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TRANSACTION EXEMPTIONS IN THE SECURITIES ACT OF 1933: AN ECONOMIC ANALYSIS

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# TRANSACTION EXEMPTIONS IN THE SECURITIES ACT OF 1933: AN ECONOMIC ANALYSIS

C. Steven Bradford *

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I. INTRODUCTION

The Securities Act of 1933 is an important restriction on capital markets in the United States. Unless an exemption is available, the Act requires companies selling securities to the public first to file with the Securities and Exchange Commission (SEC) a registration statement containing detailed information about the company, its business, its finances, and the contemplated offering. Offers cannot be made (except to underwriters) until the registration statement is filed, and the securities can be sold only after the registration statement survives the sometimes-

1 Section 5 of the Securities Act, the key to the registration requirements, requires the use of "any means or instruments of transportation or communication in interstate commerce or of the mails." See 15 U.S.C. § 77e (1994). I shall assume throughout this Article that the requisite nexus with interstate commerce exists.

2 A number of different forms of registration statements are available. The forms available depend on the type of issuer and on the type of offering. Form S-1 is the most broadly available registration form and also the most comprehensive. Form S-1, 2 Fed. Sec. L. Rep. (CCH) ¶ 7121. Other registration statement forms available to U.S. issuers include Form S-2, id. at ¶ 7141; Form S-3, id. at ¶ 7151; Form S-4, id. at ¶ 7161; Form SB-1, id. at ¶ 7312; and Form SB-2, id. at ¶ 7313. Some of these forms allow the incorporation by reference of information in other SEC filings. See, e.g., Form S-3, Item 12, id. at ¶ 7151.

For a detailed discussion of the contents of the registration statement and prospectus, see LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 599-742 (3d ed. 1989). See also 1 THOMAS HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 94-103 (1990).

3 Section 5(c) of the Securities Act of 1933 makes it unlawful to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security .

15 U.S.C. § 77e(c) (1994). The exception for offers to underwriters arises out of the statutory definitions of "offer," "offer to sell," and "offer to buy," which exclude preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer).
lengthy SEC review process and becomes effective. In addition, the securities seller must at some point furnish investors with a prospectus, which contains much of the information in the registration statement.

Economic analysis of the Securities Act, both theoretical and empirical, has focused on the desirability of the registration requirement. Some scholars have questioned whether the registration requirement is economically sound; others have argued that mandatory disclosure is necessary to correct market failures in the securities markets.

Lost in the debate on the economic merits of the registration requirement are the exemptions from that requirement—the offerings for which


Unless a registration statement is in effect as to a security, § 5(a) of the Securities Act makes it unlawful

1. to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
2. to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.


Until the registration statement becomes effective, the Securities Act restricts written communications with prospective purchasers. Section 5(b)(1) of the Act, 15 U.S.C. § 77e(b)(1) (1994), makes it unlawful to transmit any prospectus unless the prospectus meets the requirements of § 10 of the Act. Section 2(10), 15 U.S.C. § 77b(10) (1994), broadly defines "prospectus" to include any writing offering a security for sale or confirming the sale of a security (with some exceptions). However, the SEC has approved both preliminary and summary prospectuses as meeting the requirements of § 10 and therefore not prohibited by § 5(b)(1). Rule 430, 17 C.F.R. § 230.430 (1995) (preliminary prospectus); Rule 431, 17 C.F.R. § 230.431 (1995) (summary prospectus).

A final prospectus (the final, complete version of the prospectus contained in the registration statement that becomes effective) must be sent to purchasers at the earlier of two times: (1) when a confirmation of the sale is mailed to the purchaser, or (2) when the security purchased is delivered to the purchaser. Securities Act of 1933 §§ 5(b), 2(10), 15 U.S.C. §§ 77e(b), 77b(10) (1994).

In the interest of brevity, I will refer to the registration and prospectus delivery requirements collectively as the registration requirement.


For a brief introduction to this debate, see infra part II.A.
registration is not required. This Article fills the gap in the economic analysis of the Securities Act by examining the economics of the exemptions from registration. I will assume for the purpose of analysis that, in at least some cases, the registration requirement is economically sound: its benefits exceed its costs. I will then review the exemptions to see why that conclusion might not hold for particular types of exempted offerings. For the reader who believes the registration requirement is economically efficient, my analysis of the exemptions will highlight offerings in which that efficiency is less likely. For the reader who believes the registration requirement is economically inefficient, my analysis of the exemptions will highlight offerings for which the inefficiency is greatest.

I begin in Part II with a brief focus on the registration requirement itself. Part II summarizes the economic debate concerning registration and, as a prelude to an economic analysis of the exemptions, discusses the costs and benefits of registration.

In Part III, I turn to the exemptions from registration and ask why, if the benefits of registration generally exceed the costs, that might not be true for these exempted offerings. The transaction exemptions are extraordinarily different from each other. Some exemptions limit the dollar amount of the offering; others limit the number or types of purchasers to whom securities can be sold; others are contingent on oversight by some authority other than the SEC. I show that the exemptions can be placed into three categories, each with a slightly different economic justification. After establishing an economic model for each type of exemption, I explore some of the requirements of the current exemptions to see if they are economically sound. In Part IV, I focus on one particular feature of some of the exemptions—limits on the number of purchasers in an offering.

Finally, in Part V, I examine an issue that has caused great difficulty for scholars, practitioners, the courts, and the SEC: What should happen when a single issuer makes two ostensibly separate, but roughly contem-

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8 This approach has two justifications. The first justification is theoretical. The exemptions have been ignored in the economic debate. The only sensible way to examine the exemptions is to assume that registration is efficient for some offerings and ask why that might not be true for other offerings. The second justification for this assumption is practical. The registration requirement of the Securities Act of 1933 is unlikely to be repealed, even if its opponents' challenges are correct. The exemptions are more likely to be modified. Focusing on the exemptions is therefore more likely to lead to productive change.
poraneous offerings and claims a different exemption for each? In determin-
ing whether an exemption is available, should the offerings be com-
bined and treated as a single offering, or should their separation be
respected? I explore how well the integration doctrine and the safe-harbor
regulations that the SEC and the courts have developed to deal with this
problem fit the economic model.

II. THE REGISTRATION REQUIREMENT
OF THE SECURITIES ACT OF 1933

A. The Economics of Registration

From an economic perspective, the registration requirement of the Se-
curities Act is defensible only if the benefits of registration exceed the
costs. Letting B represent all of the benefits of registration and C all of the
costs, then registration is economically efficient only for offerings in which
$B > C$—in other words, only if registration produces a positive net bene-
fit.\(^9\) If it would cost $200,000 to register a particular offering of securities
and the information made available would only save investors $100, regis-
tration is inefficient. If, on the other hand, registration of the offering
would produce a $300,000 gain to investors and only cost $200,000, regis-
tration is economically efficient.

The practical problem, of course, is measuring the costs and benefits.
George Stigler initiated a heated debate in 1964 when he compared new
issues of common stock before and after the passage of the federal securi-
ties laws and concluded that "the SEC registration requirements had no
important effect on the quality of new securities sold to the public."\(^{10}\)
Stigler concluded that "grave doubts exist whether if account is taken of
costs of regulation, the SEC has saved the purchasers of new issues one
dollar."\(^{11}\) Irwin Friend and Edward Herman promptly challenged both
Stigler's methodology and his interpretation of the data.\(^{12}\) They found

\(^9\) Throughout this Article, I will use the term "net benefit" to refer to the difference, positive or
negative, between total benefits and total costs.

\(^{10}\) Stigler, supra note 6, at 124.

\(^{11}\) Stigler, supra note 6, at 124.

\(^{12}\) Irwin Friend & Edward S. Herman, The S.E.C. Through a Glass Darkly, 37 J. Bus. 382
(1964).
“evidence of superior relative price performance of new issues in the post-SEC period.” Additional exchanges followed, and, in 1969, George Benston produced additional analyses supporting Stigler’s claim. Benston’s conclusions, like Stigler’s, were promptly challenged. Other scholars, such as Henry Manne and Joel Seligman, have subsequently joined the debate, either in support of or in opposition to the registration requirement.

Critics of the registration requirement argue that firms have an incentive to produce an efficient amount of information even in the absence of the mandatory provisions in the Securities Act. If this is true, the federal mandate merely increases the cost of offering securities, with little corresponding benefit: \( C > B \). On the other hand, supporters of the registration requirement argue that, due to various market failures, an unregulated securities market would not produce the optimal amount of

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13 Id. at 398.


17 Henry G. Manne, Economic Aspects of Required Disclosure Under Federal Securities Laws, in WALL STREET IN TRANSITION: THE EMERGING SYSTEM AND ITS IMPACT ON THE ECONOMY 21 (Henry G. Manne & Ezra Solomon eds., 1974). Manne argues that Stigler’s basic point—that the Securities Act has not benefited shareholders and investors—has not been refuted. Id. at 51.

18 Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1 (1983). Professor Seligman uses historical research to argue that the mandatory disclosure system has led to less concealment and misrepresentation, id. at 10-45, has reduced underwriters’ compensation, id. at 45-51, and has increased public confidence in the securities markets by reducing risk, id. at 51-53. He also argues that no alternative mechanism could have ensured the optimal level of corporate disclosure. Id. at 53-56.

19 For a good discussion of the voluntary disclosure argument and its limitations, see EASTERBROOK & FISCHEL, supra note 6, at 288-92.
As a result of these market failures, the benefits outweigh the costs: \( B > C \).

As indicated in Part I, I do not intend to join the general debate about the efficiency of registration. My focus is on the exemptions. I assume for the purpose of analysis that the supporters of the Securities Act are at least partially correct: in some cases, the benefits of registration exceed the costs \( (B > C) \). A transaction should be exempted from registration only if, for the particular transaction, the benefits of registration do not exceed the costs \( (B < C) \). The issue to be examined is why the net benefit of registering exempted offerings might differ from the net benefit for offerings required to register.

B. The Costs and Benefits of Registration

What are the costs and benefits of registration? This question must be answered before we can intelligently explore how those costs and benefits differ in exempted offerings. Unfortunately, the available data, particu-
larly concerning the benefits of registration, are not as certain as one would prefer. Nevertheless, the types of costs and benefits are clear and their magnitudes can at least be approximated. I will first discuss the costs and benefits of registration generally and then focus on the exemptions.

In considering these costs and benefits, one point must be kept clearly in mind. The costs and benefits of registration are not the same as the costs and benefits of a registered offering. Some of the costs incurred by an issuer in a registered offering would have been incurred even if registration were not required. Some of the benefits to investors of the information required to be disclosed would have been provided through voluntary disclosure. The costs and benefits of registration are the incremental costs and benefits above those that would have occurred in an unregulated securities offering.

1. The Benefits of Registration

The purpose of the registration requirement “is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions.”23 The mandatory disclosure required by the Securities Act might benefit securities investors in two ways: (1) by increasing investors’ returns; and (2) by reducing the riskiness of investments. Each of these possible benefits is difficult to quantify.

a. Increased Returns

The information provided in the registration statement and prospectus might enable investors to estimate more accurately the expected value of the returns generated by the security and thereby avoid losses due to mispricing. For example, assume that Acme Corporation is offering to sell an investor one share of stock. And assume that, if registration is not required, the investor assigns the following probabilities and values to the Acme stock:

If the investor is not risk averse, she should be willing to pay up to $50 for the stock because that is the stock’s expected present value.

Assume now that the Acme offering is registered and that the prospectus provides the investor with better information than she had in the absence of registration, allowing her to revise her valuation of the security. Assume that she now assigns the following probabilities and values to the Acme stock:

<table>
<thead>
<tr>
<th>Probability</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/3</td>
<td>$10</td>
</tr>
<tr>
<td>1/3</td>
<td>$40</td>
</tr>
<tr>
<td>1/3</td>
<td>$70</td>
</tr>
</tbody>
</table>

EXPECTED PRESENT VALUE = $40

With better information about the company, the investor is willing to pay only $40 for the stock. Her benefit from registration (ignoring the cost of compliance) is $10, the loss she avoided by being better able to calculate the investment’s expected value.24

b. Reduced Risk

A second possible benefit of mandatory disclosure is reduction of an investment’s riskiness even if the expected value of the investment does not change.25 Assume again that, in the absence of registration, the investor

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24 The investor might not capture the entire benefit. The distribution of the benefit between the investor and Acme will depend on the relative shapes of the demand and supply curves for capital. 25 This second theory is probably more likely. As Carol Simon argues, The existence of substantial uncertainty about the true value of a security need not imply that the issue will be, on average, overvalued or undervalued. Rather the expectations of rational investors should be unbiased. The availability of quality information will, however, affect the riskiness of the purchase. As such, the effects of legislation aimed at increasing investor information should be reflected in changes in the dispersion of market-adjusted returns.
calculates a \( \frac{1}{3} \) chance of a $10 present value, a \( \frac{1}{3} \) chance of a $50 present value, and a \( \frac{1}{3} \) chance of a $90 present value, for an expected present value of $50. Using the information provided in the registration statement, the investor revises her estimates as follows:

<table>
<thead>
<tr>
<th>Probability</th>
<th>Present Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/3</td>
<td>$40</td>
</tr>
<tr>
<td>1/3</td>
<td>$50</td>
</tr>
<tr>
<td>1/3</td>
<td>$60</td>
</tr>
</tbody>
</table>

**EXPECTED PRESENT VALUE = $50**

The expected value of the investment is still $50, the same as without registration, but the risk associated with the investment is now lower. Using the information in the registration statement, the investor has limited the possible outcomes to a narrower range. If she is risk averse, her gain is the reduction in the risk of the investment.\(^26\)

c. *The Available Evidence*

A few studies have tried to measure the benefits of registration by comparing the returns on stock issues prior to the passage of the Securities Act with the returns on stock issues subsequent to passage of the Act.\(^27\) They have, for the most part, found no statistically significant differences in the market-adjusted performance of securities issues after passage of the Act: investors did not earn significantly better returns after 1933 than before. This result is inconsistent with the better-returns theory of the benefits of registration; if returns were not better after 1933, registration has not allowed investors, on average, to more accurately price securities. However, the evidence is mixed. A study by Carol Simon found no significant increases in returns after 1933 on the whole, but “a highly significant in-

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\(^{26}\) If the investor is completely risk neutral, the risk is irrelevant to her. Because the expected value of the investment is the same with or without registration, registration has not benefitted her.

crease in the average returns on . . . [non-New York Stock Exchange initial public offerings]."  

All of the studies have found a significantly lower variance in returns after the passage of the Securities Act. However, this difference is subject to two interpretations. The reduced variance could be the result of investors having better information as a result of the registration requirement, with a resulting reduction in risk. This would be a benefit to risk-averse investors. Another interpretation is that the registration requirement drove riskier, but net positive value, securities from the public markets to unregulated markets or out of the market entirely. The variance dropped not because investors had better information about returns, but because the riskier securities were no longer in the market. If this is true, registration may have produced a loss to investors, especially investors who are not risk-averse, by limiting their investment choices.

2. The Costs of Registration

The cost of making a registered securities offering includes (1) the direct expenses of preparing, filing, and distributing the required disclosure documents, (2) the commissions and fees paid to underwriters and others selling the securities, (3) the delay associated with registration, (4) the costs of maintaining the government registration system, and (5) other miscellaneous costs associated with registration. Some of the costs in the first two categories—disclosure and selling expenses—would have been incurred even in the absence of a registration requirement. For those costs, the cost of the registration requirement is the increase in cost resulting from registration. The costs in the final three categories are directly attributable to the registration requirement; they would not have been incurred in an unregulated market.

