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STATE LIMITED AND PRIVATE OFFERING EXEMPTIONS: THE MARYLAND EXPERIENCE IN A NATIONAL PERSPECTIVE

Mark A. Sargent†

A limited or private offering of securities exempted from federal registration still may have to be registered in one or more states, because the state exemptions for these transactions are often different from the available federal exemptions. These differences, however, do not reflect a principled allocation of regulatory responsibilities between the Securities and Exchange Commission and the state securities administrators, but rather derive from historical, philosophical, and structural differences between the federal and state securities laws. Recent reforms of the federal exemptive system have produced new concern about the impact of these differences on the capital formation process, and have led to a reevaluation of the goals of state limited and private offering exemptions. Reevaluation of the exemptive scheme under the Maryland Securities Act in light of these developments has resulted in both statutory amendment and adoption of two new exemptive rules. The author, who was one of the draftsmen of these rules, explores their relation to the national and Maryland experience with state limited and private offering exemptions, and examines many of the novel questions of policy and practice generated by the new Maryland rules.

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INTRODUCTION

Federal securities law provides several exemptions from registration for private and limited offerings of securities. Limited offerings are exempted primarily because of the small size of the offering. Private offerings are exempted because the relationship between the issuer and purchaser of securities makes registration unnecessary. State securities laws traditionally have also permitted some exemption of limited and private offerings, but to widely varying degrees. These state exemptions are rapidly being transformed. The new exemptive rules under the Maryland Securities Act are no exception; indeed, they are among the most novel of the new state exemptions.

This article will describe those rules, explain how they are intended to operate, and analyze the many questions of policy they present. It will not confine itself, however, to an analysis of Maryland law. Instead, it will also show why the new Maryland exemptive rules must be viewed in light of the national experience that influenced their development. These rules must be viewed in that perspective because they were not drafted in a vacuum: they were drafted with an acute awareness of the long standing problems encountered by practitioners trying to structure offerings under state limited and private offering exemptions. They were also drafted with an understanding of how recent reforms of the federal exemptive system demonstrated the need for change in the state approach and created new possibilities for reform of the state exemptions. Accordingly, Section II of this article examines
the traditional problems associated with most state limited and private
offering exemptions. Section III then describes how pressures for
change in the state approach to limited and private offerings have in­
creased as a result of the recent reform of the federal exemptive system,
leading to substantial reform both nationally and in Maryland. Sec­
tions II and III thus provide the context in which the purpose and func­
tioning of the new Maryland rules must be understood.

The new Maryland rules were also drafted with an awareness of
the historical traditions of Maryland securities law. That law has al­
ways reflected a commitment to coordination of state and federal secur­ities law and to the elimination of duplicative or needlessly inconsistent
state regulation. This commitment was expressed in Maryland’s 1961
adoption of a revised Uniform Securities Act (Uniform Act) and in the
exemptive rules adopted by the Maryland Securities Division in the
1970’s. It is also expressed in the new Maryland exemptive rules dis­
cussed in this article, since the changes brought about by those rules
represent new ways of achieving federal-state coordination. In sum,
the recent changes in the Maryland exemptions express an essential
continuity within Maryland securities law. Section IV of this article
examines this pattern of continuity and change in Maryland securities
law and provides a historical introduction to Section V’s analysis of the
current exemptive system.

The current Maryland exemptive system is an outgrowth of two
1981 amendments to the exemptive provisions of the Maryland Securi­
ties Act. Those amendments required the Securities Division to de­
velop administrative rules to implement the new exemptions. Section
V of this article explores the nature and effects of the 1981 amend­
ments, identifies the goals of the rulemaking process that followed, de­
fines the functional relationship of the rules developed in that process,
and finally analyzes in detail the rules themselves.

II. STATE EXEMPTIONS: THE TRADITIONAL DIFFICULTY

The exemptions from state securities registration have always had
a motley air. The problem is essentially structural: the exemptions
were originally little more than grudging exceptions to the basic statu­
tory presumption that every securities transaction is subject to registra­
tion. While broad exemptions inevitably have developed, the blue sky

1. This presumption was the legacy of the pre-World War I development of the blue
sky laws as highly paternalistic and comprehensive schemes of licensing securities
transactions. See L. Loss & E. Cowett, Blue Sky Law 3-10 (1958); J. Mofsky,
Blue Sky Restrictions on New Business Promotions 11, 12 (1971). The first
blue sky law, adopted by Kansas in 1911, reflected this presumption by exempting
from registration only United States bonds, Kansas state and municipal bonds,
and notes secured by mortgages on real estate located in Kansas. 1911 Kan. Sess.
Laws 133, § 1. For contemporary discussion of this statute, see Dolley, The Kan­
sas “Blue Sky” Law, 75 Cent. L.J. 221 (1912); Mulvey, Blue Sky Law, 36 Can. L.
Times 37 (1916). The blue sky exemptions have become considerably more thor-
exemptive system does not represent a systematic harmonization of the need for investor protection, the necessity to reduce compliance costs, and the principles of federalism. It is, instead, a crazy quilt of practical solutions and political compromises.² This approach is not necessarily objectionable, however, since it seems to work, at least sometimes.

A good example of how this patchwork system seems to work is the blue sky treatment of secondary transactions. Although it is difficult to define precisely the nature of the states’ interest in the regulation of secondary transactions,³ and although there is no blue sky equivalent of the federal concept of statutory underwriter,⁴ the combined effect of several aspects of the blue sky law does seem to constitute workable regulation. Those aspects include class registration (the device by which all securities of the same class covered by a registration statement are deemed registered),⁵ the isolated non-issuer,⁶ manual⁷ and unsolicited broker-dealer⁸ transactional exemptions, and the exchange-listed,⁹ blue chip,¹⁰ and National Association of Securities

2. An example is the early effort by the Investment Bankers Association (IBA) to establish a variety of exemptions from state securities registration, such as the exemption for exchange-listed securities. For a discussion on the activities of the IBA, see C. Cowings, Populists, Plungers and Progressives 69 (1965); M. Parrish, Securities Regulation and the New Deal 7-20 (1970). As one commentator noted, however, “[e]xpeditency was the main propellant of [IBA] policy.” Id. at 9. Since the IBA’s real concern was for the issues underwritten by its members—the major investment banking houses—it did not propose or support a coherent system of exemptions responsive to the needs of small as well as large issuers. J. Mofsky, supra note 1, at 12.

3. As the draftsman of the Uniform Act observed: “Perhaps the most difficult aspect of the area of securities registration . . . is the application of the registration provisions to secondary distributions or other transactions not involving the issuer of the security.” L. Loss, Commentary on the Uniform Securities Act 72 (1976). The problem is more than one of application. Recent studies of the efficient market hypothesis have questioned whether the states have a significant interest in regulating either primary or secondary distributions by widely-followed issuers. See Mofsky, Reform of the Florida Securities Laws, 2 Fla. St. U.L. Rev. 1, 22-23 (1974); Mofsky & Tollison, Demerit in Merit Regulation, 60 Marq. L. Rev. 367, 368-69 (1977); Walker & Hadaway, Merit Standards Revisited: An Empirical Analysis of the Efficiency of Texas Merit Standards, 7 J. Corp. L. 651, 658-59 (1982).

7. Id. § 402(b)(2).
8. Id. § 402(b)(3).
9. Id. § 402(a)(8), 7A U.L.A. at 639.
Dealers Automated Quotations (NASDAQ) securities exemptions. Judicious use of one or more of these devices will ordinarily allow the free flow of securities in the secondary markets.

There is growing criticism of some aspects of this "system" from both the regulators and representatives of the securities industry, but it has not generated the kind of trouble produced by the state exemptions for issuer offerings involving private transactions, small numbers of offerees or purchasers, a limited aggregate offering price, or smaller issuers. The past and present difficulty in this area has produced a renewed cry that the blue sky exemptive system does not work, and that some degree of federal preemption may be needed. It

10. There is no blue chip exemption in the Uniform Act. These exemptions allow seasoned issuers that meet specified criteria of duration and stability to avoid registration of their public offerings. For a discussion of the policy and definitional issues associated with this exemption, see authorities cited infra note 13. For an example of this type of exemption, see New Mexico's version of the exemption. N.M. STAT. ANN. § 58-13-29 F (1983).

11. There is no exemption in the Uniform Act for securities traded pursuant to the NASDAQ system. For an example of this type of exemption, see MD. CORPS. & ASS'NS CODE ANN. § 11-601(12) (Supp. 1984).

12. A committee of the North American Securities Administrators Association (NASAA) is currently examining the securities industry's use of the manual and unsolicited broker-dealer transactional exemptions to circumvent state merit regulation of primary offerings. The problem identified by NASAA is the use of these exemptions to release securities into the secondary markets of states in which the issuer did not or would not meet the merit criteria applicable to the primary offering.

13. Representatives of the bar and the industry self-regulatory organization (SRO) have urged broader state adoption of securities exemptions based on either blue chip criteria or Federal Reserve Board Margin List status. See, e.g., Letter of Robert M. Royalty & Robert R. Grew to Conrad G. Goodkind (Sept. 10, 1976) (letter from members of the State Regulation of Securities Committee of the American Bar Association (ABA) Section on Corporation, Banking and Business Law, urging Uniform Act adoption of a blue chip exemption) (copy on file at the University of Baltimore Law Review office); Letter of Dennis C. Hensley to Robert C. Guido (Mar. 31, 1982) (letter from Vice President of Corporate Financing of the National Association of Securities Dealers, Inc. (NASD), urging state adoption of an exemption based on Federal Reserve Board Margin List status) (copy on file at the University of Baltimore Law Review office).


15. An indication of the renewed interest in the preemption question was a panel discussion on that topic held at the 1983 NASAA Annual Meeting. See NASAA Adopts ULOE, Endorses Uniformity, Focuses on Threats to Merit Regulation, 15 SEC. REG. & L. REP. (BNA) 1833, 1836-37 (1983). The Securities Industry Association (SIA) recently urged consideration of the possibility of federal preemption. See Myriad of Approaches to Uniformity of State Regulation Urged at Hearing, 15
should be emphasized, however, that there is no single "difficulty" in this area, but a complex set of interlocking problems with sources deeply rooted in the overlapping state and federal regulatory schemes.

A. The Problems

There are three basic problems in this area of state exemption. First, state securities acts have traditionally de-emphasized the role of exemptions based on the private or limited character of the offering. For example, the Uniform Act provides an exemption for "offerings to a limited number of persons," provided that the offer is directed to not more than ten persons within a twelve-month period, and no commission or other remuneration is paid in connection with the sales effort. While the Securities and Exchange Commission's (SEC) adoption of Regulation D has accelerated a preexisting trend toward broader federal exemptions, section 402(b)(9) of the Uniform Act reflects the blue sky law's traditionally restrictive approach to this type of exemption.

Second, the lack of uniformity among the states has been, and to some extent still is, extreme. The draftsman's commentary to section 402(b)(9) described the statutes in this area as being "sharply and irreconcilably split." Later commentators have made similar observations. Counsel for issuers attempting to blue sky an exempt transaction thus have had to contend with a broad variety of bases and conditions for exemption.

Third, there has been a substantial lack of coordination between the federal and state exemptions. A transaction exempt at the federal level is not by definition exempt at the state level; the issuer has to find a separate state exemption. This basic fact has created practical difficulties, because the states have tended to take a more restrictive approach to exemptions than Congress and the SEC, and because state-
to-state uniformity has been lacking. Accordingly, counsel for issuers who have structured a transaction to comply with a state of the art federal exemption may still have to comply with inconsistent or at least additional exemptive criteria imposed by every state in which the offering is made.21 The net result may be that the state with the "toughest" exemptive conditions determines the structure of the transaction, or that the offering is registered in some states and exempted in others. That latter result may be unfortunate from the issuer's standpoint, since it may be crucial to avoid the delay and expense incident to state registration by qualification.

B. Their Sources

These problems have several sources. To some extent, the difficulty is conceptual. State securities acts lack a unified theory of why private or limited offerings should be exempted. This results in part from the absence of state parallels to the federal law concepts of "distribution," "public offering," and "non-public offering," essential to the section 4(2) exemption of the Securities Act of 1933 (the 1933 Act).22

The problems also result from widespread disagreement and uncertainty over whether the state exemption should depend on one or more of the following factors:23 (1) the number and nature of the purchasers; (2) the number and nature of the offerees; (3) the issuer's size, character, or locus of organization; (4) the size of the offering; (5) the manner of the offering; (6) the "isolated" nature of the sales; (7) the use of a disclosure document; or (8) some degree of pre-commencement administrative review of the offering.24 This conceptual uncertainty

21. For an explanation of the jurisdictional premises of the state securities acts, see L. Loss, supra note 3, at 158 (official comment to section 414 of the Uniform Act); see also Long, The Conflict of Laws Provisions of the Uniform Securities Act, or When Does a Transaction "Take Place in this State?", 31 OKLA. L. REV. 781 (1978) (detailed consideration of blue sky jurisdictional questions).
23. For example, the complex Pennsylvania exemption contains the following limitations, requirements, and obligations: (1) specific numerical limits on both the number of offerees and the number of purchasers; (2) mandatory filing of the offering document as well as the notice of sales; (3) the seller and purchaser must execute a special agreement imposing certain restrictions on resale; and (4) the issuer is under an affirmative obligation to amend the notice filing to reflect any material changes during the period of the offering. PA. STAT. ANN. tit. 70, § 1-203(d)-(e) (Purdon Supp. 1983); PA. ADMIN. CODE § 203.041, reprinted in 2 BLUE SKY L. REP. (CCH) ¶ 48,435 (Apr. 1981).
24. The Massachusetts Securities Division currently requires substantive merit review of offerings to be exempted under the limited offering exemption of the Massachu-
has inhibited the development of state-to-state uniformity and has prevented true federal-state coordination. The lack of a state parallel to the federal "non-public offering" exemption of section 4(2) of the 1933 Act\(^{25}\) and the associated "safe harbor" provisions of Federal Rules 146\(^{26}\) and 506\(^{27}\) has created serious problems for the many issuers engaged in federal "private placements" under section 4(2) and its implementing rules.\(^{28}\) The confusion created by the lack of a common theoretical basis for exemption were exacerbated by the states' reliance on exemptive conditions foreign to federal law, such as restrictions on sales remuneration,\(^{29}\) pre-commencement administrative review,\(^{30}\) and the domestic status of the issuer.\(^{31}\)

The difficulty may also reflect certain preconceptions about the allocation of regulatory responsibilities. A state administrator may argue, for example, that certain exemptions from federal registration represent nothing less than a deferral to state regulation. If that is the case, then a matching exemption at the state level is inappropriate, and state registration should be required. The SEC has on more than one occasion used this kind of reasoning\(^{32}\) to justify particular exemptions, such as Rule 147's\(^{33}\) safe harbor for the 1933 Act's section 3(a)(11)\(^{34}\)


\(^{27}\) Id. § 230.506 (1983).

\(^{28}\) These observations are not intended to suggest that the SEC's and the federal judiciary's approach to the 1933 Act exemptions has been a model of clarity or balanced policymaking. In fact, an opposite conclusion may be more accurate, and it is fair to say that the problems with federal-state coordination reflect the inadequacies of federal exemptive law and policy as well as those of the state securities acts. It remains true, however, that the 1933 Act's concept of nonpublic offerings lacks a conceptual parallel in state law, and that has been a major problem. For descriptions of this problem and how the Maryland Securities Division attempted to resolve it through the adoption of Rule S-7 (MD. ADMIN. CODE tit. 02, § .02.03.07 (rescinded 1983)), see Md. Sec. Act Release No. 5, reprinted in 1 BLUE SKY L. REP. (CCH) ¶ 15,553 (Sept. 28, 1972); Notes & Comments, Maryland Blue Sky Reform: One State's Experiment with the Private Offering Exemption, 32 MD. L. REV. 273 (1972); Note, supra note 18, at 168-70.

\(^{29}\) See UNIF. SEC. ACT § 402(b)(9), 7A U.L.A. 641 (1956) (limited offering exemption prohibits remuneration for sales efforts).

\(^{30}\) See supra note 23.

\(^{31}\) This approach is no longer prevalent. See L. Loss, supra note 3, at 127 (discussing Pennsylvania's former reliance on domestic incorporation as a condition to exemption). Domestic organization or location of the issuer may still play, however, a limited role in a state exemption. See MD. ADMIN. CODE tit. 02, § .02.04.09C (1983) (the "Local Issuer Exemption" under Maryland Regulation 9).


intrastate offering exemption, and Regulation D’s Rule 504 limited offering exemption. The traditionally restrictive approach to state exemptions, however, may reflect a belief on the part of some state administrators that other federal exemptions also represent a deferral to rigorous state regulation.

Finally, the state securities administrators’ attitude toward these kinds of exemptions may have been shaped by their historical experience as frontline combatants against fraud in relatively small, localized securities offerings. While it is difficult to quantify levels and types of enforcement activity over long periods of time in fifty jurisdictions, it may be fair to assume that the state securities administrators have a perspective on abusive practices in exempt transactions that the SEC may lack.

