
**SMALL ISSUE PUBLIC OFFERINGS
CONDUCTED OVER THE INTERNET:
ARE THEY “SUITABLE” FOR THE
RETAIL INVESTOR?***

JEFFREY J. HASS**

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** Associate Professor of Law, New York Law School. B.S., 1984, Florida State University; J.D., 1988, University of Pennsylvania. E-mail: <jhass@nyls.edu>. I gratefully acknowledge New York Law School’s support of my research through summer research stipends. I also would like to thank the following individuals: Aleta Estreicher and Armando Belly for their valuable suggestions; Andy Klein of Wit Capital Corporation, with whom I had the privilege of working at New York’s Cravath, Swaine & Moore; Richard Kendall of Global Financial Press for his continuing friendship and generosity; Greg Hass for providing a scenic location at which to write this Article; and Ronald Sarubbi and Charles Kassouf for their research assistance.

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INTRODUCTION

March 4, 1996, was a cold, blustery day in New York City. Andrew “Andy” Klein, president and founder of Spring Street Brewing Company, Inc., was happy to trade the cold outside for the warmth afforded by his Greenwich Village office. Little did he know, however, exactly how warm his day would become, for this was Klein’s day to be on the hot seat.

With no forewarning, the call came at about 11:00 a.m. Klein’s secretary simply informed him that someone was on hold. With a cup of coffee in one hand, Klein casually picked up the handset with his other and offered his usual salutation: “Hello, Andy here.” Much to Klein’s surprise,

a

staff attorney of the Securities and Exchange Commission (“SEC”) greeted him. He asked Klein to make himself available for a conference call later that day.

When the second call finally arrived, Klein found himself on the receiving end of a conference call with twelve high-ranking SEC staff members, most of whom were attorneys. They had a few questions for Klein about Spring Street’s activities on the Internet—a few very tough questions. Klein nervously called to his secretary to hold his calls. He anticipated this one would take a while.¹

The SEC inquired about Spring Street’s bulletin board trading system (“BBTS”) for its common stock. Spring Street’s was the world’s first BBTS established on the Internet’s World Wide Web (the “Web”).² Known as “Wit-Trade” and named after the company’s trademark Wit Beer product, the BBTS was designed to provide Spring Street’s common stockholders with a mechanism for selling their otherwise illiquid shares.³ These stockholders and other interested parties could access the BBTS through the home page⁴ of the Web site⁵ established by Spring Street.⁶ Klein had established Wit-Trade on March 1, 1996. The SEC’s call came three days later. Only the weekend was sandwiched in between.

1. These facts were provided to the author by Andy Klein. See also Andrew Klein, *Wall-Street.com: How the Beer Company That Created the First Internet IPO Is Shaking Up the Stock Market*, WIREd, Feb. 1998, at 88, 92.

2. As explained by Joseph Cella and John Stark:

The [World Wide Web or] Web is a hypertext based information and resource system for the Internet and, as the fastest growing part of the Internet, it is most likely responsible for the amazing interest in the Internet itself. Each screenful of information includes menu choices and highlighted words through which the user can call up further information, either from the same computer or by linking automatically to another computer anywhere in the world.

Joseph J. Cella III & John R. Stark, *SEC Enforcement and the Internet: Meeting the Challenge of the Next Millennium—A Program for the Eagle and the Internet*, 52 BUS. LAW. 815, 821 (1997) (citations omitted). Cella and Stark further describe a “hyperlink” as an electronic code “embedded in a Web page [that] enables a user to jump from one piece of information to a related item no matter where on the Internet the information may be stored.” *Id.* at 821 n.34 (citation omitted).

3. See *infra* text accompanying notes 134-36.

4. A “home” or “index” page is the initial screen that greets visitors to a particular Web site and guides them through the information available at the site. See Cella & Stark, *supra* note 2, at 821 n.33.

5. A “Web site” refers to the space on a computer server that is occupied by the information maintained by a particular business or individual. That business or individual has the freedom to change that information as often as necessary in order to keep it current. See *id.*

6. Spring Street’s home page, which no longer contains a hyperlink to its BBTS, was located at <<http://plaza.interport.net/witbeer/withome.html>>, which the author last visited March 1, 1998.

Klein is a man of many firsts—a reluctant cult hero of capitalism.⁷ He conducted the world's first initial public offering ("IPO") of common stock over the Internet to raise capital for his fledgling beer company.⁸ The offering generated so much publicity⁹ that Klein was quickly overwhelmed with calls from the heads of other small businesses asking for advice on how to raise money over the Internet. In Klein's mind, these calls had "opportunity" written all over them. He seized it by establishing the world's first Internet investment banking firm, Wit Capital Corporation ("Wit Capital").¹⁰

Klein is, indeed, a financial revolutionary; he led the way in using the Internet as a tool to offer and sell securities to the public. Through his BBTS, he demonstrated how the Internet could be used to provide liquidity to investors. The SEC, too, has recognized the Internet has a tremendous potential in the capital markets. While attempting to embrace this new technology, the SEC has aggressively provided guidance to issuers through various releases and no-action letters.¹¹ For this, the SEC should be commended.

7. Cf. Deborah Lohse, *Wit Capital Will Launch On-Line Site—Founder Says Brokerage Will Give Public Easy Access to IPOs*, WALL ST. J., Sept. 15, 1997, at B12I (reluctantly labeling Klein a "minor celebrity").

8. See Ronald M. Loeb & David J. Richter, *Electronic Offerings: Securities Law in the Age of the Internet, Advanced Securities Law Workshop*, at 319 (PLI Corp. Law & Practice Course Handbook Series No. B4-7142, 1996). For a description of how an Internet stock offering is conducted, see *infra* text accompanying notes 115-41.

9. See, e.g., Udayan Gupta, *Microbrewery Uses the Internet to Post Circular on Its IPO*, WALL ST. J., Feb. 24, 1995, at B5; Klein, *supra* note 1, at 90; Lohse, *supra* note 7; Robert A. Mamis, *Andy Klein: Inc. Talks to Spring Street Brewery's Founder About How He Raised Capital Through the World Wide Web*, INC., July 1996, at 38.

10. See Wit Capital Home Page (visited Mar. 1, 1998) <<http://www.witcapital.com>>. For a recent update on Wit Capital, see Peter Truell, *Investment Maverick Navigates the Internet*, N.Y. TIMES, Nov. 9, 1998, at C1.

11. See, e.g., Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Securities Act Release No. 7516, 63 Fed. Reg. 14,806 (Mar. 23, 1998); Use of Electronic Media by Broker-Dealers, Transfer Agents and Investment Advisors for Delivery of Information: Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934 and Investment Company Act of 1940, Securities Act Release No. 7288, 61 Fed. Reg. 24,644 (May 9, 1996) [hereinafter Use of Electronic Media by Broker-Dealers Release]; Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 3200, at 3128 (Oct. 6, 1995) [hereinafter Use of Electronic Media for Delivery Purposes Release]; Lamp Technologies, Inc., SEC No-Action Letter, 8 Fed. Sec. L. Rep. (CCH) ¶ 77,453, at 78,327 (May 29, 1998) (addressing accredited investor access to a password-controlled list of private investment funds exempt from registration under sections 3(c)(1) and (7) of the Investment Company Act of 1940); Net Roadshow, Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 107 (Jan. 30, 1998), available in LEXIS, Fedsec Library, Noact File (discussing on-line roadshows made available to institutional investors); Bloomberg L.P., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1023 (Dec. 1, 1997), available in LEXIS, Fedsec Library, Noact File (same); Private Financial Network, SEC No-Action Letter, [1997 Transfer Binder] Fed.

There is, however, a dark side to this story that is beginning to reveal itself to those least capable of protecting themselves.¹² The Internet and other electronic media have made it possible for “not ready for prime time” companies to throw the financing roadmap traditionally followed by growing companies out the window.¹³ These financially immature companies now have the means to bypass most private financing sources and offer their securities directly to the general public without the investor protections and assistance afforded by underwriters.¹⁴ Companies conducting these offerings rely primarily on one of the small issue public offering (“SIPO”) exemptions¹⁵ to the registration requirements of the Securities Act of 1933 (the “Securities Act”).¹⁶

Sec. L. Rep. (CCH) ¶ 77,332, at 77,675 (Mar. 12, 1997) (addressing video transmission of offering roadshows); Baltimore Gas & Elec. Co., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 14 (Jan. 6, 1997), available in LEXIS, Fedsec Library, Noact File (addressing listing of company’s Web site address in company prospectus); ITT Corp., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,340, at 77,701 (Dec. 6, 1996) (same); Angel Capital Elec. Network, SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,304, at 77,515 (Oct. 25, 1996) (addressing allowing accredited investors to access a password-controlled list of small corporate offerings at ACE-Net’s home page); PerfectData Corp., SEC No-Action Letter, 1996 SEC No-Act. LEXIS 700 (Aug. 5, 1996), available in LEXIS, Fedsec Library, Noact File (addressing passive bulletin board trading systems); IPONET, SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252, at 77,271 (July 26, 1996) (addressing accredited investors’ access to a password-controlled list of private placements listed on IPONet’s Web site); Real Goods Trading Corp., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,226, at 77,131 (June 24, 1996) [hereinafter Real Goods No-Action Letter] (addressing passive bulletin board trading system); Spring Street Brewing Co., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,201, at 77,001 (Apr. 17, 1996) [hereinafter Spring Street No-Action Letter] (same).

12. See Cella & Stark, *supra* note 2, at 817. Cella and Stark portray this dark side as a den of thieves prepared to assault unsuspecting travelers of the information superhighway. See *infra* note 217 and accompanying text.

13. See, e.g., Sana Siwolop, *Pouring Itself Into the Stock Market*, N.Y. TIMES, May 25, 1997, § 3, at 4 (describing the efforts of a four-year-old company specializing in coffee bars to raise capital via a self-managed initial public offering over the Internet).

14. The offer and sale of securities by an issuer directly to members of the public without the underwriting assistance of one or more investment banks is referred to throughout this Article as a “self-managed offering.” For general information on self-managed offerings, see Stephen M. Graham, *Self-Managed Public Offerings for Emerging Companies*, 43 PRAC. LAW. 75 (1997) (discussing the savings advantage of self-managed public offerings). See also Steven E. Levingston, *Tiny Firms Offer Stock ‘Direct’ to Public*, WALL ST. J., May 20, 1996, at C1 (discussing the recent rise in self-managed offerings).

15. As discussed more fully in *infra* Part I, “small issue” offering exemptions consist of those exemptions promulgated by the SEC under its authority granted by Congress under section 3(b) of the Securities Act. See 15 U.S.C. § 77c(b) (1994 & Supp. III 1997). “Small issue public offering” or “SIPO” exemptions consist of those small issue offering exemptions that allow issuers or persons acting on their behalf to offer or sell securities to the public through general solicitation or advertising activities. The focal point of this Article is on the SIPO exemptions of Regulation A and Rule 504 of Regulation D, because they allow issuers to engage in those activities. See 17 C.F.R. §§ 230.251-.263 (1998); *id.* §§ 230.501-.508.

16. 15 U.S.C. §§ 77a-77aa.

These companies directly and purposefully solicit a hungry, untapped segment of the investor market—so-called “unpreferred retail investors.” These investors consist of members of the general public, many of whom—in the parlance of the securities laws—are financially unsophisticated,¹⁷ have limited net worths, and are easily and quickly intoxicated by the aroma of get-rich-quick schemes. Historically denied meaningful participation in registered IPOs underwritten by mainstream investment banks,¹⁸ these investors have clamored to get in on ground floor IPO action during the unprecedented bull market of the 1990s.¹⁹ While attempts to include these retail investors in quality IPOs are being made,²⁰ success is likely to be modest at best.²¹

The heightened desire of unpreferred retail investors to participate in IPOs has coincided with the increased ability of unseasoned businesses to solicit capital aggressively directly from members of the public²² through the Internet and other unconventional means.²³ Despite suggestions to the contrary,²⁴ subjecting these retail investors to the virtually unfiltered “cold call” solicitations of unseasoned companies is not the solution to their IPO

17. The Securities Act differentiates between sophisticated and unsophisticated investors particularly in the context of transactions exempt from the registration requirements of section 5. *See id.* § 77e (1994). *See also, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953) (limiting the section 4(2) private placement exemption to offerings to investors who can “fend for themselves”); 17 C.F.R. § 230.501(a) (defining an “accredited investor” for purposes of Rules 505 and 506 of Regulation D); *id.* § 230.506(b)(2)(ii) (specifying that “purchasers” must be limited to those nonaccredited investors having “such knowledge and experience in financial and business matters that [they are] capable of evaluating the merits and risks of the prospective investment”).

18. *See infra* Part II.B.

19. Netscape Communication’s 1994 IPO is a prime example of where ordinary retail investors, including this author, sought access to IPO shares but were denied. In this same vein, the president of Fidelity Brokerage Services, Inc., gave the following response in an undated letter sent to retail customers who requested information about Fidelity’s new liaison with Salomon Smith Barney Holdings, Inc.: “Thank you for your recent request for more information about initial public offerings (IPOs) and secondary offerings available through Fidelity Brokerage. We know that many of you are eager to have access to these new issue equity securities. Now, as a Fidelity Brokerage customer, you can.” Letter from Robert P. Mazzarella, President of Fidelity Brokerage Services, Inc. (received Aug. 8, 1997) (on file with author). For a discussion of Fidelity’s liaison with Salomon, see *infra* notes 174-76 and accompanying text.

20. *See infra* notes 174-78 and accompanying text.

21. *See infra* Part II.B.

22. *See infra* text accompanying notes 131-33. This development is dripping with irony. Traditional underwriters have historically ignored the capital formation needs of unseasoned businesses on the one hand, and the investment needs of unpreferred retail investors on the other. These two groups—perennial wallflowers at the public offering dance—can now interact directly without any matchmaking assistance from traditional underwriters. The question remains, however, as to whether they will prove to be compatible dance partners. For more on this point, see *infra* note 27.

23. *See infra* note 131.

24. *See Mamis, supra* note 9; *Future Directions in Film Financing—the Emerging On-Line Option* (visited Mar. 12, 1998) <<http://www.webcinema.org/seminar1.html>>.

access problem. These investors want what all investors want: the financial wheat, not the chaff. But instead of participating in the offerings of companies underwritten by investment banks who risk their reputational capital and are subject to liability under the securities laws, these investors increasingly are bombarded with a smorgasbord of self-managed offerings with risk-reward ratios heavily skewed toward risk.

Even assuming that these self-managed SIPOs comply with applicable federal disclosure requirements and survive the scrutiny of state blue sky regulators, the securities offered thereby are not likely to constitute suitable investments for many unsophisticated retail investors. Of course, it is exactly those investors' dearth of financial savvy that makes them the perfect target for SIPO issuers.²⁵ No doubt many retail investors who can ill-afford to gamble with their limited savings may be lured into participating in these offerings with financially disastrous results and little, if any, effective legal recourse under current law.²⁶ The "learning through suffering," however, is a highly inappropriate solution to this suitability problem.²⁷ Moreover, it could unnecessarily tarnish the Internet's image

25. See NASAA Comment Letter to SEC Secretary Jonathan Katz Regarding SEC Release 33-6924 on Small Business Initiatives, [1986-1993 Transfer Binder] NASAA Rep. (CCH) ¶ 9346, at 9374 (July 24, 1992) (noting that businesses engaging in smaller public offerings often sell to less financially sophisticated investors); Stephen J. Choi, *Gatekeepers and the Internet: Rethinking the Regulation of Small Business Capital Formation*, 2 J. SMALL & EMERGING BUS. L. 27, 31 (1998) ("Small companies . . . present investors with the greatest risk of getting stuck with a lemon.").

26. How many retail investors will this entail? While no definitive answer is available, Professor Donald Langevoort has made the following point:

No doubt there are some investors willing to "take a flier" simply on the basis of either their own analysis of the issuer's prospects or an appealing multimedia presentation. The persistence of the more unsavory segment of the penny stock market shows that there is a market for investors who buy impulsively, even in the absence of solid reputational intermediation.

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, 14 (1998) (citations omitted).

27. Some commentators are skeptical about the efficacy of self-managed offerings and, therefore, do not appear overly concerned by this suitability problem. See, e.g., John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1213 (1997) (stating that "self-distributed equity offerings [may] be so rare, at least at first, that they will receive special scrutiny by the SEC"); Langevoort, *supra* note 26, at 26 (arguing that "predictions of the advent of disintermediation are premature" based on the economic and social role that intermediaries play); Jennifer Files, *Camelot on the Web*, DALLAS MORNING NEWS, Apr. 9, 1997, at 1D (noting that although hundreds of companies have tried to raise capital over the Internet in the past few years, "perhaps 20 have been successful"); Lohse, *supra* note 7 (discussing how Andy Klein's cyber efforts have helped "unleash a wave of as-yet-unfulfilled excitement about cyber-deals and cyber-trading").

An important distinction, however, must be made. The notion that technology will enable *seasoned* businesses to access the public capital markets without the assistance of traditional financial intermediaries (so-called "disintermediation") is distinctly different from the notion that technology will enable *unseasoned* businesses that could seldom enlist the aid of financial intermediaries in the

as an effective medium of capital formation. To prevent this, the SEC should require unseasoned issuers who conduct self-managed SIPOs to comply with this Article's proposed suitability standard before selling securities to unsophisticated retail investors.

Part I of this Article briefly describes how unseasoned companies now offer their common stock directly to the public via the Internet and other electronic media. Part I also discusses the renaissance in the use of Regulation A²⁸ and Rule 504 of Regulation D²⁹—the primary SIPO exemptions relied upon by unseasoned issuers. Part II discusses the investor protection services that investment banks provide in underwritten registered offerings that self-managed SIPOs lack. It also discusses the frustration unpreferred retail investors face when attempting to participate in offerings underwritten by mainstream investment banks. Part III first addresses the legal concepts of full disclosure, merit review, and suitability as mechanisms for investor protection. It then examines why suitability concerns arise in the context of self-managed SIPOs conducted over the Internet. Part III finishes by demonstrating that the on-line initiatives undertaken by the SEC and various states have failed to address these concerns. Finally, Part IV analyzes the suitability standards employed by the National Association of Securities Dealers, Inc. ("NASD") and the SEC in other contexts. It then proposes and explains a new federal suitability standard for self-managed SIPOs directed at unsophisticated retail investors.

I. CONDUCTING SMALL ISSUE PUBLIC OFFERINGS OVER THE INTERNET

The interaction of two complimentary elements—one statutory and the other technological—provides unseasoned companies with an unprecedented opportunity to raise capital directly from the general public without the aid of underwriters. The first element consists of section 3(b) of the

first place to access the public capital markets directly. This author agrees with Professors Coffee and Langevoort that disintermediation with respect to the capital-raising efforts of seasoned businesses is likely to occur in a slow, piecemeal fashion. By contrast, use of the term "disintermediation" with respect to the public capital-raising efforts of unseasoned businesses is improper, because few of those businesses have been able to entice financial intermediaries to aid in those efforts in the first place. In other words, little to no intermediation has occurred in this context to date. Managers of the *unseasoned* businesses with whom this author has interacted already view self-managed SIPOs as a viable financing alternative. It is, indeed, the ultimate irony that the Internet and other electronic media have made it possible for unseasoned businesses and unpreferred retail investors—the two groups traditionally shunned by financial intermediaries—to transact directly with each other. *See infra* Part II.

28. 17 C.F.R. §§ 230.251-.263 (1998).

29. *Id.* §§ 230.501-.508.

Securities Act and the rules and regulations promulgated thereunder by the SEC. The second element consists of the Internet and related technologies that bring significant economies of scale to the distribution of information to thousands of targeted recipients. While the statutory provision and related rules and regulations have existed in various iterations for decades, the advent of the Internet has transformed them into incredibly powerful tools for raising capital in a cost-effective manner.

A. GENERAL SOLICITATION IN A SMALL ISSUE OFFERING CONTEXT

The high cost of registering and offering securities in compliance with section 5 of the Securities Act³⁰ makes it impractical for most small business issuers³¹ seeking to raise a relatively small amount of capital³² from the public to pursue a full-fledged registered offering.³³ Congress and the SEC recognize this and have provided these issuers with two primary alternatives. The first alternative is to register securities under section 5 but on registration forms more user-friendly to small businesses than Form S-1,³⁴ the traditional IPO registration form. These more user-friendly forms are Forms SB-1 and SB-2,³⁵ whose use has been estimated to save an issuer up to \$125,000 per offering.³⁶ In addition, these forms allow small business issuers to adhere to the simplified disclosure guide-

30. 15 U.S.C. § 77e (1994).

31. Securities Act Rule 405 defines a "small business issuer" as any U.S. or Canadian issuer that has revenues and a public float (the value of voting shares in the hands of nonaffiliates) of less than \$25 million and is not an investment company under the Investment Company Act of 1940. *See* 17 C.F.R. § 230.405.

32. For purposes of this Article, any securities offering of \$5 million or less is "small." This \$5 million threshold corresponds to the maximum dollar amount of securities that can be sold in reliance on the exemption provided by section 3(b) of the Securities Act during any 12-month period. *See* 15 U.S.C. § 77c(b) (1994 & Supp. III 1997).

33. *See* THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.13, at 187 (3d ed. 1996); *The Impact of the 1992 Small Business Initiatives*, 47 ADMIN. L. REV. 511, 512 (1995) [hereinafter *Impact of Small Business Initiatives*] ("In fact, the costs and confusion spawned by SEC regulation may prevent entrepreneurs from exercising the option of a public stock offering.").

34. 17 C.F.R. § 239.11.

35. *Id.* §§ 239.9-.10. Any small business issuer can use Form SB-1 to register up to \$10 million of securities to be sold for cash, so long as that issuer has not registered more than \$10 million in any continuous 12-month period, including the transaction being registered. *See id.* § 239.9. Form SB-2 can be utilized by any small business issuer to register any dollar amount of securities to be sold for cash. *See id.* § 239.10. For a convenient reprint of Forms SB-1 and SB-2, see RICHARD W. JENNINGS, HAROLD MARSH, JR., JOHN C. COFFEE, JR. & JOEL SELIGMAN, *FEDERAL SECURITIES LAWS: SELECTED STATUTES, RULES AND FORMS 436-45* (1997 ed.) [hereinafter JENNINGS ET AL., *FEDERAL SECURITIES LAWS*].

36. *See Impact of Small Business Initiatives*, *supra* note 33, at 519.

lines in Regulation S-B,³⁷ rather than the more stringent ones in Regulation S-K.³⁸

The second alternative for small business issuers is to offer their securities pursuant to one of the “small issue” offering exemptions to registration. These exemptions were promulgated by the SEC pursuant to authority granted by Congress under section 3(b) of the Securities Act,³⁹ and were adopted “in recognition of the economics involved [in small issue offerings] and . . . because of the SEC’s view that . . . [those offerings] do not call for the expansive disclosure required by a full-fledged 1933 Act registration.”⁴⁰ These exemptions include Regulation A⁴¹ and Rule 504 of Regulation D⁴² among others.⁴³

37. 17 C.F.R. § 228.10. Regulation S-B is an “integrated disclosure system” specifically designed for a new class of issuers (“small business issuers”) that applies to the annual and quarterly reports filed by those issuers under the Securities Exchange Act of 1934 (the “Exchange Act”), *see* 15 U.S.C. §§ 78a-78mm, and the securities offering registration statements filed pursuant to the Securities Act. *See Impact of Small Business Initiatives*, *supra* note 33, at 513 & n.13. Prior to 1992, the disclosure made by small business issuers was governed by Regulation S-K. *See* 17 C.F.R. § 229.10.

38. 17 C.F.R. § 229.10. Regulation S-K, adopted in 1982 to replace parallel, yet duplicative disclosure systems under the Securities and Exchange Acts, is an “integrated disclosure system” applicable to all issuers. It applies to the annual and quarterly reports filed by issuers under the Exchange Act and the securities offering registration statements filed pursuant to the Securities Act. In 1992, “small business issuers” were allowed to comply with the more simplified disclosure requirements of Regulation S-B. *See HAZEN*, *supra* note 33, § 3.3, at 124-25.

