

# RELAXING THE BAN: IT'S TIME TO ALLOW GENERAL SOLICITATION AND ADVERTISING IN EXEMPT OFFERINGS

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## I. INTRODUCTION

Small businesses play a pivotal role in the United States economy. “They are the foundation of the Nation’s economic growth: virtually all of the new jobs, 53 percent of employment, 51 percent of private sector output, and a disproportionate share of innovations come from small firms.”<sup>1</sup> A large portion of these numbers, however, is driven by

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1. THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1 (1997); *see also* THE STATE OF SMALL BUSINESS: A REPORT OF THE PRESIDENT 1 (2001) (“Small businesses have always been the backbone of our economy. They perennially account for most innovation and job creation, and not just when our economy is robust and growing. Small businesses have sustained the economy in weaker times as well, and put us back on the track to long-term growth.”); Sulin Ba et al., *Small Business in the Electronic Marketplace: A Blueprint for Survival*, TEX. BUS. REV., Dec. 1999, at 1 (“Economists have long recognized the importance of small business in the economy. The active existence of numerous small

a small subset of small businesses—specifically, entrepreneurial companies that start small and grow fast.<sup>2</sup> These so-called emerging companies<sup>3</sup> “represent the potential for innovation, job creation and high returns for investors claimed by the small business community.”<sup>4</sup> Some of today’s most successful, established companies were small, emerging companies in the not-so-distant past. For example, in 1975 Microsoft Corporation was nothing more than a vision shared by two young men to put a personal computer in every home and office.<sup>5</sup> Likewise, in 1971 Federal Express Corporation was nothing more than an idea set forth in a college economics term paper that received a “C” grade.<sup>6</sup> In 2003 Microsoft and Federal Express employed 55,000<sup>7</sup> and 134,000<sup>8</sup> people and, in 2004, had market capitalizations of \$306.85 billion<sup>9</sup> and \$24.29 billion,<sup>10</sup> respectively. For fiscal year 2003, Microsoft’s net income was \$13 billion on revenues of \$32 billion,<sup>11</sup> and Federal Express’s operating income was \$786 million on revenues of \$16 billion.<sup>12</sup> For fiscal year 2003, Microsoft and Federal Express paid \$4.7 billion<sup>13</sup> and \$258 million,<sup>14</sup> respectively, in federal income taxes.

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business firms, each exercising a reasonable degree of independence, is considered basic to the maintenance of a competitive market.”).

2. Jeffrey E. Sohl, *The Early-Stage Equity Market in the USA*, 1 VENTURE CAP.: INT’L J. ENTREPRENEURIAL FIN. 101, 105 (1999); see also Ronald L. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1068 (2003) (“Beyond representing an important engine of macroeconomic growth and job creation, [emerging companies] have been a major force in commercializing cutting-edge science . . .”); Steven H. Hobbs, *Toward a Theory of Law and Entrepreneurship*, 26 CAP. U. L. REV. 241, 297 (1997) (“Between 1990 to 1994 [emerging companies] accounted for all of the nation’s net new jobs.”).

3. These companies are also sometimes referred to as gazelles. Hobbs, *supra* note 2, at 297.

4. Sohl, *supra* note 2, at 105.

5. JAMES WALLACE & JIM ERICKSON, *HARD DRIVE: BILL GATES AND THE MAKING OF THE MICROSOFT EMPIRE* 90 (1992).

6. Eugene Carlson, *American Entrepreneurs: Federal Express Wasn’t an Overnight Success*, WALL ST. J., June 6, 1989, at B2.

7. MICROSOFT CORP., ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED JUNE 30, 2003 (FORM 10-K), File No. 0-14278, at 7, available at <http://sec.gov/Archives/edgar/data/789019/000119312503045632/d10k.htm> [hereinafter MICROSOFT 10-K].

8. FEDERAL EXPRESS CORP., ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED MAY 31, 2003 (FORM 10-K), File No. 1-7806, at 4, available at <http://sec.gov/Archives/edgar/data/230211/000104746903024447/a2114482z10-k.htm> [hereinafter FEDERAL EXPRESS 10-K].

9. YAHOO! INC., key statistics for Microsoft Corp., at <http://finance.yahoo.com/q?s=msft> (updated frequently, last visited Aug. 10, 2004).

10. YAHOO! INC., key statistics for Fedex Corp., at <http://finance.yahoo.com/q?s=fdx> (updated frequently, last visited Aug. 10, 2004).

11. MICROSOFT 10-K, *supra* note 7, at 10.

12. FEDERAL EXPRESS 10-K, *supra* note 8, at 19.

13. MICROSOFT 10-K, *supra* note 7, at 19.

14. FEDERAL EXPRESS 10-K, *supra* note 8, at F-5.

Obviously, most emerging companies do not enjoy the spectacular growth and success of Microsoft or Federal Express. Countless emerging companies do not even get out of the gate because they are unable to raise the necessary capital “to move promising technology from the laboratory to the marketplace.”<sup>15</sup> This, of course, costs the United States untold thousands of jobs and innovations and billions of dollars of tax revenue.<sup>16</sup>

Many emerging companies fail to raise critical early-stage capital largely because of market inefficiencies.<sup>17</sup> An assumption underlying financial theory is that capital markets are efficient and thereby all material information concerning sources of capital is available to companies seeking capital.<sup>18</sup> This generally holds true with respect to established companies.<sup>19</sup> For an established company, “financial markets supply a complete variety of financing instruments, with these markets being relatively accessible and the owner/manager left to decide the optimum mix of a financial structure based on the cost of capital.”<sup>20</sup> This assumption may not hold true with respect to emerging companies.<sup>21</sup> Emerging companies typically have limited collateral and operating histories and no public market for their stock. And oftentimes as a result, their only financing option is private equity financing.<sup>22</sup> Estimates indicate, however, that financial markets fall short by some \$60 billion annually in meeting the demand of small companies for early-stage private equity financing.<sup>23</sup> This unmet need is referred to as the funding gap.<sup>24</sup>

This funding gap for emerging companies seems to result from information inefficiencies.<sup>25</sup> Sufficient capital appears to be available to fund the needs of emerging companies.<sup>26</sup> However, sufficient information about potential sources of early-stage capital is not available to emerging companies.<sup>27</sup> Likewise, sufficient information about poten-

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15. Jeffrey E. Sohl, *The U.S. Angel and Venture Capital Markets: Recent Trends and Developments*, J. PRIVATE EQUITY, Spring 2003, at 7, 14.

16. See Gilson, *supra* note 2, at 1077.

17. See Sohl, *supra* note 15, at 14.

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. See GEN. ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, COMM. ON SMALL BUS., U.S. SENATE, SMALL BUSINESS EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 1 (2000) [hereinafter GAO REPORT].

23. *Id.* at 2; see also Sohl, *supra* note 2, at 110.

24. See Sohl, *supra* note 15, at 14; see also GAO REPORT, *supra* note 22, at 3-4 (“In general, . . . equity capital is widely viewed as less accessible and more costly per dollar raised for small businesses compared with large businesses.”).

25. See Sohl, *supra* note 15, at 14.

26. See *id.*

27. *Id.*; see also JOHN FREEAR ET AL., U.S. SMALL BUS. ADMIN., CREATING NEW CAPITAL MARKETS FOR EMERGING VENTURES 9 (1996) (“Private investing in early-stage ventures occurs in an inefficient market. There are no directories of private investors, no

tial investment opportunities is not available to those interested in investing in early-stage companies.<sup>28</sup> As a result, “[a]n entrepreneur’s search for equity capital is often a time-consuming process, resulting in missed market opportunities and unsuccessful avenues.”<sup>29</sup>

This information gap is exacerbated by securities regulations that limit the avenues an emerging company can pursue in locating capital and providing the marketplace with information. An emerging company generally cannot, for example, contact every person in its region that owns a Lamborghini sports car to see if any would be interested in making an early-stage private equity investment in the company.<sup>30</sup> This is because both federal and state securities regulations prohibit the use of general solicitation and advertising in private placements.<sup>31</sup> The U.S. Securities and Exchange Commission (SEC) interprets this prohibition to restrict investors in a company’s private placement to those with whom the company or someone acting on its behalf has a preexisting, substantive relationship.<sup>32</sup> So unless the company or someone acting on its behalf has this requisite relationship with the Lamborghini owners, contacting them to participate in the offering would violate the prohibition on general solicitation and advertising.

In light of this information gap and the importance of emerging companies to the nation’s well-being, this Article calls for new securities regulations that would allow emerging companies and others to engage in general solicitation and advertising in their quest for capital. Part I discusses the typical financing path of an emerging company and the importance of angel equity capital in this path. Part II describes the regulatory scheme applicable to raising private equity capital. It examines in depth the ban on general solicitation and advertising and finds the ban to have a negative impact on the capital-raising efforts of emerging companies. Part III demonstrates that there is no strong ideological foundation for the ban. Thus, Part IV calls for regulatory reform to allow, subject to certain limitations, companies and broker-dealers to seek investors in private placements through general solicitation and advertising, regardless of the

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public records of their investment transactions, few vehicles exist for bringing together potential investors and ventures seeking funds and transaction costs are high.”)

28. Sohl, *supra* note 15, at 14.

29. *Id.*

30. The assumption is that someone who owns a very expensive and high-powered sports car would likely have the funds and stomach for an early-stage investment in an emerging company.

31. See, e.g., 17 C.F.R. § 230.502(c) (2003); ROSA M. MOLLER, CA. RESEARCH BUREAU, SECURITIES REGULATIONS AND THEIR EFFECTS ON SMALL BUSINESSES 3 (2000).

32. See *infra* text accompanying notes 125 and 126 for the definition of preexisting, substantive relationship.

preexisting relationship (or lack thereof) between the companies or broker-dealers and the potential investors.

## II. EMERGING COMPANY FINANCING PATH

There are four recognized broad categories of equity financing that a typical emerging company requires as it grows and matures: seed financing, start-up financing, early-stage financing, and later-stage financing.<sup>33</sup> Seed financing represents the relatively small amount of funding needed by an entrepreneur to prove a concept.<sup>34</sup> Start-up financing is used to complete product development and begin marketing.<sup>35</sup> Early-stage financing is used for initial expansion.<sup>36</sup> Later-stage financing is used for major expansion to meet increasing sales volumes or to support an emerging company expecting to go public within six to twelve months.<sup>37</sup>

Seed funding is often supplied by the owner/investor through personal savings, credit card debt, and second home mortgages.<sup>38</sup> Start-up funding may initially come from friends and families.<sup>39</sup> Once these sources are tapped out, an emerging company then looks to outside sources of financing. Generally speaking, funding could be in the form of equity, such as an investment in common or preferred stock, or debt, such as a bank loan. For emerging companies, however, debt is generally not an option—they do not have the necessary collateral, operating history, or proven track record to qualify for bank loans.<sup>40</sup> The primary source of equity capital at the start-up and early stages comes from angel investors.<sup>41</sup> Thus, attracting the interest of angel investors is critical to the success of an emerging company.<sup>42</sup>

Angel investors are generally high-net worth individuals that typically possess substantial business and entrepreneurial experience.<sup>43</sup> Oftentimes their investment capital and experience come from their own successes in starting, growing, and then cashing out of emerging companies.<sup>44</sup> Angel investors typically invest in companies involved in technologies and markets in which they have some expertise or familiarity and, therefore, take active roles in advising and

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33. Sohl, *supra* note 2, at 106; *see also* GAO REPORT, *supra* note 22, at 9.

34. Sohl, *supra* note 2, at 106.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at 107.

39. *Id.*

40. GAO REPORT, *supra* note 22, at 5; *see also* FREEAR, *supra* note 27, at 5.

41. Sohl, *supra* note 2, at 108; *see also* GAO REPORT, *supra* note 22, at 3.

42. *See* Sohl, *supra* note 2, at 108; FREEAR, *supra* note 27, at 4.

43. Sohl, *supra* note 2, at 108; *see also* FREEAR, *supra* note 27, at 7-8; GAO REPORT, *supra* note 22, at 10.

44. *See* Sohl, *supra* note 2, at 108.

mentoring the managers of these emerging companies.<sup>45</sup> Thus, angel investors contribute not only capital but also business experience, which many entrepreneurs consider to be just as valuable as the capital invested by angel investors.<sup>46</sup>

A typical round of angel financing is in the \$100 thousand to \$2 million range, involving six to eight angel investors.<sup>47</sup> Estimates indicate that between 300,000 and 350,000 angel investors invest roughly \$30 billion every year in approximately 50,000 ventures.<sup>48</sup> This money is considered patient capital since angel investors typically have exit horizons on such investments of five to ten years or more.<sup>49</sup>

As an emerging company's need for cash begins to outstrip the resources of angel investors, the company will likely look to venture capital funds for larger rounds of equity financing.<sup>50</sup> These funds are the primary source of later-stage financing for emerging companies.<sup>51</sup> Total investment by the venture capital industry has grown dramatically during the last decade from approximately \$2.7 billion annually in 1994 to between \$30 and \$35 billion in 2003.<sup>52</sup> A typical round of venture financing is a "later-stage deal in the \$10 to \$15 million range."<sup>53</sup> To attract an investment by a venture capital fund, the emerging company will need to have progressed beyond the seed and start-up stages of its development and show signs of sustainable growth.<sup>54</sup> Many, if not most, emerging companies fail to attract venture financing.<sup>55</sup>

As mentioned in the introduction, estimates indicate that the total unmet need for early-stage equity financing for small companies is \$60 billion annually.<sup>56</sup> This unmet need, or funding gap, is likely more than double the estimated \$30 billion in early-stage equity financing provided annually by angel investors. At the same time, the venture capital industry has undergone a systemic shift towards even later-stage and larger deals.<sup>57</sup> Hence, the dramatic increase in

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45. FREEAR, *supra* note 27, at 8.

46. Sohl, *supra* note 15, at 12.

47. *Id.* at 13.

48. *Id.*

49. FREEAR, *supra* note 27, at 8; *see also* Sohl, *supra* note 2, at 111.

50. Sohl, *supra* note 15, at 13.

51. *Id.*; *see also* GAO REPORT, *supra* note 22, at 11.

52. Sohl, *supra* note 15, at 13.

53. *Id.*

54. Sohl, *supra* note 2, at 109.

55. GAO REPORT, *supra* note 22, at 3 ("[M]any small businesses have difficulty attracting venture capital financing because of the selection criteria used by venture capitalists in deciding where to invest their funds."). "[O]nly about 1 percent of all business plans submitted to venture capital funds typically has received financing in recent years . . . ." *Id.* at 20 (footnote omitted).

56. *Id.* at 2 (estimate based on 1996 study); *see also* Sohl, *supra* note 2, at 110.

57. Sohl, *supra* note 15, at 13; *see also* GAO REPORT, *supra* note 22, at 13.

venture capital funding over the last decade has done nothing to address the funding gap at the start-up and early stages of the financing paths of emerging companies.<sup>58</sup> Additionally, the speculation that the use of Internet-based technology by small companies seeking private equity would help close the funding gap<sup>59</sup> does not appear to have materialized—as of spring 2003, a significant funding gap remains.<sup>60</sup> Thus, a company that would have grown into the next Microsoft or Federal Express may have been conceived on more than one occasion but died in the seed stage because its founder was unable to obtain the necessary angel financing to survive.<sup>61</sup>

As alluded to in Part I, it appears that this funding gap is not due to a shortage of angel capital. Estimates suggest that the number of potential or latent angel investors exceeds the number of active angel investors by a ratio of five to one.<sup>62</sup> Therefore, the potential pool of angel capital may be as large as \$150 billion annually. Hence, getting these latent or potential angel investors to become active angel investors would likely eliminate the funding gap.

