

Promoting Capital Formation and Maintaining Investor Protection By Removing  
General Solicitation and Advertising Prohibitions In Exempt Offerings By “Small  
Private Issuers.”

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Introduction

A regulatory structure designed to encourage small business formation and rapid growth is essential to economic prosperity. It has been said, “[a] healthy economy is a dynamic organism that is constantly in a state of change and renewal.”<sup>1</sup> This process has been described as “Creative Destruction,”<sup>2</sup> in which competition and innovation serve as catalysts, “incessantly destroying the old [economy], incessantly creating a new one”<sup>3</sup> This process depends upon mechanisms through which competition and innovation can serve as catalysts, the more efficient the mechanism, the more likely the process will result in a healthy economy. Entrepreneurial start-up ventures are one such mechanism.<sup>4</sup>

The efficiency of these ventures depends upon a number of factors, the primary factor being the ease with which “patient,” high risk capital can be acquired.<sup>5</sup> Unfortunately, start-up ventures face significant obstacles in their quest for capital, which ultimately decrease their efficiency.<sup>6</sup> This is particularly troubling given their increasing economic significance.<sup>7</sup> “Small businesses have always been the backbone of our economy. . . . [they] have sustained the

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<sup>1</sup> JOSEPH A. SCHUMPTER, CAPITALISM, SOCIALISM, AND DEMOCRACY 83 (3d ed., 1950).

<sup>2</sup> SCHUMPTER, *supra* note 1.

<sup>3</sup> See John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in The Private Capital Raising Setting*, 37 ARIZ. ST. L. J. 861 (2005).

<sup>4</sup> See *id.*

<sup>5</sup> Freear, et al., *Creating New Capital Markets For Emerging Ventures*, (stating “for entrepreneurs, raising, patient, high risk equity financing is the critical capital formation challenge”); see also Jeffrey E. Sohl, *The U.S. Angel and Venture Capital Markets: Recent Trends and Developments*, J. Private Equity (stating untold numbers of emerging companies fail because of their inability to raise sufficient capital “to move promising technology from the laboratory to the marketplace”). “Patient” high risk capital refers to capital invested in the “seed” or “early stage” rounds of financing in which the investor has a longer exit horizon, typically five to seven years. *Id.*

<sup>6</sup> Sohl, *supra* note 5. Sohl states:

Highgrowth Ventures need patient, value added equity capital to fuel growth. Under efficient market conditions capital flows from the suppliers of the capital, angels and venture capital funds, unimpeded to the demand side, the [] entrepreneurs. In the United States, the private equity market does not meet this standard of efficiency, not by a long shot.

*Id.*

<sup>7</sup> Jeffrey E. Sohl, *The Early Stage Equity Market in the United States*, available at. Sohl states that “as recently as 1979, the U.S. began a transition from a declining industrial and manufacturing economy to an emerging entrepreneurial/innovation-driven economy.” *Id.* This trend, according to Sohl, continues to accelerate. *Id.*

economy in weaker times . . . and put us back on the track to long term growth.”<sup>8</sup> According to the U.S. Small Business Administration Office of Advocacy, small businesses represent more than 99% of all employers, employ half of the private sector employees, create more than 50% of non-farm private gross domestic product, and generate 60% to 80% of net new jobs annually.<sup>9</sup> These numbers are somewhat misleading, as they represent the impact that small businesses as an entire class have on the economy and fail to give credit where credit is due. The bulk of job and new wealth creation is attributable to a small segment of the small business community, namely entrepreneurial ventures that start small but are designed to grow fast.<sup>10</sup>

It is estimated that the financial needs of emerging ventures for patient, high risk capital is approximately 60 billion dollars annually or about fifteen times the annual investment of the institutional venture capital pool.<sup>11</sup> This phenomena, called the “funding gap,” can be attributed to the lack of an “efficient” market.<sup>12</sup> An efficient market is characterized by informed buyers and sellers and low transaction costs.<sup>13</sup> Early-stage equity financing, however, occurs in a market where access to information is extremely limited and transaction costs are prohibitively

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<sup>8</sup> The State of Small Business: A Report of the President 1 (2001) [hereinafter Small Business Report]; *see also* The State of Small Business: A Report of the President 1 (1997); (“[Small Businesses] are the foundation of the Nation’s economic growth: virtually all jobs, 53 percent of employment, 51 percent of private sector output, and disproportionate share of innovations come from small firms”).

<sup>9</sup> U.S. Small Business Administration, Frequently Asked Questions, at <http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24>.

<sup>10</sup> Sohl, *supra* note 7. There are three types of small businesses, the living dead, middle market ventures, and high potential ventures. The “living dead,” represent income businesses created to provide employment and fulfill owner lifestyle needs. These companies represent 90% of small businesses and are characterized by five year revenue projections under 10 million and the lack of any clear exit strategy. *Id.* Middle market ventures are characterized by 5 year revenue projections of 10 to 50 million, and may, if properly structured, offer capital gains and cash out opportunities for investors. High potential ventures have 5 year revenue projections in excess of 50 million, and represent potential jackpots for investors and entrepreneurs. These high potential ventures represent 1 percent of the small business class, and are designed to be publicly traded or acquired within 5 years. *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> Frear, *supra* note 5. *see also* Sohl, *supra* note 5.

<sup>13</sup> *See* Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Markets*, 47 OKLA. L. REV. 291 (1994) (stating well developed markets . . . absorb[] information instantaneously, so that prevailing prices of securities reflect[] the value that an informed investor would rationally be willing to pay. . .”).

excessive.<sup>14</sup> In fact, innumerable small ventures fail because they cannot raise the necessary capital to get their “promising ideas from the laboratory to the market place”,<sup>15</sup> costing the “United States untold thousands of jobs and innovations, and billions of dollars of tax revenue.”<sup>16</sup>

Considering the need for well-informed market participants, it would seem that any regulatory structure should be designed to produce an environment conducive to the free flow of relevant reliable information. The current regulatory structure, however, contains numerous rules that restrict both issuers’ and investors’ ability to provide and obtain relevant information. This contributes to the continued expansion of the “funding gap,” which ultimately decreases the portion of capital available for ventures in the seed and early stage of financing.<sup>17</sup>

Few vehicles exist for bringing together potential investors and ventures seeking capital. Transaction costs are high for the entrepreneur, raising private equity capital involves a costly time consuming personal networking process, and for the investor, with considerable time and dollars spent searching and evaluating investment opportunities. The majority of active private sector investors report that they have additional capital available to invest but limited quality deal flow is the primary constraint.<sup>18</sup>

The early stage equity market is composed of two categories of investors, who can be distinguished by, among other things, the stage at which they enter the capital “life” of a venture.<sup>19</sup> The first category is comprised of institutional investors, such as venture capital funds. These investors typically do not involve themselves in the seed or early stage rounds of

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<sup>14</sup> Freear, *supra* note 5. (attributing market inefficiencies to a lack of directories of private investors, public records of investment transactions, and vehicles for matching investors and entrepreneurs).

<sup>15</sup> Sohl, *supra* note 7.

<sup>16</sup> William K. Sjostrom, *Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings*, 32 FLA. ST. U. L. REV. 1 (2004); See Freear, *supra* note 5; General Accounting Office, Report of the Chairman, Comm. on Small Bus., U.S. Senate, Small Business Efforts to Facilitate Equity Capital Formation 1, 3-4 (2000) (“In general, . . . equity capital is widely viewed as less accessible and more costly per dollar raised for small businesses compared with large businesses”).

<sup>17</sup> Sohl, *supra* note 5.

<sup>18</sup> Sohl *supra* note 5.

<sup>19</sup> Sohl *supra* note 5.

financing. The remaining category is composed of individual investors, known as “Angels.” Angel investors are high net worth individual investors and have historically invested in the seed and early stage rounds of financing.<sup>20</sup> When viewed individually, Angels may not “merit a blip on any chart of total investment capital in this country;” however, taken as a whole, Angels “have quickly become the nations major source of start-up capital” whose investments “serve as spawning grounds for their venture capitalist counterparts.”<sup>21</sup>

The solution to the inefficiencies in the private equity market lies in finding the appropriate balance between the informational needs of small issuers and private investors and the government’s interest in investor protection. These two, often times conflicting interests, have unfortunately led to the development of a body of law replete with internal inconsistencies. In an attempt to facilitate a balance, Congress enacted the Securities Act of 1933<sup>22</sup> (the “Securities Act”) creating a system of registration and administrative review designed to eliminate fraud and other abuses stemming from the lack of a regulated securities market.<sup>23</sup> Congress believed the registration system would eliminate securities fraud by assuring adequate

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<sup>20</sup> Angels continue to be the largest source of seed and start-up capital, with 55 percent of 2005 angel investments in the seed and start-up stage. This preference for seed and start-up investing is followed closely by post-seed/start-up investments of 43 percent. The increase in post-seed/start-up investing continues a trend that began in 2004 and represents a 10 percent increase in historical levels. UNH Center For Venture Research: 2005, *Angel Market Exhibits Modest Growth Health Care/Medical Sector Is Hot; Women Entrepreneurs Cashing In On Capital*, at [http://www.unh.edu/news/news\\_releases/2006/march/lw\\_060327angel.html](http://www.unh.edu/news/news_releases/2006/march/lw_060327angel.html)

While angels are not abandoning seed and start-up investing, it appears that market conditions, and the preferences of large formal angel alliances, are resulting in angels engaging in more later-stage investments. . . . This shift in investment strategies toward post seed investments reduces the proportional amount of seed and start-up capital. This restructuring of the angel market has in turn resulted in fewer dollars available for seed investments, thus exacerbating the capital gap for seed and start-up capital in the United States.

Id.

<sup>21</sup> Sohl, *supra* note 7.

<sup>22</sup> 15 U.S.C. §§ 77a-77aa (2000).