Whatever their sources, the problems with narrow, nonuniform, and uncoordinated state exemptions for limited and private offerings have frustrated securities practitioners for many years. The pressure for change in the states’ approach to these transactions, furthermore, has increased because reform of the federal exemptive system has made capital financing through exempt offerings more useful and important. As these transactions have become more important, the limitations imposed by the state exemptions have produced greater costs, greater delays, and greater frustration. In response to these developments, some progress has been made nationally toward reform of the state exemptions. Reform of the federal scheme was the condition precedent to

38. Some data have been collected, but they are quite general, and provide no real basis for historical comparisons or comparisons of federal-state activities. See Empirical Research Project—Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground, 7 J. CORP. L. 689, 797-800 (1982) (survey of percentage of office time devoted by state securities administrations to enforcement matters) [hereinafter cited as Empirical Research Project].
39. The use of the term “progress” to describe the recent developments in the exemptive area reflects, of course, the author’s bias. Others regard the “liberalization” of the federal and state transactional exemptions as an unjustifiable threat to the needs of investor protection. E.g., Memorandum of NASAA Enforcement Liaison Committee to NASAA Small Business Finance Committee 3, Apr. 19, 1983 (“Questionable tax shelter deals have been proliferating. . . . The encouragement of these offerings through unlimited sales and without full disclosure is
reform of the state exemptions; the purposes and scope of the federal reform thus need to be understood.

III. PRESSURES FOR CHANGE AND THE REFORM OF THE FEDERAL EXEMPTIVE SCHEME

The reform of the federal approach to registration exemptions developed slowly. This reform has taken more than a decade, and has reflected not only the interests of small business issuers, but also the SEC’s and the securities bar’s interest in developing more efficient and less costly exemptive mechanisms. The main directions of this reform movement were the reduction of compliance costs (particularly for small business issuers) and the elimination of exemptive conditions that did not significantly protect investors, such as offeree suitability requirements.

The first important catalyst of reform was the Wheat Report of 1969. This report was the product of an internal study group formed by the SEC “to examine the operations of the disclosure provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and the Commission rules and regulations thereunder.” Although most of the report’s recommendations concerned problems of disclosure in federally registered offerings, it also identified what the drafters described as the “grave shortcomings” of the then current approach to the nonpublic offering exemption of section 4(2). This description quite accurately reflected the tendencies of federal courts to adopt the SEC’s narrow construction of the exemption and to grant recovery to purchasers by denying the availability of the exemption. In essence, the Wheat Report identified the conceptual and practical problems that led other commentators to suggest that the SEC was seriously undermining, if not destroying, the practical utility of the exemption.

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41. Id. at 3 (quoting Securities Act Release No. 4885 (Nov. 28, 1967)).
42. Disclosure to Investors, supra note 40, at 155-57.
45. See, e.g., R. Jennings & H. Marsh, Securities Regulation 239 (5th ed. 1982);
The SEC responded to the concerns of the Wheat Report and other commentators through its 1974 adoption of Rule 146, a safe harbor for the section 4(2) exemption.\(^46\) 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)."\(^47\) Many commentators felt, however, that the rule merely injected more complexity and uncertainty into an already troubled area, and did not provide the kind of relief needed most acutely by small business issuers.\(^48\)

The SEC did not ignore this criticism, but attempted to balance the needs of investors and issuers by shifting its attention to the exemption under section 3(b) of the 1933 Act\(^49\) for issues with a limited aggregate offering price. The SEC had long permitted certain smaller issues of securities to be offered publicly under Regulation A,\(^50\) an exemption adopted by the agency under section 3(b). Regulation A, however, has always been a complex exemption. In fact, it functions as if it were a type of short form registration,\(^51\) and it generates significant compliance costs for the issuer.\(^52\) Regulation A thus did not exploit section 3(b)'s full potential as an exemption. In particular, Regulation A was not tailored to the needs of small business issuers and offered them little relief from the burdens of registration. The SEC tried to respond to this problem in 1975 by adopting Rule 240,\(^53\) an exemption specifically designed to provide exemptive relief for the small business issuer.\(^54\) Rule 240, however, was not extensive; it merely offered an

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46. 17 C.F.R. § 230.146 (rescinded 1982).


51. 17 C.F.R. § 230.255 (1983) requires filing in an SEC Regional Office of an offering statement at least 10 days prior to the initial offering of any Regulation A securities. The offering statement receives an SEC staff review similar to that received by a registration filed in connection with a registered offering. For a summary of the similarities and differences between offerings exempted under Regulation A and registered offerings, see Burge, *Regulation A: A Review and Look at Recent Developments*, 46 L.A. Bar J. 290, 291 (1971). One important difference is that section 11 liability does not apply to Regulation A offerings, because Regulation A is an exemption. Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1982); see also L. Loss, *supra* note 50, at 611 (although Regulation A is an exemption, it functions as a form of simplified registration).


issuer having one hundred or fewer beneficial owners an exemption for sales of securities totaling less than $100,000 for any twelve-month period. Rule 240 thus did not stem the tide of criticism. Although it provided the issuer with a relatively certain safe harbor, critics emphasized that it imposed unnecessary restraints on small business financing, such as the limitation on the aggregate offering price to $100,000 and the prohibition on remuneration of persons engaged in the selling effort.\(^{55}\)

The criticism of Rule 240, when viewed in connection with the criticism of section 4(2), Rule 146, and Regulation A, reflected frustration with the entire exemptive system, not just with the individual exemptions. Although this frustration was felt by counsel for all types of issuers, it was felt most acutely by counsel for small business issuers.\(^{56}\)

The special concerns of small business came to the fore in 1977 when the SEC’s Advisory Committee on Corporate Disclosure urged the agency to evaluate the impact of its regulatory scheme on small business. Accordingly, the SEC began an extensive examination of the effect of the federal securities laws on small business financing. This examination began with a series of public hearings held in six cities across the country.\(^{57}\) After learning that the small business community did not regard Rules 146 and 240 as particularly helpful,\(^{58}\) the SEC adopted several significant reforms. First, the aggregate amount of securities that could be offered under Regulation A was increased from $500,000 to $1,500,000.\(^{59}\) Second, Regulation A was amended to permit the use of a preliminary offering circular prior to the commencement of the offering.\(^{60}\) Third, the SEC adopted Form S-18,\(^{61}\) a

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57. These hearings were announced in Securities Act Release No. 5914, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,530 (Mar. 6, 1978).


60. See 17 C.F.R. § 239.256(h) (1983).

61. Id. § 239.28; Securities Act Release No. 6049, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,046 (Apr. 3, 1979). In 1983, the ceiling on the aggregate offering
simplified registration statement for certain smaller issuers going public for the first time and offering securities with an aggregate offering price of no more than $5,000,000. Fourth, the SEC used its authority under section 3(b) to adopt Rule 242 in early 1980.62

Rule 242 represented perhaps the most significant innovation.63 It introduced the concept of “accredited person” purchasers who could be excluded from calculation of the number of purchasers to whom the Rule 242 securities could be sold.64 Rule 242’s accredited person concept was thus the predecessor to Regulation D’s “accredited investor” formulation. In addition, Rule 242 did not require the issuer to establish as a condition of the exemption that the offerees or purchasers were “suitable,” i.e., that they were so sophisticated or so wealthy that they would not need the benefits of registration.65 This section 3(b) limited offering exemption therefore rejected many of the exemptive criteria crucial to the section 4(2) Rule 146 nonpublic offering exemption. Since Rule 242 could be used to exempt issues with an aggregate offering price of $2,000,000, some significant change had been achieved.

The pressures for even more significant change, however, did not abate,66 and the initiative shifted to Congress. The Small Business Issuers’ Simplification Act of 198067 and the Small Business Investment Incentive Act of 198068 produced amendments to the 1933 Act designed to achieve significant reform in the exemptive system.

The first statutory change was the addition to the 1933 Act of section 4(6),69 which provides an exemption for offers and sales solely to

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63. For evaluations of Rule 242, see, e.g., Parnell, Kohl & Huff, supra note 43, at 660-68 (Rule 242, in conjunction with other federal exemptive rules, provided significant safe harbor relief for issuers in search of capital); Note, Rule 242 and Section 4(6) Securities Registration Exemptions: Recent Attempts to Aid Small Business, 23 WM. & MARY L. REV. 73, 101 (1981) (“rule 242 . . . is a welcome addition to the regulatory scheme”).
66. An important example of the continued agitation was the Snowmass Small Business Securities Conference, held at Snowmass, Colorado, on September 27-29, 1979. The conference was held before Rule 242 was adopted but after it had been proposed. The conference report thus included substantial criticism (as well as praise) for the proposed Rule 242, together with proposals for more sweeping reform of the overall exemptive system. See Danner, supra note 55, at 1370-76.
accredited investors, without any public solicitation, if the aggregate amount of securities offered is $5,000,000 or less. That figure matched the aggregate offering price of issues eligible for exemption under section 3(b). The second change was the addition to the 1933 Act of section 19(c), a provision declaring the policy "that there should be greater Federal and State cooperation in securities matters," and directing the SEC to work with state representatives toward that end. Section 19(c) made especially clear that the SEC should work with the state administrators in mitigating the burdens imposed on small business issuers by their exemptive systems.

The major result of these SEC and congressional initiatives was the development of the SEC's Regulation D. Since Regulation D has received abundant comment, it need not be summarized in detail here. Regulation D, although not revolutionary, represents a major


71. Incentive Act § 301 (codified at 15 U.S.C. § 77c(b) (1982)).

72. Id. § 505(c)(2) (codified at 15 U.S.C. § 77s(c)(2) (1982)).

73. Id. § 505(c)(l) (codified at 15 U.S.C. § 77s(c)(l) (1982)).

74. Id. § 505(c)(3)(C) (codified at 15 U.S.C. § 77s(c)(3)(C) (1982)).


77. Regulation D consists of six interrelated rules. Rules 501-502 set forth definitions and conditions applicable to the specific exemptions provided in Rules 504-506. Rule 503 states a notice filing requirement. Rule 504, adopted under section 3(b) of the 1933 Act, provides a simple exemption for offerings with an aggregate offering price of no more than $500,000. Rule 504 replaces former Rule 240. Rule 505, also adopted under section 3(b), provides a more complex exemption for offerings with an aggregate offering price of no more than $5,000,000. It replaces former Rule 242. Rule 506 is a safe harbor under section 4(2) of the 1933 Act, and replaces former Rule 146. There is no dollar ceiling for Rule 506 transactions, but Rule 506 imposes certain exemptive conditions not applied under Rules 504 or 505. For more detailed summary of Regulation D, see authorities cited supra note 76. Because of the substantial coordination of the new Maryland exemptive rules and Regulation D, some aspects of Regulation D will be considered below in more detail. See infra text accompanying notes 189-216.

78. For critical discussion of Regulation D, see Kripke, Has the SEC Taken the Dead Wood Out of its Disclosure System?, 8 BUS. LAW. 833 (1983); Nimkin, Offeree So-
attempt to eliminate three general problems: (1) the conceptual and terminological inconsistencies fostered by the ad hoc character of the preexisting federal exemptive system; (2) the low dollar ceilings imposed on section 3(b) exemptions; and (3) the serious compliance problems generated by the offeree suitability requirements of section 4(2) and Rule 146. These substantial changes, furthermore, meant more than reform of federal law: Regulation D also created a new framework for substantial federal-state coordination.

Regulation D created this framework because it is, at least in comparison to the preexisting system, relatively coherent, systematic, and justifiable as a balancing of the needs of investor protection and capital formation.79 In addition, since Regulation D promises to be a major financing device for both large and small issuers, substantial pressure has been placed on the states by the SEC, the securities industry, and the bar to conform to some aspects of the Regulation D approach.

The SEC's adoption of Regulation D has forced state administrators to rethink the conceptual premises of their exemptive systems, their approach to the allocation of regulatory responsibilities, and the balance to be struck between their traditional concern for investor protection and the need to reduce the costs of capital formation. The state response to Regulation D, although by no means uniform,80 reflects a serious effort by state administrators to accomplish that rethinking and to create a state exemptive system that is both practicable and theoretically coherent. This article will not survey the universe of state responses to Regulation D. Instead, it will analyze how the exemptive system under the Maryland Securities Act has been revised to facilitate federal-state coordination and capital formation, particularly small business capital formation. This article will also explain how the recent revision of the Maryland exemptive system used the reform of the federal exemptive system to mitigate the problems traditionally associated with the blue sky treatment of limited and private offerings.

The impact of the recent revisions, however, must be analyzed in light of the historical development of limited and private offering ex-
IV. BACKGROUND TO REFORM: CONTINUITY AND CHANGE UNDER THE MARYLAND SECURITIES ACT

A. The 1962 Enactment and the Principle of Coordination

The first Maryland blue sky statute, which was enacted in 1920, differed dramatically from the far-reaching, paternalistic statutes of the Midwest. Although the statute empowered the state’s attorney general to investigate possible securities frauds and to issue an order directing the offender to cease and desist therefrom, it did not define securities fraud as a crime, require securities registration, or mandate delivery of a disclosure document to offerees or purchasers. The General Assembly amended the statute in 1937 to require limited licensing of persons selling securities in the state, but no other effort was made to expand the scope of Maryland securities regulation until 1961.

By 1961, the Uniform Act, or major parts of it, had been adopted in fourteen states. Most states, regardless of whether they had adopted the Uniform Act, required the registration of securities offerings. Maryland thus found itself in a somewhat anomalous position. This sense of being out of the mainstream of modern securities regulation, when coupled with a perception of a sizable increase in the number of securities dealers registered in Maryland and in the volume of securities sold in the state, led to action. In 1961, the governor appointed the Committee to Study the Administration of the Blue Sky Law.
Law in Maryland (Study Committee). The Study Committee’s Report recommended the adoption of a modified version of the Uniform Act and the creation of a Division of Securities (Division) within the State Law Department.

The subsequent legislative adoption in 1962 of a modified version of the Uniform Act represented a significant expansion of the regulatory scheme. The statute created a new administrative agency, required registration of securities, imposed stricter conditions for registration of broker-dealers, and defined a set of civil and criminal liabilities—all novelties in Maryland. The Maryland version of the Uniform Act also reflected, however, the Study Committee’s desire to make state regulation practicable through maximum coordination between state and federal law. This principle has become a key characteristic of Maryland securities regulation, and has provided an essential element of continuity throughout more than twenty years of statutory and administrative change. Indeed, this principle was one of the primary sources of the exemptive concepts used in the new regulations described below, as an overview of the Maryland Securities Act (Act) and the rules issued thereunder will show.

This principle was clearly expressed in three aspects of the original Act. First, the Study Committee excluded from the Act those provisions of the Uniform Act that permitted the administrator to deny registration to an offering because of excessive compensation to underwriters, sellers, and promoters. By excluding those provisions, the Study Committee refused to follow the Uniform Act in adopting some of the typical blue sky standards governing the substantive merits of the underlying transactions. Accordingly, the Study Committee also declined to follow the example of the many non-Uniform Act jurisdictions that permitted the administrator to deny registration be-

89. Id. The Chairman of the Study Committee was Arthur W. Machen, Jr., a member of the Maryland Bar.
90. Id. at 6.
91. Id. at 7.
93. See infra text accompanying notes 152-330.
94. See Unif. Sec. Act § 306(a)(F), 7A U.L.A. 621 (1956) (permitting denial, suspension, or revocation of effectiveness on the ground that "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options"). The Maryland statute also omitted those provisions of the Uniform Act that permit the administrator to require impoundment of the offering proceeds or place in escrow the offering proceeds of promoter's stock. Id. § 305(g), 7A U.L.A. at 614. These regulatory devices are typical of the merit statutes and are foreign to the 1933 Act.
95. L. Loss, supra note 3, at 85 (many merit states imposed limitations on selling costs, promoters' profits, and options issued to underwriters, promoters, insiders, and other persons).
cause the offering was not "fair, just and equitable" with respect to the investing public. Its Report identifies the basis for this departure from the Uniform Act and blue sky tradition: the drafters were "adhering strongly to the philosophy of disclosure as reflected in the Securities Act of 1933." Although the Report does not articulate its premises in detail, the rejection of merit regulation in favor of disclosure regulation reflected a conviction that Maryland and federal securities regulation should operate upon similar principles.

96. Id. at 84 (California and Kansas are examples of states imposing a "fair, just and equitable" standard).

97. MARYLAND REPORT, supra note 85, at 6. This language was used to support the Study Committee's recommendation that the new Maryland statute require delivery of a prospectus in connection with the offering. The Uniform Act left the question of prospectus delivery to the discretion of the administrator. UNIF. SEC. ACT § 304(a), 7A U.L.A. 612 (1956); see L. Loss, supra note 3, at 61-63.

The disclosure premises of the new Maryland statute were also expressed by Decatur H. Miller, the first Maryland Securities Commissioner, who stated that the statute "regulates certain offerings of securities with the principal purpose of assuring that full disclosure of the material facts will be made to every prospective investor." Miller, supra note 85, at 292.

98. It is unclear whether a residual merit authority can be found in Md. CORPS. & ASS'NS CODE ANN. § 11-511(a)(5) (1975), which permits the administrator to deny, suspend, or revoke the effectiveness of any registration statement on the grounds that "[t]he offering has worked or tended to work a fraud on purchasers or would so operate." The Division has, in a very few instances, informally interpreted this provision as giving it the authority to deny effectiveness to clearly egregious offerings, even in the absence of true disclosure problems. The Division's disclosure of its intention to rely on this subsection has typically led the would-be registrant to withdraw the registration statement.