28 Simon, supra note 25, at 306.
29 Jarrell, supra note 27, at 667; Simon, supra note 25, at 309; Stigler, supra note 6, at 122; Stigler, supra note 14, at 419.
30 Easterbrook & Fischel, supra note 6, at 313; Romano, supra note 20, at 94-95.
31 Irwin Friend and Edward Herman suggest that the reduced variance found by Stigler "was a result of improved disclosure of the degree of risk and a consequent greater reluctance by investors to buy risky new issues." Friend & Herman, supra note 12, at 391.
32 For example, George Stigler points out that "many more new companies used the market in the 1920s than in the 1950s—from one viewpoint a major effect of the SEC was to exclude new companies." Stigler, supra note 6, at 122.
a. **Direct Expenses of Preparing, Filing, and Distributing the Required Disclosure**

Attorneys must draft the registration statement and shepherd it through the SEC review process. Accountants must prepare and audit the company's financial statements. The company must print the registration statement and distribute the prospectus to potential investors. In an initial public offering, these costs directly associated with the preparation of the registration statement could total from $200,000 to $500,000.\(^3\) One study found that, for initial public offerings, these direct expenses ranged from an average of 2.10% to an average of 9.64% of the gross offering amount, depending on the size of the offering.\(^4\) Offerings by seasoned issuers are less expensive. Another study indicated average expenses ranging from 0.14% to 6.78% of the offering amount for underwritten public offerings by companies already publicly traded on a stock exchange.\(^5\) A company making a registered public offering also has increased internal costs. Executives and employees are diverted from the company's business to preparing the registration statement and otherwise complying with the registration requirement.\(^6\) These costs are not as easy to quantify.

Of course, some of these costs would have been incurred even if the offering was not registered. It is difficult to estimate the additional direct costs imposed by the registration requirement because "we do not know what things firms would disclose, and to whom, in the absence of the

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\(^3\) Alan K. Austin & Teresa L. Remillard, *An Overview of Initial Public Offerings*, Practicing Law Institute, CREATIVE CORPORATE FINANCING TECHNIQUES 1986 (Oct. 21, 1986) (WESTLAW, 541 PLI/Corp 467) ($200,000-500,000); John F. Olson & Scott D. Krill, *What Makes a Company a Good Candidate for Going Public?*, ALI-ABA POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW (June 21, 1993) (WESTLAW, C859 ALI-ABA 5) (approximately $400,000 for a $5 million offering); Howard D. Sterling, *Deciding to Go Public: The Importance of the Intangible Factors*, Practicing Law Institute, HOW TO PREPARE AN INITIAL PUBLIC OFFERING 1989 (July 1, 1989) (WESTLAW, 656 PLI/Corp 23) ($200,000-500,000); Carl W. Schneider et al., *Going Public: Practice, Procedure and Consequences*, 27 VILL. L. REV. 1, 29-31 (1981) ($175,000-350,000). An SEC advisory committee found average costs of $105,151 for filing an S-1 registration statement and $163,450 for filing an S-7 registration statement, but those figures were based on a very limited number of observations. See REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SEC, supra note 20, at 26.


Some attorneys claim that the costs of an exempted private placement are "only a fraction of the cost of an [initial public offering]." George Benston found that accounting and other direct expenses in private placements on average ranged from fifty to seventy-five percent less than the expenses in registered public offerings, depending on the size of the offering. These differences undoubtedly overstate the impact of the registration requirement. Because the availability of the exemptions from registration turns on factors such as the number of purchasers, their sophistication, and whether they have an existing relationship with the issuer, private placements are, on average, quite different from registered offerings. Everything else being equal, a public offering would be more expensive than the typical private placement even if the public offering did not have to be registered. Thus, although the registration requirement probably accounts for a significant portion of the legal, accounting, printing, and other direct costs of offering securities, the exact magnitude is unclear.

b. Underwriting Fees and Sales Commissions

The compensation paid to underwriters and securities dealers in a public offering varies from roughly six to ten percent of the gross proceeds of the offering, although the percentage can be lower for large offerings by seasoned issuers. Compensation would have to be paid to sellers even if registration was not required, but the Securities Act clearly imposes higher costs on underwriters. For one thing, section 5 of the Act restricts the manner in which securities can be sold; these restrictions undoubtedly make the offering more costly to administer. The Act also makes underwriters liable in certain circumstances for material misstatements or omissions in the registration statement and other sales-related materials. This liability forces the underwriters (and others involved in the offering) to

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37 Easterbrook & Fischel, supra note 6, at 310.
38 Olson & Krill, supra note 33, at *21.
39 Benston, supra note 15, at 64.
40 Austin & Remillard, supra note 33 (7 to 10%); Olson & Krill, supra note 33 (6 to 9%); Ritter, supra note 34, at 272 (7.24 to 10.63%, depending on the size of the offering and the type of underwriting); Schneider et al., supra note 33, at 29-31 (7 to 10%).
41 See Smith, supra note 35, at 276 (in a study limited to seasoned issuers, reporting underwriting compensation under 4% for certain very large offerings).
participate actively in the preparation and verification of the registration statement and in effect provides investors partial insurance against risk. Some of the underwriters' compensation in a registered offering must be attributed to these verification and insurance functions.

The exact magnitude of the increased selling costs due to registration is uncertain. George Benston found that compensation in private placements of debt in the early 1950s was on average roughly one-half to one-fifth of the compensation in public offerings, depending on the size of the offering, but given the differences between private placements and registered offerings, this probably overstates the increased underwriting costs resulting from registration.

c. The Cost of Delay

Another cost of registration is the delay that results from the registration process. Before the issuer may sell the securities, it must prepare and file a registration statement and wait for the SEC to review it so it can become effective. The delay can vary from issue to issue, but, for an initial public offering, the lapse of time between beginning to prepare the registration statement and its effective date "may well exceed six months. It rarely will be less than three months." In 1994, the average delay between the filing of an S-1 registration statement and its effectiveness was seventy-four days. The average delay for Form S-2 filings was forty-nine days and the average delay for Form S-3 filings was forty-three days.

The cost of this delay to the issuer is the loss in present value between the time the proceeds would have been received without registration and when they were actually received. For example, assume that an issuer is

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48 Benston, supra note 15, at 62.
46 Schneider et al., supra note 33, at 28.
45 Letter from James R. Mayo, SEC Staff Accountant to the author (June 30, 1995) (on file with author). This average includes what the SEC calls "restarts." Restarts include two situations: (1) when the delay between completion of SEC staff processing and the filing of a subsequent amendment exceeds 90 days; and (2) when "an original filing is so poorly prepared that the staff is not in a position to begin the review process until a substantive amendment is filed." Id. Excluding restarts, the average delay for an S-1 filing in 1994 was 62 days. Id.
47 Id.
raising $1 million (after expenses), that the investment for which the money is being raised will produce a four percent net annual return, and that registration causes a three month delay. The cost associated with the delay is:

\[
\frac{\$1 \text{ million}}{1 + 0.04} = \$9901.
\]

However, the cost of the delay associated with registration would be less to the extent that issuers are able to anticipate their need for capital and initiate the registration process before the money is actually needed (as in a shelf registration).

d. Costs of the Regulatory System

Another major cost of the Securities Act's registration requirement, sometimes overlooked, is the cost to the SEC of operating the regulatory system: the cost of reviewing and commenting on registration statements, taking enforcement actions against those who fail to comply, producing regulations and releases explaining and interpreting the registration requirement, and so on.

In 1995, the SEC handled an estimated 1200 initial filings of registration statements and an estimated 4670 repeat filings and post-effective amendments. The SEC devoted approximately 125 staff years to the review of registration statutes in 1995, at an approximate cost of $14 million. The average employee cost per filing, including repeat filings and

<table>
<thead>
<tr>
<th>Year</th>
<th>Initial</th>
<th>Repeat &amp; Post-Effective Amendments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>707</td>
<td>3588</td>
</tr>
<tr>
<td>1992</td>
<td>1047</td>
<td>4246</td>
</tr>
<tr>
<td>1993</td>
<td>1174</td>
<td>4652</td>
</tr>
<tr>
<td>1994 (est.)</td>
<td>1190</td>
<td>4660</td>
</tr>
<tr>
<td>1995 (est.)</td>
<td>1200</td>
<td>4670</td>
</tr>
</tbody>
</table>


The following table provides similar figures for prior years:
post-effective amendments, was $2392 in 1995.\textsuperscript{50} Figures from prior years are comparable.\textsuperscript{51} The average employee cost per each initial filing, excluding repeat filings and post-effective amendments, is probably a better measure of the SEC cost for each offering. Over the past five years, this cost ranged from $10,174 per filing in 1992 to $12,607 per filing in 1991.\textsuperscript{52}

These numbers undoubtedly understate the regulatory cost of the registration requirement. They exclude overhead.\textsuperscript{53} They cover only the review of registration statutes and exclude other registration-related activities.

<table>
<thead>
<tr>
<th>Year</th>
<th>Staff Years</th>
<th>Approximate Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>91</td>
<td>$8,913,000</td>
</tr>
<tr>
<td>1992</td>
<td>105</td>
<td>$10,652,000</td>
</tr>
<tr>
<td>1993</td>
<td>113</td>
<td>$12,219,000</td>
</tr>
<tr>
<td>1994 (est.)</td>
<td>122</td>
<td>$12,953,000</td>
</tr>
<tr>
<td>1995 (est.)</td>
<td>125</td>
<td>$14,043,000</td>
</tr>
</tbody>
</table>

Letter from Susan Baumann, SEC Deputy Executive Director to the author (Nov. 3, 1994) (on file with author). A staff year is approximately 2080 hours of employee time (40 hours a week times 52 weeks). Letter from Herbert Scholl, Chief Management Analyst, SEC Division of Corporation Finance to the author (Sept. 28, 1994) (on file with author). These figures do not include investment company registration statements. Letter from Susan Baumann, \textit{supra}. They also do not account for any overhead. Letter from Herbert Scholl, \textit{supra}.

\textsuperscript{50} This figure was calculated by dividing the employee cost figure for 1995 by the total number of filings.

\textsuperscript{51} The complete figures are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Employee Cost Per Filing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>$2075</td>
</tr>
<tr>
<td>1992</td>
<td>2012</td>
</tr>
<tr>
<td>1993</td>
<td>2097</td>
</tr>
<tr>
<td>1994 (est.)</td>
<td>2214</td>
</tr>
<tr>
<td>1995 (est.)</td>
<td>2392</td>
</tr>
</tbody>
</table>

\textsuperscript{52} The complete figures are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Employee Cost Per Initial Filing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>$12,607</td>
</tr>
<tr>
<td>1992</td>
<td>10,174</td>
</tr>
<tr>
<td>1993</td>
<td>10,408</td>
</tr>
<tr>
<td>1994 (est.)</td>
<td>10,885</td>
</tr>
<tr>
<td>1995 (est.)</td>
<td>11,703</td>
</tr>
</tbody>
</table>

These figures tell us little about the regulatory costs associated with any particular offering because the SEC resources devoted to each filing vary tremendously. Among other things, the SEC devotes more effort to reviewing the registration statements of companies making initial public offerings. Abba Poliakoff, \textit{SEC Review: Comfort or Illusion?}, 17 BALT. L. REV. 40, 44-45 (1987).

\textsuperscript{53} Letter from Herbert Scholl, \textit{supra} note 49.
such as issuing no-action letters and interpretive releases and bringing enforcement actions against those who fail to comply. They also ignore the costs of criminal prosecutions incurred by the Attorney General and various U.S. Attorneys. These figures do, however, provide a rough order-of-magnitude estimate of the costs incurred by the SEC in administering the registration requirement.

Securities Act registrants must pay a filing fee of one twenty-ninth of one percent of the maximum aggregate offering price,\(^5\) \(\$345\) for every \(\$1\) million raised. However, it would be double-counting to include both this filing fee and the administrative costs of the SEC as costs of registration because the filing fee is used to offset administrative costs. The filing fee is merely a redistribution of the administrative cost from the SEC to the issuer. If the SEC’s actual registration-associated costs exceed the filing fees it collects, only the actual administrative costs should be counted. If the filing fee exceeds the actual SEC costs associated with registration, the excess should be considered a tax on registrants. The total cost to issuers is then the amount of the filing fee.

e. Other Costs

Registration involves other costs that are less direct and, in some cases, more difficult to quantify, but nevertheless real. One such cost is the possible competitive disadvantage to the issuer from having to disclose detailed information about the company to the public, including competitors.\(^6\) Another cost is that the registration requirements trigger periodic reporting


\(^6\) Report of the Advisory Comm. on Corporate Disclosure to the SEC, supra note 33, at 22-23; Smith, supra note 36, at 19-20; Sterling, supra note 33. The Advisory Committee concluded that “although companies do use the disclosure documents of their competitors to compare performance, there does not appear to be any significant competitive cost associated with current reporting obligations.” Report of the Advisory Comm. on Corporate Disclosure to the SEC, supra note 20, at 22-23. Only three of the 26 companies the Advisory Committee studied acknowledged such a competitive cost. Report of the Advisory Comm. on Corporate Disclosure to the SEC, supra note 20, at 23 n.23.
requirements under the Securities Exchange Act of 1934. These Exchange Act reporting requirements are expensive and involve considerable executive and employee time. However, these costs are more properly attributable to the Exchange Act than to the Securities Act. And if a company is already subject to the Exchange Act reporting requirements, Securities Act registration does not significantly increase the Exchange Act cost.

III. TRANSACTION EXEMPTIONS FROM THE REGISTRATION REQUIREMENT

The Securities Act exempts from the registration requirement sales of both particular types of securities (securities exemptions) and of nonexempt securities in particular types of transactions (transaction exemptions). The Act also authorizes the SEC to enact additional regulatory transaction exemptions. The exemptions only free the issuer from the Act's registration requirements; in general, the prohibitions against fraud in the offer or sale of securities still apply.

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56 Section 15(d) of the Exchange Act requires issuers whose registration statements have become effective under the Securities Act to file certain Exchange Act reports, unless the registered securities are held by fewer than 300 persons. Securities Exchange Act of 1934 § 15(d), 15 U.S.C. § 78o(d) (1994).

57 One author estimates that the costs associated with periodic reporting "should be minimally budgeted at $75-150,000 per year." Sterling, supra note 33, at *4.

58 See Securities Act of 1933 § 3(a), 15 U.S.C. § 77c(a) (1994). Not all of the exemptions in § 3(a) are securities exemptions; some are actually transaction exemptions. 1 HAZEN, supra note 2, at 128; STEINBERG, supra note 3, at 48.


60 Section 3(b) of the Securities Act of 1933, 15 U.S.C. § 77c(b) (1994), authorizes the SEC to exempt issues of securities with an aggregate offering price to the public not in excess of $5 million, "if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering . . . ." Id. See also Securities Act of 1933 § 3(c), 15 U.S.C. § 77c(e) (1994) (authorizing the SEC to exempt securities issued by small business investment companies if regulation "is not necessary in the public interest and for the protection of investors.").

61 Section 4 of the Act provides only that "[t]he provisions of section 5 shall not apply to" the exempted transactions. Securities Act of 1933 § 4, 15 U.S.C. § 77d (1994). Anti-fraud provisions such as §§ 12(a)(2) and 17(a) still apply. The securities exemptions in § 3 appear more general, but a parenthetical in § 12(a)(2) indicates that it covers securities "whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) of said section." Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (1994). Similarly, § 17(c) specifically provides that "[t]he exemptions provided in section 3 shall not apply to the provisions of this section." Securities Act of 1933 § 17(c), 15 U.S.C. § 77q(c) (1994). But see Gustafson v. Alloyd Co., 115 S. Ct. 1061 (1995) (confus-
This Article focuses on exempted transactions—particular kinds of offerings which Congress or the SEC has decided do not need to be registered. The transaction exemptions can be grouped into three categories, each with a different economic justification. Some of the transaction exemptions are based on the view that, for relatively small offerings, the cost of registration is proportionately too great compared to the benefit. I call these exemptions the small offering exemptions. Some of the exemptions are premised on a belief that certain offerees, because of their sophistication, bargaining power, or access to information about the issuer, do not need the protection registration provides. I call these exemptions the sophisticated offeree exemptions. A third category of exemptions, which I call the deference exemptions, is based on the view that regulation of the offering by some other authority eliminates the need for registration with the SEC.

