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# Recent Legislation: Sec Rule 240—Exemption of Certain Limited Offers and Sales by Closely Held Issuers

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# RECENT LEGISLATION

## SEC RULE 240—EXEMPTION OF CERTAIN LIMITED OFFERS AND SALES BY CLOSELY HELD ISSUERS.

The enactment of the Securities Act of 1933<sup>1</sup> created a continuous disclosure system designed to protect investors.<sup>2</sup> The House Report stated, however, that “the Act carefully exempts from its application certain types of . . . securities transactions where there is no practical need for its application or where the public benefits are too remote.”<sup>3</sup> Pursuant to Section 3(b) of the Act,<sup>4</sup> and aware of the labyrinth of limitations and requirements for disclosure under Rule 146,<sup>5</sup> the Commission adopted Rule 240.<sup>6</sup>

Rule 240 provides that certain offers and sales of securities of the issuer are exempt from the registration provisions of Section 5 of the Act,<sup>7</sup> but not from the federal securities anti-fraud provisions<sup>8</sup> or state securities laws.<sup>9</sup> The primary purpose of the Rule is to aid small businesses in their efforts to raise capital. Potential users of the Rule should be aware of the specific limitations, conditions or prohibitions on: the manner of offering;<sup>10</sup> the aggregate sales price;<sup>11</sup> the number of beneficial owners;<sup>12</sup> the resale of the securities;<sup>13</sup> payments for soliciting buyers;<sup>14</sup> and, the notification of certain transactions.<sup>15</sup> These requirements restrict the Rule to securities

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1. 15 U.S.C. § 77a (1970) [hereinafter referred to as the “Act.”]
  2. Securities Act of 1933, Preamble.
  3. H.R. REP. No. 85, 73d Cong., 1st Sess. 5 (1933).
  4. 15 U.S.C. § 77c(b) (1970). The section reads as follows:

The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this section where the aggregate amount at which such issue is offered to the public exceeds \$500,000.
  5. SEC Rule 146, 17 C.F.R. § 230.146 (1975). Although designed to provide objective standards to establish when offers or sales are not transactions involving any public offering within the meaning of Section 4(2) of the Act, SEC Rule 146 is often unavailable to small, unsophisticated issuers desiring to raise capital from a relatively limited number of investors.
  6. SEC Rule 240, 17 C.F.R. § 230.240 (1975) (effective March 15, 1975). To provide for notification of certain transactions made in reliance on the Rule, SEC Form 240 was also adopted. SEC Form 240, 17 C.F.R. § 239.240 (1975); see p. 411 *infra*. SEC Rule 144 was amended to provide for the resale of SEC Rule 240 securities. SEC Rule 144(a)(3), 17 C.F.R. § 230.144(a)(3) (1975).
  7. 15 U.S.C. § 77e (1970).
  8. SEC Rule 240, 17 C.F.R. § 230.240 (1975), Preliminary Note 1.
  9. *Id.* 240, Preliminary Note 2.
  10. SEC Rule 240(b)-(c), 17 C.F.R. §§ 230.240(b)-(c) (1975).
  11. *Id.* 240(e), 17 C.F.R. §§ 230.240(e).
  12. *Id.* 240(f), 17 C.F.R. § 230.240(f).
  13. *Id.* 240(g), 17 C.F.R. § 230.240(g).
  14. *Id.* 240(d), 17 C.F.R. § 230.240(d).
  15. *Id.* 240(h), 17 C.F.R. § 230.240(h).

transactions which are limited in character. Although the Rule may offer numerous advantages, its technicalities may ensnare both the naive layman and the experienced attorney.<sup>16</sup>

The Rule is available to most issuers<sup>17</sup> of closely held securities. Securities of the issuer include all those issued by it as well as "all securities issued . . . by any affiliate of the issuer."<sup>18</sup> An affiliate is "a person<sup>19</sup> that directly or indirectly . . . controls, or is controlled by, or is under the common control [with]"<sup>20</sup> another person. The existence of an affiliate may restrict the application of the Rule. Corporation A, for instance, wishes to use the Rule; it controls or is controlled by Corporation B which sold unregistered securities valued at \$40,000.<sup>21</sup> After its attempted transaction under Rule 240, Corporation A sold securities for \$70,000. Because the aggregate sales price of the securities of the two corporations is \$110,000 and Rule 240 limits the amount to \$100,000, Corporation A's transaction does not qualify for the Rule.<sup>22</sup> An issuer intending to rely on the Rule, therefore, cannot determine its availability in isolation, but must carefully review the status of each affiliate.<sup>23</sup>