39. 15 U.S.C. § 77c(b). Through section 3(b), the SEC is empowered to develop rules and regulations exempting issues of securities from the registration requirements of the Securities Act so long as the aggregate per issue offering price does not exceed \$5 million. *See HAZEN*, *supra* note 33, § 4.15, at 196. Newly added section 4(6) of the Securities Act, 15 U.S.C. § 77d(6) (1994), allows for small offerings up to \$5 million to be made solely to “accredited investors,” as defined in section 2(a)(15) of the Securities Act, *id.* § 77b(a)(15) (Supp. III 1997), and Securities Act Rule 215, 17 C.F.R. § 230.215. However, section 4(6) is not a viable exemption for an Internet IPO because it prohibits the use of general solicitation and advertising.

40. *HAZEN*, *supra* note 33, § 4.13, at 186. *See also* HAROLD S. BLOOMENTHAL, HOLME ROBERTS & OWEN, *SECURITIES LAW HANDBOOK* § 6.02[1], at 364 (1998) (calling Regulation A “a less stringent form of registration for relatively small offerings”).

41. 17 C.F.R. §§ 230.251-.263.

42. *Id.* § 230.504.

43. Other rules promulgated by the SEC include: Securities Act Rule 505 of Regulation D, *id.* § 230.505; Securities Act Rule 701, *id.* § 230.701; and Regulation CE, *id.* § 230.1001. Offerings made pursuant to Rule 505, which allows issuers to offer and sell up to \$5 million in securities within any twelve-month period, are not discussed in this Article because issuers cannot conduct a Rule 505 offering over the Internet. This preclusion stems from the prohibition on the issuer, or any person acting on the issuer’s behalf, from offering or selling securities by “any form of general solicitation or general advertising . . .” *Id.* § 230.502(c). Rule 701 exempts from the Securities Act registration requirements offerings by certain issuers of securities to employees, directors, officers, and/or consultants pursuant to either a written compensatory benefit plan or a written compensatory contract. Thus, Rule 701 is not materially relevant to a discussion of Internet SIPOs. Finally, Regulation CE provides an exemption for offers and sales of securities that satisfy the conditions of section 25102(n) of the California Corporations Code. Because the exemption is limited to California issuers and non-

Virtually all small business issuers that have conducted Internet IPOs to date have utilized the second alternative rather than the first.⁴⁴ While both alternatives satisfy the primary goal of these issuers—the ability to solicit the general public—only the second alternative does so in a highly cost-effective manner and with less governmental involvement. The second alternative achieves this in several ways.

First, disclosure requirements are significantly less stringent and less expensive to comply with under the second alternative. While a Regulation A offering and a full-fledged registered offering have many similarities,⁴⁵ the SEC allows corporate issuers preparing Regulation A offering circulars to format them based on either Offering Circular Model A or B of Form 1-A, Part I of Form SB-2,⁴⁶ or the state-developed Form U-7.⁴⁷ Both

California issuers with a significant nexus to California, and restricts offers and sales to qualified purchasers, it is not materially relevant to a discussion of Internet SIPOs.

44. Andy Klein's Spring Street Brewing Company has conducted two Internet offerings pursuant to Regulation A. Spring Street offered up to 2,702,700 shares of its common stock at a price of \$1.85 per share pursuant to an offering statement on Form 1-A under Regulation A, qualified by the SEC on February 6, 1995. The offering statement contains the offering circular used to market the shares. See SPRING STREET BREWING COMPANY, INC., UP TO 2,702,700 SHARES OF COMMON STOCK AT \$1.85 PER SHARE (1995) [hereinafter SPRING STREET OFFERING CIRCULAR I]. Spring Street subsequently offered up to 1,200,000 shares of its common stock at a price of \$2.75 per share pursuant to an offering statement on Form 1-A under Regulation A, qualified by the SEC on September 30, 1996. The offering statement contains the offering circular used to market those shares. See SPRING STREET BREWING COMPANY, INC., UP TO 1,200,000 SHARES OF COMMON STOCK AT \$2.75 PER SHARE (1996) [hereinafter SPRING STREET OFFERING CIRCULAR II].

45. Because of these similarities, Regulation A is often mistakenly referred to as a "mini-registration." See RICHARD W. JENNINGS, HAROLD MARSH, JR., JOHN C. COFFEE, JR. & JOEL SELIGMAN, SECURITIES REGULATION: CASES AND MATERIALS 433 (8th ed. 1998) [hereinafter JENNINGS ET AL., SECURITIES REGULATION]; HAZEN, *supra* note 33, § 4.15, at 196. See also LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS 137 (3d ed. 1996) ("In the vernacular of securities lawyers, a Regulation A transaction has . . . been called a short-form registration."). These similarities include, among others:

- (i) a mandatory filing of an offering statement on Form 1-A with the SEC much like the filing requirement for an issuer in a registered offering;
- (ii) preparation of an offering circular containing a substantial portion of the information that must be included in a prospectus used in connection with a registered offering;
- (iii) the SEC staff's comment/review process that must be completed prior to consummating sales of securities;
- (iv) the permissible use of a preliminary offering circular similar to the permissible use of a preliminary ("red herring") prospectus by an issuer in a registered offering; and
- (v) offering circular delivery requirements that mirror the prospectus delivery requirements for a registered offering.

As a technical matter, however, Regulation A only provides an issuer with an exemption to registration and is not an alternative form of registration. Thus, Regulation A issuers are not subject to liability under section 11 of the Securities Act. See 15 U.S.C. § 77k (1994); JENNINGS ET AL., SECURITIES REGULATION, *supra* (noting that "Form 1-A is not a registration statement for purposes of § 11 of the 1933 Act").

46. See Form 1-A, Part II—Offering Circular, 17 C.F.R. §§ 230.253, 239.9; JENNINGS ET AL., FEDERAL SECURITIES LAWS, *supra* note 35, at 358-83. Issuers that are not corporations are not al-

Offering Circular Model A and Form U-7 provide issuers with a "question and answer" format in order to simplify their disclosure burden.⁴⁸ With respect to Rule 504 offerings, no federally mandated disclosure exists,⁴⁹ although those offerings "are not exempt from the antifraud, civil liability or other provisions of the federal securities laws."⁵⁰

With respect to financial statement disclosure, Regulation A issuers are not required to include audited financial statements in their offering circulars unless audited financials have previously been prepared for other purposes.⁵¹ In addition, financial statements need only comply with generally accepted accounting principles ("GAAP"), rather than with the more complicated Regulation S-X,⁵² which contains accounting disclosure guidelines for most registered offerings.⁵³ This difference can significantly cut an issuer's costs associated with a Regulation A offering, as the issuer can avoid hiring an outside accounting firm in connection with the

lowed to follow the "question and answer" format of Offering Circular Model A. Issuers preparing offering circulars based on Part I of Form SB-2 are not required to prepare the financial statements called for therein.

47. Form U-7 is commonly referred to as the SCOR (Small Corporate Offering Registration) form and consists of a question and answer format developed by state securities administrators. *See* CARL W. SCHNEIDER, JOSEPH M. MANKO & ROBERT S. KANT, *GOING PUBLIC: PRACTICE, PROCEDURE & CONSEQUENCES* 66 (1995).

48. Although the question and answer format facilitates disclosure, some criticize it because it does not provide an attractive means for marketing securities. *See id.*

49. *See* 17 C.F.R. § 230.502(b)(1) (1998); SCHNEIDER ET AL., *supra* note 47, at 74 (noting, however, that applicable state laws effectively limit the ability of an issuer to complete a public offering without complying with some mandated disclosure requirements). In response to perceived abuses by issuers conducting Rule 504 offerings, the SEC is considering making state level registration and financial statement disclosure conditions to the use of Rule 504. In addition, the SEC is considering restricting resales of Rule 504 securities by deeming them "restricted securities," as defined under Rule 144. *See* 17 C.F.R. § 230.144. *See also* Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 7541, 63 Fed. Reg. 29,168 (May 21, 1998) [hereinafter Rule 504 Release]; Michael Schroeder, *SEC Approves Rules to Curb 'Microcap' Fraud*; Russell 2000, *Nasdaq Composite Post Solid Gains*, WALL ST. J., Feb. 11, 1998, at C9.

50. Regulation D: Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933, Preliminary Notes, 1 Fed. Sec. L. Rep. (CCH) ¶ 2373, at 2635 n.1 (1998).

51. *See* Form 1-A, Part F/S; JENNINGS ET AL., *FEDERAL SECURITIES LAWS*, *supra* note 35, at 383-85. Financial statements included in a Regulation A offering circular, however, must be prepared in accordance with U.S. generally accepted accounting principles. A different situation exists, however, with respect to state blue sky laws. Because most states require issuers to include audited financial statements in their offering materials, most Regulation A offering circulars include audited financials even though Regulation A itself ordinarily does not require them.

52. 17 C.F.R. § 228.10.

53. A small business issuer registering securities on Forms SB-1 or SB-2 must include audited financial statements. Those financial statements, however, need not comply with Regulation S-X, except with respect to the report and qualifications of the issuer's independent accountant. *See* Regulation S-B, Item 310, Note 2, *id.* § 228.310.

offering.⁵⁴ Rule 504 offerings fare even better because, as noted above, there is no federally mandated disclosure of any kind.

Second, because offerings conducted under the first alternative are still full-fledged registered offerings rather than exempt ones, they are subject to the full comment and review process employed by the staff of the SEC (the "Staff"). While it is true that the Staff also subjects offering statements on Form 1-A used for Regulation A offerings to a comparable comment and review process, the Staff understandably is more patient and flexible with Regulation A issuers due to such issuers' general unfamiliarity with the securities laws.⁵⁵ These issuers also benefit because the Staff's accounting review of a Regulation A offering is significantly less involved than its accounting review of a traditional registered offering due to Regulation A's less stringent accounting requirements.⁵⁶ By contrast, materials used in connection with Rule 504 offerings are not required to be filed with the SEC, and thus are not reviewed by the Staff.

Third, as described more in Part I.B, Regulation A allows an issuer to solicit indications of interest from investors prior to filing a Form 1-A offering statement with the SEC. In other words, an issuer can put out "feelers" to see if an offering is feasible without running afoul of the "gun-jumping" prohibition of section 5(c) of the Securities Act.⁵⁷ Issuers proposing to engage in a registered offering, including those registered on Forms SB-1 or SB-2, are forbidden from engaging in unauthorized publicity activities prior to filing a registration statement with the SEC.⁵⁸

54. See SCHNEIDER ET AL., *supra* note 47, at 54 (reporting that accounting fees range from \$100,000 to \$250,000 for a first-time issuer with no previous audits). Of course, when unaudited financials are used, concerns about reliability and consistency arise that add to the risks of a given offering.

55. See Telephone Interview with Richard Wulff, Assistant Director-Small Business of the SEC Division of Corporation Finance (July 23, 1997). This does not mean, however, that the Staff's review/comment process for a Regulation A offering necessarily is quicker than for a full-fledged registered offering. In fact, the offerings of some Regulation A issuers have taken more than a year to satisfactorily complete the Staff's review/comment process, mainly due to those issuers' inexperience with the process itself. See *id.*

56. See Telephone Interview with Christina Chalk, Attorney-Adviser of the SEC Division of Corporation Finance (July 31, 1997). Financial statements in Regulation A offerings can be unaudited and need not comply with Regulation S-X.

57. "Gun-jumping" refers to all actions, other than certain prescribed actions, taken by or on behalf of an issuer that have the effect of publicizing a forthcoming offering prior to the time the issuer has filed a registration statement with the SEC. See 15 U.S.C. § 77e(c) (1994); 17 C.F.R. § 230.135.

58. *But see generally* Solicitations of Interest Prior to an Initial Public Offering, Securities Act Release No. 7188, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,639, at 86,885 (June 27, 1995) [hereinafter Proposed Rule 135d Release] (proposing Securities Act Rule 135d, which would allow nonreporting issuers and their underwriters conducting registered offerings to "test the waters"

Fourth, because securities sold pursuant to the exemptions of either Regulation A or Rule 504 are not listed on a stock exchange, an issuer of those securities is not required to comply with the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") until such time as it has 500 or more security holders of record and total assets of more than \$10 million.⁵⁹ Accordingly, until those two milestones are reached, Regulation A and Rule 504 issuers avoid the substantial costs associated with the preparation and filing of annual, quarterly, and other reports. By contrast, issuers engaged in full-fledged registered offerings, even those on Forms SB-1 or SB-2, generally must comply with the Exchange Act's extensive reporting requirements.⁶⁰

Fifth, issuer liability concerns are lessened when issuers sell securities pursuant to the second alternative. Registering securities on either Form SB-1 or SB-2 subjects the issuer to section 11 and section 12(a)(2) liability;⁶¹ selling securities pursuant to Regulation A or Rule 504 does not.⁶²

Finally, filing fees are lower for offerings conducted under the second alternative than under the first. The registration fees in section 6(b) of the Securities Act continue to apply to registrations made on either Form SB-1 or SB-2.⁶³ By contrast, there is no federal filing fee applicable to either Regulation A or Rule 504 offerings,⁶⁴ although filing fees are incurred in connection with state registration.

in a manner similar to Regulation A's Rule 254); The Regulation of Securities Offerings, Securities Act Release No. 7606A, 63 Fed. Reg. 67,174 (Dec. 4, 1998) [hereinafter Aircraft Carrier Release] (proposing to liberalize the use of "free writing" in the public offering context).

59. See 15 U.S.C. § 78l(g)(1) (1994 & Supp. III 1997); 17 C.F.R. § 240.12g-1; SPRING STREET OFFERING CIRCULAR I, *supra* note 44, at 4; SPRING STREET OFFERING CIRCULAR II, *supra* note 44, at 4-5. In fact, the SEC raised the asset threshold of the Exchange Act's periodic reporting requirements from \$5 million to \$10 million because of the recent increase in Regulation A's offering limit from \$1.5 million to \$5 million. The SEC was concerned that, without this change, many Regulation A issuers would inadvertently become reporting companies under the Exchange Act. See Relief from Reporting by Small Issuers, Securities Act Release No. 7186, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,637, at 86,877 to 86,878 (June 27, 1995).

60. Those issuers are normally required to register their securities under either section 12(b) or 12(g) of the Exchange Act, because the securities are either listed on a national securities exchange, such as the Nasdaq, or because the issuer has over \$10 million in total assets and a class of 500 or more equity securities holders of record. See 15 U.S.C. § 78l(b), (g); 17 C.F.R. § 240.12g-1. Reporting companies are required to comply with the Exchange Act's continuous disclosure requirements. See 15 U.S.C. § 78l(b), (g); *id.* § 78m (1994).

61. See 15 U.S.C. § 77k (1994 & Supp. III 1997); *id.* § 77l(a)(2) (Supp. III 1997).

62. See Choi, *supra* note 25, at 34-35. See generally JENNINGS ET AL., SECURITIES REGULATION, *supra* note 45, at 433.

63. See 15 U.S.C. § 77f(b) (1994 & Supp. III 1997).

64. Prior to 1996, Rule 252(f) of Regulation A required an issuer to pay a \$500 filing fee. See 17 C.F.R. § 230.252(f) (1995).

Despite these advantages, offerings conducted pursuant to small issue offering exemptions do have two important drawbacks. First, despite the adoption of the National Securities Markets Improvement Act of 1996 ("NSMIA"),⁶⁵ securities issued under the exemptive authority of section 3(b) of the Securities Act do not qualify as "covered securities" under section 18(b) of the Securities Act.⁶⁶ Therefore, they must continue to be registered under the blue sky laws of the states in which they will be offered and sold.⁶⁷ By contrast, securities registered on Forms SB-1 and SB-2 are treated as "covered securities" if they are listed for trading on the New York Stock Exchange ("NYSE"), the American Stock Exchange ("AMEX"), the National Market System of Nasdaq, or certain other exchanges.⁶⁸ Nevertheless, because it is unlikely that many Form SB-1 or SB-2 issuers will meet the listing requirements of those exchanges, SIPO issuers are not necessarily any worse off in this regard.⁶⁹

A second drawback is that securities issued pursuant to small issue offering exemptions lack a liquid secondary trading market. In comparison, fully registered securities listed on securities exchanges provide investors with a quick and easy way in which to monetize their investments. As discussed below, however, Andy Klein's BBTS initiative constitutes an important first step in providing desperately needed liquidity to Regulation A and Rule 504 securities.⁷⁰

65. Pub. L. No. 104-290, 110 Stat. 3416 (1996).

66. See 15 U.S.C. § 77r(b)(4)(C)-(D) (Supp. III 1997).

67. The SEC is currently considering denying Rule 504 issuers a federal exemption if they fail to make requisite state blue sky law filings. See Rule 504 Release, *supra* note 49; Schroeder, *supra* note 49.

68. See 15 U.S.C. § 77r(b)(1)(A). To the extent securities registered with the SEC are not listed on any of those exchanges, full-fledged registration provides no state blue sky benefits over a section 3(b) exemption.

69. Under Securities Act section 18(b)(1)(B), the SEC can determine by rule that securities listed or authorized for listing on a given national securities exchange are "covered" if the listing requirements for that exchange are substantially similar to those of the NYSE, AMEX, or National Market System of Nasdaq. For example, through its adoption of Rule 146(b), the SEC recently designated securities listed on the Chicago Board Options Exchange, Tier I of the Pacific Stock Exchange, and Tier I of the Philadelphia Stock Exchange as covered securities for purposes of section 18. See 17 C.F.R. § 230.146(b) (1998); Covered Securities Pursuant to § 18 of the Securities Act of 1933, Securities Act Release No. 7494, 1804 Fed. Reg. 80,101 (Jan. 2, 1998).

70. See *infra* text accompanying notes 134-36. But see Rule 504 Release, *supra* note 49; Schroeder, *supra* note 49 (noting that the SEC is considering imposing resale restrictions on Rule 504 securities).

B. REGULATION A VERSUS RULE 504

Once an issuer decides to proceed with an Internet offering pursuant to a SIPO registration exemption, it must choose between proceeding under Regulation A or Rule 504. Until 1992, the choice was easy. Rule 504, as it then existed, placed restrictions on an issuer's ability to solicit the general public—the primary goal of those engaged in Internet IPOs.⁷¹ “Old” Rule 504 also placed limits on an investor's ability to resell Rule 504 securities and conditioned its exemption upon the issuer's registration of the offering with state securities regulators.⁷² Those restrictions made Rule 504 unpalatable to many issuers.⁷³ The Small Business Initiatives adopted in 1992, however, eliminated those restrictions.⁷⁴

Despite the fact that Rule 504 contains no mandatory disclosure provisions,⁷⁵ SIPO issuers typically prefer Regulation A over Rule 504 for several reasons. First, Rule 504 places a very low limit on the dollar amount of securities that can be offered. An issuer cannot offer more than \$1 million of securities pursuant to that rule and any other section 3(b) exemption within a twelve-month period.⁷⁶ By contrast, Regulation A allows an issuer to raise up to \$5 million through the sale of securities within a twelve-month period.⁷⁷ Issuers seeking to raise more than \$5 million in one offering from the public have to conduct a full-fledged registered offering.⁷⁸

71. See Small Business Initiatives, Securities Act Release No. 6949, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,439, at 62,165 (Aug. 13, 1992) [hereinafter SBI Release].

72. The SEC is considering bringing back the state level registration condition and the restrictions on resales. See Rule 504 Release, *supra* note 49; Schroeder, *supra* note 49.

73. See Rule 504 Release, *supra* note 49; Schroeder, *supra* note 49.

74. See *Impact of Small Business Initiatives*, *supra* note 33.

75. Rule 505(b)(1) of Regulation D requires issuers to satisfy the informational requirements of Rule 502(b). See 17 C.F.R. §§ 230.502(b), .505(b)(1) (1998). Rule 253 of Regulation A requires an issuer's offering circular to include the narrative and financial information required by Form 1-A, *see id.* § 230.253, while Rule 252(a) requires “any other material information necessary to make the required statements, in light of the circumstances under which they are made, not misleading,” *see id.* § 230.252(a).

76. *See id.* § 230.504(b)(2).

77. *See id.* § 230.251(b). “Regulation A provides a greater opportunity to small businesses for capital-raising than before because it allows them to sell more than three times the previous amount while remaining exempt from the full registration process and reporting status.” *Impact of Small Business Initiatives*, *supra* note 33, at 519.

78. Issuers qualifying as small business issuers can register up to \$10 million of securities on streamlined Form SB-1 or more than \$10 million on Form SB-2, rather than on the traditional Form S-1. This is true even though an issuer may have recently sold securities pursuant to an exemption under Regulation A, as offers and sales made pursuant to a full-fledged registration will not be integrated as a general matter with those made in reliance on Regulation A. See 17 C.F.R. § 230.251(c)(2)(i).

A second, though intangible, advantage of Regulation A lies in the inference perceived by the investing public that the SEC has “blessed” each Regulation A offering. This inference arises from specific references to the SEC contained in a Regulation A offering circular.⁷⁹ Although the SEC has gone to great lengths to dispel this inference,⁸⁰ the fact remains that investors take comfort in knowing that the Staff has reviewed an offering⁸¹ even though its review may have been less stringent than one given to a registered offering.⁸²

A third advantage of Regulation A involves its detailed disclosure requirements. Once the Staff believes that an issuer’s Form 1-A offering statement, including the offering circular, satisfies those disclosure requirements, the SEC will qualify its use.⁸³ Thereafter, an issuer can have at least some confidence that its offering circular satisfies those requirements. Rule 504, by contrast, does not contain a detailed disclosure blueprint.⁸⁴ Thus, an issuer must turn to other provisions of federal and/or state law to aid it in preparing offering materials.

79. The offering circular in an issuer’s Form 1-A has the appearance, but not the complete substance, of a regular prospectus used in connection with a registered offering. For better or for worse, an offering circular will make specific reference to the fact that the offering statement on Form 1-A is filed with the SEC, and that the form can be reviewed at the SEC’s public reference room in Washington, D.C. See, e.g., SPRING STREET OFFERING CIRCULAR I, *supra* note 44, at Inside Cover Page. In addition, the cover of the offering circular contains a mandatory legend that references the SEC. See 17 C.F.R. § 230.253(d); Form 1-A, Part II (Offering Circular Model A, Cover Page; Offering Circular Model B, Item 1, Cover Page); JENNINGS ET AL., FEDERAL SECURITIES LAW, *supra* note 35, at 359-60, 375.

80. The SEC requires an issuer to print the following legend on the cover page of its offering circular in bold capital letters at least as large as that used generally in the body of the offering circular:

THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION DOES NOT PASS UPON THE MERITS OF OR GIVE ITS APPROVAL TO ANY SECURITIES OFFERED OR THE TERMS OF THE OFFERING, NOR DOES IT PASS UPON THE ACCURACY OR COMPLETENESS OF ANY OFFERING CIRCULAR OR OFFERED SELLING LITERATURE. THESE SECURITIES ARE OFFERED PURSUANT TO AN EXEMPTION FROM REGISTRATION WITH THE COMMISSION; HOWEVER, THE COMMISSION HAS NOT MADE AN INDEPENDENT DETERMINATION THAT THE SECURITIES OFFERED HEREUNDER ARE EXEMPT FROM REGISTRATION.

17 C.F.R. § 230.253(d).

81. Professor Coffee argues that the SEC is the “most logical gatekeeper” to assure informational veracity in connection with self-managed equity offerings, and that the SEC’s services as a gatekeeper are valuable. Coffee, *supra* note 27, at 1213. See also Choi, *supra* note 25, at 30 (arguing that in an Internet-based securities market, regulators may “join the competitive arena as potential certifiers of investment information and value”); Abba David Poliakoff, *SEC Review: Comfort or Illusion?*, 17 U. BALT. L. REV. 40 (1987) (arguing that the SEC’s gatekeeper function is valuable).