The three categories are not necessarily mutually exclusive. Rule 504, for example, is to some extent both a small offering exemption and a deference exemption. Rule 505 has elements of both a small offering exemption and a sophisticated offeree exemption. However, it is easier to discuss the three categories separately because the economic theory supporting each is different. The next sections summarize the particular exemptions within each of the three categories and discuss the economics underlying each category.

<sup>62</sup> See infra part III.A. I refer to an offering that qualifies for such an exemption as a small offering.

<sup>63</sup> See infra part III.B. I refer to an offering that qualifies for such an exemption as a sophisticated offeree offering.

<sup>64</sup> See infra part III.C. I refer to an offering that qualifies for such an exemption as a deference offering.

<sup>65</sup> See infra text accompanying notes 73-74 and 152-53.

<sup>66</sup> See infra text accompanying notes 75-80.

<sup>67</sup> The Securities Act contains transaction exemptions other than those discussed above. Most of these exemptions are directed at the problem of resales by the original purchasers in an offering or the liability of securities professionals in the secondary trading of securities. See Securities Act of 1933 § 4(1), 15 U.S.C. § 77d(1) (1994) (exempting transactions by any person other than an issuer, underwriter, or dealer); § 4(3), 15 U.S.C. § 77d(3) (1994) (exempting transactions by dealers that are not part of a distribution by the issuer and occur more than a specified period of time after the issuer's public offering); § 4(4), 15 U.S.C. § 77d(4) (1994) (exempting broker's executions of customers' market trading transactions, if those transactions are not solicited by the broker).
A. Small Offering Exemptions

1. An Overview of the Small Offering Exemptions

Regulation A\(^{68}\) and Rules 504 and 505 of Regulation D\(^{69}\) are the major small offering exemptions. Regulation S\(^{70}\) is also best treated as a small offering exemption.

Rules 504 and 505 of Regulation D were adopted pursuant to the SEC's authority under section 3(b) of the Act to exempt offerings with an aggregate offering price of not more than $5 million.\(^{71}\) They were "designed primarily for smaller issuers that are not subject to periodic disclosure requirements and for which the preparation of offering circulars and the expenses resulting from the registration process may be disproportionately burdensome."\(^{72}\)

Rule 504 exempts offerings whose aggregate offering prices do not exceed $1 million.\(^{73}\) Rule 504 is available only to companies that are not subject to the reporting requirements of the Exchange Act,\(^{74}\) but the number of offerees and purchasers is unlimited and very few other restrictions apply. No information of any sort has to be provided to investors.

Rule 505 of Regulation D exempts offerings with an aggregate offering price of up to $5 million.\(^{75}\) Rule 505 is available to reporting companies, but it is otherwise more restrictive than Rule 504. The issuer may sell to no more than thirty-five nonaccredited purchasers,\(^{76}\) plus an unlimited number of accredited investors.\(^{77}\) The issuer must furnish to nonaccredited

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Those exemptions are important, but do not relate directly to the basic problem covered in this Article: the protection of investors in primary offerings by issuers. Therefore, I will not discuss the other exemptions.


purchasers information about the issuer, its business, and the securities being offered.\textsuperscript{78} General solicitation of investors and general advertising are prohibited\textsuperscript{79} and resale of the securities purchased in a Rule 505 offering is restricted.\textsuperscript{80}

Regulation A,\textsuperscript{81} another section 3(b) exemption, exempts offerings with an aggregate offering price of up to $5 million.\textsuperscript{82} The issuer must file with the SEC a disclosure document known as an offering statement\textsuperscript{88} and must provide investors with a prospectus-like document known as an offering circular,\textsuperscript{84} which includes the same narrative and financial information as the filed offering statement.\textsuperscript{85} Regulation A does not involve a statutory registration, but it is, in essence, a "mini-registration,"\textsuperscript{86} a "less expensive and less burdensome" version of the statutory filing and prospectus delivery requirements.\textsuperscript{87}


\textsuperscript{79} 17 C.F.R. § 230.502(c) (1995).

\textsuperscript{80} 17 C.F.R. § 230.502(d) (1995).


\textsuperscript{82} 17 C.F.R. § 230.251(b) (1995).


\textsuperscript{84} No sales may be made pursuant to Regulation A unless the Form 1-A offering statement has been qualified, a preliminary or final offering circular is furnished to the investor at least 48 hours prior to mailing the confirmation of sale, and a final offering circular is delivered to the investor with or prior to the confirmation of sale. Rule 251(d)(1)(i), 17 C.F.R. § 230.251(d)(2)(i) (1995).

\textsuperscript{85} Rule 253(a), 17 C.F.R. § 230.253(a) (1995).

\textsuperscript{86} 7A J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 5-19 (rev. ed. 1993). Accord, 3A HAROLD BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 5.05[1] (1995) ("Regulation A, although technically and conceptually a conditional exemption from the registration requirements for many purposes is a less stringent form of registration for relatively small offerings.").

\textsuperscript{87} 7A HICKS, supra note 86, at 5.20.
Regulation S88 exempts certain offerings of securities outside the United States. Rule 903,89 the exemption for primary extraterritorial offerings, imposes two general conditions. First, all offers and sales must be made in “offshore transaction[s].”90 The offer may not be made to a person in the United States and the buy order must originate from a buyer outside the United States or on the floor of a foreign securities exchange.91 Second, no “directed selling efforts” may be made in the United States.92 The general effect of Regulation S is to exempt offerings that are entirely (or almost entirely) extraterritorial.

Regulation S might appear to be a deference exemption: for offerings wholly outside the United States, the SEC is deferring to the appropriate foreign regulators.93 However, Regulation S is not in any way conditioned on the existence of foreign regulation. It is available even when the offshore offering is completely unregulated, and even when there is no one to defer to. Regulation S is more appropriately categorized as a small offering exemption. The SEC sees Securities Act registration as “intended to protect the U.S. capital markets and investors purchasing in the U.S. market . . . .”94 Because Regulation S applies only when there are no offers or sales within the United States, a Regulation S offering is, for the SEC’s purposes, essentially the same as no offering at all—the ultimate small offering.

92 Rule 903(b), 17 C.F.R. § 230.903(b) (1995). Rule 902(b)(1) defines “directed selling efforts” as any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on this Regulation S. Such activity includes placement of an advertisement in a publication with a general circulation in the United States that refers to the offering of securities being made in reliance upon this Regulation S. 17 C.F.R. § 230.902(b)(1) (1995). The rule contains several exclusions from this general definition. See Rule 902(b)(2)-(7), 17 C.F.R. § 230.902(b)(2)-(7) (1995).
94 Id.
2. The Economics of the Small Offering Exemptions

a. The Basic Theory

The economic rationale for the small offering exemptions rests on economies of scale—the relative increase in the total costs and benefits of registration as the dollar amount of an offering increases. The total benefit of registration ought to increase in direct proportion to the dollar amount of the offering. The more money investors invest, the more they could lose and the more they benefit from registration, everything else being equal. The average benefit of registration per dollar invested should be relatively constant.

Changes in the dollar amount of the offering affect the total cost of registration differently. Registering an offering involves a substantial fixed cost, no matter how large the offering. For a relatively small offering, the average cost per dollar of proceeds is relatively high. As the dollar amount of the offering increases, the issuer incurs additional costs, increasing the total cost of registration, but the initial fixed cost is spread over a larger offering amount. Due to these economies of scale, the total cost of registration increases as the dollar amount of the offering increases, but at a rate less than the rate of increase of the dollar amount. As a result, the average cost of registration per dollar invested decreases as the size of the offering increases.

Studies by Jay Ritter, Clifford W. Smith, Jr., and George Benston have all found economies of scale in registered offerings. Ritter surveyed 1028 underwritten initial public offerings and found that, for both firm commitment and best efforts underwritings, the percentage of the proceeds going to both the underwriting discount and other cash expenses varied inversely with the size of the offering. For example, the average total

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9 If there is secondary trading of the registered securities, the disclosure in the registration statement could have spillover effects benefitting the secondary trading market. That would increase the total benefit of registration, but would not significantly affect the analysis.

96 "Because the offering expenses other than underwriting costs do not vary significantly with the size of the offering, the [average] cost of capital in a public offering is reduced if more money is raised." Austin & Remillard, supra note 33, at *4. Even the SEC has accepted this argument. See Securities Act Release No. 5914, 43 Fed. Reg. 10876, 10882 (Mar. 15, 1978) ("If the offering is for a relatively small amount of money, the portion of the proceeds utilized for third party services may be quite large.").

97 Ritter, supra note 34, at 272. Ritter's full results appear in the following table:
direct cash expenses for a firm commitment offering of from $100,000 to $1,999,999 were 19.48% of the proceeds, compared to 9.34% for offerings of $10 million or more. Smith reviewed common stock offerings by seasoned issuers from 1971 to 1975 and, like Ritter, found that the average percentage of offering proceeds devoted to expenses was inversely related to the size of the offering. For offerings between $500,000 and $1 mil-

**Ritter, supra note 34, at 272. This comparison understates the difference between smaller and larger offerings because smaller offerings were more likely to be best efforts underwritings, which had slightly higher expenses. Ritter, supra note 34, at 272.**

**Smith, supra note 35, at 276. Smith's results appear in the following table:**

<table>
<thead>
<tr>
<th>Size of issue ($ millions)</th>
<th>Number</th>
<th>Compensation as a percent of proceeds</th>
<th>Other expenses as a percent of proceeds</th>
<th>Total cost as a percent of proceeds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 0.50</td>
<td>0</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>0.50 to 0.99</td>
<td>6</td>
<td>6.96</td>
<td>6.78</td>
<td>13.74</td>
</tr>
<tr>
<td>1.00 to 1.99</td>
<td>18</td>
<td>10.40</td>
<td>4.89</td>
<td>15.29</td>
</tr>
<tr>
<td>2.00 to 4.99</td>
<td>61</td>
<td>6.59</td>
<td>2.87</td>
<td>9.47</td>
</tr>
<tr>
<td>5.00 to 9.99</td>
<td>66</td>
<td>5.50</td>
<td>1.53</td>
<td>7.03</td>
</tr>
<tr>
<td>10.00 to 19.99</td>
<td>91</td>
<td>4.84</td>
<td>0.71</td>
<td>5.55</td>
</tr>
<tr>
<td>20.00 to 49.99</td>
<td>156</td>
<td>4.30</td>
<td>0.37</td>
<td>4.67</td>
</tr>
<tr>
<td>50.00 to 99.99</td>
<td>70</td>
<td>3.97</td>
<td>0.21</td>
<td>4.18</td>
</tr>
<tr>
<td>100.00 to 500.00</td>
<td>16</td>
<td>3.81</td>
<td>0.14</td>
<td>3.95</td>
</tr>
<tr>
<td><strong>Total/Average</strong></td>
<td><strong>484</strong></td>
<td><strong>5.02</strong></td>
<td><strong>1.15</strong></td>
<td><strong>6.17</strong></td>
</tr>
</tbody>
</table>
lion, total expenses averaged 13.74% of the proceeds, compared to 3.95% for offerings between $100 million and $500 million. Benston’s analysis of debt issues in the 1950s is similar. He found that the total cost of publicly offered debt issues ranged from 10.24% of gross proceeds for offerings in the $500,000-$999,999 range to 1.22% for offerings of $20 million or more. Benston also found that private placements were cheaper on average than comparable public offerings. Significantly, Benston’s study found that the difference between public offerings and private placements was also inversely related to the size of the offering: the smaller the offering, the greater the differential cost of registration. In effect, due to economies of scale, “the registration system operates as a regressive tax based on the size of the issue and presumably, therefore, the issuer.”

Smith’s work also considered rights offerings; the relative results were similar, but, for any given offering size, the percentages were smaller. Smith, supra note 35, at 276.

Benston, supra note 15, at 61.
Benston, supra note 15, at 61. Benston’s full results are reproduced below:

<table>
<thead>
<tr>
<th>Size of Issue (millions)</th>
<th>.5-9</th>
<th>1.0-1.9</th>
<th>2.0-4.9</th>
<th>5.0-9.9</th>
<th>10.0-19.9</th>
<th>over 20.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Cost</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publicly offered</td>
<td>10.24</td>
<td>8.00</td>
<td>3.33</td>
<td>1.53</td>
<td>1.44</td>
<td>1.22</td>
</tr>
<tr>
<td>Privately placed</td>
<td>2.14</td>
<td>1.52</td>
<td>1.12</td>
<td>.83</td>
<td>.63</td>
<td>.44</td>
</tr>
<tr>
<td>Difference</td>
<td>8.10</td>
<td>6.48</td>
<td>2.21</td>
<td>.70</td>
<td>.81</td>
<td>.78</td>
</tr>
<tr>
<td>Compensation (a)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publicly offered</td>
<td>6.50</td>
<td>5.50</td>
<td>2.25</td>
<td>.70</td>
<td>.68</td>
<td>.73</td>
</tr>
<tr>
<td>Privately placed</td>
<td>1.31</td>
<td>.97</td>
<td>.69</td>
<td>.49</td>
<td>.31</td>
<td>.22</td>
</tr>
<tr>
<td>Difference</td>
<td>5.19</td>
<td>4.03</td>
<td>2.56</td>
<td>.30</td>
<td>.37</td>
<td>.51</td>
</tr>
<tr>
<td>Other Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publicly offered</td>
<td>3.14</td>
<td>2.20</td>
<td>1.24</td>
<td>.85</td>
<td>.61</td>
<td>.42</td>
</tr>
<tr>
<td>Privately placed</td>
<td>.83</td>
<td>.59</td>
<td>.43</td>
<td>.34</td>
<td>.32</td>
<td>.22</td>
</tr>
<tr>
<td>Difference</td>
<td>2.31</td>
<td>1.61</td>
<td>.81</td>
<td>.51</td>
<td>.29</td>
<td>.20</td>
</tr>
</tbody>
</table>

(a) Compensation refers to the amount received by investment bankers, finders, or agents.

Benston, supra note 15, at 61.
Benston, supra note 15, at 61. Benston's full results are reproduced below:

Manne, supra note 17, at 49.
Figure A illustrates the relationship between the total cost and the total benefit of registration and the dollar amount of the offering.\textsuperscript{105}

The curve TB represents the total benefit of registration: it is proportionate to the dollar amount of the offering. The curve TC shows the total cost of registration: it indicates a large fixed cost and a declining average cost as the amount of the offering increases. The net benefit of the registration requirement for any given offering amount is the vertical difference between the TB curve and the TC curve. When the dollar amount of the offering is less than $x$, the difference is negative; the total cost of registration exceeds the total benefit. Registration of an offering of this size is economically inefficient. As the dollar amount of the offering in-

\textsuperscript{105} The costs and benefits shown in Figure A are the costs and benefits of registration—the incremental costs and benefits above those in an unregulated offering. Neither the exact slopes of the two curves nor their linear nature is crucial to the analysis.
creases, the total benefit of registration increases faster than the total cost. Eventually (when the offering amount is more than $x), the total benefit of registration exceeds the total cost, and registration becomes efficient.¹⁰⁸

If the only choices were full registration or full exemption, the dictates of economic efficiency would be straightforward: require offerings to be registered if their dollar amount exceeds $x; exempt them otherwise.¹⁰⁷ For example, consider an offering of $1000 worth of stock to 100 investors. Assume that it would cost $100,000 to register that offering and that the benefit of registration to the investors is $100. Requiring this offering to be registered would be inefficient. The net cost of registration ($100,000) far exceeds the expected benefit ($100).¹⁰⁸

Now, consider an offering of $5 million worth of stock to the same 100 investors. Assume that the proportionate benefit of registration is the same as in the $1000 offering. Thus, if registration is required, the total benefit would be $500,000. The cost of registration might be higher, but as explained above, not proportionately higher. Assume that the total cost of registration for the $5 million offering is $300,000. The total benefit of registration, $500,000, now exceeds the total cost, $300,000, and it is economically efficient to require registration.

b. A Complication—Intermediate Disclosure Exemptions

The analysis in the preceding section oversimplifies the small offering exemptions. It assumes a dualistic choice between registration and a complete, unconditional exemption from all federal disclosure requirements. Rule 504 of Regulation D nearly fits that idea of a total, unconditional exemption. It exempts offerings of less than $1 million, with no additional federal requirements. But there are other alternatives--intermediate op-

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¹⁰⁷ Of course, determining $x$, the dollar amount at which the net benefit becomes positive, would be far from simple.

