RECENT DEVELOPMENT

A GUIDE TO THE SEC'S SMALL BUSINESS INITIATIVE

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I. Introduction

Heeding the Bush Administration's call for regulatory simplification, the Securities and Exchange Commission (the Commission) has recently adopted a series of regulatory initiatives to facilitate capital formation for small businesses. On July 30, 1992 (effective August 13, 1992), the Commission published a series of new regulations and rule amendments designed to ease regulatory burdens applicable to small businesses (hereinafter Release).[1]

In the Release introducing the Commission's small business initiative, (hereinafter Proposing Release), the Commission states that the initiative is a recognition that "[s]mall businesses are the cornerstone of the United States economy."[2] The Proposing Release also notes that "the Commission has historically recognized the distinct financing concerns of start-up and development stage business newly entering the public market."[3]

The Release covers a wide variety of subjects and includes: (1) amendments to Regulation A[4] that, among other things, increases from $1.5 to $5 million the amount that may be sold pur-

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1 Release Nos. 33-6949, 34-30968, 39-2287, 57 Fed. Reg. 36,442 (Aug. 13, 1992) [hereinafter Release].

2 Small Business Initiative, Sec. Act Rel. No. 6924 (Mar. 11, 1992), [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,931. *See also* Small Business Initiative, Sec. Act Rel. No. 6924 (Mar. 11, 1992), [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,928 [hereinafter Proposing Release].

3 *See* Proposing Release, *supra* note 2, at 82,482.

4 17 C.F.R. § 230.251-264 (1992). Regulation A consists of Rules 251 through 264.

suant to the exemption;[5] (2) amendments to Rule 504 of Regulation D[6] to eliminate previous requirements relating to general solicitations and restrictions on resale;[7] and (3) a new registration, reporting and disclosure system applicable to "small business issuers."[8]

The Commission has also submitted a legislative proposal to Congress designed to facilitate capital formation by small businesses.[9] The Commission is seeking legislation to increase its exemptive authority under Section 3(b) of the Securities Act of 1933 (hereinafter Securities Act)[10] and a number of amendments to the Investment Company Act of 1940 (hereinafter Investment Act).[11]

The bill, entitled the 1992 Small Business Incentive Act, was introduced on April 2, 1992, by Senator Christopher Dodd (D-Conn.), Chairman of the Senate Banking Securities Subcommittee.[12] Representative Edward Markey (D-Ma.), Chairman of the House Telecommunications and Finance Subcommittee, introduced a similar bill in the House shortly after the Senate bill was introduced.[13] As of the date of this article, because of the technical issues involved, the prospects for early passage of the measures seem remote.[14]

In light of the effect these amendments and additional proposals may have on small business capital formation, the purpose of this article is to provide a working review of and commentary on the key sections of the Release.

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5 57 Fed. Reg. 36,443 (1992).

6 17 C.F.R. § 230.501-508 (1992). Regulation D consists of Rules 501 through 508.

7 57 Fed. Reg. 36,445 (1992).

8 57 Fed. Reg. 36,445-36,448 (1992).

9 *SEC Submits Small Business Incentive Act to Congress*, 92 SEC TODAY 1 (Mar. 27, 1992).

10 15 U.S.C. § 77c(b) (1982)[hereinafter Securities Act].

11 *See supra* note 9. *See also* 15 U.S.C. § 80a-1 (1982) [hereinafter Investment Act].

12 S. 2518, 102d Cong., 2d Sess. (Apr. 2, 1992).

13 H.R. 4938, 102d Cong., 2d Sess. (Apr. 9, 1992).

14 *See Small Biz Legislative Push May Be Dead In the Water*, 18 INSTITUTIONAL INVESTOR, No. 31, at 4.