82. See *supra* text accompanying notes 55-56.

83. See 17 C.F.R. § 230.252(g).

84. See *id.* § 230.502(b)(1).

A final advantage is Regulation A's new "test the waters" provision adopted in 1992.⁸⁵ Labeled the "most innovative and controversial development under the [Small Business Initiatives],"⁸⁶ Rule 254 of Regulation A permits an issuer to "publish or deliver to prospective purchasers a written document or make scripted radio or television broadcasts to determine whether there is any interest in a contemplated securities offering."⁸⁷ In other words, an issuer can test the waters prior to committing substantial managerial energy and financial resources to an offering when its successful completion is far from certain.⁸⁸ While presumably a Rule 504 issuer can similarly test the waters and attempt to offer and sell securities based merely on a few oral representations,⁸⁹ Regulation A issuers can rest easy at least with respect to federal law by simply following the safe harbor guidelines of Rule 254.

Rule 254 requires issuers to submit written documents or scripts of any broadcast to the SEC on or before the date of their first use.⁹⁰ Once these submissions have been made, oral communications between issuers and prospective investors are permissible, although those communications are still subject to the antifraud provisions of the federal securities laws.⁹¹ Furthermore, the SEC has specifically provided that solicitation materials that comply with the provisions of Rule 254 "shall not be deemed to be a prospectus as defined in section 2(10) of the Securities Act."⁹² Solicita-

85. See SBI Release, *supra* note 71. Prior to the Small Business Initiatives, Regulation A issuers were prohibited from engaging in pre-filing publicity by Rule 255(a). See 17 C.F.R. § 230.255(a) (1992). For a discussion of the merits and drawbacks of Regulation A's "test the waters" provision, see Note, "Testing the Waters"—the SEC's Feet Go from Wet to Cold, 83 CORNELL L. REV. 464 (1998).

86. *Impact of Small Business Initiatives*, *supra* note 33, at 517. See also SCHNEIDER ET AL., *supra* note 47, at 67 (describing the test the waters provision as "potentially a very valuable technique that cannot be used currently in the context of a registered public offering").

87. 17 C.F.R. § 230.254(a) (1998). The SEC has elaborated that communication with prospective investors through any print, broadcast, telephone, facsimile, or electronic medium, including the Internet, would be permissible. See Proposed Rule 135d Release, *supra* note 58, at 86,888.

88. Securities Act Rule 254 is particularly significant in light of the strict limits placed on what issuers can say about their proposed *registered* offerings. See 15 U.S.C. § 77e(c) (1994); 17 C.F.R. § 230.135. Furthermore, only nonreporting issuers can take advantage of Regulation A, while only reporting issuers can distribute notices concerning proposed *unregistered* offerings pursuant to Securities Act Rule 135c. See 17 C.F.R. § 230.135c. Thus, without the test the waters provision, an issuer that meets Regulation A's issuer requirements could not say anything publicly about its proposed offering prior to filing its Form 1-A with the SEC.

89. See SODERQUIST, *supra* note 45, at 145-46.

90. See 17 C.F.R. § 230.254(b)(1). However, such submission is "not a condition to any exemption pursuant to this section . . ." *Id.* § 230.254(b).

91. See *id.* § 230.254(a).

92. *Id.* § 230.254(e).

tions under the rule, however, must cease once an issuer files its Form 1-A offering statement with the SEC.⁹³

Not surprisingly, Rule 254 prohibits issuers from soliciting or accepting money or other consideration from prospective investors, or requiring any binding or nonbinding commitment from prospective investors.⁹⁴ Issuers also cannot consummate actual sales of securities until the later of either the date on which the offering statement is qualified by the SEC or twenty calendar days after the last publication or delivery of solicitation materials.⁹⁵

Surprisingly, the SEC does not give specific guidance regarding what issuers may say to the public about their proposed Regulation A offerings in test the waters solicitations. The SEC has simply stated that “the written documents, broadcasts and oral communications are each subject to the antifraud provisions of the federal securities laws.”⁹⁶ The SEC, however, does require an issuer to:

- (i) state that no money or other consideration is being solicited, and if sent in response, will not be accepted;
- (ii) state that no sales of the securities will be made or commitment to purchase accepted until delivery of an offering circular that includes complete information about the issuer and the offering;
- (iii) state that an indication of interest made by a prospective investor involves no obligation or commitment of any kind; and
- (iv) identify the chief executive officer of the issuer and briefly and in general its business and products.⁹⁷

Thus, “[a]side from a few essentially formal items of required disclosure, the test the waters document is essentially ‘free writing’”; issuers presumably could distribute copies of their business plans to members of the public.⁹⁸

93. *See id.* § 230.254(b)(3).

94. *See id.* § 230.254(a).

95. *See id.* § 230.254(a), (b)(4).

96. *Id.* § 230.254(a).

97. *Id.* § 230.254(b)(2). Interestingly, the SEC specifically states that the inclusion of the above-mentioned information is “not a condition to any exemption pursuant to this section.” *Id.* § 230.254(b). Presumably, issuers who fail to include this information in their test the waters solicitations expose themselves to SEC fines, sanctions, or other penalties, but not a loss of their section 3(b) exemption.

98. SCHNEIDER ET AL., *supra* note 47, at 65. *See also* BLOOMENTHAL, *supra* note 40, § 6.02[6], at 373.

Regulation A's test the waters provision, however, has proven controversial on at least two levels.⁹⁹ First, leaving aside investor protection concerns, it seems patently unfair to allow proposed Regulation A issuers to "gun jump" when issuers planning traditional registered offerings are prohibited from doing so.¹⁰⁰ After all, the same "gun-jumping" concern about conditioning the market prior to the availability of a legally adequate disclosure document exists in both cases.¹⁰¹ While the SEC has proffered Proposed Rule 135d to allow such efforts by nonreporting issuers and their underwriters proposing to conduct registered offerings, prefiling publicity efforts currently remain unlawful.¹⁰²

Second, the SEC adopted Rule 254 without adequately addressing the concerns of state securities regulators.¹⁰³ State regulators have expressed their belief that Rule 254 "deregulates the riskiest securities, small tentative offerings, leaving investors unprotected and vulnerable to sales techniques employed by these businesses."¹⁰⁴ States can impede issuers' use of the test the waters provision by maintaining conflicting regulations or by prohibiting such solicitations outright.¹⁰⁵ Indeed, as one commentator has pointed out, "[i]f the test the waters provision is to be meaningful, it needs the cooperation of [the North American Securities Administrators Association, Inc.] and the blue sky administrators, or preemptive legislation from Congress."¹⁰⁶

Clearly, the test the waters provision underscores the fact that the SEC has placed the interests of small businesses ahead of those of more mature businesses. The ability to test the marketplace prior to incurring

99. For a listing of certain commentators' critical assessment of the Small Business Initiatives in general and Regulation A's test the waters provision in particular, see Note, *supra* note 85, at 494 n.206.

100. The SEC is contemplating the adoption of a similar "test the waters" rule for registered IPOs conducted by nonreporting issuers. See Proposed Rule 135d Release, *supra* note 58, at 86,885. In addition, the SEC has proposed liberalizing the use of "free writing" in the context of registered offerings. See Aircraft Carrier Release, *supra* note 58.

101. See Coffee, *supra* note 27, at 1205-06 (calling Regulation A's test the waters provision a "loophole" and arguing that the adoption of a similar provision, like Proposed Rule 135d, for registered offerings "seems likely to trivialize the preliminary prospectus").

102. See 15 U.S.C. § 77e(c) (1994); 17 C.F.R. §§ 230.134, .135, .137-.139. *But see* Proposed Rule 135d Release, *supra* note 58, at 86,885; Aircraft Carrier Release, *supra* note 58.

103. See *Impact of Small Business Initiatives*, *supra* note 33, at 520-21.

104. *Id.* See also Rosalyn Retkwa, *States Slap Roadblock on SEC's Small Business Initiatives*, CORP. CASHFLOW, Apr. 1993, at 37, 37-39 (explaining how "unethical operators will 'drop the hook' with an oral pitch, and investors won't pay attention to the written disclosure documents that arrive later").

105. See discussion *supra* text accompanying notes 65-69; *Impact of Small Business Initiatives*, *supra* note 33, at 520-21.

106. BLOOMENTHAL, *supra* note 40, § 6.02[6], at 374.

the costs of an offering is a tremendous advantage for small businesses. It is troubling, however, that the SEC appears to have placed the promotion of small businesses above its mandate of investor protection. While the test the waters provision has been chalked up to election year politics¹⁰⁷ and contains some prophylactic measures to protect investors,¹⁰⁸ the fact remains that Regulation A issuers can solicit the general public without concurrently providing them with full disclosure.

C. THE INTERNET AND THE RENAISSANCE OF SMALL ISSUE PUBLIC OFFERINGS

The SIPO exemptions of Regulation A and Rule 504 have had dramatically different histories prior to their use with self-managed offerings over the Internet. Regulation A, on the one hand, is the elder statesperson of the section 3(b) small issue exemptions.¹⁰⁹ Since its adoption in 1936, the maximum amount of capital an issuer can raise under Regulation A has grown from \$100,000 to \$5 million.¹¹⁰ Prior to the late 1970s, Regulation A was widely used by small issuers.¹¹¹ However, with the SEC's adoption of simplified small business registration on Form S-18 in 1979, Regulation A temporarily became a "dead letter."¹¹² In 1992, Regulation A was modestly revived when the SEC adopted the Small Business Initiatives.¹¹³

107. The Small Business Initiatives were announced and hastily enacted soon after "President George Bush announced his intention to assist small businesses as a method of improving economic conditions during the 1992 presidential campaign." *Impact of Small Business Initiatives*, *supra* note 33, at 523.

108. See *supra* notes 90, 94-95, and accompanying text.

109. See HAZEN, *supra* note 33, § 4.15, at 196.

110. When Regulation A was first adopted by the SEC, the maximum amount of an offering permitted under section 3(b) and Regulation A was \$100,000. Pursuant to statutory authorization, the SEC amended Regulation A in 1945 to increase that amount to \$300,000. In 1971, the SEC increased it again to \$500,000. In 1978, the maximum amount of an offering was raised to \$1.5 million, even though the SEC had the authority to increase it to \$2 million. See Increase in Amount of Small Offering Exemption, Securities Act Release No. 5977, [1978 Transfer Binder] Fed. Sec. L. Rep. ¶ 81,710, at 80,877 (Sept. 11, 1978). In July 1992, the SEC increased Regulation A's maximum offering amount to \$5 million. See SBI Release, *supra* note 71, at 62,167.

111. See HAZEN, *supra* note 33, § 4.15, at 196 n.3; SODERQUIST, *supra* note 45, at 139.

112. See SODERQUIST, *supra* note 45, at 139. See also *Impact of Small Business Initiatives*, *supra* note 33, at 516 ("Utilization of the Regulation A exemption had decreased substantially in the years prior to 1992, so the SEC remodeled the exemption to stimulate its use by small businesses."). As a minor piece of anecdotal evidence, this author had never met any securities law practitioner who had ever represented a client in a Regulation A offering or, for that matter, knew anyone who had conducted a Regulation A offering until recently.

113. See BLOOMENTHAL, *supra* note 40, § 6.02[1], at 365; JENNINGS ET AL., SECURITIES REGULATION, *supra* note 45, at 432. Regulation A was revitalized in part by raising its dollar limita-

Rule 504, on the other hand, forms part of Regulation D though it seems ill-suited for such inclusion. Indeed, Rule 504 is largely severed from Regulation D except for the integration provisions of Rule 502(a) and the Rule 503 requirement that a Form D be filed.¹¹⁴ Rule 504, like Regulation A, received a boost in 1992 from the adoption of the Small Business Initiatives and the removal of the rule's public solicitation restrictions, state level filing requirement, and resale restrictions.

While Regulation A and Rule 504 certainly were not created with the Internet in mind, the Internet with its World Wide Web¹¹⁵ appears to be the optimal SIPO launching pad.¹¹⁶ Today, a "plethora of IPO-related sites" exist on the Web and provide "IPO information to users, all instantaneously and free of charge."¹¹⁷ The reasons why the Internet has transformed the way in which SIPOs are conducted and why it will revolutionize the traditional registered offering process in the future are threefold.

First, the Internet minimizes the costs associated with producing offering materials.¹¹⁸ Instead of incurring the substantial expense associated with printing those materials, an issuer engaged in a SIPO can simply place those materials on a Web site established specifically for its offering.¹¹⁹ This has become so incredibly simple that even a nontechnophile

tion to \$5 million, adding the test the waters provision in Rule 254, and adding the good faith compliance provision in Rule 260. See BLOOMENTHAL, *supra* note 40, § 6.02[1], at 365.

114. See 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 5.08[1] (1997).

115. See *supra* note 2.

116. See Loeb & Richter, *supra* note 8, at 325-26 (noting that "development stage issuers . . . may stand to benefit the most from electronic offerings").

117. Cella & Stark, *supra* note 2, at 819 (citing Deborah Lohse, *Want IPO Information? Try the Internet*, WALL ST. J., Oct. 21, 1996, at C1).

118. See Loeb & Richter, *supra* note 8 ("Put simply, cyberspace is a new frontier of securities law, offering a new means of capital formation at a fraction of the cost of traditional methods.").

119. Due to the federal antifraud provisions, an issuer must be careful not to place its circular within any of its existing Web sites, especially one used for marketing its products or services, lest the information that is extraneous to the offering be deemed incorporated by reference into the offering circular. Similarly, an issuer must be careful not to hyperlink its offering Web site to other Web sites, and vice versa, due to the same antifraud concerns.

Yahoo! Inc.'s on-line registered IPO of common stock in 1996 followed these precautionary methods. Yahoo, whose primary business is to assist on-line users by providing hyperlinks to Internet sites of interest, included a copy of the home page of its regular Web site in its on-line prospectus. (Yahoo's Web site address for its offering was <http://ipo.yahoo.com>, however, the on-line prospectus is no longer available.) Yahoo disconnected the hyperlinks on that page to prevent all the information on the Internet that a user could peruse from the home page of its regular Web site from being incorporated by reference into Yahoo's prospectus and thus subjected to the federal antifraud provisions. While this precaution may seem ludicrous to those unfamiliar with securities laws, it underscores the primary need of putting a box around an issuer's on-line offering materials to limit liability.

can succeed.¹²⁰ For example, if a Regulation A issuer makes use of a preliminary offering circular,¹²¹ the issuer can easily amend that circular¹²² or convert it instantly on-line into its final offering circular¹²³ by simply filling in price-dependent information once that information is known.¹²⁴ Indeed, in a pure Internet offering, an issuer need only create an on-line version of its offering materials.¹²⁵

Second, SIPO issuers can minimize the substantial mailing and distribution expenses associated with sending offering materials to potential investors.¹²⁶ Once an issuer places its materials on-line, a potential investor

120. According to Cella and Stark:

Finding space on a server is easy and cheap; promoters of servers have become ubiquitous on the Web and in the telephone yellow pages. Many [Internet] access providers even allocate to users free space for their own Web sites, in exchange for merely signing an access agreement. Moreover, countless software packages offer users simple and easy to follow instructions that make constructing a good looking Web site *as easy as typing a word processing document*. So, building the Web site is a breeze, hooking it up on the Web is a snap, and *you need not be a programmer or technophile to succeed*.

Cella & Stark, *supra* note 2, at 821-22 (emphasis added).

121. Similar to the ability of an issuer in a registered offering to make written offers by means of a preliminary or "red herring" prospectus once its registration statement has been filed with the SEC, a Regulation A issuer is allowed to make written offers by means of a preliminary offering circular once its offering statement on Form 1-A has been filed with the SEC. Compare 15 U.S.C. §§ 77e(b)(1), 77j(b) (1994) (discussing use of preliminary prospectus in registered offering) with 17 C.F.R. §§ 230.251(d)(1)(ii)(B), .255 (1998) (discussing use of preliminary offering circular in Regulation A offering).

122. See 17 C.F.R. §§ 230.252(h), .255(b).

123. The process of creating a preliminary or final offering circular for an on-line offering is virtually the same as for a paper-based offering, except for one wrinkle. In both a paper-based and on-line offering, the text of the offering circular is prepared using any number of popular word-processing programs. Instead of printing and photocopying the circular for distribution, an issuer engaged in an on-line offering can simply convert the word processed document of the offering circular into a computer-based format with the click of a button. Once converted, the reformatted document can be read by an Internet Web browser. In many ways, the conversion process is similar to translating a document in English into Spanish so that it can be read by another audience. Like all conversions, a document will not be converted from a word-processing format to a Web-supported format perfectly the first time, and thus certain remediation must be completed before allowing access to it.

124. See 17 C.F.R. § 230.255(a)(2) (detailing the price-dependent information that may be omitted from a preliminary offering circular).

125. It is hard to predict at what point in the future issuers will only create an on-line version of their offering circulars. To date, all Regulation A issuers known by this author to have conducted on-line offerings created both on-line and paper-based versions of their offering circulars. See, e.g., SPRING STREET OFFERING CIRCULAR I, *supra* note 44; SPRING STREET OFFERING CIRCULAR II, *supra* note 44. The exclusive computerization of offering materials will gradually occur as the investing public becomes increasingly familiar with and dependent on investing on-line and as on-line technology evolves. See Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 77 (1998) (arguing that "Internet offerings will undoubtedly become more successful as investors and issuers become accustomed to electronic offering procedures").

126. According to the SEC, electronic media "enhances the efficiency of the securities markets by allowing for the rapid dissemination of information to investors and financial markets in a more cost-efficient, widespread and equitable manner than traditional paper-based methods." Use of Elec-

“[o]utfitted with a home computer, some software, a phone line, and an Internet access provider”¹²⁷ can either view the offering circular while visiting the issuer’s home page on the Internet or download it electronically for later on-screen viewing or printing if a hard copy is desired.¹²⁸ Thanks to the SEC’s recent proactive position on both prospectus and offering circular delivery requirements,¹²⁹ Regulation A issuers can now satisfy their obligation to deliver a final offering circular electronically.¹³⁰

Because an offering’s home page constitutes a passive informational delivery system, the toughest job of an issuer conducting an on-line SIPO is luring potential investors to that home page to learn more about the offering. But here, too, the Internet can help. First, some of the money saved by not printing and mailing substantial quantities of offering materials can be used for strategically placed advertisements that will alert potential investors to the offering’s existence and home page address.¹³¹

tronic Media for Delivery Purposes Release, *supra* note 11, at 3129. *See also* Choi, *supra* note 25, at 39 (“Through Internet-based offerings, small businesses may reach the attention of potentially thousands, or even millions, of investors with little cost or effort.”).

127. Cella & Stark, *supra* note 2, at 815. *See also* Klein, *supra* note 1, at 90 (“[A]ll the would-be investor had to do was click on the button to view the prospectus, download it, and print it.”).

128. The SEC requires issuers not to make investor access to electronically delivered information unduly burdensome. For example, issuers may not require investors to proceed through “a confusing series of ever-changing menus to access a required document.” Use of Electronic Media for Delivery Purposes Release, *supra* note 11, at 3131-2 n.24. Indeed, investor access to electronic documents must be comparable to the access they have to documents received through the postal mail. *See id.* at 3131-2.

129. *See id.*, *supra* note 11, at 3129 n.9; Loeb & Richter, *supra* note 8, at 321-24. *See also* John R. Hewitt, *SEC Takes Control of Cyberspace*, N.Y.L.J., Aug. 1, 1996, at 5 (stating that the Use of Electronic Media for Delivery Purposes Release demonstrates that the SEC “obviously is encouraging the use of electronic delivery”).

The SEC’s main concerns relating to electronic delivery have been with (1) ensuring that investors are put on notice that they have information meriting their review and (2) evidencing the satisfaction of delivery requirements. With respect to notice, no additional notice is required when information is transmitted via the postal system or through an e-mail. Issuers that transmit information to investors over a passive informational delivery system, such as a home page on the Web, however, must provide investors with actual notice of the availability of the final prospectus or offering circular. Actual notice can be given by e-mail or regular postal mail. *See* Use of Electronic Media by Broker-Dealers Release, *supra* note 11, at 24,646 n.21. With respect to evidencing the satisfaction of delivery requirements, an issuer relying on an electronic medium can do so through:

- (a) obtaining an investor’s informed consent to receive information through a given electronic medium, so long as the requirements of access and notice are also met;
- (b) obtaining actual evidence of delivery, such as a return e-mail receipt or confirmation that an investor has accessed, downloaded, or printed the offering document; or
- (c) obtaining evidence that an investor has accessed another document that contains a hyperlink to the offering document in question.

See Use of Electronic Media for Delivery Purposes Release, *supra* note 11, at 3131-3.

130. *See* Use of Electronic Media for Delivery Purposes Release, *supra* note 11, at 3131-6.

131. For example, Spring Street strategically placed quarter-page ads twice in the sports section of *USA Today*, alerting potential investors to the existence of its first Regulation A offering and its

Second, as discussed earlier in the context of a Regulation A offering, e-mail can be used first to test the waters electronically and later to transmit offering materials to potential investors who have returned indications of interest.¹³² Finally, a number of Web sites have sprung up that provide centralized locations at which prospective investors can learn about public offerings—including Regulation A and Rule 504 offerings—and, in certain cases, private offerings.¹³³

Internet address for the offering. Spring Street also placed ads with respect to its second Regulation A offering. See SPRING STREET OFFERING CIRCULAR II, *supra* note 44, at 6-7. Of course, the same strategy can be used in the context of a registered offering conducted on-line. For example, Salomon Brothers Inc created a home page for Berkshire Hathaway Inc.'s 1996 offering of Class B Common Stock. Salomon placed a full-page ad in the *Wall Street Journal* in conformity with Securities Act Rule 134 to alert potential investors of, among other things, the offering's home page address that included a prospectus and a list of selling group members. See *Berkshire Hathaway Inc. Class B Common Stock Offering*, WALL ST. J., Apr. 22, 1996, at C9.

With the ability to engage in general solicitation and advertising, SIPO issuers have conjured up creative ways to "get the word out" about their offerings. Spring Street, for example, publicized its offerings at beer festivals, through notices placed in retail stores selling microbrew beers, and even on the sides of its six-pack beer cartons in addition to advertising in newspapers. See SPRING STREET OFFERING CIRCULAR II, *supra* note 44, at 6-7. See also John Accola, *Rare Stock: Little-Used Regulation A Offerings Help Small Firms Like Columbine Cellars in Their Quest to Go Public*, ROCKY MOUNTAIN NEWS, Sept. 17, 1995, at 115A (discussing Columbine Cellars Ltd.'s newspaper advertisement encouraging prospective investors to "Be a part of Colorado's Wine Industry!" by participating in Columbine's Regulation A offering); Levingston, *supra* note 14 (discussing offering materials advertised in catalogs of goods (Real Goods Trading Corp.)); Siwolop, *supra* note 13 (showing how some offering materials are advertised or available at coffee shops (Dalton Specialties Ltd.) and on macaroni boxes (Annie's Homegrown)).

132. See discussion *supra* text accompanying notes 85-98; Use of Electronic Media by Broker-Dealers Release, *supra* note 11, at 24,646 n.21 (discussing use of e-mail in connection with satisfying prospectus delivery requirements); SPRING STREET OFFERING CIRCULAR II, *supra* note 44, at 7 ("[T]he Company plans to contact additional potential investors by direct e-mail and regular mail solicitation."). But see Citizens Protection Act of 1997, H.R. 1748, 105th Cong. (proposing to ban transmission of unsolicited advertisements by e-mail and requiring that sender identification be included with e-mails); Amy Harmon, *Biggest Sender of Junk Mail on Internet Agrees to Stop*, N.Y. TIMES, Mar. 29, 1998, at A23 (discussing private and public efforts to stop distribution of junk e-mails). For a discussion of the numerous proposed legislative and industry responses to regulate junk e-mail, see Don Clark, *Start-Up Firm Plans to Attack Unwanted E-Mail*, WALL ST. J., July 20, 1998; Rebecca Quick, *Measures to Rid Cyberspace of 'Spam' Run Into Snags*, WALL ST. J., May 18, 1998, at B1; John Simons, *Various Firms, Groups to Offer Way to Curb Unsolicited E-Mail on Internet*, WALL ST. J., July 14, 1998, at B6.

