

July 1984

New Montana Exemptions to Securities Registration

John G. Crist
University of Montana School of Law

Follow this and additional works at: <https://scholarworks.umt.edu/mlr>



Part of the [Law Commons](#)

Let us know how access to this document benefits you.

Recommended Citation

John G. Crist, *New Montana Exemptions to Securities Registration*, 45 Mont. L. Rev. (1984).
Available at: <https://scholarworks.umt.edu/mlr/vol45/iss2/5>

This Comment is brought to you for free and open access by ScholarWorks at University of Montana. It has been accepted for inclusion in Montana Law Review by an authorized editor of ScholarWorks at University of Montana. For more information, please contact scholarworks@mso.umt.edu.

COMMENTS

NEW MONTANA EXEMPTIONS TO SECURITIES REGISTRATION

John G. Crist

I. INTRODUCTION

Persons who wish to raise capital through the sale of securities¹ face a myriad of legal problems. Chief among these is the cost and complication of registering the securities with the Securities and Exchange Commission (SEC) and the Montana Securities Department (Department). In the past two years new federal and state exemptions from registration have been created to simplify and add certainty to the process of selling securities. This comment discusses these exemptions, in particular, how an issuer can use complementary federal and state exemptions to make sales in compliance with applicable securities laws.

II. BACKGROUND

A. *The Statutory Framework*

The Securities Act of 1933² requires issuers to register with the SEC any securities sold by use of interstate commerce.³ Once

1. The Securities Act of 1933 defines securities to include: any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77(b)(1) (1982).

While a thorough definition of "security" is beyond the scope of this comment, practitioners should familiarize themselves with two tests courts have used to define "security." The first is the "investment contract" test. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). The second is the "risk capital" test. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 13 Cal. Rptr. 186, 361 P.2d 906 (1961); *Great Western Bank & Trust v. Kotz*, 532 F.2d 1252, 1256-58 (9th Cir. 1976).

2. 15 U.S.C. § 77(a)-(aa) (1982).

3. Securities Act of 1933, § 5, 15 U.S.C. § 77(e) (1982). Interstate commerce is broadly

the registration has been approved, the issuer may sell securities only if it delivers a prospectus containing investment information to each potential purchaser.⁴ Similarly, it is unlawful to sell securities in Montana unless they have been registered.⁵ Failure to register a security or the sale of securities without giving investors adequate information can result in both criminal and civil liability.⁶

The policy behind securities laws is to foster confidence in the securities market and protect the public from fraudulent securities transactions. Persons are provided with the information necessary to evaluate legitimate investment opportunities while federal and state regulatory agencies can prevent fraudulent financings. But the cost of registration, attorney's fees and drafting a disclosure document is high. Small businesses often find such requirements severe impediments to raising capital to pursue new business ideas. In response to this need, both the SEC and the Montana Securities Department have created exemptions from federal⁷ and state⁸ registration. These attempt to balance the need to protect consumers against the nation's interest in the development of small business.⁹ These exemptions evolved over fifty years and can best be understood in their historical context.

B. *Prior Federal Exemptions*

Section 4(2) of the Securities Act exempts from federal registration "transactions not involving any public offering" of securities.¹⁰ Until the Supreme Court interpreted this section in 1953, issuers had little to guide them in structuring exempt transactions. In *SEC v. Ralston Purina Co.*,¹¹ the Court held offerings were public, and therefore not exempt from registration, if the persons purchasing the security were in need of protection under the Securities Act and did not have access to the information necessary to make an informed investment decision. Later cases indicated

defined to include any transportation of securities materials physically or by mail, or the use of other communication instrumentalities in interstate commerce.