How then can an emerging company reach these potential angel investors? The commonsense answer is through marketing. However, since it is equity in the company that is being marketed, that is, securities such as common or preferred stock, any such marketing must be done within the strictures of federal and state securities regulations.

### III. FEDERAL AND STATE SECURITIES REGULATIONS

Pursuant to the Securities Act of 1933 (“Securities Act”),<sup>63</sup> it is illegal for anyone to offer or sell a security<sup>64</sup> in the United States unless the offer and sale are registered with the SEC or are exempt from registration.<sup>65</sup> The term *offer* includes “every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.”<sup>66</sup> This language has been construed much more

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58. GAO REPORT, *supra* note 22, at 13.

59. *See, e.g.*, Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 64 (1998) (“By reducing the cost of matching angels and investment opportunities on a national scale, the Internet may increase such matches.”).

60. *See* Sohl, *supra* note 15, at 11.

61. *See id.* at 13.

62. Sohl, *supra* note 2, at 108.

63. Securities Act of 1933, 15 U.S.C. §§ 77a-77r (2000).

64. The term *security* is broadly defined under the Securities Act to include “any note, stock, treasury stock, . . . bond, debenture, . . . investment contract, . . . option, . . . or warrant or right to subscribe to or purchase, any of the foregoing.” *Id.* § 77b(a)(1).

65. *Id.* § 77e(a). *See generally* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 385-521 (3d ed. 1999).

66. *Id.* § 77b(a)(3).

broadly than the common law of contracts definition of *offer*.<sup>67</sup> Hence, while under the common law of contracts, advertisements are not ordinarily construed as offers,<sup>68</sup> an advertisement by a company seeking investors in its securities would clearly constitute an offer for purposes of the Securities Act.<sup>69</sup>

Registering an offering with the SEC is expensive<sup>70</sup> and time-consuming.<sup>71</sup> Further, successfully completing a registered offering generally requires that the issuer retain an underwriter to handle the deal.<sup>72</sup> As a general rule, however, no underwriter will take a company public unless the company has, at a minimum: (1) annual revenue of \$20 million, (2) net income of \$1 million, and (3) the potential to achieve and sustain significant growth rates (such as twenty percent or greater in revenues) for the next five to ten years.<sup>73</sup> Since few, if any, early-stage emerging companies meet the foregoing criteria, a registered offering is not an option for them. That leaves exempt offerings, or, in other words, offerings conducted in compliance with exemptions from registration.<sup>74</sup> The most commonly relied-on exemptions for stock offerings by emerging companies are those provided by Regulation D under the Securities Act.<sup>75</sup>

#### A. Regulation D

Regulation D comprises Rules 501 through 508 and includes three exemptions from registration under the Securities Act. These exemptions are contained in Rules 504, 505, and 506. Rules 501 through 503 provide certain definitions and conditions that generally apply to each Regulation D exemption.<sup>76</sup> Rule 507 disqualifies certain issuers from relying on any of the three Regulation D exemptions.<sup>77</sup> Finally,

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67. 2 LOSS & SELIGMAN *supra* note 65, at 1138.19-.20 n.520.

68. 1 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 27 (3d ed. 1957).

69. Publication of Information Prior to or After Effective Date of Registration Statement, Securities Act of 1933 Release No. 3844 (Oct. 8, 1957), 1957 SEC LEXIS 332, at \*7 (example 1).

70. See GAO REPORT, *supra* note 22, at 23 tbl.2 (citing NASDAQ, GOING PUBLIC (4th ed. 1999)).

71. William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 576-77 (2001).

72. See *id.* at 581-82.

73. GAO REPORT, *supra* note 22, at 21-22. As noted, this is only a general rule and, as such, is an oversimplification. Exceptions to the rule include companies that have an innovative product in a hot market or that are, or are on track to be, first to market in a particular field. See Laird H. Simons III, *Considerations in Selecting the Managing Underwriter(s) for an Initial Public Offering*, in HOW TO PREPARE AN INITIAL PUBLIC OFFERING 1999, at 37, 41 (PLI Corp. Law & Practice Handbook Series No. B-1135, 1999).

74. See GAO REPORT, *supra* note 22, at 27.

75. 17 C.F.R. §§ 230.501-.508 (2003).

76. *Id.* §§ 230.501-.503.

77. *Id.* § 230.507.

Rule 508 provides issuers with relief for insignificant deviations from compliance with the requirement of a Regulation D exemption.<sup>78</sup>

Regulation D only provides exemptions from the registration requirements of the Securities Act. It does not exempt an offering from the antifraud or civil liability provisions or any other provision of the federal securities laws.<sup>79</sup> Nor does it provide an exemption from any applicable state law relating to the offer and sale of securities.<sup>80</sup> Further, the Regulation D provisions exempt from registration the offering of securities, not the securities themselves, and are available only to the issuer of the securities and not to resellers of the issuer's securities.<sup>81</sup>

Rule 504 was promulgated under section 3(b) of the Securities Act.<sup>82</sup> Under Rule 504, a company can offer and sell securities to an unlimited number of persons.<sup>83</sup> The total dollar amount of the offering, however, cannot exceed \$1 million less the aggregate offering price of all securities sold by the company during the preceding twelve months in reliance on Rule 504, Rule 505, or Regulation A or in violation of the registration requirements of the Securities Act.<sup>84</sup> Unlike securities issued in reliance on Rule 505 or 506, no specific information with respect to the company or the offering needs to be furnished to investors,<sup>85</sup> and there is no limit on the number of "non-accredited" investors that can participate in the offering.<sup>86</sup> Rule 504 is not available to a reporting company, that is, a company that is required to file periodic reports with the SEC under the Securities Exchange Act of 1934 ("Exchange Act"),<sup>87</sup> a start-up company with no specific business plan, or an investment company.<sup>88</sup>

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78. *Id.* § 230.508.

79. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act of 1933 Release No. 33-6389 (Mar. 8, 1982), 1982 SEC LEXIS 2167, at \*13 (describing Preliminary Note 1 of Regulation D) [hereinafter Regulation D Adopting Release].

80. *Id.* (describing Preliminary Note 2 of Regulation D).

81. *Id.* at \*14 (describing Preliminary Note 4 of Regulation D).

82. 15 U.S.C. § 77c(b) (2000). See *infra* text accompanying notes 333 and 334 for a description of Securities Act section 3(b).

83. Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Release No. 33-7644 (Feb. 25, 1999), 1999 SEC LEXIS 408, at \*3 [hereinafter "Seed Capital" Exemption Release].

84. 17 C.F.R. § 230.504(b)(2) (2003).

85. 1 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK 464-65 (2002); see also GAO REPORT, *supra* note 22, at 28.

86. BLOOMENTHAL, *supra* note 85.

87. A company does not have to file periodic reports with the SEC unless its securities are registered under the Exchange Act. Registration is generally required of any class of equity securities of a company with \$1 million or more in total assets held of record by between 500 and 750 shareholders or at least 750 shareholders. 15 U.S.C. § 78l(g)(1); 17 C.F.R. § 240.12g-1. See generally BLOOMENTHAL, *supra* note 85, at 585-86. A company that does not fall within these requirements can nevertheless voluntarily register. *Id.* at 586-87.

88. 17 C.F.R. § 230.504(a).

Rule 505 was also promulgated under section 3(b) of the Securities Act<sup>89</sup> and provides an exemption for offerings of up to \$5 million less the aggregate offering price of all securities sold by the company during the preceding twelve months in reliance on Rule 504, Rule 505, or Regulation A or in violation of the registration requirements of the Securities Act.<sup>90</sup> Neither the issuer nor anyone acting on its behalf can solicit investors in an offering made in reliance on Rule 505 through any form of “general solicitation” or “general advertising.”<sup>91</sup>

While under Rule 505 a company can offer and sell securities to an unlimited number of “accredited” investors,<sup>92</sup> there must be no more than, or the issuer must reasonably believe that there are no more than, thirty-five nonaccredited investors in the offering.<sup>93</sup> Rule 501(a) defines *accredited investor* as, among other things, banks, insurance companies, mutual funds, and certain other specified institutional investors;<sup>94</sup> “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds \$1,000,000”;<sup>95</sup> “[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year”;<sup>96</sup> and executive officers<sup>97</sup> and directors of the issuer.<sup>98</sup> Additionally, the issuer must furnish to any nonaccredited investors that purchase securities in the offering certain specified information about the issuer and the offering within a reasonable time prior to the purchase.<sup>99</sup> Securities issued pursuant to Rule 502 are considered “restricted securities,”<sup>100</sup> which means

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89. *See id.*

90. *Id.* § 230.505(b)(2)(i).

91. *Id.* §§ 230.505(b)(1), .502(c).

92. Regulation D Adopting Release, *supra* note 79, at \*43-\*44, \*79.

93. 17 C.F.R. § 230.505(b)(2)(ii).

94. *Id.* § 230.501(a)(1).

95. *Id.* § 230.501(a)(5).

96. *Id.* § 230.501(a)(6).

97. *Id.* § 230.501(a)(4). Rule 501(f) defines *executive officer* as “the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer.” *Id.* § 230.501(f).

98. *Id.* § 230.501(a)(4).

99. *Id.* § 230.502(b)(1). While Rule 502(b)(1) does not require that any information be furnished to accredited investors in a Rule 505 or 506 offering, Rule 502(b)(1) includes a note that provides as follows: “When an issuer provides information to investors pursuant to paragraph (b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws.” *Id.*

100. *Id.* § 230.144(a)(3)(ii).

they cannot be resold unless certain holding periods or other conditions, or both, are met.<sup>101</sup>

Rule 506 was promulgated under section 4(2) of the Securities Act<sup>102</sup> and not section 3(b); therefore, there is no monetary limit on the size of a Rule 506 offering. Like Rule 505, under Rule 506 a company can offer and sell securities to an unlimited number of accredited investors,<sup>103</sup> but there must be no more than, or the issuer must reasonably believe that there are no more than, thirty-five *nonaccredited* investors in the offering.<sup>104</sup> Rule 506, however, includes an additional requirement not included in Rule 505 that

[e]ach purchaser who is not an accredited investor 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, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.<sup>105</sup>

Like Rule 505, neither the issuer nor anyone acting on its behalf can solicit investors in an offering made in reliance on Rule 506 through any form of “general solicitation” or “general advertising,”<sup>106</sup> securities issued in reliance on Rule 506 are considered “restricted securities,”<sup>107</sup> and the issuer has to furnish certain specified information to any nonaccredited investors that purchase securities in the offering.<sup>108</sup>

In addition to complying with federal securities laws, anyone offering or selling securities must also comply with the securities laws of the states in which they are making the offers and sales, all of which, except for the State of New York, require registration of the offering with state regulators unless the offering falls within an exemption therefrom.<sup>109</sup> In 1996, however, Congress passed the National Securities Markets Improvement Act (NSMIA).<sup>110</sup> NSMIA, among other things, amended section 18 of the Securities Act to provide that no state law, rule, regulation, or order “requiring, or with respect to, registration or qualification of securities, or registration or

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101. See BLOOMENTHAL, *supra* note 85, at 523; see also GAO REPORT, *supra* note 22, at 54.

102. See 17 C.F.R. § 230.506(a). See *infra* Part IV.A for a description of Securities Act section 4(2).

103. See Regulation D Adopting Release, *supra* note 79, at \*46, \*80.

104. 17 C.F.R. § 230.506(b)(2)(i).

105. *Id.* § 230.506(b)(2)(ii).

106. *Id.* §§ 230.506(b)(1), .502(c).

107. See *id.* § 230.144(a)(3)(ii).

108. *Id.* §§ 230.506(b)(1), .502(b).

109. 1 LOSS & SELIGMAN, *supra* note 65, at 69.

110. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified at 15 U.S.C. § 77r (2000)) [hereinafter NSMIA]. See generally 1 LOSS & SELIGMAN, *supra* note 65, at 60-67.

qualification of securities transactions, shall directly or indirectly apply to a security that . . . is a covered security.”<sup>111</sup> The definition of a covered security includes a security issued pursuant to Rule 506, but does not include a security issued pursuant to Rule 504 or Rule 505.<sup>112</sup> As a result, most private placements are conducted in compliance with Rule 506 since doing so avoids having to comply with state registration and exemption requirements.<sup>113</sup> This saves both time and money, especially for multistate offerings.<sup>114</sup> Rule 506 has the additional advantage of having no monetary cap on the size of the offering, unlike Rule 504 and Rule 505 offerings.<sup>115</sup>

### B. *The Prohibition on General Solicitation and Advertising*

As mentioned above, Regulation D prohibits the use of general solicitation or general advertising to solicit investors in a Rule 505 and Rule 506 offering. Specifically, Rule 502(c) of Regulation D provides that “neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising.”<sup>116</sup> Hence, analyzing the application of Rule 502(c) can be divided into the following two inquiries: (1) Is the communication general?; and (2) Is the communication made by or on behalf of the issuer?<sup>117</sup> If the answer to either of these questions is no, the issuer will not be in violation of Rule 502(c).<sup>118</sup> Each of these inquiries is discussed below.

#### 1. *General Solicitation/Advertising*

The terms *general advertising* and *general solicitation* are not defined in Rule 502(c) nor were the terms discussed in the release adopting Regulation D.<sup>119</sup> Rule 502(c) does, however, state that soliciting investors through “(1) [a]ny advertisement, article, notice or

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111. 15 U.S.C. § 77r(a)(1).

112. *Id.* § 77r(b)(4)(D); *see also* BLOOMENTHAL, *supra* note 85, at 1354-55.

113. 15 U.S.C. § 77r(b)(4)(D). A state can require an issuer conducting a Rule 506 offering in that state to make a notice filing of the offering. *Id.*; *see also* GAO REPORT, *supra* note 22, at 30 (“According to SEC statistics, rule 506 offerings have increased dramatically since 1994, growing from 5,414 in that year to 13,112 in 1999.”).

114. Each of the fifty states has its own securities laws. These laws lack uniformity in many areas, including registration requirements and exemptions therefrom. 1 LOSS & SELIGMAN, *supra* note 65, at 31-42. Thus, an issuer conducting a multistate private placement subject to state registration requirements would incur additional legal fees in navigating what could be a complicated maze of overlapping and varying state laws. *See* Sjostrom, *supra* note 71, at 587.

115. *See supra* text accompanying notes 84 and 90.

116. 17 C.F.R. § 230.502(c) (2003).

117. Interpretive Release on Regulation D, Securities Act of 1933 Release No. 33-6455 (Mar. 3, 1982), 1983 SEC LEXIS 2288, at \*45 [hereinafter Interpretive Release on Regulation D].

118. *Id.*

119. *See* Regulation D Adopting Release, *supra* note 79.

other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; [or] (2) [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising”<sup>120</sup> would constitute general solicitation or advertising. Thus, it is clear from the first example above that an issuer conducting a Rule 506 offering could not place an advertisement in, for example, the *Wall Street Journal* soliciting investors in the offering.<sup>121</sup> The second example is not of much additional help because it is circular in that it turns on the definition of general solicitation or general advertising.

The SEC has provided guidance on what constitutes general solicitation or advertising mostly through no-action letters.<sup>122</sup> In interpreting the ban on general solicitation and advertising, the SEC has focused on the relationship between the solicitor and the potential investor.<sup>123</sup> Specifically, for a communication to a potential investor not to be considered general solicitation or advertising, the SEC requires a preexisting, substantive relationship between the solicitor and potential investor.<sup>124</sup> The SEC considers a relationship preexisting if it is established prior to the solicitation for the particular offering.<sup>125</sup> The SEC considers a relationship substantive if it “would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration.”<sup>126</sup> While the SEC asserts “that prior relationship is [not] the only way to show the absence of general solicitation,”<sup>127</sup> to date, the

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120. 17 C.F.R. § 230.502(c).