II. Regulation A

A. *General*

The Release revises Regulation A[15] to: (1) raise the annual ceiling for use of Regulation A from $1.5 million to $5 million per year;[16] (2) allow pre-offering publication of factual information about the issuer before actual filing of the Regulation A disclosure documents;[17] and (3) allow use of a simplified question and answer format and revised procedural requirements for Regulation A offerings.[18]

B. *Eligibility Requirements*

As amended by the Release, Regulation A now provides an exemption from the registration requirements of the Securities Act for public offers and sales of up to $5 million of the issuer's securities during any 12 month period by any issuer meeting the eligibility requirements of Rule 251.[19] The issuer must be an entity organized under state or federal law in the United States or Canada with its principal place of business in the United States or Canada.[20]

Regulation A continues to exclude investment companies registered or required to register under the Investment Company Act.[21] "Blank check" companies as defined by Section 7(b) of the Securities Act issuing penny stock are ineligible for Regulation A.[22] However, the amendments permit other issuers to offer penny stocks under Regulation A.[23] Such securities, however,

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15 *See supra* note 4.

16 57 Fed. Reg. 36,443-36,444 (1992).

17 57 Fed. Reg. 36,444 (1992).

18 57 Fed. Reg. 36,443 (1992).

19 57 Fed. Reg. 36,443 (1992)(to be codified at 17 C.F.R. § 203.254(a)).

20 57 Fed. Reg. 36443 (1992). While the Proposing Release suggested the exclusion of Canadian issuers on the ground of their infrequent use of Regulation A, (*see* Proposing Release, *supra* note 2, at 82,485), under the Release Canadian issuers remain eligible to use Regulation A. 57 Fed. Reg. 36,443.

21 17 C.F.R § 230.252(b)(2) (1991). Registered small business investment companies will be able to rely on an expanded Regulation E. 17 C.F.R. § 230.601 *et seq.* (1992).

22 A "blank check" company is one that has no specific business or plan except to locate and acquire a presently unknown business or opportunity. *See* Section 7(b) of the Securities Act, 15 U.S.C. § 77g(b).

23 The Commission had sought comment on this issue but decided that a com-

if sold by a broker-dealer, are subject to Rule 15c2-6, the penny stock cold-call rule, and to the Commission's penny stock disclosure rules adopted pursuant to Section 15(g) of the Securities Exchange Act of 1934 (hereinafter Exchange Act).[24]

The Release did not adopt the Proposed Release's denial of access to amended Regulation A to any partnership or other entity organized primarily for the purpose of investing or reinvesting "monies" in securities, properties, commodities, business opportunities or "similar media of speculative opportunity."[25] An issuer of fractional undivided interests in oil and gas rights or a "similar interest in other mineral rights" remains ineligible to employ Regulation A under the Release.[26]

Finally, issuers falling within the so-called "bad boy" provisions are disqualified from utilizing Regulation A.[27]

C. *Dollar Limitations*

The Release increases the limit for a Regulation A offering from $1.5 million to $5 million.[28] While Regulation A is available for selling security holders, Rule 251(b), as amended,[29] provides that "[n]o affiliate resales are permitted if the issuer has not had net income from continuing operations in at least one of its last two fiscal years."[30]

Prior to its amendment, Regulation A did not directly address the question of integration of offerings.[31] Accordingly, the

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plete ban on penny stock offerings under Regulation A was not warranted. *See* 57 Fed. Reg. 36,443 (1992).

24 Sec. Exch. Act Rel. No. 30571 (Apr. 10, 1992), [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,938.

25 57 Fed. Reg. 36,443 (1992).

26 *Id.* 17 C.F.R. § 230.252(b)(1) (1992).

27 *See* 17 C.F.R. § 230.252(c) (1992).

28 57 Fed. Reg. 36,443 (1992).

29 57 Fed. Reg. 36,468 (1992) (to be codified at 17 C.F.R. § 230.254(b)). Amended Rule 251 provides that a "public offer or sale" of securities that meets the conditions of Regulation A shall be exempt from the registration provisions of the Act pursuant to Section 3(b) thereof. A condition of Amended Rule 254 is that the "sum of all cash and other consideration to be received for the securities ('aggregate offering price') in any continuous 12-month period shall not exceed $5,000,000, including no more than $1,500,000 offered by all selling security holders. . . ."

30 57 Fed. Reg. 36,468 (1992)(to be codified at 17 C.F.R. § 230.251(b)).

31 Current Rule 254(d) excludes several limited categories of securities in determining the quantitative limitations. 17 C.F.R. § 230.254(d) (1992).

