SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 230

[Release No. 33–7644; S7–14–98]

RIN 3235–AH35

Revision of Rule 504 of Regulation D, the ''Seed Capital'' Exemption

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''we'' or ''Commission'') is adopting amendments to Rule 504 of Regulation D, which provides an exemption from Securities Act registration for securities offerings of non-reporting companies that do not exceed an aggregate annual amount of $1 million. Recent fraudulent secondary transactions in the over-the-counter markets of ''microcap'' companies have involved freely tradable securities issued in Rule 504 offerings. To curb these abuses, we are modifying Rule 504 to limit the circumstances where general solicitation is permitted and ''freely tradable'' securities may be issued in reliance on the rule to transactions registered under state law requiring public filing and delivery of a disclosure document to investors before sale, or exempted under state law permitting general solicitation and advertising so long as sales are made only to accredited investors. Since most transactions under Rule 504 are private ones, they will continue to be permissible under the exemption, but general solicitation and advertising will not be permitted and the securities will be ''restricted.''

EFFECTIVE DATE: April 7, 1999.

FOR FURTHER INFORMATION CONTACT: Richard K. Wulff or Barbara C. Jacobs (202–942–2950), Office of Small Business, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Executive Summary and Background

Congress has passed significant legislation to aid small businesses in raising capital in the private and public securities markets over the years. The Small Business Investment Incentive Act of 1980, for example, was designed to reduce the regulatory restraints on small business capital formation.[1] In response to that Act, in 1982, we adopted Regulation D[2] under the Securities Act of 1933 (''Securities Act'').[3] Regulation D is an exemption from Securities Act registration that was designed to:

- Simplify existing rules and regulations;
- Eliminate any unnecessary restrictions that those rules and regulations placed on issuers, particularly small businesses; and
- Achieve uniformity between state and federal exemptions in order to facilitate capital formation consistent with the protection of investors.[4]

Regulation D provides exemptions from Securities Act registration for securities offerings under three separate rules: Rules 504, 505 and 506.[5] Rule 504 is the limited offering exemption designed to aid small businesses raising ''seed capital.'' Currently, Rule 504 permits a non-reporting issuer[6] to offer and sell securities to an unlimited number of persons without regard to their sophistication or experience and without delivery of any specified information in a public offering.[7] General solicitation and general advertising are permitted for all Rule 504 offerings. The aggregate offering price of this exemption is limited to $1 million in any 12-month period; and certain other offerings must be aggregated with the Rule 504 offering in determining the available sales amount.[8] Securities sold under this exemption may be resold freely by non-affiliates of the issuer[9] who are not otherwise acting as an underwriter.[10]

While Regulation D offerings are exempt from federal securities registration requirements, currently these offerings must be registered in each state in which they are offered unless a state exemption is available.[11] The vast majority of states require registration of public Rule 504 offerings.[12] In adopting Rule 504, we placed substantial reliance upon state securities laws because the size and local nature of these small offerings did not appear to warrant imposing extensive federal regulation. These offerings continue, however, to be subject to federal antifraud and other civil liability provisions.

Unfortunately, there have been recent disturbing developments in the secondary markets[13] for some securities

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[1] Pub. L. No. 96–477, 944 Stat. 2275. That Act amended the Securities Act by adding Section 4(6) [15 U.S.C. 77(d)(6)], which among other matters, exempts from registration offers or sales of securities in the aggregate amount of $5 million or less if solely made to ''accredited investors''.

[2] 17 CFR 230.501 *et seq. See* Release No. 33–6389 (March 8, 1982) [47 FR 11251].

[3] 15 U.S.C. 77a *et seq.*

[4] *See* Release No. 33–6389 at Section II.A.

[5] Rules 504 and 505 are dedicated to the needs of small issuers; they are based on our authority under Section 3(b) of the Securities Act [15 U.S.C. 77(b)], which permits us to create exemptions where the aggregate amount of the offering does not exceed $5 million. In 1996, Section 28 was added to the Securities Act [15 U.S.C. 78bb], which gives us broad general exemptive authority without dollar limit. In a companion release, we are adopting amendments to Rule 701 of the Securities Act [17 CFR 230.701] pursuant to this new authority. *See* Release No. 33–7645.