On a related note, this author recently received offering materials for a private placement via e-mail. The materials were sent to prospective investors who had pre-qualified as accredited, foreign, and/or sophisticated investors on IPONet's Web Site. See E-mail from b-d@iponetusa to Jeffrey J. Hass <jhass@nyls.edu> entitled "Notice of New Private Placement" (Oct. 27, 1998) (on file with author) (containing the Amended Confidential Private Placement Memorandum of Neighborhood Box Office, Inc.).

133. See, e.g., *Direct Stock Market, Inc.* (visited Mar. 1, 1998) <<http://www.direct-stock-market.com>>; IPONet Home Page (visited Mar. 1, 1998) <<http://www.zanax.com/iponet>> (IPONet has recently been folded into Rule506.com located at <<http://www.rule506.com>>.).

The third reason why the Internet has transformed the way in which SIPOs are conducted is that the Internet has at least eased the illiquidity problem associated with SIPO securities by allowing issuers to develop and maintain on-line BBTSSs. BBTSSs solve the most important informational problem associated with illiquid securities—namely, the identities of those interested in selling and buying the securities at any given time.¹³⁴ A typical BBTSS will contain on-line lists of sellers and buyers, including the amount and price of securities willing to be sold or bought, and pertinent contact information such as telephone numbers and e-mail addresses. Individual sellers and buyers may then independently contact each other in order to enter into buy/sell arrangements. The consummation of these arrangements is facilitated by an independent agent, such as a bank stock transfer department or escrow agent hired by the issuer. Because of the substantial opportunity for investor fraud and market manipulation in this area,¹³⁵ the SEC has issued several no-action letters that detail the prophylactic measures that issuers must adopt in connection with their BBTSSs.¹³⁶

The absolute raw power of a SIPO offering conducted over the Internet can be seen in a very simple, yet realistic example. Suppose an embryonic manufacturer of custom-made golf clubs is in need of \$3 million of new capital and is considering raising it in a Regulation A offering. The manufacturer can then conduct an offering in two stages, depending on whether a given state allows for pure or modified test the waters solicitations. In the first stage, prior to expending considerable time and expense on preparing offering materials and engaging in a sales campaign, the is-

134. As Cella and Stark have commented:

[S]ecurities historically doomed to bathe in their own illiquidity and large bid and asked spreads, such as limited partnerships, thinly traded over-the-counter (OTC) "Pink Sheet" stocks, and other securities unavailable for purchase or sale in the traditional marketplace, now have unprecedented ways of increasing their trading volume. Whether through a pairing of a buyer and seller via a simple Internet [BBTSS], or through a more complicated arrangement such as an online trading facility, promoters, buyers, and sellers can meet instantly and transact business at very little cost to one another.

Cella & Stark, *supra* note 2, at 816.

Importantly, self-managed offerings apparently have piqued the interest of at least one stock exchange. The Pacific Stock Exchange spent three years working with state and federal regulators on special listing rules for securities issued in self-managed offerings. To the extent stock exchanges get into the picture, the liquidity problems associated with securities offered in self-managed offerings could greatly ease. See Levingston, *supra* note 14.

135. In particular, the SEC is "concerned that investors' funds and securities be handled appropriately, that investors understand the risks involved in purchasing illiquid and speculative securities, that buyers are aware of last sales prices and that investors are provided with ongoing disclosure about the [issuer]." Spring Street No-Action Letter, *supra* note 11, at 77,001.

136. See, e.g., *id.*; Real Goods Trading No-Action Letter, *supra* note 11, at 77,131.

suer can “spam”¹³⁷ golf aficionados in those states that do allow some variant of the test the waters provision. By doing so, the issuer can gauge the interest of those potential investors in the proposed offering. Based on the information obtained, the issuer should then be in a position to extrapolate nationwide interest in the offering and make a decision about whether to proceed. In the second stage—assuming the issuer decides to proceed with the offering—the issuer may send offering materials via e-mail to those who expressed interest. The issuer can also “spam” golf aficionados in states without test the waters provisions with offering materials after registering its offering in those states.¹³⁸

Figuring out whom to spam is a very easy task. In much the same way merchandisers purchase mailing lists from a variety of sources, e-mail lists can also be purchased.¹³⁹ These lists can be custom-tailored to fit the particularized needs of the issuer. In the case of the golf club manufacturer, it could purchase a list of the e-mail addresses of all subscribers to *Golf Digest* magazine, for example, and then simply conduct a massive “junk” e-mail distribution to those subscribers at very little cost to itself.¹⁴⁰

137. “Spamming” refers to the sending of unsolicited e-mails to multiple recipients. It is the Internet’s equivalent to “junk” mail. The terms “spamming” and “spam” were coined from a skit performed by the comedic group Monty Python during which the word “spam” was repeated ceaselessly. See Amy N. Lipton & Jennifer S. Taub, *Real World Examples of Successful Electronic Commerce*, in *DOING BUSINESS ON THE INTERNET: THE LAW OF ELECTRONIC COMMERCE* 405, 419 (1996).

138. Of course, this two-stage offering process can be modified. For example, an issuer that conducts test the waters solicitations may find enough potential investors in the test the waters states to avoid having to conduct the offering in states without test the waters provisions. Alternatively, an issuer could proceed directly with a full-fledged Regulation A offering in a number of states without regard to whether or not those states allow for test the waters solicitations.

139. See, e.g., E-mail from Kellner Enterprises <Mail4cash@usa.net> to Jeffrey J. Hass <jhass@nyls.edu> entitled “\$\$\$\$. . .” (received Dec. 1, 1998) (on file with author) (offering to sell a compact disc with 30 million e-mail addresses for \$169 plus tax and shipping).

140. Accomplishing this type of e-mail distribution is becoming easier. Recently, the Direct Marketing Association stated the following with regard to a seminar it offered for marketing via e-mail:

E-mail is one of the most powerful new direct marketing tools to come along in decades. Attend this special seminar and you’ll learn everything you need to know to make it work for you *including*:

- How to identify and purchase bonafide Spam-free e-mail lists;
- How to write e-mail copy that sells;
- How to piggyback other company’s e-mailings through sponsorships and banner ads;
- How to target your e-mail to reach your prime prospects;
- How to develop and maintain your own in-house e-mail list—or how to effectively out-source the project;
- How to measure results.

DIRECT MARKETING ASS’N, *A CRASH COURSE IN EMAIL MARKETING* (1997) (on file with author) (promoting a seminar on the utility of e-mail for direct marketing).

Issuers not interested in conducting the actual spamming can hire others for the job. The expense involved with spamming is minimal; in fact, one company paid a spammer only \$1,000 to send e-mails to 800,000 addresses. See Lipton & Taub, *supra* note 137, at 420. Cyber Promotions, Inc.,

Another practice that aids in locating potential investors is “mining.” Mining is the collection of e-mail addresses from a particular newsgroup—one involving golf, for example—by operating a user-friendly automated software mining program.¹⁴¹

II. UNDERWRITTEN OFFERINGS VERSUS SELF-MANAGED OFFERINGS: INVESTMENT BANKS AND THEIR ROLE IN PROTECTING INVESTORS

A SIPO issuer can either choose to self-manage its offering¹⁴² or, at least in theory, engage the services of one or more investment banking firms to underwrite its offering.¹⁴³ If a SIPO issuer is successful in enticing an investment bank to underwrite its offering, that bank, rather than the issuer, will be directly responsible for the marketing and sales functions relating to the offering. For the reasons that follow, however, it is the rare SIPO that is underwritten.

The first and overriding reason for this rarity of underwriting stems from investment banks’ concern for the bottom line. Underwriters receive a discount on the stock they purchase in an amount ranging from six to ten percent of the aggregate offering proceeds.¹⁴⁴ Assuming that a particular Regulation A issuer is seeking to raise the maximum amount of \$5 million, the underwriting commission will range from \$250,000 to \$500,000. Underwriters, on the one hand, will likely view this commission as trifling in

whose president is known as both the “Spam King” and “Spamford” (his Internet nickname), had claimed to have over 4,000 clients before falling on hard times. *See id.*; Harmon, *supra* note 132 (discussing Cyber Promotions agreement “to pay \$2 million to settle the last of several lawsuits brought against it by Internet service providers”). *See also* Jared Sandberg, *AOL Declares Win Over Junk E-Mailer and Will Receive Unspecified Damages*, WALL ST. J., Dec. 19, 1997, at B6 (discussing America On-line’s federal court victory over the spammer Over the Air Equipment Inc.).

Issuers can also engage in do-it-yourself spamming. “Thanks to the development of readily available junk-mail software packages and mailing lists, virtually anyone can set up shop as a spammer.” Thomas E. Weber, *EarthLink Deal Bars Junk E-Mail from Marketer*, WALL ST. J., Mar. 30, 1998, at B8.

141. *See* Cella & Stark, *supra* note 2, at 830.

142. “Self-managed” means that the issuer itself performs the marketing and sales functions of the offering, rather than having an underwriter perform those functions.

143. Regulation A contains provisions addressing the use of one or more underwriters. *See, e.g.*, 17 C.F.R. §§ 230.251(d)(2)(ii), .255(a)(2) (1998); Form 1-A, Part I, Item 1(i)-(m); JENNINGS ET AL., FEDERAL SECURITIES LAWS, *supra* note 35, at 357.

144. *See* Stoel Rives Boley Jones & Grey, GOING PUBLIC 3 (4th ed., RR Donnelley Fin.) [hereinafter GOING PUBLIC]; Graham, *supra* note 14, at 76. It should be noted that underwriting arrangements and underwriter compensation for an offering are reviewed by the NASD, which is the securities industry’s self-regulatory organization, “to ensure that ‘arm’s length’ transactions are maintained.” Hambrecht & Quist, *The Initial Public Offering Process, How to Prepare an Initial Public Offering* at 397 (PLI Corp. Law & Practice Course Handbook Series No. B4-7043, 1993).

light of the time and effort to be expended and the potential for liability under the securities laws.¹⁴⁵ On the other hand, a Regulation A issuer—especially the “do-it-yourself” maverick considering Internet IPOs—will be reluctant to share any proceeds with an underwriter, much less reimburse that underwriter for out-of-pocket expenses.¹⁴⁶

Reputational concerns, however, also provide investment banks with a strong incentive to avoid SIPOs. Because most SIPO issuers are not seasoned companies,¹⁴⁷ investment banks are squeamish about selling the securities of those issuers to the institutional and retail clientele they worked so hard to develop.¹⁴⁸ In fact, in discussing the price performance of a stock following its offering, one commentator noted:

[Aftermarket performance] can serve as a proxy for the investment bank's credibility with investors and the perceived ability of the firm to provide and assess good opportunities. Investors will be more receptive to transactions managed by an investment bank that has a history for taking quality companies public. A solid track record of aftermarket performance gives the investment bank's sales force a substantial advantage.¹⁴⁹

In sum, investment banks seek to underwrite those offerings that will prove profitable to both themselves and their investor clientele. By achieving that goal, investment banks will increase their reputational capital and consistently be able to go back to their clientele with future offerings. All this leaves the vast majority of SIPO issuers without underwriters for their offerings. With the advent of the Internet and related technologies, however, this is not the problem it once was.

145. See Hambrecht & Quist, *supra* note 144, at 402. In fact, “[m]ost major bracket investment banks will not manage IPOs less than \$15 million.” *Id.* at 409.

146. As some commentators have stated:

It is theoretically possible for a company to sell its stock directly to the public (“self-underwrite”) without the use of a conventional underwriter or professional intermediary. Some entrepreneurs approach the going public process with a high degree of confidence that they can locate investors directly. As a practical matter, however, it is extremely difficult, absent unusual circumstances, to have a successful public offering of significant size without the participation of professional underwriters.

SCHNEIDER ET AL., *supra* note 47, at 13. See also Levingston, *supra* note 14 (discussing Annie's Homegrown, a company that “balked at using expensive Wall Street underwriters in pinstripes,” electing instead to “[sell] the shares ‘direct’ to the public”).

147. Recall that reporting companies cannot issue securities under either Regulation A or Rule 504. See 17 C.F.R. §§ 230.251(a)(2), .504(a)(1).

148. See SCHNEIDER ET AL., *supra* note 47, at 9 (“There are some small and speculative offerings for which the trick is to find any underwriter . . .”). See also *infra* text accompanying notes 172-73 (discussing targeting of institutions and high net worth retail investors by underwriters attempting to sell securities).

149. Hambrecht & Quist, *supra* note 144, at 406. See also GOING PUBLIC, *supra* note 144, at 5; FRANKLIN A. GEVURTZ, BUSINESS PLANNING 525-26 (2d ed. 1995).

A. WHAT INVESTMENT BANKS ADD TO THE MIX

Services that underwriters provide can be broken down into the following four categories: merit review, due diligence, suitability, and after-market support.¹⁵⁰ As described below, these services play an instrumental role in the protection of investors. Because these services are not performed to the same extent in the self-managed SIPOs context, unsophisticated retail investors targeted by SIPO issuers confront serious risks not faced by investors participating in traditional underwritten offerings.

Perhaps the most important service that an underwriter performs is a cold-hearted review of the merits of a proposed offering: Should the securities of this particular issuer be offered to the public in the first instance? An underwriter's merit review is crucial because, except in specific instances,¹⁵¹ the SEC is prohibited from reviewing the merits of a proposed offering.¹⁵² In addition, this merit review is important because many investors buy securities based wholly or partially on the reputation of the investment bank underwriting the offering.¹⁵³ In other words, these investors bet on the jockey rather than the horse.

Unlike the merit review performed by the state blue sky administrators of certain states,¹⁵⁴ the merit review performed by underwriters cen-

150. While not the focus of this Article, it is important to note the multidimensional sales function performed by investment banks. This ranges from knowing who the customers are and how to contact them to socializing rough-edged entrepreneurs for their public capital-raising debut. For an excellent discussion of the socialization aspects of the underwriting process, see Langevoort, *supra* note 26, at 16-18. See also Comment Letter from Perry L. Taylor, Jr., Chairman, Capital Markets Committee of the Securities Industry Association, to Jonathan G. Katz, SEC Secretary, § 2 (Sept. 19, 1995) (discussing the filtering role provided by investment banks in the IPO process).

151. See, e.g., 15 U.S.C. § 77g(b) (1994); 17 C.F.R. § 230.419 (relating to offerings by "blank check" companies).

152. According to one commentator:

After considerable debate, Congress decided not to follow the pattern of the state [securities] acts and eschewed the idea of a merit approach, opting instead for a system of full disclosure. The theory behind the federal [securities law] framework is that investors are adequately protected if all relevant aspects of the securities being marketed are fully and fairly disclosed. The reasoning is that full disclosure provides investors with sufficient opportunity to evaluate the merits of an investment and fend for themselves. It is a basic tenet of federal securities regulation that investors' ability to make their own evaluations of available investments obviates any need . . . for the more costly and time-consuming governmental merit analysis of the securities being offered.

HAZEN, *supra* note 33, § 1.2, at 7.

153. See Stephen P. Ferris, Janine S. Heller, Glenn A. Wolfe & Elizabeth S. Cooperman, *An Analysis and Recommendation for Prestigious Underwriter Participation in IPOs*, 17 J. CORP. L. 581, 584 (1992) ("The participation of a particular underwriter gives a 'seal of approval' to buyers who may not be familiar with the company that is going public, but who are familiar with the underwriter and its reputation.").

154. See *infra* text accompanying notes 183-84.

ters around profit: Will the proposed offering prove profitable to both the underwriter and its investor clientele,¹⁵⁵ most of which are highly sophisticated institutional investors? These twin profitability goals are closely intertwined. Indeed, if the issuer, its offering, and its prospects for the future are not initially appealing to investors, the underwriter may not be able to place the issue and collect its commission. Once the deal is sold, a poor showing of the securities in the aftermarket can drain the underwriter's reputational capital and its ability to place additional securities with its investor clientele in the future. By favoring issuers with good business stories that currently have "sustainable revenues and consistent operating margins,"¹⁵⁶ investment banks prevent many unseasoned issuers from infiltrating the IPO gene pool. Issuers, of course, valiantly try to convince the banks that they indeed are ready for prime time.¹⁵⁷

Underwriters are also prodded into protecting investors by the *in terrorem* effect of section 11(a) of the Securities Act.¹⁵⁸ That section imposes liability on underwriters for material misstatements and omissions in registration statements. According to one commentator:

[This liability is] based on the premise that an underwriter is in a unique relationship with the issuer and can act as the devil's advocate to pressure the issuer for adequate and truthful disclosure. If the underwriter

155. Before a particular offering is given the green light, a team of investment bankers will perform a thorough review of the issuer's financial condition and operating prospects. Typically, one or more team members will discuss the merits of the offering with the underwriting committee of the investment banking firm. PaineWebber Incorporated, for example, has an underwriting committee that must give its approval before the firm can participate as an underwriter for a given offering. See Telephone Interview with Dan Mittman, First Vice President and Associate General Counsel, Investment Banking Division of PaineWebber Incorporated (Mar. 27, 1998).

156. Hambrecht & Quist, *supra* note 144, at 400. Hambrecht & Quist adds that: "The company should first consider whether it is indeed ready to go public. The more predictable a company's results of operations, the more 'ready' it is for an IPO." *Id.*

Another factor that an investment bank will examine is whether a prospective issuer is the type of company with which it can establish a long-term business relationship. An investment bank hopes that the issuer will direct additional business to it in the future, such as secondary offering underwritings or tender offer management.

157. As one commentator has noted:

If the company is a so-called start-up company, has no prior history of earnings or, for various reasons, may be considered speculative, it may be unable to obtain an underwriter to sell its securities. If it succeeds in finding an underwriter, the underwriter may not have sufficient capital to handle a firm [commitment] underwriting and probably will insist on a so-called best-efforts underwriting.

BLOOMENTHAL, *supra* note 40, § 6.01, at 363.

158. Securities Act section 11(a) states:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue . . . [e]very underwriter with respect to such security.

15 U.S.C. § 77k(a) (1994 & Supp. III 1997).

does not agree with the information in the registration statement, it can refuse to proceed with the sale.¹⁵⁹

Underwriters can avoid this liability by proving the affirmative defense of "due diligence" under section 11(b) of the Securities Act.¹⁶⁰ To do so, they and their legal counsel must have conducted an often painstaking double check of the disclosure contained in a registration statement.¹⁶¹ If the underwriters fail to adequately perform their role as gatekeepers of informational veracity, disgruntled investors can sue them for damages.¹⁶²

Underwriters also perform a suitability function that helps protect investors. As described in greater detail below,¹⁶³ "suitability" in this context refers to the determination of whether a particular security is right for a given investor. Because "[m]ost, if not all, underwriters of any securities offering will generally be members of the [NASD],"¹⁶⁴ their sales efforts will be subject to the NASD Conduct Rules.¹⁶⁵ One of these rules requires any broker-dealer who recommends the purchase, sale, or exchange of a security to a client to ensure that the recommendation is suitable for that client, given the client's financial status, tax status, investment objectives, and other pertinent information.¹⁶⁶ Members of the underwriting syndicate and selling group for a particular offering must make suitability determi-

159. Ferris et al., *supra* note 153, at 584 (citation omitted).

160. Securities Act section 11(b) states:

Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof . . . [t]hat: (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, . . . he had, after reasonable investigation, reasonable ground to believe and did believe . . . that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading

15 U.S.C. § 77k(b).

161. For a description of the due diligence review process, see generally GARY M. LAWRENCE, *DUE DILIGENCE IN BUSINESS TRANSACTIONS* (1997). The seminal cases discussing the due diligence defense include *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); and *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

162. See 15 U.S.C. § 77k(a)(5). Performing due diligence also helps preserve an underwriter's reputational capital. As explained by one commentator:

Financial intermediaries . . . have reputations to protect as repeat players in the capital marketplace. They may suffer in terms of future business if they attest to the quality of the issuer and fraud is later discovered. Thus, they take steps to investigate before associating. Recognizing this, investors are more likely to rely on the disclosures when a reputable intermediary is involved, and hence demand less of a risk premium.

Langevoort, *supra* note 26, at 14.

163. See *infra* text accompanying notes 195-96.

164. HAZEN, *supra* note 33, § 2.1, at 77.

165. See NASD MANUAL CONDUCT RULES at 4101 (National Ass'n of Sec. Dealers, Inc. 1996).

166. See *id.* IM-2310-2 (discussing Conduct Rule 2310); 17 C.F.R. § 240.15g-1 (1998); 17 C.F.R. § 240.15g-9 (applicable to penny stocks as defined in Exchange Act Rule 3a51-1, 17 C.F.R. § 240.3a51-1).

nations whenever they recommend the securities being offered to their clientele. Those determinations, however, are not required when a particular customer unilaterally places an order for those securities.

Finally, lead underwriters protect investors by providing aftermarket support services. Indeed, many issuers choose an underwriter based on its ability to provide this support.¹⁶⁷ Members of the firm of Hambrecht & Quist described this support in the following way:

In the aftermarket, the managing underwriters of the IPO will usually provide services for the company through their research, sales and trading departments. The research department of each managing underwriter will write and distribute periodic reports which provide an evaluation of the company's stock as an investment through an analysis of the company's performance and detailed projections for the company's near-term operating results. Such reports target an audience of institutional investors, brokers and the financial press. Active and effective research coverage can affect the stock price of a company by stimulating buying demand or selling interest. For companies going public on the NASDAQ market, the sales and trading departments of the managing underwriters will devote resources to market making activities. For a substantial period of time after the offering, the managing underwriters will be the most active participants in the trading of the stock. The managing underwriters' familiarity and relationship with the major buyers and sellers of the stock and their active market making provide increased support for the stock.¹⁶⁸

Thus, the aftermarket support provided by an underwriter provides a vital service to both the issuer and investors that is generally absent in a self-managed SIPO.

B. THE INABILITY OF UNPREFERRED RETAIL INVESTORS TO PARTICIPATE MEANINGFULLY IN UNDERWRITTEN IPOs

Unpreferred retail investors have long sought to participate in IPOs underwritten by mainstream investment banks but have met with little success.¹⁶⁹ These investors' appetite for IPO shares has only grown during

167. See Hambrecht & Quist, *supra* note 144, at 404.

168. *Id.* at 405. See also SCHNEIDER ET AL., *supra* note 47, at 12 (discussing aftermarket support generally).

169. As explained by Wit Capital:

In traditional Initial Public Offerings, corporate issuers sell shares to underwriters who resell the shares to institutions and very wealthy individuals. Many of these buyers in turn hope to profit by quickly 'flipping' the shares to ordinary individual investors and smaller institutions.

the unprecedented bull market of the 1990s. Unfortunately, “[i]t is no news that underwriters make most of the shares in hot IPOs available not to the little-guy investor but to institutions, such as mutual-fund companies and pension funds, that provide a lot of trading commissions and other business.”¹⁷⁰ Those individuals that do succeed in participating in a hot IPO often are coerced by underwriters into a buy and hold strategy while institutions remain free “to dump hot new stocks at their whim, often within hours or minutes of the stock’s first trade.”¹⁷¹ Accordingly, the

Aided by brokers who actively promote new issues to their individual investor customers, the process generally works well for underwriters and their preferred customers: The average IPO rises 18 percent in value in the first few hours of public trading.

But individual investors are virtually excluded from the rewards. They rarely get to buy shares at the offering price. Moreover, when they do buy in the secondary market, they have to pay brokerage commissions.

Retail. When asked about retail distribution, underwriters often agree to distribute 15 to 25 percent of a deal to individual investors through traditional retail brokerage.

Notwithstanding the good intentions of their capital markets professionals, however, the major firms have never been able to discipline branch office managers or powerful brokers.

The result is always the same: shares allocated for retail wind up in the accounts of very wealthy, preferred investors intent on flipping.

Wit Capital Home Page, *Raising Capital* (visited Dec. 2, 1997) <<http://www.witcapital.com/ibs/capital/raise.html>>.

An unpreferred retail investor’s best chance to participate in a particular IPO occurs when (1) subscriptions from an underwriter’s traditional investor base (institutional investors and preferred retail investors) are insufficient to sell all the shares in the IPO and/or (2) that investor’s brokerage account is with the underwriter’s broker-dealer division or subsidiary.