Commission's traditional integration principles were applied in determining whether two or more offerings would be deemed to be part of the same Regulation A offering.[32] Amended Rule 251(c), which now expressly provides that offers and sales made in reliance on Regulation A will not be integrated with prior offers or sales of securities, appears to reflect a change from traditional SEC policy under which two offerings being made within a short time of each other may be deemed part of the same offering.[33]

The amendments to Regulation A also provide that offers and sales made subsequent to a Regulation A offering will not be integrated with subsequent offers or sales of securities that are registered under the Securities Act, made in reliance on Rule 701[34] or Regulation S[35] under the Act, or made more than six months after the completion of the Regulation A offering.[36]

D. *"Testing the Waters" — The Solicitation of Interest Document*

The most controversial aspect of the amendments, in the view of certain commentators, particularly the North American Securities Administrators Association (NASAA), are the procedures that will allow a "testing of the waters" without making a formal filing with the Commission.[37] The amendments permit "pre-offering solicitations of indications of interest subject to Commission oversight."[38] Amended Rule 254 allows an issuer to publish or deliver to prospective purchasers a written document to determine whether there is any interest in a contemplated securities offering.[39] The document must state that no money or other consideration sent in response to the document will be accepted and that no sales or commitments to purchase will be accepted until delivery of an offering circular with complete

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32 *See generally* Darryl B. Deaktor, *Integration of Securities Offerings*, 31 U. FLA. L. REV. 465, 477-480 (1979).

33 57 Fed. Reg. 36,468 (1992)(to be codified at 17 C.F.R. § 230.251(c)).

34 17 C.F.R. § 230.701 (1992).

35 17 C.F.R. §§ 230.901-230.904 (1992).

36 57 Fed. Reg. at 36,468 (1992)(to be codified at 17 C.F.R. § 230.251(c)).

37 57 Fed. Reg. 36,444-36,445 (1992).

38 *See* Proposing Release, *supra* note 2, at 82,487; 57 Fed. Reg. 36,444 (1992)(to be codified at 17 C.F.R. § 230.254).

39 57 Fed. Reg. 36,470 (1992)(to be codified at 17 C.F.R. § 230.254(a)).

information about the issuer.[40] The Release and Rule 254, as amended, do not otherwise specify the content of the solicitation of interest document.

The Release observes that issuers will be permitted to "free write," but only factual presentation is permitted.[41] The document and any oral communications are subject to the anti-fraud provisions of the securities laws.[42]

Prior to its first use, the solicitation of interest document must be filed with an appropriate regional office of the Commission and include the name and telephone number of a person able to answer the staff's questions about the document.[43] After the solicitation of interest document is made available, the issuer may orally communicate with prospective investors, but may not make any sales until (1) qualification of the offering statement and (2) 20 calendar days after publication or delivery of the "solicitation of interest document."[44] No consideration sent in response to a solicitation of interest document may be accepted.[45] Although the issuer may not accept funds or make sales at this preliminary stage, the "solicitation of interest" document may include a "coupon, returnable to the issuer indicating interest in a potential offering."[46]

In the Proposing Release, the Commission sought comment from the public on whether the "testing the waters" provision will be "useful, and whether it provides adequate protection to prospective investors."[47] The comments received by the Commission reflect the firestorm of controversy among state securities regulators ignited by certain aspects of the initiatives, especially the "testing the waters" proposal. State securities regulators, who have been reviewing proposed Regulation A and Regulation D changes with Commission representatives for several years, criticized parts of the proposals as going too far to help small businesses at the expense of potentially unsophistica-

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40 *Id.*

41 57 Fed. Reg. 36,445 (1992).

42 57 Fed. Reg. 36,470 (1992)(to be codified at 17 C.F.R. § 230.254(a)).

43 57 Fed. Reg. 36,445 (1992)(to be codified at 17 C.F.R. § 230.254(b)(1)).

44 57 Fed. Reg. at 36,470 (to be codified at 17 C.F.R. § 230.254(b)(3) and (4)).

45 *Id.* (to be codified at 17 C.F.R. § 230.254(a)).

46 *Id.* (to be codified at 17 C.F.R. § 230.254(c)).