4. *Id.*

5. MONT. CODE ANN. § 30-10-202 (1983).

6. MONT. CODE ANN. §§ 30-10-306, -307 (1983).

7. Regulation D, 17 C.F.R. §§ 230.501-.506 (1983).

8. MONT. ADMIN. R. 6.10.120-.123 (1984); 1984 Mont. Admin. Reg. 352, 588 (to be codified at MONT. ADMIN. R. 6.10.124).

9. It must be emphasized that exemptions from registration in no way insulate the issuer from either state and federal anti-fraud statutes or civil fraud actions brought by purchasers.

10. Securities Act of 1933, § 4(2), 15 U.S.C. § 77(d)(2) (1982).

11. 346 U.S. 119 (1953).

that the number of offerees had to be limited,¹² investors had to have information equivalent to that in a registration statement even if they were experienced businessmen,¹³ and investors had to be given an opportunity to inspect the corporate records on which the assertions in a prospectus were based, even where the prospectus provided information equivalent to that in a registration statement.¹⁴ If investors were not given this information, the offering was considered public and registration was required.

The unpredictability of the courts in interpreting section 4(2) of the Securities Act made reliance on that exemption hazardous. To bring some order to this area of the law, the SEC issued Rules 146, 240, and 242 from 1974 to 1980.¹⁵ Rule 146 clarified the existing law, but had two extremely onerous requirements. The issuer had a duty to investigate each offeree and assure itself he was "qualified."¹⁶ An offeree was qualified if he had sufficient business sophistication to evaluate the risks of the purchase or if he was wealthy enough to bear the loss.¹⁷ In addition, a disclosure document required by Rule 146 had to provide information roughly equivalent to that in a full registration prospectus.¹⁸ Thus Rule 146, while clarifying the state of the law, did little to reduce its burdens. Some large issuers could benefit from this certainty. The small issuer, however, simply did not have the resources to do the thorough background checks of investors or to create the offering document.¹⁹

Some relief came with the adoption of Rule 240 in 1975.²⁰ The qualification and disclosure document requirements were removed for businesses issuing up to \$100,000 in securities in a twelve-month period.²¹ The \$100,000 limit, however, severely restricted use of this exemption by many small investors.

12. Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

13. *Id.*

14. SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).

15. 17 C.F.R. §§ 230.146, -.240, -.242 (1981) (rescinded effective June 30, 1982, in Securities Act Release No. 6389, 1981-82 Transfer Binder, Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982)).

16. 17 C.F.R. § 230.146 (1981) (rescinded effective June 30, 1982, in Securities Act Release No. 6389, 1981-82 Transfer Binder, Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982)).

17. *Id.*

18. *Id.*

19. *Id.* Modifications were later made to Rule 146 for issues under \$1.5 million, which did benefit some small issuers.

20. 17 C.F.R. § 230.240 (1981) (rescinded effective June 30, 1982, in Securities Act Release No. 6389, 1981-82 Transfer Binder, Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982)).

21. *Id.*

Further advances were made with the adoption of Rule 242 in 1980.²² It eliminated the qualification requirements for certain "accredited investors" and allowed use of a modified disclosure document for issues of less than \$2 million.²³

The SEC had by 1980 moved a long way from the confusion created by *Ralston Purina*²⁴ and its progeny.²⁵ Yet problems remained. One commentator summarized the problems as follows:

- (1) the \$100,000 ceiling of Rule 240 was too low;
- (2) the accredited investor concept of Rule 242, while a worthwhile innovation, was too limited;
- (3) the disclosure document for financings under Rule 242 was still too burdensome for small businesses;
- (4) the ceiling of \$2,000,000 for Rule 242 transactions was too low;
- (5) the requirement for qualified offerees and the disclosure document requirements under Rule 146 were too burdensome for small business financing.²⁶

C. *The Montana Exemption*

Persons wishing to avoid the cost and complication of state registration faced similar frustrations in Montana. Prior to 1983, Montana had only one exemption from state registration. It exempted:

[A]ny transaction pursuant to an offer directed by the offeror to not more than 10 persons . . . in this state during any period of 12 consecutive months, whether or not the offeror or any of the offerees is then present in this state, if:

- (a) the seller reasonably believes that all the buyers are purchasing for investment; and
- (b) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer²⁷

This exemption has proved to be of little value because of limitations inherent in the statute and the manner in which it has been interpreted by the Montana Securities Department.