Rule 505 is designed to help small businesses because it permits sales to a small number of nonaccredited, unsophisticated investors. Rule 506 is our non-exclusive safe harbor rule adopted under the ''non-public'' offering exemption of Section 4(2) of the Securities Act [15 U.S.C. 77d(2)]. It permits sales only to accredited investors and a limited number of sophisticated investors.

[6] A non-reporting issuer is an issuer that is not required to file reports with the Commission under Section 13 or 15(d) of the Securities Exchange Act of 1934 [15 U.S.C. 78a *et seq.*] (''Exchange Act''). We recently approved a proposed rule amendment to Rule 6530 of the National Association of Securities Dealers, Inc. (''NASD'') to limit quotations on the OTC Bulletin Board (''OTCBB'') to the securities of issuers that make current filings under Section 13 or 15(d) or other applicable regulatory authority, among other matters. *See* Release No. 34–40878 (January 4, 1999) [64 FR 1255]. As such, once an OTCBB issuer becomes subject to our reporting requirements, it would be ineligible to use Rule 504.

In our recent Securities Act Reform proposals, we solicited comment on whether a reporting company should be able to rely on Rule 504 for the issuance of securities underlying convertible securities and warrants that it had previously offered in compliance with Rule 504 when it was not a reporting company. *See* Release No. 33–7606 (November 3, 1998) [63 FR 67174].

[7] Other issuers that are ineligible to use Rule 504 include investment companies or development stage companies that either have no specific business plan or purpose or have indicated that the business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person. *See* Rule 504(a) of Regulation D.

As with all Regulation D offerings, we require a Form D, a simple six-page notice, to be filed with us no later than 15 days after the first sale in the Rule 504 offering. *See* Rule 503 of Regulation D [17 CFR 230.503]. Filing a Form D is not, however a condition to the exemption.

[8] Rule 504 offerings are aggregated for this purpose with all other offerings exempt under Section 3(b) (*e.g.*, Rule 504 or Rule 505 offerings) and all offerings made in violation of Section 5(a) of the Securities Act [15 U.S.C. 77e(a)].

[9] *See* interpretive letter to Mr. E.H. Hawkins (June 26, 1997), setting forth the views of the Division of Corporation Finance that affiliates who receive securities in a Rule 504 offering are subject to resale limitations.

[10] *See* fn. 17 and 18, below.

[11] *See, e.g.*, the Uniform Limited Offering Exemption (''ULOE'') developed by the North American Securities Administrators Association, Inc. (''NASAA''), which was designed to be a coordinating state exemption with Rule 505 of Regulation D, and optionally Rule 506. Rule 504 is not a part of ULOE.

NASAA is an association of securities commissioners from each of the 50 states, the District of Columbia, Puerto Rico, Mexico and several provinces of Canada.

[12] New York and the District of Columbia do not require registration of Rule 504 offerings.

[13] These secondary markets include the OTCBB operated by the NASD or the pink sheets published by the National Quotation Bureau, Inc.

initially issued under Rule 504,[14] and to a lesser degree, in the initial Rule 504 issuances themselves.[15] These offerings generally involved the securities of ''microcap'' companies, *i.e.*, those characterized by thin capitalization, low share prices, limited public information and little or no analyst coverage. Recent market innovations and technological changes, most notably, the Internet, have created the possibility of nation-wide Rule 504 offerings for securities of non-reporting companies that were once thought to be sold locally.

In some cases, Rule 504 has been used in fraudulent schemes to make prearranged ''sales'' of securities under the rule to nominees in states that do not have registration or prospectus delivery requirements. As a part of this arrangement, these securities are then placed with broker-dealers who use cold-calling techniques to sell the securities at ever-increasing prices to unknowing investors. When their inventory of shares is exhausted, these firms permit the artificial market demand created to collapse, and investors lose much, if not all, of their investment. This scheme is sometimes colloquially referred to as ''pump and dump.''