47 *See* Proposing Release, *supra* note 2, at 82,485.

ted investors.[48] In a July 24th comment letter to the Commission, Massachusetts Securities Division Director Barry Guthary, also president-elect of the NASAA, wrote that the Commission was effectively "embarking on an attempt to facilitate the sale of the riskiest securities in the market to the least sophisticated of buyers."[49] Moreover, the NASAA comment letter complained that the state regulators' suggestions have been ignored and "it appears that the Commission is pursuing a political agenda with virtually no concern as to whether small business will derive any benefit from its action."[50] The private bar has also been critical of the Commission's dealings with state authorities. In a July 8th comment letter to the Commission addressing the Proposing Release, a committee of the American Bar Association also expressed concern about the apparent lack of state and federal coordination concerning the initiatives.[51]

E. *Simplified Forms and Procedures*

The Release substantially revises the Commission's approach to disclosure in Regulation A offerings. Under the amendments, a corporate issuer selling securities pursuant to Regulation A has three choices regarding preparation of the narrative disclosure portion of the offering circular. First, it may use "Model A," which is a replication of the Form U-7 registration adopted by NASAA in 1989 as a model registration form for small corporate offerings.[52] Second, corporate or other issuers may furnish the information specified in Model B of Part II of Form 1-A, which follows the disclosure model of existing Regulation A.[53] Finally, corporate or other issuers may satisfy narrative disclosure requirements of Regulation A by furnishing informa-

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48 *See infra* note 49.

49 *See generally* NASAA Comment Letter to SEC Secretary Regarding SEC Release 33-6924 (July 24, 1992), NASAA Reports (CCH) ¶ 9346 [hereinafter NASAA Reports (CCH)].

50 *Id.*

51 Letter from John F. Olson, Chairman, American Bar Association Committee on Federal Regulation of Securities to the Honorable Richard C. Breeden, Chairman, United States Securities and Exchange Commission (July 8, 1992)(on file with the Seton Hall Legislative Bureau).

52 57 Fed. Reg. 36,477 (1992). *See generally* Leslie J. Levinson and Anthony De Toro, *Tapping Equity Markets for Small Business: The SCOR Alternative*, 25 REV. OF SEC. AND COMM. L. 159 (Aug. 1992).

53 57 Fed. Reg. 36,488 (1992).

tion (except for financial statements) required by Part I of Form S-B.[54]

Model A permits issuers to use the format of NASAA Form U-7, entitled "Small Corporate Offerings Registration Form."[55] The disclosure required by Model A calls for as much or more extensive information than as called for under the other formats, but the information is to be presented in a "fill in the blank" format. The required disclosure includes risk factors; business and properties; offering price factors; use of proceeds; capitalization; description of securities; plan of distribution; dividends, distributions and redemptions; officers and key personnel; directors; principal stockholders; management relationships, transactions and renumeration; litigation; and federal tax matters.[56]

Model B requires the issuer to furnish the financial statements required by Part F/S of the Offering Circular section of Form 1-A.[57] The issuer may file unaudited financial statements unless it has already prepared audited statements.[58] The issuer also may choose to follow the disclosure requirements of Part I of Form S-B (except for the financial statement requirements thereof), a new form adopted by the Release in tandem with the Regulation A amendments.[59]

F. *Substantial and Good Faith Compliance*

The Release also provides relief to issuers relying on Regulation A for so-called "insignificant deviations" from terms and conditions of the Regulation.[60] Rule 260 appears to be modeled on Rule 508 which the Commission added to Regulation D in 1989.[61] Under Rule 260, a failure to comply with a term or condition of Regulation A will not cause the loss of the exemption for an offer or sale to a particular person, if the seller shows: (1) the defalcation did not pertain to a term or condition "directly in-

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54 57 Fed. Reg. 36,475 (1992). *See also* Section IV, *infra*.
55 *See* NASAA Reports (CCH), *supra* note 49, ¶ 5057.
56 *See supra* note 52, at 36, 477.
57 17 C.F.R. § 239.90; *See* 57 Fed. Reg. at 36,503 (1992).
58 57 Fed. Reg. 36,491 (1992).
59 *See* Section IV, *infra*.
60 57 Fed. Reg. 36,444 (1992) (to be codified at 17 C.F.R. § 230.260).
61 17 C.F.R. § 230.508 (1992).