121. See 1-1 SECURITIES LAW TECHNIQUES: TRANSACTIONS AND LITIGATION § 1.03[2][b][iii] (A.A. Sommer, Jr. ed., Matthew Bender & Co. 2003), available at LEXIS Securities, Treatises & Analytical Materials; see also *Hill York Corp. v. Am. Int'l Franchises, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971) (“[P]ublic advertising is incompatible with the claim of private offering.”), *rev'd in part on other grounds*, *Pinter v. Dahl*, 486 U.S. 622 (1988).

122. A no-action letter is a method of securing informal advice from the SEC on a specific proposed transaction. In a no-action letter, the SEC advises the recipient whether it is likely to bring legal action if the proposed transaction occurs or will take no action. See 2 LOSS & SELIGMAN, *supra* note 65, at 532-33 n.29.

123. BLOOMENTHAL, *supra* note 85, at 472; see also *Kenman Corp.*, Securities Act of 1934 Release No. 34-21962 (Apr. 19, 1985), 1985 SEC LEXIS 1717, at \*9 n.6 (“In determining what constitutes a general solicitation, the Commission’s Division of Corporation Finance has underscored the existence and substance of pre-existing relationships between the issuer and those being solicited.”) [hereinafter *Kenman Corp. Release*]; *Woodtrails-Seattle Ltd.*, SEC No-Action Letter (July 8, 1982), 1982 SEC No-Act. LEXIS 2662, at \*1-\*2; Interpretive Release on Regulation D, *supra* note 117, at \*46.

124. 3 LOSS & SELIGMAN, *supra* note 65, at 1440; see also *Robert T. Willis, Jr., P.C.*, SEC No-Action Letter (Jan. 18, 1988), 1988 SEC No-Act. LEXIS 34, at \*2.

125. See *E.F. Hutton & Co.*, SEC No-Action Letter (Dec. 3, 1985), 1985 SEC No-Act. LEXIS 2917, at \*2.

126. *Mineral Lands Research & Mktg. Corp.*, SEC No-Action Letter (Dec. 4, 1985), 1985 SEC No-Act. LEXIS 2811, at \*2.

127. Regulation D, Securities Act of 1933, Release No. 33-6825 (Mar. 15, 1989), 1989 SEC LEXIS 520, at \*8 n.12.

SEC has failed to issue any no-action letter finding the absence of general solicitation in the absence of such relationship.<sup>128</sup>

## 2. *By or on Behalf of the Issuer*

In a private placement, investors are typically solicited by the issuer's management or employees of an investment banking firm retained by the issuer to solicit investors. In these situations, it is obvious that the investors are solicited by or on behalf of the issuer. Questions, however, sometimes arise concerning whether an unrelated third-party communication was made on behalf of an issuer.<sup>129</sup>

For example, in the Tax Investment Information Corporation no-action letter,<sup>130</sup> the SEC considered whether the publication of an analysis of private placements by individuals who had no connections to the issuers or the offerings being analyzed would violate Rule 502(c).<sup>131</sup> The SEC noted that Regulation D does not directly prohibit such a third party communication but "refused to agree that such a publication would be permitted under Regulation D because of its susceptibility [sic] to use by participants in an offering."<sup>132</sup> Under this "susceptible-to-use" theory, a Rule 506 offering could be thwarted<sup>133</sup> by a third-party publication of an analysis of the offering even if the issuer can prove it in no way authorized or assisted in preparing the analysis.

## C. *Effect of the Prohibition on General Solicitation and Advertising*

The end result of the SEC's narrow interpretation of what does not constitute general solicitation or advertising is that to complete a successful private placement, an emerging company must either (1) have preexisting relationships with a large number of accredited investors or (2) know or hire someone who does. Otherwise, an emerging company is left with the very difficult task of attracting buyers to a product, that is, its securities, without advertising. Common sense dictates that the company is doomed to fail.

The financial industry has responded to the plight of the emerging company in pursuit of equity capital. Note that implicit in the language "the issuer [or] any person acting on its behalf" in Rule

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128. SECURITIES LAW TECHNIQUES, *supra* note 121, at § 1.03[2]; *see also* Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 107 (1989).

129. *See generally* Daugherty, *supra* note 128, at 93-102.

130. Tax Investment Info. Corp., SEC No-Action Letter (Feb. 7, 1983), 1983 SEC No-Act. LEXIS 1737.

131. Interpretive Release on Regulation D, *supra* note 117, at \*47.

132. *Id.*

133. Rule 502(a) provides that "[a]ll sales that are part of the same [R]egulation D offering must meet all of the terms and conditions of [R]egulation D." 17 C.F.R. § 230.502(a) (2003).

502(c)<sup>134</sup> is the concept that the solicitor can be someone other than the issuer, for example, an investment banking firm.<sup>135</sup> This means that investment banking firms can, in effect, rent their preexisting, substantive relationships to companies seeking private equity. Typically, an emerging company in need of private equity will retain an investment banking firm to solicit investors on behalf of the company, especially those investors with whom the investment banking firm has the requisite preexisting, substantive relationships. In exchange for this service, an investment banking firm charges a commission of up to ten percent of the gross offering proceeds plus expenses. The firm may also command common stock warrants and the contractual right to participate in future company offerings, either of which can end up being much more lucrative than the initial cash commission.

Hence, an investment banking firm has a strong incentive to build a pool of accredited investors with which the firm has the requisite preexisting, substantive relationship.<sup>136</sup> A large pool allows an investment banking firm to quickly raise sizeable amounts of private equity which, in turn, allows the firm to attract the most desirable emerging companies as clients, that is, those in hot market sectors. In the 1985 Bateman Eichler no-action letter, the SEC provided guidance on how an investment banking firm can build up its pool of potential investors in Regulation D offerings without running afoul of the Rule 502(c) ban on general solicitation and advertising.<sup>137</sup>

As described in the Bateman Eichler no-action letter, Bateman Eichler was a licensed broker-dealer that operated in forty-seven states and regularly acted as a selling agent in connection with private offerings of limited partnership interests in reliance on Rule 505 and Rule 506 of Regulation D.<sup>138</sup> In an effort to expand its pool of qualified offerees, Bateman Eichler proposed establishing a program for identifying potential investors.<sup>139</sup> The proposed programs would involve limited monthly mailings by Bateman Eichler account executives to local professionals and businessmen, such as attorneys, accountants, and corporate executives.<sup>140</sup> The mailing would consist of a

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134. *Id.* § 230.502(c).

135. See H. B. Shaine & Co., Inc., SEC No-Action Letter (May 1, 1987), 1987 SEC No-Act. LEXIS 2004, at \*1 (“[I]n most cases a substantive relationship must exist between the issuer or its agents and the offerees . . . .”) (emphasis added).

136. See Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of “Technological Disintermediation” for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 7 (1998).

137. Bateman Eichler, Hill Richards, Inc., SEC No-Action Letter (Dec. 3, 1985), 1985 SEC No-Act. LEXIS 2918.

138. *Id.* at \*3.

139. *Id.* at \*4.

140. *Id.*

letter and a questionnaire.<sup>141</sup> The account executives would then review the completed questionnaires and contact the respondents to obtain additional personal and financial information.<sup>142</sup> Bateman Eichler would then place respondents, from whom it obtained sufficient additional information, on a list of prospective offerees for the type of programs they indicated were of interest and for which Bateman Eichler deemed the respondents suitable.<sup>143</sup>

The program would include procedures so that no respondent would be solicited for an offering which was ongoing or contemplated at the time of the initial mailing to that respondent.<sup>144</sup> Further, Bateman Eichler would wait at least forty-five days from the time of the initial mailing before soliciting a respondent to invest in an offering.<sup>145</sup>

Under the above facts, the SEC stated that “the proposed program of contacting prospective offerees does not constitute an offer to sell securities.”<sup>146</sup> The SEC stressed the fact that the solicitation would be generic and would not refer to any specific ongoing or contemplated offering of Bateman Eichler.<sup>147</sup> The SEC also emphasized that Bateman Eichler “will implement procedures designed to insure that persons solicited are not offered any securities that were offered or contemplated for offering at the time of the solicitation.”<sup>148</sup>

The SEC also concluded “that later offers to persons who respond to the mailings would not be deemed made by a general solicitation as a result of the initial solicitation provided a substantive relationship has been established with the offeree between the time of the initial solicitation and the later offer.”<sup>149</sup> The SEC noted that Bateman Eichler could establish a substantive relationship with “a person who has provided a satisfactory response to a questionnaire that enables Bateman Eichler with sufficient information to evaluate the prospective offeree’s sophistication and financial circumstances.”<sup>150</sup>

The SEC provided further guidance in the 1987 H.B. Shaine & Co. no-action letter.<sup>151</sup> Shaine was a registered broker-dealer and a member of the New York Stock Exchange.<sup>152</sup> Similar to Bateman Eichler, it proposed using a questionnaire to identify potential investors in

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141. *Id.*

142. *Id.* at \*4-\*5.

143. *Id.* at \*5.

144. *Id.*

145. *Id.*

146. *Id.* at \*1.

147. *Id.*

148. *Id.*

149. *Id.* at \*1-\*2.

150. *Id.* at \*2.

151. H.B. Shaine & Co., *supra* note 135.

152. *Id.* at \*3.

Regulation D offerings.<sup>153</sup> Shaine anticipated that some of the individuals responding to the questionnaires would have no previous relationship with Shaine.<sup>154</sup> The questionnaire, among other things, called for specific information about a respondent's employment history, business experience, education, investment experience, income, and net worth.<sup>155</sup> The questionnaire also requested the respondent's opinion on his ability to evaluate the merits and risks of venture capital investments.<sup>156</sup>

Shaine indicated that the questionnaire would be updated annually.<sup>157</sup> Shaine also indicated, consistent with the SEC's position in Bateman Eichler, that sufficient time will have elapsed between a respondent initially completing the questionnaire and being solicited for a particular offering.<sup>158</sup> The SEC concluded that the above procedure "would establish a preexisting substantive relationship with a respondent provided that the respondent furnishes complete responses to the questionnaire."<sup>159</sup> The SEC, in effect, endorsed a questionnaire form that an investment banking firm could use to establish substantive relationships and build up its pool.<sup>160</sup> It also channeled Regulation D financings through broker-dealers since they

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153. *Id.* at \*1.

154. *See id.*

155. *Id.* at \*4.

156. *Id.*

157. *Id.*

158. *Id.* at \*1-\*2.

159. *Id.* at \*2.

160. The SEC reaffirmed and extended the questionnaire approach in its 1996 IPONET no-action letter. IPONET, SEC No-Action Letter (July 26, 1996), 1996 SEC No-Act. Lexis 642. IPONET established a website where it intended to post private offering materials accessible only by password. *Id.* at \*8-\*10. To obtain a password, an investor would have to complete an online questionnaire modeled after the H.B. Shaine questionnaire. *Id.* at \*9. The SEC endorsed the method stating that

[t]he qualification of accredited or sophisticated investors in the manner described and the posting of a notice of a private offering in a password-protected page of IPONET accessible only to IPONET members who have qualified as accredited investors would not involve any form of "general solicitation" or "general advertising" within the meaning of Rule 502(c) of Securities Act Regulation D. In reaching this conclusion, we note that (a) both the invitation to complete the questionnaire used to determine whether an investor is accredited or sophisticated and the questionnaire itself will be generic in nature and will not reference any specific transactions posted or to be posted on the password-protected page of IPONET; (b) the password-protected page of IPONET will be available to a particular investor only after Gallagher has made the determination that the particular potential investor is accredited or sophisticated; and (c) a potential investor could purchase securities only in transactions that are posted on the password-protected page of IPONET after that investor's qualification with IPONET.

*Id.* at \*1-\*2.

were the only entities with the financial motivation and expertise to prequalify potential investors.<sup>161</sup>

*D. Exceptions to the Prohibition on General Solicitation and Advertising*

The SEC has recognized that the ban on general solicitation and general advertising “hampers the utility of [Regulation D] exemption[s] and may raise the costs to companies of trying to do these exempt offerings.”<sup>162</sup> In fact, the SEC has sought public comments on whether to eliminate the ban.<sup>163</sup> While to date the ban remains intact, over the past twenty years the SEC has, from time to time, promulgated new rules and regulations and amended existing rules and regulations, ameliorating its effect to a limited extent. These rules and regulations include Rule 135c,<sup>164</sup> Rule 135e,<sup>165</sup> Rule 155,<sup>166</sup> Rule 504,<sup>167</sup> Regulation A,<sup>168</sup> and Regulation CE,<sup>169</sup> each of which is described briefly below.

*1. Rule 135c*

The SEC adopted Rule 135c in April 1994.<sup>170</sup> The Rule allows an issuer to notify the public that it “proposes to make, is making or has

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161. Langevoort, *supra* note 136, at 7. It is not clear whether an emerging company could itself prequalify investors pursuant to the Shaine-type procedures. In a 2000 Release, the SEC stated:

Generally, staff interpretations of whether a “pre-existing, substantive relationship” exists have been limited to procedures established by broker-dealers in connection with their customers. This is because traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and thus, implies that a substantive relationship exists between the broker-dealer and its customers. We have long stated, however, that the presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case. Thus, there may be facts and circumstances in which a third party, other than a registered broker-dealer, could establish a “pre-existing, substantive relationship” sufficient to avoid a “general solicitation.”

Use of Electronic Media, Securities Act of 1933 Release No. 33-7856 (Apr. 28, 2000), 2000 SEC LEXIS 847, at \*60 (footnote omitted).

162. Exemption for Certain California Limited Issues, Release No. 33-7185 (June 27, 1995), 1995 SEC LEXIS 1522, at \*14.

163. *Id.* at \*15.

164. 17 C.F.R. § 230.135c (2003).

165. *Id.* § 230.135e.

166. *Id.* § 230.155.

167. *Id.* § 230.504.

168. *Id.* §§ 230.251-.263.

169. *Id.* § 230.1001.

170. Simplification of Registration and Reporting Requirements for Foreign Companies; Safe Harbors for Public Announcements of Unregistered Offerings and Broker-Dealer Research Reports, Securities Act of 1933 Release No. 33-7053, Securities Exchange Act of 1934 Release No. 34-33918 (Apr. 19, 1994), 1994 SEC LEXIS 1298 [hereinafter Public Announcement Safe Harbor Release].

made an offering of securities not registered or required to be registered under the [Securities] Act.”<sup>171</sup> The notice “may take the form of a news release or a written communication directed to security holders or employees, as the case may be, or other published statements.”<sup>172</sup> Hence, Rule 135c allows an issuer to advertise a Regulation D private placement notwithstanding the Rule 502(c) prohibition against general solicitation and advertising. This point was made clear by the SEC when, in connection with adopting Rule 135c, it amended Rule 502(c) to specifically exclude 135c notices from such prohibition.<sup>173</sup>

A Rule 135c notice is subject to a number of limitations. The notice must not be “used for the purpose of conditioning the market in the United States for any of the securities offered”<sup>174</sup> and must state “that the securities offered will not be or have not been registered under the Act and may not be offered or sold in the United States absent registration or an applicable exemption from registration requirements.”<sup>175</sup> The rule allows the notice to include only basic information about the issuer and the offering.<sup>176</sup> Further, Rule 135c is only available to United States issuers that are required to file peri-

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171. 17 C.F.R. § 230.135c(a).

172. *Id.* § 230.135c(b).

173. Public Announcement Safe Harbor Release, *supra* note 170, at \*22 n.46; *see also* 17 C.F.R. § 230.502(c).

174. 17 C.F.R. § 230.135c(a)(1).

175. *Id.* § 230.135c(a)(2).