Paragraph (c) of the Rule prohibits "any means of general advertising or general solicitation"<sup>24</sup> when the issuer offers for sale or sells his securities. Because the language of the paragraph is extremely broad, issuers cannot be certain what forms of advertising or solicitation are permissible. The only useful guidelines are found in the Release that accompanied the proposed Rule.<sup>25</sup> The Release implies that the use of newspapers, magazines and radio or television broadcasts is prohibited. It further suggests that contacts are to be on an individual basis. The individuals are either to have "some knowledge about each other, or some reason to know about each other."<sup>26</sup> To aid the issuer, the Commission could have qualified the

16. While the Commission anticipates that small businesses will be able to use the Rule without the aid of counsel, several conceptual areas including, for example, valuation of the securities, may raise problems which are difficult even for experienced securities attorneys to resolve.
17. SEC Rule 240, 17 C.F.R. § 230.240 (1975), Preliminary Note 4. Investment companies required to be registered under the Investment Company Act of 1940 are barred from use of the Rule. *Id.* 240(b), 17 C.F.R. § 230.240(b). The Rule is not available for resales of the issuer's securities by affiliates or other persons. *Id.* 240, Preliminary Note 4.
18. *Id.* 240(a)(1), 17 C.F.R. § 230.240(a)(1).
19. The term "person" includes; an individual, a corporation and a partnership. 15 U.S.C. § 77b(2) (1970).
20. SEC Rule 240(a)(2), 17 C.F.R. § 230.240(a)(2) (1975).
21. For purposes of the illustration, it is assumed that neither corporation has sold any other securities without registration under the Act since the effective date of the Rule.
22. The issuer and his counsel should note that a purported or attempted reliance on SEC Rule 240 does not act as an election. In the example presented, Corporation A may "claim the availability of any other applicable exemption." SEC Rule 240, 17 C.F.R. § 230.240 (1975), Preliminary Note 3.
23. In addition to considering the aggregate sales of unregistered securities of an affiliate, an issuer should direct particular attention to the number of beneficial owners of the affiliate's unregistered securities.
24. SEC Rule 240(c), 17 C.F.R. § 230.240(c) (1975).
25. SEC Securities Act Release No. 5499 (June 3, 1974).
26. *Id.* at 4.

language of paragraph (c) by incorporating these guidelines in the Release.<sup>27</sup>

As a further means of limiting the scope of the transaction, paragraph (d) forbids payment of commissions or similar remunerations "directly or indirectly for soliciting any prospective buyer or in connection with sales of the securities."<sup>28</sup> The purpose of the prohibition is to bar the use of high pressure tactics or organized securities distribution in the offer or sale of securities. The effect will be to make it difficult for small businessmen not having direct access to sources of capital to use the Rule,<sup>29</sup> since a businessman's ability to raise capital frequently can be expedited by an intermediary who is entitled to compensation. The intermediary is usually a real estate broker or someone in a similar relationship, and not a registered broker-dealer or salesman. If an issuer requires an intermediary, circumvention of the remuneration prohibition may result.<sup>30</sup> If safeguards are necessary, the Commission could have achieved its purpose by placing a compensation limitation of some small percentage on the aggregate dollar amount of the transaction.<sup>31</sup> Such a qualification effectively would have prevented an unconscionable portion of the dollars raised from being diverted to an intermediary.

Paragraph (e) of the Rule states that the "aggregate sales price of all sales of securities of the issuer . . . in reliance on this Rule or otherwise without registration under the Act within the twelve months preceding the point in time immediately after the last such sale shall not exceed \$100,000."<sup>32</sup> If an issuer has used a private offering exemption within the time period prescribed by the Rule, the aggregate dollar amount available to the issuer must be reduced by deducting the amount raised by the private offering from the \$100,000 limitation of Rule 240.<sup>33</sup> The issuer, therefore, must be forewarned not to view any transaction as an isolated event.