tended to protect that particular individual or entity"; (2) the defalcation was "insignificant with respect to the offering as a whole"; and (3) a "good faith and reasonable attempt was made" to comply with all terms and conditions of the Regulation.[62]

III. Modifications to Rule 504 of Regulation D

Under Rule 504[63] as revised pursuant to the Release, an issuer which is neither an Exchange Act reporting company, an investment company nor a "blank check company"[64] may offer and sell up to $1 million of its securities less the aggregate offering price for all securities sold within the twelve month period before the start of and during the subject offering. As a result of the modification to the Rule, all restrictions on general solicitation, general advertising and resales of the securities sold under the Rule have been eliminated. Accordingly, other than complying with the remaining requirements of Rules 501 and 502 of Regulation D and subject to the issuers continuing anti-fraud and other civil liability responsibilities under the Securities Act, an issuer of securities can now effectively make a public offering of up to $1 million of its securities within a given one year period without significant marketing and resale restrictions and without being required to deliver any mandated form of disclosure document. Like the former version of the Rule, a Form D must still be filed with the Commission in Washington, D.C.,[65] and issuers must continue to be mindful of the integration doctrine embodied in Rule 502(a).[66] Issuers must also continue to comply with the state securities law requirements of the states in which their offering is conducted. On a practical level, because of the continuing applicability of the anti-fraud and state securities rules, issu-

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62 *See supra* note 60.

63 Existing Rule 504 has been redesignated as Rule 504(a) which may still be utilized by "blank check" companies.

64 Blank check companies are defined under the Rule as a development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies or other entity or person. 17 C.F.R. § 230.504(a)(3). *See also supra* note 22. The Commission has indicated its intention to eliminate by further rule making the opportunity for such companies to conduct Rule 504(a) offerings. *See* Release, *supra* note 1, at 19 and Additional Small Business Initiatives, Sec. Act. Rel. No. 33-6950, at 21 [hereinafter Supplemental Release].

65 17 C.F.R. § 230.503.

66 17 C.F.R. § 230.502(a).

ers will in all likelihood be counseled to continue the custom of preparing and disseminating some form of offering circular[67] to potential investors.

The modifications to the Rule contained in the Release are truly significant in that previous limitations on general advertising and solicitation, together with the classification of the securities as restricted securities, limited to a great extent the utility of Rule 504 as a mechanism for raising smaller amounts of capital. With these restrictions eliminated, issuers will now be able to reach a broader audience of potential investors, as well as be afforded greater liquidity in their investment. Obviously, the primary consideration from an investor protection point of view is whether the continued applicability of the anti-fraud rules and continuing state securities regulations will be sufficient to safeguard investors.

IV. Integrated Disclosure System for Registration and Reporting for Small Business Issuers

A. *General*

Issuers that meet the definition of a small business issuer (including Canadian issuers) are eligible to use the new small business integrated disclosure system adopted by the Commission in the Release.[68] The thrust of this new disclosure system is Regulation S-B and the accompanying Securities Act and Exchange Act forms to be used in conjunction therewith.[69]

A "small business issuer" is defined as an entity with revenues of less than $25 million whose public float (the aggregate market value of the issuers voting stock held by non-affiliates) does not equal or exceed $25 million.[70] If the small business is-

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[67] Under former Rule 504, in circumstances where by the terms of the Rule specific disclosure documentation was not required. *See* 17 C.F.R. § 230.502(b)(1), counsel would frequently advise the issuer to prepare disclosure documentation even if less complete than a comprehensive offering memoranda customarily used in private placement transactions, to mitigate against any claims of misrepresentation.

[68] Issuers may still continue to utilize the existing Securities Act and Exchange Act Forms such as S-1 and 10-K. Form S-18 has been rescinded, although issuers may continue to use the Form through December 31, 1992.

[69] Part 228-Integrated Disclosure System for Small Business Issuers, 17 C.F.R. § 228.10.