Although the Division has used this interpretation only in a very few cases involving offerings with a high potential for abuse, the authority for the interpretation remains unclear. First, § 11-511(a)(1) authorizes the Commissioner to deny, suspend, or revoke effectiveness if the registration statement "contains any statement which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact." This separate provision allows the Commissioner to act on the basis of fraudulent statements or omissions contained within the filing. Section 11-511(a)(5), like UNIF. SEC. ACT § 306(a)(2)(E), 7A U.L.A. 620-21 (1956), must allow the Commissioner to do something else. The problem is defining that "something else." Unfortunately, the draftsman's commentary to UNIF. SEC. ACT. § 306(a) is cryptic, and provides little guidance:

Clause (E): This clause, after Clause (F), is one which gives the Administrator the greatest amount of discretion. On the one hand, § 401(d) codifies the traditional view that the term "fraud" in securities legislation is not limited to common-law deceit. On the other hand, Clause (E) is not meant to be as broad as the old "sound business principles" standard in Kansas, for example, or the "fair, just, and equitable" standard in California. Somewhere between the narrow limitation of common-law deceit and the opposite extreme of permitting the Administrator to substitute his business judgment for the registrant's, a degree of flexibility seems to be essential. Substantially, the Clause (E) standard is today universal or almost so. It could not be deleted, as two or three commentators suggested it should be, without going over to a purely disclosure philosophy which is simply not the philosophy of the overwhelming majority of the blue sky laws and the problem could not be altogether
Second, the new Act permitted registration by coordination with Regulation A offerings.\textsuperscript{99} This was not a common provision at that time, and expressed clearly the Study Committee's desire to promote the coordination of state and federal regulation: "We recommend extension of the coordination principle to filings under Regulation A so that any offering which is registered under the 1933 Act or qualified for exemption from registration under federal administrative regulation may be registered for local sale by following the simplest possible coordination procedure."\textsuperscript{101}

Third, and most important for purposes of this article, the new

avoided even under a disclosure statute, as the federal experience has richly demonstrated.

L. Loss, \textit{supra} note 3, at 84-85.

Loss gave us flexibility, but his commentary does not explain \textit{how much} flexibility has been granted. In addition, his commentary provides little guidance for the interpretation of this language in the context of a version of the Uniform Act from which \textit{all} other merit provisions have been excised.

The author is aware of three different interpretations of this language common to the Uniform Act and the Maryland statute. The first is the restrictive interpretation suggested by the first Maryland Securities Commissioner. Referring to the "work a fraud" language, the Commissioner stated: "[t]his of course covers the situation where the fraud inheres in the methods used to sell the securities rather than in the registration statement." Miller, \textit{supra} note 85, at 305. Miller cites no authority for this proposition, but it is perhaps supported by a literal reading of the statute. Section 11-511(a)(1) permits denial of effectiveness when the fraud inheres in the "registration statement." Section 11-511(a)(1) permits denial when the fraud inheres in the "offering." The literal language thus may contemplate only a difference in the manner and timing of the fraud: in the filing or in the sales effort.

The second is the interpretation applied informally by the Division in recent years. As described above, this interpretation would permit the Division to deny effectiveness to the clearly egregious offering. This interpretation has been applied, furthermore, on the premises that these offerings are infrequent, and that this language cannot support a scheme of routine and detailed merit regulation.


The inconsistency of these three interpretations underscores the need for a formal administrative interpretation of this language or statutory change.


\textsuperscript{100} Md. Ann. Code art. 32A, § 21(d) (repealed and recodified at Md. Corps. & Ass'ns Code Ann. § 11-503(d) (1975)).

\textsuperscript{101} \textit{See} \textit{Maryland Report}, \textit{supra} note 85, at 42. The Study Committee also stated: "We also recommend that certain minor changes be made in the administrative provisions of the Uniform Act to eliminate needless local controls over coordinated offerings." \textit{Id}.
Act's version of the Uniform Act's section 402(b)(9) exemption represented an attempt to approximate the federal exemption, as it was then understood, under section 4(2) of the 1933 Act. Section 402(b)(9) exempted only transactions pursuant to offers to not more than ten persons during any period of twelve consecutive months, if the seller reasonably believed that all the buyers in this state were purchasing for investment, and no commission or other remuneration was paid or given directly or indirectly for soliciting any prospective buyer. In contrast, the Act exempted under section 26(b)(9) "any transaction pursuant to an offer directed by the offeror to not more than twenty-five persons," and it dropped the prohibition on sales remuneration, differences reflecting a desire to make the Maryland exemption more consistent with federal law.

The Maryland exemption was made more consistent with the federal exemption by raising the ceiling on offerees to twenty-five (the maximum number of offerees then thought to be permissible under an early SEC interpretation of section 4(2), and eliminating the Uniform Act's prohibition against remuneration of persons engaged in the selling effort, a concept foreign to section 4(2). In short, the general commitment to substantial coordination of Maryland and federal securities regulation was specifically expressed in the new Act's exemption for private and limited offerings of securities. It is difficult, however, to determine how well the section 26(b)(9) statutory exemp-

102. Unif. Sec. Act § 402(b)(9), 7A U.L.A. 641 (1956). This section exempted: any transaction pursuant to an offer directed by the offeror to not more than ten persons . . . 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 buyers in this state . . . 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.

Id. (emphasis added).


104. The 25 offeree rule of thumb applied in 1961 was based largely on an early opinion of the SEC General Counsel that indicated that under ordinary circumstances an offering to approximately 25 or fewer persons would presumably not involve a public offering. Securities Act Release No. 33-2285, 1 Fed. Sec. L. Rep. (CCH) ¶¶ 2740-2744 (Jan. 24, 1935). See L. Loss, supra note 50, at 661-62 (1961); Section 4(2) and Statutory Law, 31 Bus. Law. 485, 486 (1975). By 1969, however, Loss remarked that "one can no longer assume that an offering to not more than twenty-five persons (or any lesser number) will be considered exempt. . . ." L. Loss, supra note 50, at 2644; see also L. Loss, supra note 76, at 370-71.

105. The Committee formed to analyze the administration of the blue sky law in Maryland stated:

Since the number of 25 offerees is often considered a rule of thumb for gauging the eligibility of a transaction for the private sale exemption in Section 4(1) of the Securities Act of 1933, we suggest that this figure be used in § 26(b)(9) of the Securities Act . . . .

We have also deleted a condition (albeit subject to waiver by the Commissioner) in the Uniform Act prohibiting the payment of any com-
tion of the 1962 enactment "worked" without empirical data demonstrat­ing how the Division implemented its exemptive policies and how the private bar adapted its practice to those policies. The following evaluation, therefore, reflects informal observation of the Maryland experience with this exemption.

B. The Evolution of Rule S-7

Many nonspecialist practitioners seemingly read the section 26(b)(9) exemption in a simplistic manner. They tended to ignore the statutory language requiring the seller to establish a reasonable belief in the purchaser's investment intent, and they either ignored or failed to discover the Division's informal policy requiring offeree sophistication as a condition of the exemption. In short, these practitioners regarded the twenty-five offeree limit as the only criterion. In addition, they sometimes tended to read the number twenty-five as applying to purchasers rather than offerees, as if there were no difference between the two. Indeed, it is still possible today to hear the nonspecialist argue that if his client sells to no more than twenty-five persons, the client will be "safe" in Maryland. This problem was compounded by a tendency among more careful but perhaps less scrupulous practitioners to sell to no more than twenty-five persons and then, in communications with the Division, to reconstruct the number of offerees to make the offering appear to comply with the statute. From the investor protection perspective, therefore, section 26(b)(9) created problems. Its apparent simplicity led to naive oversimplification and misreading, because the statute's brief reference to investment intent was often ignored, and the Division's informal policy requiring offeree sophistication might be either ignored or unknown. The limitation on the number of offers, furthermore, provided relatively little social benefit since it was difficult to enforce, and it imposed a questionable burden on the small business enterprise seeking to raise a limited amount of capital.

To experienced securities law practitioners, section 26(b)(9) was not simple, but was instead a complex trap for the unwary. The sense of complexity arose because the principle of coordination had led to a tradition of analyzing section 26(b)(9) in terms of section 4(2) of the

mission or other remuneration in private transactions. This condition is not imposed by the SEC, and it seems to us needlessly restrictive.

MARYLAND REPORT, supra note 85, at 46.


107. See Release No. 5, supra note 106, at 3-4; Notes & Comments, supra note 28, at 280.

108. See Release No. 5, supra note 106, at 5; Notes & Comments, supra note 28, at 280.

1933 Act. Accordingly, the confusion over the section 4(2) exemption that developed in the late 1960's and early 1970's spread to section 26(b)(9). The practitioner involved in the debates over section 4(2)'s requirements of "sophistication" and "access to information" had to think carefully about the role of these concepts in the Maryland exemption. Section 26(b)(9) thus amounted to a paradox: it was either too simple or too complex, depending upon who was reading it. This provision seemed to encourage noncompliance by the practitioner eager to rely on a fanciful, bright line twenty-five offeree or purchaser test, and it frustrated the conscientious attorney by dragging him into the morass of section 4(2) law.

By the early 1970's, the Maryland policy of encouraging coordination of section 26(b)(9) and section 4(2) exemptions seemed to have created more problems than it had solved. The Division's awareness of this problem with federal coordination, when coupled with its perception of investor abuse under section 26(b)(9), led to the 1972 adoption of Rule S-7, a safe harbor under the statutory exemption.

The 1972 version of Rule S-7 was an attempt to define with precision the exemptive conditions necessary for investor protection. First, the rule made clear that investor sophistication was a condition of exemption. This represented an administrative codification of informal Division policy and a reflection of then current trends on the federal level. The only exception to this requirement was an exclusion from the sophistication requirement for certain "related persons." Second, Rule S-7 reemphasized the distinction between offerees and purchasers. This was accomplished by distinguishing between transactions with an aggregate offering price of $50,000 or more and those with an aggregate offering price of a lesser amount. The offerings of less than $50,000 could include no more than twenty-five purchasers in Maryland, but with no limit on the number of offerees per se.

110. See supra note 45.
111. See Release No. 5, supra note 106, at 3-4; Notes & Comments, supra note 28, at 280-85.
112. Maryland Securities Rule S-7 (1972), MD. ADMIN. CODE tit..02, § .02.03.07 (rescinded 1974) [hereinafter referred to as 1972 Rule S-7]; see Release No. 5, supra note 106. The text of the 1972 version of Rule S-7 is contained in Notes & Comments, supra note 28, at 286-88. That rule was substantially revised in 1974. See infra note 121. The designation "S-7" reflects a mode of codifying Maryland administrative regulations that has since been abandoned.
113. MD. ADMIN. CODE tit. .02, § .02.03.07(b)(I)-(2) (rescinded 1974).
114. Id. "Related persons" were defined in the rule to include "the officers and directors, or general and managing partners, of the issuer, their spouses, parents, brothers, sisters, and children." Id. § .02.03.07(a)(5) (rescinded 1974).
115. Id. § .02.03.07(b)(I)-(2) (rescinded 1974).
116. A practical limit on the number of offerees, however, was the Rule's ban on "general advertising." Id. § .02.03.07(b)(1) (rescinded 1974). In addition, institutional investors were excluded from the calculations of the numbers of offerees and purchasers. Id. § .02.03.07(f) (rescinded 1974). With respect to a subsequent revision of this aspect of 1972 Rule S-7, see infra note 125.
offerings involving $50,000 or more remained limited to twenty-five offerees in Maryland. Third, the rule avoided the section 4(2) problem of determining whether the offerees had access to information by not requiring access to information or any specific form of disclosure as a condition of the exemption. Fourth, the rule required a short notice filing with the Division after completion of the offering—a device intended to help the Division detect abuses.117

When viewed as a whole, the version of Rule S-7 adopted in 1972 represented a liberalization of the exemptive concepts being developed under section 4(2). Rule S-7 permitted the issuer to disregard the number of offerees in smaller deals; it allowed the issuer to avoid the sophistication requirement in transactions with related persons; and it rejected the federal principle that access to information or specific disclosure should be a condition of the exemption. The functional relationship between the federal and state exemptions could thus be stated in the following terms: if the issuer complied with the more stringent requirements of the section 4(2) exemption, it would almost certainly qualify for exemption under Rule S-7, provided that it made the appropriate notice filing in a timely manner. If, however, the issuer structured the transaction to exploit one or more of the liberalized aspects of Rule S-7, the transaction might not qualify for the stricter section 4(2) exemption on the federal level. This anomaly thus created a snare for those practitioners not sensitive to the more restrictive requirements of federal law.118

The continued proliferation of section 4(2) decisional law and the SEC's adoption of Rule 146119 in 1974 caused the Division to adopt a new Rule S-7. The 1974 version, however, represented more than an updating. Its express application of the concept of "exemption by coordination" reflected once again the basic principle defined by the Study Committee and currently being applied in the new Maryland exemptive regulations.120

Exemption by coordination under the 1974 version of Rule S-7 was a simple matter. The rule provided that any offering complying with the conditions of Rule 146 would be deemed in compliance with Rule S-7 upon receipt by the Division of the issuer's representation on Form D-1 that the issuer had complied with Rule 146.121 This direct

117. MD. ADMIN. CODE tit. .02, § .02.03.07(a) (rescinded 1974).
118. See authorities cited supra note 48 (with respect to the restrictiveness of section 4(2)).
120. See supra text accompanying notes 92-105; see also infra text accompanying notes 147-67 (discussing two new state exemptions, MD. ADMIN. CODE tit. 02, § .02.04.09 and § .02.04.15, which allow federal-state coordination).
121. Maryland Securities Rule S-7 (1974), MD. ADMIN. CODE tit. .02, § .02.03.07.H (rescinded 1983) [hereinafter referred to as 1974 Rule S-7]. For a comment on this coordinating device, see Coles, supra note 45, at 462; Notes & Comments, supra note 28, at 296-98. The promulgation of 1974 Rule S-7 followed two years
approach to the problem of coordinating state and federal exemptions represented a significant advantage for the issuer engaged in an inter-state transaction under Rule 146. Issuer's counsel would not have to consider restructuring the transaction to comply with the more restrictive requirements of a Maryland exemption because there were no such restrictive requirements. Indeed, counsel would not even have to spend time reading the regulation to discover that there were no such requirements—the coordinating language was simple and clear.

The 1974 version of Rule S-7 also went beyond coordination with Rule 146. The Division recognized that a transaction could be exempted at the federal level under the statutory section 4(2) exemption rather than under the Rule 146 safe harbor, or as an intrastate offering under section 3(a)(11) of the 1933 Act. Accordingly, Rule S-7 also provided an exemption used in connection with offerings exempted on those bases.

This aspect of Rule S-7 can be characterized as a liberalized application of some of the section 4(2) and Rule 146 concepts. For instance, the state exemption drew upon the familiar section 4(2) criteria of offeree sophistication, a thirty-five person limit on the number of purchasers "in this state," a restriction on resale and limitations on the manner of offering. The exemption, however, was substantially less rigorous than these federal exemptions in three key respects. First, it did not impose as a condition any specific disclosure or access to information. Second, it excepted related person offerees from the sophistication requirement. Third, it permitted the issuer to exclude related persons from the calculation of thirty-five purchasers. The only potential snare was the requirement that a timely notice be filed as


123. MD. ADMIN. CODE tit. .02, § .02.03.07 A-G (rescinded 1983).
124. Id. § .02.03.07 D (rescinded 1983).
125. Id. § .02.03.07 E (rescinded 1983). A 1973 amendment of 1972 Rule S-7 eliminated the distinction between offerings of less than $50,000 (25 purchasers) and those of more than $50,000 (25 offerees), and replaced it with a single limitation to 35 purchasers in Maryland. See Release No. 11, supra note 121, at 3. This approach was carried over into 1974 Rule S-7.
126. MD. ADMIN. CODE tit. .02, § .02.03.07 F (rescinded 1983).
127. Id. § .02.03.07 C (rescinded 1983).
128. Cf. Rule 146(e), 17 C.F.R. § 230.146(e) (rescinded 1982) (disclosure or access to information required as a condition of the exemption).
129. MD. ADMIN. CODE tit. .02, § .02.03.07 D (rescinded 1983).
130. Id. § .02.03.07 E(2)(a)(v) (rescinded 1983).
a condition of the exemption. Since this ministerial task might easily be overlooked, the filing requirement created some cause for concern. The concern, however, was not all that substantial. Rule S-7 was a safe harbor, a nonexclusive rule. An offering that failed to meet each of the specific requirements of the exemption could, in the appropriate case, fall-back on the statutory exemption. This statutory fall-back could be especially helpful when the only noncompliance was failure to make the notice filing in a timely fashion.

Rule S-7 thus was an effective rule. It was a useful coordinating device for the many interstate transactions that proceeded under Rule 146, and it also provided a practicable framework for transactions exempted under section 3(a)(11). In addition, it posed no obstacle to the issuer's reliance on the statutory section 4(2) exemption, because an offering that met the more stringent requirements of that federal exemption would almost certainly qualify for the less stringent Maryland exemption. The only problem in this regard was the same one associated with the 1972 version of Rule S-7: an issuer that took advantage of Rule S-7's exception of related persons from the sophistication requirement, or that failed to provide a disclosure document or access to information, might have found the section 4(2) exemption unavailable.

Although Rule S-7 was effective, developments in state and federal law eventually rendered it obsolete. By 1981, it had become apparent that some modification was needed in the Maryland statutory exemption. The need for amendment of section 11-602(9), as former section 26(b)(9) was designated after the 1975 recodification of the Act, derived from three problems.