22. 17 C.F.R. 230.242 (1981) (rescinded effective June 30, 1982, in Securities Act Release No. 6389, 1981-82 Transfer Binder, Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982)).

23. *Id.*

24. 346 U.S. 119 (1953)

25. *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971); *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972).

26. *Coles, Regulation D—New Rules for Raising Capital In Non-Public Financings*, 70 LL. B.J. 612 (1982).

27. MONT. CODE ANN. § 30-10-105(9) (1983).

The statutory exemption allows ten offers to be made, not ten purchases.²⁸ Any offeree may decide not to invest, causing the issuer to use up one of his offers without raising any capital. Even if all ten offerees invest, each would have to invest a great deal if a substantial amount is to be raised. The prohibition against commissions or other remuneration for soliciting buyers²⁹ also limits the pool of possible investors. Professional salespersons have a large clientele of possible investors. Without access to this group many issuers are unable to locate interested persons.

The Montana Securities Department has strongly urged issuers not to rely upon this exemption when selling securities,³⁰ and has limited its usefulness by a restrictive interpretation of statutory language. The Department has indicated that the ten offers allowed by this statute include offers to both Montana residents and nonresidents, regardless of whether those persons were in the state when the offer was made.³¹ The Department cited *Upton v. Trinidad Petroleum Corp.*³² in support of its interpretation.³³ In *Upton*, a corporation sold oil interests to fourteen persons, less than ten of whom were Alabama residents.³⁴ The court held offers to both residents and nonresidents are to be counted in calculating the ten allowable offers, and Trinidad was not exempt from registration because it had made fourteen offers.³⁵ The court did not cite any Alabama Supreme Court cases in support of its interpretation and failed to cite a single jurisdiction which interpreted the ten offers to include both residents and nonresidents.³⁶ Instead, it relied upon the unpublished opinion of the Alabama Securities Commission, derived from trial testimony, as dispositive of legislative intent.³⁷ Both *Upton* and the Securities Department's interpretation are against the weight of authority. In five jurisdictions that have exemptions similar to Montana's statutory exemption, only residents are counted in calculating the allowed ten offers.³⁸ It

28. *Id.*

29. *Id.*

30. BLUE SKY L. REP. (CCH) ¶ 36,504 (Mar. 3, 1983).

31. *Id.*

32. 468 F. Supp. 330 (N.D. Ala. 1979), *aff'd*, 652 F.2d 424 (5th Cir. 1981). Only the district court considered the meaning of "not more than 10 offers." The Fifth Circuit affirmed the case on other grounds, expressly refusing to affirm the lower court's interpretation of the phrase in question.

33. BLUE SKY L. REP. (CCH) ¶ 36,504 (Mar. 3, 1983).

34. 468 F. Supp. at 333.

35. *Id.* at 335.

36. *Id.* at 330.

37. *Id.*

38. FLA. STAT. § 517.061(12)(a) (1983); *Hohensee v. State*, 42 Md. App. 329, 400 A.2d

is also clear that the drafters of the exemption on which Montana's statutory exemption is modeled intended the ten offers to include only those to residents.³⁹ Despite this, issuers run the risk that the Montana Securities Department will limit them to ten offers, whether the offerees are residents or nonresidents.