Regulation D is only available for offers and sales by an issuer of securities to initial purchasers; it is not available to any affiliate of the issuer or to any person for resales of the securities.[16] Thus, where a purchaser of Rule 504 securities wishes to sell these securities, he or she must either register the transaction or have an exemption for the transaction. Those who purchase such securities with a view to their distribution are acting as ''underwriters'' [17] and thus their sales of the securities are not exempt from registration.[18] In these circumstances, these persons could be charged with violating Section 5 of the Securities Act.[19] In addition, they could be charged with violating the antifraud provisions of the Securities Act and the Exchange Act for any material misrepresentations made in the Rule 504 offering.[20]

On May 21, 1998, we proposed amendments to Rule 504 to eliminate the freely tradable nature of the securities issued under the exemption.[21] If we adopted that proposal, these securities could be resold only:

- After the one-year holding period of Rule 144[22];
- Through registration; or
- Through another exemption (such as Regulation A[23]), if available.

By making all securities issued in a Rule 504 transaction restricted, we thought that unscrupulous persons would be less likely to use the rule as the source of freely tradable securities they need to facilitate their fraudulent transactions.

In the Rule 504 Proposing Release, we also solicited comment on an alternative to revise Rule 504 so it would be substantially similar to its pre-1992 format, permitting public offerings only where the issuer complies with state registration processes that require the preparation and delivery of a disclosure document to investors before sale of the securities. We also solicited comment on the appropriate treatment for offerings made under certain state exemptions, such as the one recently developed for sales to accredited investors.[24]

For the reasons discussed below, we are again conditioning the availability of Rule 504 for public offerings on the extent of state regulation over those offerings by making the exemption substantially similar to its pre-1992 format.[25] We believe that this alternative is an effective way to combat the abuses we have described and at the same time preserve the ability of legitimate small businesses to raise capital. This approach is more narrowly targeted to the abuses we have observed than simply restricting all securities issued in a Rule 504 transaction. As amended, the rule establishes the general principle that securities issued under the exemption, just like the other Regulation D exemptions, will be restricted, and prohibits general solicitation and general advertising, unless the specified conditions

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[14] *See, e.g., SEC* v. *Szur, et al.*, Lit. No. 15595, S.D.N.Y., December 18, 1997; *SEC* v. *Badger, et al.* Lit. No. 15595, S.D.N.Y., December 18, 1997; *SEC* v. *Scudiero, et al.*, Lit. No. 15595, S.D.N.Y., December 18, 1997; *SEC* v. *Ruge, et al.*, Lit. No. 15595, S.D.N.Y., December 18, 1997; and *SEC* v. *Pignatiello, et al.*, Lit. No. 15595, S.D.N.Y., December 18, 1997. In these cases, we filed five civil injunctive actions charging fifty-eight defendants with manipulation of the over-the-counter markets for ''microcap'' securities. The five actions were the result of an undercover investigation into illegal practices in these markets conducted by the United States Attorney's Office for the Southern District of New York and the Federal Bureau of Investigation, with assistance from the NASD and us.

See also Schroeder, ''Penny Stock Fraud is Again on a Resurgence, Bolstered by Loopholes and New Technology, Wall St. J., September 4, 1997 at 12.

[15] *See, e.g., SEC* v. *Millennium Software Solutions, Inc. and Mark Shkolir*, Lit. No. 15603, S.D.N.Y., December 23, 1997 and *SEC* v. *Spacedev, Inc. and James W. Benson*, Securities Act Rel. No. 7561, August 6, 1998.

[16] *See* Preliminary Note 4 to Regulation D.

[17] The term ''underwriter'' is defined in Section 2(a)(11) of the Securities Act [15 U.S.C. 77(b)(11)] to include ''any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking. * * *

[18] In particular, the ''resale'' exemption of Section 4(1) of the Securities Act [15 U.S.C. 77d(1)] is unavailable since the exemption is available to ''any person other than an issuer, underwriter or dealer.'' In this case, the purchasers are acting as underwriters, as explained above. The dealer exemption of Section 4(3) of the Securities Act [15 U.S.C. 77d(3)] also is unavailable where the person relying upon the exemption acts as an ''underwriter.''