First, the adoption and widespread use of Rule S-7 created substantial disparities between the statutory exemption and the rule exemption. The disparities were of both a philosophical and a practical nature. The statute, for example, permitted no more than twenty-five offerees. Rule S-7, following Rule 146, permitted sales to thirty-five purchasers (excluding related persons), and placed no limit on the number of offerees. This exercise of the commissioner's statutory authority to "further condition this exemption, [and] increase or decrease the number or offerees permitted," created an important inconsistency between the statutory exemption and the rule exemption. Similarly, the section 4(2) and Rule 146 ban on general solicitation and public advertising may have been implicit in the section 11-602(9) exemption, but the statute made no express reference to it. Rule S-7, in contrast, explicitly stated the prohibition. Rule S-7 thus reflected the

131. Id. § .02.03.07 G (rescinded 1983). That filing was to be on Form D-1, or contain the information required by that form. Id.
132. See supra text accompanying notes 39-80.
133. MD. ADMIN. CODE tit. .02, § .02.03.07 E (rescinded 1983).
135. MD. ADMIN. CODE tit. .02, § .02.03.07 E (rescinded 1983).
Second, the availability of this partially inconsistent statutory exemption outside of the Rule S-7 safe harbor generated both uncertainty and a threat to investor protection. The uncertainty arose from the previously discussed disparity between the conditions of the statutory exemption and those of the rule exemption. The threat to investor protection was demonstrated most clearly in the 1979 decision by the Court of Special Appeals of Maryland in *Hohensee v. State*, a case that reflected a tendency to read the statutory exemption in a simplistic and misleading manner.

In *Hohensee*, the court reversed a criminal conviction of an individual who had allegedly violated the Act through employing an unregistered agent. The court found that because the defendant's offers in Maryland were exempt under section 11-602(9), there had been no need for the agent to register, and hence no criminal violation had occurred. The court's conclusion that the offers of sale were exempt was based solely on a finding that there were less than twenty-five offerees in the state. The court ignored the express statutory requirement conditioning the exemption upon the sellers' reasonable belief in the buyer's investment intent. In addition, the court failed to read section 11-602(9) against the backdrop of section 4(2) law, Rule S-7, and informal Division policy, and did not consider the possibility that the exemption should depend upon the seller's demonstration that the offerees (or even purchasers) met some kind of suitability criteria and that no general solicitation or public advertising had been used.

The failure of the *Hohensee* court to apply all the statutory conditions and to acknowledge section 4(2) and Rule S-7 as relevant sources of authority for interpretation of the exemption produces an inaccurate, reductionist reading of the statutory exemption. That reading, furthermore, undermined the Division's attempt to define a coherent and comprehensive exemption in Rule S-7. Rule S-7 attempted to balance the

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136. See supra text accompanying notes 102-05.
139. The court was able to reach this conclusion because the Act excludes from the definition of agent an individual who represents an issuer in effecting a transaction exempt under section 11-602. *Id.* § 11-101(b)(3)(ii).
141. The court was apparently aware of the existence of Rule S-7. See *id.* at 335 n.17, 400 A.2d at 459 n.17. The court's failure to read the exemption against the backdrop of section 4(2) was especially perplexing in view of its quotation of the Study Committee's statement in the *Maryland Report* that "the Act roughly approximates locally the coverage of the two principal federal securities laws. . . ." *Id.* at 331, 400 A.2d at 457.
interests of capital formation and investor protection; it is unclear whether the *Hohensee* court was even aware of the need for this kind of balancing. The decision thus demonstrated the risks associated with an exemptive system divided between a detailed rule and a statute that might be read simplistically.

Third, the Commissioner's adoption of the Rule S-7 exemption by coordination arguably could be supported by the Commissioner's statutory authority to further condition the section 11-602(b)(9) exemption. The usefulness of the coordination device, however, suggested the need for specific statutory authority. A specific authorization would not only legitimize the Rule 146 coordination but also could be used as a basis for coordination with other important new federal rules, such as those being developed by the SEC under section 3(b) of the 1933 Act.

V. THE NEW MARYLAND EXEMPTIONS FOR LIMITED AND PRIVATE OFFERINGS: REGULATIONS 9 AND 15

A. First Steps: The 1981 Amendments to the Maryland Securities Act

The former Commissioner of the Division, K. Houston Matney, responded to these problems with the Maryland exemptive system by proposing certain amendments to the Act in the 1981 session of the Maryland General Assembly. This legislation was enacted, resulting in the amendment of section 11-602(9) and adoption of a new section 11-602(15). The current amended version of section 11-602(9) provides:

To the extent the Commissioner by rule or order permits, any offer or sale in a transaction involving the sale by an issuer to not more than 35 persons, other than those designated in item (8) of this section, in this State during any period of 12 consecutive months, whether or not the seller or any purchaser is then present in this State, if the seller reasonably believes that all the purchasers in this State, other than those designated in item (H) of this section, are purchasing for investment, and if the securities have not been offered to the general public by advertisement or general solicitation but the Commissioner by rule or order, as to any security or transaction or any type of security or transaction, may withdraw or further condition this exemption, increase or decrease the number of purchasers permitted, or waive the condition relating to their investment intent.  

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145. *Id.* § 11-602(9).
These changes require little explanation since they were directly responsive to the problems outlined in the previous section. The tension between inconsistent statutory and rule exemptions was eliminated by deleting the purely statutory exemption: a transaction can now be exempted under section 11-602(9) only "to the extent the Commissioner by rule or order permits." Any rule implementing section 11-602(9) thus would not be merely a safe harbor. Instead, it would be the exclusive means of gaining the exemption, save through exercise of the Commissioner's order power. Modernization was achieved by replacing a reference to "twenty-five offerees" with a reference to "thirty-five purchasers," and by substituting "purchaser" or "purchasers" for "offerees" throughout the section. The statute thus supplies the basis for a rule reflecting the modern trend toward purchaser rather than offeree regulation. Finally, the statute now expressly prohibits public advertising and general solicitation.

New section 11-602(15) provides:

To the extent permitted by rule or order of the Commissioner, any offer or sale within this State by an issuer now or hereafter exempted from § 5 of the Securities Act of 1933 by virtue of a rule or regulation adopted by the United States Securities and Exchange Commission under § 3(b) or § 4(2) of that Act; if the issuer files with the Commissioner a notice of intent to claim exemption under this paragraph, at such time or times, in such form, and containing such information as the Commissioner determines.146

This exemption, like that under section 11-602(9), is not self-executing, but depends upon the Commissioner's exercise of administrative authority. Accordingly, the 1981 legislation set the stage for a rulemaking project.

B. The Rulemaking Project: Defining Different Exemptions for Different Functions

That rulemaking project commenced in the autumn of 1981 as a cooperative effort of a committee composed of representatives of the Division and the Securities Law Committee of the Section of Corporation, Banking, and Business Law of the Maryland State Bar Association (the Rulemaking Committee).147 Although the Rulemaking Committee's efforts were delayed by the SEC's proposal and ultimate adoption of Regulation D, it finally proposed new Regulations 9.148 and

146. Id. § 11-602(15).
147. The Rulemaking Committee consisted of former Commissioner K. Houston Matney and Assistant Attorney General Susan M. Rittenhouse, representing the Division, and Theodore Kaplan, Edward E. Obstler and this author, representing the Securities Law Committee.
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15\textsuperscript{149} as responses to changes in federal law. Regulation 15 was implemented by administrative order on June 7, 1982,\textsuperscript{150} and both regulations were formally published on April 1, 1983.\textsuperscript{151} The balance of this article will describe these regulations and will identify some potential problems with their application. In particular, this article will explain how these regulations represent the Rulemaking Committee's attempt to achieve three goals: (1) promotion of federal-state coordination; (2) modernization and simplification of the exemptions; and (3) reduction of compliance costs for small businesses attempting to raise capital through exempt transactions.

The Rulemaking Committee's recognition of these three different although related goals led it to produce not one but two exemptive regulations. The committee produced two rules rather than one because it understood that one rule could not serve all of these goals with respect to all issuers and all offerings. Furthermore, the Rulemaking Committee felt compelled to design an exemptive system that would account for the changes effected by Regulation D. Regulations 9 and 15, therefore, were designed to have different, although complementary functions within the exemptive scheme. Before turning to individual analysis of each of these exemptions, this subsection will provide a brief overview of how the Rulemaking Committee defined the different functions of these two rules. The key to this definition, perhaps, is a perception of what Regulation D did and did not do.

Regulation D was designed, in part, to make the federal exemptive scheme more systematic.\textsuperscript{152} The attempt was generally successful, largely because Regulation D contains a common set of definitions and exemptive conditions, and because it makes the strictness of the exemption proportional to the aggregate offering price. The more money the issuer wants to raise, the more regulatory restraints will be applied; conversely, the less money, the fewer restraints. Despite all of its systematic qualities, Regulation D did not totally transform the federal exemptive system because Congress and the SEC allowed several important non-Regulation D exemptions to remain in existence after the

\textsuperscript{149} Id. § .02.04.15 [hereinafter cited as Reg. 15]; see Sargent & Matney, Bluer Skies in Maryland: An Introduction to the New Maryland Exemptions for Limited and Private Offerings of Securities, 14 U. BAL. L.F. 22 (Fall 1983) (reviewing Reg. 9 and Reg. 15); Sargent, Dealing with Maryland Blue Sky Reform: A Step-by-Step Case Study and Guide, Daily Rec., Sept. 28, 1983, at 4, col. 1. The Division has published a brief explanatory release covering these regulations. Maryland Securities Act Release No. 24, 1A BLUE SKY L. REP. (CCH) ¶ 30,566 (Dec. 15, 1983) [hereinafter cited as Release No. 24].

\textsuperscript{150} Order, In the Matter of Exemption by Coordination with SEC Rule 505 and 506, Maryland Securities Commissioner (June 7, 1982) (Copy on file at the Division).

\textsuperscript{151} 10 Md. Admin. Reg. 55d1 (Mar. 18, 1983).

adoption of the regulation. Notably, the statutory 4(2) exemption remains available outside the Rule 506 safe harbor.\textsuperscript{153} Similarly, an issuer may still rely on the section 3(a)(11)/Rule 147 intrastate offering exemption. In addition, the Regulation A and section 4(6) exemptions remain available.\textsuperscript{154} As a result, the Rulemaking Committee was faced with the task of considering the appropriate state treatment of transactions exempted at the federal level under the statutory 4(2) exemption, section 4(6), Rule 147, and Regulation A as well as under one of the three Regulation D exemptions.

Regulation A and section 4(6) presented little difficulty for several reasons. First, Regulation A offerings could be registered by coordination in Maryland.\textsuperscript{155} Second, the relatively insignificant section 4(6) exemption is primarily useful for smaller placements to institutional investors,\textsuperscript{156} which can be exempted under Maryland’s statutory institutional offering exemption.\textsuperscript{157} The statutory 4(2) and Rule 147 exemptions, however, presented more challenging problems. These problems had to be resolved in tandem with the issue of defining a state approach to the different Regulation D exemptions. The Rulemaking Committee’s resolution reflected its three interrelated goals of promoting federal-state coordination, modernizing and simplifying the state law, and reducing small business compliance costs. The net result was two new exemptive rules.

Regulation 15 is the key to the system. It permits exemption by


\textsuperscript{155} MD. CORPS. & ASS’NS CODE ANN. § 11-503(d) (1975).

\textsuperscript{156} Since the SEC’s 1982 publication of a rule defining the term “accredited investor” for purposes of § 4(6) (17 C.F.R. § 230.215 (1983)), securities may be sold under § 4(6) to natural persons. This has made § 4(6) more useful than before. \textit{Cf.} L. Loss, \textit{supra} note 76, at 348-49 (suggesting that § 4(6) has limited utility). Although the exemption may still be largely redundant, it could be a useful alternative to Rule 505 in some circumstances because: (1) it does not require delivery of a disclosure document; (2) it contains no “bad boy” disqualifications; and (3) offerings made during the prior 12 months under a section 3(b) exemption do not have to be aggregated for purposes of calculating the § 4(6) aggregate offering price. \textit{See} H. Bloomenthal, \textit{supra} note 76, at xliv. If an issuer sells securities under § 4(6) to other than institutional investors, however, the state exemption for offers and sales solely to these investors will not be available. \textit{See} MD. CORPS. & ASS’NS CODE ANN. § 11-602(8) (1975). In Maryland, the offering will have to be registered or meet the exemptive conditions of Reg. 9. In view of the liberal terms of the federal exemption, this seems to be an appropriate alternative at the state level. For a discussion of the development of § 4(6) and Rule 215, see Helman, \textit{The Sophisticated Accredited Investor}, 14 REV. SEC. REG. 861 (1981).

coordination with Rules 505 and 506. An offering made in compliance with Rule 505 or 506 will be exempt under section 11-602(15) of the Act provided a simple notice filing is made with the Division and two additional, but relatively minor, conditions are satisfied.158 The crux of the state exemption, therefore, is compliance with the requirements of either Rule 505 or 506. Rules 505 and 506 are perhaps the most important bases for interstate exempt offerings; exemption by coordination under Regulation 15 allows those offerings to proceed in Maryland without the need to restructure or restrict the offering except in relatively minor ways.159 This promotion of federal-state coordination, moreover, is accomplished through a simple cross-reference. As a re-

158. See infra text accompanying notes 189-216.
159. The Maryland device of exemption by coordination should be compared to the Uniform Limited Offering Exemption (ULOE) adopted by NASAA. 1 BLUE SKY L. REP. (CCH) ¶ 5294 (revised version adopted Sept. 21, 1983). Since 1981 NASAA has been trying to develop an exemption for limited and private offerings that could be adopted on a uniform basis by its members. See Release No. 6339, supra note 154, ¶ 83,014 at 84,458. The goal of the project was “to reduce the burdens on small issuers by eliminating in most instances the multiplicity of regulations imposed at both the state and federal levels.” Id. ULOE has gone through numerous drafts and has been the subject of criticism from within NASAA, see NASAA Memorandum, supra note 39, and without, see Halloran & Linderman, supra note 14, at 165-74.

In comparison to Reg. 15, NASAA's current ULOE is a more tentative approach to exemption by coordination. The basic problem is that ULOE still contains conditions reflecting regulatory concerns that the SEC has either rejected or deemphasized. For example, ULOE permits the payment of sales remuneration only to persons appropriately registered in the state. ULOE ¶ 1.A., 1 BLUE SKY L. REP. (CCH) ¶ 5294 (revised version adopted Sept. 21, 1983); cf: ULOE ¶ 1. Ann. 2-3 (identifying certain options). The SEC proposed a similar restriction in its original version of Regulation D, see Release No. 6339, supra note 154, but that restriction was dropped from the final version. Reg. 15 imposes a less stringent remuneration restriction than that set forth in ULOE. See MD. ADMIN. CODE tit. .02, § .02.04.15(B)(3) (1984). In addition, section D of ULOE requires the issuer to meet sophistication and risk-bearing suitability standards for all nonaccredited investors. It is noteworthy that an earlier version of ULOE contemplated additional individual suitability standards for the accredited investors as well. See NASAA Memorandum, supra note 39, at 7. In contrast, neither Rule 505 nor Reg. 15 impose any suitability standards on nonaccredited investors, and Rule 506 does not require risk-bearing suitability for these investors. Furthermore, section C of ULOE would permit a state to require either pre- or post-commencement notice filing. ULOE ¶ C n.4, 1 BLUE SKY L. REP. (CCH) ¶ 5294 (revised version adopted Sept. 21, 1983). Both Regulation D and Reg. 15 require only post-commencement filing. Finally, ULOE contemplates coordination with only Rule 505 offerings. Although explanatory footnote 1 to ULOE suggests that "[i]n those states where facts and circumstances permit, it would not be inconsistent with the regulatory objectives of this exemption" to coordinate with Rule 506, ULOE itself does not permit this coordination. Furthermore, ULOE footnote 1 contains language highly critical of the use of Rule 506 in connection with tax shelter investments.

Reg. 15 represents a more direct approach to coordination since it: (1) expressly coordinates with Rule 506 as well as Rule 505; (2) imposes no additional suitability standards; and (3) requires only post-commencement notice filing. It adds to Rules 505 and 506 only through imposing a restriction on remuneration (a
suit, counsel need not read through a multipage rule to determine that a substantial degree of coordination is intended. The major benefit of coordination and simplification, finally, is reduction of compliance costs—a boon to all issuers, especially small business issuers, upon whose smaller offerings compliance costs fall with a disproportionately greater weight.160

The Rulemaking Committee recognized, however, that state exemption by coordination would not be appropriate with respect to all federal exemptions. In particular, it recognized that the basis of the Rule 504 exemption was deferral to state regulation. Rule 504 represents a decision by the SEC to remove significant federal regulatory restraints from certain smaller offerings because those offerings are de minimis from the federal perspective, and because they could and would be regulated by the states.161 The SEC contemplated that those offerings would be either state registered or subjected to a stricter state exemption; the SEC did not contemplate that Rule 504 would be the basis for a wholly coordinated state exemption. The Rulemaking Committee gave effect to the SEC's recommendation by extending Regulation 15 exemption by coordination only to Rule 505 and 506 offerings, thereby recognizing that a state exemption for quasi-public offerings with an aggregate offering price of $500,000 to an unlimited number of offerees and purchasers without any kind of mandatory disclosure or suitability standards would seriously threaten Maryland investors.

Similarly, the Rulemaking Committee decided that exemption by coordination would not work for Rule 147 and section 4(2) exemptions. The Rule 147 problem was similar to the Rule 504 problem; the basis for the intrastate offering exemption is deferral to state regulation, as the SEC made clear in its explanatory release accompanying Rule 147. Exemption by coordination with Rule 147 made no sense conceptually or as a matter of policy.