176. This information is limited to:

(i) The name of the issuer;

(ii) The title, amount and basic terms of the securities offered, the amount of the offering, if any, made by selling security holders, the time of the offering and a brief statement of the manner and purpose of the offering without naming the underwriters;

(iii) In the case of a rights offering to security holders of the issuer, the class of securities the holders of which will be or were entitled to subscribe to the securities offered, the subscription ratio, the record date, the date upon which the rights are proposed to be or were issued, the term or expiration date of the rights and the subscription price, or any of the foregoing;

(iv) In the case of an offering of securities in exchange for other securities of the issuer or of another issuer, the name of the issuer and the title of the securities to be surrendered in exchange for the securities offered, the basis upon which the exchange may be made, or any of the foregoing;

(v) In the case of an offering to employees of the issuer or to employees of any affiliate of the issuer, the name of the employer and class or classes of employees to whom the securities are offered, the offering price or basis of the offering and the period during which the offering is to be or was made or any of the foregoing; and

(vi) Any statement or legend required by State or foreign law or administrative authority.

Public Announcement Safe Harbor Release, *supra* note 170, at \*30-\*31.

odic reports with the SEC under the Exchange Act and certain foreign issuers.<sup>177</sup>

An emerging company generally is not required to file periodic reports with the SEC until after its initial public offering.<sup>178</sup> Hence, Rule 135c will generally not be available to a private emerging company. I suspect this is not a big loss to emerging companies since, from a marketing perspective, the odds of attracting an investor through a Rule 135c notice seem quite low as a result of the limited information allowed in the notice.

The SEC did not, however, adopt Rule 135c to enhance the ability of reporting companies to attract investors in their private placements. Instead, the SEC adopted Rule 135c to address the conflict between a reporting company's obligation to keep investors informed of material developments, including raising funds through a private placement, and the prohibition against general solicitation and general advertising.<sup>179</sup> Nonetheless, Rule 135c certainly represents a narrowing of the prohibition against general solicitation and general advertising by the SEC and recognition by the SEC, at least in one specific area, of a problem with such a prohibition.

## 2. Rule 135e

In October 1997, the SEC adopted Rule 135e,<sup>180</sup> which, among other things, provides a safe harbor for foreign private issuers<sup>181</sup> relating to press conferences held outside the United States and press-

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177. *Id.* at \*29. An issuer is not required to file periodic disclosure documents with the SEC unless its securities are registered under the Exchange Act. See *supra* note 87 for a brief description of when an issuer is required to register under the Exchange Act.

178. See *supra* note 87. Because of the time and expense involved in preparing the filings and the fact that the filings and, hence, sensitive information about the company are a few mouse clicks away to anyone with web access, most emerging companies avoid for as long as possible being required to file periodic reports.

179. See Public Announcement Safe Harbor Release, *supra* note 170, at \*8.

180. See Offshore Press Conferences, Meetings with Company Representatives Conducted Offshore and Press-Related Materials Released Offshore, Securities Act of 1933 Release No. 33-7470, Exchange Act of 1934 Release No. 34-39227 (Oct. 10, 1997), 1997 SEC LEXIS 2155, at \*1 [hereinafter Exemption for Standardized Options Release].

181. The Securities Act defines a *foreign private issuer* as any foreign issuer other than a foreign government except an issuer meeting the following conditions:

- (1) More than 50 percent of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and
- (2) Any of the following:
  - (i) The majority of the executive officers or directors are United States citizens or residents;
  - (ii) More than 50 percent of the assets of the issuer are located in the United States; or
  - (iii) The business of the issuer is administered principally in the United States.

17 C.F.R. § 230.405 (2003).

related materials released outside of the United States.<sup>182</sup> The SEC viewed Rule 135e as necessary because American journalists were routinely being excluded from offshore press activities of foreign issuers, potentially putting American investors at a disadvantage.<sup>183</sup> Foreign private issuers were excluding American journalists out of concern that the journalists would disseminate information in the United States that would violate United States securities laws such as the ban on general solicitation and advertising.<sup>184</sup>

To qualify for the safe harbor, a foreign private issuer must meet several conditions. First, the press activities must occur outside of the United States.<sup>185</sup> Second, the offering to which the press activities relate must not be conducted solely within the United States.<sup>186</sup> Third, access to the offshore press activities must be available to both American and foreign journalists.<sup>187</sup> Fourth, any written press-related materials pertaining to the United States portion of the offering must include certain cautionary statements<sup>188</sup> and may not include a purchase order or coupon whereby a person could indicate interest in the offering.<sup>189</sup>

Rule 502(c) of Regulation D expressly excludes press activities that fall within the Rule 135e safe harbor from the definition of general solicitation and advertising.<sup>190</sup> Hence, a foreign private issuer could theoretically obtain United States investors in a Regulation D offering who were located through offshore press releases in compliance with Rule 135e that were widely circulated in the United States.

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182. *Id.* § 230.135e.

183. Exemption for Standardized Options Release, *supra* note 180, at \*3.

184. *Id.* at \*4-\*5.

185. 17 C.F.R. § 230.135e(a).

186. *Id.* § 230.135e(a)(1).

187. *Id.* § 230.135e(a)(2).

188. Such materials must state that

the written press related materials are not an offer of securities for sale in the United States, that securities may not be offered or sold in the United States absent registration or an exemption from registration, that any public offering of securities to be made in the United States will be made by means of a prospectus that may be obtained from the issuer or the selling security holder and that will contain detailed information about the company and management, as well as financial statements.

*Id.* § 230.135e(b)(1).

189. *Id.* § 230.135e(b)(3).

190. *Id.* § 230.502(c).

### 3. Rule 155

The SEC adopted Rule 155 in January 2001 to address specific problems caused by the concept of integration.<sup>191</sup> Under the concept of integration, two or more offerings, which an issuer structured as separate exempt offerings, may be “integrated,” or treated as one larger offering for which no exemption is available.<sup>192</sup> Integration is generally intended to prevent an issuer from circumventing the registration requirements of the Securities Act by structuring a large offering for which no exemption is available as two or more smaller exempt offerings.<sup>193</sup> If the SEC integrates a series of apparently exempt offerings, the integrated offering must qualify for an exemption.<sup>194</sup> If it does not, since by definition the integrated offering was not registered, all sales in connection therewith will have been made in violation of section 5 of the Securities Act,<sup>195</sup> resulting in, among other things, each purchaser in the offering having a right to rescind the transaction.<sup>196</sup>

In determining whether a series of exempt offerings should be integrated into one offering, the SEC considers the following five factors: (1) whether the offerings are part of a single plan of financing; (2) whether the offerings are made for the same general purpose; (3) whether the offerings involve the issuance of the same class of securities; (4) whether the offerings are made at or about the same time; and (5) whether the offerings involve the same type of consideration.<sup>197</sup> This multifactor test has been criticized as being subjective<sup>198</sup> and lacking clarity.<sup>199</sup> Adding to the murkiness is the lack of express guidance from the SEC or the courts on how to weigh the factors when analyzing a series of offerings.<sup>200</sup> It is clear, however, that not all factors need be present for two or more offerings to be integrated.<sup>201</sup>

Regulation D contains an integration safe harbor that applies to Rule 506 offerings. Rule 502(a) provides:

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191. Integration of Abandoned Offerings, Securities Act of 1933 Release No. 33-7943 (Jan. 26, 2001), 2001 SEC LEXIS 166, at \*1 [hereinafter *Integration of Abandoned Offerings Release*].

192. 3 LOSS & SELIGMAN, *supra* note 65, at 1231-32.

193. *Id.*; Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula That Fosters the Policies of Securities Regulation*, 25 LOY. U. CHI. L.J. 199, 209 (1994).

194. Wade, *supra* note 193, at 200.

195. 15 U.S.C. § 77e (2000).

196. *See id.* § 77l(a).

197. Non-Public Offering Exemption, Securities Act of 1933 Release No. 33-4552 (Nov. 6, 1962), 1962 SEC LEXIS 166, at \*10; *see also* 17 C.F.R. § 230.502(a) (2003); 3 LOSS & SELIGMAN, *supra* note 65, at 1232-42.

198. 3 LOSS & SELIGMAN, *supra* note 65, at 1233 n.7.

199. Wade, *supra* note 193, at 200-01.

200. 3 LOSS & SELIGMAN, *supra* note 65, at 1242.

201. *Id.*

Offers and sales that are made more than six months before the start of a [R]egulation D offering or are made more than six months after completion of a [R]egulation D offering will not be considered part of that [R]egulation 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 [R]egulation D.<sup>202</sup>

It is not, however, uncommon for a fast-growing emerging company to have to raise equity financing through Rule 506 private placements separated by less than six months. In such a situation, the Rule 502(a) safe harbor will be unavailable, and the issuer will have to obtain legal advice on the likelihood, based on the above five factors, of the second offering being integrated with the first.<sup>203</sup> The cost of this legal advice is considerable and often comes at a time in the life of an emerging company when cash is extremely precious.<sup>204</sup> Alas, because of the murkiness of the five-factor test, issuers' counsel are unable to provide any guarantee against a later finding of integration.<sup>205</sup>

It is at a critical stage in the life of the unlucky emerging company that the integration doctrine and the ban on general solicitation and advertising combine to hamper the company's ability to obtain greatly needed equity capital—immediately following the company's unsuccessful, registered initial public offering. This is because the SEC views the mere filing of a registration statement as general solicitation of investors in the offering.<sup>206</sup> It is not uncommon, especially during the last few years, for a company to incur hundreds of thousands of dollars in expenses<sup>207</sup> to get to the verge of going public only to have the offering delayed or abandoned due to market conditions.<sup>208</sup> This leaves the emerging company with large bills to pay from the failed public offering, in addition to its existing capital needs, but no offering proceeds. At this point, generally the only op-

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202. 17 C.F.R. § 230.502(a).

203. Wade, *supra* note 193, at 200-01.

204. *Id.*

205. *Id.* at 201.

206. *New Rule 155—Two Integration Safe Harbors*, CORP. COUNS., Jan.-Feb. 2001, available at <http://thecorporatecounsel.net> (subscription needed or on file with author) [hereinafter *New Rule 155*]. A registration statement is publicly available shortly after filing through the SEC's website.

207. Legal, accounting, filing, and other fees for preparing and filing a registration statement with the SEC generally range from \$300,000 to \$500,000. See GAO REPORT, *supra* note 22, at 23 tbl.2; John F. Olson & Daniel W. Nelson, *What Makes a Company a Good Candidate for Going Public? Criteria, Advantages, and Disadvantages Related to Going Public*, in 1 POSTGRADUATE COURSE IN FEDERAL SECURITIES LAW 591 (ALI-ABA 1999).

208. See, e.g., Raymond Hennessey, *IPO Outlook: For IPO Market, More Bad News Is Likely for Now*, WALL ST. J., Apr. 17, 2000, at C23 (noting that fifteen of the twenty-three IPOs scheduled to go effective the previous week were delayed because of market conditions).

tion for the company is to seek an additional round of private equity capital, mainly, a Rule 506 offering.<sup>209</sup> In this scenario, the integration doctrine comes front and center. If the subsequent private offering were to be integrated with the failed public offering, the Rule 506 exemption would not be available since this integrated offering would then involve general solicitation (the filing of the registration statement).<sup>210</sup>

The SEC recently passed Rule 155(c) to specifically address this scenario.<sup>211</sup> Rule 155(c) provides an integration safe harbor for a private offering following an abandoned public offering.<sup>212</sup> As the SEC stated in the adopting release, “[w]e are concerned particularly about reducing the capital-raising costs of small businesses and believe that adopting Rule 155 will advance that goal significantly.”<sup>213</sup> To qualify for the Rule 155(c) safe harbor, the following conditions must be met: (1) no securities were sold in the public offering; (2) the issuer withdrew the public offering registration statement; (3) at least thirty days have elapsed between the effective date of the withdrawal of the registration statement and the commencement of the private offering; and (4) the issuer notifies each offeree in the private placement that (a) the securities are not registered, (b) the securities are restricted and may not be resold except if registered or pursuant to an exemption, (c) section 11 of the Securities Act does not apply to the offering, and (d) the issuer filed and then withdrew a registration statement for the public offering and the effective date of the withdrawal.<sup>214</sup> Items (c) and (d) of condition (4) seem to imply that persons solicited in the abandoned public offering, which, by definition, involves general solicitation,<sup>215</sup> could participate in the private offering. What is not clear is whether offerees found through the public offering, that is, offerees that had no relationship with the underwriter or issuer prior to the public offering, could be included in the private offering.

#### 4. Rule 504

As originally adopted in 1982, investors in a Rule 504 offering could not be solicited through general solicitation or advertising, and securities issued thereunder were restricted from resale unless “the entire offering [was] made exclusively in states that require registration and the delivery of a disclosure document, and . . . the offering

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209. *New Rule 155*, *supra* note 206.

210. 17 C.F.R. §§ 230.506(b)(1), .502(c) (2003).

211. *Id.* § 230.155(c).

212. *Id.*

213. Integration of Abandoned Offerings Release, *supra* note 191, at \*4.

214. 17 C.F.R. § 230.155(c).

215. *See supra* text accompanying note 206.

[was] in compliance with those requirements.”<sup>216</sup> In July 1992, the SEC amended Rule 504 to eliminate all restrictions on the Rule 504 exemption and, hence, thereafter an issuer could solicit investors in any Rule 504 offering through general solicitation and advertising, and the securities issued in such offering would generally be freely tradeable.<sup>217</sup> The SEC’s reasoning behind the different treatment of Rule 504 offerings versus Rule 505 and 506 offerings was that “the size and local nature of these small offerings did not appear to warrant imposing extensive federal regulation.”<sup>218</sup>

In February 1999, the SEC reversed course and essentially returned to the pre-1992 format with respect to the manner of offering and transferability of securities issued under Rule 504.<sup>219</sup> Hence, today investors in a Rule 504 offering cannot be solicited through general solicitation or advertising, and securities issued thereunder are restricted from resale unless the offering is made

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

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

(iii) [e]xclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to “accredited investors.”<sup>220</sup>

This reversal was in reaction to the use of securities issued in reliance on Rule 504 in fraudulent “pump and dump” schemes that took advantage of the fact that securities issued under Rule 504 were freely tradeable.<sup>221</sup> The SEC reasoned that by making securities is-

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216. Regulation D Adopting Release, *supra* note 79, at \*42-\*43.

217. Small Business Initiatives, Securities Act of 1933 Release No. 33-6949, Securities Exchange Act of 1934 Release No. 34-30968, Trust Indenture Act of 1939 Release No. 39-2287 (July 30, 1992), 1992 SEC LEXIS 1757, at \*22-\*23 [hereinafter Small Business Initiatives Release].

218. “Seed Capital” Exemption Release, *supra* note 83, at \*6; *see also* GAO REPORT, *supra* note 22, at 28 & n.b.

219. “Seed Capital” Exemption Release, *supra* note 83, at \*14.

220. 17 C.F.R. § 230.504(b)(1) (2003).

221. “Seed Capital” Exemption Release, *supra* note 83, at \*7, \*9. The schemes involved issuers making prearranged sales of securities under Rule 504 to cohorts in states that do not have registration or disclosure requirements. *Id.* at \*9. Unscrupulous broker-dealers

sued under Rule 504 generally restricted, “unscrupulous persons would be less likely to use the rule as the source of freely tradeable securities they need to facilitate their fraudulent transactions.”<sup>222</sup> However, nowhere in the release reinstating the limitations did the SEC mention that allowing general solicitation and advertising in Rule 504 offerings facilitated or contributed to these fraudulent transactions.