See also Note 6 to Regulation D, which provides that Regulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with the rules, is part of a plan or scheme to evade the registration provisions of the Securities Act. In such cases, registration is required.

[19] 15 U.S.C. 77e.

[20] Section 17 of the Securities Act [15 U.S.C. 77q(a)], Section 10(b) of the Exchange Act [15 U.S.C. 78j(b)] and Rule 10b–5 thereunder [17 CFR 240.10b–5].

[21] Release No. 33–7541 (May 21, 1998) [63 FR 29168] (''Rule 504 Proposing Release''). The Commission received 33 letters of comment. The comment letters are available for inspection and copying in the Commission's Public Reference Room in File No. S7–14–98. Comments that were submitted electronically are available on the Commission's website (www.sec.gov).

[22] 17 CFR 230.144.

[23] 17 CFR 230.251 *et seq.*

[24] State exemptions of this nature include those based upon the ''Model Accredited Investor Exemption,'' which was adopted by NASAA in 1997. CCH NASAA Reporter Para.361. Generally, the rule exempts offers and sales of securities from state registration requirements, if among other matters, the securities are sold only to persons who are, or are reasonably believed to be, ''accredited investors'' as defined in Rule 501(a) of Regulation D [17 CFR 230.501(a)]. The model restricts transfer of the securities for 12 months after issuance except to other accredited investors or if registered. Written solicitations under that provision are generally limited to a type of ''tombstone'' ad.

As of December 31, 1998, 29 states and the Commonwealth of Puerto Rico have an accredited investor exemption permitting some form of general solicitation and two states had adopted specific accredited investor exemptions to work with the U.S. Small Business Administration's Angel Capital Electronic Network (ACE-Net). Of these, 15 states have adopted NASAA's Model Accredited Investor Exemption through statute, regulation or executive order. The remaining 14 states either have accredited investor exemptions pre-dating the Model Exemption or have adopted variations of the Model Exemption. Of the 19 states that do not have an accredited investor exemption permitting general solicitation, seven have statutory or regulatory language pending to adopt such an exemption.

ACE-Net is an Internet-based, securities listing service where small, growing companies can list their stock offerings to accredited investors. It is a public/private partnership between the SBA and 38 non-profit, university-and state-based entities around the country. *See* Angel Capital Electronic Network (pub. avail. October 25, 1996).

[25] Unlike the rule as amended today, the pre-1992 format of Rule 504 did not include a provision for state law exemptions for sales made to accredited investors or any requirement for publicly filing the disclosure document that is delivered to investors although this has long been a standard feature of state registration provisions. It also required issuers in private Rule 504 offerings to advise purchasers of the resale limitations on the securities a reasonable period of time before sale.

permitting a public offering are met. These conditions are:

- The transactions are registered under a state law requiring public filing and delivery of a disclosure document before sale. For sales to occur in a state without this sort of provision, the transactions must be registered in another state with such a provision and the disclosure document filed in that state must be delivered to all purchasers before sale in both states; or
- The securities are issued under a state law exemption that permits general solicitation and general advertising so long as sales are made only to ''accredited investors'' as that term is defined in Regulation D.[26]

Investor protection concerns require that this action be taken to curb misuse of this exemption in the markets for ''microcap'' companies. Requiring issuers to go through state registration and deliver disclosure documents to investors in order to issue freely tradable securities in Rule 504 transactions provides information for prospective investors to make more informed investment decisions. These amendments are part of our comprehensive agenda to deter registration and trading abuses, particularly by ''microcap'' issuers. We have developed a four-pronged approach to deter ''microcap'' fraud: enforcement, investor education, compliance examinations, and regulation.[27]

We believe the amendments to Rule 504 adopted today will deter the abuses we have seen, while not impeding legitimate ''seed capital'' offerings. We will monitor the use of the rule, as revised, and also contact the state regulatory authorities regarding their experience with these offerings. If it appears that Rule 504 is still being misused, we will consider adding stronger measures, such as requiring an after-market information delivery requirement[28] or disqualification provisions.[29] With respect to the accredited investor aspect of the revised rule, we will work with the states to assess its use. If the new regulatory scheme is being misused, particularly in states that do not impose transfer restrictions on the resale of the securities by accredited investors, we will explore with these states the viability of imposing such restrictions under their provisions. Failing that, we would consider making the securities ''restricted'' as defined in Rule 144.