¹⁰⁸ If the investors do absolutely no investigation and lose their entire investment, the total loss is only $1000. It would cost 100 times that much to register the offering. Even if registration were totally effective in preventing unexpected loss, which it undoubtedly is not, the gain would not be worth the cost.
tions between filing a registration statement and no mandatory disclosure at all. Regulation A and Rule 505 have higher dollar limits than Rule 504, but also impose additional requirements on the issuer. In particular, both rules require that certain information about the issuer be made available to purchasers.

Intermediate disclosure rules like these—requiring some disclosure, but not full registration—produce different costs and benefits than full registration. The cost of producing the information required by Rule 505 or Regulation A is certainly less than the cost of full registration. But the slope of the cost curve should be similar to that for a registered offering. Producing the information required by the intermediate disclosure exemptions involves a relatively large fixed cost, with lesser additional costs as the dollar amount of the offering increases.

The benefits of intermediate disclosure should also be less than the benefits of registration. Less information is provided and the information provided may be less reliable. But those benefits, like the benefits of registration, should increase in proportion to the size of the offering, because investors' gains from fuller disclosure depend on the size of their total investment.

Figure B illustrates the economics of these intermediate disclosure small offering exemptions.

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109 The following analysis would also apply to the simplified registration forms, such as Forms SB-1 and SB-2, available to small-business issuers.

110 If not, no rational issuer would ever choose to use those exemptions.

111 The information required by Regulation A and Rule 505 is not subject to the same extensive verification procedures as the information in the registration statement. Among other things, § 11 liability does not apply. In addition, the Regulation A and Rule 505 information is not required to be in the same standardized format as the registration statement, so any benefits of standardization are lost.
The curves $TB_R$ and $TC_R$ duplicate the curves in Figure A. They represent the total benefit and total cost of registration. As in Figure A, they intersect when the amount of the offering equals $x$. The curve $TC_i$ shows the total cost associated with an intermediate disclosure exemption like Rule 505, which imposes lesser information requirements. The curve $TB_i$ shows the total benefit associated with the same intermediate disclosure exemption. As indicated earlier, for any given dollar amount, the cost and benefit of intermediate disclosure are each less than the cost and benefit of a comparable registered offering.

The introduction of an intermediate disclosure option modifies our prior conclusions about economic efficiency. Neither registration nor the

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112 The slope of $TC_i$ should not exceed the slope of $TC_R$. Several costs of registration that vary with the size of the offering—including the cost of delay, prospectus delivery requirements, and registration fees—are greater in a registered offering. There is no reason to suspect that any of the marginal costs would be greater in an intermediate disclosure offering.
intermediate disclosure small offering exemption produce a positive net benefit for offerings smaller than $y. These offerings should be completely exempted. If the size of the offering exceeds $y, the intermediate disclosure exemption produces a positive net benefit. At this point, it is efficient to eliminate the full, absolute exemption and force issuers to use the intermediate disclosure exemption. For offerings of more than $x, both registration and the intermediate disclosure exemption produce positive net benefits. The preferred alternative is the one that, for any particular offering, produces the greatest net benefit. The intermediate disclosure exemption should be available until the point at which the net benefit of registration ($TB_r - TC_r$) exceeds the net benefit of the intermediate small offering exemption ($TB_I - TC_I$). In Figure B, this occurs approximately when the dollar amount of the offering is $z. When the offering becomes this large, the intermediate disclosure exemption should be unavailable and registration should be required.

This analysis supports a multi-part regulatory structure: (1) a minimum dollar amount below which offerings are left unregulated; (2) an intermediate range of offerings for which some disclosure is required, but not full registration; and (3) a dollar amount above which offerings must be registered. This is precisely the structure one finds in the current law. Rule 504 is a complete, unconditional exemption from federal disclosure requirements, but it is only available for offerings not exceeding $1 million. Rule 505 and Regulation A are available for offerings of up to $5 million, but the issuer must make certain information available to investors. No small offering exemption is available for offerings that exceed $5 million; they must be registered unless some other type of exemption is available.

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114 The net benefit of registration must at some point exceed the net benefit of the intermediate exemption because of the original assumption that registration is economically efficient in at least some cases. If not, the registration requirement should be eliminated and "intermediate" disclosure required for all offerings in an amount greater than $x.

115 This analysis might support a continuously variable regulatory structure—some minimum offering amount below which no disclosure is required, with the amount of disclosure and verification increasing continuously as the dollar amount of the offering increases. The SEC has not adopted such a structure. One economic reason not to is the cost, both to the SEC and to issuers, of determining the applicable level of disclosure for any given offering. Given the increased transaction costs associated with administering a continuous system, a tiered system like the one currently used by the SEC might be economically preferable.
The efficiency of a multi-level structure does not prove the efficiency of the SEC’s current small offering exemptions. The current small offering exemptions are efficient only if the dollar amounts are set at the correct levels. The foregoing theoretical analysis cannot show whether $1 million is the equivalent of $y in Figure B or $5 million is the equivalent of $z.\textsuperscript{116} Even if the $1 million and $5 million figures were correct when they were adopted, they are not correct today. If the amounts are correct now, they were not correct in the past and will not be correct in the future. Inflation has a differential impact on the cost and benefit of registration. The cost of registration increases as the cost of legal, accounting, underwriting, printing, and other services increases. Inflation will also cause issuers to seek greater amounts of capital on average, but for any given offering amount, the benefit of registration is, for the most part, unaffected by inflation. The risk of loss against which registration protects remains relatively constant if the dollar amount of the offering is unchanged. Thus, inflation causes the cost, but not the benefit, of registration to increase for any given offering amount. The effect of inflation is to reduce the net benefit of registration for every offering amount and thereby increase the dollar amount at which registration (or an intermediate disclosure exemption) becomes efficient. To correct for this problem, the dollar amounts of the small offering exemptions should be indexed for inflation or at least changed regularly.\textsuperscript{116} The SEC has occasionally changed the dollar amounts, but not regularly enough to account for inflation.\textsuperscript{117}

B. Sophisticated Offeree Exemptions

1. An Overview of the Sophisticated Offeree Exemptions

The rationale for the sophisticated offeree exemptions is that certain offerees, because of their sophistication, bargaining power, or access to information about the issuer, do not need the protection that registration

\textsuperscript{115} Neither can the analysis show that the types of disclosure the SEC requires in the intermediate disclosure exemptions maximize net benefits.

\textsuperscript{116} Rulemaking to change the dollar amounts is not costless, so indexing is economically preferable. The only economic argument against changing the dollar amount is that such changes increase information costs—investors and their lawyers must look up the correct dollar amount. However, compared to the other costs associated with an offering of securities, the additional information costs of an indexed dollar amount are trivial.

\textsuperscript{117} The maximum amount in Rule 505, for example, has not been changed since the adoption of Regulation D in 1982.
provides. The primary examples of sophisticated offeree exemptions are sections 4(6) and 4(2) of the Securities Act and the regulatory safe harbor for section 4(2), Rule 506 of Regulation D. Section 3(a)(9) of the Act probably also fits into the sophisticated offeree category.

Section 4(2) of the Act exempts "transactions by an issuer not involving any public offering."\textsuperscript{118} The legislative history of this exemption provides little guidance,\textsuperscript{119} but the Supreme Court has held that section 4(2) was meant to exempt offers to "those who are shown to be able to fend for themselves" or those such as "executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement."\textsuperscript{120} The dollar amount of a section 4(2) offering is unlimited.

Rule 506 of Regulation D\textsuperscript{121} is a regulatory safe harbor for section 4(2).\textsuperscript{122} It allows sales of an unlimited amount of securities to two classes of investors: (1) up to thirty-five purchasers each of whom "either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment";\textsuperscript{123} and (2) an unlimited number of "accredited investors," defined to include mainly institutional investors and wealthy individuals.\textsuperscript{124} A Rule 506 issuer must provide to nonaccredited purchasers the same information required for Rule 505 offerings.\textsuperscript{125} General solicitation of investors and advertising are prohibited,\textsuperscript{126} and resale of the securities purchased in a Rule 506 offering is restricted.\textsuperscript{127}

Section 4(6) of the Act also exempts offerings to accredited investors if the offering amount is not greater than the amount the SEC is allowed to

\textsuperscript{119} LOSS & SELIGMAN, supra note 2, at 1350-52.
\textsuperscript{120} SEC v. Ralston Purina Co., 346 U.S. 119, 125-26 (1953).
\textsuperscript{121} 17 C.F.R. § 230.506 (1995).
\textsuperscript{124} 17 C.F.R. § 230.501(a) (1995).
\textsuperscript{126} 17 C.F.R. § 230.502(e) (1995).
\textsuperscript{127} 17 C.F.R. § 230.502(d) (1995).
exempt under section 3(b) (currently $5 million), and there is no advertising or public solicitation.\textsuperscript{128} Rule 506 is available in almost every case in which section 4(6) would be available, and Rule 506 is generally less restrictive. Thus, section 4(6) "is of little, if any, use today."\textsuperscript{129}

Section 3(a)(9) of the Act exempts "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."\textsuperscript{130} The rationale for section 3(a)(9) is, at least in part, based on the existing security holders' knowledge of the issuer and its affairs. They may have already received information about the transaction and, in any event, they are not investing additional money, but merely changing the form of their investment in an issuer about which they are presumably already informed.\textsuperscript{131}

Another exemption for sales to sophisticated or institutional investors is Rule 144A.\textsuperscript{132} Rule 144A is not, however, an issuer exemption; it exempts resales of securities after their original purchase from the issuer and is thus beyond the scope of this Article.

2. \textit{The Economics of the Sophisticated Offeree Exemptions}

The economic argument for the sophisticated offeree exemptions focuses on the benefits of registration, which are less for some offerees than for


\textsuperscript{129} \textsc{James Cox et al., Securities Regulation: Cases and Materials} 433 (1991).

\textsuperscript{130} Securities Act of 1933 § 3(a)(9), 15 U.S.C. § 77c(a)(9) (1994). The exchange must be exclusively between the issuer and its existing security holders; no new investors may participate in a § 3(a)(9) offering. 7A Hicks, \textit{supra} note 86, § 2.05[1]; Loss & Seligman, \textit{supra} note 2, at 1232-33. In addition, the security holders must be exchanging only their existing securities for the new securities; no new consideration may be required. The SEC only allows cash payments by the security holders to adjust equitably for dividends or interest paid or payable on the outstanding securities. Rule 149, 17 C.F.R. § 230.149 (1995).

\textsuperscript{131} 7A Hicks, \textit{supra} note 86, at 2-126 to 2-127. Hicks questions the soundness of this rationale.

7A Hicks, \textit{supra} note 86, at 2-127 to 2-133.

\textsuperscript{132} 17 C.F.R. § 230.144A (1995).
others. Certain offerees, because of their sophistication, bargaining power, and access to information about the issuer, receive less benefit from registration per dollar invested than do other offerees. The nature of the offerees has little effect on the cost of registration, but due to the reduced benefit of registration, the cost-benefit tradeoff is different when the offering is exclusively to sophisticated investors.

Figure C illustrates this point.

133 William J. Carney, Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis, 33 Emory L.J. 311, 353-54 (1984). It is possible, even probable, that sophisticated investors will be better able to use the information in the registration statement than unsophisticated investors. However, this does not mean that registration provides greater benefits to sophisticated investors because they would have better access to information even without registration. What matters is the comparative benefit—the difference between registration and no registration. Unsophisticated investors gain more from registration. Unsophisticated investors would benefit particularly from the standard format, the highlighted risk factors, and the verification of information that registration provides.
The curves $TB_R$ and $TC_R$ are the same curves which appeared in Fig. A. They represent the total cost and total benefit of registering an ordinary offering. The total cost curve does not change much if the offering is limited to sophisticated offerees; it is essentially the same as $TC_R$. However, the total benefit of registration in an offering limited to sophisticated investors is substantially less. The curve $TB_s$ represents the total benefit of registering an offering limited to sophisticated investors.

Because of the reduced benefit, registration of an offering to sophisticated investors does not produce a positive net benefit when the dollar amount of the offering is $S_x$. For an offering of that size, the total cost of registration is still far more than the total benefit—registration is inefficient. If the total benefit of registering an offering to sophisticated offerees

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134 To focus solely on the sophisticated offeree exemptions, disregard for now the possibility of an intermediate disclosure small offering exemption.
ever exceeds the total cost, it does so only when the dollar amount of the offering is much greater.135

But how much greater? Neither the section 4(2) private offering exemption nor its Rule 506 safe harbor limit the dollar amount of the offering. This is efficient only if the total benefit of registering an offering to sophisticated offerees never exceeds the total cost; in other words, only if $TB_s$ and $TC_R$ in Figure C never intersect. Whether this is true is an empirical question. If the total benefit of registration does at some point exceed the total cost, the sophisticated offeree exemptions are economically unsound; they should contain a dollar limit above which the exemption is unavailable and registration is required.136

C. Deference Exemptions

1. An Overview of the Deference Exemptions

The rationale for the deference exemptions is that regulation of the offering by some other authority eliminates the need for regulation by the SEC.137 Examples of deference exemptions are the bankruptcy-related exemptions (section 3(a)(7) of the Securities Act138 and sections 1145(a) and 364(f) of the Bankruptcy Code139); sections 3(a)(10)140 and 3(a)(11)141 of the Securities Act; Rule 147,142 the regulatory safe harbor for section 3(a)(11); and, at least in part, Rule 504 of Regulation D.143

Section 3(a)(10) of the Act exempts exchanges of securities that are approved by a state or federal court or administrative agency after a hearing

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135 This would occur where $TB_s$ and $TC$ intersect. In Figure C, the two curves never intersect; registration of a sophisticated offeree offering never produces a positive net benefit.

136 That dollar limit should, of course, be greater than the dollar limit of the small offering exemptions.

137 This rationale is not limited to the question of which securities to exempt. The Supreme Court has looked to the presence or absence of another regulator to help determine whether an investment is a "security." See Reves v. Ernst & Young, 494 U.S. 56, 67, 69 (1990); Marine Bank v. Weaver, 455 U.S. 551, 558-59 (1982); International Bhd. of Teamsters of Am. v. Daniel, 439 U.S. 551, 569-70 (1979).


on the fairness of the exchange.144 The justification for this exemption is that "the examination and approval by the body in question of the fairness of the issue in question is a substitute for the protection afforded to the investor by the information which would otherwise be made available to him through registration."145

Section 3(a)(11) of the Act and its regulatory safe harbor, Rule 147,146 provide another deference exemption. Section 3(a)(11) exempts:

Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.147

The legislative history of section 3(a)(11) is "sparse,"148 but the intent apparently was to relegate purely local offerings to state regulation.149 Of course, states may always regulate securities offerings, whether or not

144 Section 3(a)(10) provides in full:
Except with respect to a security exchanged in a case under title 11, any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.


148 Loss & Seligman, supra note 2, at 1276.

149 The 1963 Special Study of Securities Markets stated that:
The exemption reflects a congressional policy expressed, in various provisions of the Securities Act, not to preempt the field of securities regulation or to supersede State control, but rather to fill the gap in those areas where State regulation cannot adequately meet a national need . . . .