The second gray area is the interpretation of "commission or other remuneration . . . given directly or indirectly for soliciting prospective buyers."⁴⁰ Neither the Montana Supreme Court nor the Securities Department has interpreted this language. Other jurisdictions have given this clause a broad interpretation and have uniformly ignored the statutory requirement that the remuneration be "for soliciting."⁴¹ A "consulting fee" paid to issuers for work done in developing an apartment complex was held to be indirect remuneration for solicitation of securities.⁴² A "supervisory fee" for managing oil drilling operations has also been held to be indirect remuneration,⁴³ as has the retention of a partial interest in an oil development for consideration grossly below that paid by investors.⁴⁴ The sale by issuers of oil interests well in excess of the project's actual cost was indirect remuneration despite the issuers claim the excess was ordinary "profit" or a "contingency fund"⁴⁵ for the project.

Taken together these cases indicate that capital raised in excess of the actual amount needed for the project will be considered remuneration regardless of whether substantial services are provided by the issuer in exchange for that excess.⁴⁶ Further, whether

455 (1979); Nebraska Dep't of Banking and Finance, Interpretive Opinion No. 1, BLUE SKY L. REP. (CCH) ¶137,455 (Oct. 13, 1977); *In re* Information Resources Corp., 126 N.J. Super. 42, 312 A.2d 671 (1973); TEX. ADMIN. CODE tit. 7, §139 (1983).

39. L. LOSS & E. COWETT, BLUE SKY LAW 373 (1958).

40. MONT. CODE ANN. § 30-10-105(9) (1983).

41. *Upton v. Trinidad Petroleum Corp.*, 468 F. Supp. 330 (N.D. Ala. 1979), *aff'd*, 652 F.2d 424 (5th Cir. 1981); *Schultz v. Rector-Philips-Morse, Inc.*, 261 Ark. 269, 552 S.W.2d 4 (1977); *Prince v. Heritage Oil Co.*, 109 Mich. App. 189, 311 N.W.2d 741 (1981); *Petroleum Resource Dev. Corp. v. State*, 585 P.2d 346 (Okla. 1970).

42. *Schultz v. Rector-Philips-Morse, Inc.*, 261 Ark. 269, 552 S.W.2d 4 (1977).

43. *Petroleum Resource Dev. Corp. v. State*, 585 P.2d 346 (Okla. 1970).

44. *Prince v. Heritage Oil Co.*, 109 Mich. App. 189, 311 N.W.2d 741 (1981).

45. *Upton v. Trinidad Petroleum Corp.*, 468 F. Supp. 330 (N.D. Ala. 1979), *aff'd*, 652 F.2d 424 (5th Cir. 1981).

46. The Massachusetts Securities Division has reviewed the relevant case law and drafted rules that summarize the broad interpretation remuneration has been given. BLUE SKY L. REP. (CCH) ¶ 31,603 (Nov. 1983). It states "indirect remuneration" includes:

- (1) any profit on the sale or lease of any services to a program or venture by any promotor or sponsor;
- (2) any profit on services provided to a program or venture by any promotor or sponsor;
- (3) any management, consulting or other fees charged to a program at a rate

the remuneration is actually paid "for soliciting" buyers appears irrelevant to an interpretation of this exemption.

III. NEW FEDERAL EXEMPTIONS

Ralston Purina, its progeny, and Rules 146, 240, and 242 created a patchwork exemptive scheme which remained unsatisfactory to potential issuers. The small businessperson in particular suffered from its cost and complexity. The creation of Regulation D⁴⁷ was a fresh approach. The SEC swept aside Rules 146, 240, and 242, and in their place created three exemptions tailored to fit the needs of a range of issuers. The SEC also intended to work with the North American Securities Administrators Association (NASAA) to create state exemptions that complement and are coordinated with Regulation D.⁴⁸ NASAA created the Uniform Limited Offering Exemption (ULOE), which can be used with two Regulation D exemptions.⁴⁹

A. *The Regulation D Exemptions*

1. *Rules 501-503*

Regulation D is a series of six rules.⁵⁰ The actual exemptions are contained in Rules 504-506;⁵¹ however, Rules 501-503⁵² provide several conditions that must be met to qualify for the exemptions. Rule 501 is a definitional section. Its key provisions define eight categories of "accredited investors"⁵³ and establish guidelines for calculating the number of purchasers of an issue.⁵⁴ Rule 502 establishes a six-month "safe harbor" for separating Regulation D is-

above the customary rate for similar services; and

(4) any payment made to any person connected with a program or venture which is based upon a percentage of the funds to be raised from investors.