<sup>23</sup> See Stuart R. Cohn, *Securities Markets For Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. Fla. L. Rev. 1 (1986); H.R. Rep. No. 85, 73d Cong., 1<sup>st</sup> Sess. 2 (1933); *but see* Macy & Miller, *Origin of the Blue Sky Laws*, 70 Texas L. Rev. 347, 350 (1991) (stating that “although fraudulent securities [activities] undoubtedly occurred . . . the standard account that securities fraud was rampant before the advent of [securities] regulation is not proven”).

disclosure of material information.<sup>24</sup> Requiring disclosure was also intended to provide investors and issuers the information necessary to make informed investment or other relevant decisions and increase the efficiency of the securities market.<sup>25</sup> Congress, however, did not intend to impose the registration process on every single offering of securities; Congress understood that in certain circumstances “companies and transactions are of insufficient magnitude to warrant full federal regulation or any regulation at all.”<sup>26</sup> As such, Congress designed the private offering exemption<sup>27</sup> and authorized the SEC to create additional exemptions “where there is no practical need for its application or where the public benefits are too remote.”<sup>28</sup>

Unfortunately, the SEC, and to a lesser extent the courts, have imposed conditions on availability of registration exemptions that fail to serve any practical need or produce any significant public benefit.<sup>29</sup> Of those prerequisites, the prohibition on general solicitation<sup>30</sup> and

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<sup>24</sup> Jeffrey T. Haughey & Kevin M. Velar, *Empirical Research Project, Blue Sky Laws and State Takeover Statutes: New Importance for an Old Battleground*, 7 J. CORP. LAW 689 (1982) (stating “[f]ederal securities laws [traditionally] have been drafted with the aim of providing investors with accurate and complete information on which to base their investment decisions”). Congress declined to adopt the merit approach, irrespective of the value or fairness of a transaction or other corporate action, after adequate disclosure, the investor ultimately determines the merits of the investment. *Id.* The SEC does not have any authority to prevent an offering from going forward because it considers the investment overly risky. MARK I. STEINBERG, *SECURITIES REGULATION* 1 (4<sup>th</sup> ed., 2004); *but see* L. BRANDEIS, *OTHER PEOPLES MONEY* 92 (1914) (stating “[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants.”); R. STEVENSON, *CORPORATIONS AND INFORMATION – SECRECY, ACCESS, & DISCLOSURE* 81-82 (stating “[t]oday the disclosure requirements of the securities laws are used, in a variety of ways, for the purpose of influencing a wide range of corporate primary behavior”).

<sup>25</sup> *See* Haughey & Velar, *supra* note 24.

<sup>26</sup> Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, Securities Act Release No. 8666, [hereinafter Advisory Report] 2006 WL 520112 (February 28, 2006).

<sup>27</sup> Section 4(2) of the Securities Act exempts from registration “transactions by an issuer not involving any public offering.” 15 U.S.C. § 7d(2) (2000).

<sup>28</sup> *See* H.R. Rep. No. 85, 73d Cong., 1<sup>st</sup> Sess. 5 (1993).

<sup>29</sup> *See* Cohn, *supra* note 23; *see also* Joel Seligman, *Götterdämmerung for the Securities Act?*, 75 WASH. U. L.Q. 887 (1997) (suggesting an ideological shift has occurred from early concerns of fraud to the current concern the “the cost of registration . . . no longer can be justified.”)

<sup>30</sup> The term “general solicitation” denotes the use of “mass media or other similar marketing techniques to effect a widespread offering of securities to the public.” Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L. J. 67 (1989)

advertising serves as the most significant barrier for small companies seeking capital.<sup>31</sup> The prohibition applies to both the statutory private offering exemption under section 4(2) of the Securities Act, and to all offerings, with the exception of Rule 504,<sup>32</sup> falling under the “safe harbors” of Regulation D.<sup>33</sup> Therefore, to benefit from the relief provided by the Regulation D “safe harbors” small companies, in offerings of any real size, must refrain from engaging in advertising or any other activities that could be deemed general solicitations.

This article argues conditioning the availability of exemptions from registration on what amounts to an unnecessary restriction on the free flow of information not only undermines the purpose of the private offering exemption, but forecloses the possibility that an efficient market

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<sup>31</sup> Daugherty, *supra* note 30, at 68.

<sup>32</sup> Rule 504 permits general solicitation in certain exempt offerings not exceeding 1,000,000 in the following circumstances

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

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

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

17 C.F.R. § 230.504(b)(1) (2000).

Rule 504 was intended to provide an exemption for “seed capital” offerings; however, the limited dollar amount and the lack of preemption of state regulation resulted in an exemption almost completely devoid of practical utility. *See*, Daugherty, *supra* note 30, at 69. Rule 504 fails to address the practical realities involved as a venture progresses through the various stages of financing. In the early stages of financing “seed capital,” is usually supplied by the owner through “personal savings, credit card debt, and second home mortgages.” Sjostrum, *supra* note 16, at 5. The venture is not yet ripe for outside investors. It is not until the company progresses past the “seed financing” stage where access to outside investors essential to their continued existence. Once the company has progressed past the stage of seed financing rule 504, because of its 1 million dollar ceiling is of no practical significance. *see also* Cohn, *supra* note 23, at 13.

The relief accorded by this provision is of little practical value, as most issuers that seek exemption from federal registration similarly seek to avoid state registration, since the later also entails filing and review of a disclosure document, additional costs, delays and, in some instances, uncertainties related to ‘merit review’ standards of state law.

Cohn, *supra* note 39, at 13 n.55.

<sup>33</sup> 17 C.F.R. §§ 230.501-.506 (2000). *See* rule 502(c), *id.* § 230.502(c), discussed in detail *infra* notes 102-14 and accompanying text. Rules 504 and 505 of Regulation D, *id.* §§ 230.504-.505, were adopted under § 3(b) of the Securities Act, 15 U.S.C. § 77c(b) (2000). *See* Revisions of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11,251, at 11,267 (Mar. 16, 1982). Rule 506, 17 C.F.R. § 230.506 (2000), was adopted under § 4(2). *See id.* at 11,267.

for the securities of small issuers will develop.<sup>34</sup> As such, an exemption that provides small issuers with well defined and objective “issuer friendly” criteria is needed<sup>35</sup>, to assure not only small issuers, but the small offering industry as a whole, that the exemption will not be lost because of a mere technical oversight.<sup>36</sup> The current system fails to meet this standard, in large part, because the presence of a general solicitation or advertising in connection with a single offer or sale of securities results in the loss of an exemption from registration requirements.<sup>37</sup>

The ease with which an individual can access or distribute information has completely altered small offering landscape.<sup>38</sup> Advancements in communications technology have introduced new variables into the cost/benefit equation, such that any benefits a general solicitation and advertising prohibition may have produced are no longer sufficient to justify the costs imposed on small issuers considering the economic significance of entrepreneurial start-up

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<sup>34</sup> See Sargent, *The Federal Securities Law and Small Business*, 33 BUS. LAW. 901, 916 (1978). One former SEC Commissioner has stated:

[T]he attitude of the Commission and its over-zealous regulation is, in part, responsible for killing the capital market for small, innovative, start-up companies. How can a new venture capital company file a registration statement for an equity security today? The costs are prohibitively high and the chances for a successful offering are almost nil.

Id.; see Malkiel, *The Capital Formation Problem in the United States*, 34 J. FIN. 291 (1979).

<sup>35</sup> The lack of objective requirements has plagued the private offering exemption for decades, as one SEC Chairman put it, the “private offering exemption had become an almost impassable, not to say impossible, legal jungle.” Casey, *supra* note 1, at 583.

<sup>36</sup> A finding that an offering failed to comply with the provisions of a statutory or regulatory exemption results in a violation of the registration statement and prospectus requirements of § 5 of the 1933 Act, 15 U.S.C. § 77(e) (2000). Section 12(1) of the Act, 15 U.S.C. § 77l (2000), provides civil remedies of rescission or damages for purchasers of stock sold in violation of § 5, and no good faith or other mitigating defenses are available to an issuer in violation. Civil liability under § 12(1) may be imposed against participants, including broker-dealers, instrumental in the sales process. *Lewis v. Walston & Co.*, 487 F.2d 617 (5th Cir. 1973); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971).

<sup>37</sup> Concerns that an exemption could be lost due to a finding that a general solicitation has occurred are certainly justified. As one scholar has pointed out:

The lack of experience and knowledge about securities laws remains today among many lawyers and is reminiscent of Professor David Ratner’s hilarious (and perhaps apocryphal) *Letters From A Kentucky Lawyer* . . . A Kentucky lawyer writes to the SEC (in response to an SEC inquiry) that ‘[t]here are a dozen lawyers in this town, and I would not give two cents for what all of us put together know about Federal laws.... If some poor fellow comes in with a Federal problem, I tell him to write his Congressman.’

Stuart R. Cohn, *The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten Off the Ground?* 3 J. SMALL & EMERGING BUS. L. 315 (1999) (citing *Letters from a Kentucky Lawyer*, in DAVID L. RATNER & THOMAS L. HAZEN, *SECURITIES REGULATION, CASES AND MATERIALS* 342-44 (5th ed. 1996))

<sup>38</sup> See e.g., Use of Electronic Media for Delivery Purpose SEC Release No. 33-7233 (Oct. 6, 1995).

companies.<sup>39</sup> Stated another way, the public/private distinction, inasmuch as it depends upon the absence of a general solicitation or advertising, no longer serves to adequately differentiate between those investors who deserve the protections of the Securities Act and those who do not.<sup>40</sup>

Part I briefly outlines the registration process and disclosure requirements to show that in addition to the excessive financial burdens registration imposes on small companies, there are other legitimate reasons why a small company may wish to avoid a “public offering.”

Part II examines the legislative history, administrative pronouncements, and case law interpreting the private offering exemption leading up to Regulation D. This section illustrates that the prohibition on general solicitation is an administrative and, to a lesser extent, judicial perquisite lacking any statutory or practical justification.

Part III discusses the anti-solicitation doctrine as embodied in Rule 502(c), of Regulation D. This section argues that, as applied, the prohibitions on general solicitation and advertising inhibit capital formation and are neither necessary nor sufficient to maintain investor protection.

Part IV offers a simple solution that appropriately balances the needs of small issuers in acquiring patient capital with the government’s interest in protecting investors. This section argues that the problems associated with the prohibition on general solicitation and advertising can be alleviated by an administrative rule adopting an exemption from the registration for Small

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<sup>39</sup> Concerns regarding the excessive burdens the current exemptive scheme places on small businesses have existed for decades. See 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, 356 (1984). The SEC conducted a study to determine the effect of securities regulations on small businesses, which revealed concerns that the registration requirements of the Securities Act disproportionately restrained small businesses trying to raise capital through the sale of securities. See *id.*

<sup>40</sup> The Supreme Court in *SEC v. Ralston Purina Co.*, interpreted the requirements of the private offering exemption and made clear that in determining whether a particular offering is within the purview of exemption the primary concern is whether the offerees need the protection of the federal securities laws. 346 U.S. 119 (1953); see Friedman, *supra* note 13, at 306 (stating that the prohibition on general solicitation and advertising has “operated to encourage the concentration of risky securities sold in private offerings in the portfolios of limited numbers of investors”).

Private Issuers (“SPI’s”)<sup>41</sup> that would permit general solicitation and advertising in connection with the offer or sale of securities.

## I. AVOIDING REGISTRATION AT ANY COST

Section 5 of the Securities Act makes it illegal for anyone to use any means of interstate commerce or of the mails to sell or offer to sell a security in the United States unless the offer and sale are registered or exempt from registration.<sup>42</sup> Under the Securities Act, an 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>43</sup> and has been given a much broader interpretation than “offer” under the common law of contracts.<sup>44</sup> For example, while advertisements are not considered common law offers “an advertisement by a company seeking investors in its securities would clearly constitute an offer for purposes of the Securities Act.”<sup>45</sup> This places a heavy burden on small issuers who may not have pre-existing relationships with investors willing to provide the necessary capital.<sup>46</sup>

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<sup>41</sup> This article suggests that SPI’s should be defined as a company that meets all of the following criteria:

- (i) Is not a Reporting Company, e.g., one that is obligated to file periodic reports with the SEC under section 15(d) or 13(a) of the Exchange Act.
- (ii) Has annual revenues of less than \$20,000,000;
- (iii) Is a U.S. issuer; and
- (iv) Is not an investment company and is not an asset-backed issuer (as defined in § 229.1101 of chapter 17 U.S.C.).