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27. Areas of doubt would have remained even if the guidelines had been incorporated. It appears likely, however, that an issuer would be permitted to contact prior business, fraternal or church acquaintances.
  28. SEC Rule 240(d), 17 C.F.R. § 230.240(d) (1975).
  29. The Commission's decision to adopt a prohibition stand on remunerations apparently was based upon similar provisions found in several state securities statutes. The Commission was unwilling to heed the advice of those commentators who had thoroughly criticized the prohibition as unrealistic and unworkable.
  30. For example, while no compensation will be paid for the service of raising capital, it would not be unusual to discover upon completion of the transaction that the intermediary was in receipt of a contract from the issuer to provide for financial advisory service.
  31. To further protect the investor, the Commission could have required that the issuer notify a prospective purchaser that no more than a stated percentage of the dollars raised would be applied to compensate intermediaries.
  32. SEC Rule 240(e), 17 C.F.R. § 230.240(e) (1975). For a full understanding of the "twelve month" concept, an issuer should review Notes 1 and 2 which accompany paragraph (e). *Id.* 240, Notes 1 and 2. Note 3 of paragraph (e) states that cash, services, property, notes, etc. are to be characterized as consideration in calculating the aggregate sales price. *Id.* 240, Note 3. Further, the paragraph provides that securities evidencing certain indebtednesses or sold to specific purchasers shall not be included in the aggregate sales price. *Id.* 240(e)(1)-(2), 17 C.F.R. § 230.240(e)(1)-(2).
  33. Issuers should be aware of the difficulties which may be encountered in determining the value of consideration such as services and property.

To further limit the scope of the Rule, paragraph (f) restricts the number of beneficial owners of the issuer's securities immediately before and after any transaction to one hundred persons.<sup>34</sup> The Rule states by subparagraph how particular beneficial owners shall be counted.<sup>35</sup> Because an issuer cannot be sure that there are no undisclosed purchasers, the Rule requires only that an issuer, "after making a reasonable inquiry, have reasonable grounds to believe and shall believe"<sup>36</sup> that the number of beneficial owners does not exceed one hundred persons.<sup>37</sup> Because the number of beneficial owners of an issuer's securities may bear little or no relationship to the economic size, capital requirements or limited character of an issuer, this restriction may foreclose certain avenues of financial flexibility which are often crucial to small businesses.<sup>38</sup> Although it is reasonable that the beneficial owner test could have been eliminated without destroying any of the protective purposes of the Rule, the relatively large number of owners for which it provides seems to be a fair distinction between the small corporation and the large, publicly held business.

Securities acquired from an issuer relying on the Rule are unregistered securities deemed to have the same status as if they were securities acquired pursuant to Section 4(2) of the Act.<sup>39</sup> The securities are subject to limitations upon resale and "cannot be resold without registration under the Act or exemption therefrom."<sup>40</sup> To avoid resale to underwriters,<sup>41</sup> the issuer by "exercise of reasonable care"<sup>42</sup> must: make a reasonable inquiry to ascertain whether the "purchaser is acquiring the securities for his own account or on behalf of other persons;"<sup>43</sup> inform the "purchaser of resale restrictions";<sup>44</sup> and, place a resale restriction legend on the document evidencing the security.<sup>45</sup> Technical compliance with this paragraph is not

34. SEC Rule 240(f), 17 C.F.R. § 230.240(f) (1975).

35. For example, the spouse of a beneficial owner is "deemed the same and not a separate beneficial owner." *Id.* 240(f)(1)(i), 17 C.F.R. § 230.240(f)(1)(i).

36. *Id.* 240(f), 17 C.F.R. § 230.240(f).

37. *Id.*

38. For example, in recent years economically small corporations often are owned, at least partially, by employees. If such corporations consist of more than one hundred employees, who are beneficial owners of the corporation, it is barred from use of the Rule.

39. 15 U.S.C. § 77d(2) (1970).