170. Michael Siconolfi, *Underwriters Set Aside IPO Stock for Officials of Potential Customers*, WALL ST. J., Nov. 12, 1997, at A1. See also Cella & Stark, *supra* note 2, at 819 (“[S]mall investors often remain out of luck when it comes to getting in on the hottest initial public offerings . . .”); Langevoort, *supra* note 26, at 25 (“The triple forces of technology, institutionalization and internationalization are rapidly creating markets for securities beyond the direct reach of smaller investors, and segmenting those to which the smaller investor does have access.”); *Briefly*, L.A. TIMES, Aug. 29, 1996, at D2 (citing research of the National Council of Individual Investors that revealed that small investors were denied the opportunity to earn profits of up to \$1.1 billion in 1995 because they were shut out of IPOs); Rebecca Buckman, *More On-Line Brokers Seek Access to IPOs*, WALL ST. J., July 21, 1998, at C1 (“[T]he best [IPO] deals are usually reserved for powerful institutional investors.”); Deborah Lohse, *IPO Market Still Cooking, But with a Lack of Sizzle*, WALL ST. J., Nov. 17, 1997, at C1 (in discussing the quick rise or “pop” in IPO share prices by 15% or more in their first trading day, Lohse argues “[t]hat pop is rarely available to small individual investors, who aren’t invited into the ground floor of most quality IPOs.”).

171. Michael Siconolfi & Patrick McGeehan, *Wall Street Brokers Press Small Investors to Hold IPO Shares*, WALL ST. J., June 26, 1998, at A1. Underwriters pressure retail investors indirectly by punishing those brokers whose retail clientele flip IPO shares. In such cases, underwriters often take away brokerage commissions from those brokers. Brokers in general, therefore, have a strong incentive to exclude those retail investors likely to flip shares from participating in IPOs in the first place.

Wit Capital, by contrast, directly penalizes its customers who flip IPO shares within 60 days of purchase. It does so by maintaining a rating score for each customer that tracks that customer’s record for buying and holding public offering shares. Customers who flip shares score negative points and thus reduce the likelihood that they will obtain shares in subsequent public offerings. See *Wit Capital*

typical unpreferred retail investor's hope is that one of the mutual funds in which she may own shares will purchase shares in quality IPOs.

The bias against the unpreferred retail investor is not really a bias at all. It is simply a recognition by the investment banking community as to which side of their bread is buttered and, more importantly, who holds the butter knife. Underwriters consistently go back to the same investors to sell the securities they underwrite. These investors are institutional investors and "preferred" retail investors.¹⁷² Underwriters also favor individuals in decisionmaking roles at potential clients.¹⁷³ Because these investors frequently participate in offerings that are undersubscribed, investment banks often reward them by including them in oversubscribed offerings. Simply stated, the typical unpreferred retail customer is not given the opportunity to buy shares in a hot IPO because that customer was nowhere to be found when shares in more mundane offerings were previously sold.

Some efforts have been made to include more unpreferred retail investors in underwritten IPOs. For example, Fidelity Brokerage Services, Inc. ("Fidelity") recently formed an exclusive strategic alliance with Salomon Smith Barney Holdings, Inc. ("Salomon") to offer Fidelity customers access to IPOs and secondary offerings underwritten in a lead manager capacity by Salomon.¹⁷⁴ According to Fidelity, "[t]his arrangement [with Salomon] makes Fidelity Brokerage the first discount broker to offer their customers new issue equity securities of significant size and number."¹⁷⁵

Home Page, Wit Capital Rules & Procedures (visited Dec. 1, 1998) <<http://www.witcapital.com/rules/purchase.html#flipsec>>.

172. Institutional investors include, among others, investment companies (mutual funds), banks, retirement plans, and insurance companies. "Preferred" retail investors typically include individuals qualifying as "accredited investors" due to their high net worths and/or income levels. See 17 C.F.R. § 230.501(a)(5)-(6) (1998) (setting forth the accredited investor standard for natural persons for purposes of Regulation D).

Because these investors, particularly institutional investors, generally subscribe for large blocks of securities, underwriters who sell to these investors achieve certain efficiencies that are not realized when selling to unpreferred retail investors. As some commentators have noted: "[I]nstitutional investors often will pay a higher price than retail investors for securities of a company with highly favorable prospects if the institutional investors are able to purchase securities in sufficient quantity." SCHNEIDER ET AL., *supra* note 47, at 8.

173. See Michael Siconolfi, *Unexpected Turn: The Issue of 'Spinning' Ended Merrill's Interest in Hambrecht & Quist*, WALL ST. J., Feb. 13, 1998, at A1 ("Spinning occurs when an underwriter allocates IPO shares to the personal brokerage account of a corporate or venture-capital executive—shares often sold, or 'spun,' for quick profit—in a possible bid [for] future business from the executive's company.").

174. See FIDELITY BROKERAGE SERVS., INC., INITIAL PUBLIC OFFERINGS AND SECONDARY OFFERINGS: ADDED ADVANTAGES FOR THE FIDELITY BROKERAGE ACCOUNT (1997) (brochure on file with author) [hereinafter FIDELITY IPO BROCHURE].

175. *Id.*

By acting as a selling group member of an offering underwritten and lead-managed by Salomon, Fidelity generates commissions under the alliance when it sells securities to its customers.¹⁷⁶

Others, too, have jumped on the IPO bandwagon.¹⁷⁷ Discount broker Charles Schwab & Company (“Schwab”) recently entered into an arrangement with three underwriters, JP Morgan, Hambrecht & Quist, and CS First Boston, allowing certain Schwab brokerage customers access to IPO shares in offerings managed by one of those underwriters. Access, however, is restricted to brokerage customers maintaining high balances and/or executing a specified number of trades.¹⁷⁸ Because of these strings, the Schwab plan offers the true unpreferred retail investor nothing more than the cold shoulder he already knows all too well.

While some of these efforts are helpful to unpreferred retail investors, they are unlikely to change in any material way the financial benefits that underwriters reap by presenting offerings first and foremost to their traditional client base. All of this, of course, plays very nicely into the hands of SIPO issuers planning Internet offerings. As Joseph Cella and John Stark have noted:

The entrepreneur, the inventor, and the small business owner now have a cheap and efficient alternative means to reach millions of potential interested parties without the expense of a road show, without hiring the usual cadre of lawyers and financial advisers, without hiring a printing service, and, most of all, without leaving the house.¹⁷⁹

In turn, these “potential interested parties”—read “unpreferred retail

176. *See id.*

177. *See* Buckman, *supra* note 170. Not surprisingly, Wit Capital has taken the most aggressive role in attempting to include unpreferred retail customers in quality IPOs. “[Wit Capital] offer[s] individual investors unprecedented first come, first serve access to investment opportunities and services Wall Street has long denied to individuals, such as IPOs of major underwriters at the offering price and venture capital offerings.” E-mail from Wit Capital <alex@witcapital.com> to the Jeffrey J. Hass <jhass@nyls.edu> entitled “Wit Capital Update—Unprecedented Investment Opportunities” (Sept. 16, 1997) (on file with author). Wit Capital’s experiment, however, has apparently met with mixed results. *See* Truell, *supra* note 10; Buckman, *supra* note 170. Lately, the demand for IPO shares distributed by Wit Capital has far outstripped the supply, leaving many of Wit Capital’s customers with no shares at all. *See* E-mail from Wit Capital <NewIssueAlert@witcapital.com> to Jeffrey J. Hass <jhass@nyls.edu> entitled “New Issue Allocation” (Feb. 16, 1999) (on file with author).

178. Shares can be accessed by either Schwab 500 investors (those who engage in a minimum of four trades per month and have an account balance of at least \$50,000 in equity) or Schwab Priority Gold investors (those who have a minimum account balance of \$1 million but are not required to engage in a minimum amount of trades). *See* Telephone Interview with Paul Bishop, Broker at Charles Schwab & Co. (March 3, 1998). *See also* Buckman, *supra* note 170 (“[A]t discount firms that do get some [IPO] shares, such as Schwab, Fidelity and E*Trade, demand for the deals generally far exceeds supply. And often, only such firms’ best customers are eligible.”).

179. Cella & Stark, *supra* note 2, at 816.

investors”—are turning to the Internet “as a place where they can discover that golden investment opportunity.”¹⁸⁰ They are anxious to learn about any IPO in the hope of getting in on the ground floor. Exacerbating this problem “is the remarkably benevolent culture and trustworthy nature of Internet users.”¹⁸¹ Because these offerings are almost always self-managed, however, these investors receive few of the crucial investor protections provided by underwriters in the context of a traditional underwritten offering.

III. SUITABILITY AND THE RETAIL INVESTOR

When addressing the relationship between suitability and the retail investor, important questions must be answered. What exactly does “suitability” mean in this context? How does suitability differ from the concepts of merit review and full disclosure, two other mainstays of investor protection? These questions are important because if suitability concerns are already fully addressed by those other concepts, then nothing needs to be done to regulate self-managed SIPOs conducted over the Internet by unseasoned companies. If, however, those concerns are not fully addressed, then the SEC should adopt appropriate regulatory changes.

A. MERIT REVIEW, FULL DISCLOSURE, AND SUITABILITY

“Merit review” is a particularly subjective concept that varies depending on the specific standards employed by the individual or entity performing the review. A review of an offering’s merits may be made by either a financial intermediary, a state blue sky administrator, or both, depending on the type of offering in question. Of course investors, including unpreferred retail investors, conduct their own merit review when determining whether to purchase a particular issuer’s securities. While many investors are in a position to “fend for themselves” upon receipt of full and fair disclosure about an issuer and its offering, many cannot. It is with respect to these vulnerable investors that suitability concerns arise.

As seen earlier in this Article, prospective underwriters review the merits of an offering in order to determine whether the offering makes financial sense for themselves and their investor clientele.¹⁸² By contrast, state blue sky administrators who review the merits of an offering subjectively review that offering to determine whether or not it meets “a mini-

180. *Id.* at 816-17.

181. *Id.* at 827.

182. *See supra* text accompanying notes 151-57.

num level of fairness.”¹⁸³ These administrators “speak for the average investor in good faith” in order to ensure that an offering is initially worthy of *any* investor’s consideration, much less any specific investor’s consideration.¹⁸⁴ In either case, the focus of the reviewer is always on characteristics relating to the issuer and the offering, rather than on those relating to a particular investor.

Full disclosure—the target at which the federal securities laws are primarily aimed¹⁸⁵—is also a concept unconcerned about the characteristics of a particular investor. Like merit review, full disclosure is issuer- and offering-specific. Unlike merit review, full disclosure operates on the premise that each and every offering is meritorious, no matter how speculative or complex, so long as investors have adequate and truthful disclosure about the offering and its issuer upon which to base their investment decisions.¹⁸⁶ Once full disclosure is made, “it is not within the prerogative of the [SEC] to prevent a financial product from coming to the marketplace.”¹⁸⁷ Indeed, “[t]he SEC’s mandate is to provide protection through disclosure.”¹⁸⁸ Once investors have been supplied with full disclosure, they are left to fend for themselves—to decide based on that information whether or not to invest.¹⁸⁹

In essence then, full disclosure rests squarely on the noble proposition that, from an investing perspective, “all persons are created equal.” Give investors the information they need, preferably in a readable format,¹⁹⁰ and

183. Manning Gilbert Warren III, *Legitimacy in the Securities Industry: The Role of Merit Regulation*, 53 BROOK. L. REV. 129, 136 (1987). See also SCHNEIDER ET AL., *supra* note 47, at 25 (while state standards vary, each generally requires an offering to be “fair, just and equitable”); Cheryl T. Farson, *At What Cost Paternalism? A Call to State Legislatures to Reconsider the Propriety of Merit Review of Securities Offerings*, 22 ARIZ. ST. L.J. 963, 963 (1990) (arguing that, while there is no universally accepted definition of “merit review,” many merit standards require offerings to be fair, just, and equitable).

184. Warren, *supra* note 183, at 137. According to one commentator:

[Blue sky] statutes emerge from the basic assumption that, without regulation, investors are unable to make intelligent investment decisions. This assumption is based on three factors. First, the average investor does not have access to information and relies on the issuer or underwriter for material information regarding the offering. Second, information available to the underwriter is so complex that even sophisticated analysts find risk assessment difficult. Third, average investors, if provided with the information, are incapable of properly evaluating the material facts necessary for determining an investment’s merit.

Farson, *supra* note 183, at 965-66.

185. See *North Star Int’l v. Arizona Corp. Comm.*, 720 F.2d 578, 582-83 (9th Cir. 1983).

186. See SCHNEIDER ET AL., *supra* note 47, at 25.

187. Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105, 117 (1987).

188. Warren, *supra* note 183, at 136.

189. See SECURITIES AND EXCHANGE COMM’N, *THE WORK OF THE SEC 3-4* (1986).

190. The SEC now requires issuers to write their prospectuses and other offering materials in “plain English” and with a minimum of legalese. See Securities Act Rule 421(b), (d), 17 C.F.R.

they will be able to make informed investment decisions. Because investing IQs and financial circumstances vary widely from person to person, however, this proposition is highly suspect.¹⁹¹ It is a little like saying that anyone who reads through the owner's manual for a sophisticated four-head VCR with toggle control magically will be able to edit and dub his own home movies. The irony of all this is that not even the SEC itself has complete faith in a system based on full disclosure.¹⁹² One need not look any further than the "purchaser" sophistication requirement in Securities Act Rule 506¹⁹³ and the SEC's own suitability rule for penny stocks¹⁹⁴ for evidence of this.

Unlike the concepts of merit review and full disclosure, suitability is an inherently investor-specific concept. In fact, the NASD's suitability rule is referred to as the "Know Your Customer Rule."¹⁹⁵ While a particular investment may be suitable for Investor A, it may be totally unsuitable for Investor B. In this instance, it is not the particular offering, issuer, or disclosure that has changed, but rather the identity of the investor. Thus, the suitability of an investment is measured against the fundamental characteristics of a particular investor. The characteristics of the particular

§ 230.432(b), (d) (1998); Regulation S-K, Items 501-503, 17 C.F.R. §§ 229.501-.503; Plain English Disclosures, Securities Act Release No. 7497, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,003, at 80,125 (Jan. 28, 1998); Plain English Disclosures, Securities Act Release No. 7380, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,879, at 88,902 (Jan. 14, 1997). See also BLOOMENTHAL, *supra* note 40, § 5.03[3] (explaining, by example, the SEC's Plain English Initiative); J. Peder Zane, *For Investors, an Initial Public Offering of English*, N.Y. TIMES, Aug. 25, 1996, § 3, at 7 (discussing how the Plain English Initiative will affect mutual fund prospectus disclosure).

191. Indeed, Professor Langevoort questions the "self-protective ability" of even certain accredited investors, particularly those whose high incomes are derived from activities requiring no financial acumen. See Langevoort, *supra* note 26, at 22-23. He calls for empirical work in this area, speculating that "our traditional form of regulation—mandatory disclosure—[may add] less value than we think, precisely because other influences dominate the decision-making process." *Id.* at 23.

192. Former SEC Commissioner Francis M. Wheat comments in his report (*Wheat Report*) to his SEC colleagues:

At what audience should disclosure be aimed? Is the literature elicited by the Commission's requirements intended primarily to aid the unsophisticated? Is it, on the contrary, designed to assist the assiduous student of finance who searches for every clue to the intrinsic value of securities? Or should the Commission strive to meet the needs of the hypothetical "reasonable" investor of "reasonable" sophistication?

Throughout its history, the Commission has struggled with these questions. They may well be unanswerable. A balance must be struck which reflects, to the extent possible, the needs of all who have a stake in the securities markets.

U.S. SECURITIES AND EXCHANGE COMM'N, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 51-52 (1969).

193. 17 C.F.R. § 230.506(b)(2)(ii).

194. See *infra* Part IV.A.2 (discussing Exchange Act Rule 15g-9, 17 C.F.R. § 240.15g-9).

195. See *infra* Part IV.A.1 (discussing NASD MANUAL CONDUCT RULE 2310 (National Ass'n of Sec. Dealers, Inc. 1996) (Recommendations to Customers (Suitability))).

offering and its issuer are only important in determining whether they comport with a particular investor's financial profile.

The suitability of a particular investment for a given investor is a function of that investor's financial objectives, sophistication, and wherewithal. If the investment does not fit with all three, then the investment is not suitable for the investor. An investor's financial objectives are important because an investment should only be chosen if it could help achieve them.¹⁹⁶ Financial sophistication, by contrast, tests whether a particular investor truly understands the risks and rewards of a given investment and how they compare with those of alternative investments. Without the requisite amount of sophistication, an investor will be unable to determine whether a particular investment will help meet his financial objectives. Financial wherewithal focuses on the ability of a particular investor to lose some or all of his investment, and thus it is based on an investor's current and anticipated financial condition.

To illustrate the importance of these three elements of investor suitability, assume an investor in question is a young, newly-minted MBA in finance who just started her first full-time job. She is loaded down with student loans and has little savings. Her financial objective, which is to achieve maximum capital appreciation, has led her to consider shares in a risky high-tech company listed on the Small Cap section of Nasdaq.

At first glance, the investment appears suited to her. The investment clearly meets her financial objective. From a financial sophistication standpoint, she should be able to understand the risks and rewards of the investment based on her education. However, given her limited savings and her substantial monthly student loan payments, the investment appears unsuitable from a financial wherewithal perspective. Indeed, due to the investment's illiquidity, she may be unable to monetize her investment as quickly as needed. In addition, a total loss of her investment could wipe out a large portion of her limited savings.

B. THE NEED FOR SUITABILITY DETERMINATIONS ARISES

For the reasons discussed below, substantial policy grounds now exist for requiring unseasoned issuers involved in self-managed SIPOs to make suitability determinations prior to consummating sales of securities to un-

196. For example, a risky high-tech stock issued by an unseasoned issuer would not support the financial objectives of an elderly investor who is seeking a steady stream of income. By contrast, that stock could fit perfectly with the financial objectives of a younger investor with a steady income who is seeking maximum capital appreciation.

sophisticated retail investors. Later in this Article, the author proposes a specific federal suitability standard to help protect investors involved in those offerings.¹⁹⁷ The purpose of this section, however, is to discuss why suitability determinations are warranted today in the context of self-managed SIPOs when they were not in the past.

Simply put, suitability determinations designed to protect unsophisticated retail investors are needed because technological developments have altered the financing “roadmap” traditionally followed by most growing businesses. Indeed, a growing business historically satisfied its need for capital by following a well-trodden financing path from which it was difficult, if not impossible, to deviate. A business began by raising money first from a hierarchy of private sources and, much later in its growth cycle, from public sources.¹⁹⁸ As the business followed this roadmap, over time it would achieve certain financial and business milestones relating to revenue and market share among other things. The achievement of each milestone would result in a step down in risk associated with the business. As one prominent accounting firm has noted, “[A]s a company demonstrates its ability to achieve various goals, its probability of succeeding increases and its danger of failing decreases. . . . In exchange for the reduction in risk, [the business] can negotiate higher prices per share in each successive round [of financing.]”¹⁹⁹

The initial private sources of financing for new businesses historically came from localized sources. First, an entrepreneur would look in her own pocket and/or tap friends and family sympathetic to the business or, more likely, to the entrepreneur herself.²⁰⁰ If the business had significant collateral-worthy assets and/or the entrepreneur herself had wealth sufficient to support a personal guarantee, then the entrepreneur would also approach

197. See *infra* Part IV.B.

198. Fidelity has described this roadmap in the following terms:

The road to public ownership often begins with an entrepreneur who has developed an idea for a product or service and borrows enough money to launch a start-up business. If the company grows, the entrepreneur can get funds for expansion from the private equity market. Investors then pull together pools of money, referred to as venture capital. If a company finds its product or service in great demand, it quickly outstrips the ability of venture capitalists to provide money for rapid growth. That’s when it may decide to go public.

FIDELITY IPO BROCHURE, *supra* note 174.

199. DELOITTE & TOUCHE, RAISING VENTURE CAPITAL 52-53 (1982).

200. See GOING PUBLIC, *supra* note 144, at 6.

local financial institutions for a loan.²⁰¹ She might also have been successful in convincing a local “angel” to supply equity capital to the business.²⁰²

Soon, however, these businesses’ need for capital outgrew localized sources of private financing. At their next stage of development, they traditionally did not raise capital from public sources. The expense and red tape involved with public offerings and the difficulty of attracting investment banks to underwrite small offerings made public financing unappealing at this stage.²⁰³ Growing businesses, therefore, raised capital by privately placing their equity securities with venture capital firms and other institutional investors.

Capital raised from these sources was costly. Because venture capital firms and other institutions were highly sophisticated and had a keen understanding of the risk-reward calculus, they demanded sizable equity positions at low prices per share in return for providing needed capital. Frequently, they demanded additional control over the management of the company.²⁰⁴ Indeed, in their view the acceptance of the significant risks associated with young, growing businesses was only warranted when the rewards received were commensurate.²⁰⁵

Once private sources of capital were outstripped or the amount of needed capital warranted the incurrence of the expenses associated with a public offering, growing businesses turned to the public capital markets. In doing so, businesses either could solicit the aid of one or more financial intermediaries to act as underwriters, or conduct direct or self-managed offerings. Although issuers that conducted self-managed offerings benefited by keeping more of the offering proceeds, most issuers sought underwriters for their offerings. As one commentator has noted, self-managed offerings were “especially rare because most issuers [did] not have the wherewithal or expertise in the financial industry to handle a public offer-

201. See Fisch, *supra* note 125, at 60-61.

202. See *id.* at 62 (explaining that business “[a]ngels are high net worth individual investors who provide private equity financing to firms on an informal basis and typically a smaller scale than venture capital investments”).

203. See *supra* text accompanying notes 142-49.

204. See GOING PUBLIC, *supra* note 144, at 6. See generally Theresa A. Gabaldon, *Love and Money: An Affinity-Based Model for the Regulation of Capital Formation by Small Business*, 2 J. SMALL & EMERGING BUS. L. 259 (1998) (discussing friends and family financing and, in connection therewith, proposing a new fiduciary-based exemption to securities registration).

205. But see Fisch, *supra* note 125, at 62-63, 83 (arguing that while “the cost of venture capital funds is considered high [by many observers], . . . the managerial services provided by venture capitalists are rarely reflected in this assessment”; and that “[i]nformation costs, higher risk, and the possibility of fraud all offer explanations why the high cost of small business capital may be an appropriate response to market conditions rather than evidence of a market failure”).

ing.”²⁰⁶ In other words, they did not have the ability to “stimulate investor interest”²⁰⁷ to the same extent as members of the investment banking community.

Most self-managed offerings that were completed were pitched directly to existing security holders or institutional investors, “thus eliminating the necessity for a promotional or retailing sales effort.”²⁰⁸ Both these groups of investors were either already familiar with the issuers in question and/or were sophisticated enough to protect themselves. Thus, due to the paucity of self-managed offerings in general, and the even smaller number that were directed to retail investors in particular, the issue of whether these offerings were suitable for retail investors historically did not exist for all intents and purposes.

Technological developments, however, have changed this dramatically. Indeed, today’s young, growing businesses now have the ability literally to throw the traditional financing roadmap out the window. These developments, particularly the Internet and e-mail, have made it possible for these businesses to make a financial quantum leap from the friends and family financing stage directly to the public offering financing stage without skipping a beat. The ramifications of this progression are tremendous.

First, small businesses have the ability to bypass entirely the venture capital/institutional investor stage of private financing.²⁰⁹ This is the financing stage that proves so costly to small businesses in terms of having to sell large equity stakes at low prices per share. Now through these new technologies, without any step down in risk, SIPO issuers can sell smaller equity chunks to members of the IPO-hungry general public. Indeed, unlike venture capitalists and institutions, geographically dispersed members of the public generally lack the sophistication and negotiating power to demand rewards commensurate with the risks they are accepting.²¹⁰ Frequently the prices per share that Regulation A issuers require investors to pay for their stock are literally pulled out of thin air.²¹¹ By contrast, IPO

206. HAZEN, *supra* note 33, § 2.1, at 73.

207. *Id.*

208. *Id.*

209. See generally Langevoort, *supra* note 26, at 3 n.5 (noting that the dependence on venture capital financing will be reduced as direct distributions of securities become more efficient).