The question of coordination with the statutory section 4(2) exemption was different because that exemption does not represent a sim-
deferral to state regulation. The difficulties in coordinating with section 4(2) were more complex. Particularly troublesome was the elusiveness of the exemption. Because section 4(2) law is still a non-systematic combination of decisional law, administrative interpretation, and lawyers' rules of thumb, it is difficult to determine exactly when the statutory exemption exists. Since one of the purposes of the 1981 legislation was elimination of uncertainty and promotion of predictability through administrative rule making, the elusive statutory exemption seemed to fit poorly with the coordinating device. Furthermore, the exemption still depends upon some outmoded concepts, notably offeree suitability and stringent disclosure requirements. Accordingly, section 11-602(15) only permits coordination with a rule or regulation adopted under section 4(2).

The question thus became what should be done at the state level with Rule 504, Rule 147, and section 4(2) offerings. The issuer could register those shares by qualification, but it seemed inappropriate to force all these offerings into registration. As an alternative, the Rulemaking Committee provided Regulation 9, which was designed for use with offerings under any of those three exemptions. It is a mold into which those offerings can be poured to qualify for a state exemption. Regulation 9 will be analyzed in detail below, but a few key points about its relationship with Regulation 15 and the federal exemptions must be emphasized here.

First, Regulation 9 is not a coordinating exemption. Its availability does not depend upon qualification for some federal exemption. The issuer does not have to establish a Rule 504, Rule 147, section 4(2), or any other federal exemption to use it. It is simply available for use in connection with offerings federally exempted on any one of those bases. Conversely, qualification under one of those federal exemptions does not automatically entitle the issuer to the Regulation 9 exemption; instead, compliance with each of the conditions of Regulation 9 is required. Counsel thus should not regard Regulation 9's use of Regulation D terminology and concepts as implying "coordination" in the Regulation 15 meaning of that word. The Rulemaking Committee borrowed terminology and concepts from Regulation D because some aspects of that regulation could be put to use in Regulation 9, and that is the only connection between those two regulations.

Second, Regulation 9 was intended to be a simple exemption for use principally by small business. Although it will probably be used

163. See Section 4(2) and Statutory Law, supra note 104, at 486, 489.
164. See Nimkin, supra note 78, at 865-67.
165. MD. CORPS. & ASS'NS CODE ANN. § 11-504 (1975).
166. The use of Regulation D terminology and concepts in Reg. 9 makes SEC interpretation of Regulation D relevant to Division interpretation of Reg. 9. Those interpretations, however, are merely relevant, because nothing in Reg. 9 makes them automatically binding on the Division. Accordingly, they will become binding only if the Division adopts them as such.
most often in connection with Rule 504 offerings, it is available to other issuers and is not exclusively a mechanism for small business capital formation.

Third, although Regulation 9 implements the section 11-602(9) exemption, it is not merely a safe harbor. It is the exclusive means of gaining that exemption, except through order of the Commissioner. The relationship of Regulation 9 and section 11-602(9) thus does not parallel the relationship of Rule 506 and section 4(2).

In sum, Regulations 9 and 15 have different functions. Regulation 15 is a coordinating device that permits Rule 505 and 506 transactions to proceed in Maryland without incurring substantial additional compliance costs. Regulation 9 is not a coordinating device as such, but is designed for use in connection with federally exempted offerings that can meet its specific conditions. It was intended to be especially useful for Rule 504 offerings that the issuer does not wish to register in Maryland. Because it is a relatively simple exemption, small business should find it to be an inexpensive means of raising capital in Maryland. If counsel is sensitive to the different functions of these two regulations, the choice of exemption in Maryland should be easy to make.

C. Regulation 15: Exemption by Coordination

1. Incorporation by Reference of Federal Law

Regulation 15, on its surface, is simple. Section A states the exemption: "Offers and sales of securities that satisfy the conditions and limitations in [section] B of this regulation shall be exempt under Corporations and Associations Article, [section] 11-602(15)." The crucial substantive provisions of Regulation 15 are located in section B. Subsection B(1) sets out the coordinating device. The offer or sale must be "part of an offering which is made in compliance with Rule 505 or 506 (17 C.F.R. Parts 230.505 or 506, incorporated herein by reference) as such rules may be amended from time to time." Crucial to this exemption is the reference to Rules 505 and 506 as they currently exist and as they may be amended in the future. This device should permit substantial coordination between the federal and state exemptions. Indeed, the basis of the state exemption is establishment of the federal exemption. This premise is also expressed in subsection B(2), which characterizes the issuer’s mandatory filing of the SEC Form D as "the issuer’s representation and affirmation to the Di-

167. While Reg. 9 was not adopted on a uniform basis with any other state, it still provides a form of exemption useful in connection with a Rule 504 offering. It is thus a step toward the recommendation stated in November 1982 by the SEC Government-Business Forum on Small Business Capital Formation. See SEC FORUM, supra note 160, at 60-61.
169. Id. § .02.04.15B(1).
vision that it has complied with SEC Rule 505 or 506.\textsuperscript{170}

It must be emphasized, however, that the express incorporation by reference of Rules 505 and 506 means that those rules themselves are technically part of Maryland law. If that is the case, the Division may be entitled to interpret Rules 505 and 506 for purposes of Regulation 15 in a manner different from the SEC or the federal courts. The practical problem created is the risk that an issuer could establish a Rule 505 or 506 exemption for purposes of federal law but then be denied a Regulation 15 exemption because the Division interprets Rule 505 or 506 more restrictively. Because Regulation 15 expressly makes those rules part of state law, inconsistent state interpretations of Rules 505 and 506 as state law are possible.

Although this theoretical possibility is created by the language of incorporation by reference, and although it may give the Division some useful flexibility in responding to sudden or questionable changes in SEC interpretation, it seems wholly inconsistent with the basic purpose of Regulation 15. That purpose is to make the state exemption hinge upon: (1) the establishment of the federal exemption under federal law; and (2) the issuer's satisfaction of the three additional conditions specifically stated within the rule. The whole purpose of "exemption by coordination" is elimination of duplicative or unnecessarily inconsistent state regulation in the context of certain exempt transactions; the purpose is not the creation of state variants of Rules 505 or 506.\textsuperscript{171} The creation of these state variants would be especially troublesome if their character could be determined only from no-action letters, orders pursuant to administrative hearings, or more informal policy statements. Although the Division will probably exhibit its traditional restraint in this regard, it may be appropriate to amend Regulation 15 by deleting the phrase "incorporated herein by reference" from subsection B(1). If that is done, it will be more clear that the state exemption depends upon establishment of the federal exemption under federal law.

2. The Problem of Delegation

Regulation 15's coordination of the state exemption with the federal exemption also generates the more serious problem of delegation. That problem arises because subsection B(1) refers to Rules 505 and 506 as they "may be amended from time to time." In essence, state law

\textsuperscript{170} Id. § 02.04.15B(2).

\textsuperscript{171} It is noteworthy that neither the Rulemaking Committee's drafts nor the Division's proposed version of Regulation 15B(1) contained the words "incorporated herein by reference." The language was added by the Division apparently in response to concerns of the Division of State Documents about potential delegation problems. See Letter of Dennis M. Sweeney, Assistant Attorney General, to Robert J. Colborn, Division of State Documents (Jan. 17, 1983) [hereinafter cited as Sweeney Letter]. As the discussion below will show, because there should be no delegation problem under Reg. 15, the "incorporated herein by reference" language is superfluous. See infra text accompanying notes 172-88.
has been tied to future federal law; if Regulation D is amended by the SEC, the basis for exemption under state law will change. There is some risk that this could be regarded as an unconstitutional delegation of state authority to the SEC, because the delegation doctrine has been interpreted to mean that the state law cannot be pegged to "changes in the federal laws or regulations to occur in the future."172

The main problem here is not with section 11-602(15), Regulation 15's enabling statute, despite that section's exemption of transactions "now or hereafter"173 exempted under section 4(2) or 3(b) of the 1933 Act. This reliance on future federal law, while questionable, is not necessarily invalid on delegation grounds because it will occur only to the extent the Commissioner by rule or order permits. The statute contemplates that the state agency, and not the federal government, will ultimately determine the effect of changes in federal law on the state exemption. Section 11-602(15) thus should be considered valid under State v. Ciccarelli, a case decided by the Court of Special Appeals of Maryland in 1983.174 The Ciccarelli court rejected a delegation challenge to a Maryland statute that classified as "controlled dangerous substances" materials that had been so designated by federal authorities and to which no objection was made by the Maryland Department of Health and Mental Hygiene.175 The court specifically rejected the defendant's contention that this section allowed the federal agency to create state law.176

The court held first that the statutory reservation of a thirty day period in which the state agency could decide whether to object to the state classification of the federally designated substance meant that "[i]t is the state agency, not the federal one, that makes the final determination."177 Section 11-602(15) even more clearly relies on state administrative action; a federal rule under sections 4(2) and 3(b) will become the basis for a state exemption only if the Commissioner affirmatively acts. The Commissioner's mere failure to object will not trigger coordination with the new federal rule.

The Ciccarelli court then held that the statute in question was valid because it would "guide and restrain" the agency's exercise of discre-


175. Ciccarelli, 55 Md. App. at 154, 461 A.2d at 553.

176. Id. at 154, 461 A.2d at 553.

177. Id. at 156, 461 A.2d at 554. The court expressly approved a similar decision by the Supreme Court of Missouri in State v. Thompson, 627 S.W.2d 298 (Mo. 1982).

179 Ciccarelli, 55 Md. App. at 155-56, 461 A.2d at 554.

180 See supra text accompanying notes 92-103.

under Ciccarelli's application of the delegation doctrine.\textsuperscript{182}

Although the regulation may be vulnerable, it is not necessarily invalid. If prospective application of future amended versions of Rules 505 and 506 is deemed an impermissible delegation, the court may sever the offending provision and thereby prohibit coordination with the future versions of Rules 505 and 506 while permitting coordination with the version in effect at the time of publication.\textsuperscript{183}

Furthermore, Regulation 15 is merely an administrative rule. If Rules 505 or 506 are amended in a manner that would make exemption by coordination inappropriate, the Division can revise the regulation. Legislative action would be unnecessary, as it would be if Regulation 15 were a statute. Because the Division can respond to changes in federal law more rapidly and efficiently than the General Assembly, the degree of actual delegation to the SEC is proportionately less than it would be if section 11-602(15) were a self-executing statutory exemption that did not require administrative implementation by rulemaking.

Finally, substantial considerations of public policy may make rigid adherence to the delegation doctrine both unnecessary and counterproductive.\textsuperscript{184} As Congress, the SEC,\textsuperscript{186} and state securities administrators\textsuperscript{187} have recognized, inconsistent federal-state regulation of limited and private offerings may impose an unnecessary restraint on capital formation. The restraint results from three interrelated problems: (1) the compliance costs generated by the need to identify and understand additional or different state exemptive requirements; (2) the compliance costs produced by the delays incident to multistate blue sky compliance; and (3) the burden of restructuring a transaction eligible for a federal exemption to qualify for a more restrictive or at least different state exemption. The exemption by coordination device is intended to reduce these restraints by promoting consistency in exemptive policies and techniques. Exemption by coordination will be more effective, however, if the Division permits virtually automatic coordination with amended versions of Rules 505 and 506. If this coordi-

\textsuperscript{182} See Ciccarelli, 55 Md. App. at 158 n.4, 461 A.2d at 555 n.4. The Ciccarelli court distinguished State v. Rodriguez, 397 So. 2d 1084 (La. 1980), in which the stricken statute had provided that the secretary of the appropriate state agency \textit{shall} add any substance to the controlled list if the federal Drug Enforcement Agency classified it as controlled. In Rodriguez, "[t]he secretary of the state agency was but a 'rubber stamp', divested of any discretion in the matter." Ciccarelli, 55 Md. App. at 158, 461 A.2d at 555.


\textsuperscript{184} For an argument that the delegation doctrine should not be applied in a rigid manner, and that state adoption of future federal law should be considered in light of the substantive regulatory policies at issue in the area subject to concurrent state and federal regulation, see Rochvarg, \textit{State Adoption of Federal Law—Legislative Abdication or Reasoned Policymaking?}, 36 ADMIN. L. REV. 277 (1984).


\textsuperscript{187} See NASAA ULOE (1983), 1 BLUE SKY L. REP. (CCH) ¶ 5294 (Sept. 21, 1983).
nation is not permitted, serious disparities between state and federal law may develop. 188

The prevention of a time lag between federal and state changes will prevent temporary (and not so temporary) interference with the efficient functioning of the coordination device. It will also simplify the administrative task. The Commissioner will not have to carry out the rulemaking process every time the SEC amends Regulation D so as to update Regulation 15. That process will need to be initiated only if the Commissioner wants to further condition the coordination exemption because of changes in federal law. Neither Regulation 15 nor section 11-602(15) would prevent the Commissioner from exercising discretion in that regard.

In addition, automatic coordination with amended versions of the federal rules is not an abdication of the Division's responsibility to protect Maryland investors. The federal rules in question will be revised by an agency with both substantial expertise and a traditional concern for the needs of investors. If automatic coordination can reduce the compliance costs associated with inconsistent state regulation without undermining the Division's ability to protect Maryland investors, then the delegation problem should not prove fatal.

The major interpretative and policy problems with Regulation 15 are thus created by subsection B(1). A summary of the rest of the exemption, however, will reveal a few other notable issues.

3. The Filing Requirement: A Trap for the Unwary?

Subsection B(2) requires the issuer to file with the Division "not later than 15 days after the first sale of securities under this regulation, a manually signed notice on completed SEC Form D . . . together with a $100 check." 189 There are two points to note about this apparently innocuous notice filing provision. First, the filing must be made not later than fifteen days after the first sale of securities "under this regulation." Sales "under this regulation" are, obviously, the sales made in Maryland. Because this filing is a requirement of Maryland law, the Division is not bound by SEC interpretations of when a sale occurs

188. The Division recognized this possibility in one of its internal documents:
Experience has indicated that regulations and forms change at the federal level more frequently and with greater speed than such changes at the state level. The time lag which would result from forcing the State to continually play "catch-up-ball" with regard to state regulations intended to fully coordinate with regard to certain federal regulations is likely to result only in diminished confidence in, and compliance with, the state regulatory structure. In such a case there could be no assurance that the state regulations have not been caught in a "time-warp" in its efforts to keep pace with changes at the federal level.

Sweeney Letter, supra note 171, at 3.

189. MD. ADMIN. CODE tit. .02, § .02.04.15B(2) (1984).
under Regulation D.\textsuperscript{190} The Division thus could develop a more or less restrictive definition of when the first sale occurs.

Second, the notice filing requirement is a condition of the exemption. Failure to satisfy this simple requirement in a timely fashion can result in loss of the exemption, just as a failure to file Form D with the SEC can result in loss of the Regulation D exemption.\textsuperscript{191} This severe penalty arguably must exist if the Division is to be able to monitor all Regulation 15 transactions for misuse of the exemption. It is questionable, however, whether the issuer should incur this kind of penalty\textsuperscript{192} for failure to make a notice filing or failure to make it in a timely fashion. Regulation 15's filing requirement is easier to comply with than Regulation D's\textsuperscript{193} because the Maryland rule requires only one filing, but the use of the filing as a condition of the exemption perhaps needs reexamination. In any event, issuer's counsel should keep well aware of this simple, but stringent requirement.

4. Restrictions on Remuneration

Subsection B(2) imposes an additional filing requirement to that imposed by Regulation D. Subsection B(3), however, imposes a condition foreign to Regulation D—a restriction on the persons the issuer may remunerate for their sales efforts.\textsuperscript{194} Specifically, a Rule 505 or 506 offering may be exempted in Maryland under Regulation 15 only if any sales remuneration is paid exclusively to the persons designated in subsections B(3)(a)-(b). This restriction on remuneration represents not only an additional state requirement superimposed on the federal requirements of Rules 505 and 506, but also a departure from Rule S-7, which never imposed any restrictions on remuneration. Subsection B(3) provides that remuneration for selling efforts may be paid only to a broker-dealer that the issuer reasonably believes is registered in Maryland, or:

\begin{itemize}
  \item \textbf{(b)} To a natural person who the issuer reasonably believes has not received a commission or similar remuneration for ef-
\end{itemize}

\textsuperscript{190} The SEC has issued a set of interpretations of when the Form D should be filed. \textit{See} Securities Act Release No. 6455, \textit{I FED. SEC. L. REP. (CCH)} ¶ 2380, at 2637-17 (questions 82-84) (Mar. 3, 1983). The Division currently follows the SEC in considering the “first sale” to occur “when the subscription agreement is delivered to the issuer or its representative or when a purchaser's check is delivered to the issuer or its representative, whichever occurs first.” Release No. 24, \textit{supra} note 149, ¶ 30,566, at 25,583-84.

\textsuperscript{191} Release No. 6339, \textit{supra} note 154, ¶ 83,014.

\textsuperscript{192} See Kripke, \textit{supra} note 78, at 851; Schneider, \textit{supra} note 78, at 988.

\textsuperscript{193} Rule 503 requires the issuer to file a notice of sale on Form D not later than 15 days after the first sale, every six months thereafter, and no later than 30 days after the last sale. 17 C.F.R. § 230.502(a)(1)-(3) (1983).