It is typically available for the offering by a small businessman of a limited amount of securities to his friends, relatives, business associates, and others. . . . Small local offerings of this character are not a matter of Federal concern, and can be adequately supervised by State authority to the extent that regulation is deemed necessary.

those offerings are federally exempted. Section 18 of the Securities Act\textsuperscript{150} expressly protects state securities regulation against federal preemption, and many federally registered offerings are also subject to state registration.\textsuperscript{151} The economic argument for federal deference for section 3(a)(11) offerings is that, because of the especially local nature of the offering, a single state may regulate and control the offering more effectively than it could a nationwide offering. Given the enhanced effectiveness of state regulation of an intrastate offering, the incremental benefits of federal regulation are correspondingly less than they would be for other offerings, even though those other offerings are also state regulated.

Rule 504 of Regulation D is also at least partially a deference exemption. The other two Regulation D exemptions, Rules 505 and 506, were meant to be uniform exemptions from both federal and state registration, but Rule 504 was not.\textsuperscript{162} For offerings falling within Rule 504, \"[b]ecause of the small amount of the offering and the likelihood that sales will occur in a limited geographic area, the [SEC and the North American Securities Administrators Association] believe that greater reliance on state securities laws is appropriate.\"\textsuperscript{163} Thus, Rule 504 is probably best treated as a hybrid small offering/deference exemption.

The federal Bankruptcy Code contains two additional deference exemptions from the Securities Act registration requirements.\textsuperscript{154} Section 1145(a) of the Bankruptcy Code\textsuperscript{165} exempts from section 5 of the Securities Act\textsuperscript{166} certain offerings of securities of a bankruptcy debtor, an affiliate participating in a joint plan with the debtor or a successor to the debtor under a

\textsuperscript{151} Some federal exemptions, such as Rules 505 and 506, have coordinated state exemptions; others are purely federal, and the states continue to regulate such offerings. See Securities Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106, at 84,909-84,910 (Mar. 8, 1982). See also 7A HICKS, supra note 86, § 7.01[3][d].
\textsuperscript{153} Id.
\textsuperscript{154} For a more extended discussion of these exemptions, see Richard J. Morgan, Application of the Securities Laws in Chapter 11 Reorganizations Under the Bankruptcy Reform Act of 1978, 1983 U. Ill. L. Rev. 861, 874-80.
\textsuperscript{156} This exemption also applies to any state or local registration requirement.
plan. The offering must be pursuant to a bankruptcy plan and must be wholly or principally in exchange for existing claims against or interests in the debtor or the affiliate. The bankruptcy court must review and approve the plan pursuant to which the securities are sold, and the Bankruptcy Code contains its own disclosure requirements for the issuance of such securities.

The second deference exemption in the Bankruptcy Code is section 364(f), which is closely related to the exemption in section 3(a)(7) of the Securities Act. Section 3(a)(7) exempts "[c]ertificates issued by a receiver or by a trustee or debtor in possession in a case under [the Bankruptcy Code], with the approval of the court." It is unclear whether this is a security exemption or a transaction exemption, but, whichever it is, it fits the deference rationale. Section 364(f) of the Bankruptcy Code exempts from Securities Act registration certain offerings of debt securities. To the extent that section 364(f) exempts court-approved offerings, it overlaps the section 3(a)(7) exemption, and it fits the deference rationale. However, section 364(f) also allows the bankruptcy trustee to issue debt securities without court approval. To that extent, it goes beyond section 3(a)(7) and departs from the deference rationale.

2. The Economics of the Deference Exemptions

The economic rationale for the deference exemptions is more complicated than the rationales for the other two types of exemptions. When a

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187 11 U.S.C. § 1145(a)(2) (1994). In addition, if a warrant, option, right to subscribe, or conversion privilege was issued pursuant to the section 1145(a)(1) exemption, the subsequent offer or sale of the underlying security is also exempt from registration.


193 RICHARD JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 448 (7th ed. 1992) and authorities cited therein; Morgan, supra note 154, at 878. The accepted view is that it is a security exemption. JENNINGS ET AL., supra. See also LOSS & SELIGMAN, supra note 2, at 1210.

194 Morgan, supra note 154, at 879-80. For a listing of the differences between the two, see LOSS & SELIGMAN, supra note 2, at 1209-10.

195 LOSS & SELIGMAN, supra note 2, at 1210; Morgan, supra note 154, at 880.

196 An offering without court approval would fit the deference justification only if the trustee were considered a neutral official likely to protect the interests of those purchasing the securities.
deference exemption applies, there are two potential regulators: the SEC and the other authority to whom the SEC might defer—the alternative regulator. The economic justification for the deference exemptions is based on a comparison of the costs and benefits associated with each potential regulator.

As Table 3 shows, four regulatory options exist: (1) neither the SEC nor the alternative regulator regulates a particular offering, (2) only the SEC regulates the offering (an exemption from the alternative regulation), (3) only the alternative regulator regulates the offering (an exemption from the Securities Act registration requirement), or (4) both the SEC and the alternative regulator regulate the offering.

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The choice between the first and second options has already been discussed. The first option—an unregulated offering—results when a small offering or sophisticated offeree exemption is available. The second option—Securities Act registration—results when no such exemption is available. I argued earlier that the second option is preferable to the first only when the total benefit of registration exceeds the total cost. But this need not be true for a deference exemption to apply. Deference exemptions can be economically efficient even when Securities Act registration would produce a positive net benefit. To understand this, consider the third and fourth options.

The third option is to grant the issuer a deference exemption from the Securities Act and allow an alternative regulator to regulate the offering. The alternative regulation would produce its own costs and benefits, which presumably would differ from the costs and benefits associated with
Securities Act registration. The required disclosure would be different, the alternative regulator could be more or less efficient than the SEC in reviewing the offering, and so on. Regulation by the alternative regulator (the third option) is preferable to registration with the SEC (the second option) if the alternative regulation produces a greater net benefit (because of greater benefits, lower costs, or both) than registration.\textsuperscript{167}

The third option's superiority to the second option is a necessary, but not a sufficient, condition to justify a deference exemption. The fourth option—dual regulation—must also be considered. Assume that regulation of an offering by an alternative regulator produces greater net benefits than either registration or a complete exemption from regulation. Then, the third option is preferable to the first two. In choosing between options three and four, the question is whether the incremental benefit to investors of Securities Act registration, given that the alternative regulator is already acting, exceeds the incremental cost. Let $TB_{SEC}$ equal the additional incremental benefit of federal registration to investors, given that the alternative regulator has acted. And let $TC_{SEC}$ equal the additional cost that federal registration would entail.\textsuperscript{168} If registration results in a positive net benefit even when the alternative regulator is regulating the offering (in other words, if $TB_{SEC} > TC_{SEC}$, then registration is still efficient. Option four is preferred. If, on the other hand, registration produces a negative incremental net benefit when the alternative regulator is acting ($TB_{SEC} < \ldots$)

\textsuperscript{167} If the alternative regulation produces greater net benefits for all offerings, then the efficient result might be to eliminate the Securities Act registration requirement in all cases and rely on the alternative regulator. However, an alternative regulator might be more efficient for some, but not all, offerings. The greater net benefit associated with the alternative regulation may be unique to a particular type of offering. For example, regulation by a single state is effective only for localized, intrastate offerings. Similar cost savings would not be present if that state tried to regulate a nationwide offering. In addition, the alternative regulator may have a comparative advantage over the SEC only at the margin. Extending the alternative regulator's responsibilities to cover all offerings might increase the alternative regulator's costs above those associated with registration. Thus, the economic argument for displacing the SEC in certain cases does not necessarily support the displacement of the SEC in all cases.

\textsuperscript{168} Both the cost ($TC_{SEC}$) and the benefit ($TB_{SEC}$) should be less than the total cost and benefit of registration in the absence of an alternative regulator. Some of the legal, accounting, and other disclosure costs of registration might also be incurred to comply with the alternative regulation. The incremental cost of registration would not include these costs already incurred. Similarly, the alternative regulation should produce at least some of the same benefits as registration. Therefore, the incremental benefit of also requiring registration should be less than the total benefit of registration alone.
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Option three is preferred, and a deference exemption from Securities Act registration is economically efficient.

Empirical analysis of the deference exemptions is extremely difficult. One must determine not only the costs and benefits of registering a particular offering, but also the costs and benefits of the alternative regulation and, to evaluate the possibility of dual regulation, the incremental costs and benefits of registration when the alternative regulator is already acting. I have already discussed the difficulties of measuring the costs and benefits of registration. Even less is known about the costs and benefits of a state-regulated intrastate offering, an offering pursuant to a section 3(a)(10) fairness hearing, or an offering of securities in bankruptcy. Thus, for now, the examination of the deference exemptions must remain fairly theoretical.

The discussion of the small offering exemptions showed that costs and benefits vary with the dollar amount of the offering: holding everything else constant, the net benefit of registration increases as the offering amount increases. The relationship between net benefits and the dollar amount of the offering should have no major effect on the choice between the second option—registration without alternative regulation and the third option—alternative regulation without registration. The net benefit of each regulatory system should increase as the dollar amount of the offering increases. As long as the rate of increase is roughly the same for each regulator, a change in the dollar amount of the offering should not affect the choice between regulators. If the alternative regulation produces a higher net benefit than registration, it will continue to produce a higher net benefit as the dollar amount of the offering changes.

The dollar amount of the offering could affect the choice between option three—deference to the alternative regulator—and option four—dual regulation. If, as the dollar amount of the offering increases, the incremental benefit of registration increases more rapidly than the incremental cost, registration could produce a positive net incremental benefit at some point. Figure D illustrates this point.

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109 See supra text accompanying notes 95-106.
TBₐ and TCₐ represent the total benefit and the total cost of the alternative regulation. TBₜₚ and TCₜₚ represent the incremental benefit and incremental cost of Securities Act registration, given that the alternative regulator is acting. When the dollar amount of the offering is less than $y, a deference exemption is preferred to dual regulation. Below this amount, adding registration to the protection provided by the alternative regulation would produce a negative net benefit. However, when the amount of the offering exceeds $y in Figure D, TBₜₚ exceeds TCₜₚ, and Securities Act registration would produce a positive net benefit. Thus, if the incremental costs and benefits increase like those shown in Figure D as the dollar amount increases, the deference exemptions should not be absolute; the dollar amount of the offering should be limited.

None of the deference exemptions depend on the size of the offering; the dollar amount of the offering is unrestricted. Unlimited deference exemptions like this are economically sound only if the incremental benefit
of registration never exceeds the incremental cost (that is, if the marginal incremental benefit of registration as the dollar amount increases is lower than the marginal incremental cost across the range of possible offerings). Whether this is true is an empirical question that cannot be answered with existing data.

IV. Restrictions on the Number of Purchasers

Both Rule 505 and Rule 506 of Regulation D are available only if there are no more than thirty-five nonaccredited purchasers in the offering. Other exemptions have no such limits. Is there an economic basis for limiting the number of purchasers? If so, does it make sense to apply that limit to some, but not all, of the exemptions? An answer to these questions requires an examination of how the costs and benefits of registration are affected by the number of purchasers in the offering.

A. The Number of Purchasers and the Costs of Registration

Some of the costs of registration do not change much, if at all, as the number of purchasers in any given offering increases. The number of purchasers does not affect the cost of SEC review or the issuer's attorneys' or accounting fees. The cost of the delay caused by registration is solely a function of the dollar amount of the offering rather than the number of purchasers. Similarly, the competitive disadvantage associated with mandatory disclosure does not depend on the number of purchasers.

Other costs of registration increase as the number of purchasers increases. The more purchasers there are, the greater the cost to print and deliver prospectuses. The cost of complying with the section 5 restrictions on offers and sales also becomes greater as the number of purchasers increases; with a large number of purchasers, it is more difficult to moni-


171 The cost of informing investors increases as the number of purchasers increases, whether or not the offering is registered. However, everything else being the same, the cost of delivering information is higher in a registered offering than in an unregistered offering. Therefore, as the number of purchasers increases, the total cost of registration associated with informing investors (the increased cost above the cost in an unregistered offering) also increases.
tor the selling group and inadvertent noncompliance becomes more likely. The Exchange Act periodic reporting, triggered by registration, also becomes more costly as the number of purchasers increases because the cost of distributing those periodic reports increases. At the limit, when there are fewer than 300 holders of the security after the offering, the periodic reporting trigger does not apply, and there are no Exchange Act costs at all.

Underwriting fees probably also increase as the number of purchasers increases. Everything else being equal, it is more costly to solicit and sell to ten thousand people than to ten. In addition, the liability cost to the underwriter may increase as the number of investors increases. For any given offering amount, more purchasers mean a smaller average investment. Smaller investors are, on average, less sophisticated than larger investors and thus more likely to be confused or misinformed. To the extent that this translates into greater liability risk for the underwriters, underwriting fees should rise when there are more investors.

B. The Number of Purchasers and the Benefits of Registration

The total benefit of registration also increases as the number of purchasers increases. This conclusion is not immediately obvious. It seems that, if registration increases the expected return or reduces the risk of a security, the resulting gain should be a percentage of the total amount invested. For example, if registration increases the returns in a $5 million offering by two percentage points, the gain appears to be $100,000 whether the $5 million is paid by ten investors or ten thousand.

However, this view fails to consider investors' options if the offering is not registered. In an unregistered offering, each offeree has three options: (1) refuse to invest, (2) fully investigate the issuer and the offering and acquire the same information that would be provided in the registration statement (with the same gains), or (3) invest without acquiring full information and bear some or all of the risk that a fuller investigation would

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173 Although investors with larger investments are probably more likely to sue when things go awry, an aggressive class action practice in securities cases probably counteracts this.
The rational investor will choose the option that results in the greatest net benefit. An investor will choose to invest (options two and three) only if the expected net gain from investing exceeds the opportunity cost of the money invested. The expected net gain from investing equals the predicted return of the investment (adjusting for the uncertainty and expected risk) less the information costs of predicting that return. Option two involves greater information costs than option three, but it also involves a more certain return (less risk). As between options two and three, a rational investor will prefer option three and not investigate unless the investigation and verification costs associated with option two are less than the gains expected from a more thorough investigation.

If, as indicated in the discussion of the small offering exemptions, the benefit of having information increases as the size of the investment increases, individuals investing more in an offering are more likely to choose option two and investigate for themselves. The more money one invests, the greater the expected loss associated with not investigating. A ten percent risk of loss costs a $1 million investor more than it does a $10,000 investor. The costs of investigation and verification, on the other hand, do not depend much on the size of one's investment. Thoroughly investigating an issuer costs as much whether one is investing $10,000 or $1 million. Thus, the cost of option two is relatively constant. Therefore, the greater the amount of one's investment, the greater the net benefit of option two. At some point, as the size of an individual's investment increases, option two becomes preferable to option three. Large investors will fully investigate the issuer themselves rather than bear the risk resulting from a lack of information. Smaller investors, however, might find option three preferable. If transaction costs make collective action by small investors impossible, it is cheaper for each small investor to suffer the risk than to investigate the issuer. Collectively, the loss to smaller investors

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174 The latter two choices are not discrete, but continuous. An investor may acquire and verify any amount of information from none at all to the amount of verified information in the registration statement and beyond. Presenting the collection of information as a continuous choice would complicate, but not alter, my discussion of the effect of the number of purchasers.

175 Or, viewing the collection and verification of information as a continuous choice, a rational investor will collect and verify information until the marginal cost of investigation equals the marginal benefit.

176 See Carney, supra note 133, at 346 n.143 (stating that the marginal gain from investigating an issuer increases as the size of the investment increases).

177 Carney, supra note 133, at 346, 355.
may be greater than the cost of investigation and verification, but, for each individual, the cost of investigation and verification is greater than the expected loss.

As a result, small investors benefit more from registration than larger investors. The benefit of registration to all small investors is the sum of the collective losses they suffer because they do not fully investigate the issuer. The benefit of registration to larger investors, who investigate the issuer if the offering is not registered, is the smaller sum of their collective costs to investigate. If we hold the dollar amount of the offering constant, the greater the number of investors, the smaller the amount of each person's investment. Because the benefit of registration is inversely correlated with the size of each person's investment, the greater the number of purchasers in the offering, the greater the benefit of registration.