The revenue limitation was set at less than 20 million to address the needs of (1) start up companies in their research and initial commercialization stage, (2) middle market companies; and (3) high potential companies. These companies, as previously discussed, are the traditional private equity market participants considered to be most severely impacted by federal and state securities regulations. *See e.g.*, Sohl, *supra* note 7.

<sup>42</sup> 15 U.S.C. § 77e (2000).

<sup>43</sup> 15 U.S.C. § 77b(a)(3) (2000).

<sup>44</sup> Under common law, an offer is defined as “the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it.” 1 RESTATEMENT (SECOND) OF CONTRACTS § 26 comment a (2005) (emphasis added).

<sup>45</sup> 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.

<sup>46</sup> One factor in determining whether a general solicitation has taken place is the presence or absence of a pre-existing relationship between the issuer and the offeree. According to a number of SEC no action letters the relationship must provide the issuer with sufficient information to evaluate the offeree’s financial circumstances. *See generally* Mineral Lands Research & Marketing Corp., SEC No-Act WL 55694 (Dec. 4, 1985); Robert T. Willis, SEC No-Act. WL 233597 (Jan 18, 1988); Royce Exchange Fund Quest Advisory Corp., SEC No-Act. WL 490692 (Aug. 28, 1996); Bateman Eichler, Hill Richards, Inc., SEC No-Act. 55679 (Dec. 3, 1985).

By reaching out to find potential investors the issuer will almost certainly engage in a prohibited solicitation and lose the benefit of the private placement exemption.

The question then becomes, so what? Why doesn't the issuer simply register with the SEC? As previously discussed, the costs associated with registration are often prohibitive, however, there are other reasons why a small company may not wish to take the leap from private venture to "public company." This section discusses some of the costs, both financial and otherwise, associated with "going public," and suggests that there are legitimate reasons, in addition to dollars and cents, that may foreclose the possibility of entering the public markets.

*A. Registration Just Costs Too Much*

To register an offer or sale under § 5, a registration statement must be filed with the SEC and a prospectus must be provided to the purchaser either at the time the security is delivered or confirmation of the sale is received, whichever comes first. A registration statement is an extremely long document containing detailed and complex disclosures. The costs associated with the preparation of a registration statement, "including accountant, attorney, investment banker, and printer fees, can easily run into the tens if not hundreds of thousands of dollars."<sup>47</sup> The cost and nature of registration statements are a direct result of § 11 of the 1933 Act, which, in effect, imposes a due diligence requirement on various parties, such as the issuers, directors, and certain of its executive officers, the underwriters, and other experts.<sup>48</sup> If a disgruntled purchaser institutes a suit under § 11 and it is shown that a material misstatement or omission was made in the registration statement, parties to the registration statement, except the issuer, can avoid liability only by establishing that they "had conducted a reasonable investigation and, after

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<sup>47</sup> Steinberg, *supra* note 24.

<sup>48</sup> *Id.*

such investigation, had no reason to believe and did not believe that the registration statement contained any materially false or misleading statements.<sup>49</sup>

Even though the issuer is the only party that will be held strictly liable, the issuer may be insolvent and plaintiffs' will undoubtedly look to the "deep pockets" party, usually the accountants or underwriters.<sup>50</sup> The result is that "deep pockets" parties to a transaction, in an attempt to insulate themselves from liability, will require extensive, perhaps even excessive, due diligence and disclosure.<sup>51</sup> For an SPI, particularly in the early stages of financing, these costs are typically prohibitive.<sup>52</sup>

### *B. Airing Out Your Dirty Laundry*

The initial cost in preparing a registration statement is only one of the negative aspects of a public offering. The registration statement, as discussed previously, requires extensive disclosure. In "going public" the issuer will be required to hang its dirty linen out for public viewing.<sup>53</sup> Once the venture consummates the public offering, certain provisions of the Securities Exchange Act of 1934, such as § 12(g) or § 15(d), kick in imposing continuing disclosure requirements. Under these disclosure rules the venture will be required to file annual, quarterly, and other periodic reports with the SEC as well as to provide periodic reports to its shareholders.<sup>54</sup>

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<sup>49</sup> Id. Nonexperts, in regards to the expertized portion of the registration statement, need not conduct an investigation, and need only show that they had no reason to believe and did not believe that the expertized portions of the registration statement contained any materially false or misleading statement. Experts are liable under § 11 only for the portion of the registration statement which they "expertized. Id.

<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> The SEC conducted a study to determine the effect of securities regulations on small businesses which revealed concerns that the registration requirements of the Securities Act disproportionately restrained small businesses trying to raise capital through the sale of securities. See 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, 356 (1984).

<sup>53</sup> See e.g., *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 384 (2d Cir. 1974).

<sup>54</sup> In its original form the Exchange Act, enacted to regulate post-distribution trading in securities, required companies to register only if their securities were traded on a national securities exchange, thereby assuring that

### *C. Sticking Your Neck Out*

The Sarbanes-Oxley Act of 2000, Section 404, charged the SEC with the responsibility of adopting rules requiring all reporting companies, other than registered investment companies, to include in their annual reports a statement of management's responsibility for establishing and maintaining adequate internal control over the companies financial reporting, along with an evaluation of the efficiency of those internal controls.<sup>55</sup> Adhering to these additional requirements will subject the venture to public scrutiny, increase operating expenses in the form of accountants and legal fees, and raise a continuous threat of litigation as a result of public disclosure.<sup>56</sup>

Compliance with the Sarbanes-Oxley Act has, from the beginning, posed special problems for small public companies.<sup>57</sup> Smaller companies, because of "limited resources, fewer internal personnel and less revenue with which to offset both implementation costs and the disproportionate fixed costs of section 404 compliance," have been disproportionately subjected to the burdens associated with section 404 compliance.<sup>58</sup>

### *D. No One Wants the Little Guy on Their Team*

In addition to the registration and disclosure requirements, registered public offerings require that the issuer obtain the assistance of an underwriter, which, as a practical matter, may

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smaller companies of insufficient size to warrant exchange listing would not be subject to the overly burdensome federal securities regulation. Advisory Report, *supra* note 26, at 14.

<sup>55</sup> Advisory Report, *supra* note 26, at 17.

<sup>56</sup> STEINBERG, *supra* note 24. To make matters worse, the benefits associated with section 404 compliance, while obviously important to large public companies, are of less obvious value to smaller public companies. The excessive burdens, taking into consideration the nominal value, results in a skewed cost/benefit analysis that "many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete." Advisory Report, *supra* note 21, at 18.. (finding these factors increasingly problematic given the crucial role small companies play in job creation and economic growth).

<sup>57</sup> Advisory Report, *supra* note 26, at 14.

<sup>58</sup> *Id.*

prove impossible for most small ventures.<sup>59</sup> Generally, “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>60</sup> Very few start-up ventures would qualify under this general rule, as such, they are required to proceed under an exemption from registration in order to conduct a successful offering.<sup>61</sup>

#### *E. Not so Fast, the State Gets a Piece*

With certain exceptions, perfecting a federal exemption from registration does not insulate the issuer from the problems associated with the registration and disclosure requirements previously discussed.

A dual system of federal-state securities regulation has existed since the adoption of the Securities Act.<sup>62</sup> Unless an exemption from State registration requirements is available, an issuer

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<sup>59</sup> William K. Sjostrum, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 576-77 (2001).

<sup>60</sup> Sjostrum, *supra* note 15, at 4. (citing 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)). “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.” *Id.* (citing *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)).

<sup>61</sup> *See* Sostrum, *supra* note 15, at 4.

<sup>62</sup> *See* Haughey, *supra* note 24. Congress, by declining to preempt state regulation or limit it to disclosure provisions, created a dual regulatory system. *Id.* The first state blue sky law was passed in Kansas in 1911 for the purpose of “protecting the consumers from the robber barons.” State administrators “set out to save the public from imprudent investments.” *See* J. Mulvey, *Blue Sky Law*, 36 CANADIAN L. TIMES 37 (1916).

The State of Kansas, most wonderfully prolific and rich in farming products, has a large population of agriculturists not versed in ordinary business methods. This State was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky merchants, and the legislation intended to prevent their frauds was called Blue Sky Law.

Mulvey, *supra* at 37.

These laws met with resistance from the securities industry. That conflict came to a head in *The Blue Sky Cases of 1917*. *See Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); and *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917). The issue before the United States Supreme Court, in the *Blue Sky Cases of 1917*, was whether the states had the power to enact a comprehensive licensing system to protect their citizens from fraud. *See id.* The securities industry conceded the constitutionality of limited

must register any offer or sale of securities with each state in which the security is offered or sold.<sup>63</sup> The entire regime has historically been characterized by securities industry discontent, resulting from a lack of regulatory uniformity, both between the state and federal exemptive schemes<sup>64</sup> and among the different state securities laws.<sup>65</sup>

In recent years, both Congress and the SEC have recognized the need for greater uniformity in securities regulation; however, resulting legislative and administrative actions have failed to adequately address the problems of the dual system.<sup>66</sup> In certain respects, state exemptive regimes have continued to be more protective of investor interests than their federal

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registration, but opposed regulatory standards considered reaching far beyond the states legitimate interest in regulating fraud. *See id.* The Court held that the merit based comprehensive licensing statutes of Michigan, Ohio, and South Dakota statutes were constitutional. *See id.*

<sup>63</sup> *See* STEINBERG, *supra* note 24, at 156; A thorough discussion of the state blue-sky regime is beyond the scope of this article, however, to fully satisfy the capital needs of the small ventures, federal-state uniformity is essential. Critics disagree about the means in uniformity is to be achieved, some argue that coordinated efforts allowing the states to retain regulatory authority are needed while others suggest that Congress should flex its preemptive muscles and remove the barriers imposed by state securities laws. *See, e.g.,* Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 Wash. U. L.Q. 497 (2000).

<sup>64</sup> The North American Securities Administrators Association (“NASAA”) promulgated the Uniform Limited Offering Exemption (ULOE), that with qualifications exempts offerings sold in compliance with Rules 501-503 and 505 of the Regulation D. *See* STEINBERG, *supra* note 24, at 156. Most states have adopted the ULOE in one form or another, however, ULOE does not address the problems associated with the anti-solicitation doctrine. *See id.*

<sup>65</sup> *Id.* Although the constitutionality of these state regulations has been determined, commentators continue to disagree as to whether “these rules create a fabric of efficient government control or a web of excessive entanglement.” Haughey, *supra* note 24, at 697.