\textsuperscript{194} The proposed version of Regulation D contained a restriction on remuneration. \textit{See} Release No. 6339, \textit{supra} note 154, ¶ 83,014, at 84,464-65. The restriction was deleted from the final version. \textit{See} Release No. 6389, \textit{supra} note 152, ¶ 83,106, at 84,910.
fecting any sale of securities on behalf of more than one other issuer within a 12-month period immediately preceding the first sale by that person in the offering being made in reliance on this regulation.\textsuperscript{195}

It should be emphasized that this restriction applies not only to classic brokers' sales commissions, but also to more unconventional arrangements. This approach reflects current blue sky decisional law, which has tended to give a broad reading to state restrictions on remuneration.\textsuperscript{196} Subsection B(3), however, is still a relatively mild restriction on remuneration. Other states go much further and will either absolutely prohibit remuneration,\textsuperscript{197} or will allow it to be paid only to state registered broker-dealers.\textsuperscript{198}

As subsections B(2)(a)-(b) demonstrate, there are two categories of persons to whom remuneration can be paid. The first category consists of broker-dealers whom the issuer reasonably believes are registered under the Act. The reasonable belief qualification could be important. If a broker-dealer's registration is revoked during the course of the offering and before the broker-dealer stops offering and selling the securities, the qualification might prevent loss of the exemption.\textsuperscript{199}

The second category essentially consists of issuers' agents who have not slipped over the line into the status of unregistered broker-dealers. This concept needs some explanation. Section 11-101(c)(2)(i)\textsuperscript{200} of the Act states that the term "broker-dealer" does not include an "agent." Under section 11-101(b)(1), "agent" means "an individual other than a broker-dealer who represents an issuer in effecting or attempting to effect purchases or sales of securities."\textsuperscript{201} The statute goes on, however, to exclude from the definition of agent "an individual who represents an issuer in: . . . (ii) effecting transactions exempted by section 11-602."\textsuperscript{202} This sequence of definitions and ex-

\textsuperscript{195} MD. ADMIN. CODE tit. .02, § .02.04.15B(3) (1984).
\textsuperscript{196} See, e.g., Schultz v. Rector-Phillips-Morse, Inc., 261 Ark. 769, 552 S.W.2d 4 (1977) (excess profits on sale or lease to partnership constitute remuneration); Caldwell v. Trans-Gulf Petroleum Corp., 322 So. 2d 171 (La. 1975) (fees paid to finders constitute remuneration); Prince v. Heritage Oil Co., 109 Mich. App. 189, 311 N.W.2d 741 (1981) (retention of an interest in a partnership or a well at reduced or no consideration constitutes remuneration); Petroleum Resources Dev. Corp. v. Day, 585 P.2d 346 (Okla. 1978) (remuneration present even if sales commissions are subsequently disallowed by issuer or promoter).
\textsuperscript{197} See, e.g., PA. STAT. ANN. tit. 70, § 203(d)(iii) (Purdon Supp. 1983-1984); PA. ADMIN. CODE § 203.041(g), reprinted in 2 BLUE SKY L. REP. (CCH) ¶ 48,435, at 43,509 (May 11, 1974).
\textsuperscript{199} This does not intimate, however, that the issuer can avoid establishing a reasonable belief in the broker-dealer's registered status before it authorizes the broker-dealer to commence the offering. The Division, however, has not specifically defined the steps appropriate for the establishment of reasonable belief.
\textsuperscript{201} Id. § 11-101(b)(1).
\textsuperscript{202} Id. § 11-101(b)(3)(ii).
A natural person may represent numerous issuers during a relatively short period of time in the placement of securities exempted under sections 11-602(9) or 11-602(15). That person, according to this argument, is excluded from broker-dealer status because he is an issuer's agent, and also excluded from statutory agent status because he is engaged only in transactions exempt under section 11-602. Exclusion from each status would mean that this person is subject to neither broker-dealer nor agent registration.

The Division has correctly refused to countenance this argument. In a 1974 release discussing the applicability of the broker-dealer registration provisions to transactions in limited partnership interests, the Division stated that "persons who solicit limited partnership interests on a private basis are by statute not considered [statutory] agents although they occupy the traditional common law agency position. Hence such persons may not claim entitlement to the agent exclusion from the definition of broker-dealer set forth in [section] 11-101(b)(1)." These persons may be broker-dealers under section 11-101(c)(1) if they are "engaged in the business of effecting transactions in securities for the account of others. . . ." The Division clarified the consequences of this position by stating in that same release that any person:

whether he be a true statutory agent or a common law agent who represents an issuer in a [section] 11-602(9) private transaction, is subject to a presumption that he is a broker-dealer if he solicits limited partnership interests for and on behalf of three or more issuers within a twelve month period.

In short, the representation of the third issuer in a twelve month period creates the presumption that the person is engaged in the business of effecting transactions in securities for the account of others. Subsection B(3)(b) is merely a new application of this presumption in a different context. It has the effect of prohibiting the Regulation 15 issuer from remunerating persons who are presumably unregistered broker-dealers selling in violation of the Act.

Because subsection B(3) imposes an exemptive condition foreign to both Regulation D and Rule S-7, it raises a question as to whether this form of exemptive condition is appropriate. At the outset, it is important to note that the restriction is not all that severe. Although subsection B(3) employs a broad definition of remuneration, it is not an absolute prohibition of remuneration or a statement that only registered persons may be remunerated. The issuer will thus be able to

compensate its own personnel for their sales efforts without losing the exemption. Similarly, the issuer will be able to retain personnel to engage in the sales effort, and will be able to compensate an accountant or a lawyer for services in connection with the offering. The issuer need only establish a reasonable belief that those persons have not been similarly compensated by more than one other issuer in the relevant time period.

Subsection B(3) thus will not have the negative effects of an absolute prohibition or a limitation to registered persons—interference with the issuer's ability to market sound securities, and encouragement of less scrupulous issuers to compensate unregistered persons in a covert or unconventional manner.206 In addition, it may produce a degree of investor protection by encouraging the use of registered securities professionals who are subject to supervision by the Division,207 who must make determinations as to the suitability of the investment for their

206. In a comment letter, the ABA stated:

We strongly oppose Rule 502(e) which makes the limited offering exemptions unavailable if any remuneration is given for solicitations or in connection with sales to persons other than broker-dealers registered under federal and state laws. While we recognize that many states prohibit the payment of remuneration in exempt limited offerings, we believe it is counterproductive for the Commission, which has been charged by Congress to diminish the burdens of raising capital for small business, to impose additional federal requirements in areas where none previously existed in its regulations. Accordingly, we recommend that Rule 502(e) be eliminated in its entirety. Issuers would be free to remunerate third parties in Regulation D offerings—whether they be broker-dealers, business finders, business brokers, or promoters, officers, directors, employees or shareholders of the issuer, or others.

We believe that the proposed restriction on remuneration would have the following undesirable consequences:

(1) One effect of the proposal is to grant a monopoly in the exempt limited offering market to registered broker-dealers, a result we assume was unintended. We believe any such result is certainly unjustified. Broker-dealers play an integral role in capital raising efforts as do promoters, business finders, business brokers (particularly in the context of business combinations) and other persons who are compensated for their solicitation efforts. Many, if not most, of those persons are neither registered nor required to be registered as broker-dealers under federal and state law.

(2) It is not uncommon for small businesses seeking to raise capital to be unable to attract or afford registered broker-dealers. However, since proposed Rule 502(e) prohibits the payment of compensation to persons other than registered broker-dealers, another effect of the proposal is to force small businesses that wish to remunerate such persons to register their offerings or abandon them.

(3) Another effect of the proposal is to cause persons who are compensated for solicitation or sales to register as broker-dealers even though the nature of their activities in many circumstances does not subject them to registration under present federal and state law. We also assume that this result was unintended.

ABA Comment Letter, supra note 154, at 42.

customers, and who have fiduciary obligations to them.\textsuperscript{208} These persons thus may help police the transaction. Similarly, the limitations may reinforce Regulation D's ban on general advertising and solicitation.\textsuperscript{209} Furthermore, subsection B(3)(b) may have the effect of excluding from the sales effort persons who have demonstrated a lack of concern with securities law compliance.

Subsection B(3) is thus a relatively mild restriction on remuneration that may help protect investors. A few questions, however, remain. First, it is unclear whether restrictions on remuneration actually protect investors, because we do not know whether the persons who may be compensated under section B(3) will actually "police the deal." The SEC has not resolved this question, and it dropped from the final version of Regulation D the restriction on remuneration that had appeared in the proposed version.\textsuperscript{210} Second, how may the issuer establish reasonable belief that nonregistered agents have not represented more than one other issuer within the relevant time period? What level of due diligence on the part of the issuer is required? Is a questionnaire sufficient, or will the issuer have to undertake some more rigorous inquiry? Finally, is it appropriate to use an issuer exemption to enforce indirectly the broker-dealer registration requirement? In essence, should the issuer bear the risk of the remunerated persons' non-compliance with that requirement? The restrictions on remuneration thus raise questions of efficacy (do they really protect investors?), practicality (how can reasonable belief as to compensability be established?), and policy (who should bear the risk of violation of the broker-dealer registration requirement?). A period of experimentation may produce some insight into the efficacy and practicability of these restrictions. If it is determined that these restrictions are in fact practicable and provide a measure of investor protection, then it may be possible to decide as a matter of policy that the issuer should bear some of the risk of broker-dealer registration violations by the persons it has compensated.

5. "Bad Boy" Disqualifications

Subsection B(4) also produces some important questions. That provision sets out a series of so-called "bad boy" disqualifications.\textsuperscript{211}

\begin{itemize}
\item \textsuperscript{208} See No. 6339, \textit{supra} note 154, ¶ 83,014, at 84,464-65.
\item \textsuperscript{209} 17 C.F.R. § 230.502(c) (1983).
\item \textsuperscript{210} See Release No. 6339, \textit{supra} note 154, ¶ 83,014, at 84,464-65.
\item \textsuperscript{211} Regulation 15 provides:
\begin{quote}
An exemption under this regulation is not available if the issuer, any of its directors, officers, general partners, or beneficial owners of 10 percent or more of any class of its equity securities, any of its promoters currently connected with it in any capacity, or any person (other than a broker-dealer currently registered under Corporations and Associations Article, § 11-405) which has been or will be paid or given, directly or indirectly, any commission or similar remuneration for solicitation of any prospective purchaser or in connection with sales of securities in reliance on this regulation:
\end{quote}
\end{itemize}
In effect, it denies the exemption if the issuer, or any of its directors, officers, general partners, beneficial owners of ten percent or more of any class of the issuer's equity securities, promoters currently connected with the issuer in any capacity, or nonregistered recipients of remuneration has been subject to specified judicial or administrative actions within five years prior to the first sale of securities under Subsection B(4). All of the specified actions concern discipline for acts of a fraudulent or deceitful nature. Two key points need to be made about this condition.

First, it causes bad boy disqualifications to apply to Rule 506 offerings in Maryland. Rule 506 itself contains no such disqualifications; Rule 505 is the only one of the three Regulation D exemptions that contains bad boy provisions.\textsuperscript{212}

Second, the subsection B(4) disqualifications are somewhat broader than the Rule 505 disqualifications. In particular, subsection B(4) disqualifies the issuer when the specified persons have been convicted or are currently subject to judicial restraint for false filings with a state securities administrator, or are subject to a state administrative order entered by a state securities administrator in which fraud or deceit was found. In short, subsection B(4) will disqualify an issuer if a court or a state administrator has found that one of the specified persons violated some state's securities law through a false filing or the commission of fraud or deceit. The SEC's original version of Rule 505 had contained similar state bad boy disqualifications,\textsuperscript{213} but they were

\begin{itemize}
\item[(a)] Has been convicted or has pleaded \textit{nolo contendere} within 5 years prior to the first sale in any offering in reliance on this regulation of any felony or misdemeanor in connection with the purchase or sale of any security or in connection with the making of any false filing with the United States Securities and Exchange Commission or any state securities administrator, or of any felony involving fraud, or deceit, including but not limited to, forgery, embezzlement, obtaining money under false pretenses, larceny, conspiracy to defraud, or theft;
\item[(b)] Is subject to any order, judgment, or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction, entered within 5 years prior to the first sale in any offering in reliance on this regulation, permanently restraining or enjoining that person from engaging in or continuing any conduct or practice in connection with the making of any false filing with the United States Securities and Exchange Commission or any state securities administrator; or
\item[(c)] Is subject to a United States Postal Service false representation order entered within 5 years prior to the first sale in any offering in reliance on this regulation; or
\item[(d)] Is subject to any state administrative order entered by a state securities administrator in which fraud or deceit was found if the order was entered within 5 years prior to the first sale in any offering in reliance on this regulation.
\end{itemize}

\textsuperscript{212} \textsuperscript{17} C.F.R. \textsection 230.505(b)(2)(iii) (1983).
\textsuperscript{213} Release No. 6339, \textit{supra} note 154, \textsection 83,014, at 84,468.
dropped from the adopted version. In essence, subsection B(4) reinstates, for purposes of transactions in Maryland, disqualifications very similar to those dropped by the SEC.

The imposition of bad boy disqualifications on Rule 506 transactions in Maryland and the engrafting of additional state disqualifications on Rule 505 transactions can best be described as a form of indirect regulation. Instead of strictly limiting the number and nature of the offerees and purchasers, Regulation 15 tries to keep the transactions honest by excluding from participation those persons with a record of securities law noncompliance. Regulation 15, however, arguably should not have added state disqualifications to Rule 505 transactions or applied any to Rule 506 transactions. The addition of these disqualifications may be viewed as inconsistent with the principle of exemption by coordination. This argument is plausible, but not compelling. State securities administrators are often engaged in enforcement actions in which the SEC may play no role and about which the federal agency may not even know. The crucial track record of fraud or deceit may exist only at the state level. It thus may be reasonable to require the issuer to extend its due diligence inquiry to the state administrations as well as to the SEC and the courts.

In any event, the potential harshness of subsection B(4) may be mitigated by subsection B(5), which provides that "[d]isqualification under B(4) does not apply to any transaction if the Commissioner determines that it is not inconsistent with the public interest that the exemption be available." 216

D. Regulation 9: A Noncoordinating Exemption

Regulation 9 was designed for use with transactions exempted on some basis other than Rules 505 or 506. A summary of the regulation will show how it is a flexible device adaptable to use in connection with most Rule 504, Rule 147, and section 4(2) transactions. 217

216. Md. Admin. Code tit. 02, § 02.04.15B(5) (1984). That subsection continues: "This determination by the Commissioner shall be without prejudice to the Commissioner in any other proceeding or matter with respect to the issuer or any other person."

One possible effect of the imposition of subsection B(4)'s disqualifications on Rule 506 transactions might be the occasional registration by qualification of those offerings in Maryland. If one of the general partners in a limited partnership syndication, for example, is a firm with large numbers of officers or general partners, registration in Maryland may be less time consuming than a due diligence survey of disciplinary records.

217. Of course, there may be problems with meeting both the federal and state exemp-
As previously explained, Regulation 9 does not truly coordinate with Regulation D. Its structure and terminology, however, reflect the influence of that set of rules. This should not be a source of confusion. The borrowings from Regulation D are merely an acknowledgement of some of the useful aspects of that regulation; the availability of the Regulation 9 exemption does not depend upon establishment of a Regulation D exemption, and the establishment of a Regulation D exemption does not entitle the issuer to a Regulation 9 exemption.

Regulation 9 actually consists of two separate exemptions: the Local Issuer Exemption and the General Transactional Exemption. The Local Issuer Exemption provides a very simple exemption for certain local small business issuers, and the General Transactional Exemption provides a somewhat more complex exemption for a broader class of issuers. The rest of Regulation 9 sets out definitions and conditions common to both exemptions. Since those definitions and conditions apply throughout the Regulation, they should be examined first.

1. Definitions

Section A of Regulation 9, like Rule 501 of Regulation D, sets forth definitions applicable throughout the regulation. Section B functions similarly to Rule 502, defining conditions applicable to all transactions to be exempted under the regulation. Regulation 9's notions in all cases. Regulation 9 is intentionally more restrictive than Rule 504. See supra text accompanying note 161. An issuer who wishes to take full advantage of Rule 504's liberality thus may want to register by qualification in Maryland. State registration, of course, would allow the issuer to offer the Rule 504 securities through general solicitation and public advertising, and without restrictions on resale. See 17 C.F.R. § 230.504(b)(1) (1983).

Regulation 9 also imposes exemptive conditions that are not necessarily more restrictive than those of Rule 147, but are quite different. They are different because they focus on the limited and private character of the offering rather than its intrastate character. The issuer seeking both exemptions must therefore be able to place the intrastate offering into a limited and private offering mold. Ordinarily, that should not be very difficult. For a useful discussion of some of the complexities of the intrastate offering exemption, see Long, A Lawyer's Guide to the Intrastate Exemption and Rule 147, 24 Drake L. Rev. 471 (1975).

The problem is reversed for statutory section 4(2) transactions. By abandoning offeree suitability requirements, deemphasizing the role of mandatory disclosure, and adopting the accredited investor concept, Regulation 9 created an exemption considerably more liberal than that of statutory section 4(2). Thus, an offering that takes full advantage of Regulation 9 may not be able to qualify under section 4(2). This was, however, a potential problem under Rule S-7 as well, see supra text accompanying notes 131-32, and never seemed to generate great concern. This lack of concern perhaps reflects the tendency of issuers to ensure federal compliance before worrying about blue sky compliance.