### 5. Regulation A

The SEC adopted Regulation A in 1936 under section 3(b) of the Securities Act and has revised it several times throughout the years, most recently in 1992.<sup>223</sup> Today, Regulation A provides a conditional exemption from registration for offerings of up to \$5 million of securities.<sup>224</sup> To qualify for the exemption, a company must prepare and file with the SEC an offering statement describing, among other things, its business operations, financial conditions, risk factors, and management.<sup>225</sup> The offering statement is typically prepared by the company’s counsel in conjunction with management and the company’s outside accountants. Hence, preparing a Regulation A offering statement can cost a small company a significant amount of money and management time.

In the release adopting the 1992 revisions to Regulation A, the SEC noted that

[o]ne of the major impediments to a Regulation A financing for a small start-up or developing company with no established market for its securities, is the cost of preparing the mandated offering statement. The full costs of compliance would be incurred without knowing whether there will be any investor interest in the company.<sup>226</sup>

To address this impediment, the SEC adopted Rule 254,<sup>227</sup> which has been heralded as an innovative provision.<sup>228</sup> Rule 254 allows a com-

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would then use cold-calling techniques to “pump” the price of the securities by selling them to unsuspecting investors at higher and higher prices. *Id.* Once all these shares are “dumped,” the artificial market demand, and therefore the price of the securities, collapses resulting in huge losses to investors. *Id.*

222. *Id.* at \*13.

223. 3 LOSS & SELIGMAN, *supra* note 65, at 1341-48.

224. 17 C.F.R. § 230.251(b).

225. *Id.* § 230.253(a); see *Form 1-A, Regulation A Offering Statement Under the Securities Act of 1933*, U.S. Sec. & Exch. Comm’n, available at <http://www.sec.gov/about/forms/form1-a.pdf> (last visited Sept. 27, 2004).

226. Small Business Initiatives Release, *supra* note 217, at \*17-\*18.

227. 17 C.F.R. § 230.254.

228. See, e.g., BLOOMENTHAL, *supra* note 85, at 419; David T. Mittelman, Note, *Testing-the-Waters: How Warm is Regulation A’s Model for Soliciting Investor Interest?*, 32 SUFFOLK U. L. REV. 233, 241 & n.54 (1998).

pany to “test the waters”<sup>229</sup> through written communications and scripted radio and television broadcasts directed to the general public to determine if there is any interest in the offering before spending the time and money to undertake a full-blown Regulation A offering.<sup>230</sup>

The written document or script of the broadcast must include certain specified statements and information.<sup>231</sup> Following filing of the written communication or scripted broadcast with the SEC, the company can engage in oral communications with prospective investors.<sup>232</sup> The company may include, with its written “test-the-waters” materials, a coupon whereby a person would indicate her interest in the offering by filling in her name, address, and telephone number and sending it to the company.<sup>233</sup> The company must discontinue use of its “test-the-waters” solicitation materials once the company files its offering document with the SEC.<sup>234</sup> Hence, Regulation A explicitly permits general solicitation and general advertising in compliance with Rule 254, notwithstanding the fact that Regulation A, like Regulation D, provides an exemption from the registration requirements of the Securities Act.

## 6. Regulation CE

The SEC adopted Regulation CE, a coordinated federal-state exemption from registration, in May 1996 under section 3(b) of the Securities Act.<sup>235</sup> Regulation CE is comprised of a single rule, Rule 1001, which exempts from federal registration “[o]ffers and sales of securities that satisfy the conditions of paragraph (n) of section 25102 of the California Corporations Code.”<sup>236</sup> Hence, Rule 1001 in-

229. Mittelman, *supra* note 228, at 241.

230. See 17 C.F.R. § 230.254.

231. Rule 254(b)(2) provides:

The written document or script of the broadcast shall:

(i) State that no money or other consideration is being solicited, and if sent in response, will not be accepted;

(ii) State that no sales of the securities will be made or commitment to purchase accepted until delivery of an offering circular that includes complete information about the issuer and the offering;

(iii) State that an indication of interest made by a prospective investor involves no obligation or commitment of any kind; and

(iv) Identify the chief executive officer of the issuer and . . . in general its business and products.

*Id.* § 230.254(b)(2).

232. *Id.* § 230.254(a).

233. *Id.* § 230.254(c).

234. *Id.* § 230.254(b)(3).

235. Exemption for Certain California Limited Issues, Securities Act of 1933 Release No. 33-7285 (May 1, 1996), 1996 SEC LEXIS 1181 [hereinafter California Exemption Release].

236. 17 C.F.R. § 230.1001.

incorporates section 25102(n) of the California Corporations Code (“California section 25102(n)”) by reference and, therefore, the meat of the exemption is found in that section. California Section 25102(n) exempts from California blue sky law registration requirements offers and sales of securities to “qualified purchasers.”<sup>237</sup> The term *qualified purchaser* is similar, but not identical, to the term *accredited investor* under Regulation D.<sup>238</sup>

California section 25102(n) permits limited general solicitation and, therefore, Rule 1001 does as well.<sup>239</sup> Under California section 25102(n), an issuer can publish a written general announcement of a proposed offering so long as it contains only specified information.<sup>240</sup> This general announcement concept is modeled after the “test-the-

237. CAL. CORP. CODE § 25102(n)(2) (West 2004).

238. California Exemption Release, *supra* note 235, at \*2. The term *qualified purchaser* includes:

designated professional or institutional purchasers or persons affiliated with the issuer;

certain relatives residing with qualified purchasers;

promoters;

any person purchasing more than \$150,000 of securities in the offering; entities whose equity owners are limited to officers, directors and any affiliate of the issuer;

reporting companies under the [Exchange Act] if the transaction involves the acquisition of all of an issuer’s capital stock for investment;

a natural person whose net worth exceeds \$500,000, or a natural person whose net worth exceeds \$250,000 if such purchaser’s annual income exceeds \$100,000—in either case the transaction must involve:

(a) only a one-class voting stock (or preferred establishing the same voting rights),

(b) an amount limited to no more than 10 percent of the purchaser’s net worth, and

(c) a purchaser able to protect his or her own interests (alone or with the help of a professional advisor); pension and profit sharing trusts, as well as 401(k) plans and Individual Retirement Accounts of individual qualified purchasers.

*Id.* at \*5-\*6 (footnotes omitted); *see also* CAL. CORP. CODE § 25102(n)(2). *See supra* text accompanying notes 94-98 for the Regulation D definition of *accredited investor*.

239. California Exemption Release, *supra* note 235, at \*2.

240. CAL. CORP. CODE § 25102(n)(5)(A). The following information must be included in the announcement: “(i) [t]he name of the issuer of the securities[;] (ii) [t]he full title of the security to be issued[;] (iii) [t]he anticipated suitability standards for prospective purchaser[;] (iv) [a] statement that” no money is being sought or will be accepted, that an indication of interest involves no commitment to purchase, and that under certain circumstances a disclosure document will be provided prior to purchase; and the name, address and telephone number of a person who can provide further information about the offering.

*Id.* The announcement may also include any of the following information:

(i) [a] brief description of the business of the issuer[;]

(ii) [t]he geographic location of the issuer and its business[;] and

(iii) [t]he price of the security to be issued, or, if the price is not known, the method of its determination or the probable price range as specified by the issuer, and the aggregate offering price.

CAL. CORP. CODE § 25102(n)(5)(B).

waters” notion of Regulation A.<sup>241</sup> The general announcement may be disseminated to persons who are not qualified purchasers,<sup>242</sup> but only qualified purchasers can be solicited by telephone.<sup>243</sup> The issuer must also file a notice with the California Corporations Commissioner concurrent with the publication of a general announcement of proposed offering or at the time of the initial offer of securities, if earlier.<sup>244</sup>

An exempt offering made in reliance on Rule 1001 is limited by Rule 1001(b) to \$5 million less the aggregate offering price of any other securities sold in the same offering pursuant to a different exemption.<sup>245</sup> A more significant limitation, however, is found in California section 25102(n)(1). That section limits the availability of the exemption to: (1) issuers that are business entities organized under the laws of California,<sup>246</sup> and (2) non-California business entities (a) that can attribute more than fifty percent of their property, payroll, and sales to California and (b) whose voting securities are held of record by persons with California addresses.<sup>247</sup> Section 25102(n)(1) also makes the exemption unavailable to a “blind pool” issuer and an investment company subject to the Investment Company Act of 1940.<sup>248</sup> Thus, while the SEC designed Regulation CE to “facilitate small business[es] capital raising” ability,<sup>249</sup> it can actually only assist the capital raising of a small subset of small businesses, mainly those organized in California or with substantial ties to California. Nonetheless, Regulation CE does reflect another example where the SEC determined that an exempt offering that allows at least limited general solicitation of potential investors is not inconsistent with investor protection.<sup>250</sup>

### 7. State Exceptions

As noted above, offers and sales of securities are also subject to state securities laws which require, like federal law, that any offering in the state be either registered with the state or exempt from such registration.<sup>251</sup> The states have various exemptions that correspond

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241. California Exemption Release, *supra* note 235, at \*8. For a brief overview of Regulation A’s “test-the-waters” provisions, see *supra* text accompanying notes 232-34.

242. CAL. CORP. CODE § 25102(n)(5)(D).

243. *Id.* § 25102(n)(6).

244. *Id.* § 25102(n)(7).

245. 17 C.F.R. § 230.1001(b) (2003).

246. CAL. CORP. CODE § 25102(n)(1).

247. *Id.* §§ 25102(n)(1), 2115; see also California Exemption Release, *supra* note 235, at \*4.

248. CAL. CORP. CODE § 25102(n)(1).

249. California Exemption Release, *supra* note 235, at \*3.

250. See *id.* at \*10 (“The provisions of the California law are consistent with investor protection and the public interest, and therefore warrant the Commission’s full exercise of its exemptive authority under Section 3(b).”).

251. See *supra* text accompanying note 109.

fairly well to the federal Regulation D exemptions.<sup>252</sup> Like the Regulation D exemptions, these exemptions generally ban general solicitation and general advertising.<sup>253</sup> In recent years, however, the North America Securities Administration Association (NASAA), an association in which the securities administrators of all fifty states are members,<sup>254</sup> adopted a resolution relating to Internet offers of securities and a model accredited investor exemption, both of which allow general solicitation and advertising.

NASAA adopted the Internet resolution in January 1996<sup>255</sup> to address the emerging practice of companies soliciting investors by posting offering documents on the World Wide Web. Since state boundaries have no impact on the accessibility of a website, such a posting raises the issue of whether a company is offering its securities in a particular state merely because residents of that state have accessed or can access the offering document through the Web. The Uniform Securities Act provides that an offer is made in a state, whether or not either party is then present in the state, when the offer is directed by the offeror to the state and received at the place to which it is directed.<sup>256</sup> A state could thus take the position that, since the offering document is accessible to its residents through the Internet, the company is directing offers to the state. NASAA passed the Internet resolution to resolve this issue. The resolution generally exempts Internet offers from state registration requirements when the following criteria are met: (1) The Internet “offer indicate[s] that the securities are not being offered to residents of the state; (2) the [Internet] offer is not being specifically directed to any persons in the state”; and (3) no sales of the company’s securities are made in the state as a result of the Internet offer until such time as the securities being offered have been registered or an exemption is available.<sup>257</sup> As of 2003, forty-one states had adopted some form of the resolution.<sup>258</sup>

Hence, a company could theoretically attract an investor from a state that has adopted the Internet resolution merely from the inves-

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252. 7A J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, § 7:277 (2d ed. 2002); *see also* BLOOMENTHAL, *supra* note 85, at 1335.

253. *See*, for example, section 402(11) of the Uniform Securities Act, which expressly bans general solicitation and advertising, and the NASSA Uniform Limited Offering Exemption, which implicitly bans general solicitation and advertising by exempting offers and sales made in compliance with Regulation D. *See* BLOOMENTHAL, *supra* note 85, at 1370-73.

254. *See* NASAA, *Overview*, at <http://nasaa.org/nasaa/abtnasaa/overview1.asp> (last visited Sept. 28, 2003).

255. Resolution Regarding Securities Offered on Internet, NASAA Rep. (CCH) ¶ 7040, at 7046 (Jan. 7, 1996).

256. Uniform Securities Act § 414(c), 1 Blue Sky L. Rep. (CCH) ¶ 5554 (NASAA Feb. 2003).

257. Internet: Exemption (for Offers) and BD/IA Advertising, Blue Sky L. Rep. (CCH) ¶ 6481, at 2581 (Apr. 2003).

258. *See id.*

tor stumbling across the company's offering documents while surfing the Internet. Obviously, in such a case the company would not have the requisite preexisting, substantive relationship with the investor to demonstrate the absence of general solicitation.<sup>259</sup> However, since under the Internet resolution locating an investor in the foregoing fashion would not be considered an offer in that state, presumably the company could still rely on an exemption from that state's registration requirements—even if the exemption prohibits general solicitation and advertising.

NASAA developed the Model Accredited Investor Exemption (MAIE) in 1997.<sup>260</sup> MAIE exempts from state registration requirements sales of securities made exclusively to persons the issuer reasonably believes are accredited investors as defined in Regulation D, Rule 501(a), provided the offering meets the other specified conditions of MAIE.<sup>261</sup> The exemption is not available to a development-stage company that has no specific business plan or purpose or its business plan is to acquire or merge with unidentified entities.<sup>262</sup> Additionally, the issuer must reasonably believe that all investors in the offering are purchasing for investment purposes and not with a view to resale.<sup>263</sup>

Like California Corporate Code section 25102(n), MAIE permits general solicitation through a general announcement containing certain specified information.<sup>264</sup> The general announcement may be made by any means.<sup>265</sup> Further, while MAIE is limited to accredited investors, disseminating the general announcement to nonaccredited investors does not disqualify the issuer from relying on MAIE.<sup>266</sup>

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259. See *supra* text accompanying notes 125 and 126 for the definition of a preexisting, substantive relationship.

260. Letter from Joseph P. Borg, NASAA President and Director, Alabama Securities Commission, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission 9 (Mar. 4, 2002), <http://www.sec.gov/rules/proposed/s72301/borg1.htm> (last visited Sept. 28, 2004) [hereinafter Borg Letter].

261. See BLOOMENTHAL, *supra* note 85, at 1367-68.

262. Model Accredited Investor Exemption, NASAA Rep. (CCH) ¶ 361(B) (Apr. 27, 1997).

263. *Id.* ¶ 361(C).

264. *Id.* ¶ 361(E)(1)-(2).

265. *Id.* ¶ 361(E)(1).

266. *Id.* ¶ 361(H). The announcement may generally include only the following information:

- (a) The name, address and telephone number of the issuer of the securities;
- (b) The name, a brief description and price (if known) of any security to be issued;
- (c) A brief description of the business of the issuer in 25 words or less;
- (d) The type, number and aggregate amount of securities being offered;
- (e) The name, address and telephone number of the person to contact for additional information; and
- (f) A statement that:

Unlike California section 25102(n), MAIE does not require that the issuer have a connection to the particular state.<sup>267</sup>

According to the SEC, as of December 2001, forty states had adopted MAIE or a similar provision exempting from state registration offerings to accredited investors.<sup>268</sup> Hence, by adopting MAIE, at least forty states have presumably recognized that an exempt offering that allows at least limited general solicitation of potential investors is not inconsistent with investor protection. As discussed below, however, MAIE is not very useful to companies seeking private equity capital because there is no corresponding federal exemption.<sup>269</sup>

#### 8. *Breadth of Exceptions*

In my opinion, the above federal and state measures to soften the ban on general solicitation and advertising do not go far enough. The federal measures are narrow. Rule 135c is generally only available to a company that has completed an initial public offering.<sup>270</sup> Rule 135e is available only to foreign private issuers.<sup>271</sup> While the SEC enacted Rule 155(c) specifically with small business capital raising in mind, Rule 155(c) only addresses a narrow set of circumstances, that is, a company seeking private equity following a failed public offering.<sup>272</sup> Hence, Rule 155(c) provides no relief from the ban on general solicitation and advertising for an emerging company seeking early rounds of private equity. Rule 504 allows general solicitation and advertising only in narrow circumstances and is limited to offerings of \$1 million or less.<sup>273</sup> The Regulation A, Rule 254 “test-the-waters” provision, at first blush, supplies some relief because it does allow a company to engage in limited general solicitation and advertising during any stage of fundraising.<sup>274</sup> However, the states have essentially nullified Rule 254 and, thus, in reality, it is of little use.<sup>275</sup>

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(i) sales will only be made to accredited investors;

(ii) no money or other consideration is being solicited or will be accepted by way of this general announcement; and

(iii) the securities have not been registered with or approved by any state securities agency of the U.S. Securities and Exchange Commission and are being offered and sold pursuant to an exemption from registration.