210. As one commentator has pointed out, “Unlike institutions and most ‘accredited investors,’ many individual investors lack the information and experience to compare different types of offerings, have no negotiating leverage, and rely extensively on securities salesmen eager to confirm sales.” Warren, *supra* note 183, at 137.

211. For example, the following was one of a total 21 risk factors listed in Spring Street Offering Circular I:

Arbitrary Determination of Purchase Price

prices in underwritten offerings are set by underwriters in consultation with issuers and are based on a variety of factors, including among others the trading prices of shares of comparable, publicly traded companies.²¹²

Second, these new technologies provide small businesses with unprecedented “cold calling” access to millions of unsophisticated retail investors. Through e-mail, for example, issuers can easily target members of the public who have already shown an affinity towards their products or services. As if this were not enough, this access to the public is highly cost-efficient. The costs of placing an offering circular on-line and preparing e-mail distribution lists are modest, and the actual cost of delivering information on-line once this has been done is negligible.²¹³

Finally, these new technologies not only allow issuers to jump from the friends and family financing stage to the public financing stage, but they also enable issuers to reach the public without the assistance of underwriters. While the proponents of disintermediation will undoubtedly cheer this development, self-managed SIPOs lack substantially all the protections associated with traditional underwritten offerings. In this regard, the issuers themselves rather than experienced underwriters are deciding whether they are ready to go public. Self-managed SIPOs also lack the rigorous due diligence review performed by underwriters and their legal counsel.²¹⁴ In addition, because broker-dealers are not usually involved, it is not necessary to make suitability determinations. Finally, lit-

The purchase price of the Shares was determined by the Company and does not necessarily bear any relationship to the Company's asset value, net worth or other established criteria of value. Each prospective investor should make an independent evaluation of the fairness of such price. . . .

SPRING STREET OFFERING CIRCULAR I, *supra* note 44, at 4. See also SPRING STREET OFFERING CIRCULAR II, *supra* note 44, at 4 (listing virtually the same risk factor); Amendment No. 5 to Form 1-A of The Pathways Group, Inc., at 9, 13 (filed July 14, 1997) (stating in the offering circular that “the offering price of the Common Stock is not necessarily related to the Company's asset value, net worth or other criteria of value” and later that “the Subscription Price has been established arbitrarily by the Board of the Company . . . [and] [a]s such, should not be considered the actual value of the Shares”).

212. As one group of commentators has pointed out:

The proposed initial public offering price reflects a variety of factors, including prevailing market conditions, the results of operations of the company in recent periods, the type of business it conducts, its future prospects, the stage of its development, and an assessment of its management. The most important determination of price generally is the price-earnings or EBITDA (earnings before . . . interest, taxes, depreciation, and amortization) multiples of other companies in the industry. Typically, a company will be valued at a slight discount from established companies in its industry in order to provide an incentive to purchase the stock being offered rather than that of the more established companies.

SCHNEIDER ET AL., *supra* note 47, at 11.

213. See Klein, *supra* note 1, at 90.

214. See Langevoort, *supra* note 26, at 20-21 (arguing that the loss of the disciplinary influence of intermediaries on issuer disclosure “will involve a social cost; prima facie, we might need some alternative strategy (for example, greater SEC or Blue Sky Law supervision) to offset it”).

tle if any aftermarket support will be available to assist current and future investors.

In this new era, investor suitability concerns, which were largely non-existent in the recent past, now loom large. Indeed, in the self-managed SIPO context little stands between the fox and the chickens.²¹⁵ The SEC, of course, will help ensure that a given Regulation A offering circular contains the streamlined disclosure required by Regulation A.²¹⁶ In addition, state blue sky administrators in those states that conduct merit reviews will help ensure that the terms of a particular offering meet their own notions of fairness. Nevertheless, the fact remains that issuers engaged in the most speculative offerings will be pitching their securities directly to the most vulnerable segment of the investing public.

To illustrate, take the case of an unseasoned issuer engaged in a highly speculative business that decides to raise capital by selling common stock in a self-managed Regulation A offering conducted over the Internet and through e-mail. Assume that the issuer's offering materials fully comply with Regulation A disclosure requirements and are otherwise truthful and complete. Assume also that the offering was "blue-skyed" in the states in which the issuer is offering the common stock. Clearly, for many retail investors this risky, speculative offering will be perfectly well-suited. Those investors have an appetite for this type of offering and are sophisticated enough to understand the risks involved. They also understand the financial loss they will incur if the issuer's business is not successful. Most importantly, if the common stock becomes worthless, they have the financial wherewithal to bear the loss.

This particular investment, however, will be ill-suited to many other retail investors. Some of these investors simply will not understand the risks and rewards of investing in the common stock of a speculative issuer. For others the common stock will be inconsistent with their financial objectives. Still others will be unable to bear the financial repercussions of a partial or total loss of their investment.

Leaving aside the issue of suitability for the moment, no investor, based on the assumptions above, will have any legal recourse against either the issuer or its principals in the event the common stock becomes worthless. The issuer, after all, has made truthful and legally adequate

215. As Professor Langevoort has stated, "In the direct marketing program, what is lost most is the regulatory oversight over selling practices." *Id.* at 21 (citation omitted).

216. See Coffee, *supra* note 27, at 1213 (arguing that the SEC could step in as the informational gatekeeper with respect to direct issuer equity offerings if the SEC's role in regulating the offerings of mature companies diminishes upon the adoption of a system of "company registration").

disclosure about itself and the offering. Required filings at the federal and state level have been made. Things simply did not work out the way the issuer and the investors had hoped they would.

For those investors for whom the common stock was a suitable investment, this is an unfortunate but not totally unexpected turn of events. They are sophisticated enough to understand that strikeouts occur much more frequently than home runs. But for those investors for whom the common stock was unsuitable, the decline in value of the common stock they hold could be disastrous. They may be totally unprepared both mentally and financially for this result.

The best way to protect unsophisticated retail investors from unsuitable self-managed SIPO securities is to ensure that they do not purchase them in the first place. In other words, make sure that those securities are channeled only into the hands of retail investors capable of understanding and dealing with the associated risks and consequences. However, any channeling system must accomplish its goal of investor protection while minimizing its impact on the ability of unseasoned issuers to raise capital through self-managed SIPOs.

This author argues that a new federal suitability standard will both enhance investor protection and foster capital formation by improving investors' perception of the legitimacy of self-managed SIPOs. Indeed, if too many unsophisticated investors lose their shirts in Internet offerings that are entirely unsuited for them, then the medium itself could lose its effectiveness as a means of capital formation. The proposed federal suitability standard discussed below will require unseasoned issuers engaged in self-managed SIPOs to make suitability determinations with respect to unsophisticated retail investors prior to selling securities to them. Such a suitability standard protects these issuers' ability to solicit the general public at large over the Internet, through e-mail, and by other means. Only after a particular investor has expressed a desire to purchase securities will an issuer be required to make a suitability determination.

C. FEDERAL AND STATE INITIATIVES IN THE ON-LINE OFFERING CONTEXT

As discussed below, the SEC has taken significant steps to help protect investors against on-line fraud. Individual states have also adopted certain measures in this area, but have generally been less proactive than the SEC. Unfortunately, neither the SEC nor any individual state has

adopted any specific measure to ensure that particular securities offered by unseasoned SIPO issuers over the Internet are suitable for a given investor.

1. *Efforts of the SEC*

The SEC is well aware of the potential for fraudulent investment activity occurring on the Internet. According to two prominent Staff members:

[A]s investors turn to the Internet as a source of [investment] information and guidance, they will undoubtedly also encounter the dark side of the Internet. Inhabitants of the dark side, the crooks and thieves who are always on the lookout for a fresh scheme or a neoteric hook, will take advantage of the Internet to lie, cheat, steal, and spoil the boom for the rest of us.²¹⁷

In this regard, the SEC's Division of Enforcement (the "Division") has broken down its Internet-related concerns into the following six categories: (1) the illegal offer and sale of securities, (2) improper market manipulation, (3) faulty on-line trading facilities, (4) spamming activities relating to bogus securities and investment opportunities, (5) unregistered investment advisers and investment newsletters, and (6) unregistered off-shore broker-dealers and other financial service entities.²¹⁸ Of these six categories, only the first relates to the topic of this Article and is discussed below.²¹⁹

217. Cella & Stark, *supra* note 2, at 816-17. See also Michael Schroeder & Rebecca Buckman, *U.S. Attacks Stock Fraud on Internet*, WALL ST. J., Oct. 29, 1998, at C1; Rebecca Buckman, *Cyber-Sleuths: Dogged On-Line Investors Are SEC's Top Source in Internet Probes*, WALL ST. J., Aug. 4, 1998, at C1; Dean Starkman & John R. Emshwiller, *Authorities Probe Growing Wave of Stock-Market Touts*, WALL ST. J., Apr. 23, 1998, at C1.

218. See Cella & Stark, *supra* note 2, at 820-35. See also Schroeder & Buckman, *supra* note 217, at C1 (discussing the SEC's biggest crackdown to date on stock market fraud committed on-line); Starkman & Emshwiller, *supra* note 217, at C1 (discussing SEC enforcement actions with respect to improper market manipulations).

219. The other five concerns are briefly described as follows:

Improper market manipulation involves the posting of false information concerning securities on message boards and Usenet (Users Network) in an attempt to manipulate the price of a particular stock. The false information often appears believable because the sender either disguises himself as someone "in-the-know," such as a corporate insider of a publicly traded company, or assumes or "spoofs" the identity of a real person for the purpose of impersonation.

Faulty on-line trading facilities involves BBTSs or other on-line trading facilities that operate without fundamental investor protections. These protections include, among others, the safeguarding of investors' funds and securities during the transfer process, ensuring that purchasers understand the risks associated with buying illiquid and speculative securities over the Internet, the provision of last sale prices, and ensuring ongoing and adequate company disclosure.

Spamming addresses the practice of certain individuals ("spammers") who peddle bogus get-rich-quick schemes by transmitting their message to an e-mail distribution list. These individuals combine the skills of mass marketers with the sales tactics of cold-callers. According to the Division,

The first category covers the offer and sale of securities over the Internet in connection with an offering that is neither registered nor exempt. Given the “maverick” mentality of many of those involved with the Internet, perhaps it is not surprising that the Division has encountered a class of securities promoters that “show[s] little concern for the mandates of federal securities laws.”²²⁰ In this regard, the Division seeks to ensure that investors are making investment decisions with the benefit of legally-mandated disclosure. Without full disclosure, investors cannot “evaluate the merits of an investment and fend for themselves.”²²¹

The first category also covers the offer and sale of fraudulent securities. Not surprisingly, the Division has already bumped into Internet versions of old-time classics. These include offerings involving pyramid schemes, eel farms, ostrich farms, cattle breeding, oil and gas drilling, and portable nuclear reactors.²²² Scam artists selling these “securities” seek out “credulous investor[s] and divorce them from their savings.”²²³ Internet newsgroups and message boards²²⁴ have proved to be potent tools in defrauding investors through the sale of bogus securities.²²⁵

of all the complaints received by it relating to the Internet, complaints about spamming in connection with investments rank first.

Unregistered investment advisers and investment newsletters relate primarily to the tremendous proliferation of individuals on the Internet claiming to be investment advisers without having registered with the SEC under the Investment Advisers Act of 1940. In addition, this concern also addresses the numerous investment newsletters posted on the Internet. Publishers of a given newsletter that hypes a particular stock must disclose the nature and substance of any consideration received from the issuer, underwriter, or dealer of that security under section 17(b) of the Securities Act.

Unregistered offshore broker-dealers and other financial service entities concern the increasing number of foreign financial service entities that have been operating in the United States through the Internet without registering under the Exchange Act as a broker-dealer.

For a more detailed description of these five concerns of the Division, see Cella & Stark, *supra* note 2, at 825-35.

220. *Id.* at 824.

221. HAZEN, *supra* note 33, § 1.2, at 7.

222. See Cella & Stark, *supra* note 2, at 821; Alexander C. Gavis, *The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Initiatives*, 52 BUS. LAW. 317, 361-62 (1996).

223. Cella & Stark, *supra* note 2, at 822.

224. Newsgroups are usually topic-specific message areas within Usenet (Users Network), a collection of discussion groups that allow for debate, chat, and discussion across the Internet. Bulletin-board systems, or message boards, allow for the posting of messages, typically to solicit a reply or to comment on a prior message. See *id.*

225. See *id.*

The Division's initiatives with respect to the Internet do not yet address suitability concerns. Except in limited circumstances,²²⁶ the Division is simply not charged with the responsibility of ensuring that a particular security sold in a legally permissible offering is suitable for a particular investor. This reflects the fundamental premise of the Securities Act that investors make up their own minds with respect to a particular investment once they have received full and fair disclosure. As discussed earlier, however, significant technological developments that aid small businesses in raising capital give rise to suitability concerns that warrant the SEC's attention.

2. *State Initiatives*

Because the Internet "operates as an interstate and international network of computers," and thus "can be accessed by investors from . . . every state in the United States,"²²⁷ state securities regulators understandably have expressed concern about Internet offerings. State initiatives in three areas have a direct impact on issuers engaging in self-managed SIPOs over the Internet. The first area concerns the jurisdiction of states over Internet offerings. The second relates to the degree to which administrators in those states that require registration actually review the merits of SIPOs. The final area concerns the efforts of states to embrace the test the waters provision of Regulation A.

a. *State Jurisdiction Over Internet Offerings*: Many state securities regulators, together with the NASAA, have examined and taken action with respect to "the issue of when an offer of securities made over the Internet or other electronic media would fall under the purview of [a particular] state's securities laws."²²⁸ This jurisdictional issue is crucial to SIPO issuers, because the securities they issue are not "covered" securities exempt from the registration requirements of the various states.²²⁹ If a SIPO conducted over the Internet falls within the jurisdiction of a given state because it constitutes an offer to sell securities in that state, the issuer will have to comply with that state's registration requirements.

226. See 17 C.F.R. § 240.15g-9 (1998) (requiring brokers or dealers to make suitability determinations when recommending a penny stock to any client except institutional accredited investors and officers, directors, and other affiliates of the issuer of that stock).

227. Gavis, *supra* note 222, at 352.

228. *Id.* at 323-24.

229. See 15 U.S.C. § 77r (Supp. III 1997).

In resolving this jurisdictional issue, the Commonwealth of Pennsylvania has taken the lead.²³⁰ Pennsylvania believed that an Internet offering constituted an offer for the purchase or sale of a security and a general solicitation under its blue sky laws.²³¹ In August 1995, however, Pennsylvania issued a discretionary order that provided issuers with a self-executing exemption from state law registration with respect to the offer, but not the sale, of securities over the Internet if three conditions were met.²³² First, an issuer must indicate, through either direct or indirect language, that no offer or sale of the securities is intended to take place in Pennsylvania. Second, the issuer or anyone acting on its behalf must refrain from directing an offering of securities to any person in Pennsylvania. Finally, the issuer must not sell any of its securities in Pennsylvania as a result of the Internet offering. With respect to this final condition, the Pennsylvania order prohibited an issuer that relied on the Internet exemption to register and sell the securities that were offered over the Internet within the state at a later date.²³³

Concerned about uniformity with respect to a state law Internet exemption, the NASAA in January 1996 adopted a resolution that encouraged all "state security regulators to develop a uniform policy concerning offers of securities on the Internet that is consistent with the goals of investor protection and access to capital markets."²³⁴ The resolution contained a model exemption that could be adopted by the states. This exemption was substantially similar to the Pennsylvania exemption, except that if certain conditions were met, issuers that took advantage of the exemption could later register and sell the securities subject to the exemption

230. See Gavis, *supra* note 222, at 354.

231. According to the Deputy Chief Counsel of the Pennsylvania Securities Commission:

Based on the fact that materials appearing on the Internet are available to anyone in Pennsylvania who has access to a computer, a modem and a phone line, . . . a communication on the Internet designed to raise capital for an issuer would constitute an offer for the purchase or sale of a security . . . under [the 1972 Pennsylvania Securities Act] . . . and, for purposes of [that Act], constitute a mass mailing, public media advertisement and general solicitation.

G. Philip Rutledge, *Securities Commission Addresses Internet Offerings* (visited Apr. 1, 1997) <http://www.state.pa.us/PA_Exec/Securities/corpfm/internet1.html>. See also *The Pennsylvania Securities Act of 1972*, PA. STAT. ANN. tit. 70, § 1-101 (West 1994).

232. See *In re Offers Effected Through Internet That Do Not Result in Sales in Pennsylvania*, 1995 WL 5746478 (Pa. Sec. Comm'n 1995) (admin. order).

233. Apparently the objective of this prohibition is to ensure that issuers that receive a tremendous response through e-mail or other means from Pennsylvania residents to an exempt offering do not later register that offering in an effort to take advantage of the interest shown. Such after-the-fact registrations would allow exempted offerings to be "utilized by an issuer as a universal 'Test the Waters' procedure." K. Robert Bertram, *Advanced Technology Issues—the Internet, and State Securities Registration—a Primer*, PA. B. ASS'N Q., July 1996, at 137 n.34.

234. NASAA Resolution Regarding Securities Offered on the Internet, NASAA Rep. (CCH) ¶ 7040 (Jan. 1996).

in that state.²³⁵ Today, thirty-eight states have adopted Internet offering exemptions.²³⁶ Predictably, the exemptions are neither consistent as among themselves nor with the NASAA model.²³⁷

b. *State Registration Requirements and Merit Review*: If a SIPO issuer conducting an Internet offering intends to target offerees in a particular state, it must comply with the registration requirements of that state.²³⁸ Although significant differences exist among state securities laws, most states have adopted variants of either the Uniform Securities Act or the Revised Uniform Securities Act.²³⁹ Both acts require an issuer to register an offering at the state level generally in one of three ways, depending on how long an issuer has been established and whether the issuer is registering the offering on the federal level or relying on a federal registration exemption. These three ways are “registration by notification,”²⁴⁰ “registration by coordination,”²⁴¹ and “registration by qualification.”²⁴²

For purposes of this Article, only the first and third methods of state registration are important. The second method—registration by coordination—is the easiest, as it simply requires an issuer to file copies of its current federal prospectus and any other information requested by a state securities administrator at the state level.²⁴³ State registration then be-

235. One of the following two conditions must be met in order to sell the securities in state at a later date: “(A) No sales of the securities [are] made in any state until the offering has been registered and declared effective and the final prospectus . . . has been delivered to the investor prior to such sale; or (B) The sales are exempt from registration.” *Id.*

236. The following states have adopted Internet offering exemptions either through legislation or agency actions: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Mississippi, Montana, Nebraska, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. For a listing of those states that have adopted a version of the NASAA Resolution, see *Internet: Exemption (For Offers) and BD/IA Advertising*, 1 Blue Sky L. Rep. (CCH) ¶ 6481, at 2581 (1999).

237. See Gavis, *supra* note 222, at 358.

238. As discussed previously, Regulation A securities are required to be registered under state law because they do not constitute “covered” securities for purposes of section 18 of the Securities Act. See *supra* text accompanying notes 65-69. In addition, it should be noted that Regulation A issuers cannot take advantage of the most widely available state law exemptions to registration. See Rutherford B. Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 193 (1997).

239. UNIF. SEC. ACT (amended 1997); REVISED UNIF. SEC. ACT (1985).

240. UNIF. SEC. ACT § 302; REVISED UNIF. SEC. ACT § 302. The Revised Uniform Securities Act refers to the concept of “registration by notification” as “registration by filing.”

241. UNIF. SEC. ACT § 303; REVISED UNIF. SEC. ACT § 303.

242. UNIF. SEC. ACT § 304; REVISED UNIF. SEC. ACT § 304.

243. See sources cited in *supra* note 241.

comes effective concurrently upon the effectiveness of the issuer's federal registration statement.²⁴⁴ Registration by coordination, however, is only available for offerings officially registered under the Securities Act. SIPO issuers, therefore, cannot avail themselves of this method of state registration.²⁴⁵

Whether or not a SIPO issuer can register by qualification or notification at the state level generally depends on how long the issuer has been in business. Registration by notification entails the filing of a short-form registration statement containing factual information about the issuer and the offering, and the payment of a registration fee.²⁴⁶ To take advantage of registration by notification, however, an issuer generally must have had an established business for at least five years.²⁴⁷ Otherwise, the issuer must file the dreary, long-form registration statement used in connection with registration by qualification.

Registration of securities by qualification is required when neither a registration exemption nor another registration procedure is available. Once an issuer has filed on the prescribed form, the securities administrator of a given state may analyze the merits of the offering before allowing securities to be sold within that state's borders. While the severity of the merit review applied by securities administrators varies between states, such review generally goes beyond the full disclosure approach of the Securities Act.²⁴⁸ In this regard, state securities administrators generally are given broader authority than the SEC to deny the effectiveness of a registration statement.²⁴⁹ Once they are satisfied with a particular offering, however, these administrators may declare it effective by either an entry in a given state's registry of securities or by the issuance of a permit.²⁵⁰

As this discussion suggests, the states theoretically can partially fill in the "merit review" gap that exists when SIPO issuers self-manage their offerings. The author uses the term "theoretically" because of the uncertainty surrounding the ability of state security administrators to provide the same thorough, consistent, and cold-hearted review as that provided by a profit-motivated investment bank in the registered offering context. Nev-

244. See 1 Blue Sky L. Rep. (CCH) ¶ 511, at 385 (1997); HAZEN, *supra* note 33, § 8.2, at 397.

245. See HAZEN, *supra* note 33, § 8.2, at 397-98.

246. See 1 Blue Sky L. Rep. (CCH) ¶ 510, at 385 (1997).

247. See sources cited *supra* note 240.

248. See generally HAZEN, *supra* note 33, § 8.1, at 389.

249. See generally *id.* § 8.2, at 394.

250. See 1 Blue Sky L. Rep. (CCH) ¶ 513, at 386 (1997).

ertheless, one can argue that the states could at least partially plug this hole.

c. *Testing the Waters Under State Securities Laws*: States also have dampened the enthusiasm surrounding Regulation A's test the waters provision. That provision, along with the rest of the Small Business Initiatives, was proposed unilaterally by the SEC without first coordinating with state securities administrators.²⁵¹ To put it mildly, the states were not amused. "State regulators have argued that the 'test the waters' provision deregulates the riskiest securities, small tentative offerings, leaving investors unprotected and vulnerable to sales techniques employed by these businesses."²⁵² The NASAA joined by arguing that encouraging uninformed decisions by investors was anathema to the purposes behind securities regulation.²⁵³ The end result was that state securities laws were not changed when the Small Business Initiatives were enacted in 1992.

The NASAA eventually attempted to coordinate state law with the Small Business Initiatives by developing its own proposal for testing the waters. The NASAA's proposal, however, requires issuers to supply more information in their solicitation materials directed to investors than does Regulation A's Rule 254. It also requires a longer period of time to pass between submission of those materials to regulators and their communication to the public.²⁵⁴

State adoption of the NASAA proposal has occurred slowly, and some states have fashioned their own versions or have failed to adopt one at all.²⁵⁵ Because the states' ability to regulate SIPOs remained intact following the passage of NSMIA, testing the waters cannot occur in states that have not embraced it.²⁵⁶ Even with regard to those states that have

251. See *Impact of Small Business Initiatives*, *supra* note 33, at 522-23.

252. *Id.* at 520-21.

253. See Stanley Keller, *SEC Small Business Initiatives: New Opportunities Created*, PRENTICE HALL L. & BUS. INSIGHTS, June 1993, at 15.

254. See *id.* For a more thorough discussion of the differences between Regulation A's Rule 254 and the NASAA's proposal, see Note, *supra* note 85, at 507-11.