Many view the small investor as unsophisticated and in need of protection from promoters of fraudulent and worthless schemes. Much more compelling in today’s political climate, however, may be the fear that government over regulation has interfered with the free market system to such an extent that the growth of business enterprise and the market economy has been inhibited.

Haughey, *supra* note 24, at 692.

<sup>66</sup> Congress passed the National Securities Markets Improvement Act of 1996 (NSMIA), Pub. L. No. 104-290, 110 Stat. 3416 (codified in scattered sections of 15 U.S.C. (2000)), which removed preexisting state power to require pre-sale registration disclosures by issuers, including the power to conduct presale disclosure review, merit review, or any kind of fairness review in most public and certain private offerings. Warren III, *supra* note #,; Discussed *infra* notes #-# and accompanying text.

counterparts.<sup>67</sup> The result is that the intended beneficiaries, namely small companies, never fully realize the benefits of federal exemptions from registration.<sup>68</sup>

Legitimate investor protection concerns should limit the extent to which regulators are able to provide relief from the requirements of federal or state securities law; however, in regards to small issuers, the costs associated with trying to enter the public capital markets are usually prohibitive.<sup>69</sup> Small business transactions tend to raise less money than their large counterparts who can spread the costs of securities regulation compliance over “a broader base of income, assets, and shareholders resulting in a lower average cost of funds.”<sup>70</sup> This places small companies at a distinct disadvantage when competing for public capital with their larger public counterparts.<sup>71</sup> In most cases, the ability to perfect an exemption from registration determines whether or not the company will be able to acquire the necessary capital.

The next section explores the history of the private offering exemption and will show that there is nothing in the Securities Act or legislative history to suggest Congress intended to prohibit general solicitation in the private offering context, let alone support the outcome determinative effect it has been given under Regulation D.

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<sup>67</sup> See STEINBERG, *supra* note 24, at 157. Steinberg finds state attitude in favor of strong investor protection intriguing considering the “race to the bottom” approach taken by these same states under corporation laws. See *e.g.*, Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

<sup>68</sup> See *e.g.*, Campbell, *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553, 519 (1985) (asserting that “millions of dollars are spent each year on a system of [state] regulation that provides no significant protection to investors and retards capital formation.”); *but see*, Tyler, *More About Blue Sky*, 39 WASH. & LEE L. REV. 899 (1982).

<sup>69</sup> 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, 2 (1998) (stating that historically the bulk of investment frauds have always been “heavily concentrated among new and unfamiliar ventures”).

<sup>70</sup> Daugherty, *supra* note 30, at 71 (arguing that small businesses are “undeniably handicapped in the competitive search for public capital”).

<sup>71</sup> Daugherty, *supra* note 30, at 71; *see also*, Cohn *supra* note 23, at 7.

## II. THE PRIVATE OFFERING EXEMPTION: NO SHIRT, NO SHOES & ABSOLUTELY NO SOLICITATION

Section 4(2) of the Securities Act exempts from the registration requirements “transactions by an issuer not involving any public offering.”<sup>72</sup> The definition of “issuer” under the Act is clear-cut,<sup>73</sup> however, figuring out exactly what constitutes a “public offering” is a much more daunting task.<sup>74</sup> Unfortunately, the term is not defined in the statute, and the conclusion of any inquiry into its breadth is highly fact dependent.<sup>75</sup>

Although there is nothing in the legislative history that would indicate Congressional intent to prohibit general solicitation or advertising in an offering exempted under section 4(2),<sup>76</sup> the anti-solicitation doctrine has evolved into what can only be described as a fundamental element of the current regulatory scheme.<sup>77</sup>

The Supreme Court, interpreting section 4(2) in light of its stated purpose,<sup>78</sup> in the seminal decision of *S.E.C. v. Ralston Purina*,<sup>79</sup> reasoned:

[s]ince the exempt transactions are those as to which ‘there is no practical need for [the bills] application’, the application of 4[2] should turn on whether the

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<sup>72</sup> 15 U.S.C. § 7d(2) (2000).

<sup>73</sup> An “issuer” is the “person who issues or proposes to issue” a security. Section 2(a)(4). This definition, while not particularly helpful, doesn’t present any interpretive problems because it is understood that the term “issuer” means the entity that originally sells the security. *See* LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS § 6.2, at 6-4.

<sup>75</sup> *See, e.g.*, Letter of General Counsel Discussing the Factors to be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 33-6389, 17 C.F.R. 231.285 (1935) [hereinafter 1935 Opinion] (stating “the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are of moment.”) The 1935 opinion included the following six factors the SEC considered “important” in its “surrounding circumstances” review: (1) the number of offerees; (2) their relationship to each other; (3) their relationship to the issuer; (4) the number of units offered; (5) the size of the offering; and (6) the manner of the offering. *See* 1935 Opinion, *supra* note 75.

<sup>76</sup> *See* Daugherty, *supra* note 30, at 72 (stating “[i]ndeed, there is nothing at all in the Act or in its legislative history that might indicate what a “general solicitation” is”). *See also*, Cohn, *supra* note 23, at 9. (stating “[g]iven the scant legislative history . . . it would be unreasonable to argue that the legislation has created a firmly defined public private distinction.”);

<sup>77</sup> *Id.* at 68.

<sup>78</sup> The legislative history expressly states that the purpose of section 4(2) is to exempt those transactions from registration “where there is no practical need for [such] application . . . [or] where the public benefits are too remote.” H.R. Rep. No. 85, 73<sup>rd</sup> Cong., 1<sup>st</sup> Sess. 5 (1933).

<sup>79</sup> 346 U.S. 119 (1953).

particular class of persons needs the protection of the Act. An offering to those who are shown to be able to fend for themselves in a transaction is a transaction ‘not involving any public offering.’<sup>80</sup>

The Court considered that transactions in which the offerees have knowledge of or access to the same kind of information that the act would make available in the form of a registration statement, are the kinds of transactions that fall within the private offering exemption.<sup>81</sup>

In *Ralston Purina*, the Court determined that the sale of unregistered securities to employees the corporation termed “key employees” constituted a public offering and sale of unregistered securities in violation of section 5.<sup>82</sup> The court held that since the employees were “not shown to have access to the kind of information which registration would disclose” and there “existed obvious opportunities for pressure and imposition,” section 4(2) did not exempt the sale.<sup>83</sup> However, the Court made clear that not every offer or sale of securities to employees would constitute a public offering, stating “some employee offerings may come within section 4(2), e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement.”<sup>84</sup>

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<sup>80</sup> Id.

<sup>81</sup> Id.

<sup>82</sup> *Ralston Purina* sold nearly \$2,000,000 in unregistered stock to its employees. *Ralston Purina*, 346 U.S. at #. The corporation, passed a resolution authorizing the sale of common stock “to employees . . . who shall, without any solicitation by the Company or its officers or employees, inquire or any of them as to how to purchase common stock of Ralston Purina Company.” Id. A memorandum was sent to branch and store managers advising that “[t]he only employees’ to whom this stock will be available will be those who take the initiative and are interested in buying stock at present market prices.” Id. The employees responding to these offers were employees with the duties of artist, bakeshop foreman, clerical assistant, and others similarly situated. Id.

<sup>83</sup> *Ralston Purina*, 346 U.S. at 120. However, the Court made clear that not every offer or sale of securities to employees would constitute a public offering, stating “some employee offerings may come within the §4(2), e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement.”

<sup>84</sup> *Ralston Purina*, 346 U.S. at 120. Whether the offeree has access to the kind of information which registration would disclose was one of the factors stressed in an advisory opinion rendered by the Commission’s General Counsel in 1935.

I [] regard as significant the relationship between the issuer and offerees. Thus, an offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering that is an offering to the members of a class of the same size who do not have this advantage. This factor would be particularly important in offerings to employees, where a class of

The *Ralston Purina* Court's holding was simply "a refinement of the principle . . . that the seller in a private offering must at least have a rational basis for choosing particular offeree's."<sup>85</sup> The Court focused on the nature of the offeree's. Under *Ralston Purina*, a particular offering should fall within the section 4(2) exemption so long as the seller extends offers only to those investors he reasonably believes are capable of fending for themselves. The Court certainly did not impose any restrictions on the methods used to choose a particular class of offerees capable of fending for themselves. "If *Ralston Purina* suggested a general solicitation prohibition at all, it suggested only that the seller cannot solicit among a group of offerees determined randomly or arbitrarily."<sup>86</sup>

The aftermath of *Ralston Purina* resulted in a more restrictive application of the section 4(2) exemption than the Supreme Court would mandate.<sup>87</sup> The principles that have emerged in

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high executive officers would have a special relationship to the offeror which subordinate employees would not enjoy.

11 Fed. Reg. 10952.

In *Ralston Purina*, the Commission wanted the court to go even further and argued that an offer to a substantial number of the public is by definition not a private offering; however, the Court refused, as a matter of statutory interpretation, to "superimpose a quantity limit on private offerings." *Ralston Purina*, 346 U.S. at 120.

<sup>85</sup> Daugherty, *supra* note 30, at 74.

The interpretation pointed out that the basis on which the offerees are selected is of greatest importance and indicated that where the offerees are chose from the general public at random, the offering may be found to be a public offering even though only a small number of offerees is involved.

<sup>86</sup> Daugherty, *supra* note 30, at 87.

<sup>87</sup> See Transactions by An Issuer Not Deemed to Involve any Public Offering, Securities Act Release No. 33-53336 (November 8, 1972). The SEC provided the following indication of its position on the interpretation of the factors traditionally considered in determining whether a particular offering was a transaction not involving a public offering:

'sophistication' is not a substitute for access to the same type of information that registration would provide, and . . . a person's financial resources or sophistication are not, without more, sufficient to establish the availability of the exemption. On the other hand, . . . an offeree need not be an insider such as an officer or director of the issuer in order to have access to information . . . access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables an offeree to obtain information from the issuer in order to evaluate the merits and risks of the investment as distinguished from situations where such position does not exist and the issuer voluntarily offers to provide or provides such information. Moreover, . . . the mere disclosure of the [] kind of information that would be contained in a registration statement is not sufficient in itself to establish the availability of an exemption under Section 4(2) of the Act.