*Id.* ¶ 361(E)(2).

267. BLOOMENTHAL, *supra* note 85, at 1368-69.

268. Defining the Term “Qualified Purchaser” Under the Securities Act of 1933, Securities Act of 1933 Release No 33-8041 (Dec. 19, 2001), 2001 SEC LEXIS 2620, at \*27 [hereinafter “Qualified Purchaser” Release].

269. *See infra* text accompanying notes 371-72.

270. *See supra* Part III.D.1.

271. *See supra* Part III.D.2.

272. *See supra* Part III.D.3.

273. *See supra* Part III.D.4.

274. *See supra* Part III.D.5.

275. *See infra* text accompanying notes 360-62.

Regulation CE does provide some relief since it allows a form of general solicitation and advertising.<sup>276</sup> However, this relief is of little help to the majority of emerging companies because Regulation CE is available only to those companies organized in California or with substantial ties to California.<sup>277</sup> Finally, at the state level, NASAA's adoption of the Internet resolution and the MAIE are encouraging.<sup>278</sup> However, as things stand today, they are of little use to an emerging company seeking private equity since they do not complement Rule 506, the key federal exemption. Hence the encouragement comes from an inference that can be drawn from NASAA's adoption, that is, a recognition by the states that the ban on general solicitation and advertising should be softened.

Again, common sense dictates that the key to selling a product is marketing. Take a company like Callaway Golf Co., the world's largest manufacturer of premium golf clubs.<sup>279</sup> Callaway Golf was a one-time emerging company seeking to revolutionize the golf club industry through radical new club designs.<sup>280</sup> One logical approach for a company like Callaway Golf to raise early-stage private equity capital would be to contact individuals who are likely to be wealthy and have an interest in the company's story. For a manufacturer of premium golf clubs, a starting point could be targeted marketing to all professional golfers and members of high-end country clubs.<sup>281</sup> However, the SEC has made it clear that, absent a preexisting, substantive relationship with all those targeted, such marketing would constitute general solicitation and advertising.<sup>282</sup>

This point is demonstrated by the 1982 Aspen Grove no-action letter.<sup>283</sup> Aspen Grove was a limited partnership engaged in a thoroughbred racehorse boarding, training, and breeding business.<sup>284</sup> Aspen Grove proposed distributing marketing materials for the sale of its limited partnership interests.<sup>285</sup> Aspen Grove intended to mail a brochure to members of the "Thoroughbred Owners and Breeders Association" in the states of Illinois, Louisiana, and Texas.<sup>286</sup> The bro-

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276. See *supra* Part III.D.6.

277. See *supra* Part III.D.6.

278. See *supra* Part III.D.7.

279. United States Small Business Administration, *Small Business Investment Companies (SBIC) Program, Success Story: Callaway Golf*, <http://www.sba.gov/INV/callaway.html> (last visited Sept 28, 2004).

280. *Id.*

281. This could include proven techniques used in marketing public offerings, such as road shows.

282. See *supra* Part III.B.1.

283. Aspen Grove, SEC No-Action Letter (Dec. 8, 1982), 1982 SEC No-Act. LEXIS 3136.

284. *Id.* at \*1.

285. *Id.* at \*2.

286. *Id.*

chure would also be distributed at a fall horse sale in Lexington, Kentucky.<sup>287</sup> Finally, the brochure information would be reprinted in *The Blood-Horse*, a trade journal read by racehorse enthusiasts.<sup>288</sup> Hence, Aspen Grove was attempting to specifically target its marketing materials in mediums that would reach people with an interest in Aspen Grove's business. The SEC, however, declined to find that these marketing methods would not involve general solicitation or advertising.<sup>289</sup>

Likewise, in *In re Kenman Corp.*,<sup>290</sup> Kenman Securities, a registered broker-dealer, engaged in targeted marketing with respect to two offerings of limited partnership interests in real estate ventures in reliance on Rule 506.<sup>291</sup> Specifically, Kenman mailed information concerning the offerings to an unknown number of people comprised of persons who had participated in prior Kenman offerings, executive officers at *Fortune 500* companies, persons who had previously invested \$10,000 or more in real estate offerings, California physicians, Hughes Aircraft managerial engineers, and presidents of New Jersey industrial companies.<sup>292</sup> The SEC noted that the makeup of the group "may indicate that the persons themselves have some degree of investment sophistication or financial well-being,"<sup>293</sup> and one suspects that is exactly why Kenman targeted them. However, because Kenman did not have the requisite preexisting, substantive relationship with each offeree, the SEC concluded that Kenman engaged in general solicitation, and therefore the offerings were not exempt from registration.<sup>294</sup>

#### IV. IDEOLOGICAL FOUNDATION FOR THE PROHIBITION ON GENERAL SOLICITATION AND ADVERTISING

Given the importance of emerging companies to the economy and the critical role private equity financing plays in their emergence, one would assume that the prohibition on general solicitation and advertising would have a strong ideological foundation. I submit that it does not. The ban is simply the product of the historic statutory basis of the private placement exemptions entrenched by the overlapping federal and state regulation of securities offerings.

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287. *Id.*

288. *Id.*

289. *Id.* at \*1.

290. Kenman Corp. Release, *supra* note 123.

291. *Id.* at \*3-\*4.

292. *Id.* at \*5.

293. *Id.* at \*9 n.6.

294. *Id.* at \*8-\*9.

### A. Statutory Basis of Private Placement Exemptions

The original private placement exemption, enacted by Congress in 1933, is today found in section 4(2) of the Securities Act.<sup>295</sup> Section 4(2) exempts from registration with the SEC “transactions by an issuer not involving any public offering.”<sup>296</sup> Thus, the availability of the section 4(2) exemption turns on the definition of public offering. However, neither the Securities Act nor the rules promulgated thereunder define the term.<sup>297</sup> The legislative history provides little guidance other than the broad statements that the exemption applies to transactions “where there is no practical need for [the Securities Act’s] application or where the public benefits are too remote,” and that “a specific or an isolated sale of its securities” would fall within the exemption.<sup>298</sup>

The SEC has provided further guidance. In a 1935 release, it stated that “the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment. In no sense is the question to be determined exclusively by the number of prospective offerees.”<sup>299</sup> The release goes on to state that the principal factors to be considered in determining the availability of the exemption are the following: “1. The number of offerees and their relationship to each other and to the issuer; 2. The number of units offered; 3. The size of the offering; and 4. The manner of the offering.”<sup>300</sup>

The Supreme Court weighed in on the scope of section 4(2) when it decided *SEC v. Ralston Purina Co.* in 1953.<sup>301</sup> The case involved annual offerings by Ralston Purina, a manufacturer and distributor of feed and cereal products, of its common stock to select employees.<sup>302</sup> In some years, over 400 employees, including those in various low-level positions, purchased the company’s stock.<sup>303</sup> At issue in the

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295. 15 U.S.C. § 77d(2) (2000). As adopted in 1933, what is now section 4(2) of the Securities Act was the second clause of section 4(1) of the Securities Act. 3 LOSS & SELIGMAN, *supra* note 65, at 1361 n.365.

296. 15 U.S.C. § 77d(2).

297. Notice of Adoption of Rule 146 Under the Securities Act of 1933—“Transactions by an Issuer Deemed Not to Involve Any Public Offering,” Securities Act of 1933 Release No. 33-5487 (Apr. 23, 1974), 1974 SEC LEXIS 3297, at \*3 [hereinafter Rule 146 Release].

298. HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, FEDERAL SUPERVISION OF TRAFFIC IN INVESTMENT SECURITIES IN INTERSTATE COMMERCE, H.R. REP. NO. 73-85, at 5, 15-16 (1933). *See generally* 3 LOSS & SELIGMAN, *supra* note 65, at 1362-66; James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 37 (1959).

299. Securities Act of 1933 Release No. 33-285, Fed. Sec. L. Rep. (CCH) ¶ 2740 (Jan. 24, 1935), available at 1935 SEC LEXIS 485, at \*3.

300. *Id.* at \*1-\*2.

301. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

302. *Id.* at 120-21.

303. *Id.* at 121-22.

case was whether these offerings fell within the exemption.<sup>304</sup> The lower court found that these offerings did fall within section 4(2), reasoning that “the intra-organizational offerings of stock by [Ralston Purina], unaccompanied by any solicitation, which have resulted in a limited distribution of stock, for investment purposes, to a select group of employees considered by the management to be worthy of retention and probable future promotion” did not involve a public offering.<sup>305</sup> The Supreme Court reversed, reasoning that “the applicability of [section 4(2)] should turn on whether the particular class of persons affected needs the protection of the [Securities] Act. An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”<sup>306</sup> The Court went on to state that in analyzing the availability of the exemption, “[t]he focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose.”<sup>307</sup> The Court did not, however, go as far as the SEC had urged, rejecting the SEC’s argument that “‘an offering to a substantial number of the public’ is not exempt under [section 4(2)].”<sup>308</sup> Although the Court noted that “[i]t may well be that offerings to a substantial number of persons would rarely be exempt,”<sup>309</sup> it refused to “superimpos[e] a quantity limit on private offerings as a matter of statutory interpretation.”<sup>310</sup> Nonetheless, it did state that “nothing prevents the [SEC], in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims.”<sup>311</sup>

Thus, while the Court rejected a numerical cap on the number of offerees for a private offering, it appeared to invite the SEC to adopt a numerical floor on the number of offerees, below which an offering would be deemed private.<sup>312</sup> Consequently, shortly after *Ralston Purina*, the SEC adopted a rule of thumb that an offering to no more than twenty-five offerees falls within the section 4(2) exemption.<sup>313</sup>

This rule of thumb was short lived. After 1958, “the number of [SEC] disavowals of any safe numerical test grew to the point that no

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304. *Id.* at 120.

305. *SEC v. Ralston Purina Co.*, 200 F.2d. 85, 93 (8th Cir. 1952).

306. *Ralston Purina*, 346 U.S. at 125.

307. *Id.* at 127.

308. *Id.* at 125.

309. *Id.*

310. *Id.*

311. *Id.*

312. 3 LOSS & SELIGMAN, *supra* note 65, at 1374-75.

313. HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, AMENDING CERTAIN PROVISIONS OF THE SECURITIES ACT OF 1933, THE SECURITIES EXCHANGE ACT OF 1934, THE TRUST INDENTURE ACT OF 1939, AND THE INVESTMENT COMPANY ACT OF 1940, H.R. REP. NO. 83-1542, at 19 (1954).

one could any longer assume as a practical matter that an offering to no more than some 25 persons (or any lesser number) would be considered exempt by the [SEC].<sup>314</sup> In fact, in 1973, the Tenth Circuit concluded that a sale of a large block of stock by one individual to another individual was not a transaction not involving a public offering.<sup>315</sup> The court reasoned that “[t]here was no evidence . . . of what knowledge [the buyer] possessed concerning either the stock or the company, nor was he shown to be in a position to know such information as would have been disclosed by registration.”<sup>316</sup> With no objective numerical safe harbor, issuers, their counsel, and the courts were left to apply the subjective “needs” and “access” tests established by *Ralston Purina*.<sup>317</sup> Some courts emphasized the relationship between the issuer and the purchasers,<sup>318</sup> some focused on the sophistication of the purchasers,<sup>319</sup> and some stressed the type of disclosure made to purchasers and the number of offerees.<sup>320</sup> One attorney categorized the resulting section 4(2) jurisprudence as

a kind of mishmash. The issuer is now told that all of these factors have something to do with whether he has an exemption under Section 4(2), but he is never given a hint as to the proper proportions in the brew. The saving recipe is kept secret, a moving target which he can never be sure he has hit.<sup>321</sup>

The SEC attempted to clean up the mishmash in 1974 when it adopted Rule 146.<sup>322</sup> Rule 146 was “designed to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed to be transactions nt [sic] involving any public offering within the meaning of Section 4(2) of the [Securities] Act.”<sup>323</sup> Under Rule 146, offers or sales of securities by the issuer were deemed to fall within section 4(2) if four conditions were met. First, no offers could be made by means of any form of general solicitation or general advertising.<sup>324</sup> Second, immediately prior to making any offer, the issuer must have had reasonable grounds to believe and must have believed that the offeree had sufficient knowledge to evaluate the merits and risks of the investment or would be able to

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314. 1 LOSS & SELIGMAN, *supra* note 65, at 1378.

315. *G. Eugene England Found. v. First Fed. Corp.*, 663 F.2d 988, 990 (10th Cir. 1973).

316. *Id.*

317. 3 LOSS & SELIGMAN, *supra* note 65, at 1380.

318. *See, e.g., Hill York Corp. v. Am. Int'l Franchises, Inc.*, 448 F.2d 680, 690 (5th Cir. 1971).

319. *See, e.g., United States v. Hill*, 98 Fed. Sec. L. Rep. 179, 184 (D. Conn. 1969).

320. *See, e.g., SEC v. Cont'l Tobacco Co.*, 463 F.2d 137, 157 (5th Cir. 1972).

321. Ray Garrett, Jr., *The Private Offering Exemption Today*, in *FOURTH ANNUAL INSTITUTE ON SEC REGULATION* 3, 10-11 (Robert H. Mundheim et al. eds., 1973).

322. Rule 146 Release, *supra* note 297, at \*2.

323. *Id.* at \*1.

324. *Id.* at \*49.

bear the economic risk of the investment.<sup>325</sup> Third, immediately prior to making any sale, the issuer must have had reasonable grounds to believe and must have believed, after making reasonable inquiry, that the purchaser had sufficient knowledge to evaluate the merits and risks of the investment or that the purchaser, with his representative, had sufficient knowledge to evaluate the merits and risks of the investment and would be able to bear the economic risk of the investment.<sup>326</sup> Fourth, each offeree must have had access to or been furnished specified information about the issuer.<sup>327</sup> While there was no dollar limitation on the size of an offering in reliance on Rule 146, the number of purchasers was limited to thirty-five, but a person who purchased or agreed to purchase \$150,000 or more of securities in the offering would not be counted.<sup>328</sup>

Rule 146 was not well received.<sup>329</sup> "Compliance with the rule was described as unduly complex, costly, and subjective, with an unacceptable level of risk that the exemption may be lost inadvertently."<sup>330</sup> In fact, a House advisory committee report characterized the rule as a failure and called for its repeal.<sup>331</sup>

In partial response to this criticism, the SEC promulgated two additional exemptions, Rule 240 and Rule 242, under section 3(b) of the Securities Act.<sup>332</sup> Section 3(b) empowers the SEC to adopt rules exempting offerings of securities up to \$5 million<sup>333</sup> "if it finds that the enforcement of . . . [the Securities Act] 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."<sup>334</sup> Rule 240, adopted in 1975, allowed an issuer to sell up to \$100,000 of securities in any twelve-month period without registration under the Securities Act so long as investors were not solicited through general advertising and the issuer did not pay commission or similar remuneration for soliciting investors.<sup>335</sup> Additionally, both before and after an offering relying on Rule 240, there must have been one hundred or fewer beneficial owners of the issuer's securi-

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325. *Id.* at \*50.

