laws, which should be given preference and why? An answer to this question necessarily implies that an analysis of the factors to be considered has been completed. Herein the authors have demonstrated that the Blue Sky limited offering exemptions vary from state to state, impose certain restrictions which necessarily hinder the efforts of entrepreneurs to obtain capital, and are subject to amendment without detriment to the public. On the other hand, revision of our tax laws to reflect lower rates of personal and corporate taxation will necessarily affect other areas of our economy. A tax rate amendment would, for example, necessarily decrease the spending ability of our government, with the result that government contracts to industry would probably decline. In turn we would most likely realize a decrease in our gross national product. While our tax laws do not exist in a vacuum, for a change in one area will have an effect elsewhere, it is suggested that the typical private offering exemption is totally unrelated to our business economy. As between the two it is therefore advanced that a change in our state statutes is to be preferred over revision of our tax structure.

It is suggested that a similar analysis of the other factors affecting financing of the firm would produce the same results. One example is the banking community. As previously mentioned, banks are reluctant to aid the new firm in its quest for capital primarily because of the risk factors involved. Risk analysis has always played an integral part in the making of business decisions, and the banking industry is clearly justified in following such an approach. Without some form of governmental indemnity it seems unlikely that the risk factor can be legislated out of commercial loan considerations. Most probably, therefore, the needs of small business will not be satisfied by commercial banks. Again, it appears that the initial effort in securing capital for business should be placed upon amendment of the Blue Sky limited offering exemptions.

IX. Conclusion

In summary, it is the opinion of the authors that the small business —the close corporation—is in need of funds which are not being supplied by either the traditional or statutory modes of financing. By and large the various state Blue Sky limited offering exemptions appear to be too economically prohibitive. At the same time these statutes do not afford the investing public the degree of protection contemplated.

124. *Supra* note 10, at 541.

It is hoped, therefore, that this article and the proposed model statute will stimulate economic evaluation of both this exemption and other Blue Sky provisions, in order that regulation will not be enacted merely for the sake of regulation.