Securities Act Release No. 33-53336, *supra*.

an attempt to stake out the boundaries of section 4(2), by both courts and Commission, provide little if any certainty for issuers attempting to structure an offering that falls under the purview of section 4(2).<sup>88</sup> One thing, however, is certain, the decades of administratively, and to a lesser extent judicially, imposed requirements have, removed any utility section 4(2) may have had as a stand-alone exemption.<sup>89</sup>

A. *Rule 146 : “Serious Investor Protection, All Day and All Night”*

In an effort to clarify the private offering exemption under section 4(2), the SEC promulgated Rule 146. The Rule 146 “safe harbor,” was enacted in response to growing concerns that the ambiguity of section 4(2) did not provide issuers adequate standards upon which they could rely in structuring an offering.<sup>90</sup> When the Rule was adopted, the Commission indicated its belief that that the Rule should provide “objective standards [upon which] responsible businessmen could rely,” and “deter reliance on the private offering exemption for securities offerings to persons unable to fend for themselves in terms of obtaining information about the issuer and of assuming the risk of the investment.”<sup>91</sup>

In adopting Rule 146, the SEC looked to legislative history, statutory language, and judicial decisions interpreting section 4(2), stating that “the significant concepts in determining when a transaction is deemed not to involve any public offering are access to information that registration would disclose and the ability of offerees to be able to fend for themselves so as not

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<sup>88</sup> See, e.g., Sjostrum *supra* note 16, at 37. Sjostrum notes that one attorney has characterized section 4(2) jurisprudence arising after *Ralston* has been described as a kind of mishmash, “[t]he 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 portions of the brew.” *Id.* (citing 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).

<sup>89</sup> See McDermott, *The Private Offering Exemption*, 59 IOWA L. REV. 525, 549 (1974); Directorate of Exon. & Pol’y Analysis, SEC, *An Analysis of Regulation D 14* (1984) (“40 years of case law has left issuers without any certainty that their offerings complied with Section 4(2)”).

<sup>90</sup> See *The Private Placement Exemptive Rule*, Securities Act Rule Release No. 5913, 1978 WL 197118.

<sup>91</sup> *Id.* Many commentators expressed concern that the rule would swallow the broader section 4(2) exemption. In response the SEC included a preliminary note to the rule explicitly stating that the rule was “non-exclusive,” thereby preserving the statutory exemption of 4(2). *Id.*

to need the protections afforded by registration.”<sup>92</sup> The SEC felt that limitations on the manner of offering,<sup>93</sup> particularly a prohibition on general advertising in connection with any offering pursuant to the exemption, were essential to ensure “that persons to whom such securities are offered have the necessary access to information concerning the issuer and can fend for themselves.”<sup>94</sup>

Rule 146 contained a quasi-exception from the prohibition on general solicitation and advertising for communications to “qualified offerees,”<sup>95</sup> that would have otherwise been

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<sup>92</sup> Transactions by An Issuer Not Deemed to Involve any Public Offering, Securities Act Release No. 33-53336 (November 8, 1972).

<sup>93</sup> The manner of offering restrictions have always been of concern to the SEC, in the 1935 Opinion the SEC expressed concerns regarding what it called “preliminary” conversations, stating:

I have very serious doubt whether, in many of those cases where it is stated that an offering is to be made only to an insubstantial number of persons, there may not be preliminary conversations for the purpose of ascertaining which of the various possible purchasers would be willing to accept an offer of the security in question if it were made to them. Any such preliminary negotiations or conversations with a substantial number of prospective purchasers would, in my opinion, cause the offering in question to be a public offering, thereby necessitating prior registration of the securities in question.

These concerns were codified in Rule 146(c),

Limitation on Manner of Offering: Neither the issuer nor any person acting on its behalf shall offer, offer to sell, offer for sale, or sell the securities by means of any form of general solicitation or general advertising, including but not limited to, the following:

- (1) Any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over television or radio;
- (2) Any seminar or meeting, except that if subparagraph (d)(1) is satisfied as to each person invited to or attending such seminar or meeting, and as to persons qualifying only under subdivision (d)(1)(ii), such persons are accompanied by their offeree representative(s), then such seminar or meeting shall be deemed not to be a form of general solicitation or advertising; and
- (3) Any letter, circular, notice or other written communication, except that if subparagraph (d)(1) is satisfied as to each person to whom the communication is directed and the communication contains an undertaking to provide the information specified by subparagraph (e)(1) on request, such communication shall be deemed not to be a form of general solicitation or general advertising.

<sup>94</sup> See Securities Act Release No. 33-53336. As proposed, rule 146 required that offerings under the rule could only be made through a negotiated transaction, which it defined as one where the terms and arrangements relating to the sale of the securities would be arrived at through direct communication between the issuer or any person acting on its behalf and the purchaser or his investment representative. See Securities Act Release No. 33-53336 (November 28, 1972). The negotiated transaction requirement was deleted when Rule 146 was revised, however, the revision included a “direct communication” concept requiring that an offeree or offeree representative be given the opportunity to ask questions of, and receive answers from, the issuer or any person acting on its behalf, concerning the transaction’s terms. See Securities Act Release No. 33-5430 (October 10, 1973). As adopted, rule 146, did not retain the term “direct communication,” but retained the substantive requirement that the offeree or his representative be given the opportunity to ask questions of, and receive answers from, the issuer or a person acting on its behalf. See Securities Act Release No. 33-5487 (April 23, 1974).

<sup>95</sup> Rule 146(d): Nature of Offerees. The issuer and any person acting on its behalf who offer, offer to sell, offer for sale or sell the securities shall have reasonable grounds to believe and shall believe:

considered improper.<sup>96</sup> The exemption operated as a “‘safe harbor’ within a ‘safe harbor’ and minimized close questions on the application of the condition prohibiting general solicitation.”<sup>97</sup> Availability of the “qualified offeree” safe harbor depended upon the issuer’s reasonable belief that that the offeree could bear the economic risk involved with the investment or had sufficient knowledge and experience in financial and business matters, alone or with the help of a purchaser representative, to evaluate the risks and benefits of the proposed investment. However, other than in a limited context<sup>98</sup>, the SEC did not provide any significant interpretations of the manner of offering limitations.<sup>99</sup> Some have suggested that the lack of interpretive releases is due to the wiggle room provided by the qualified offeree exception to the general solicitation prohibition.<sup>100</sup>

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- (1) immediately prior to making any offer, either:
    - (i) that the offeree 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
    - (ii) that the offeree is a person who is able to bear the economic risk of the investment; and
  - (2) immediately prior to making any sale, after making reasonable inquiry, either:
    - (i) that the offeree 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
    - (ii) that the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment.

<sup>96</sup> Rule 146 (c)(3) provided that

[a]ny letter, circular, notice or other written communication, except that if subparagraph (d)(1) is satisfied as to each person to whom the communication is directed and the communication contains an undertaking to provide the information specified by subparagraph (e)(1) on request, such communication shall be deemed not to be a form of general solicitation or general advertising.

17 C.F.R. § 230.146(c)(2)-(3).

<sup>97</sup> See David B. H. Martin, Jr. & L. Keith Parsons, *The Preexisting Relationship Doctrine Under Regulation D: A Rule Without Reason?*, 45 WASH. & LEE REV. 1031, 1035 (1988).

<sup>98</sup> See e.g., A. A. Ajax Co., Sec No. Action Letter, (Jan. 15, 1979); Trust Mortgage and Loan Svc., SEC No. Act Letter, (Dec. 27, 1979); Econative Corp., SEC No Action Letter, (Feb. 27, 1978).

<sup>99</sup> In addition to manner of offering restrictions, the rule required that any written materials include a statement indicating that access to or furnishing of the information in Rule 146(e)(1) would be made available upon request. Rule 146(e)(1) was the codification of the preexisting rule that offerees have access to the same kind of information that was required by Schedule A of the Act to the extent that the issuer possessed or could acquire the information. A distinction was made between reporting and non-reporting companies. Additionally, the offeree or offeree's representative had to be given an opportunity to verify the accuracy of this information. See Release No. 33- 5487 (April 23, 1974).

<sup>100</sup> See Martin, *supra* note 97 at 1035.

Although Rule 146 provided issuers some ability to solicit potential investors, the rules focus on offerees posed numerous problems for small issuers. In order to make a determination as to the offeree’s sophistication the issuer would surely have to provide some information about the offering. The SEC’s position on preliminary conversations legitimizes these concerns. The SEC had stated any “preliminary negotiations or conversations with a substantial number of prospective purchasers would . . . cause the offering in question to be a public offering, thereby necessitating prior registration of the securities in question.”<sup>101</sup> In addition, Rule 146 did not address the problem of state registration requirements, which, as previously stated, pose many of the same problems as federal registration requirements.

*B. Regulation D: “Subject to Offeree Approval”*

In 1980, the SEC, given the opportunity to fix the problems created by the anti-solicitation doctrine, not only refrained from removing the prohibitions, but extended them to section 3(b) limited offerings as well. The Small Business Investment Incentive Act of 1980<sup>102</sup> (the “Incentive Act”), amended section 3(b) of the Securities Act providing the SEC with the authority to exempt securities offerings up to 5 million dollars, expanded the definition of “accredited investor,”<sup>103</sup> and provided for the development of a uniform federal-state exemption

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<sup>101</sup> See 1935 Opinion *supra* note 75.

<sup>102</sup> 94 Stat. 2275, codified in scattered sections of 15 U.S.C.

<sup>103</sup> Regulation D gives preferential treatment to accredited investors “based on a theory that the persons that fall within the . . . designated categories can fend for themselves, and thus do not need the 1933 Act’s protection for their investment decisions.” Warren, *supra* note #, at #. In addition to various institutional investors the category of “accredited investors” includes certain individual based on net worth, annual income, and relationship to issuer.

Section 501(a) Accredited investor. Accredited investor shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

- . . .
- (4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
- (5) Any 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;

from registration for small issuers.<sup>104</sup> Pursuant to that authority the SEC promulgated Regulation D, which became effective April 15, 1982.

Regulation D emerged in 1982 as the latest of several attempts to balance the SEC's traditional concern for investor protection with a renewed interest in removing unnecessary restraints on capital formation, particularly by small business.<sup>105</sup> Regulation D is a series of six rules including three transactional exemptions included in rules 504, 505, and 506.<sup>106</sup> Rule 506<sup>107</sup> was adopted under section 4(2) and replaced rule 146, while 504<sup>108</sup> and 505<sup>109</sup> were adopted under section 3(b), and replaced 240 and 242 respectively.<sup>110</sup>

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(6) Any 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;

...

(8) Any entity in which all of the equity owners are accredited investors.

<sup>104</sup> Martin, *supra* note 97.

<sup>105</sup> Mark L. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 Wash. U. L.Q. 225, (1990) (stating "[t]he SEC of the 1980s obviously was willing to go much farther in this direction than the SEC of the 1970s, whose approach to the 1933 Act exemptions was always somewhat grudging, but the long-term trend was basically consistent."). Sargent, *supra* note 75, at#. Sargent explains that the "perception of the SEC's attitude as 'grudging' is reflected in the intense criticism of rule 146" Id. (citing 17 C.F.R. § 230.146 (rescinded 1982)). He also notes that many thought the rule created more problems than it solved. *See, e.g.,* Campbell, *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139; Coles, *Has Securities Law Regulation in the Private Capital Market Become a Deterrent to Capital Growth?: A Critical Review*, 58 MARQ. L. REV. 395, 463 (1975); Note, *SEC Rules 144 and 146: Private Placements for the Few*, 59 VA. L. REV. 886, 921-22 (1973); Note, *Revising the Private Placement Exemption*, 82 Yale L.J. 1512, 1519 (1973). "Another SEC experiment of the 1970s, rule 240, 17 C.F.R. § 230.240 (rescinded 1982) was criticized for being of little practical use because only offerings of no more than \$100,000 could be exempted thereunder." Id. (citing *see* Securities Act Release No. 6339, 46 Fed. Reg. at 41,800.