326. *Id.*

327. *Id.* at \*51.

328. *Id.* at \*56-\*57.

329. 3 LOSS & SELIGMAN, *supra* note 65, at 1412.

330. 3 *Capital Formation: Hearing Before the Senate Select Comm. on Small Bus.*, 95th Cong. 584 (1978).

331. HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, 95TH CONG., REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SEC 530 (Comm. Print 1977).

332. See 15 U.S.C. § 77c(b) (2000).

333. *Id.* As originally enacted, the section 3(b) cap was \$100,000. 3 LOSS & SELIGMAN, *supra* note 65, at 1328. The cap was raised to \$300,000 in 1945, \$500,000 in 1970, \$1.5 million in 1978, and finally to \$5 million in 1980. *Id.* at 1329-34.

334. 15 U.S.C. § 77c(b).

335. 3 LOSS & SELIGMAN, *supra* note 65, at 1413.

ties.<sup>336</sup> Rule 240, however, did not require that investors be furnished with or given access to any information about the issuer.<sup>337</sup>

Recognizing that Rule 240 was of limited utility to small businesses, in 1980 the SEC adopted Rule 242.<sup>338</sup> Rule 242 allowed an issuer to sell up to \$2 million of securities in any six-month period to an unlimited number of “accredited persons” and up to thirty-five other purchasers.<sup>339</sup> *Accredited person* was defined as certain specified institutional investors, purchasers of \$100,000 or more of securities in the offering, and executive officers and directors of the issuer.<sup>340</sup> If the issuer made sales only to accredited purchasers, there were no information requirements.<sup>341</sup> If nonaccredited purchasers were included in the offering, Rule 242 required that certain information about the issuer be furnished to all investors.<sup>342</sup> Rule 242 prohibited an issuer from soliciting investors through general advertising.<sup>343</sup>

Less than two years after adopting Rule 240 and in the wake of various congressional and SEC hearings,<sup>344</sup> which resulted in the adoption of the Small Business Investment Incentive Act of 1980,<sup>345</sup> the SEC proposed and, seven months later, adopted Regulation D, the current principal exemption regime for offerings by small businesses, as discussed above.<sup>346</sup> The intent of Regulation D was to create “a more coherent pattern of exemptive relief, particularly as it relate[d] to the capital formation needs of small business.”<sup>347</sup> Specifically, Regulation D significantly revised Rules 146, 240, and 242 and consolidated them into one regulation—with common definitions, terms, and conditions—in an effort to simplify the then-existing exemptive scheme that many viewed as unnecessarily complex.<sup>348</sup> As

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336. *Id.*

337. *Id.*

338. Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act of 1933 Release No. 33-6180 (Jan. 17, 1980), 1980 SEC LEXIS 2234, at \*6.

339. *Id.* at \*2.

340. *Id.*

341. *Id.*

342. *Id.*

343. *Id.* at \*3.

344. See Examination of the Effects of Rules and Regulations on the Ability of Small Business to Raise Capital and the Impact on Small Businesses of Disclosure Requirements Under the Securities Act, Securities Act of 1933 Release No. 5914, Securities Exchange Act of 1934 Release No. 14529 (Mar. 6, 1978), 1978 SEC LEXIS 2089, at \*5, \*5-\*7 nn.1-9.

345. Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

346. Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act of 1933 Release No. 33-6339 (Aug. 7, 1981), 1981 SEC LEXIS 924, at \*1.

347. *Id.* at \*2.

348. *Id.* at \*2-\*4; see also Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 355-59 (1984).

noted above, the exemptions are contained in Rules 504, 505, and 506, all of which replaced the exemptions provided by Rules 240, 242, and 146, respectively.<sup>349</sup>

As discussed above, Regulation D also retained the prohibition against general solicitation and general advertising included in Rule 240 and interpreted it in accordance with *Ralston Purina*.<sup>350</sup> This is not surprising since Rule 504 and Rule 505 were promulgated under section 3(b) of the Securities Act,<sup>351</sup> and Rule 506 was promulgated under section 4(2) of the Securities Act.<sup>352</sup> Section 3(b) provides that the SEC can exempt offerings of up to \$5 million if a small amount is involved (Rule 504), or the offering is of limited character (Rule 505).<sup>353</sup> Section 4(2) exempts transactions by an issuer not involving a public offering.<sup>354</sup> General solicitation and general advertising are inconsistent with (1) an offering of limited character and (2) an offering not involving a public offering. As the SEC has stated, “we have long construed general solicitation or advertising to impart a public character to an offering.”<sup>355</sup> Consequently, in the SEC’s view “[t]he prohibition on general solicitation and advertising is what keeps the offering ‘private.’”<sup>356</sup>

### B. *Overlapping Federal and State Securities Regulations*

Recall that offers and sales of securities are subject to regulation at both the federal and state level. As noted above, all but one state requires that offers and sales of securities be registered with state regulators unless the offering falls within an exemption.<sup>357</sup> Thus, prior to the enactment of NSMIA in 1996, a company undertaking a private offering had to structure the offering so that it fit within a federal exemption, mainly, Regulation D, and an exemption for each state in which the company intended to offer the securities.<sup>358</sup> This was possible to do, even if the company contemplated seeking investors in numerous states, because all states generally have exemptions that complement the Regulation D exemptions; hence, if an offering was exempt at the federal level under Regulation D, it was typically exempt at the state level.<sup>359</sup> However, for example, if the

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349. 17 C.F.R. §§ 230.504-.508 (2003).

350. See *supra* Part III.A.

351. See *supra* notes 82 and 88.

352. See *supra* note 102.

353. 15 U.S.C. § 77c(b) (2000).

354. *Id.* § 77d(2).

355. Integration of Abandoned Offerings Release, *supra* note 191, at \*16; see also Langevoort, *supra* note 136, at 4, 24.

356. GAO REPORT, *supra* note 22, at 30.

357. See *supra* text accompanying note 109.

358. See HICKS, *supra* note 252, § 7:277.

359. *Id.*

SEC had decided prior to 1996 to eliminate Regulation D's ban on general solicitation and advertising, the states would likewise have had to lift the ban with respect to their corresponding exemptions in order for this federal change to have had any effect. Completely lifting the ban with respect to United States jurisdiction would have required each of the fifty states and Guam, Puerto Rico, and Washington, D.C., to change their securities laws.

This point is poignantly exemplified by the states' reaction to Rule 254 "test-the-waters" provisions of Regulation A, adopted by the SEC in 1992.<sup>360</sup> As noted above, Rule 254 explicitly permits a limited form of general solicitation and advertising notwithstanding the fact that Regulation A is an exemption from the registration requirements of the Securities Act. Many state administrators viewed Rule 254 as contrary to investor protection.<sup>361</sup> Hence, state laws generally were not modified to coordinate with Rule 254, ultimately nullifying Rule 254.<sup>362</sup>

On the flip side, if one or more states changed its securities laws to allow general solicitation and advertising in an exempt offering, the SEC would need to make a corresponding change to the federal exemptions. This, in fact, is what happened with section 25102(n) of the California Corporations Code,<sup>363</sup> enacted by California in 1994.<sup>364</sup> Recall that California section 25102(n) provides an exemption from California's registration requirements but allows limited general solicitation and advertising.<sup>365</sup> However, if a company engaged in such solicitation, neither a Rule 505 nor a Rule 506 exemption from federal registration would be available.<sup>366</sup> As discussed above, the SEC

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360. See *supra* text accompanying notes 229-30.

361. Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 409-10 (1993). NASAA adopted a resolution stating that it "recognizes the policy objectives underlying the testing-the-waters exemption . . . , but has substantial concerns as to whether it can adequately ensure that investors are protected." Resolution of the NASAA Regarding Testing-the-Waters Exemption, NASAA Rep. (CCH) ¶ 7036, at 7043 (Apr. 25, 1993); see also NASAA Comment Letter to SEC Secretary, Jonathan Katz, Regarding SEC Release Nos. 33-6950, 34-30969, 39-2288; Additional Small Business Initiatives, [1986-1993 New Developments] NASAA Rep. (CCH) ¶ 9349, at 9390 (Oct. 5, 1992) (describing testing-the-waters concept as short-sighted and unwise).

362. Steinberg, *supra* note 361, at 411. The states' response to Rule 254 is in contrast to the states' response to MAIE, which as of December 2001 had been adopted by forty states. Perhaps this is because offerings in reliance on MAIE are limited to accredited investors while Regulation A offerings are open to all investors. Further, MAIE was championed by NASAA while Rule 254 was championed by the SEC, and some perceived Rule 254 as politically motivated. *Id.* at 410-11. A few states did change their securities laws to allow testing-the-waters. See Mittelman, *supra* note 228, at 251.

363. CAL. CORP. CODE § 25102(n) (West 2004).

364. BLOOMENTHAL, *supra* note 85, at 1372-73.

365. See *supra* note 240 and accompanying text.

366. BLOOMENTHAL, *supra* note 85, at 1372-73.

adopted Regulation CE in 1996 to provide a federal exemption specifically for a California section 25102(n) offering.<sup>367</sup>

In adopting Regulation CE, the SEC stated that it would create an exemption for any state that adopts an “exemption incorporating the same standards used by California.”<sup>368</sup> In response to this invitation,<sup>369</sup> NASAA developed the Model Accredited Investor Exemption (MAIE) discussed above.<sup>370</sup> Notwithstanding its statements in adopting Regulation CE, the SEC has not adopted a corresponding federal exemption for MAIE.<sup>371</sup> Perhaps this is because MAIE lacks a state connection requirement and therefore does not “incorporat[e] the same standards used by California.”<sup>372</sup> Regardless, the SEC’s failure to adopt an exemption corresponding to MAIE provides another example of the nullifying effect of overlapping federal and state securities regulation.

### C. Securities Fraud Prevention

One could also argue that the ban on general solicitation and advertising is justified because it helps prevent securities fraud.<sup>373</sup> Specifically, the prohibition makes it more difficult for promoters of fraudulent investment schemes to attract investors.<sup>374</sup> While the ban may not deter such promoters from using all forms of public advertising, it likely curtails their activities; that is, if their solicitation activities are too public, they will attract the attention of the SEC or state regulators.

According to an SEC official, “[t]he prohibition on general solicitation . . . helps minimize the risks of widespread fraud.”<sup>375</sup> The foregoing, however, has not been cited in the historical development of the ban as an ideological basis. Regardless, such a basis is subject to attack because the remedy is overbroad. While the ban may help prevent securities fraud, it has a much greater impact on the ability of an honest, legitimate company to attract investors since, in light of the ban, such a company will not engage in any general solicitation or advertising, whereas someone willing to perpetrate securities fraud likely is not troubled in the least by violating the ban.

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367. See *supra* notes 235 and 238 and accompanying text; see also BLOOMENTHAL, *supra* note 85, at 1372-73.

368. California Exemption Release, *supra* note 235, at \*13.

369. Borg Letter, *supra* note 260.

370. See *supra* text accompanying notes 260-67.

371. Borg Letter, *supra* note 260, at 9-10.

372. See *supra* note 368 and accompanying text.

373. See HICKS, *supra* note 252, § 7:160.

374. *Id.*

375. GAO REPORT, *supra* note 22, at 30.

## V. PROPOSED REGULATORY REFORM

With the enactment of NSMIA in 1996, there is now clear statutory authority under which the SEC could adopt rules allowing general solicitation and advertising in exempt offerings without these rules being subject to state nullification. Specifically, NSMIA added section 28 to the Securities Act:

The [SEC], by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.<sup>376</sup>

Thus, section 28 provides the SEC with general exemptive authority similar to that provided by section 3(b) of the Securities Act<sup>377</sup> but with no monetary limit or references to offerings of limited amount or character. Hence, there is no need that an exemption adopted under section 28 be consistent with the public/private distinction jurisprudence of the existing exemptions.<sup>378</sup>

NSMIA also added subsection (b) to section 2 of the Securities Act:

Whenever pursuant to this subchapter the [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the [SEC] shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and *capital formation*.<sup>379</sup>

Hence, the SEC could adopt an exemption under section 28 that allows general solicitation and advertising so long as the exemption is (1) necessary or appropriate in the public interest and (2) consistent with investor protection.<sup>380</sup> In making the first determination, Congress has specifically directed the SEC to consider capital formation.

As mentioned above, NSMIA also amended section 18 of the Securities Act to provide that states may not directly or indirectly require registration of offerings involving “covered securit[ies].”<sup>381</sup> This resulted in the preemption of state registration requirements for ex-

376. 15 U.S.C. § 77z-3 (2000).

377. See *supra* text accompanying notes 332-34.

378. Hence, the assertion by an SEC official that “[t]he prohibition on general solicitation and advertising is what keeps the offering ‘private’” is now irrelevant. GAO REPORT, *supra* note 22, at 30.

379. 15 U.S.C. § 77b(b) (emphasis added).

380. See Securities Uniformity; Annual Conference on Uniformity of Securities Laws, Release No. 33-7413 (Apr. 4, 1997), 1997 SEC LEXIS 747, at \*3.

381. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 102(a), 110 Stat. 3417 (1996); 15 U.S.C. § 77r(a).

empt offerings of covered securities.<sup>382</sup> Section 18 defines a *covered security* as a security listed or approved for listing on the New York Stock Exchange or the American Stock Exchange, a security admitted or approved for admission and trading on the Nasdaq National Market,<sup>383</sup> and, as mentioned above, a security issued pursuant to Rule 506.<sup>384</sup> Section 18 also provides that “[a] security is a covered security with respect to the offer or sale of the security to qualified purchasers, as defined by the [SEC] by rule.”<sup>385</sup> Therefore, the SEC could adopt a new private placement exemption under section 28 that allows general solicitation and advertising without the exemption being subject to state nullification. The SEC could achieve this by including within the definition of *qualified purchaser* all offerees and purchasers of securities pursuant to this new exemption. This, in turn, would bring securities issued under this new exemption within the definition of covered security, resulting in the preemption of state registration requirements for an offering under this new exemption.<sup>386</sup>

Since enactment, the SEC has on four occasions adopted rules in reliance on section 28.<sup>387</sup> For example, in December 2002, the SEC relied on section 28 in adopting Rule 238 under the Securities Act.<sup>388</sup> Rule 238 exempts certain standardized options from all requirements of the Securities Act other than the anti-fraud provisions.<sup>389</sup> Additionally, in December 2001, the SEC proposed a definition of *qualified purchaser* for purposes of the definition of a *covered security* under section 18 of the Securities Act that mirrors the definition of *accredited investor* under Regulation D.<sup>390</sup> To date, the SEC has not acted on its proposal.

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382. Rutheford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 196-97 (1997).

383. 15 U.S.C. § 77r(b)(1)(A).

384. See *supra* text accompanying note 112.

385. 15 U.S.C. § 77r(b)(3).

386. See Campbell, *supra* note 382, at 207.

387. See Amendments to Investment Company Advertising Rules, Securities Act of 1933 Release No. 33-8294, Securities Exchange Act of 1934 Release No. 34-48558, Investment Company Act of 1940 Release No. IC-26195 (Sept. 29, 2003), 2003 SEC LEXIS 2315, at \*11 n.15; Exemption for Standardized Options from Provisions of the Securities Act of 1933 and from the Registration Requirements of the Securities Exchange Act of 1934, Securities Act of 1933 Release No. 33-8171, Securities Exchange Act of 1934 Release No. 34-47082 (Dec. 23, 2002), 2002 SEC LEXIS 3298, at \*11-\*12 [hereinafter Offshore Press Activities Release]; Regulation of Takeovers and Security Holder Communications, Securities Act of 1933 Release No. 33-7760, Securities Exchange Act Release No. 34-42055, Investment Company Act of 1940 Release No. IC-24107 (Oct. 22, 1999), 1999 SEC LEXIS 2291, at \*33-\*34 n.47; Rule 701—Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act of 1933 Release No. 33-7645 (Feb. 25, 1999), 1999 SEC LEXIS 406, at \*7-\*8.