218. See supra text accompanying notes 165-67.
219. Id.
tice filing requirement, however, is stated within section B, rather than stated separately in an equivalent to Regulation D’s Rule 503. Sections C and D of Regulation 9 are roughly parallel to Rules 504-506; they concisely define the exemptions to which the preceding definitions and conditions apply. Section E has no analogue in Regulation D, because it merely declares the unavailability of the exemption for offerings registered under the 1933 Act or exempted under Regulation A, Rule 505, or Rule 506. There is also no Regulation D equivalent to Form MD-2, a disclosure document specifically designed for use with some Regulation 9 offerings. The structural affinities between Regulation 9 and Regulation D are thus substantial, but it must be reemphasized that this is a state exemption that must be established as a matter of state law.

Section A begins with a definition of “accredited investor.” As explained below, the question of whether a person is an accredited investor is relevant to the calculation of the number of purchasers allowed under the exemption, the determination of the issuer’s disclosure responsibilities, and the definition of “local issuer.”

Since the definitions of accredited investor set forth in subsections A(1)(a)-(h) are practically identical to those contained in Rule 501(a), no extended summary and discussion of the different categories of accredited investor is needed. It is necessary, however, to identify certain key differences in the state and federal definitions.

Subsection A(1)(d) tracks Rule 501(a)(4) in defining as an accredited investor “[a]ny director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer. . . .” Subsection A(1)(d), however, goes on to broaden this category of accredited investor by including “any relative, spouse, or relative of the spouse of any such individual specified in this paragraph who has the

226. Of course, although SEC and federal court interpretations of similar language in Regulation D may be relevant in interpreting Regulation 9, those interpretations are not binding on the Division or the Maryland courts.
228. See infra text accompanying notes 283-87.
229. See infra text accompanying notes 316-29.
230. See infra text accompanying notes 295-300.
same principal residence as that individual."\textsuperscript{233} Similarly, Rule 501(a)(7) defines as an accredited investor "[a]ny natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 in the current year."\textsuperscript{234} Subsection A(1)(f) adds after the words "individual income" the phrase "or an income combined with the income of that person's spouse."\textsuperscript{235} Subsections A(1)(f) and A(1)(d) represent modest attempts to broaden two of the important categories of accredited investors.\textsuperscript{236}

The definition of accredited investor is followed by definitions of "affiliate,"\textsuperscript{237} and "aggregate offering price,"\textsuperscript{238} both of which parallel equivalent provisions in Rule 501 of Regulation D.\textsuperscript{239} Subsection A(4) defines "beneficial owner" of a security to mean "any person with the power to vote or direct the disposition of the security."\textsuperscript{240} This definition plays a role in subsection A(6)'s definition of "local issuer."\textsuperscript{241} The definition of "local issuer" is the key to section C's Local Issuer Exemption, because only local issuers may use that exemption.\textsuperscript{242} The definition of local issuer follows subsection A(5)'s definition of "executive officer"—a definition tracking Rule 501(f).\textsuperscript{243}

Subsection A(7) provides a broad definition of "promoter."\textsuperscript{244} It

\begin{itemize}
\item \textsuperscript{233} MD. ADMIN. CODE tit. .02, § .02.04.09A(1)(d) (1984).
\item \textsuperscript{234} 17 C.F.R. § 230.501(a)(7).
\item \textsuperscript{235} MD. ADMIN. CODE tit. .02, § .02.04.09A(1)(f) (1984).
\item \textsuperscript{236} It may be appropriate in general to broaden the concept of accredited investor. One way to do so might be by defining sophisticated investors as accredited, although this definition might be inconsistent with the other aspects of the definition of accredited investor, all of which depend upon objective standards. At least one commentator, however, has argued that this definition makes sense: [M]y objection is to the fact that the definition of accredited investor does not include a purchaser who specifically meets the stringent test of rule 506 of being able, either alone or with one or more purchaser representatives, to have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment." Such a person can fend for himself. A sale to him is "one of those transactions where there is no practical need for [the bill's] application or where the public benefits are too remote."
\item Kripke, supra note 78, at 836 (footnotes omitted).
\item \textsuperscript{237} MD. ADMIN. CODE tit. .02, § .02.04.09A(2) (1984).
\item \textsuperscript{238} Id. § .02.04.09A(3).
\item \textsuperscript{239} 17 C.F.R. § 230.501(b)-(c) (1983).
\item \textsuperscript{240} MD. ADMIN. CODE tit. .02, § .02.04.09A(4) (1984).
\item \textsuperscript{241} Id. § .02.04.09A(6); see infra text accompanying notes 295-300.
\item \textsuperscript{242} MD. ADMIN. CODE tit. .02, § .02.04.09C (1984); see infra text accompanying notes 295-303.
\item \textsuperscript{243} MD. ADMIN. CODE tit. .02, § .02.04.09A(5) (1984).
\item \textsuperscript{244} 17 C.F.R. § 230.501(f) (1983).
\item \textsuperscript{245} Regulation 9 states:
\begin{itemize}
\item \textsuperscript{246} "Promoter" means:
\begin{itemize}
\item (a) Any person who, acting alone or in conjunction with one or more persons, directly or indirectly takes the initiative in founding and organizing the business or enterprise of an issuer; or
\item (b) Any person who, in connection with the founding or organization
encompasses both shareholders\textsuperscript{246} and non-shareholders.\textsuperscript{247} This definition plays a key role in the bad boy disqualifications set forth in subsection B(9)\textsuperscript{248} and the subsection D(3)(b)(i)\textsuperscript{249} "cheap stock" disclosure provisions of the General Transactional Exemption.\textsuperscript{250} Subsection A(8) is an elaborate definition of "purchaser representative."\textsuperscript{251} Like Rule 501(h) of Regulation D, subsection A(8) is designed to prevent conflicts of interest among the issuer, the purchaser, and the purchaser representative,\textsuperscript{252} and to ensure that the purchaser representative actually has the ability to evaluate the investment.\textsuperscript{253} The definition of purchaser representative ends with an "Agency Note" advising the purchaser representative to consider the applicability of the state and federal antifraud, broker-dealer, and investment adviser provisions.\textsuperscript{254} The concept of purchaser representative plays only a limited role in Regulation 9; a purchaser representative can be used to establish purchaser suitability for purposes of the disclosure requirements of the General Transactional Exemption under subsection D(3)(a)(iii)(bb).\textsuperscript{255}

2. Conditions

Section B lists nine conditions applicable to all transactions to be of the business or enterprise of an issuer, directly or indirectly receives in consideration of services or property, or both services and property, 10 percent or more of any class of securities of the issuer or 10 percent or more of the proceeds from the sale of any class of securities. However, a person who receives those securities or proceeds either solely as brokerage commissions or solely in consideration of property will not be deemed a promoter within the meaning of this paragraph if the person does not otherwise take part in founding and organizing the enterprise.

\textsuperscript{246} Id. § .02.04.09A(7)(b).
\textsuperscript{247} Id. § .02.04.09A(7)(a).
\textsuperscript{248} Id. § .02.04.09B(9).
\textsuperscript{249} Id. § .02.04.09D(3)(b)(i).
\textsuperscript{250} Id. § .02.04.09D.
\textsuperscript{251} Id. § .02.04.09A(8).
\textsuperscript{252} See id. § .02.04.09A(8)(a) (prohibiting reliance on a purchaser representative connected with the issuer, except under specified circumstances); id. § .02.04.09A(8)(c) (mandating disclosure to investor of potential conflicts of interest).
\textsuperscript{253} See id. § .02.04.09A(8)(b) (requiring purchaser representative to be able to evaluate the risks and merits of the investment).
\textsuperscript{254} The "Agency Note" states:

A person acting as a purchaser representative should consider the applicability of the broker-dealer registration and anti-fraud provision of the Maryland Securities Act and of the Securities Exchange Act of 1934, and the applicability of the Maryland Securities Act, Corporations and Associations Article, § 11-302 and the Investment Advisers Act of 1940 to investment advisers.

exempted under Regulation 9. Subsection B(1)(a)\textsuperscript{256} states the issuer’s basic option: compliance with either section C’s Local Issuer Exemption or section D’s General Transactional Exemption. The issuer must, however, comply with all the conditions of subsection B, whichever option it follows. Subsection B(1)(a) also makes clear that “[t]he burden of proving an exemption under the regulation is on the person claiming the exemption.”\textsuperscript{257} Subsection B(1)(b) mitigates the potentially harsh effect of Regulation 9’s status as an exclusive rule and not a safe harbor.\textsuperscript{258} It does so by allowing an issuer to obtain an exemptive order from the Commissioner by showing “[t]hat the transaction demonstrates substantial compliance in good faith with the conditions of the regulation,”\textsuperscript{259} and “that the order would not be inconsistent with the public interest.”\textsuperscript{260} The key point is that the issuer who cannot satisfy all of the regulation’s requirements has the burden of persuading the Commissioner that an exemption would still be appropriate. The standards governing the Commissioner’s issuance of that order are broadly stated, and permit a flexible response to different financing needs. This kind of flexibility will be needed if the order mechanism is to function as a release from the burden of the regulation’s exclusivity. Although subsection B(1)(b) is flexible, the issuer must still demonstrate “substantial compliance in good faith.”\textsuperscript{261}

Subsection B(2)\textsuperscript{262} applies the familiar concept of integration\textsuperscript{263} to Regulation 9 transactions. The language of subsection B(2) is derived from Rule 502(a), and provides similar six month safe harbors for offers and sales made more than six months before the commencement of an offering under Regulation 9 and six months after completion of the

\textsuperscript{256} Id. § .02.04.09B(1)(a).
\textsuperscript{258} In contrast, MD. CORPS. & ASS’NS CODE ANN. § 11-602 (1975) and 1974 Rule S-7 had a safe harbor relationship. See supra text accompanying notes 133-46.
\textsuperscript{259} MD. ADMIN. CODE tit. .02, § .02.04.09B(1)(b)(i) (1984).
\textsuperscript{260} Id. § .02.04.09B(1)(b)(ii).
\textsuperscript{261} Only experience with the Division’s implementation of this provision will demonstrate the stringency of this requirement.
\textsuperscript{262} MD. ADMIN. CODE tit. .02, § .02.04.09B(2) (1984).
offering. Subsection B(2) further states that offers and sales made within those six month periods, "depending on the particular facts and circumstances, may be deemed to be 'integrated' with the offering." The subsection does not indicate what "facts and circumstances" would determine the question. The Division traditionally has taken a flexible approach to this question and can be expected to draw upon the five factor analysis applied by the SEC under section 4(2) and Regulation D.

Integration issues apparently have not created great concern in Maryland, but the topic recently received considerable national attention as a result of SEC v. Murphy, a 1980 decision by the United States Court of Appeals for the Ninth Circuit. In Murphy, a corporate promoter sold limited partnership interests in about thirty separate cable television partnerships to approximately four hundred investors. The court disregarded the limited partnerships' status as nominal issuers of the securities, integrated the offerings, characterized the corporate promoter as the "issuer," and held that no section 4(2) exemption was available for the integrated offering. Murphy has led to a serious attempt to define a safe harbor for discrete offerings by limited partnerships with affiliated sponsors; it may be appropriate for

264. The six month safe harbors apply if:
During those 6 month periods there are no offers or sales of securities by or for the issuer that are of the same or similar class as those offered or sold under this regulation, other than those offers or sales of securities under an employee benefit plan of the type referred to in Corporations and Associations Article, § 11-601(11) (1975).

MD. ADMIN. CODE tit. .02, § .02.04.09B(2) (1984).

265. In its "Note" to 17 C.F.R. § 230.502(a) (1983), the SEC states:
The following factors should be considered in determining whether offers and sales should be integrated for purposes of the exemptions under Regulation D:
(a) Whether the sales are part of a single plan of financing;
(b) Whether the sales involve issuance of the same class of securities;
(c) Whether the sales have been made at or about the same time;
(d) Whether the same type of consideration is received; and
(e) Whether the sales are made for the same general purpose.


266. 626 F.2d 633 (9th Cir. 1980).
267. Id. at 637.
268. Id. at 642-44.
269. The attempt was made by the ABA Subcommittee on Partnerships, Trusts, and Unincorporated Associations of the Federal Regulation of Securities Committee in a position paper, Integration, supra note 263. Oregon has recently adopted the ABA proposal as an integration safe harbor for limited partnership offerings. OR. ADMIN. R., 815-36-015(3), reprinted in 2 BLUE SKY L. REP. (CCH) ¶ 47,634C (Oct. 10, 1982). Oklahoma, in contrast, has expressly adopted the Murphy analysis. See "Opinion Letter-Limited Partnership—Integration of Offerings," 2 BLUE SKY L.
the Division to consider adopting a formal position on this issue.270 Subsection B(3) prohibits "any form of general solicitation or advertising."271 This provision basically tracks Rule 502(c),272 and reflects one of the requirements of section 11-602(9).273 Rule S-7 contained a similar prohibition.274 Subsection B(4) imposes a restriction on remuneration paid for solicitation or for sales.275 Because the language follows that of Regulation 15.B(3),276 some of the policy questions that arose in that context arise here as well.277 Subsection B(5) provides that "[s]ecurities acquired in a transaction cannot be resold without registration under the Maryland Securities Act or an exemption therefrom."278 In addition, this provision requires the issuer to "exercise reasonable care to assure that the purchasers of the securities in any offering under this regulation are purchasing for investment and not with a view to distribution of the securities."279 This characterization of securities exempted under Regulation 9 as restricted securities is derived from section 4(2), Rule 146, and Regulation D.280 It also reflects the Division's longstanding policy toward secondary distributions of nonregistered securities.281 Subsection B(5) concludes by listing some of the standard techniques by which the issuer can exercise reasonable care in establishing investment intent.282

Both the Limited Offering and General Transactional Exemptions limit the number of purchasers to whom the exempted securities may be sold.283 Subsection B(6) provides a method of calculating the

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273. MD. CORPS. & ASS'NS CODE ANN. § 11-602(9) (Supp. 1984) ("if the securities have not been offered to the general public by advertisement or general solicitation").
274. MD. ADMIN. CODE tit. .02, §.02.03.07C (rescinded 1983).
275. Id. § .02.04.09B(4) (1984).
276. Id. § .02.04.15B(3).
279. Id.
280. See 17 C.F.R. § 230.502(d) (1983), which describes Regulation D securities as having the status of restricted securities acquired in a transaction under section 4(2).
282. MD. ADMIN. CODE tit. .02, §.02.04.09B(5)(a)-(d) (1984) (reasonable inquiry as to purpose of acquisition, restrictive legending, issuance of stop transfer instructions, and obtaining investment letter). The subsection does not make these the exclusive means of establishing the requisite due diligence.
283. See infra text accompanying notes 301-09.
number of purchasers that excludes from the total certain purchasers. Most notable is the exclusion for accredited investors.\textsuperscript{284} Also noteworthy is the exclusion of "[a]ny relative, spouse, or relative of the spouse of a purchaser who has the same principal residence as the purchaser."\textsuperscript{285} Similar to that exclusion are exclusions for trusts, estates, corporations, partnerships, and other entities controlled by a purchaser.\textsuperscript{286} In addition, subsection B(6)(b) states that a corporation, partnership, or other entity shall be counted as one purchaser, provided that the entity is not organized for the specific purpose of acquiring the securities offered under the exemption.\textsuperscript{287}

Regulation 9’s notice filing requirement is contained in subsection B(7).\textsuperscript{288} The filing requirement does not apply to all Regulation 9 offerings; instead, it is triggered only when the aggregate offering price exceeds $100,000.\textsuperscript{289} If that figure is exceeded, the issuer must make a notice filing with the Division not later than fifteen days after the first sale of securities under the regulation. The issuer must file either a Form MD-\textsuperscript{1290} or a document containing the information required by this form, together with a filing fee. Form MD-1 is a short, fill-in-the-blank form containing eighteen items. These items require identification of the issuer and its business; description of the securities being offered and the manner of the offering; identification of the issuer’s officers, directors, general partner, trustees, beneficial owners, and sales representatives; and a listing of facts which may create a bad boy disqualification. The timely filing of Form MD-1, like the timely filing of Form D under Regulation 15,\textsuperscript{291} is a condition of the exemption; the policy questions about Regulation 15’s filing requirement are thus pertinent here as well.

Subsection B(8) makes a standard disclaimer: exemption from registration under Regulation 9 does not provide an exemption from the Act’s antifraud provisions.\textsuperscript{292} Exemption from securities registration is
not an exemption from securities regulation. Subsection B(9) enumerates certain bad boy disqualifications.\(^{293}\) This subsection is identical to Regulation 15.B(4), and serves the same purpose.\(^{294}\)

3. The Exemptions

a. The Local Issuer Exemption

Much of the substance of Regulation 9, like that of Regulation D, can be found in the statements of definitions and conditions. The sections defining the exemptions themselves are relatively succinct. Section C's Local Issuer Exemption contains only four short subsections imposing conditions additional to those already imposed by section B. The Rulemaking Committee intended to make section C brief and simple because the Local Issuer Exemption was designed to be a practically self-executing exemption for the small business issuer. It was felt that these issuers should be able to raise a limited amount of capital without having to qualify the purchasers, deliver a disclosure document, or make a notice filing. This reduction of regulatory restraint and compliance costs would, presumably, ease the small business issuer's difficulties with capital formation.

The two-fold task before the Rulemaking Committee, therefore, was definition of the type of issuer that needed this kind of exemption and limitation on the size of the offering eligible for this liberal exemption. The solutions proposed by the Rulemaking Committee and adopted by the Division were essentially ad hoc, and should be regarded as experimental. This is an area in which rigorous empirical analysis of the capital needs and costs of Maryland's small business issuers may be needed. In any event, the Rulemaking Committee's solutions were expressed in the Local Issuer Exemption of section C.