II. Amendments to Rule 504

Before 1992, Rule 504 exempted both public and private offerings. It exempted public offerings if sales did not exceed $1 million[30] in a 12-month period and if the offering was registered with one or more states that required the preparation and delivery of a disclosure document to investors before sale.[31] Private offerings, in which general solicitation and general advertising were prohibited, were exempt if sales did not exceed $500,000. State registration was not a condition to the exemption in the private context.

In July 1992, we adopted revisions to our rules and forms to facilitate capital raising by small businesses by reducing the compliance burdens placed on those companies by the federal securities laws.[32] The amendments eliminated all restrictions on the manner of offering and on resales under Rule 504. As a result, a non-reporting company could offer up to $1 million of securities in a 12-month period and be subject only to the antifraud provisions of the federal securities laws. General solicitation and general advertising were permitted for all Rule 504 offerings. Further, securities sold under Rule 504 were not ''restricted'' securities and thus were available for immediate resale by non-affiliates of the issuer, as long as they were not otherwise ''underwriters''[33] of the offering.[34]

In the Rule 504 Proposing Release, we proposed that all securities issued in a Rule 504 transaction would be ''restricted'' from resale for a one-year period after issuance. This proposal directly addressed the abuses we witnessed in the secondary markets. Almost all commenters objected to this approach, since it would require issuers to offer a significant liquidity discount in all Rule 504 issuances, even fully state registered ones, causing a significant reduction in the amounts of capital they could raise. While acknowledging that this approach would have some impact upon the targeted problem in the secondary market, commenters, including NASAA, believed that our alternative approach, which was to reinstitute the rule largely as it had been in effect for a number of years before 1992, would be equally, if not more, effective since if an issuer goes through state registration and must deliver a disclosure document to prospective investors, sufficient information ought to be available in the markets to permit investors to make more informed investment decisions and thus deter manipulation of Rule 504 securities. They also noted that this approach would not unduly penalize small businesses, since they would have some avenue open to them to issue freely transferable securities.

The amendments we adopt today implement the alternative narrower reform. By returning the Rule 504 exemption largely to its pre-1992 framework, we intend to deter ''microcap'' fraud. We believe that the vast majority of current Rule 504 offerings are private. Private offerings under Rule 504 will be permitted for up to $1 million in a 12-month period, under the same terms and conditions, except for the specific disclosure requirements,[35] as offerings under Rules 505 and 506. Securities in these offerings will be restricted, and these offerings may no longer involve general solicitation and advertising.

On the other hand, the rule as revised leaves avenues open for issuers to make less limited offerings under Rule 504. By focusing on state registration, review and disclosure requirements, we are still

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[26] *See* Rule 501(a) of Regulation D.

[27] We are issuing four companion releases today. *See* Release No. 33–7646, which adopts revisions to Form S–8, the short-form registration statement for issuing securities to employees, consultants and advisors as compensation, in order to curb abusive situations and Release No. 33–7647, which contains additional proposals to Form S–8 to further reduce abuse of the form. *See* Release No. 34–41110, which reproposes amendments to Exchange Act Rule 15c2–11 [17 CFR 240.15c2–11] to require the first broker-dealer that publishes any quotation for a covered security to review information about the issuer and thereafter other broker-dealers to review information about the issuer when they first publish or resume publishing a priced quotation for a covered security. *See also* Release No. 33–7645, which adopts amendments to Form 701, the exemption for non-reporting companies to issue securities to employees, consultants and advisors.