The benefit of registration increases for another reason as the number of purchasers increases. The information provided by registration benefits not only those who purchase in the offering, but also, to some extent, the secondary trading market, which consists of investors who repurchase from the offering's original purchasers. The larger the number of purchasers in the original offering, the greater the likelihood of an active secondary trading market in the securities and the greater the likelihood that investors trading in the secondary market will benefit from the information provided by registration. In addition, traders in the secondary market will benefit from the periodic reporting mandated by section 15(d) of the Exchange Act.

However, if an offering is exempt from registration, resale of the securities without registration by the original purchasers is often restricted. These resale restrictions minimize the costs to secondary traders of not having the information that registration would have provided and thus reduce the benefit of registration to secondary traders. As a result, every-

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178 This relates to the SEC's concern in limiting the number of purchasers. The release adopting Rule 146, a predecessor to Regulation D, explained that "the Commission believes that a limitation on the number of purchasers serves to assure that the offering does not involve or result in a deferred distribution." Securities Act Release No. 5487, 1 Fed. Sec. L. Rep. (CCH) ¶ 2710 (Apr. 23, 1974).

179 See supra notes 56-57 and accompanying text.

thing else being equal, limitations on the number of purchasers would be more defensible for exemptions without resale restrictions. However, the SEC rules are exactly to the contrary. Rules 505 and 506, which restrict the number of purchasers, are subject to resale restrictions. Rule 504 and Regulation A, which do not restrict the number of purchasers, are not subject to resale restrictions.

C. The Net Effect of the Number of Purchasers

As the number of purchasers in an offering increases, the total benefit of registration increases. But so does the total cost. The net effect—whether an increase in the number of purchasers increases or decreases the net benefit of registration—depends on the relative magnitude of the two changes. If costs increase more rapidly than benefits as the number of purchasers increases, the net benefit of registration falls, and the case for exemption is stronger. If benefits increase more rapidly than costs as the number of purchasers increases, the net benefit of registration rises, and the case for exemption is weaker.

Figure E shows the possible relationships among costs, benefits, and the number of purchasers.

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182 See supra part III.A.1.
Line TB shows an increase in the total benefits of registration as the number of purchasers increases (the amount of the offering being held constant). The two cost curves in Figure E, TC\textsubscript{L} and TC\textsubscript{H}, illustrate the two possible relationships between costs and benefits.

TC\textsubscript{H} shows an increase in the costs of registration as the number of purchasers increases that is greater than the corresponding increase in benefits. As the number of purchasers increases, the net benefit of registration (TB - TC\textsubscript{H}) decreases. If TC\textsubscript{H} shows the true relationship between costs and the number of purchasers, limits on the number of purchasers, such as those in Rules 505 and 506, would not be efficient. The more purchasers there are, the stronger the case for exemption. In this scenario, exemptions for offerings with more than a specified number of purchasers might be justified. Registration might be efficient for a particular offering when there are only thirty purchasers but, due to the decreasing net benefit, inefficient when the same offering has three hundred purchasers.
TRANSACTION EXEMPTIONS IN THE SECURITIES ACT

TCₜ shows an increase in the costs of registration as the number of purchasers increases that is lower than the corresponding increase in benefits. As the number of purchasers increases, the net benefit of registration \((TB - TCₜ)\) increases. If TCₜ shows the true relationship between costs and the number of purchasers, limits on the number of purchasers, such as those in Rules 505 and 506, could be efficient. The greater the number of purchasers, the stronger the case for registration. Registration might be inefficient for a particular offering when there are only thirty purchasers but, due to the increasing net benefit, efficient when that same offering involves 300 purchasers.

Unfortunately, prior to this Article, none of the studies of the costs and benefits of registration have considered the effect of the number of purchasers. As a result, no empirical evidence is available, and it is therefore impossible to determine whether limits on the number of purchasers in Rules 505 and 506 are efficient. However, some theoretical observations can be made about those limits and the lack of purchaser limits in other exemptions.

1. Small Offering Exemptions

One of the small offering exemptions, Rule 505, is limited to offerings to no more than thirty-five nonaccredited purchasers. The other small offering exemptions, Rule 504 and Regulation A, contain no such limit. Two issues arise: (1) whether the thirty-five-purchaser limit in Rule 505 is efficient, and (2) whether there is any justification for treating Rule 505 offerings differently from offerings pursuant to Rule 504 or Regulation A.

a. Rule 505’s Thirty-Five-Purchaser Limit

As explained above, the economic efficiency of purchaser limits depends ultimately on the relative increase in the total benefit and the total cost of registration as the number of purchasers increases. A limit on the number of purchasers makes sense only if the net benefit (total benefit minus total cost) of registration increases as the number of purchasers increases. But, even if we assume this is true, the thirty-five-purchaser limit in Rule 505 still has a fundamental flaw.

To qualify for the Rule 505 exemption, an offering must meet two conditions: (1) the amount of the offering must not exceed $5 million and (2)
the number of nonaccredited purchasers must not exceed thirty-five. Figure F illustrates these two restrictions. The vertical axis represents the dollar amount of the offering and the horizontal axis represents the number of purchasers. Any offering with a purchaser/amount combination that falls within the shaded area is exempt from registration, assuming that the other requirements of Rule 505 are met. Any offering with a purchaser/amount combination that falls outside the shaded area must be registered (assuming that no other exemption is available).

Thus, offering A, a $5 million offering to thirty-five purchasers, is exempt. Assume that offering B on Figure F is a $5,001,000 offering to one purchaser and offering C is a $1000 offering to thirty-six purchasers. Offerings B and C must be registered—B because it is slightly above the $5 million limit and C because it is slightly above the thirty-five-purchaser limit.
To understand the flaw in Rule 505, assume that the SEC was correct in making Offering A the largest exempt offering—a $5 million offering to thirty-five purchasers is the point beyond which the net benefit of registration exceeds the net benefit of the Rule 505 intermediate disclosure rule. Offering A should be exempted, but one dollar or one purchaser more and the net benefit of registration is positive.

If the net benefit of registering Offering A is zero, what does that say about Offerings B and C? We know that the net benefit of registration increases as the amount of the offering increases and decreases as the amount of the offering decreases. And we are assuming that the net benefit of registration increases as the number of purchasers increases and decreases as the number of purchasers decreases. Thus, as we move from point A to point B, the net benefit of registration decreases because the number of purchasers falls and increases because the offering amount rises. Because point A represents a net benefit of zero, the net benefit of registering offering B is positive only if the marginal change that results from a slight increase in the dollar amount is greater than the marginal change that results from a drastic decrease in the number of purchasers. In other words, registration of Offering B is efficient only if the dollar amount has a greater effect than the number of purchasers on the net benefit of registration. But consider offering C. As we move from point A to point C, the net benefit of registration increases because the number of purchasers rises and decreases because the offering amount falls. Because point A represents a net benefit of zero, the net benefit of registering Offering C is positive only if the marginal change resulting from a slight increase in the number of purchasers is greater than the marginal change resulting from a drastic decrease in the dollar amount. In other words, registration of Offering C is efficient only if the number of purchasers has a greater effect than the dollar amount on the net benefit of registration. But this is exactly the opposite of what was necessary for the registration of Offering B to be efficient. Thus, if registration of Offering B is efficient, registration of Offering C is inefficient and vice versa.

The flat caps of $5 million and thirty-five purchasers for all offerings are the problem. Rule 505 does not effectively recognize the offsetting effects of changes in the offering amount and changes in the number of purchasers. An offering to thirty-six purchasers must be registered whether its amount is $50 million or $50,000. An offering of more than
$5 million must be registered whether it is to one or one hundred purchasers. A sliding scale would be more appropriate. If registration is efficient for a $5 million offering when the number of purchasers exceeds thirty-five, it might be efficient for a $3 million offering only if there are more than seventy-five purchasers, for a $1 million offering only when there are more than 150 purchasers, and so on.

b. Rule 505 and the Other Small Offering Exemptions

If a purchaser limit applies to Rule 505 offerings, shouldn’t it apply to all the small offering exemptions? What conceivable justification is there for limiting Rule 505 offerings to thirty-five purchasers, but not similarly limiting offerings pursuant to Rule 504 or Regulation A?

(1) Rule 504

Consider first Rule 504. Rule 504 has a $1 million limit, compared to Rule 505’s $5 million limit. This alone could justify a difference in their respective purchaser limits. We know that, holding everything else constant, the net benefit of registration increases as the dollar amount of the offering increases. Thus, the net benefit of registering a $5 million Rule 505 offering is greater than the net benefit of registering a $1 million Rule 504 offering, given that each has the same number of purchasers. Because of its greater dollar amount, the net benefit of registering a $5 million Rule 505 offering to thirty-five purchasers might be greater than for a $1 million Rule 504 offering to forty, fifty, or even sixty purchasers. In fact, if the dollar amount of the offering affects the net benefit of registration significantly more than the number of purchasers does, it is possible that registering a $1 million Rule 504 offering (with any reasonable number of purchasers) would never produce a positive net benefit even though registering a Rule 505 offering with thirty-six purchasers would. If so, having a thirty-five-purchaser limit for a $5 million Rule 505 offering and no limit for a $1 million Rule 504 offering could be efficient.

183 Whether this hypothesis is correct depends on the relative effect on net benefits of increasing the number of purchasers versus increasing the amount of the offering.
However, the distinction between Rule 504 and Rule 505 suffers from the same flaws as Rule 505 itself. It fails to account for marginal changes in the dollar amount of the offering or the number of purchasers. Not all Rule 505 offerings are for $5 million; the $5 million figure is a cap, not an absolute requirement. An issuer would prefer to use Rule 504 for offerings of less than $1 million because it is less restrictive, but Rule 505 offerings could range in amount from slightly more than $1 million to the full $5 million. The net benefit of registering a $1.1 million Rule 505 offering to thirty-six purchasers might not be greater than the net benefit of registering a $1 million Rule 504 offering to 200 purchasers. As indicated earlier, a sliding scale would be more defensible.

(2) Regulation A

The attempted distinction between Rule 504 and Rule 505 was based on the difference in their maximum dollar amounts. But what about the difference between Rule 505 and Regulation A? Both are intermediate-disclosure small offering exemptions limited to offerings of $5 million or less. Yet, Rule 505 has a thirty-five-purchaser limit, and Regulation A does not limit the number of purchasers. Is there an economic justification for this difference?

It is possible, of course, that the SEC is simply being inconsistent. Regulation A and Regulation D, which contains Rule 505, arose in different eras and their histories are quite different. However, other differences between the two rules might justify their different treatment of the number of purchasers. Regulation A issuers must file an offering statement

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and other sales material with the SEC. The information provided to nonaccredited purchasers in a Rule 505 offering does not have to be filed with the SEC. SEC review and verification of the disclosure required in a Regulation A offering could increase the benefit of that information to investors. If so, for any given number of purchasers, the incremental benefit of registering a Regulation A offering is less than the benefit of registering a comparable Rule 505 offering. Registration might be justified when there are thirty-six purchasers in a Rule 505 offering, but not for the same number of purchasers under Regulation A.

This argument, although plausible, presents several difficulties. First, it does not justify the complete absence of a limit on the number of purchasers in Regulation A; it merely justifies a higher limit. Even if the benefits of registering a Regulation A offering are less, as long as benefits increase faster than costs as the number of purchasers increases, the total benefit of registration should at some point exceed the total cost. The absence of a limit on the number of purchasers in Regulation A makes sense only if, for any likely number of purchasers in a $5 million offering, the incremental benefit of registration never exceeds the cost.

The second problem with the distinction between Regulation A and Rule 505 is that Rule 505 purchasers are subject to resale restrictions and Regulation A purchasers are not. Therefore, immediate secondary trading is less likely in a Rule 505 offering. Registration to some extent benefits those in the secondary trading market, and secondary trading becomes more likely as the number of purchasers increases. Because of this, as the number of purchasers increases, the benefits of registration should rise more rapidly for a Regulation A offering than for a Rule 505 offering. This at least partially offsets any differences in benefits due to SEC review of the Regulation A offering statement.

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187 Regulation D issuers are required to file a Form D notice, Rule 503(a), 17 C.F.R. § 230.503(a) (1995), but that form is not an investor-oriented disclosure document. See Form D, 2 Fed. Sec. L. Rep. (CCH) ¶ 7341.
188 If, for example, the net benefit of registering a Regulation A offering becomes positive only if there are 50,000 purchasers, it would be senseless to have a 50,000-purchaser limit if no issuer were ever expected to make such an offering.
A final problem with the argument that the net benefit of registering a Regulation A offering is less than the net benefit of registering a comparable Rule 505 offering is that it also justifies a difference in the dollar amounts of the two exemptions. If the net benefit of registering a Rule 505 offering to thirty-five purchasers becomes positive when the amount of the offering is $5 million, the net benefit of registering a Regulation A offering to thirty-five purchasers must be less at that point. Registration of a Regulation A offering would be efficient only if the dollar amount of the offering was some amount greater than $5 million. The dollar amount of the Regulation A exemption should, therefore, be greater than the dollar amount of the Rule 505 exemption. Thus, if the argument supporting the difference in the number of purchasers succeeds, the identity of the dollar amounts is wrong. Both aspects of the two exemptions cannot be efficient.

2. Deference and Sophisticated Offeree Exemptions

Another issue is whether it makes sense to limit the number of purchasers in sophisticated offeree or deference exemptions. None of the deference exemptions limit the number of purchasers, but Rule 506, a sophisticated offeree exemption, limits the number of nonaccredited purchasers to thirty-five.

The analysis of deference and sophisticated offeree offerings earlier in this Article\(^\text{180}\) showed that the benefits of registering such offerings generally are less than the benefits of registration. For sophisticated offeree offerings, this is because sophisticated offerees gain less from registration. For deference offerings, this is because an alternative regulator protects investors, and the benefits of registration are only the incremental benefits above the benefits already provided by the alternative regulator. Thus, for any given number of sophisticated purchasers (or purchasers protected by an alternative regulator), the total benefit of registration is less than it would be for the same number of nonsophisticated purchasers (or purchasers not protected by an alternative regulator).

\(^{180}\) See supra parts III.B.2 and III.C.2.
Figure G illustrates this point. TB and TC represent the total cost and total benefit of registration of an offering to nonsophisticated offerees not protected by an alternative regulator. Registration is efficient when the number of purchasers exceeds x. If that same offering is limited to sophisticated purchasers (or is protected by an alternative regulator), the total cost of registration, TC, is roughly the same. However, the total benefit, TBs, is much less. Now, registration is not efficient when the number of purchasers is x. At that point, registration still results in a negative net benefit. If TBs and TC intersect at all, it is not until the number of purchasers is much greater.

This analysis indicates that, even if a purchaser limit is justified for a Rule 506 offering, it should be greater than the limit in Rule 505. For offerings with the same dollar amount, the net benefit of registration becomes positive with fewer purchasers in a Rule 505 offering than in a Rule 506 offering. Clearly, one of the two rules is wrong.
This analysis cannot show whether the sophisticated offeree and deference exemptions should have limits on the number of purchasers. If the benefits of registration increase faster than the costs, as the number of purchasers increases, the \( TB_s \) and \( TC \) curves could intersect at some point, and registration would be cost effective. An unlimited exemption is justified only if one of two things is true: (1) For sophisticated offeree and deference offerings, the costs of registration increase more rapidly than the benefits as the number of purchasers increases, or (2) Total benefits exceed total costs only when the number of purchasers is so great that the limit will never be reached, and therefore no limit is needed.

V. The Economics of Integration

A. An Introduction to the Integration Doctrine

Special problems arise when a single issuer tries to utilize exemptions for two or more roughly contemporaneous offerings. Considered separately, the cost of registering either offering might exceed the benefit, justifying either exemption. But the fact that the issuer is making multiple offerings may affect the relevant costs and benefits. Economies in registering the two offerings together could make the cost of registering both offerings less than the sum of registering either alone. If so, if we consider the two offerings together, registration might be efficient.