Subsection C(1) defines the type of small business issuer that may use the exemption.\(^{295}\) That subsection provides that exemption under section C shall be available only to "local issuers," which is defined in subsection A(6). First, the issuer must be a corporation.\(^{296}\) Second, the corporation must be either organized in Maryland or qualified to do business in Maryland, and in both cases have its principal place of business in Maryland.\(^{297}\) Third, the issuer must reasonably believe that its securities are held by not more than fifty beneficial owners, both immediately before and immediately after any sale in reliance on this exemption.\(^{298}\) These criteria reflect the Rulemaking Committee's belief

\(^{293}\) Id. § .02.04.09B(9).
\(^{294}\) See supra text accompanying notes 211-16.
\(^{295}\) MD. ADMIN. CODE tit. .02, § .02.04.09C(1) (1984).
\(^{296}\) Id. § .02.04.09A(6)(a).
\(^{297}\) Id. § .02.04.09A(6)(a)(i).
\(^{298}\) Id. § .02.04.09A(6)(a)(ii); see also id. § .02.04.09A(6)(b)(i-iii) (explaining how to calculate the number of beneficial owners). The latter provision allows related persons, certain institutional investors, and any holder of a purchase money mort-
that the small, local, corporate enterprise is the type of issuer that needs this form of regulatory relief and will not pose a significant threat of abuse. 299

The exclusion of limited partnerships from eligibility does not create a significant disadvantage for those issuers. Most major limited partnership syndications will proceed under Rules 505 and 506, and thus will be exempted by coordination under Regulation 15. Others may be exempted under Regulation 9’s more stringent General Transactional Exemption. Although the exclusion does not seriously disadvantage the limited partnership issuer, it may provide a measure of investor protection, because some state administrators have identified some limited partnership syndications as particularly abusive. 300

Subsections C(2) and (3) shift the focus from the issuer to the offering. Subsection C(2) requires that the issuer “reasonably believe that there are no more than 10 purchasers, wherever located, of securities from the issuer, in any twelve month period, in any offering pursuant to this section.” 301 Although the 10 purchaser limitation may, at first glance appear to be too low, that appearance should be dispelled by recognition of two key facts. First, the issuer may use the General Transactional Exemption or Regulation 15 for larger offerings. Second, subsection C(2) expressly mandates that the ten purchaser limit be calculated in accordance with subsection B(6). In sum, related persons, controlled entities, and accredited investors do not have to be counted toward the ten purchaser limit. Because subsection A(1)’s definition of accredited investors includes, among others, certain insiders and wealthy investors, the number of investors can swell considerably beyond ten. In effect, the Local Issuer Exemption puts a tight ceiling on the number of “widows and orphans” to whom the issuer can sell. This would seem to be an appropriate limitation for this broad exemption, and it should not pose a great problem for the type of closely held enterprise for which this exemption was designed. Consistent with this approach is the $100,000 ceiling on the aggregate offering price established by subsection C(3). 302 An issuer with greater capital needs should be able to use the General Transactional Exemption.

The self-executing character of the Local Issuer Exemption is brought into sharp relief by subsection C(4), which states simply:

gage to be excluded from the total, and permits corporations and certain other entities to be counted as single beneficial owners.

299. The limitation to 50 beneficial owners does not reflect any scientific judgment as to the identity of the “true” small business issuer. A number on the high side was recommended by the Rulemaking Committee to give the issuer some flexibility to grow through successive offerings under the Local Issuer Exemption during the first few years of operation.

300. See NASAA Memorandum, supra note 39, at 2-3, 7.


302. Id. § .02.04.09C(3): “The aggregate offering price for an offering of securities under this section in any 12-month period may not exceed $100,000.” (emphasis supplied).
availability of the exemption under this section does not depend upon delivery to any purchaser of any specific disclosure document by the issuer." 303 Although no specific form of disclosure is mandated as a condition of the exemption, the issuer remains subject to the antifraud provisions of the Act. In fact, the Local Issuer Exemption may be understood as reliance on the issuer’s fear of fraud liability as the major source of investor protection in these limited offerings.

b. The General Transactional Exemption

The General Transactional Exemption contained in section D is a much broader exemption. It imposes no ceiling on the aggregate offering price; the local or nonlocal character of the issuer is irrelevant; it imposes no limit on the size of the issuer; and it is available to a greater variety of issuers. Subsection D(1) provides that the exemption may be used by a corporation, a partnership, or a real estate investment trust (REIT). 304 Not all securities issued by these entities, however, may be exempted under section D. The exemption is available only for the following securities issued by these entities: "any note, stock, bond, debenture, evidence of indebtedness, voting trust certificate, share of beneficial interest of a real estate investment trust, partnership interest, any warrant or right to purchase or subscribe for a security listed above or any security convertible into a security listed above." 305

This limitation has the effect of excluding investment contracts from automatic eligibility on the theory that this type of security is most often used in the more exotic and dubious offerings. 306 Subsection D(1) makes this limitation effective by restricting not only the type of issuer, but also the type of security that may be covered by the exemption. Accordingly, a corporation or a partnership will have automatic eligibility for an offering of its conventional debt or equity securities under section D, but not for an investment contract offering. The Rulemaking Committee and the Division recognized, however, that not all investment contracts represent a threat to investors, and that corporations, partnerships, and REITs are not the only legitimate issuers. Subsection D(1) adds that the "Commissioner may by order extend the exemption provided by this section to other types of securities and other types of issuers in any case in which he determines that to do so would not be inconsistent with the public interest." 307 The effect of subsection B(1) is that non-specified issuers have the burden of seeking this order from the Commissioner.

The General Transactional Exemption also allows the issuer to sell

303. Id. § .02.04.09C(4).
304. Id. § .02.04.09D(1).
305. Id.
306. State administrators have long emphasized regulation of these forms of investments. See Long, supra note 37, at 543.
to more than ten purchasers—thirty-five in this state. Because this number is also calculated in accordance with subsection B(6), the actual number of purchasers may be significantly greater than thirty-five. The issuer using this exemption, like the issuer using the Local Issuer Exemption, need only establish reasonable belief as to the number of purchasers. Section D then will allow exemption of a fairly substantial offering, subject only to section D(3)'s disclosure requirements and section B's provision on integration, sales remuneration, investment intent, general solicitation and advertising, and bad boy disqualifications. In addition, subsection B(7)'s notice filing requirement is triggered only if the aggregate offering price exceeds $100,000.

Perhaps the most significant aspect of the General Transactional Exemption (indeed, of Regulation 9 as a whole) is its abandonment of offeree and purchaser suitability standards. The issuer wishing to rely on this exemption will not have to satisfy itself that either the offerees or the purchasers have the sophistication requisite to understanding the merits of the investment, or that they are capable of bearing the economic risk. The application of subjective suitability standards was long a problem in section 4(2) and Rule 146 transactions, and they created similar problems in Maryland under Rule S-7. The problems with satisfaction of suitability standards are familiar to all issuer's counsel. The sophistication requirement was perhaps the most troublesome, since the definition of "sophistication" was enormously elusive. The assessment of risk-bearing ability was perhaps easier to make, but presented a substantial practical problem: the prospective purchaser might resent the seller's inquiry into his financial status. These difficulties were compounded by an additional problem: suitability had to be established at the offeree as well as the purchaser level. An offer to a single unsuitable person thus might destroy the exemption for the entire offering, a particularly harsh result since an unsuitable offeree who has not purchased a security has not been harmed.

The Rulemaking Committee acknowledged all of these problems by excluding from Regulation 9 offeree or purchaser suitability as a condition of the exemption. Suitability only plays a modest role in

308. Id. § 02.04.09D(2).
310. MD. ADMIN. CODE tit. .02, § .02.03.07D (rescinded 1983).
311. See Soraghan, supra note 309, at 20-27; Section 4(2), supra note 104, at 492-93.
312. See Soraghan, supra note 309, at 27-34.
313. See MD. ADMIN. CODE tit. .02, § .02.03.07D(1) (rescinded 1983).
314. For evaluation of this possibility under the statutory section 4(2) exemption, see Section 4(2), supra note 104, at 493-94.
the General Transactional Exemption’s disclosure provisions.

Subsection D(3) requires the issuer to take one of four options: (1) delivery of a “Form MD-2, or a disclosure document containing the information required by this form, to each purchaser prior to any sale to the purchaser;"\(^{316}\) (2) sale only to accredited investors; (3) sale only to persons whom the issuer reasonably believes are sophisticated investors or investors with economic risk-bearing ability and a purchaser representative;\(^{317}\) or (4) sale only to a combination of the persons in categories (2) and (3). In essence, the issuer can avoid the question of suitability by delivering a relatively simple disclosure document to each purchaser. This should have the effect of encouraging issuers to produce this kind of disclosure. The result could be fewer practical problems for the issuer, a higher level of blue sky compliance, and more investor protection\(^{318}\) through timely and meaningful disclosure.

If, however, the issuer using the General Transactional exemption is able to sell only to accredited or “suitable” investors, it will not have to deliver a disclosure document as a condition of the exemption; only the sale\(^{319}\) to a nonaccredited or “unsuitable” investor will trigger the disclosure requirement. If the issuer is a corporation, it may use Form MD-2.\(^{320}\) Form MD-2 is a simplified, fill-in-the blank disclosure form. Although every issuer should rely on experienced counsel in completing Form MD-2, the form is designed to help both the seller and the buyer understand the information being disclosed. It will permit, indeed encourage, the businessperson to take a more active role in the disclosure process. As a result, it represents a major innovation and a departure from a tradition of securities regulation that mandates the production of repetitive, unreadable, and unread boilerplate disclosure.\(^{321}\) Only actual use of the form will determine whether the innovation is successful, but it is intended to make the disclosure process more meaningful to both the investor and the issuer.

Form MD-2 requires the following specific information: the securities being offered; the use of the offering proceeds; the business of the


\(^{317}\) See id. § .02.04.09A(8) (defining purchaser representative).

\(^{318}\) Rule S-7 (1974) contained no disclosure requirement, but required the issuer’s reasonable belief in both offeree and purchaser suitability. Md. Admin. Code tit. .02, § .02.03.07D (rescinded 1983).

\(^{319}\) Only the purchaser’s suitability is relevant to this requirement. See supra text accompanying notes 316-17.

\(^{320}\) Copies of Form MD-2 may be obtained from the Division.

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The issuer; the risk factors associated with the business; the organizational history of the issuer; the identity and remuneration of persons selling the securities; the identity and background of the managers and owners of the issuer; possible conflicts of interest; remuneration of management; recent distributions by the issuer; recent securities issuances; the terms of payment for the securities being offered; the expiration date of the offering; prior issuance of securities to insiders at a price lower than the offering price; and the terms of any escrow of the proceeds of the offering. In addition to the foregoing, Item 19 of Form MD-2 requires the issuer, as a condition of the exemption, to provide various forms of financial data. The amount and type of financial disclosure varies with the length of time the issuer has been in operation and the availability of certified financial statements.322

As mentioned above, only corporations may use Form MD-2. Limited partnerships and other issuers are currently required to fashion a disclosure document that will provide equivalent information in an appropriate form. These documents need not track Form MD-2’s fill-in-the-blank format. The Division plans to publish a form for use by limited partnerships after a period of experimentation with Form MD-2.

Although the use of Form MD-2 or its equivalent is unnecessary when the issuer sells only to accredited or sophisticated investors, subsection D(2)(b)323 requires another form of disclosure to all investors whenever the issuer has previously issued “cheap stock” (stock sold at a price twenty-five percent lower than the offering price) to insiders324 or does not intend to escrow the entire proceeds of the offering until completion of the offering.325 In essence, the issuer is required specially to disclose to all investors the existence of this cheap stock or the lack of escrow. Part II of Form MD-2 may be used for that purpose.326 These special disclosure requirements reflect the risks to investors that sometimes arise when the proceeds of the offering may be used before the offering is completed, and when the insiders have paid less for their equity position than the outside investors.327

These provisions do not represent a movement of the Division toward merit regulation. Although cheap stock is a traditional merit con-

322. See Form MD-2, Item 19 (copy available from the Division).
324. The category of insiders consists of officers, directors, general partners, and promoters of the issuer. Id. § .02.04.09D(2)(b)(i).
325. Id. § .02.04.09(3)(b)(ii).
326. Form MD-2, Part II will allow simple, short form disclosure of either of those two facts.
cern, subsection D(2)(b) merely imposes a special disclosure requirement,\(^3\)\(^2\)\(^8\) one that tempers the liberality of this exemption without imposing a substantial compliance burden upon the issuer.

4. Limits on the Applicability of Regulation 9

Regulation 9 ends with a simple statement of its scope. Subsection E(1)\(^3\)\(^2\)\(^9\) provides that the exemption is not available to any offering registered under the 1933 Act or exempted under Regulation A. Both types of offering, of course, may be registered by coordination. Subsection E(2)\(^3\)\(^3\)\(^0\) declares the unavailability of Regulation 9 for Rule 505 and 506 offerings, both of which may be exempted by coordination under Regulation 15.

VI. CONCLUSION

It is perhaps too early to judge the effectiveness of the current Maryland exemptive regime. In any event, no conclusions can be drawn without empirical analysis of use, compliance, costs, and patterns of fraudulent activity.\(^3\)\(^3\)\(^1\) The Maryland experience as a whole,

\(^{328}\) A comparison of the cheap stock provision of Reg. 9 and the cheap stock restrictions recommended by NASAA for use by merit states in connection with registered public offerings will make this distinction clear. See NASAA Statement of Policy on Cheap Stock, 1 BLUE SKY L. REP. (CCH) ¶ 5312 (Apr. 23, 1983).


\(^{330}\) Id. § .02.04.09E(2).

\(^{331}\) The SEC has been criticized for its failure to "publish any study concerning the incidence of fraud among issuers employing the small issue and private placement exemptions." Seligman, supra note 321, at 60. Seligman adds:

[T]he statutory responsibility of the SEC in administering the 1933 Securities Act is to protect investors. To so substantially expand the small business exemptions without publication of any analysis of the problem this may create for investors represents an ignorance of this mandate and of the problems that led to the passage of the 1933 Securities Act.

Id. at 60-61 (citations omitted). Empirical study of patterns of fraudulent activity should also be conducted at the state level. This is especially necessary in light of the heavy use of Reg. 9 and Reg. 15. Between July 1, 1982 and December 15, 1983, approximately 1,500 Reg. 15 notice filings were made with the Division, used in connection with offerings totaling more than $11.5 billion. In the same period, 135 Reg. 9 notice filings were made, used in connection with offerings totaling more than $114 million. Release No. 24, supra note 149, at 25,582. If the extensive use of Regulation D and parallel state exemptions can be shown to have caused an increase in securities fraud, then the premises of the exemptive system will have to be rethought. Particular attention will have to be focused on the effects of the reduction or elimination of specific disclosure requirements, the deemphasis of purchaser sophistication requirements, the SEC's deferral to state regulation in the context of Rule 504 offerings, the dramatic increase in dollar ceilings on the aggregate offering price, the presumption of suitability for certain accredited investors, and the extensive use of these exemptions by tax advantaged syndications rather than small corporate issuers. Although this article has operated under the assumption that the changes in the federal and state law represent a needed rationalization and expansion of the exemptive schemes, it must be cautioned that the results of these experiments should be closely monitored.
however, may contain some lessons for the treatment of limited and private offerings in every state. For example, the principle of exemption by coordination reflects one key technique of reducing securities compliance costs: reduction of duplicative or unnecessarily inconsistent state regulation. Application of this principle may require the state to abandon some of their traditional restraints on these exemptions; the Maryland experiment may demonstrate that some of these restraints were not only costly, but relatively unimportant from an investor protection standpoint.

Similarly, the Maryland experience may demonstrate the value of flexibility. Regulation 9 sets very specific limits on the number of purchasers and the number of beneficial owners of local issuers, imposes clear restrictions on sales remuneration, and requires specific disclosure to nonaccredited investors and investors who do not meet suitability standards. In all of these cases, however, the issuer need only establish its reasonable belief as to compliance—a valuable counterweight to the threat of strict liability that would result from failure to satisfy all the conditions of the exemption. The same kind of flexibility is implicit in the special order mechanisms, which give the issuer the opportunity to persuade the Commissioner to issue an exemptive order on the basis of a good faith effort to comply, or to extend eligibility for the General Transactional Exemption to issuers not specifically covered by that exemption. Bright lines, strict standards, and absolute limits may produce predictability, but they do not always allow the law to accommodate the dynamic and unexpected character of capital formation. The element of flexibility built into the Maryland rules may do so.

Finally, the Maryland experience reflects the need to experiment with different means of balancing the needs of capital formation and investor protection. There is no single way to protect investors; their needs vary with the nature of the investor, the type of security, the size of the offering, the identity of the salespersons, the manner of the offering, and the nature of the issuer. Their needs may be met by treating different issuers and securities differently, by imposing different disclosure requirements under different circumstances, and by requiring some kinds of offerings to satisfy more exemptive conditions. The crux, however, is that not every exemptive condition and every technique of investor protection should apply to every transaction. In some contexts, a particular condition may not only be burdensome to the issuer, but relatively useless to the investor. In others, the condition may be very useful and its burdensome aspects justifiable. Only experimentation, empirical analysis of the incidence of fraud and investor abuse in exempt transactions, and open minds will make the right choices possible.