[28] *See* Section 4(3) of the Securities Act [15 U.S.C. 77d(3)], Securities Act Rule 174 [17 CFR 230.174] and Rule 251(d)(2)(ii) of Regulation A [17 CFR 230.251(d)(2)(ii)].

[29] *See* Rule 505(b)(2)(iii) of Regulation D [17 CFR 230.505(b)(2)(iii)] or Rule 262 of Regulation A [17 CFR 230.262].

[30] As originally adopted in 1982, the exemption was subject to a $500,000 limitation. In 1988, the ceiling for public offerings was increased to $1 million. *See* Release No. 33–6758 (March 3, 1988) [53 FR 7866].

[31] For example, Form U–7 (also referred to as ULOR, uniform limited offering registration, or SCOR, small corporate offering registration) was developed by NASAA to be a special registration format for companies registering securities under state securities laws when relying upon the federal Rule 504 exemption. *See* Harris, Keller, Stakias & Liles, Financing the ''American Dream.''

[32] *See* Release No. 33–6949 (July 30, 1992) [57 FR 36442]. On April 28, 1993, we adopted additional revisions to further facilitate financings by small business issuers. *See* Release No. 33–6996 (April 28, 1993) [58 FR 26509].

[33] Section 2(a)(11) of the Securities Act [15 U.S.C. 77b(a)(11)].

[34] Regulation D exemptions are available only to the issuer of the securities. None of these exemptions can be used by any other person. *See* Preliminary Note 4 to Regulation D.

[35] Rule 502(b)(1) of Regulation D [17 CFR 230.501(b)(1)].

permitting legitimate small issuers to access the capital markets without having to sell restricted securities. In adopting this reform, we note that the state registration and review system is generally comprehensive. As of the effective date of these amendments, an issuer will only be able to issue unrestricted or freely tradable securities in a Rule 504 offering and engage in general solicitation or general advertising in two circumstances:

- If it registers the offering under a state law that requires the public filing[36] and delivery of a disclosure document to investors before sale; [37] or
- If the transaction is effected under a state law exemption that permits general solicitation and general advertising so long as sales are made only to ''accredited investors.'' [38]

These amendments will be effective April 7, 1999. Rule 504 offerings that begin on or after this date will have to comply with the new rule. With respect to Rule 504 offerings that are ongoing at the time of the amendments, issuers will have to discontinue offers and register under a state law requiring the preparation and delivery of a disclosure document to investors before sale in order to issue freely tradable securities.

The pre-1992 approach strikes an appropriate balance between the needs of legitimate small businesses to issue freely tradable securities to obtain seed capital, while still protecting investors.[39] The amendments will preserve an avenue for small businesses to issue freely tradable securities and not suffer deep liquidity discounts, while at the same time they will protect investors by curbing the use of Rule 504 securities in connection with fraudulent transactions.

III. Cost-Benefit Analysis

In the Rule 504 Proposing Release we asked the public for their views on the costs and benefits of the proposal and other supporting information. No commenter provided data on the plan we adopt today.

We believe that those who will rely on the rule will not have significantly increased costs. In fact, since the rule is essentially being maintained as it has always operated, given the necessity of state law compliance, the vast majority of issuers should have no additional costs of compliance. The main impact will be that issuers who make offerings in states that do not provide for the registration provision dictated by the rule will have to register in another state in order to have a public offering and issue that state's residents freely tradable securities. We understand that issuers who intend to issue securities in New York and the District of Columbia are the only ones that will be affected by this change. We understand that the average cost of preparing and filing a Form U–7 filing is $30,000.[40] It is because of the mandate of investor protection that we are making this change. Overall, the rule will maintain the benefits that allow small companies to raise ''seed capital'' with a minimal federal compliance scheme for public offerings. Private offerings also are being affected since they will no longer be able to use general solicitation or advertising and securities issued in these offerings will be restricted. The Commission has concluded that the amendments will not result in significant adverse effects on efficiency, competition, or capital formation.

IV. Summary of the Final Regulatory Flexibility Analysis

In accordance with 5 U.S.C. § 604, we have prepared a final Regulatory Flexibility Analysis (''FRFA'') regarding the amendments.