47. Regulation D, 17 C.F.R. §§ 230.501-506 (1983).

48. 17 C.F.R. § 230.501 preliminary note 2 (1983).

49. Both the SEC and NASAA placed primary responsibility for regulating issues of less than \$500,000 on the states. The ULOE exemptions are only useful for issues well in excess of \$500,000.

50. Regulation D, 17 C.F.R. §§ 230.501-506 (1983).

51. 17 C.F.R. §§ 230.504-506 (1983).

52. 17 C.F.R. §§ 230.501-503 (1983).

53. 17 C.F.R. §230.501(a) (1983).

54. 17 C.F.R. §230.501(e) (1983). Certain purchasers are excluded from the number allowed in Rules 505 and 506. They include: (a) any spouse or relative living with another purchaser; (b) a trust or estate in which the purchaser (or certain relatives) hold collectively more than a 50% beneficial interest; (c) a corporation in which the purchaser (or certain relatives) hold collectively more than a 50% beneficial interest; or (d) any accredited investor.

sues,⁵⁵ delineates the information which must be disclosed to investors,⁵⁶ and describes limitations on the manner of offerings⁵⁷ and resale by purchasers.⁵⁸ Rule 503 requires issuers to file a notice of sales with the SEC at specific times during an offering.⁵⁹ The application of these rules to each exemption varies somewhat and one must look to the specific exemption for relevant differences.

2. Rule 504

This exemption is available for issues in the aggregate up to \$500,000 in a twelve-month period.⁶⁰ Rule 504 does not limit the number of investors nor does it require them to be either accredited or sophisticated.⁶¹ No specific information must be given investors,⁶² but this does not relieve issuers from possible liability under federal anti-fraud provisions.⁶³ General public solicitation is not allowed⁶⁴ and the securities cannot be resold without registration,⁶⁵ unless sales are made exclusively in states that require registration of the securities and delivery of a disclosure document before a sale.⁶⁶ Notice of sales must be filed with the SEC within fifteen days of the first sale and every six months thereafter until the final notice is filed within thirty days after the last sale.⁶⁷

3. Rule 505

This rule exempts from federal registration issues up to \$5 million within a twelve-month period⁶⁸ made to thirty-five non-ac-

55. 17 C.F.R. § 230.502(a) (1983). When issuers wish to make a series of exempt offerings over several years, these offerings must be distinct or the SEC may treat them as a single offering. When several offers are integrated the number of offerees or total purchase price can be too great to allow the issuer to qualify for an exemption. This of course means the issuer has sold unregistered securities and faces possible criminal and civil action. Several Regulation D exemptions can be used over a period of time without fear of integration if the issuer waits six months from the date of his last sale on one offering until he makes his first sale on a new Regulation D offering. If an issuer does not wait the required six months the SEC will consider five factors delineated in Rule 502 to determine whether the offers should be integrated.

56. 17 C.F.R. § 230.502(b) (1983).

57. 17 C.F.R. § 230.502(c) (1983).

58. 17 C.F.R. § 230.502(d) (1983).

59. 17 C.F.R. § 230.503(a) (1983). See *infra* notes 67 & 74 and accompanying text.

60. 17 C.F.R. § 230.504(b)(2)(i) (1983).

61. 17 C.F.R. § 230.504 (1983).

62. 17 C.F.R. § 230.504(b)(1)(i) (1983).

63. Regulation D, Preliminary Note 1, 17 C.F.R. §§ 230.501-.506 (1983).

64. 17 C.F.R. § 230.502(c) (1983).