The integration doctrine was developed by the SEC and the courts to define what constitutes a single, discrete transaction for the purpose of applying the transaction exemptions.\(^1\) The purpose of the doctrine is to prevent issuers from artificially dividing a single, nonexempt offering into two or more parts in an attempt to obtain an exemption for one or more of the parts.\(^1\) Assume, for example, that an issuer wants to sell $10 million worth of securities, half of that amount to unsophisticated investors residing in the issuer's home state and the other half to sophisticated institutional investors residing in another state. The sales to the resident unsophisticated investors, if considered alone, might qualify for exemption under section 3(a)(11) of the Act or Rule 147. The sales to the sophisticated investors, if considered alone, might qualify for exemption under

\(^{1}\) I Hazen, supra note 2, at 232.

\(^{1}\) Loss & Seligman, supra note 2, at 1211-12; Darryl B. Deaktor, Integration of Securities Offerings, 31 U. Fla. L. Rev. 465, 473 (1979).
section 4(2) of the Act or Rule 506. However, no single exemption is available for the combined offering. To avoid registration, the issuer might try to separate the single $10 million offering into two separate offerings and argue that a transaction exemption is available for each one. The integration doctrine attempts to prevent such manipulation of the transaction exemptions. In essence, it defines what constitutes a single offering. A transaction exemption is available only if the entire, integrated offering meets the exemption’s requirements.

The SEC takes a two-tiered approach to integration. First, it has developed a five-factor test to determine whether two or more transactions should be integrated and treated as a single offering. This five-factor test is discussed in part V.A.1. Second, the SEC has adopted several safe-harbor rules that protect offerings from integration if certain conditions are met. If a safe-harbor rule protects two offerings from integration, the five-factor test is not applied. The various integration safe-harbors are briefly discussed in part V.A.2.

Integration should not be confused with a related concept known as aggregation. The concept of aggregation is used in the small offering exemptions to determine the dollar amount of the offering. In some cases, securities sold in other offerings may have to be included in that dollar amount, thus reducing the available amount, even if the other offerings would be treated as discrete under the integration doctrine. The concept of aggregation is discussed in part V.B.

In part V.C, I turn to the economics of the integration doctrine and analyze the effect of multiple offerings on the costs and benefits of registration.

1. The Five-Factor Test

The integration doctrine was developed shortly after the Securities Act was enacted. In late 1933, the Federal Trade Commission, which at the time was charged with enforcement of the Act, ruled that an issuer could not sell part of an issue using the intrastate offering exemption and then sell the rest of the issue in an interstate, registered public offering.\[199\] The

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issue arose in several subsequent SEC releases and proceedings, but the SEC did not formally articulate a standard for integrating offerings until 1961. This now well-known five-factor test considers whether:

1. the different offerings are part of a single plan of financing;
2. the offerings involve issuance of the same class of security;
3. the offerings are made at or about the same time;
4. the same type of consideration is to be received in each offering; and
5. the offerings are made for the same general purpose.

The exact meaning of each of these factors has never been totally clear. The two SEC releases that established the five-factor test made no attempt to explain it, and subsequent SEC interpretations have been confusing. Not all of the factors must be present to integrate two offerings, and two of the factors—whether there is a single plan of financing and whether the offerings are for the same general purpose—are generally given greater weight than the others. These two factors tend to overlap. To the extent there is a difference, “plan of financing” refers to things like “the method of offering the security, the timing of plans for raising capital, and whether the offerings are financially interdependent.” The intent of the issuer at the time of the first offering may be determinative in deciding whether a single plan of financing was contem-
The purpose factor refers more to the use of the proceeds—the project or projects for which the funds are needed. The "same class of security" factor is also important. When different classes of securities are offered, the courts and the SEC generally will not integrate, even if the differences between the two classes are small. The "same type of consideration" factor has rarely been a significant reason for integrating two offerings, because most offerings are for cash. However, different types of consideration have been cited to justify not integrating two offerings. The meaning of the timing factor is self-evident. It is unclear exactly how close in time two offerings must be, but a six-month separation may create a presumption against integration.

2. Integration Safe Harbors

The SEC has also adopted several rules that provide safe harbors from integration. Integration safe harbors appear in Rule 152, Rule 147, Regulation D, Regulation A, Regulation S, Rule 701, and Rule 144A. If a safe harbor protects an offering from integration, the five-factor test does not apply. However, the safe harbors are not exclusive. Offerings which do not fall within an integration safe harbor are not automatically integrated, but are subject to the usual five-factor analysis.

204 Cox et al., supra note 129, at 436-37; Wade, supra note 202, at 212-13.
205 Loss & Seligman, supra note 2, at 1214.
206 Loss & Seligman, supra note 2, at 1219-20; Wade, supra note 202, at 217.
207 Cox et al., supra note 129, at 437; Loss & Seligman, supra note 2, at 1222.
208 Loss & Seligman, supra note 2, at 1222; Wade, supra note 202, at 218.
209 The availability of the integration safe harbors, discussed below, turns mainly on the amount of time separating two offerings. See infra Part V.A.2.
211 Cox et al., supra note 129, at 437.
212 For example, a note to the Rule 502(a) integration safe harbor in Regulation D provides: If the issuer offers or sells securities for which the safe harbor rule in paragraph (a) of this Rule 502 is unavailable, the determination as to whether separate sales of securities are part of the same offering (i.e. are considered "integrated") depends on the particular facts and circumstances. . . . 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 being received; and
a. Rule 152

Rule 152, adopted in 1935, was the SEC's first integration safe harbor. It protects section 4(2) private offerings from integration if "subsequently thereto the issuer decides to make a public offering and/or files a registration statement." In a series of no-action letters, the SEC staff has held that Rule 152 applies when an issuer files a registration statement after a section 4(2) private offering is completed or abandoned even if the public offering was already contemplated when the private offering was initiated. Rule 152 applies even if the section 4(2) securities are not issued until after the public offering, as long as the decisions to invest were made before the public offering.

b. Rule 147

Rule 147, the intrastate offering safe harbor, contains an integration safe harbor. Rule 147(b)(2) establishes a six-month envelope before and after the Rule 147 offers and sales. The safe harbor protects the Rule

(e) Whether the sales are made for the same general purpose. See Release No. 33-4552 (November 6, 1962).


218 Rule 147(b)(2) provides:

For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemption provided by section 3 or section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, for sale or sales pursuant to this rule, provided, that, there are during either of said six month periods no offers, offers for
147 offering against integration with registered or exempted offers and sales outside the envelope. However, the Rule 147(b)(2) safe harbor is not available, even for offers and sales outside the envelope, if any securities of the same or a similar class as those in the Rule 147 offering are offered or sold within the envelope.\(^{219}\)

c. **Regulation D**

Regulation D’s integration safe harbor is similar to that in Rule 147. That safe harbor, Rule 502(a), also establishes a six-month envelope before and after the Regulation D offers and sales.\(^{220}\) Offers and sales outside that envelope which are registered or exempted from registration will not be integrated into the Regulation D offering. As with Rule 147(b)(2), the safe harbor is usually not available if securities of the same or a similar class to those being offered in the Regulation D offering are sold within the envelope.\(^{221}\)

d. **Regulation A**

Regulation A contains the SEC’s most recent integration safe harbor, added in 1992 when the SEC substantially revised the Regulation A exemption.\(^{222}\) This safe harbor, Rule 251(c),\(^{223}\) protects three categories of offerings from integration with Regulation A offerings:

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sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.


\(^{219}\) Id.

\(^{220}\) Rule 502(a) provides:

All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in rule 405 under the Act.


\(^{221}\) The Rule 502(a) safe harbor remains available if the offers or sales within the envelope are pursuant to an employee benefit plan. 17 C.F.R. § 230.502(a) (1995).


\(^{223}\) Rule 251(c) provides:
(1) all offers or sales prior to the Regulation A offering;\(^{224}\)

(2) offers or sales made more than six months after the completion of the Regulation A offering;\(^{225}\) and

(3) even within the six-month period, subsequent offers or sales that are registered, in reliance on the Rule 701 exemption, pursuant to an employee benefit plan, or in reliance on Regulation S.\(^{226}\)

e. Rule 701

Rule 701 exempts offerings pursuant to certain compensatory benefit plans or compensation contracts. It contains an exceptionally broad integration safe harbor. Rule 701(b)(6) protects the Rule 701 offering from integration with “any other offering or sale whether registered under the Act or otherwise exempt from the registration requirements of the Act.”\(^{227}\)

f. Regulation S

Regulation S exempts certain offerings of securities to persons outside the United States when there are no selling efforts within the United

Integration with Other Offerings. Offers and sales made in reliance on this Regulation A will not be integrated with:

(1) prior offers or sales of securities; or

(2) subsequent offers or sales of securities that are:

(i) registered under the Securities Act, except as provided in [Rule 254(d)];

(ii) made in reliance on [Rule 701];

(iii) made pursuant to an employee benefit plan;

(iv) made in reliance on Regulation S [Rules 901-904]; or

(v) made more than six months after the completion of the Regulation A offering.


\(^{226}\) Rule 251(c)(2)(i)-(iv), 17 C.F.R. § 230.251(c)(2)(i)-(iv) (1995). The provision protecting subsequent registered offerings from integration states that this protection is available “except as provided in [Rule 254(d)].” Id. § 230.251(c)(2)(ii). Rule 254(d) applies only when an issuer has begun to solicit interest in a Regulation A offering, as allowed by Rule 254, and decides to abort the Regulation A offering and register the offering instead. Rule 254(d), 17 C.F.R. § 230.254(d) (1995). The interaction of Rule 251(c) and Rule 254(d) is explained in Bradford, supra note 223, at 281-83.

States. Regulation S has no formal integration safe harbor, but the SEC has long taken the position that it will not integrate domestic offerings with simultaneous offerings made abroad solely to foreign investors. However, the SEC has indicated that this nonintegration position is only a "general view" and that "the parameters of the nonintegration position will continue to be developed through the no-action and interpretive process." Thus, the protection against integration is not as strong as that provided by an actual integration safe harbor.

\[g. \text{ Rule 144A}\]

Rule 144A, which exempts resales of previously issued securities to qualified institutional buyers, also contains an integration safe harbor. Rule 144A(e) provides: "Offers and sales of securities pursuant to this section shall be deemed not to affect the availability of any exemption or safe harbor relating to any previous or subsequent offer or sale of such securities by the issuer or any prior or subsequent holder thereof." The Rule 144A(e) integration safe harbor may in limited cases protect an original offering of securities by an issuer from integration with other offer-
B. Aggregation

The integration doctrine should not be confused with a related concept known as aggregation, which relates to the dollar amount limits in the small offering exemptions. The small offering exemptions are available only if the offering does not exceed the maximum aggregate offering price.\(^{234}\) If an offering exceeds the maximum amount, the exemption is lost for the entire offering, not just for those securities sold after the maximum is reached.\(^{236}\)

The “aggregation” provisions of Regulation A and Rules 504 and 505 of Regulation D require that the maximum dollar amount available be reduced by the amount of other specified sales of securities. Rule 504, for example, provides for a maximum aggregate offering price of $1 million, “less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this [Rule 504], in reliance on any exemption under section 3(b), or in violation of section 5(a) of the Securities Act.”\(^{238}\) Rule 505’s aggregation provision is similar.\(^{237}\) Regulation A used to contain similar language,\(^{238}\) but it

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233 See Bradford, supra note 232, at 53-57.


235 Prior to the 1992 amendments, Regulation A provided that the aggregate offering price should be calculated including the aggregate offering price of all securities of the issuer offered or sold pursuant to . . . [Regulation A] . . . and any other securities offered or sold within 1 year prior to the commencement of the proposed offering pursuant to any other exemption under section 3(b) of the Act or in violation of section 5(a) of the Act.

was amended in 1992 to provide that only sales pursuant to Regulation A reduce the allowable aggregate offering price.\textsuperscript{239}

Integration and aggregation, although related, are quite distinct. The aggregation rules apply whether or not the two offerings would be integrated.\textsuperscript{240} Aggregation has some, but not all, of the consequences of integration. In effect, the two offerings are considered a single offering only for the purpose of calculating the dollar amount. If the two offerings together exceed the allowable dollar amount, there is a violation. However, if the two offerings do not exceed the maximum dollar amount, it is irrelevant that the prior, aggregated offering does not meet other requirements of the exemption.

\section*{C. The Economics of Integration}

\subsection*{1. Introduction}

The SEC has paid little or no attention to the economics of the integration doctrine. It has instead tried to define the concepts "offering" and "part of an issue" metaphysically.\textsuperscript{241} This misdirected focus is unfortunate because the economic model developed in this Article provides several insights into the integration problem. In some instances, the SEC's approach makes sense; in other instances, it does not.

\subsection*{2. The Integration of Sophisticated Offeree Offerings With Other Offerings}

Consider first the sophisticated offeree exemptions. The economic argument for the sophisticated offeree exemptions depends on the reduced ben-


The sophisticated offeree exemptions have no dollar amount limitations. For this to be efficient, the total benefit of registration must never exceed the total cost, no matter how large the offering. The failure to cap the dollar amount of sophisticated offeree offerings may be a mistake. Registration of a sophisticated offeree offering may be efficient once the offering exceeds some maximum dollar amount. If so, sophisticated offeree offerings should be treated like any other offering for integration purposes. But assume that the sophisticated offeree exemptions are structured properly; assume, in other words, that the total benefit of registration never exceeds the total cost. Then, the effect on integration is clear and categorical: a sophisticated offeree offering should never be integrated with any other offering. The presence of other offers or sales should not affect the sophisticated offeree exemptions.

a. Two Sophisticated Offeree Offerings

It is easy to see why integration of one sophisticated offeree offering with another sophisticated offeree offering should not eliminate either exemption. Considering the two offerings as one merely increases the dollar amount of the offering. Nothing else changes. The offerees in the combined, integrated offering would still be sophisticated, and the cost and benefit curves would not change in any way. If the amount of the offering does not affect the economics of the sophisticated offeree exemptions, the total cost of registration would still exceed the total benefit, even after integration.

See supra text accompanying notes 128-29. Thus, the cap is ineffective.

See infra part V.C.3.
Figure H illustrates this point. TC and TB are the total cost and total benefit of registering a sophisticated offeree offering. TB is never greater than TC, no matter what the dollar amount.

Assume that one offering, in the amount of $x$, qualifies for a sophisticated offeree exemption if considered alone. The total cost of registration exceeds the total benefit; considering this offering in isolation, registration is inefficient. Assume that a second offering, in the amount of $y$, also qualifies for a sophisticated offeree exemption if considered by itself. At $y$, the total cost of registration exceeds the total benefit so registration of the second offering is also inefficient. If the two offerings are integrated and considered as a single offering, the dollar amount of the combined offering is $(x + y)$. But the dollar amount is all that is affected. The total cost and total benefit curves are unchanged; combining the two offerings is simply a move along those curves. If, as hypothesized, total benefits
never exceed total costs, no matter how large the offering, registration is still inefficient. Integration has no effect.

b. A Sophisticated Offeree Offering and Another Type of Offering

It also is not economically efficient to require registration when a sophisticated offeree offering is made contemporaneously with some other type of exempted offering. However, this conclusion is evident only when the marginal costs and benefits of registration per dollar amount of the offering are considered.

We are assuming that, for any dollar amount, the total cost of registration for a sophisticated offeree offering exceeds the total benefit. If this is true, then the marginal cost of registration for each additional dollar raised is probably greater than the marginal benefit.\(^{246}\) If the marginal benefit were greater than the marginal cost as the dollar amount in-

\(^{246}\) Technically, marginal cost (MC) does not have to exceed marginal benefit (MB) at all points in order for total cost (TC) always to exceed total benefit (TB). Consider, for example, the following MC and MB curves:

![FIGURE I](chart.png)
creased, the total benefit of registration would eventually exceed the total cost.