The analysis notes that the amendments to Rule 504 are a result of our view that the current configuration of the exemption may be leading to abuse, as well as concerns expressed to us by representatives of other regulators. The purpose of the revisions is to reduce the potential for abuse and yet maintain the utility of the exemption for small businesses. We have determined that the amendments will enhance the protection of the investing public.

As the FRFA describes, in calendar year 1998, 2,988 Forms D were filed by 2,499 companies with the Commission claiming the Rule 504 exemption. Rule 504 only affects non-reporting companies. The Commission has sought to minimize the reporting burden on small businesses. However, we do not collect data to determine how many of the non-reporting companies filing Form D are small businesses. The amendments will only affect issuers offering and selling in certain jurisdictions. We do not know the number of Rule 504 offerings in these jurisdictions. Therefore, we are unable to determine exactly how many small businesses will be affected by the proposed amendments.

While it is not possible to know with certainty, it is believed that most of these offerings were done by small businesses. Small businesses affected by the changed rule include those that make a ''public'' offering of securities in one of the jurisdictions that does not require prospectus delivery before sale. The rule changes would require the securities to be registered in a state that requires prospectus delivery before sale or that exempts general solicitations of accredited investors. In the alternative, these companies could use the rule to make a private offering, which could involve their offering a liquidity discount for their shares and thus increase their cost for capital. The Commission has insufficient data to

[36] The disclosure document must be publicly available at the state level. This document must provide substantive disclosure to investors, including the business and financial condition of the issuer (including financial statements), the risks of the offering, a description of the securities, and the plan of distribution. For example, the issuer could provide the information required in a Form U–7, as outlined in n.37, to satisfy this requirement.

[37] If any state that the issuer intends to make sales in does not provide for the registration or the public filing or delivery of a disclosure document to investors before sale, then in order to be able to issue freely tradable securities and to engage in public solicitation or public advertising, the issuer must register in at least one state with such a procedure. The disclosure document must be delivered before sale to *all* purchasers, including purchasers in the states that have no registration and delivery procedure. The process does not allow using one state's prospectus in another state where the second state provides a conforming procedure.

In states that have adopted the Small Corporate Offering Registration (''SCOR'') Review Statement of Policy, information on an issuer is available to investors through Form U–7. The Form U–7 contains a series of 50 very detailed questions on the issuer's business, intended use of proceeds, management, principal stockholders, and plan of distribution. In addition, the issuer must file historical financial statements prepared in accordance with generally accepted accounting principles in the United States. Form U–7 has been either formally adopted or recognized and accepted by 45 states.

[38] Generally, these securities may not be freely transferred under state law. The Model Accredited Investor Exemption provides that any resale of a security sold in reliance of the exemption within 12 months of sale will be presumed to be with a view to distribution and not for investment, a requirement of the exemption, except for limited circumstances. With respect to general solicitation and advertising, the Model Accredited Investor Exemption specifies that only a tombstone ad may be used; however, a few states have no restriction on general solicitation and advertising so long as sales are only made to accredited investors.

[39] We have an ongoing dialogue with small business and their representatives. Since September 1996, we have hosted 12 SEC Small Business Town Hall Meetings across the country to discuss issues like our capital formation rules. We learn about the current concerns and problems of small businesses in raising capital in the securities markets so that we can implement programs to meet their needs consistent with the protection of investors. Three meetings have been held since the proposals were issued. At each meeting, we discussed the Rule 504 Proposing Release and encouraged attendees to submit their views as part of the rulemaking process.

In addition, every year we host the Government-Business Forum on Small Business Capital Formation. In September 1998, we held the Seventeenth Annual Forum in Chicago. The Rule 504 Proposing Release generated significant discussion there as well.

[40] This estimate is from a 1997 survey conducted by the *SCOR Report*, a newsletter that covers all aspects of small business finance.

reliably quantify the impact on small entities offering such a discount.