65. 17 C.F.R. § 230.504(d) (1983).

66. 17 C.F.R. § 230.504(b)(1) (1983).

67. 17 C.F.R. § 230.503(a) (1983).

68. 17 C.F.R. § 230.505(b)(2)(i) (1983).

credited investors⁶⁹ and an unlimited number of accredited investors.⁷⁰ No general solicitation is allowed⁷¹ and the resale of securities without registration is prohibited.⁷² Commissions to salesmen are not restricted.⁷³ Notice provisions to the SEC are identical to those for Rule 504,⁷⁴ but the disclosure requirements are more strict. If only accredited investors purchase the securities, no specific information must be provided investors.⁷⁵ When non-accredited investors make purchases and the issuer is a non-reporting company under the Securities Exchange Act of 1934, the issuer must give investors the information required in Part I of Form S-18 and the last two years' financial statements, the most recent of which must be audited.⁷⁶

4. Rule 506

The requirements for exemption under Rule 506 are in most respects identical to those under Rule 505,⁷⁷ with three major exceptions. First, there is no limit on the total value of the offer.⁷⁸ Second, all of the thirty-five non-accredited purchasers must be sophisticated, either alone or with a purchaser representative.⁷⁹ Finally, in offers over \$5 million purchasers must be provided with the information in Part I of a registration form that would be filed under the Securities Act of 1933.⁸⁰

IV. NEW MONTANA EXEMPTIONS

Montana's new exemptions came out in two sets of rules.⁸¹ The first set was modeled after the NASAA Uniform Limited Offering Exemption and can be coordinated with the Rule 505 and

69. 17 C.F.R. § 230.505(b)(2)(ii) (1983).

70. 17 C.F.R. § 230.501(e)(iv) (1983).

71. 17 C.F.R. § 230.502(c) (1983).

72. 17 C.F.R. § 230.502(d) (1983).

73. 17 C.F.R. §§ 230.501-.506 (1983).

74. See *supra* note 67 and accompanying text.

75. 17 C.F.R. § 230.502(b)(1)(i) (1983).

76. 17 C.F.R. § 230.502(b)(2)(i)(A) (1983).

77. See *supra* notes 68-76 and accompanying text.

78. 17 C.F.R. § 230.506 (1983).

79. 17 C.F.R. § 230.506(b)(2)(ii) (1983). A purchaser is sophisticated when he "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."

80. 17 C.F.R. § 230.502(b)(2)(B) (1983).

81. MONT. ADMIN. R. 6.10.120-.123 (1984); 1984 Mont. Admin. Reg. 352, 588 (to be codified at MONT. ADMIN. R. 6.10.124).

506 exemptions.⁸² The second is a Venture Capital Exemption, which can be used with federal Rule 504.⁸³

A. *Uniform Limited Offering Exemption (ULOE)*

The ULOE exempts from registration in Montana the sale of securities sold in compliance with federal Rules 501-503 and 505 and 506 if certain conditions are met.⁸⁴

The salesperson must be registered to sell securities in Montana.⁸⁵ The issuer must file with the Securities Department copies of the notice form, which it was required to file with the SEC, ten days before any offer or sale and at all other times as required in Rule 503.⁸⁶ The initial notice must be accompanied by an undertaking to furnish the Department with the disclosure document the issuer is providing offerees, a consent to service of process, and a filing fee.⁸⁷ Issuers must also make a reasonable inquiry and determine whether the investment is suitable for the purchaser⁸⁸ and that the purchaser alone or with a purchaser representative has sufficient sophistication to evaluate the risk of the investment.⁸⁹ Finally, transactions exempt under this rule cannot be combined with other offerings, or the exemption may be forfeited.⁹⁰ This exemption also has extensive "bad boy" provisions that prevent persons who have violated securities laws in the past from using the exemption.⁹¹