[70] 17 C.F.R. § 228.10(1).

suer is a majority owned subsidiary of another company, then the parent must also meet the definition of a small business issuer.[71] The Commission estimates that approximately 3,000 reporting public companies would currently fall within the definition of a small business issuer.[72]

A company's ability to use the Regulation S-B system depends on its level of revenues in its last full fiscal year and its capitalization as of a date within sixty (60) days prior to the offering for a Securities Act registration statement or of the filing of a registration statement under the Exchange Act.[73] A company can continue to report under the S-B system until it exceeds the $25 million revenue test for two consecutive fiscal years or the public float test for two consecutive years based on its annual report on the new form 10-KSB.[74] A company which is currently reporting under the existing integrated disclosure system may utilize the new S-B system provided that it has met the definition of a small business issuer for at least two consecutive years and provided that it meets both the revenue and public float components of the test for at least two such years.[75] Small business issuers may also register securities under Forms S-2, S-3 and S-8 provided that they meet the other eligibility requirements of such Forms.[76] The reports filed under the S-B system will satisfy the periodic reports required to be filed by small business issuers using these Forms.

B. *Forms*

Form SB-2 has been designated as the Securities Act Registration Form to be used by small business issuers.[77] There is no dollar limitation for offerings on Form SB-2 and the Form may be used for initial as well as secondary offerings.[78] Small business issuers may file initial public offerings at the Commission Regional Office closest to their principal place of business or at

71 57 Fed. Reg. 36,446 (1992).
72 *Id.*
73 17 C.F.R. § 228.10(2)(ii).
74 17 C.F.R. § 228.10(2)(iii).
75 17 C.F.R. § 228.10(2)(iv).
76 57 Fed. Reg. 36,448 (1992).
77 17 C.F.R. § 228.10.
78 57 Fed. Reg. 36,448 (1992).

the Commission's headquarters in Washington, D.C.[79] Secondary offerings may be filed only in Washington, D.C.[80] Interestingly, under the new S-B Rule 501, the familiar language on the side of the Preliminary Prospectus need no longer be in red.[81]

Small business issuers will now register under the Exchange Act utilizing Form 10-SB. Form 10-KSB and Form 10-QSB will be the annual and quarterly report forms to be filed by small business issuers.[82]

C. *Comparison to Existing Integrated Disclosure System*

While a detailed analysis of all of the disclosure requirements under the new S-B system is beyond the scope of this article, it is noteworthy to consider some of the significant differences under the new system as compared to the disclosure requirements that small business issuers were required to comply with prior to the new system. As a general proposition, the disclosure requirements of Regulation S-B are streamlined and condensed somewhat from those required under Regulation S-K. The determination of the reporting category for a company is made at the time the company enters the S-B disclosure system and will thereafter govern all reports for such company for the remainder of its fiscal year.[83]

With respect to Securities Act and Exchange Act filings, respectively, on an item by item basis, Form SB-2 and Form 10-KSB require substantially all of the information required by existing Form S-1 and Form 10K respectively, the key difference being, however, in the breadth of disclosure for particular items. In its current form, Regulation S-B eliminates the requirement of Item-301 (Selected Financial Data) of Regulation S-K as well as Item 302 (Supplementary Financial Information) and proceeds directly to a new Item 303 entitled Management's Discussion and Analysis or Plan of Operation. Small business issuers that have not had revenues from operations in each of the last two fiscal years or the last fiscal year and any interim period in the current fiscal year for which financial statements are furnished are re-

79 *Id.*
80 *See* Release, *supra* note 1, at 22.
81 57 Fed. Reg. 36,460 (1992); *see also* 17 C.F.R. § 228.501.
82 57 Fed. Reg. 36,446 (1992).
83 17 C.F.R. § 228.10(2)(v).

quired to provide certain information with respect to their proposed plan of operation. All other issuers are required to provide information relating to results of operations and an analysis thereof. With respect to plan of operation information, the issuer is required to discuss its objectives during the ensuing twelve months, including but not limited to, its expectations regarding its ability to satisfy its cash requirements and whether it will have to raise additional funds within such twelve months.[84] The issuer is also required to discuss any anticipated significant purchases or sales of plant, equipment and changes in employees.[85]