The amendments do not impose any new recordkeeping requirements or require reporting of additional information. The amendments require issuers in certain jurisdictions to register in states they might not otherwise register. We understand that the average cost of a Form U–7 filing is $30,000.[41]

As discussed more fully in the FRFA, several possible significant alternatives to the proposals were considered. These included establishing different compliance or reporting requirements for small entities, exempting them from all or part of the proposed requirements, or requiring them to provide more disclosure, such as the same disclosure as required for the other Regulation D exemptions. We also considered restricting the resale of these securities. We concluded that the costs of this proprosal exceeded the benefit. The FRFA also indicates that there are no current federal rules that duplicate, overlap, or conflict with the proposed rule amendments.

We encouraged written comments on any aspect of the initial regulatory flexibility analysis (IRFA), but received no specific comments in response to our request. In particular, we sought comment on: (1) the number of small entities that would be affected by the proposed rule amendments; and (2) the determination that the proposed rule amendments would not increase the reporting, recordkeeping and other compliance requirements for small entities. A copy of the FRFA may be obtained from Twanna M. Young, Office of Small Business, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

V. Paperwork Reduction Act

We submitted the initial proposal for review in accordance with the Paperwork Reduction Act of 1995 (''the Act'').[42] The title to the affected information collection is: ''Form D.'' The specific information that must be included in Form D is explained in the form itself, and relates to the issuer, its principals and the amount of money proposed to be raised along with proposed applications of the proceeds. The information is needed for monitoring use of the exemption as well as evaluating its usefulness. The effect of the rule amendment is to require some issuers to prepare registration and disclosure documents they currently are not required to file.

The collection of information in Form D will continue to be required in order for companies to use the rule for sales of their securities. While we cannot estimate the number of respondents that may use revised Rule 504, in calendar year 1998, there were 2,988 Forms D filed by 2,499 companies with the Commission claiming the Rule 504 exemption. We believe that the vast majority of these were private Rule 504 offerings. We expect that approximately 2,250 companies each year will be relying on the exemption. With the revisions to Rule 504 the estimated burden for responding to the collection of information in Form D would not increase for most companies because the information required has not been changed. The number of eligible transactions, however, may decrease. We do not know how many issuers currently offer or sell securities pursuant to Rule 504 in states without a requirement to deliver a disclosure document to investors before sale. We estimate that the burden hours per respondent each year will be unchanged at 16. Therefore, we estimate an aggregate of 36,000 burden hours per year.

The information collection requirements imposed by Form D are mandatory to the extent that a company elects to use the Rule 504 exemption. The information will be disclosed to third parties or the public. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The OMB control number is 3235–0076.

We received no comments in response to our solicitation of comments regarding the information collection obligation.

VI. Statutory Basic, Text of Amendments and Authority

The amendments are made pursuant to Sections 2, 3(b), 6, 7, 8, 10, 19(a), 19(c) and 28 of the Securities Act.

List of Subjects in 17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is amended as follows:

PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for part 230 continues to read in part as follows:

Authority: 15 U.S.C. 77b, 77f, 77g, 77h, 77j, 77r, 77s, 77sss, 78c, 78d, 78*l*, 78m, 78n, 78o, 78w, 78*ll*(d), 79t, 80a–8, 80a–24, 80a–28, 80a–29, 80a–30, and 80a–37, unless otherwise noted.

* * * * *

2. By revising § 230.504(b)(1) to read as follows:

§ 230.504 Exemption for limited offerings and sales of securities not exceeding $1,000,000.

* * * * *

(b) *Conditions to be met.* (1) *General conditions.* To qualify for exemption under this § 230.504, offers and sales must satisfy the terms and conditions of §§ 230.501 and 230.502 (a), (c) and (d), except that the provisions of § 230.502 (c) and (d) will not apply to offers and sales of securities under this § 230.504 that are made:

(i) Exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions;

(ii) In one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or

(iii) Exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to ''accredited investors'' as defined in § 230.501(a).

* * * * *

Dated: February 25, 1999.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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[41] *See* fn. 40, above.

[42] 44 U.S.C. 3501 *et seq.*