255. For example, Oklahoma does not have any statute or rule specifically concerning test the waters solicitations. Issuers are required to submit solicitation materials in advance of their use along with a \$250 fee as part of a request for a discretionary exemption under section 401(b)(22) of the Oklahoma Securities Act. See OKLA. STAT. ANN. tit. 71, §§ 401(b)(22), 412 (West Supp. 1997). If granted, that discretionary exemption will cover offers made in connection with those materials but not sales. See Statement from the Oklahoma Securities Department on Testing The Waters issued by the Oklahoma Securities Department (facsimile received by the author on Nov. 12, 1998) (on file with author).

256. See *Impact of Small Business Initiatives*, *supra* note 33, at 521-22; Keith J. Mendelson & Cindy R. Shepard, *The SEC's Proposed Small Business Initiative: Bold Reform or Opportunity Forgone?*, PRENTICE HALL L. & BUS. INSIGHTS, July 1992, at 12, 18.

adopted the NASAA's proposal, issuers must navigate carefully within the borders of both the federal and state provisions when testing the waters.

In summary, the states can help reduce the exposure of unpreferred retail investors to self-managed SIPOs conducted over the Internet in two ways. The first is through their ability to review the merits of those offerings and, if necessary, to pull the plug on the least meritorious. The second is by frustrating the effectiveness of Regulation A's test the waters provision by either prohibiting those solicitations outright or by modifying the requirements associated with those solicitations in a way that better protects investors. Nevertheless, once the states have declared a particular self-managed SIPO effective, they do not involve themselves with ensuring that particular securities are suitable for a given investor. Similar to the position taken under federal law, once investors are provided with adequate disclosure, the states leave them to fend for themselves.

IV. TOWARDS A NEW "SUITABILITY" STANDARD FOR SELF-MANAGED SIPOS CONDUCTED BY UNSEASONED ISSUERS

As seen earlier, new technologies have materially altered the traditional financing roadmap followed by young, growing companies. These technologies allow unseasoned issuers to conduct public offerings earlier in their business development cycles than ever before. By combining these technologies with the ability to solicit the general public under Rule 504 and Regulation A, issuers are able to pitch their securities directly to the masses at very little cost and without the aid of underwriters. This ability raises substantial concerns over how suitable many of these offerings are for unsophisticated retail investors. New federal and state initiatives in the on-line area unfortunately do not address these concerns. In addition, while certain states review the merits of these offerings, their reviews are inherently unpredictable and subjective in nature, and fail to focus on each investor's particular characteristics.

A. EXISTING SUITABILITY STANDARDS

This author argues that a new federal suitability standard applicable to self-managed SIPOs directed at unsophisticated retail investors by unseasoned companies is warranted. In developing this standard, it is helpful to analyze the two main suitability standards currently employed in the securities field. One of these standards is used by the NASD, while the other is employed by the SEC in connection with "penny stocks."

1. NASD Suitability Standard

As a self-regulatory organization, the NASD is responsible for policing the sales practices of its broker-dealer members and registered broker representatives. These practices historically have been plagued by instances of heavy-handedness, overreaching, and outright greed on the part of brokers.²⁵⁷ In an attempt to prevent brokers from taking advantage of their brokerage customers, the NASD has implemented a number of rules governing transactions between brokers and their customers.²⁵⁸

The most important NASD rule for purposes of this Article is entitled "Recommendations to Customers (Suitability)," which this author will refer to as the NASD Suitability Rule.²⁵⁹ The NASD Suitability Rule only applies to broker recommendations to clients to purchase, sell, or exchange any security.²⁶⁰ In making these recommendations, a broker must have "reasonable grounds for believing" that her recommendation is suitable for her customer based on the facts, if any, disclosed by that customer as to "his other security holdings and as to his financial situation and needs."²⁶¹ The NASD Suitability Rule is one of wide application, as it applies to broker recommendations to both retail and institutional customers alike.²⁶² It also applies with respect to a recommendation of virtually any security, whether equity, debt, or derivative, of any issuer, whether seasoned or unseasoned.

257. See generally Stuart D. Root, *Suitability—the Sophisticated Investor—and Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287.

258. See NASD MANUAL CONDUCT RULE 2300 (National Ass'n of Sec. Dealers, Inc. 1996) (Transactions with Customers).

259. See *id.* CONDUCT RULE 2310 (Recommendations to Customers (Suitability)). This rule provides:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a noninstitutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

260. Importantly, the NASD Suitability Rule does not apply to issuer solicitations made directly to prospective investors.

261. NASD MANUAL CONDUCT RULE 2310(a).

262. See *id.*; Root, *supra* note 257, at 291.

With respect to a given retail customer, the NASD Suitability Rule requires a broker to be proactive in developing “reasonable grounds for believing” that a particular security, other than a money market mutual fund, is suitable for that customer.²⁶³ Thus, a broker must make reasonable efforts to obtain information about that customer. This information includes the customer’s financial status, tax status, and investment objectives. In addition, the broker must consider any other information that she considers reasonable in making recommendations to that customer.²⁶⁴

Clearly, reasonable efforts require a broker to directly ask the customer for this information, either orally or in writing. In this regard, most brokerage houses ask for suitability-related information in the investor questionnaire completed by new brokerage customers. The NASD Suitability Rule, however, makes an exception for recalcitrant customers who are not willing to proffer the facts necessary to make a suitability determination. Indeed, the rule requires suitability determinations to be made based on facts, “if any,” disclosed by the customer.²⁶⁵

Further fleshing out the NASD Suitability Rule are two NASD interpretive memos (“IMs”).²⁶⁶ The first IM alerts NASD members to the possible application of Exchange Act Rule 15c2-6 (recently renumbered to 15g-6) to recommendations made by those members and registered brokers to customers relating to certain low-priced stocks.²⁶⁷ Exchange Act Rule 15g-6 and other related rules are discussed below in greater detail.

The second IM discusses in depth the topic of fair dealing with brokerage customers. The IM first asserts that “[i]mplicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing.”²⁶⁸ In this regard, sales efforts must conform to the ethical standards of the NASD. Importantly, the IM adds:

This does not mean that legitimate sales efforts in the securities business are to be discouraged It does mean, however, that *sales efforts must*

263. The NASD Suitability Rule is silent with respect to institutional customers in this regard.

264. See NASD MANUAL CONDUCT RULE 2310(b).

265. See *id.* CONDUCT RULE 2310(a).

266. See *id.* IM-2310-1 (Possible Application of SEC Rule 15c2-6); *id.* IM-2310-2 (Fair Dealing with Customers).

267. This IM states in pertinent part:

Members should be aware that, effective January 1, 1990, any transaction which involves a non-Nasdaq, non-exchange equity security trading for less than five dollars per share may be subject to the provisions of SEC Rule 15c2-6 [now 15g-6], and this Rule should be reviewed to determine if an executed customer suitability agreement is required.

Id. IM-2310-1.

268. *Id.* IM-2310-2(a)(1).

*be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers.*²⁶⁹

In other words, recommending a security solely because a customer could potentially profit by owning it does not constitute fair treatment of that customer. Indeed, the profitability potential of a security alone is not an adequate basis for determining the suitability of that security for a particular customer.

The second IM also provides five examples of conduct that “clearly violate[]” the responsibility of fair dealing to customers.²⁷⁰ Important for purposes of this Article are the first and fifth examples.²⁷¹ These examples cover the following types of conduct:

(1) Recommending Speculative Low-Priced Securities—Recommending speculative low-priced securities to customers without knowledge of or attempt to obtain information concerning the customers’ other securities holdings, their financial situation and other necessary data [violates the responsibility of fair dealing]. The principle here is that this practice, by its very nature, involves a high probability that the recommendation will not be suitable for at least some of the persons solicited. This has particular application to high pressure telephone sales campaigns.

. . . .

(5) Recommending Purchases Beyond Customer Capability—Recommending the purchase of securities or the continuing purchase of securities in amounts which are inconsistent with the reasonable expectation that the customer has the financial ability to meet such a commitment [violates the responsibility of fair dealing].²⁷²

Needless to say, these same concerns arise when unseasoned issuers conduct self-managed SIPOs over the Internet directed at unsophisticated retail investors.

269. *Id.* IM-2310-2(a)(2) (emphasis added).

270. *See id.* IM-2310-2(b)(1)-(5).

271. Examples two through four deal with the following types of conduct:

(2) *Excessive trading activity*, often referred to as “churning” or “overtrading”;

(3) *Trading in mutual fund shares*, particularly on a short-term basis;

(4) *Fraudulent activity*, including, without limitation, establishing fictitious accounts, engaging in unauthorized transactions, misusing customers’ funds or securities, forgery and nondisclosure of material facts.

Id. IM-2310-2(b)(2)-(4).

272. *Id.* IM-2310-2(b)(1), (5).

2. SEC Suitability Standard for “Penny Stocks”

The SEC’s suitability standard relates solely to so-called “penny stocks” and reflects the congressional concern over those stocks as embodied in section 15(g) of the Exchange Act.²⁷³ Other than providing that a “penny stock” is an “equity security,” however, Congress has left it up to the SEC for the most part to define that term.²⁷⁴ In this regard, the SEC has defined “penny stock” in Exchange Act Rule 3a51-1²⁷⁵ as every equity security other than those that meet, as a general matter, the criteria of at least one of seven exemptive categories.²⁷⁶ These categories effectively exclude from the penny stock classification the vast majority of equity securities.²⁷⁷ Those that fall within the definition primarily do so because they constitute low-priced securities and/or are securities of an unseasoned issuer.²⁷⁸

With respect to low-priced securities, Exchange Act Rule 3a51-1 provides that any equity security that is purchased or sold in a transaction for less than five dollars—excluding any broker or dealer commission, commission equivalent, mark-up, or mark-down²⁷⁹—is considered a penny stock unless the security is otherwise exempt.²⁸⁰ While the Five Dollar Rule captures within the definition of “penny stock” an equity security is-

273. 15 U.S.C. § 78o(g) (1994 & Supp. III 1997).

274. *See id.* § 78c(a)(51) (defining “penny stock”). The Exchange Act defines “equity security” as follows:

The term “equity security” means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the [SEC] shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

Id. § 78c(a)(11).

275. 17 C.F.R. § 240.3a51-1 (1998).

276. In certain instances, an equity security may have to meet the criteria of more than one category to avoid classification as a penny stock. *See id.* § 240.3a51-1(a), (e)(2), (f). For example, an equity security that is authorized for quotation on Nasdaq must also meet the criteria of one of four other specified categories or it will be deemed a penny stock. *See id.* § 240.3a51-1(f).

277. Subject to certain exceptions, the following equity securities fall outside the definition of “penny stock”: (i) those for which transaction reports containing price and volume data relating to round lot purchases and sales are collected, processed, and made available pursuant to an effective transaction reporting plan; (ii) those issued by an investment company registered under the Investment Company Act of 1940; (iii) those that constitute put or call options issued by the Options Clearing Corporation; (iv) those that are registered, or approved for registration, on a national securities exchange; or (v) those that are authorized, or approved for authorization upon official notice of issuance, for quotation on Nasdaq. *See id.* § 240.3a51-1(a), (b), (c), (e), (f).

278. *See id.* § 240.3a51-1(d), (g).

279. *See id.* § 240.3a51-1(d)(1)(i).

280. The author refers to this rule as the “Five Dollar Rule.”

sued in an IPO for less than five dollars per share,²⁸¹ wily IPO issuers can take simple steps to ensure that their securities are sold for at least five dollars per share or more.²⁸² This stems from the fact that the per share offering price of IPO shares is simply a function of the aggregate amount of proceeds to be raised and the number of shares to be offered. Once those securities start trading in the secondary market, however, the Five Dollar Rule applies if the trading value falls below five dollars per share unless the security is otherwise exempt. Issuers once again could remedy this situation by simply effecting reverse stock splits to raise per share trading prices.

Exchange Act Rule 3a51-1 also provides that the equity securities of an issuer will be deemed penny stocks if the issuer is not financially seasoned unless those securities are otherwise exempt.²⁸³ The “seasoning” of an issuer is measured against two specific financial milestones. If the issuer has not achieved at least one of these financial milestones, then its securities will be considered penny stocks unless they are otherwise exempt. Unlike the Five Dollar Rule, which can be avoided by savvy issuers, the Financial Seasoning Rule is not so easily circumvented.

The first milestone of the Financial Seasoning Rule relates to the issuer’s net tangible assets. “Net tangible assets” is defined as the issuer’s total assets less intangible assets and liabilities.²⁸⁴ Assuming the equity securities of an issuer are not otherwise exempt, those securities will be deemed penny stocks unless the issuer has been in continuous operation (a) for three years or more and has net tangible assets in excess of \$2 million or (b) for less than three years and has net tangible assets in excess of \$5 million.²⁸⁵ Thus, the Financial Seasoning Rule rightfully reserves the highest net tangible assets requirement for the youngest, most unseasoned companies.

The second milestone relates to the issuer’s revenues. Unless an issuer’s equity securities are otherwise exempt, those securities will be

281. For example, the common stock issued as part of Spring Street’s two Regulation A offerings would be considered “penny stock” for purposes of Exchange Act Rule 3a51-1(d)(1), because the offering prices for the stock were both below five dollars per share and the stock was not otherwise exempt. See SPRING STREET OFFERING CIRCULAR I, *supra* note 44, at Cover Page (\$1.85 per share offering price); SPRING STREET OFFERING CIRCULAR II, *supra* note 44, at Cover Page (\$2.75 per share offering price).

282. Of course, an issuer must be mindful that enough shares are outstanding—the concept of “float”—to facilitate trading of its common stock in the secondary market.

283. The author refers to this rule as the “Financial Seasoning Rule.”

284. See 17 C.F.R. § 240.3a51-1(g)(1).

285. See *id.*

deemed penny stocks if the issuer's average revenues are less than \$6 million for the last three years.²⁸⁶ Thus, any issuer that has not been in existence for at least three years must satisfy the higher net tangible assets milestone applicable to the youngest of companies if it is relying on the Financial Seasoning Rule to exclude its equity securities from the penny stock classification.²⁸⁷

Once it is determined that a particular equity security of an issuer is a penny stock, then any broker selling that security to, or effecting the purchase of it by, a customer must comply with a set of seven rules designed to protect the customer.²⁸⁸ Of particular importance to this Article is Exchange Act Rule 15g-9, the "SEC Suitability Rule."²⁸⁹ This rule sets forth broker-dealer sales practice requirements for penny stocks in an effort to "prevent fraudulent, deceptive, or manipulative acts or practices" by those brokers or dealers in connection with penny stock transactions.²⁹⁰

Subject to certain exceptions discussed below, Rule 15g-9 generally makes it unlawful for a broker or dealer to sell a penny stock to, or to effect the purchase by, any person unless two requirements have been met prior to the time the transaction is effected.²⁹¹ First, the broker or dealer must have approved the person's account for transactions in penny stocks.²⁹² Second, the broker or dealer must have received from the person a written agreement to the "transaction setting forth the identity and quantity of the penny stock to be purchased."²⁹³

The heart of the SEC Suitability Rule is the procedure by which a broker or dealer approves a customer's account for transactions in penny stocks. This rather involved procedure requires brokers and dealers to take four steps. The first step is to obtain from the customer "information concerning the person's financial situation, investment experience, and investment objectives."²⁹⁴ The second step is to "[r]easonably determine,"

286. See *id.* § 240.3a51-1(g)(2).

287. Net tangible assets (in the case of the first milestone) and average revenues (in the case of the second) must be demonstrated by the most recent audited financial statements dated less than 15 months prior to the date of the transaction in question. See *id.* § 240.3a51-1(g)(3).

288. See *id.* §§ 240.15g-2 to .15g-9 (currently no Exchange Act Rule 15g-7 exists).

289. *Id.* § 240.15g-9.

290. *Id.* § 240.15g-9(a).

291. Importantly, the SEC Suitability Rule does not apply to issuer solicitations made directly to prospective investors.

292. See 17 C.F.R. § 240.15g-9(a)(2)(i).

293. *Id.* § 240.15g-9(a)(2)(ii).

294. *Id.* § 240.15g-9(b)(1). Cf. NASD MANUAL Conduct Rule 2310(b) (National Ass'n of Sec. Dealers, Inc. 1996) (setting forth the customer-specific information that a NASD member must make reasonable efforts to obtain in order to satisfy the NASD Suitability Rule).

based on the customer-specific information obtained and any other information known by the broker-dealer about the customer, that (i) transactions in penny stocks are suitable for the customer and (ii) the customer (or the customer's independent adviser in penny stock transactions) "has sufficient knowledge and experience in financial matters that the [customer] (or the [customer's] independent adviser . . .) reasonably may be expected to be capable of evaluating the risks of transactions in penny stocks."²⁹⁵ The "knowledge and experience" requirement, of course, is substantially similar to, but not exactly the same as, the "sophisticated purchaser" standard applied in the context of Rule 506 offerings under Regulation D.²⁹⁶

The third step that a broker or dealer must take in order to approve a customer's account for penny stock transactions is to deliver to the customer a written statement detailing, among other things, the basis upon which the broker or dealer made her suitability determination. The statement also must notify the customer that it is unlawful for the broker or dealer to effect a penny stock trade unless he has received a written agreement to the transaction from the customer prior to the trade.²⁹⁷ Finally, the broker or dealer must obtain from the customer "a manually signed and dated copy of the written statement."²⁹⁸

Not all penny stock transactions require brokers and dealers to jump through these hoops. Indeed, many transactions are specifically exempt from the application of Exchange Act Rule 15g-9.²⁹⁹ For example, transactions not recommended by the broker or dealer are exempt,³⁰⁰ as are transactions with "institutional accredited investors" as defined in Regulation D of the Securities Act.³⁰¹ In addition, transactions in which the purchaser is an "established customer" of the broker or dealer are exempt.³⁰²

295. 17 C.F.R. § 240.15g-9(b)(2).

296. *See id.* § 230.506(b)(2)(ii). This rule requires an issuer to have a "reasonable belief" that each unaccredited investor in a Rule 506 offering, "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." *Id.*

297. *See id.* § 240.15g-9(b)(3). The written statement must also state, in highlighted format immediately preceding the customer signature line, that the broker or dealer is required to provide the customer with the written statement and that the customer should not sign and return it if it does not accurately reflect the person's financial situation, investment experience, and investment objectives.

298. *Id.* § 240.15g-9(b)(4).

299. *See id.* § 240.15g-9(c).

300. *See id.* §§ 240.15g-9(c)(1), .15g-1(e).

301. *Id.* §§ 240.15g-9(c)(1), .15g-1(b). An "institutional accredited investor" means an investor that meets the criteria of Securities Act Rule 501(a)(1)-(3), (7), (8). *See id.* § 240.15g-1(b).

302. *See id.* § 240.15g-9(c)(3). An "established customer" of a broker or dealer means: any person for whom the broker or dealer, or a clearing broker on behalf of such broker or dealer, carries an account, and who in such account:

Finally, transactions that either meet the requirements of Securities Act Rule 505 or 506, but not 504,³⁰³ or qualify for the section 4(2) private placement exemption under the Securities Act are also exempt.³⁰⁴

B. PROPOSED FEDERAL SUITABILITY STANDARD FOR SELF-MANAGED
SIPOS CONDUCTED BY UNSEASONED ISSUERS

The NASD Suitability Rule and the SEC Suitability Rule can form the foundation of a new federal suitability standard for self-managed SIPOs conducted by unseasoned issuers directed at unsophisticated retail investors. Although neither rule applies to issuers per se, both contain desirable provisions that, once refined, can provide the basis for a new standard. The SEC should implement the following new standard by adding it as a new rule to Regulation A and as a new subparagraph to Rule 504 of Regulation D.

1. *Proposed Federal Suitability Standard*

The proposed federal suitability standard (the “Standard”) reads as follows:

Sales Practice Requirements Applicable to Certain Offerings

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any issuer to sell any security of that issuer to, or to effect the purchase of such security by, any person in reliance on [Regulation A] [Rule 504] unless at least one of the following provisions is met:

(1) Such issuer has:

(A) Net tangible assets (total assets less intangible assets and liabilities) in excess of (i) \$2 million if the issuer has been in

(i) Has effected securities transactions, or made a deposit of funds or securities, more than one year previously; or

(ii) Has made three purchases of penny stocks that occurred on three separate days and involved different issuers.

Id. § 240.15g-9(d)(2).

303. It is clear that the SEC has singled out securities issued in a Rule 504 offering for special treatment. A more inclusive exemption in Exchange Act Rule 15g-1(c), which could have been incorporated by reference into the exemption list for the SEC Suitability Rule, was discarded in favor of a custom-tailored exemption set forth within the SEC Suitability Rule. *Compare id.* § 240.15g-1(c) (including Rule 504 securities), *with id.* § 240.15g-9(c)(2) (excluding Rule 504 securities). By singling out Rule 504 securities, the SEC has underscored its concern about issuers who issue penny stocks pursuant to a Rule 504 exemption to the registration requirements of the Securities Act with the help of brokers or dealers. Interestingly, securities offered pursuant to Regulation A are not specifically addressed by either exemption, while securities offered pursuant to Rule 504 are addressed.

304. *See id.* § 240.15g-9(c)(2).

continuous operation in substantially the same line or lines of business for at least three years, or (ii) \$5 million, if the issuer has been in continuous operation in substantially the same line or lines of business for less than three years; or

(B) Total revenue of at least \$5 million for each of the last three fiscal years;

(2) Such security is sold to such person as part of an offering underwritten on a firm commitment basis by one or more underwriters;

(3) Such person is:

(A) An accredited investor, as defined in Rule 501(a); or

(B) Currently the direct or indirect beneficial owner of more than five percent of any class of equity security of the issuer;

(4) Such person has beneficially and continuously owned securities of the issuer for more than one year and, if those securities were purchased from the issuer after the effective date of this rule as part of an offering exempt from registration pursuant to section 3(b) of the Securities Act, the issuer complied with the requirements of this rule in connection with such previous sale; or

(5) Prior to such sale, such issuer shall have reasonably determined that the type and amount of securities proposed to be purchased by such person are suitable for such person based on the information specified in paragraph (b)(3) of this rule and any other information about such person known by such issuer at or prior to the time of sale.

(b) (1) For purposes of paragraph (a)(1) of this rule, net tangible assets or total revenues must be demonstrated by financial statements of the issuer that (A) have been audited and reported on by an independent public accountant in accordance with the provisions of Rule 2-02 of Regulation S-X and (B) are dated less than fifteen months prior to the date of the proposed sale; *provided, however*, that if the issuer does not have audited financial statements, then the issuer's most recent unaudited financial statements dated less than fifteen months prior to the date of the proposed sale shall be used.

(2) For purposes of paragraph (a)(2) of this rule:

(A) An "offering underwritten on a firm commitment basis" is an offering with respect to which an issuer has contractually agreed in writing, subject to usual and customary conditions, to sell the entire allotment of securities offered to one or more securities firms, whether or not represented by one or more

managers, managing underwriters, or principal underwriters; and

(B) An “underwriter” is any person (i) qualifying as such under section 2(11) of the Securities Act, (ii) having net tangible assets of \$25 million or more at the time of the offering, and (iii) having engaged in the underwriting of securities as one of its primary businesses during the twelve months immediately preceding the offering.

(3) For purposes of making a suitability determination pursuant to paragraph (a)(5) of this rule, the issuer shall obtain a written statement from such person setting forth information concerning:

(A) The financial condition or the combined financial condition of that person and that person’s spouse, if any;

(B) The knowledge and experience in financial and business matters of that person and/or that of any purchaser representative of that person who qualifies as such under Rule 501(h); and

(C) The investment objectives of that person.

The written statement may constitute a stand-alone document, such as a purchaser’s questionnaire, or it may be contained within another document, such as a subscription agreement for the purchase of securities. The written statement may be transmitted to the issuer either in paper or electronic form.

(c) Any specific sale of securities made in contravention of the provisions of this rule shall not be exempt under section 3(b) from the registration requirements of the Securities Act. In addition, the SEC may at any time enter an order temporarily or permanently suspending an issuer’s section 3(b) exemption with respect to an entire offering if the SEC has reason to believe that such issuer is systematically selling, whether deliberately or unintentionally, securities in contravention of the provisions of this rule.