40. SEC Rule 240(g), 17 C.F.R. § 230.240(g) (1975). SEC Rule 144 has been amended to permit resales of the securities sold in reliance on SEC Rule 240. SEC Rule 144(a)(3), 17 C.F.R. § 230.144(a)(3) (1975). Issuers, purchasers and their counsel should realize, however, that it is the availability of resales on a private basis pursuant to Section 4(1) of the Act which will serve as the primary vehicle for the resale of Rule 240 securities. 15 U.S.C. § 77d(1) (1970).

41. SEC Rule 240(g), 17 C.F.R. § 230.240(g) (1975).

42. *Id.* The Rule mandates that "reasonable care" requires, but is not limited to, compliance with all three subparagraphs of paragraph (g). *Id.*; see p. 410 *infra*. The issuer, therefore, must take any additional, reasonable precautions necessary to meet the intent of paragraph (g).

43. SEC Rule 240(g)(1), 17 C.F.R. § 230.240(g)(1) (1975).

44. *Id.* 240(g)(2), 17 C.F.R. § 230.240(g)(2).

45. *Id.* 240(g)(3), 17 C.F.R. § 230.240(g)(3). The restrictive legend would read substantially as follows:

The shares represented by this Certificate have not been registered under the Securities Act of 1933. These shares have been acquired for investment and not with

difficult; however, an issuer who complies with all other conditions and limitations will fail to satisfy the Rule unless it properly restricts its certificates.

Paragraph (h) of the Rule requires the filing of notification Form 240 subsequent to completion of certain sales transactions made in reliance on the Rule.<sup>46</sup> The inadvertent failure to timely notify the Commission presumably results in the unavailability of the Rule. Bearing no relation to the disclosure purpose of the Act,<sup>47</sup> the Form appears to fulfill no function other than to increase both the issuer's legal costs and the Commission's paperwork. Because the Form does not alter the issuer's burden of proving an exemption under the Rule, the filing requirement should have been deleted.

Despite several ambiguities and latent disadvantages, Rule 240 can be applied effectively in certain securities transactions. It may serve as a practical means for the small business to raise modest amounts of capital in a relatively uncomplicated situation; and, it is particularly appropriate for newly organized issuers attempting to raise "seed" capital.<sup>48</sup> In either instance, an issuer who desires to comply with the Rule's provisions should seek the advice of the Commission's regional office.<sup>49</sup> Further, an issuer must consider existing state securities laws which do not contain a state version of Rule 240. In order to promote uniformity and ease of compliance, state securities commissioners should consider adoption of a similar registration exemption for use in intrastate transactions.

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a view to distribution or resale, and may not be made subject to a security interest, pledged, hypothecated, or otherwise transferred without an effective registration statement under the Securities Act of 1933 or an opinion of counsel for the Corporation that such registration is not required under such Act.

46. SEC Rule 240(h), 17 C.F.R. § 230.240(h) (1975). SEC Form 240 requires basic information on the issuer, its executive officers and directors, the class of securities sold, aggregate sales price of previously sold securities and the number of beneficial owners. SEC Form 240, 17 C.F.R. § 239.240 (1975). An issuer should carefully review subparagraph (1) to determine when it must notify the Commission of a securities transaction made in reliance on the Rule. SEC Rule 240(h)(1), 17 C.F.R. § 230.240(h)(1). If an issuer otherwise complies with the paragraph, the first \$100,000 of unregistered securities sold by the issuer need not be reported to the Commission. *Id.* 240(h)(2), 17 C.F.R. § 230.240(h)(2).
47. If the Act's purpose is disclosure to the purchaser, basing the availability of an exemption on the filing of a notice which the purchaser never sees is an anomaly.
48. All issuers must realize, however, that under no circumstances can the Rule be applied in order to evade the Act's registration provisions. SEC Rule 240, 17 C.F.R. § 230.240 (1975), Preliminary Note 5. Further, whenever an issuer relies on an exemption under Rule 240 and subsequently uses other exemption provisions of the Act, the Commission may integrate the transactions. *Id.* 240, Preliminary Note 6; see SEC Securities Act Release No. 4552 (Nov. 6, 1962).
49. The Commission will provide advisory letters to issuers attempting to comply with SEC Rule 240. However, "no-action letters" will not be issued by the Commission.