388. Offshore Press Activities Release, *supra* note 387.

389. 17 C.F.R. § 230.238 (2003).

390. “Qualified Purchaser” Release, *supra* note 268, at \*1.

While with the enactment of NSMIA the SEC has the power to allow general solicitation and advertising in private placements, the question is whether it should exercise this power. Given the importance of emerging companies to the United States economy and the critical role access to private equity capital plays in the development of emerging companies, I believe the SEC should, under certain circumstances, allow general solicitation and advertising in private placements.<sup>391</sup> Hence, below is a description of a proposed new exemption I urge the SEC to adopt.

Recognizing that the current ban on general solicitation and advertising may aid in battling securities fraud, my proposal does not call for blanket elimination but, rather, it calls for an exemption targeted specifically for emerging companies. First, the SEC should adopt a new federal exemption similar to Regulation CE<sup>392</sup> but without requiring a California connection<sup>393</sup> for offers and sales of securities to accredited investors as defined in Regulation D. Like Regulation CE, the exemption would allow general solicitation and advertising,<sup>394</sup> but unlike Regulation CE, it would not restrict the content of the solicitation, only the method.<sup>395</sup> In particular, general solicitation and advertising would be allowed, but only through (1) broker-dealers registered with both the SEC and the states in which solicitation is directed<sup>396</sup> and (2) certain company personnel.<sup>397</sup> These limi-

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391. My position would likely have the support of the Subcommittee on Small Business Issuers of the Committee on Federal Regulation of Securities and members of the Small Business Committee of the Section of Business Law of the American Bar Association. See Letter from Stanely Keller et al., Chair, Committee on Federal Regulation of Securities, to SEC (Apr. 30, 2002), <http://www.sec.gov/rules/proposed/s72301/keller1.htm> (last visited Sept. 29, 2004). Additionally, NASAA has recently stated that “we believe small issuers would be better served by adopting a federal exemption in the spirit of Rule 1001 [of the Securities Act] that would make public solicitation of accredited investors more available.” Borg Letter, *supra* note 260, at 9; see also U.S. Sec. & Exch. Comm’n, Final Report of the 21st Annual SEC Government-Business Forum on Small Business Capital Formation, at 15 (Feb. 2003) (“The restrictions on the use of general solicitations to make offers and sales under Rule 506 to accredited investors should be eliminated.”); GAO REPORT, *supra* note 22, at 30 (“It has been suggested by such [industry] participants that SEC eliminate the restriction on advertising and general solicitation . . . .”); MOLLER, *supra* note 31, at 7 (“A change in the law allowing general solicitation of the offering (without restrictions) would allow issuers to reach accredited investors more easily.”); Langevoort, *supra* note 136, at 25 (“On balance, I would be willing to deregulate in the area of general solicitations. Any form of general solicitation should be permissible so long as the offering is made available only to accredited investors.”).

392. See *supra* Part III.D.6.

393. See *supra* Part III.D.6.

394. See *supra* text accompanying note 240.

395. See *supra* note 240 and accompanying text.

396. At the federal level, the Exchange Act generally requires the registration of all broker-dealers with the SEC. 15 U.S.C. § 78o(a)(1) (2000). Likewise, all states require the registration of broker-dealers. 1 LOSS & SELIGMAN, *supra* note 65, at 69. The term broker-dealer is defined generally as “any person engaged in the business of effecting transactions in securities for the account of others.” 15 U.S.C. § 78c(a)(4)(A) (West Supp. 2004); Uniform Securities Act § 401(e), 1 Blue Sky L. Rep. (CCH) ¶ 5541 (Nov. 2000). A brokerage house of

tations would, for example, prevent a company from hiring a telemarketing firm to engage in widespread telephone solicitation of potential investors, whose activities may give rise to investor protection concerns.

As for company personnel, the exemption would permit only those personnel that fall within the Exchange Act Rule 240.3a4-1, a safe harbor for avoiding federal broker-dealer registration requirements, to engage in general solicitation or advertising.<sup>398</sup> The safe harbor is limited to “associated person[s] of an issuer,” which is defined as officers, directors, and employees of the issuer or persons controlling the issuer.<sup>399</sup> To fall within the safe harbor in the emerging company context, the associated person would need to meet each of the following six conditions. First, the person cannot have been barred from associating with a member of a self-regulatory organization, that is, a brokerage house.<sup>400</sup> Second, the person must not be a partner, officer, director, or employee of a broker or dealer.<sup>401</sup> Third, the person cannot be paid a commission or other remuneration based on sales of se-

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any size will be registered with the SEC and all fifty states. Registration generally involves completing and filing Form BD, a uniform application for broker-dealer registration, with the SEC and each state in which registration is desired. *See* 1 LOSS & SELIGMAN, *supra* note 65, at 89. Form BD includes questions going to the applicant’s fitness. *See Uniform Application for Broker-Dealer Registration*, FORM BD. Registration with the SEC triggers numerous compliance requirements which, among other things, seek to insure basic competency of registered broker-dealers. 1 DAVID A. LIPTON, BROKER-DEALER REGULATION § 1.3, at 13 (2004). Both the SEC and the States may deny, suspend, or revoke registration for various reasons. *See* 15 U.S.C. § 78o(b)(1), (4).

397. As mentioned above, under the current regulatory scheme, in order to complete a successful private placement, it is critical that an emerging company retain an investment banking firm so that the company has access to the firm’s pool of accredited investors. *See* Langevoort, *supra* note 136, at 13. Allowing company personnel to solicit potential investors would make this access less critical since investors in the offering would no longer be limited to those with whom the company or the investment banking firm has a preexisting, substantive relationship. This would allow a company to avoid paying a commission, and, perhaps more importantly, it would allow an emerging company that is unable to attract an investment banking firm to raise money for it a greater chance of succeeding on its own. In practice, though, raising private equity capital without the aid of an investment banking firm is difficult. Not only do investment banking firms have established pools of investors interested in investing in emerging companies, but they also provide expert assistance in pricing, structuring, and selling the deal. *Id.* Most importantly, they signal to potential investors the information credibility of the company. *Id.* at 14; *see also* Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) (“In essence, the investment banker rents the [company] its reputation. The investment banker represents to the market . . . that it has evaluated the [company]’s product and good faith and that it is prepared to stake its reputation on the value of the innovation.”). From an investor’s perspective, investing in an emerging company is laden with high transaction costs such as uncertainty, information asymmetry, and agency costs. Gilson, *supra* note 2, at 1069. In light of these costs, having an investment banking firm involved may be critical to tipping the scale in favor of investing.

398. 17 C.F.R. § 240.3a4-1 (2003).

399. *Id.* § 240.3a4-1(a), (c)(1).

400. *Id.* § 240.3a4-1(a)(1).

401. *Id.* § 240.3a4-1(a)(3).

curities.<sup>402</sup> Fourth, the person must primarily perform substantial duties for the company other than selling its securities.<sup>403</sup> Fifth, the person cannot have been a broker-dealer or associated person of a broker-dealer during the preceding twelve months.<sup>404</sup> Sixth, the person cannot have (with certain limited exceptions) participated in the sale of securities of any company during the preceding twelve months.<sup>405</sup>

The new exemption would not limit general solicitation and advertising to accredited investors, although only accredited investors could invest in the offering. This would allow a company and its broker-dealer to use a full range of marketing techniques tailored for a particular deal to reach the coveted pool of potential or latent angel investors<sup>406</sup>—the people most willing to provide emerging companies with vital start-up and early-stage equity financing.<sup>407</sup> It would allow a company like Callaway Golf to target, on its own or through an investment banking firm, all professional golfers, members of high-end country clubs, and anyone else regardless of a lack of preexisting, substantive relationships with these individuals.

The exemption would provide that all written solicitation materials would need to include a legend specifying the name of the company representative or registered broker-dealer making the solicitation and that only accredited investors can participate in the offering. Further, no telephone solicitation would be permitted unless, prior to the solicitation, the solicitor reasonably believes that the prospective investor is accredited. Additionally, the exemption would require that the issuer reasonably believes all investors are purchasing for investment and not with a view toward resale. Further, the exemption would be unavailable to an issuer if the issuer, its directors, officers, or ten percent or greater shareholders have committed certain conduct in violation of federal or state securities laws.<sup>408</sup>

This new exemption would meet the standards required by section 28. The exemption is necessary and appropriate in the public interest because it would greatly facilitate early-stage capital raising by emerging companies, the growth engines of the United States economy. The exemption is also consistent with investor protection since it is limited to offerings sold only to accredited investors. As the SEC recently noted, “our considerable regulatory experience with the use of the term ‘accredited investor’ leads us to believe it strikes the ap-

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402. *Id.* § 240.3a4-1(a)(2).

403. *Id.* § 240.3a4-1(a)(4)(ii)(A).

404. *Id.* § 240.3a4-1(a)(4)(ii)(B).

405. *Id.* § 240.3a4-1(a)(4)(ii)(C).

406. *See supra* text accompanying note 48.

407. *See supra* text accompanying note 41.

408. *Cf.* Model Accredited Investor Exemption, [Feb. 1999] NASAA Rep. (CCH) ¶ 361(C), (D) (Apr. 27, 1997); 17 C.F.R. § 230.507 (2003).

appropriate balance between the necessity for investor protection and meaningful relief for issuers offering securities, especially small businesses.”<sup>409</sup>

Additionally, the new exemption would be similar to Rule 506, a rule promulgated over thirty years ago that, to date, has not raised significant investor protection concerns. Like Rule 506, the new exemption would have no limit on the size of the offering or number of accredited investors participating. Unlike Rule 506, the new exemption would allow general solicitation and advertising. As discussed above, however, the ban on general solicitation and advertising applicable to Rule 506 is not the result of investor protection concerns but the result of the public versus private offering distinction contained in the Securities Act, a distinction not relevant to an exemption adopted under section 28. Therefore, if Rule 506 passes investor protection muster, it follows that the new exemption would pass investor protection muster as well.

In connection with adopting the new exemption, the SEC should either adopt its proposal to define *qualified purchaser* to mirror accredited investor under Regulation D<sup>410</sup> or, as suggested above, adopt a proposal to include within the definition of *qualified purchaser* all offerees and purchasers of securities pursuant to this new exemption. Either approach would have the effect of preempting state securities regulations with respect to offers and sales of securities in reliance on this new exemption, thereby making it impossible for states to essentially nullify the exemption by failing to adopt parallel state exemptions.<sup>411</sup>

NASAA and the securities regulators of several states have recently expressed displeasure with this preemption approach.<sup>412</sup> In a

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409. “Qualified Purchaser” Release, *supra* note 268, at \*9. Note that this article takes no position on the appropriateness today of the current definition of *accredited investor*, which was established by the SEC in 1979. *Id.* at \*11. The definition has been criticized for, among other things, being based on dollar amounts that have never been adjusted for inflation. See Borg Letter, *supra* note 260, at 2. My position is that if the SEC views the current definition as an adequate objective proxy for delineating those investors that have the necessary financial sophistication and ability to fend for themselves so as “not [to] require the protections of registration under the federal securities laws,” “Qualified Purchaser” Release, *supra* note 268, at \*12, for purposes of Regulation D, then it is adequate for purposes of my proposed exemption as well.

410. See “Qualified Purchaser” Release, *supra* note 268, at \*11.

411. See *supra* text accompanying note 386.

412. See Borg Letter, *supra* note 260, at 1; Letter from Deborah R. Bortner, Director of Securities, Securities Division of the Washington State Department of Financial Institutions, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Feb. 25, 2002), <http://www.sec.gov/rules/proposed/s72301/bortner1.htm> (last visited Sept. 29, 2004); Letter from Deborah L. Dye Joyce, Commissioner of Securities, Ohio Division of Securities, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Feb. 21, 2002), <http://www.sec.gov/rules/proposed/s72301/joyce1.htm> (last visited Sept. 29, 2004); Letter from John A. Maher, Commissioner, Robert M. Lam, Chairman, and A. Richard Gerber, Commissioner, Pennsylvania Securities Commission, to Jonathan G. Katz, Secretary, U.S.

March 2002 letter to the SEC commenting on the SEC's proposed definition of *qualified purchaser*, NASAA wrote:

States frequently use violations of their registration provisions as the basis for stopping fraud. A state regulator can issue a cease and desist order or obtain a preliminary injunction by simply proving the existence of a security and the absence of an effective registration statement. Were the states, because of preemption, unable to use this tool, they would have to devote substantial time and effort to prove fraud, which prolongs the public's exposure to harm and further taxes limited state resources.<sup>413</sup>

The above points have merit. That is why, as mentioned above, my proposed exemption limits general solicitation and advertising through (1) broker-dealers registered with the SEC and the states in which the solicitation is directed and (2) certain company personnel. This is consistent with the current regime, implicitly endorsed by the SEC,<sup>414</sup> whereby broker-dealers play a key role in securing private equity capital for emerging companies by establishing relationships with a pool of accredited investors and "renting" these relationships to companies.<sup>415</sup> The exemption would further provide that company personnel who engage in general solicitation and advertising must also comply with any applicable state registration requirements. This would then allow a state to enact regulations requiring the registration of company personnel engaging in general solicitation and advertising under the new exemption.

As a result, adoption of the new exemption, including state preemption, would not foreclose states from using violations of their registration provisions as the basis for stopping fraud. Such adoption would just shift the focus from state securities registration provisions to state broker-dealer/company solicitor registration provisions.

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Securities and Exchange Commission (Feb. 19, 2002), <http://www.sec.gov/rules/proposed/s72301/lam1.htm> (last visited Sept. 29, 2004); Letter from Matthew Nestor, Director, Massachusetts Securities Division, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Feb. 25, 2002), <http://www.sec.gov/rules/proposed/s72301/nestor1.htm> (last visited Sept. 29, 2004); Letter from S. Anthony Taggart, Director, Utah Division of Securities, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Feb. 25, 2002), <http://www.sec.gov/rules/proposed/s72301/taggart1.htm> (last visited Sept. 29, 2004); Letter from Ronald W. Thomas, Director, State Corporation Commission of the Commonwealth of Virginia, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission 1 (Mar. 4, 2002), <http://www.sec.gov/rules/proposed/s72301/thomas1.htm> (last visited Sept. 29, 2004).

413. Borg Letter, *supra* note 260, at 5.

414. *See supra* Part III.B.2.

415. *See supra* Part III.C.

## VI. CONCLUSION

The prohibition against general solicitation and advertising in private placements of securities has persisted for seventy years. This persistence is not the result of strong ideology, but is the result of a seventy-year-old statutory distinction between public offerings and private or limited offerings entrenched by overlapping federal and state securities regulations. This persistence is surprising, especially following the enactment of NSMIA, given the importance of emerging companies to the United States economy and the importance of private equity capital to emerging companies. While there appears to be no shortage of potential or latent angel investors willing to invest in emerging companies, the prohibition greatly limits the methods by which an emerging company can attempt to reach these investors. The end result is a funding gap for emerging companies seeking start-up and early-stage financing.

The SEC and the states have recognized the impediment the prohibition places on fundraising efforts by small and emerging companies and have taken steps to loosen the prohibition. These steps, however, do not go far enough. Hence, this Article has proposed a new private placement exemption which would allow a company and its investment banking firm to utilize the full range of marketing techniques when raising private equity capital. By limiting the application of the proposed exemption to offerings (1) where only accredited investors can participate and (2) which are made exclusively through registered broker-dealers and company personnel, it strikes the appropriate balance between investor protection and capital formation.