Adoption of the ULOE in Montana helped issuers by bringing Montana's exemptive framework in line with federal exemptions. If an issuer qualifies for either the Rule 505 or 506 exemption, the issuer can be confident that the transaction will be exempt in Montana by fulfilling the additional Montana requirements. Practically speaking, however, adoption of these exemptions did not substantially reduce the cost and complications of selling securities in Montana. The information an issuer must compile to satisfy the Rule 505 and 506 exemptions is more detailed than the information one must file to actually register a security in Montana.⁹² Fur-

82. MONT. ADMIN. R. 6.10.120-.123 (1984).

83. 1984 Mont. Admin. Reg. 352, 588 (to be codified at MONT. ADMIN. R. 6.10.124).

84. MONT. ADMIN. R. 6.10.120(1)(a) (1984).

85. MONT. ADMIN. R. 6.10.120(1)(a)(i) (1984).

86. MONT. ADMIN. R. 6.10.120(1)(a)(iii) (1984).

87. *Id.*

88. MONT. ADMIN. R. 6.10.120(1)(a)(iv)(A) (1984).

89. MONT. ADMIN. R. 6.10.120(1)(a)(iv)(B) (1984).

90. MONT. ADMIN. R. 6.10.120(1)(a)(iv)(B)(6) (1984).

91. MONT. ADMIN. R. 6.10.120(1)(a)(ii) (1984).

92. Compare 17 C.F.R. § 230.502(b)(2)(i)(A), -(B) with MONT. CODE ANN. §§ 30-10-203

ther, the filing cost for the Montana exemption is the same as the cost of registration.⁹³ Issuers are simply spared the trouble of putting the same information into two separate documents to satisfy the SEC and Montana Securities Department, respectively. Perhaps most importantly, the small business may still find the costs of using this exemption prohibitive.

B. *The Venture Capital Exemption (VCE)*

The Venture Capital Exemption filled the gap left by the ULOE by creating a Montana exemption that can be used with Rule 504.⁹⁴ Rule 504 exempts issues of up to \$500,000 and is relatively easy for an issuer to use.⁹⁵ The VCE allows the sale of up to \$400,000 in securities in twelve consecutive months to not more than thirty-five purchasers.⁹⁶ No public solicitation is allowed⁹⁷ and all persons offering or selling securities must be registered in Montana.⁹⁸ At least ten days before any offer or sale, the issuer must file two copies of its disclosure document with the Securities Department, along with a \$200 filing fee.⁹⁹ Certain specified information must be in the disclosure document¹⁰⁰ and purchasers must be given a copy at least forty-eight hours before a sale is made.¹⁰¹

The VCE is far more useful to small businesspersons than either the ULOE or Montana's statutory exemption. Disclosure requirements are reasonable, only the disclosure document need be filed, and the filing fee is just \$200. In addition, the exemption allows thirty-five sales rather than ten offers, both increasing the pool of investors and eliminating questions of whether an offer was actually made. When the VCE is used together with Rule 504, businesses can make small offerings with relatively little cost and complication.

There are two major problems with the Venture Capital Exemption. First, the VCE allows an aggregate offering up to \$400,000, whereas Rule 504 allows offerings up to \$500,000. There is no rational reason for this disparity. Neither consumer nor busi-

to -205 (1983).

93. Compare MONT. ADMIN. R. 6.10.120(1)(a)(iv)(B) (1984) with MONT. CODE ANN. § 30-10-209 (1983).

94. 1984 Mont. Admin. Reg. 352, 588 (to be codified at MONT. ADMIN. R. 6.10.124).

95. See *supra* notes 60-67 and accompanying text.

96. 1984 Mont. Admin. Reg. 352, 588 (to be codified at MONT. ADMIN. R. 6.10.124).

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

ness interests are furthered by this difference. Persons selling \$450,000 in securities qualify for the less rigorous Rule 504 federal exemption, but they do not qualify for the VCE. They would be forced to meet the more onerous Rule 505 requirements and qualify for a Montana ULOE exemption or simply register the securities in Montana. The VCE should be amended to allow offerings up to \$500,000.