<sup>106</sup> The Regulation represented an attempt to harmonize the inconsistencies that had developed among the various section 3(b) and 4(2) exemptions. The SEC's solution was to define separate exemptions with distinct statutory bases, while providing a common set of definitions and conditions. Rules 501-503 set forth definitions, terms, and conditions that apply generally throughout the regulation.

<sup>107</sup> *See supra* note 32 and accompanying text.

<sup>108</sup> 17 C.F.R. § 230.505. exemption for limited offers and sales of securities not exceeding \$5,000,000.

(a) Exemption. Offers and sales of securities that satisfy the conditions in paragraph (b) of this section by an issuer that is not an investment company shall be exempt from the provisions of section 5 of the Act under section 3(b) of the Act.

(b) Conditions to be met--

(1) General conditions. To qualify for exemption under this section, offers and sales must satisfy the terms and conditions of §§ 230.501 and 230.502.

(2) Specific conditions--

(i) Limitation on aggregate offering price. The aggregate offering price for an offering of securities under this § 230.505, as defined in § 203.501(c), shall not exceed \$5,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under

Regulation D represented a regulatory shift in thinking, the SEC no longer focused on the qualities of “offerees;” under Regulation D, the availability of an exemption depended on the particular characteristics of “purchasers.”<sup>111</sup> Thus, a single offer to a non-sophisticated investor would not result in the loss of the entire exemption, assuming of course that the investor did not purchase the security.<sup>112</sup> It is difficult to understand, and the SEC does not provide any explanation, why, in light of the shift in exemptive significance from “offerees” to “purchasers,” the anti-solicitation doctrine was included under Regulation D.<sup>113</sup>

As the following section will show, the anti-solicitation doctrine greatly diminishes the utility of the new exemptions by injecting the same ambiguity and uncertainty that plagued both rule 146 and section 4(2) into the Regulation D.

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this section in reliance on any exemption under section 3(b) of the Act or in violation of section 5(a) of the Act.

<sup>109</sup> 17 C.F.R. § 230.506. Exemption for limited offers and sales without regard to dollar amount of offering.

(a) Exemption. Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.

(b) Conditions to be met--

(1) General conditions. To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of §§ 230.501 and 230.502.

(2) Specific Conditions--

(i) Limitation on number of purchasers. There are no more than or the issuer reasonably believes that there are no more than 35 purchasers of securities from the issuer in any offering under this section.

(ii) Nature of purchasers. Each 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>110</sup> Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6339 [hereinafter Reg. D Proposal] (Aug. 7, 1981). Rule 504 was intended to “set aside a clear and workable exemption for small offerings by small issuers to be regulated by state ‘Blue Sky’ requirements and to be subject to federal antifraud provisions and civil liability provisions such as section 12(2).” *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> The SEC simply stated its belief that “the limitation as to the manner of the offering . . . set forth in proposed 502(c) and (d) are sufficient to assure that the offering is private in nature.” Reg D Proposal, at \*21.

### III. RULE 502(C): “EXPOSING GENERAL SOLICITORS”

Rule 502(c), prohibits an issuer or any person acting on its behalf from offering or selling securities by means of any form of general solicitation, except in limited circumstances under rule 504.<sup>114</sup> Rule 502(c) provides the following nonexhaustive list of prohibited solicitations:

1. Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
2. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.<sup>115</sup>

This is similar to the provision contained in previous Rule 146(c), except an additional prohibition concerning seminars or meetings was added to reflect the abandonment of the “qualified offeree” concept.<sup>116</sup> The SEC eliminated the concept in response to commentators views that it is impossible to evaluate an offeree’s qualifications without providing the offeree basic information concerning the offering. There was concern over the possibility that an inadvertent offer would result in the loss of the “safe harbor” protection. The SEC adopted the commentators position stating, “eliminating the offeree qualifications would not result in a loss of protection to investors *since any investor would still have to be qualified before purchasing the securities.*”<sup>117</sup>

Recent history suggests the SEC continues to equate a kind of nostalgic significance to the general solicitation prohibition. It is possible that part of the reason the anti-solicitation doctrine remains a favored regulatory instrument, is due to the fact that the term “accredited investor,” as defined in regards to individuals, does not adequately differentiate between those investors who need the protection of the securities act and those who do not. The following

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<sup>114</sup> Id.

<sup>115</sup> 17 C.F.R. § 230.502 (2000).

<sup>116</sup> Reg. D Proposal, *supra* note 111.

<sup>117</sup> Id. at \*21.

sections will show that relying on the general solicitation and advertising prohibitions, as applied under Regulation D, is neither necessary nor sufficient to ensure investor protection.

A. *The Preexisting Relationship: “Maintaining the Sanctity of Private Offerings”*

The SEC added insult to injury when, for all intents and purposes, it reintroduced a stricter form of offeree qualification than that contained under previous section 146(c).<sup>118</sup> Through a number of No-action letters and interpretive releases, the SEC effectively restricted the Regulation D exemptions to transactions involving only those offerees with whom the issuer or anyone acting on his behalf has “a preexisting substantial relationship,”<sup>119</sup> because any offer made to a potential investor with whom the issuer or his representative lack a preexisting substantial relationship could be deemed a general solicitation. The SEC stated:

[t]he types of relationships with offerees that may be important in establishing that a general solicitation has taken place are those that would enable the issuer (or a person acting on his 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>120</sup>

What the SEC gave with its right hand, it took away with its left. This slight of hand resulted in a more restrictive, “issuer unfriendly” regulatory climate than the previous exemptive scheme under Rule 146. Although, a single offer to an unqualified investor would no longer result in the loss of an exemption under rule 506, the result is essentially the same. If the issuer’s relationship with an offeree did not provide the issuer or person acting on his behalf with special knowledge

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<sup>118</sup> It has also been suggested that the preexisting relationship doctrine may have been an attempt to resurrect the holding in *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699 (9<sup>th</sup> Cir. 1938) which stated that the “public” “private” distinction determination depends upon a sort of “suitability requirement.” The court said that there should be some sort of suitable relationship between the basis for selecting an investor and the purposes for which the selection was made. However, this judicial standard that has long been discredited. Martin, *supra* note X

<sup>119</sup> See generally *Mineral Lands Research & Marketing Corp.*, SEC No-Act WL 55694 (Dec. 4, 1985); Robert T. Willis, SEC No-Act. WL 233597 (Jan 18, 1988); Royce Exchange Fund Quest Advisory Corp., SEC No-Act. WL 490692 (Aug. 28, 1996); Bateman Eichler, Hill Richards, Inc., SEC No-Act. 55679 (Dec. 3, 1985). For a thorough examination of the preexisting relationship doctrine see, Martin, *supra* note 97.

<sup>120</sup> In *Mineral Lands Research & Marketing Corp.*, SEC No-Action Letter, (Dec. 3, 1985)

of the investors “financial circumstance or sophistication,” than any communication that could be considered an “attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value” could result in a finding that a general solicitation had occurred.<sup>121</sup>

It is unclear what motivated the SEC to introduce the “preexisting relationship” doctrine only months after doing away with the concept of “qualified offeree.”<sup>122</sup> Since its introduction in *Mineral Lands Research & Marketing Corp.*, the preexisting relationship requirement has been the subject of numerous No-Action requests, however, the SEC’s response to these requests have done little if anything to clarify the area.<sup>123</sup>

*B. Explaining the Concerns: “Small Issuer Seeks Wealthy Individual for Discreet Transaction, Sophistication Preferred.”*

Investor protection concerns arise as a result of the over inclusive nature of the “accredited investor” exemption. It can hardly be argued that the class of individual investors currently satisfying the wealth requirements under section 502(c) includes some members that lack any semblance of financial or business acumen sufficient to justify the conclusion that they are able to fend for themselves. Under *Ralston*, access to the type of information a registration statement would provide was considered instrumental to a finding that the offeree could fend for himself; however, the individual wealth requirements under the “accredited investor” exemption do nothing to assure that the “unsophisticated wealthy investor,” even assuming access to the type of information a registration statement would provide, possesses the ability to capably determine the merits and risks associated with a particular investment. As such, it is easy to see why the SEC considers the prohibition on general solicitation and advertising significant,

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<sup>121</sup> In *Mineral Lands Research & Marketing Corp.*, SEC No-Action Letter, (Dec. 3, 1985).

<sup>122</sup> See Martin, *supra* note 97.

<sup>123</sup> Id.

particularly when interpreted as including a “preexisting relationship” requirement. These two restrictions together certainly increase the probability that “offers” will be kept out of the hands of the wealthy yet unsophisticated investor.

The other side of the equation is that the general solicitation prohibition contributes to the “information gap.” Studies have shown that this hinders the formation of an efficient market for the securities of small ventures, which contributes to the continued expansion of the “funding gap, thereby, increasing the likelihood that the capital needs of small ventures capable of producing significant returns, to both society and investors, remain unfilled.

Although, shifting regulatory significance from the “offeree” to the “purchaser” was significant, any benefits that may have been realized were extremely short lived. Maintaining the anti-solicitation doctrine in Regulation D does not provide any benefits significant enough to justify the resulting harms. After all, it is the actual sale of the security that gives rise to the risk of loss, not the offer. The next section suggests that the SEC’s continued reliance on the anti-solicitation doctrine is the result of a false distinction drawn between private and public offerings.

*C. Not Private, Not Public: “What We’ve Got Here Is, A Failure to Differentiate”*

The SEC’s analysis regarding the appropriateness of removing “offeree qualification” from the new rule 506 private offering “safe harbor,” suggests the Commission draws a false distinction between the “private” nature of an offering and the “sophistication” concept that pervades section 4(2) jurisprudence. The Commission reasons that the prohibition on general solicitation contained in 502(c) maintains the private nature of the offering, and that the information requirements and “accredited investor” concept assures investor protection.<sup>124</sup> This suggests that the SEC reads an additional requirement of “privacy” into section 4(2) even though

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<sup>124</sup> See *supra* notes ##, and accompanying text.

there is nothing in *Ralston* or the legislative history to suggest that section 4(2) requires an independent restriction on the manner of the offering. If the offering is designed to include only those persons capable of fending for themselves, then any additional requirements are superfluous.

A private offering has historically been defined in the negative, i.e., a transaction not involving any public offering. A transaction not involving any public offering is a transaction involving investors that do not require the protection afforded by the Securities Act, i.e., sophisticated investors, or investors who can fend for themselves. If qualifying each and every purchaser assures that the transaction involves only investor's capable of fending for themselves, then by definition a transaction that qualifies every purchaser is a "private offering."<sup>125</sup> The additional requirement that issuers refrain from engaging in actions that may be considered a general solicitation is overkill.