This marginal analysis makes it clear why integration with other offerings should not eliminate a sophisticated offeree exemption. Assume that an offering to sophisticated offerees is made at the same time as an offering pursuant to some other exemption—for instance, a small offering. Figure J shows the cost and benefit curves for the small offering, considered by itself.

![Figure J](image)

The total benefit of registration exceeds the total cost only when the dollar amount of an offering exceeds $x. Because we are assuming the small offering is exempt, it must be for less than $x. Assume that the dollar amount of the small offering is $y.

The MC curve dips below the MB curve for certain offering amounts, but, as long as the cross-hatched area is larger than the shaded area, TC will always exceed TB.
What happens when we combine this small offering with a sophisticated offeree offering and treat them as one? The fixed costs of registration are already factored into the TC curve in Figure J; we do not need to add them again to compute the total cost of registering the combined offering. When we add the sophisticated investors to the small offering represented in Figure J, the only additional costs and benefits of registration would be the marginal costs and benefits associated with the additional sophisticated investors. Because the marginal costs of registration exceed the marginal benefits for sophisticated offerees, adding them to the small offering should not change the result. The total cost of registration will still exceed the total benefit. Figure K illustrates this result.

The cost and benefit curves up to dollar amount $y$ are the total cost and total benefit for the small offering. After $y$, the total cost and total benefit curves increase by the marginal cost and benefit for sophisticated offerees. Because this marginal cost is greater than the marginal benefit, the total cost of registration for the combined offering still must exceed the total
benefit. Even when we consider the offerings together, registration is not efficient.\textsuperscript{247}

The result would be the same if the offering to nonsophisticated offerees was a registered offering—if the issuer simultaneously made both a registered public offering and a sophisticated offeree offering. Assume, consistent with the initial assumption in this Article, that registering the public offering alone results in a positive net benefit. Because the marginal cost of registering an offering to sophisticated offerees exceeds the marginal benefit, the marginal net benefit of including the sophisticated offerees in the registration has to be negative. Combining the two offerings in a registration thus produces a lower net benefit than registering the public offering alone. Therefore, it is not efficient to register the sophisticated offeree offering; it should retain its exemption.

3. The Integration of Two Small Offerings

The question of whether to integrate two small offerings seems deceptively simple: Total the dollar amounts of the two offerings and require registration if the combined dollar amount exceeds the offering amount at which the total benefit of registration exceeds the total cost. Unfortunately, the issue is more complicated than that. The simple approach works only if the two small offerings are virtually identical in all respects.

\textsuperscript{247} The SEC has implicitly recognized this view, but not in the context of initial offerings by issuers. Resales of securities to qualified institutional buyers, who are sophisticated investors, are given extensive protection from integration. See Rule 144A(e), 17 C.F.R. § 230.144A(e) (1995).
Figure L is based on Figure B, the earlier graphical examination of the small offering exemptions. \( TBR \) and \( TCR \) represent the total cost and total benefit of registration for any given offering amount. \( TB_i \) and \( TC_i \) represent the total cost and total benefit of an intermediate disclosure small offering exemption like Rule 505. I previously showed that it is efficient to fully exempt from registration offerings whose dollar amount is less than \( Sy \), to allow the intermediate exemption for offerings whose dollar amount is between \( Sy \) and \( Sz \), and to require the registration of offerings whose dollar amount exceeds \( Sz \).

Assume now that an issuer engages in two separate small offerings, each with a dollar amount less than \( Sy \). Considered alone, either one should be exempt from registration (and from intermediate disclosure) because the total cost of registration (and of intermediate disclosure) exceeds the total benefit. But what happens when we consider the two small offerings together? The simplest approach would be to add the dollar amounts
of the two offerings. If their combined dollar amount is less than $y$, they should be exempted from registration. If their combined dollar amount is between $y$ and $z$, registration should not be required, but they should be relegated to an intermediate disclosure exemption. If their combined dollar amount exceeds $z$, registration should be required.

This simple approach is easy, theoretically plausible, and, in some cases, demonstrably incorrect. It assumes that the costs and benefits of registering the two offerings are perfectly additive—that combining the two offerings merely moves one along the TB and TC curves and does not change the shapes of the curves in any significant way. This assumption is justifiable if the two small offerings are roughly identical. However, if the two offerings are dissimilar in important ways, registering the combined offering could produce a lower net benefit than the simple, additive view would suggest.

Surprisingly, the much-maligned five-factor integration test developed by the SEC helps to determine when the additive view is likely to be correct and when, because of differences between the two offerings, integration makes less sense. All five factors have at least some relevance to the costs and benefits of registering the combined offering.

Consider first the “same class of security” factor. If the two offerings involve different securities with different rights, the economies of scale in registration are less than if both offerings involve the same security. Different disclosure will have to be provided in discussing the rights and liabilities of each class of security. There is a corresponding reduction in benefit to investors. If the two securities have greatly different rights, investors might be confused by a common registration statement. Because of this confusion, the benefit to investors of common registration is less per dollar invested than if each offering involved the same security. Because costs are higher and benefits are lower, the net benefit of common registration is less when the two offerings do not involve the same class of security.

I do not mean to suggest that the five-factor test was based on economic analysis. The five factors were proposed as a way to answer the metaphysical question of what an “offering” was; no economic rationale was offered. See supra note 241 and accompanying text.

I also do not claim that the five-factor test is a complete way of measuring costs and benefits for integration purposes, only that the five factors have some relevance.
The analysis of the "same general purpose" factor is similar. If the two offerings have wholly different purposes, the costs of disclosure will be slightly higher than they would be if the proceeds of the two offerings were to be used on the same project. Each project must be disclosed separately, even in a combined registration statement. Thus, the cost reduction in combining the two into a single registration statement is not as great. On the benefit side, the same potential for confusion exists. Investors might confuse the two projects, producing lower benefits per dollar invested than if each offering was for the same purpose.

The "same consideration" factor has a similar effect on the costs and benefits of registration. If materially different types of consideration are given by investors in the two offerings, separate disclosure will be required. And investors might be confused about matters that turn on consideration, such as expected returns and the dilutive effects of the offering.

The "single plan of financing" factor often serves merely as a surrogate for other factors, especially the "same or similar purpose" factor. To the extent that this is true, the previous discussion applies to it as well. But the analysis of the "single plan of financing" factor also focuses on the intent of the offeror: when the offeror initiated the first offering, was the second offering planned as part of the same financing plan? This focus on the issuer's intent also fits the cost-benefit analysis. If the second offering was already planned or anticipated at the time of the first offering, the issuer could have registered the two offerings together. If the second offering was not planned or anticipated at the time of the first offering, the cost savings associated with combining the two could not have been achieved. Registration of the combined offering simply was not a possibility. At the time of the first offering, the issuer could not register a second offering which the issuer did not yet contemplate making. At the time of the second offering, the choice is only between registering the second offering alone or exempting it. If the second offering considered alone qualifies for an exemption, integration is inefficient. The economies of scale that the integration doctrine contemplates could not occur in this context. Integration in this context imposes an additional cost on issuers whenever they engage in an exempted offering of securities: the risk that an unexpected future offering may have to be registered. This additional cost of registration has no corresponding benefit.
The fifth factor, whether the offerings are at or about the same time, raises similar concerns. To some extent, separation in time is a proxy for the intent part of the "single plan of financing" test. The further apart in time two offerings are, the less likely it is that the second offering was anticipated at the time of the first and the weaker the argument for economies of scale in registering the combined offering. However, the time between the two offerings also affects the cost-benefit tradeoff in other ways. A substantial delay between two offerings increases the cost of registering them together because the information in the registration statement could be stale by the time of the second offering. The issuer would have to update the information for the second offering or possibly substitute a new prospectus. Thus, the reduction in costs due to combining the offerings is not as great as it would be if the two offerings were simultaneous. If updating is not required, costs are minimized, but only by reducing the benefits of registration. The less current the information, the less investors in the second offering benefit. Thus, the greater the delay between the two offerings, the smaller the net benefit of registering the combined offering and the weaker the argument that registration is efficient.

Economic theory cannot indicate exactly how far apart in time two offerings must be before integration is no longer justified. There is nothing magical about the six-month period in most of the integration safe harbors. Depending on how much the net benefit of registration changes as the time between two offerings increases, either a longer or a shorter period might be justified. The SEC certainly has not offered any economic justification for the six-month period. However, this analysis does support the concept, if not the exact time limit, of the SEC's temporal safe harbors. If a significant period of time separates two offerings, they should not be integrated.

Thus, the five factors considered by the SEC in deciding whether to integrate offerings have some justification in economic theory. However, the application of the five-factor test in practice has been less than optimal. One problem is that the test itself is uncertain and poorly defined.

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249 See Deaktor, supra note 192, at 517-18 (arguing for a 90-day integration safe harbor); Perry E. Wallace, Jr., Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses, 45 Wash. & Lee L. Rev. 935, 972-73 (1988) (suggesting that a three-month interval would benefit small businesses).

250 I Hazen, supra note 2, at 233; Frame, supra note 210, at 865.
Neither the SEC nor the courts "have ever adequately articulated how these factors are to be weighed or how many factors must be present in order for integration to occur." To further complicate matters, SEC no-action letters interpreting the five-factor test are confusing and sometimes inconsistent. An American Bar Association subcommittee labelled the no-action letters dealing with integration "difficult to reconcile even when dealing with similar fact situations involving the same subject matter." According to one author, the integration doctrine "frustrate[s] issuers engaged in the capital formation process, engulfing them in a sea of ambiguity, uncertainty, and potential liability."

The uncertainty of the five-factor test is costly. It increases the risk to issuers, potentially chilling even offerings that should not be integrated. It increases the legal costs of issuers because issuers are more likely to need legal advice and because it is harder for lawyers to predict the SEC's position. It increases the possibility of mistakes by the SEC staff in particular cases and also the cost of administering the integration doctrine. Thus, although the five factors are relevant to the economic analysis of integration, using them may cost more than they are worth.

More certain rules, such as the integration safe harbors, could be underinclusive or overinclusive. They might fail to integrate offerings in which registration is efficient, or they might require integration in cases in which registration is inefficient. But the gains associated with more certain

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251 Rutheford B. Campbell, Jr., The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems That Need Attention, 74 Ky. L.J. 127, 164 (1985-1986). Accord, Committee on Federal Regulation of Securities, Integration of Securities Offerings: Report of the Task Force on Integration, 41 Bus. Law. 595, 623 (1986); Wade, supra note 202, at 222; Wallace, supra note 249, at 940. "In a number of no-action letters, a single criterion established in the release has taken precedence over the remaining four." Committee on Federal Regulation of Securities, supra, at 623. "Additionally, the SEC staff and the courts have rendered interpretations of the integration doctrine that appear to invoke factors other than" the five listed. Wallace, supra note 249, at 940.

252 Subcommittee on Partnerships, Trusts and Unincorporated Associations, Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering, 37 Bus. Law. 1591, 1605 (1982); Wade, supra note 202, at 221; Wallace, supra note 249, at 958.

253 Subcommittee on Partnerships, Trusts and Unincorporated Associations, supra note 252, at 1605.

254 Wallace, supra note 249, at 989.

255 See Ehrlich & Posner, supra note 21, at 262-63; Kaplow, supra note 21, at 605.

256 See Kaplow, supra note 21, at 569-71.

257 See Diver, supra note 21, at 74; Ehrlich & Posner, supra note 21, at 266-67.

258 See Diver, supra note 21, at 73; Ehrlich & Posner, supra note 21, at 268.
rules—reducing the risk to issuers and the other costs of imprecision—could outweigh the costs associated with underinclusiveness or overinclusiveness, especially because the application of the five-factor test appears so imprecise and inconsistent.\textsuperscript{259}

4. The Integration of a Deference Offering and Another Offering

The economics of deciding whether to integrate two deference offerings is similar to that for two small offerings. If the deference exemptions apply, the total benefit of registration for either offering alone\textsuperscript{260} is less than the total cost of registration for that offering: $TB_1 < TC_1$ and $TB_2 < TC_2$. If there are economies of scale in registering the two offerings together, then the total cost of registering the two offerings together is less than the sum of the costs of registering the two offerings separately: $TC_{(1+2)} < TC_1 + TC_2$. Because the benefits of registration are roughly additive, the total benefit of registering the two offerings together is the sum of the benefits of registering either offering separately: $TB_{(1+2)} = TB_1 + TB_2$. Because $TB_1 < TC_1$ and $TB_2 < TC_2$, we know that $TB_1 + TB_2 < TC_1 + TC_2$. However, because $TC_{(1+2)} < TC_1 + TC_2$, one cannot determine mathematically whether the benefit of registering the combined offering, $TB_{(1+2)}$, is greater or less than the cost, $TC_{(1+2)}$. The answer to this question depends on the same factors discussed with respect to the integration of two small offerings.

However, the deference exemptions have no dollar limit: no matter how large a deference offering is, it is still exempted. As with the sophisticated offeree exemptions, the lack of a limit on the amount of the offering is efficient only if, for each additional dollar, the marginal cost of registration always exceeds the marginal benefit.\textsuperscript{261} But, if this is true, integration should never destroy a deference exemption. Adding these marginal costs and benefits to the costs and benefits of registering some other offering can

\textsuperscript{259} Given the difficulty in calculating the costs and benefits of registration, it is impossible to determine if the SEC's application of the five-factor test in any given no-action letter is economically correct. However, if, as many critics have argued, the SEC's interpretations are inconsistent—dissimilar results in similar cases—it is certain that at least some of those interpretations are incorrect.

\textsuperscript{260} The total benefits and costs are, of course, the incremental benefits and costs of SEC regulation, assuming that the alternative regulator is acting.

\textsuperscript{261} See supra text accompanying note 169.
never produce an economic gain. Thus, the same argument made for the sophisticated offeree exemptions\textsuperscript{262} applies to the deference exemptions. If the absence of a dollar limit is efficient, integration should never eliminate a deference exemption.

5. The Treatment of Isolated Sales

The analysis above should make it apparent that single, isolated sales of a small dollar amount should not affect whether a separate, larger offering is exempted. Consider first a small offering exemption. Assume, for example, that an issuer makes an offering which qualifies for exemption under Rule 505. Shortly thereafter, the same issuer sells $500 worth of the same security to a single purchaser in a transaction that does not qualify for Rule 505. Should that single sale be integrated with the Rule 505 offering to destroy the Rule 505 exemption? From a cost-benefit standpoint, the answer is usually no.

For the Rule 505 exemption to be justified for the large offering, the total benefit of registration must be less than the total cost. Combining the single $500 sale and the Rule 505 offering is unlikely to affect substantially the calculation of net benefits. Factoring in the $500 sale will change a negative net benefit of registration to a positive net benefit only if the extra $500 pushes the offering above the $5 million cap (assuming that $5 million is the point at which registration becomes efficient). If that is the case, then registration should be required. But the integration doctrine is not needed to produce this result. The concept of aggregation suffices: the isolated sale should be considered in calculating the dollar amount available under Rule 505. In deciding whether registration should be required, the fact that the isolated sale does not meet other requirements of Rule 505 is irrelevant.

VI. Conclusion

The economic model developed in this Article provides a lens through which to view the transaction exemptions in the Securities Act. With that lens, one is able to analyze the economics of the registration requirement and the exemptions from that requirement. The model shows why small

\textsuperscript{262} See supra part V.C.2.
offering, sophisticated offeree, and deference exemptions could be efficient, and why certain features of the current exemptions are problematic.

The analysis provided by the model is useful, but incomplete. The model leaves several important questions unanswered: What exactly should the dollar limit of the small offering exemptions be? What disclosure should be required for the intermediate disclosure exemptions? Who should be considered sophisticated? To what other regulators should the SEC defer? Better empirical data would allow us to answer some of these remaining questions; others are likely always to turn on educated guesses, given the difficulty of measuring things like the benefits of registration.

In brief, the model developed here offers a starting point—a map towards further empirical work and an invitation to further refinements. The model takes us a long way toward understanding the transaction exemptions in the Securities Act, but further work is needed.