The second problem is a holdover from Montana's statutory exemption.¹⁰² The Securities Department has determined that offers made pursuant to the statutory exemption include offers to both residents and nonresidents.¹⁰³ This is against the clear weight of authority and, indeed, relies on a single poorly reasoned case.¹⁰⁴ It is now unclear whether the thirty-five sales allowed in the VCE include only sales to residents or to nonresidents as well. The purpose of state blue-sky laws is to protect the citizens of that state. This is particularly true for issues of less than \$500,000, and is the reason regulation of such issues was largely left to the individual states. If the number of sales made in Montana is less than thirty-five, Montana residents will be adequately protected. The Securities Department should make it clear that the thirty-five sales include only sales to Montana residents.

V. COMBINING STATE AND FEDERAL EXEMPTIONS

Issuers in Montana now have relatively symmetrical state and federal securities exemptions from which to choose in structuring an offering. The key fact in selecting an exemption is the amount to be raised; however, the availability of investors, the need to advertise publicly, and the time period in which the issue is made are also relevant factors. An example is illustrative.

A small tool and die proprietorship wishes to expand into the production of decorative wrought iron products. The owner needs \$150,000 in start-up capital for the venture, but wants to retain substantial control of the business. For tax reasons it is unwise for him to incorporate. He knows that his doctor, dentist, and brother-in-law are always looking for a good investment, but decides to consult his attorney before approaching them. What options are available to him?

The sale of three limited partnership interests would avoid the tax problems of incorporation and keep control in the owner's

102. MONT. CODE ANN. § 30-10-105(9) (1983).

103. BLUE SKY L. REP. (CCH) ¶ 36,504 (Mar. 3, 1983).

104. See *supra* note 38 and accompanying text.

hands. Limited partnerships are by definition a security.¹⁰⁵ To register a sale of three securities would be prohibitive, thus the owner should look for applicable state and federal exemptions. Issuers should look first to the least costly exemptions. In this example, the federal Rule 504 and state Venture Capital Exemption are best suited. Taken together, they allow him to raise up to \$400,000, minimize the legal costs of creating a disclosure document (as required by the VCE), keep filing fees to the lowest possible amount, and minimize notice requirements to the SEC and Securities Department.

Consider what would change if the proprietor needed to raise \$1.5 million from twenty-five to thirty-five unsophisticated investors, and wished to incorporate. Now he could sell shares of stock, which of course are securities.¹⁰⁶ The Rule 504 exemption allows sales to thirty-five persons, but is no longer plausible, because it is limited to \$500,000. Rule 505, however, would be available, as it allows issues of up to \$5 million to thirty-five non-accredited investors so long as no general public solicitation is made. If Rule 505 conditions are met, the issuer knows he can qualify for Montana's ULOE by fulfilling the specific Montana requirements. Note also that the Rule 506 exemption would be unavailable to this issuer, because to use Rule 506 all thirty-five investors must be sophisticated either alone or with a purchaser representative.

VI. CONCLUSION

The creation of Regulation D exemptions in 1982 and complementary Montana exemptions in 1984 have added much needed simplicity and certainty to the registration process. Small businesses in particular have been relieved of onerous burdens and can responsibly seek to raise capital for new business ideas. The general public is also well served by the exemptions. With the incorporation of the modifications suggested in this comment, a careful balance will be struck between the public's need for investment information and the benefits it achieves from small business growth.

105. An investment contract is defined as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party." *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946). Similarly, in a limited partnership, a limited partner invests in a common enterprise with the expectation of profit from the business efforts of the general partners. Excess involvement in business decisions destroys a limited partner's status as a limited partner. MONT. CODE ANN. § 35-12-703 (1983).

106. 15 U.S.C. § 77(b)(1) (1982).