As the next section indicates, the SEC has already, in limited circumstances, provided for general solicitation and advertising in connection with the offer or sale of unregistered securities. For 10 years, small companies in California have engaged in limited solicitation and advertising and there is no evidence to suggest that removing the prohibition on solicitation and advertising resulted in an increase of fraud or abuse.

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<sup>125</sup> Put in the form of a syllogism the argument looks like this

I. All private offerings are transactions involving purchasers that do not need the protection of the Securities Act.

II. All transactions that qualify purchasers are transactions involving purchasers that do not need the protection of the Securities Act.

Δ All transactions that qualify purchasers are private offerings.

The author, recognizing both the lack of insight such arguments rarely, if ever, provide into issues involving significant policy considerations and their inherently flawed nature, intended this syllogism to be taken as a tongue in cheek demonstration of the fuzzy logic surrounding the anti-solicitation doctrine.

#### D. Regulation CE [code name:] Concerted Effort

In an apparent retreat from the continued expansion of the anti-solicitation doctrine the SEC enacted Regulation CE, which provided an exemption from registration for “[o]ffers and sales of securities that satisfy the conditions of paragraph (n) of Sec. 25102(n) of the California Corporations Code. . . .”<sup>126</sup> The SEC considered Regulation CE to be an extension of the “test the waters” concept of Regulation A to private offerings.<sup>127</sup> Under Regulation A, the SEC allows small issuers who participate in a “mini-registration” to engage in a form of general solicitation, which permits small issuers to solicit interest from potential investors prior to actually engaging in a securities offering.<sup>128</sup> There are few limits on means of solicitation or information that can be contained in the materials as long as certain disclaimers are used and the materials are filed with the SEC.<sup>129</sup>

Regulation CE, via section 25102(n) of the California Corporations Code, exempts offerings to “qualified purchasers” and provides for limited solicitation and advertising even if

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<sup>126</sup>See Exemption for Certain California Limited Issues, Securities Act Release No. 7285, at 88,008, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,803 (June 27, 1995), and adopted in May 1996, Small Business Registration Exemption, Securities Act Release No.7285, [1996 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 85,803 (May 1, 1996. It became effective on June 10, 1996. Exemption for Certain California Limited Issues, 61 Fed. Reg. 21356 (1996).

<sup>127</sup> See Securities Act Release No. 7285 *supra* note 2, at 88,008 (“The California exemption combines a form of general solicitation using a “test the waters” concept with a qualified purchaser concept . . .”). The California exemption provides a “test the waters” type of exemption similar to Regulation A, with some additional limits on the type of statements that can be made in the preliminary solicitation and expands the class of potential investors that may be solicited. See 25 Cal. Corp. Code § 25102(n). In addition, Regulation CE, as interpreted, expressly authorizes the use of internet-based solicitation for the purpose of “testing the waters.” Commissioner’s Opinion 96/2C, (Oct. 17, 1996) *available in* LEXIS, StSec Library, Cacase File.

<sup>128</sup> See 17 C.F.R. § 230.254 (2005) (allowing issuers to solicit interest from potential investors prior to filing an offering statement).

<sup>129</sup> See Michael Keller Enterprises, SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 76,952, at 78,751 (Dec. 1, 1994) (stating expressly that there are no limitations, other than those imposed by the antifraud requirements, regarding the content of a test the waters solicitation). Neither Regulation A nor Regulation CE adequately address the problems associated with the anti-solicitation doctrine. Regulation CE is insufficient because of its geographic restrictions, furthermore, promoting individual states to enact similar exemptive provisions would only serve to ensure the development of fifty different regulatory schemes containing countless administratively and judicially imposed perquisites. A full analysis of Regulation A and CE is beyond the scope of this paper, however, it is sufficient to note that Regulation A requires a “mini registration,” which includes many of the same costs as full registration. In addition, Regulation A does not alleviate the costs associated with state registration, which as previously discussed, raises many of the same concerns as federal registration.

non-qualified purchasers receive the solicitation.<sup>130</sup> The California exemption expands the class of potential investors that may be solicited.<sup>131</sup> In addition, the California exemption, as interpreted, expressly authorizes the use of internet-based solicitation for the purpose of “testing the waters.”<sup>132</sup> This exemption was designed to increase the ability of start-up companies to acquire necessary capital, without sacrificing investor protection and was part of the SEC’s “continuing effort to ease the regulatory burdens on small businesses issuing securities.”<sup>133</sup> The SEC recognized “the inability to reach out broadly to find potentially qualified investors for . . . exempt offerings hampers the utility of the exemption and may raise the costs to companies trying to do these exempt offerings.”<sup>134</sup> The SEC also indicated that it would be willing to grant exemptions to any other state that adopted an exemption modeled after the California exemption;<sup>135</sup> however, no other state has requested a similar exemption.<sup>136</sup>

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<sup>130</sup> See Cal. Corp. Code § 25102(n) (Deering 1997).

<sup>131</sup> Id.

<sup>132</sup> Commissioner’s Opinion 96/2C, (Oct. 17, 1996) available in LEXIS, StSec Library, Ccase File.

<sup>133</sup> C. Stephen Bradford, *The SEC’s New Regulation CE Exemption: Federal-State Coordination Run Rampant*, 52 U. MIAMI L. REV. 429, 430 (1998) Bradford argues that “the basic idea underlying Regulation CE – allowing issuers to solicit qualified purchasers – is sensible,” but effectively provides “California authorities the power to determine the scope of an exemption from federal securities laws,” which likely, exceeds the SEC’s regulatory authority, violates of the Administrative Procedures Act, and violates the preemption provisions of section 18 of the Securities Act when applied to “covered securities.” Id.

<sup>134</sup> Id.

<sup>135</sup> See Securities Act Release No. 7285, Fed Sec. L. Rep (CCH) ¶ 85, 803, at 88,009 (1996). No other state has requested a similar exemption. In 1997, the North American Association of Securities Administrators (NAASA) enacted the Model Accredited Investor Exemption (MAIE), which was an attempt at a uniform system of exemption from state securities regulations for offerings to accredited investors, however, the SEC refrained from adopting the exemption with regard to section 505 and 506. See STEINBERG, *supra* note 24.

The MAIE was modeled largely after Regulation CE, however, there was not a state nexus requirement, some have suggested the lack of a nexus requirement was the primary factor the SEC refused to adopt the MAIE with regard to section 505 or 506. See STEINBERG, *supra* note 24. The MAIE provided restricted sales to persons who are or the issuer reasonably believes are accredited investors, as defined in 17 CFR 230.501(a). Pursuant to the MAIE the issuer could distribute a general announcement of the proposed offering by any means but the information that could be included in the general announcement was limited to the following: issuer’s name, address and telephone number; name, a brief description and price (if known) of any security to be issued; a brief description of the issuer’s business in 25 words or less; the type, number and aggregate amount of securities being offered; the name, address and telephone number of the person to contact for additional information; and a statement that: (1) sales will only be made to accredited investors; (2) no money or other consideration is being solicited or will be accepted by way of the general announcement; and the securities have not been registered with or approved by any state securities agency or the U.S. Securities and Exchange Commission and are being offered and sold pursuant to an exemption from registration. The MAIE provided that additional information could be provided if delivered

In the same proposal and request for comments the SEC considered amending Regulation D to eliminate the ban on general solicitation in rule 505 and 506 offerings.<sup>137</sup> There were a significant number of comments supporting the proposal, however, the SEC deferred action on eliminating general solicitation indicating that the comments would be considered in future initiatives.<sup>138</sup>

#### IV. WHAT NOW?

##### A. *The Time For Reform is Upon Us.*

The preemptive authority granted to the SEC under The National Securities Market Improvement Act of 1996<sup>139</sup> (“NSMIA”) provides the perfect opportunity to finally rid the world of the anti-solicitation doctrine.<sup>140</sup> The NSMIA was designed to modernize the securities laws, promote investment, decrease the cost of capital, and encourage competition. The legislative history makes it clear that Congress intended to preempt state regulation in offers and sales to financially sophisticated investors and gave the SEC the authority to determine the sophistication requirements for the purpose of providing a nationwide, uniform definition, thereby eliminating the variations found among the states.<sup>141</sup>

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through an electronic database that is restricted to persons who have been pre-qualified as accredited investors; or is delivered after the issuer reasonably believes that the prospective purchaser is an accredited investor. In addition the MAIE permitted telephone solicitation if the issuer prior to placing the call reasonably believes that the prospective purchaser to be solicited is an accredited investor. The exemption, also provided that disseminating the general announcement non accredited investors would not disqualify the issuer from claiming the exemption. *at* [www.nasaa.org/content/getsearchablefile.cfm?FamilyID=863&filename=Model\\_Accredited\\_Investor\\_Exemption.pdf](http://www.nasaa.org/content/getsearchablefile.cfm?FamilyID=863&filename=Model_Accredited_Investor_Exemption.pdf)

<sup>136</sup> See STEINBERG, *supra* note 24, at 118. [insert MAIE]

<sup>137</sup> See Securities Act Release No. 33-7185 (June 27, 1995).

<sup>138</sup> See Securities Act Release No. 33-7285 (May 1, 1996).

<sup>139</sup> Pub. L. No. 104-290, 104<sup>th</sup> Cong., 2d Sess. (1996).

<sup>140</sup> See Advisory Report, *supra* note 26, at \*41.

<sup>141</sup> H.R. Rep. No. 622, 104<sup>th</sup> Cong. 2d Sess. at 31 (1996) [“House Report NSMIA”] (stating “[f]irst, many states currently exempt such securities from registration requirements, but the qualification standard can vary from State to State. This provision will result in a uniform national rule for qualified purchasers, which should greatly facilitate the ability of issuers to use it.”)

Section 308 of the NSMIA amended Section 18 of the Securities Act, preempting three categories of securities from state securities regulation.<sup>142</sup> The legislation “withdrew the preexisting power of the states to require pre-sale registration disclosures by issuers, including the power to conduct presale disclosure review, merit review, or any kind of fairness review in connection with most public and private offerings of securities conducted within the states’ respective jurisdictions.”<sup>143</sup>

For the first time Congress granted the SEC general exemptive authority under the Securities Act.<sup>144</sup> Under NSMIA the SEC must determine that the use of their exemptive authority is “necessary or appropriate in the public interest and consistent with the protection of investors”<sup>145</sup> Congress granted this authority with the understanding that it would be used to adopt new approaches to registration and disclosure that furthered the underlying goal of promoting efficiency, competition, and capital formation.<sup>146</sup>

Unfortunately, SEC response to the Congressional intent fell far short of reaching any of the NSMIA’s express goals.<sup>147</sup> In December 2001, the SEC sought comments on a proposed rule that would define “qualified purchasers” to mean “accredited investor” as defined in Rule 501(a) of Regulation D. The Commission examined the preemptive effects of defining “qualified purchaser” to mean “accredited investor,” stating:

We believe that the proposed qualified purchaser definition would reduce costs for issuers by expanding the number of investors to whom issuers may offer and sell securities without complying with state registration requirements.