In connection with a discussion of the results of operations, the issuer is required to discuss its operations for each of the last two fiscal years with a particular emphasis on its prospects for the future. If material, the issuer should also disclose facts relating to liquidity, commitments for material capital expenditures and known trends and events.[86] If the issuer is required to provide interim financial statements in the applicable Securities Act registration statement or Exchange Act report, it must provide a comparable discussion with respect to such periods.[87]

In another significant simplification, under new S-B Item 101, the issuer is only required to discuss its business developments during the last three fiscal years as opposed to the five year requirement under S-K Rule 101 and Form S-18.[88]

Item 310 is the financial statement section of Regulation S-B and is similar in many respects to the financial statement requirements of Form S-18.[89] The issuer is required to file an audited balance sheet prepared in accordance with generally accepted accounting principles as of the end of the most recent fiscal year, or as of a date within 135 days if the issuer existed for a period less than one fiscal year and audited statements of income, cash flows and changes in stockholder's equity for each of the two fiscal years proceeding the date of such audited balance sheet or such

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84 17 C.F.R. § 228.303(a).
85 17 C.F.R. § 228.303(b).
86 17 C.F.R. § 228.303(b)(1).
87 17 C.F.R. § 228.303(b)(2).
88 17 C.F.R. § 228.101.
89 17 C.F.R. § 228.310.

shorter period as the issuer has been in business.[90] Interim financial statements (which may be unaudited) must include a balance sheet as of the end of the issuer's most recent fiscal quarter and income statements and statements of cash flow for the interim period up to the date of such balance sheet and the comparable period of the preceding fiscal year.[91] As noted above, in addition to eliminating S-K Items 301 and 302 from the overall financial presentation, the financial statement disclosure requirements themselves are significantly diminished from the requirements of the existing integrated disclosure system where the issuer is required to provide audited balance sheets for the two most recent fiscal years and audited income statements for each of the three most recent fiscal years.

Certain additional other changes appear in Item 310: first, significant businesses as defined in Rule 405 of Regulation C are incorporated directly into the item as opposed to cross-referencing; second, *pro forma* financial statements are required to be filed upon the occurrence of certain significant dispositions or business combinations; and finally, if a development stage company is not readily able to provide financial information for comparative periods before filing for an initial public offering, such requirement is waived.[92] By separate proposal, the Commission is also studying whether an automatic waiver of financial statement requirement relating to certain significant acquisitions is warranted when such audited statements are not available and whether small business issuers can conduct a registered initial public offering within ninety days of year end without audited financial statements for the latest fiscal year.[93]

Item 405 of Regulation S-B requires every small business issuer that has a class of equity securities registered pursuant to Section 12 of the Exchange Act[94] to identify each director, officer or ten percent beneficial owner of any class of equity securities registered under Section 12 who failed to file on a timely basis

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90 17 C.F.R. § 228.310(a).

91 17 C.F.R. § 228.310(b).

92 57 Fed. Reg. 36,446 (1992).

93 *Id. See also* Supplemental Release, *supra* note 64. Under Regulation S-X, issuers proposing to conduct an initial public offering after 45 days subsequent to the issuer's fiscal year end must provide audited financial statements for such annual period before the effective date of the registration statement.

94 15 U.S.C. § 78l (1982).

reports required by Section 16(a)[95] during the most recent fiscal year or prior years, including with respect to each such person, the number of late reports and any known failure to file a required form. The issuer's obligation to make the disclosure is based solely upon a review of Forms 3, 4 and 5 furnished to it during its most recent fiscal year.[96]

V. Conclusion

Ideally, the Commission's small business initiatives will help facilitate small business capital formation through lower financing costs, simplification of the regulatory process and increased market awareness of investment opportunities in small, yet potentially successful companies. Balanced against this is a concern, articulated particularly by state securities administrators, that investor protection will be trampled by eliminating decades of existing regulatory experience and compliance. However, the question of whether these initiatives have achieved their stated objectives cannot be adequately measured until the financial markets, the Commission and the state securities administrators have an opportunity to gauge the new amendments, from a prospective of completing financings more effectively, increasing access to capital, assessing the quality and level of disclosure and the impact on investors.

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95 15 U.S.C. § 78p(a) (1982).
96 17 C.F.R. § 228.405.