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<sup>142</sup> Pub. L. No. 104-290, 104<sup>th</sup> Cong., 2d Sess. (1996).

<sup>143</sup> Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibilities*, 78 WASH U. L.Q. 497, 498 (2000).

<sup>144</sup> See SEC Release No. 34-40632A (Nov. 17, 1998)

<sup>145</sup> 15 U.S.C. s 77z-3 (2000)

<sup>146</sup> See H.R. Rep. No. 104-622, 104 Cong. 2d. Sess. (1996).

<sup>147</sup> Campbell, *supra* note #, at 175 (expressing harsh criticism of the NSMIA and subsequent Commission response, noting the irony that the one segment of the economy in need of most relief, received the least amount of help.)

There may also be a cost to investors through the loss of benefits of state registration and oversight . . . [however] we do not think this cost will be significant . . . [because accredited investors] *do not benefit from state regulation in a way that justifies the costs to the issuers subject to state registration requirements.*<sup>148</sup>

The position taken by the commission is a departure from the notion that allowing general solicitation and advertising in connection with the offer or sale of exempt securities is inconsistent with investor protection. Any state exemption from registration for offerings to accredited investors under Rule 504 would be rendered ineffective. The Commission's proposal would have resulted in a categorical exemption from registration for offerings to accredited investors in up to 1,000,000 in any 12 month period. Unfortunately, the Commission's proposed definition never resulted in a final rule.

The SEC's failure to address the needs of small businesses despite Congress' express call to action under the NSMIA is evidence of either administrative reluctance or inability. The SEC clearly has the authority to promulgate uniform exemptions from state registration permitting the use of a general solicitation or advertising in either (1) offerings to accredited investors under section 4(2), or (2) offerings made to "qualified purchasers."

The SEC's exemptive authority extends to situations where an exemption from the requirements of the securities laws is "necessary or appropriate in the public interest and consistent with the protection of investors."<sup>149</sup> The SEC's statement in the 2001 Release that "accredited investors do not benefit from state regulation in a way that justifies the costs to the issuers subject to state registration requirements,"<sup>150</sup> supports a the proposition that an exemption for SPI's permitting general solicitation and advertising is appropriate in the public and

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<sup>148</sup> See Defining the Term Qualified Purchaser Under the Securities Act of 1933, Securities Act Release No. 8041, 2001 WL 34681692, at \*11 (December 19, 2001).

<sup>149</sup> 15 U.S.C. s 77z-3 (2000)

<sup>150</sup> See Defining the Term Qualified Purchaser Under the Securities Act of 1933, Securities Act Release No. 8041, 2001 WL 34681692, at \*11 (December 19, 2001).

consistent with investor protection. Congress' express intent to promote efficiency, competition, and capital formation further supports this conclusion.<sup>151</sup> As the previous sections have shown, the registration requirements, as applied to small companies are disproportionately burdensome and excessively prohibitive. Given the important role SPI's play in the nation's economy, such an exemption for SPI's that would permit general solicitation and advertising is both necessary for capital formation and appropriate for investor protection.

*B. A Sophisticated Proposal*

The SEC should adopt a Regulation providing SPI's a "safe harbor" under section 4(2) that would permit general solicitation and advertising. The exemption should be available for offerings involving sales to persons satisfying the definition of accredited investor or persons the issuer reasonably believes satisfy the definition of accredited investor. The only restriction on the manner of offering should be that any written materials include a legend indicating that the offering is limited to persons satisfying the definition of "accredited investor" as defined in section 501(a) and that the securities are not registered with the SEC and are being offered pursuant to an exemption from registration. The exemption should contain resale restrictions similar to those in Rule 506 and should focus only on purchasers, thereby avoiding the problems associated with Rule 146. Since the exemption would only be available in transactions where all purchasers met the definition of accredited investor there should be no formal information requirements or limits on the content of communications, subject of course to federal antifraud and civil liability provisions. These changes would provide small issuers with the flexibility to craft an offering based on the pool of potential investors and effectively preempt the states from imposing registration requirements on private offerings.

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<sup>151</sup> See H.R. Rep. No. 104-622, 104 Cong. 2d. Sess. (1996).

This article suggests that two alternative approaches are available to assuage the SEC's investor protector concerns. First, the wealth requirements with respect to individuals under § 501(a)(6) and (a)(7), could be increased. Second, the exemption could leave the definition of accredited investors as it currently stands but apply the purchaser requirements of section 506(b)(2)(ii) to individual accredited investors satisfying either 501(a)(6) or (a)(7). This would require that the issuer make a separate determination as to whether the purchaser, alone or with the assistance of others, immediately prior to the sale possesses the requisite business and financial acumen to adequately assess the merits and risks of the investment.<sup>152</sup>

It could be argued that the current accredited investor standards no longer adequately distinguish between those who need and those who do not need the protections afforded by the Securities Act. To justify the absence of any formal informational requirements the standard for individual accreditation should be premised on investor sophistication.<sup>153</sup> Although access is

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<sup>152</sup> Section 506(b)(2)(ii) requires “[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. 17 C.F.R. § 230.506(b)(2)(ii) (2000). In addition, the exemption should permit the use of purchaser representatives as defined in section 501(h). Section 501(h) states:

- Purchaser representative shall mean any person who satisfies all of the following conditions or who the issuer reasonably believes satisfies all of the following conditions:
- (1) Is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer. . . .
  - . . .
  - (2) Has such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment;
  - (3) Is acknowledged by the purchaser in writing, during the course of the transaction, to be his purchaser representative in connection with evaluating the merits and risks of the prospective investment; and
  - (4) Discloses to the purchaser in writing a reasonable time prior to the sale of securities to that purchaser any material relationship between himself or his affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

17 C.F.R. § 230.501(h).

<sup>153</sup> The Subcommittee on Capital Formation to . . . .

necessary for investor protection, because registration statements, offering memorandums, and other offering materials do not come in “For Dummies”<sup>154</sup> versions, it is not sufficient.

In the case of an unsophisticated wealthy investor, access alone will not assure that a capable assessment of the merits and risks associated with the investment will take place. While sophistication does not always guarantee access, a sophisticated individual is more likely to recognize fraud or other abuses and is less likely to enter into transactions where they are incapable of bearing the associated risks. Therefore, any requirement should place more significance on sophistication.

Although, wealth is not a proxy for sophistication, a rational relationship between the two does exist. An individual with greater income and assets is more likely to possess either the requisite business and financial acumen, or the ability to pay for the services of someone who does. As such, raising the wealth requirements to a level consistent with the goal of maximizing the number of sophisticated members that compose the class of individual accredited investors would serve to increase investor protection.<sup>155</sup>

It could be argued that the relationship between wealth and sophistication is insufficient to adequately address investor protection concerns. As previously discussed, any standard should be designed to increase the probability that each and every purchaser is capable, either alone or with the assistance of others, of evaluating the risks and merits associated with the investment. Applying section 506(b)(2)(ii) to accredited investors would greatly increase the likelihood that each and every purchaser possesses the requisite sophistication. Applying this standard, however, would sacrifice objectivity at the hands of investor protection.

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<sup>154</sup> “For Dummies” is a popular series of “do it yourself” books published by Wiley Publishing, Inc. 909 3<sup>rd</sup> Avenue, New York, NY 10022, [www.wiley.com](http://www.wiley.com).

<sup>155</sup> It has been suggested that ....

It is impossible to determine whether the benefits associated with requiring issuers to make a “sophistication” determination would outweigh any costs associated with making such a determination.<sup>156</sup> One concern with requiring issuers to make purchaser qualification decision is that the SEC and the courts could eviscerate the exemption by imposing excessive standards of “reasonable belief.” Administrative and judicial tinkering seems to increase in proportion to subjectivity. Objective bright line standards, however, operate on the assumption that “one size fits all,” which, is rarely, if ever the case.

Under either proposal, every purchaser must meet the definition of accredited investor, as the SEC itself has on occasion recognized, “*since any investor would still have to be qualified before purchasing the securities,*” there should be no loss of investor protection. The proposed exemption would facilitate the free flow of information, which would promote the formation of an efficient market. Raising the wealth standard might increase the number of sophisticated members that compose the class of accredited investors, however, requiring actual investor sophistication, or the existence of a reasonable belief of investor sophistication seems to be more consistent with current SEC positions. In essence, the sophistication determination is a restatement of the “preexisting relationship” doctrine except applied to purchasers not offerees.

This article argues that the better approach would be to leave the accredited investor definition as it is but apply the purchaser qualifications of section 506(b)(2)(ii) to accredited investors. Requiring issuers to make a sophistication determination but permitting general solicitation and advertising would promote the free flow of information, facilitate the formation of an efficient market, and provide adequate investor protection.

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<sup>156</sup> One concern with requiring issuers to make purchaser qualification determinations is that the SEC and the courts could eviscerate the exemption by imposing restrictions similar to the preexisting relationship doctrine. Administrative and judicial tinkering seems to increase in proportion to subjectivity. Objective bright line standards, however, operate on the assumption that “one size fits all,” which, is rarely if ever the case.

### *C. Reality Check*

The investor protection concerns associated with permitting general solicitation and advertising are unfounded. Just about every state recognizes “that if you advertise on the Internet but disclaim that you are not selling securities to their residents, and, in fact, do not sell to their residents, you have not made an illegal offering in that state.”<sup>157</sup> In addition, this is the same approach taken by the SEC in regards to foreign companies.<sup>158</sup> Why should a different standard be applied against U.S. issuers as “long as (1) it includes a warning that it will not sell to investors who do not meet the definition of accredited investor and (2) does not, in fact, sell to unsophisticated investors? Who is harmed?”<sup>159</sup>

### **Conclusion**

The proposed exemption serves to promote the efficiency of PSI’s as mechanisms through which competition and innovation can serve as catalysts in the process of “Creative Destruction,” and at the same time ensures adequate levels of investor protection. The increasing economic significance of innovative entrepreneurial ventures, Congressional intent, and current practice all support the conclusion that the proposed exemption is both necessary for capital formation and adequate for investor protection. By increasing access to relevant reliable information the proposed exemption will facilitate PSI capital formation, increase job and new wealth creation, and ultimately promote the formation of an efficient market, thereby, creating an environment where “ prevailing prices of [PSI] securities [more adequately] reflect[] the value that an informed investor would rationally be willing to pay.”<sup>160</sup>

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<sup>157</sup> Speech by Brian J. Lane to the American Bar Association (Nov. 13, 1999)(Nov. 13, 1999) *available at* <http://www.sec.gov/news/speech/speecharchive/1999/spch339.htm>.

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> Freidman, *supra* note 13.