2. *An Explanation of the Proposed Standard*

The Standard is designed to ensure that the securities of unseasoned issuers offered in self-managed SIPOs are channeled into the portfolios of investors, particularly retail investors, for whom the securities are suitable. Furthermore, application of the Standard is not dependent on the method by which a SIPO issuer advertises its offering. Thus, offerings conducted over the Internet, through other electronic media, and through more traditional methods are covered. Because the use of the Internet and other electronic media increases the feasibility of SIPOs, however, the Standard

naturally will have the most impact on SIPOs employing these new technologies.

The standard itself is made up of three main paragraphs. Paragraph (a) begins by noting that the Standard's purpose is to prevent "fraudulent, deceptive, or manipulative acts or practices." This language is also used in the initial provision of the SEC Suitability Rule.³⁰⁵ While its use in that rule is aimed at brokers and dealers committing malfeasance, its use in the Standard is aimed at issuers that take unfair advantage of investors by selling them securities that are not suited to their portfolios.

On its face, paragraph (a) applies to all issuers; however, all "seasoned" issuers are specifically exempted from its application. Like the NASD Suitability Rule, paragraph (a) applies to "any security." In this regard, the "equity security" limitation of the SEC Suitability Rule was not embraced, because debt and other securities of an issuer can be just as unsuitable for a particular investor as can equity securities. In addition, the SEC's Five Dollar Rule was also rejected, because security prices can be manipulated by issuers too easily for a low priced-security concept to have real teeth.

Paragraph (a) also applies only to "sales" that issuers make in reliance on a small issue offering exemption, and not to offers. This means that issuers can freely solicit prospective investors over the Internet and other media without first making suitability determinations. Paragraph (a) also includes the language "to effect the purchase of such security" in addition to the words "to sell any security of that issuer." This additional language helps capture situations in which an issuer sells its securities indirectly through certain agents.

Paragraph (a) continues with a list of five exemptions. Unless the provisions of at least one of these five exemptions is satisfied, the penalty provision of paragraph (c) applies. The first exemption relates to the type of issuer offering the securities. "Seasoned" issuers are specifically excluded from the application of the Standard. To be considered "seasoned," an issuer must meet at least one of the two financial milestones set forth in the first exemption. These financial milestones are similar to those contained in the definition of "penny stock" used in connection with the SEC's Suitability Rule.

The first financial milestone is based on the "net tangible assets" of an issuer. Net tangible assets is defined as an issuer's total assets less its

305. See *id.* § 240.15g-9(a).

intangible assets and liabilities. Similar to the Exchange Act's "penny stock" definition, in order to be deemed "seasoned" based on net tangible assets an issuer must have net tangible assets in excess of (i) \$2 million, if it has been in continuous operation for three or more years, or (ii) \$5 million, if it has been in continuous operation less than three years. Unlike the "penny stock" definition, however, the issuer's continuous operation has to have been "in substantially the same line or lines of business." This additional language protects investors from the situation in which an issuer changes its business focus and thus has no real track record in its current line of business.

The second financial milestone is based on the issuer's total revenue. While also based on the "penny stock" definition, the proposed language has significant changes. The penny stock requirement of average total revenues of \$6 million for the last three years is replaced with a revenue requirement of at least \$5 million for each of the last three fiscal years. The purpose of this change is to ensure that an issuer relying on this exemption has had minimal amounts of total revenue in each of its last three fiscal years.³⁰⁶ Under the penny stock test, a higher dollar threshold is used—\$6 million as opposed to \$5 million—and average revenues of the last three years are the focus. Averaging, however, might allow an issuer with sizable revenues in its first year but declining revenues in the next two years to pass the test. The Standard, by contrast, requires revenues of at least \$5 million in each of an issuer's last three fiscal years. After all, consistent revenues are the hallmark of a seasoned company.

The issuer financial statements necessary to demonstrate achievement of either financial milestone are discussed in paragraph (b)(1) of the Standard. Similar to the requirement in the "penny stock" definition,³⁰⁷ financial statements—either audited or unaudited—must be dated less than fifteen months prior to the date of the proposed sale of securities. If, however, an issuer has audited financial statements that are dated less than fifteen months prior to the date of the proposed sale, then those financial statements rather than any more recent unaudited financial statements must be used to demonstrate achievement of either financial milestone.

Paragraph (a)'s second exemption relates to underwritten offerings. As noted earlier, the greatest risk to investors confronted by self-managed SIPOs arises from the lack of involvement by experienced and deep-

306. Any issuer that has been in business less than three years who seeks to take advantage of the Standard's seasoned issuer exemption must qualify under the net tangible assets test of paragraph (a)(1)(A)(ii).

307. See 17 C.F.R. § 240.3a51-1(g)(3).

pocketed underwriters.³⁰⁸ Accordingly, only traditional underwritten offerings conducted by qualified underwriters are specifically excluded from the provisions of the Standard. Indeed, investors participating in those offerings can benefit from the investment banking protections discussed earlier.³⁰⁹ These include compliance by the underwriters with the NASD Suitability Rule to the extent required and, depending on the particular offering, the SEC Suitability Rule.

Paragraph (b)(2) provides an important gloss to the underwritten offering exemption. It states that only those offerings that are underwritten on a “firm commitment” basis by one or more “underwriters” are exempt. Subparagraph (A) defines “firm commitment” offering as an “offering with respect to which an issuer has contractually agreed in writing, subject to usual and customary conditions, to sell the entire allotment of securities offered to one or more securities firms, whether or not represented by one or more managers, managing underwriters, or principal underwriters.” Subparagraph (B) defines “underwriter” as:

any person (i) qualifying as such under section 2(11) of the Securities Act, (ii) having net tangible assets of \$25 million or more at the time of the offering, and (iii) having engaged in the underwriting of securities as one of its primary businesses during the twelve months immediately preceding the offering.

The implications of paragraph (b)(2) are fourfold. First, offerings underwritten on a “best efforts” basis³¹⁰ or any other basis (other than a firm commitment basis) are not excluded, because underwriters involved in those offerings have little financial risk. Indeed, “[b]est efforts underwriting is generally used by less established issuers that cannot find an investment banker who is willing to make a firm commitment because of the speculative nature of the distribution.”³¹¹ Second, a firm commitment underwriting is only “firm” if there is a contractual agreement between the issuer and one or more underwriters. That agreement, however, may be subject to usual and customary conditions, such as a “market out.”³¹² Third, an elaborate underwriting syndicate is not necessary so long as one

308. See *supra* Part II.A.

309. See *supra* Part II.A.

310. A “best efforts” underwritten offering is one in which an underwriter does not buy the securities from the issuer outright, but rather attempts to use its “best efforts” to sell them as the issuer’s agent. See generally HAZEN, *supra* note 33, § 2.1, at 76.

311. *Id.* at 77.

312. These conditions would include such events as acts of war and other hostilities, and a material adverse change affecting the issuer that materially impairs the investment quality of the offered securities.

or more underwriters have contractually agreed to purchase the entire allotment of offered securities. Finally, the term “underwriter” is defined so as to include only financially viable securities firms that are and have been engaged in the underwriting of securities as one of their primary businesses.

Unlike the second exemption, Paragraph (a)’s third exemption relates to the type of investor involved, rather than the type of offering. Specifically excluded from the protections of the Standard under paragraph (a)(3)(A) are both institutions and natural persons qualifying as “accredited investors” under Securities Act Rule 501(a). This differs from both the NASD Suitability Rule and the SEC Suitability Rule. Under the former rule, suitability determinations are required whenever a broker or dealer makes a recommendation of any security to any customer. While on its face the NASD Suitability Rule seems overly protective, it is designed to cover the recommendation of both easily understood securities, such as common stock, and complex securities, such as derivatives.³¹³ The SEC Suitability Rule specifically excludes transactions with “institutional accredited investors, as defined in Rule 501(a)(1), (2), (3), (7), or (8)[,]”³¹⁴ but leaves within its coverage natural persons who qualify for “accredited investor” status under Rule 501(a)(5) and (6).³¹⁵

By contrast, the Standard excludes all “accredited investors” under Rule 501(a) for the same reason those investors are not counted as “purchasers” in Rule 505 and 506 offerings. That reason is that these investors can “fend for themselves” and thus do not need any additional protection. It is presumed that, based on their financial success or other factors, accredited investors are either financially sophisticated in their own right or can afford to hire a financial adviser who is financially sophisticated.³¹⁶ Because this presumption is sound, it has been reflected in paragraph (a)(3)(A) of the Standard.

313. See generally Root, *supra* note 257.

314. 17 C.F.R. § 230.15g-1(b) (1998).

315. The SEC Suitability Standard does not specifically exclude individuals or entities qualifying as accredited investors under Rule 501(a)(4), because it has a separate exclusionary provision that is slightly broader than Rule 501(a)(4). Compare *id.* § 230.501(a)(4) (including within the definition of accredited investor “[a]ny 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”), with *id.* § 240.15g-1(d) (excluding “[t]ransactions in which the customer is the issuer, or a director, officer, general partner, or direct or indirect beneficial owner of more than five percent of any class of equity security of the issuer, of the penny stock that is the subject of the transaction”).

316. But see Langevoort, *supra* note 26, at 22-23 (questioning the self-protective ability of accredited investors who earned or received their wealth in ways not involving financial acumen).

The third exemption of paragraph (a) also contains a provision excluding the direct or indirect beneficial owner of five percent or more of the issuer's equity securities. Paragraph (a)(3)(B), which mirrors a similar provision in the SEC Suitability Rule, is based on the notion that owners of a significant percentage of an issuer's equity securities do not need the protection of the Standard. Indeed, through their equity stakes, these owners already have significant experience with the issuer in question and likely have the leverage to effectively access financial information about the issuer from its management.³¹⁷

Paragraph (a)'s fourth exemption is similar in many respects to paragraph (a)(3)(B), as it too excludes investors with previous experience with the securities of a particular issuer. Under the fourth exemption, any person who has beneficially and continuously owned securities of the issuer for more than one year is presumed not to need the protection of the Standard because of her prior experience with the issuer. There is one catch, however. If the investor purchased those securities after the effective date of the Standard as part of an offering exempt from registration pursuant to section 3(b) of the Securities Act, then the issuer must have complied with the requirements of the Standard in connection with the previous sale in order for this exemptive provision to be available with respect to subsequent sales to that investor.³¹⁸

Assuming no other exemption is available, a SIPO issuer must comply with the suitability provisions contained in paragraph (a)(5). This means that, prior to selling securities to a given investor, the issuer must determine that the type and amount of securities proposed to be sold to that investor are suitable for the investor. The "amount" of securities is specifically included to help prevent an investor from purchasing too much of what is perceived to be a good thing.³¹⁹ Also, an issuer's determination that a particular security is suitable for a given investor must only be "reasonable," which means close calls favor the issuer.

An issuer must make its suitability determination "based on the information specified in paragraph (b)(3) of [the Standard] and any other in-

317. See *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 903 (5th Cir. 1977) (discussing informational access in the context of the private placement exemption).

318. Of course, if the issuer relied on a section 3(b) exemption other than under Regulation A or Rule 504 of Regulation D in connection with the previous offering, then the Standard's paragraph (a)(4) exemption would not be available to that issuer with respect to subsequent sales.

319. Cf. NASD MANUAL IM-2310-2(b)(5) (National Ass'n of Sec. Dealers, Inc. 1996) (noting the unfairness of a broker "[r]ecommending the purchase of securities or the continuing purchase of securities in amounts which are inconsistent with the reasonable expectation that the customer has the financial ability to meet such commitment").

formation about such person known by such issuer at or prior to the time of sale.” As seen below, the information specified in paragraph (b)(3) must be set forth in a written statement. If, however, an issuer has garnered any other information about a potential investor that is not included in the written statement, the issuer must consider it as well. For example, the issuer may have learned something about a potential investor pertinent to suitability over the telephone during a sales call or via e-mail in response to a test the waters solicitation. This also means that if an issuer has had a preexisting relationship with a potential investor, the issuer cannot ignore what it has learned about that investor based on the relationship.

Paragraph (b)(3) specifies that information about a potential investor must be set forth in a written statement that the investor can then transmit to the issuer in either paper or electronic form.³²⁰ This written statement, however, may constitute a stand-alone document, such as an investor’s questionnaire, or be contained within another document, such as a subscription agreement for the purchase of securities. This allows an issuer to incorporate the necessary suitability-related questions within its existing subscription documentation.

The specific information to be contained in the written statement is designed to cover the three elements of suitability—namely an investor’s financial objectives, sophistication, and wherewithal. Paragraph (b)(3)(A) covers the element of financial wherewithal. Information concerning an investor’s financial condition helps an issuer decide whether or not an investor can afford to lose her investment.³²¹ If not, or if the investment would represent too great a percentage of that investor’s entire investment portfolio, the issuer should decline to sell securities to that investor. Importantly, an issuer can consider the financial condition of the investor alone or the combined financial condition of that investor and her spouse, if any.

Paragraph (b)(3)(B) of the Standard covers the element of financial sophistication. In this regard, an investor may demonstrate that she alone is sufficiently knowledgeable about financial and business matters that she is capable of understanding the risks and rewards of the particular invest-

320. Cf. 17 C.F.R. § 240.15g-9(b)(3), (4) (requiring a broker or dealer to deliver a written statement to a customer setting forth that broker’s or dealer’s suitability determination and requiring that the customer sign it and return it).

321. This same information also assists an issuer in determining whether or not the investor is an “accredited investor.” If the investor is accredited, then the exemption under paragraph (a)(3)(A) of the Standard would be satisfied and the issuer would not have to make a suitability determination under paragraph (a)(5).

ment. Alternatively, she can rely in whole or in part on the sophistication of her purchaser representative, so long as that representative meets the qualifications specified in Rule 501(h) of Regulation D.³²² In order to determine whether a particular investor and/or her purchaser representative meets the requisite level of sophistication, an issuer should request information concerning a person's educational and vocational history and investment experience.

Paragraph (b)(3)(C) of the Standard covers the final element of suitability—namely, an investor's financial objectives. In this regard, an issuer could produce a simple grid ranging from capital preservation to aggressive growth with corresponding boxes that an investor could simply check to indicate her investment objectives. To further clarify this grid, an issuer could include a notation indicating that capital preservation is the "least risky" investment objective, while aggressive growth is the "most risky." An issuer also should ask for an investor's age, because that information sheds light on how compatible a particular security is with an investor's investment horizon. In this same vein, an issuer should ask an investor when she anticipates converting her investment into cash.

Paragraph (c) of the Standard sets forth the consequences an issuer faces if it sells securities to a particular investor in contravention of the Standard. If the Standard requires the issuer to make a suitability determination and the issuer either fails to do so or makes one that is unreasonable under the circumstances, then the issuer loses its exemption under section 3(b) of the Securities Act *solely with respect to that particular sale*. Accordingly, the issuer must find another exemption to cover that sale. The availability of another exemption, however, is unlikely.

An issuer finding itself in this position cannot rely on Regulation A or Rules 504 or 505 of Regulation D, because its section 3(b) exemption is lost with respect to the violative sale by virtue of paragraph (c) of the Standard. In addition, because the issuer most likely will have solicited the general public or advertised its offering, an exemption under sections 4(2) and 4(6) of the Securities Act and Rule 506 of Regulation D also would be unavailable.³²³ Similarly, an intrastate exemption under section 3(a)(11) of the Securities Act³²⁴ and Rule 147³²⁵ would be unavailable if

322. 17 C.F.R. § 230.501(h).

323. Under those circumstances, an exemption under Rule 505 of Regulation D also will not be available; however, Rule 505, which was promulgated under the SEC's authority under section 3(b) of the Securities Act, is already lost because of the unavailability of the section 3(b) exemption.

324. 15 U.S.C. § 77c(a)(11) (1994 & Supp. III 1997).

325. 17 C.F.R. § 230.147.

the issuer solicited investors in multiple states via the Internet or otherwise. Thus, a SIPO issuer most likely would not find another exemption to cover a particular sale that violated the provisions of the Standard.

If the issuer cannot find another exemption and its securities are not registered under section 5 of the Securities Act, the issuer will have violated section 12(a)(1) of the Securities Act solely with respect to the violative sale.³²⁶ Section 12(a)(1) states:

Any person who . . . [o]ffers or sells a security in violation of Section 5 . . . shall be liable . . . to the person purchasing the security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

In other words, the investor will have an automatic and immediately available “put” right against the issuer. The investor will be able to force the issuer to buy back that security from her for any reason whatsoever, such as a realization that the security is truly illiquid or at the first hint of trouble with the issuer’s business. The only caveat will be that any action must be brought by the investor within one year after the date the security was sold to her or three years after the security was bona fide offered to the public, whichever comes earlier.³²⁷

Paragraph (c) also allows the SEC at any time to enter an order temporarily or permanently suspending an issuer’s section 3(b) exemption with respect to an entire offering, as opposed to an isolated sale. This suspension is warranted if the SEC has reason to believe that a particular issuer is systematically selling securities in contravention of the Standard. Whether or not an issuer is doing so deliberately or unintentionally would have no effect on the SEC’s ability to suspend that issuer’s section 3(b) exemption. Unintentional sales of unsuitable securities harm investors just as much as intentional sales.

3. *Arguments Against the Proposed Standard*

Three primary arguments have been raised against implementing a federal suitability standard in the context of self-managed SIPOs. Not surprisingly, the first argument stresses that the Standard, like any other regulatory provision, would dampen the efficiency of the capital markets because of increased transaction costs. Yet, where better to institute regu-

326. 15 U.S.C. § 771(a)(1) (Supp. III 1997).

327. See *id.* § 77m (1994).

latory protections than with respect to the riskiest of issuers offering securities to the most vulnerable of investors?

Moreover, those issuers that are the likely candidates to conduct self-managed SIPOs already are required to make determinations similar to those required by the Standard in the context of other exempt offerings. For example, many SIPO issuer candidates currently raise capital under either Rule 505 or 506 of Regulation D. Both rules require issuers to make the necessary determinations to ensure that they sell securities to no more than thirty-five “purchasers” and an unlimited number of “accredited investors.” Rule 506 additionally requires issuers to ensure that “purchasers” are sophisticated. Issuers relying on Rules 505 and 506, therefore, already incur transaction costs substantially similar to those that would be incurred if the Standard were implemented.

A second argument against the Standard is that certain SIPO issuers may not be capable of making the suitability determinations required by the Standard. As discussed above, however, SIPO issuer candidates already are making similar determinations in the context of exempt offerings conducted under Rules 505 and 506. Moreover, any issuer that is savvy enough to pull off a self-managed SIPO is sophisticated enough (in this author’s opinion) to make suitability determinations. To the extent an issuer truly feels uncomfortable making suitability determinations, it can retain an outside consultant to perform that task for it.

Issuers also can substantially reduce the number of suitability determinations they are required to make by simply imposing a minimum investment requirement. For example, an issuer could require a minimum investment of at least \$5,000 from each investor. Those investors unwilling or unable to invest that minimum amount of capital would be excluded from participating in the offering. This type of requirement could also help keep securities out of the hands of the most vulnerable investors—those with the least amount of money to invest (and lose).

A third argument relates to paragraph 3(c) of the Standard. That paragraph gives an investor a limited “put” right to the extent that an issuer has failed to make a suitability determination or has made an unreasonable suitability determination with respect to that investor. As a result of that “put” right, money would flow out of the issuer and into the hands of the injured investor. The argument goes that this outflow of cash would hurt the remaining investors, thus making them in effect bear the risk of issuer noncompliance with the Standard. It is argued, moreover, that when an issuer’s business takes a turn for the worse, it is patently unfair to allow

some investors to salvage their investments at a time when others must ride out the storm or even be swallowed by it.

In this regard, it is important to remember several things. First, the largest recovery an injured investor can receive is his money back. Thus, when viewed from this perspective, the net effect on the issuer is zero; money that should never have been accepted by the issuer is simply being returned by the issuer. Indeed, the “put” right is simply a recognition of the fact that an injured investor should never have been an investor in the first place. Second, those investors for whom a given investment was suitable are the ones that were able to “fend for themselves” upon receiving full disclosure. Accordingly, once the Standard is implemented those investors should simply factor the risk of issuer noncompliance into their decisionmaking calculus. If the risk of issuer noncompliance together with all the other risks of a given self-managed SIPO makes that offering too risky for a potential investor, that investor can simply choose to invest elsewhere.

It also is important to recognize that requiring SIPO issuers to make suitability determinations makes intuitive sense for the same reason that it makes sense for the NASD to compel brokers to make those determinations. Indeed, SIPO issuers’ solicitations of random members of the public over the Internet or e-mail closely resemble broker cold calls to potential customers. These solicitations, therefore, are deserving of similar regulation.

This resemblance to cold calls is manifested in at least four ways. First, just as customers receiving cold calls must “rely . . . extensively on securities salesmen eager to confirm sales,”³²⁸ investors solicited by SIPO issuers must place their trust in officers and other minions eager to raise capital. Second, like cold-calling brokers picking random names from the phone book, SIPO issuers often have no meaningful nexus to the members of the public they solicit. Third, while cold-calling brokers stand to earn commissions from their efforts, SIPO issuers stand to save on underwriting commissions by directly placing their securities. Finally, like cold-calling broker recommendations, SIPO issuers’ unilateral solicitations of random members of the public arguably constitute outright recommendations of their securities to those members.

Accordingly, it makes sense to require unseasoned SIPO issuers to make suitability determinations when making sales to unsophisticated retail investors. Just as the NASD saw the potential for abuse when broker

328. Warren, *supra* note 183, at 137.

recommendations are coupled with commission generation, the same potential for abuse arises when commission savings are coupled with capital generation in the context of self-managed SIPOs. The policy justifications in both cases for requiring suitability determinations are substantially similar.

C. OTHER MODIFICATIONS TO REGULATION A DESIGNED TO PROTECT INVESTORS

In addition to adopting the Standard, the SEC should make two additional modifications to Regulation A in order to help protect investors. First, Rule 253(d) should be modified to require issuers to add the following legend to the cover page of their offering circulars:

THE SECURITIES OFFERED HEREBY ARE HIGHLY SPECULATIVE AND INVOLVE A SUBSTANTIAL DEGREE OF RISK. ACCORDINGLY, THE SECURITIES ARE SUITABLE ONLY FOR PERSONS WHO CAN AFFORD A TOTAL LOSS OF THEIR INVESTMENT.

This legend should be the first legend appearing on the cover page and should take the form of a separate and distinct paragraph not combined with any other legend.

While the necessity of this legend is obvious, Form 1-A does not necessarily require anything like it. Form 1-A allows a corporate issuer to include in its offering circular information specified by Model A of Part II of Form 1-A, Model B of Part II of Form 1-A, or Part I of Form SB-2 (except for the financial statements called for therein).³²⁹ Model A of Part II of Form 1-A requires that an issuer include a somewhat similar legend on the cover page of its offering circular.³³⁰ However, Model B of Part II of Form 1-A and Part I of Form SB-2 do not.³³¹ A corporate issuer wishing

329. See Form 1-A, Part II-Offering Circular; JENNINGS ET AL., FEDERAL SECURITIES LAWS, *supra* note 35, at 358-83.

330. That legend reads in part: "INVESTMENT IN SMALL BUSINESSES INVOLVES A HIGH DEGREE OF RISK, AND INVESTORS SHOULD NOT INVEST ANY FUNDS IN THIS OFFERING UNLESS THEY CAN AFFORD TO LOSE THEIR ENTIRE INVESTMENT." Form 1-A, Part II-Offering Circular, Offering Circular Model A, Cover Page; JENNINGS ET AL., FEDERAL SECURITIES LAWS, *supra* note 35, at 359.

331. Model B of Part II of Form 1-A simply states the following: "The cover page of the offering circular shall include the following information: . . . (i) If applicable, identify material risks in connection with the purchase of the securities." Form 1-A, Part II-Offering Circular, Offering Circular Model B, Item 1 (i); JENNINGS ET AL., FEDERAL SECURITIES LAWS, *supra* note 35, at 375. Part I of Form SB-2 only requires an issuer to "[c]ross-reference to, and identify the location within the prospectus of (e.g., by page number or other specific location), the risk factors section of the prospectus . . ." Form SB-2, Part 1, Item 1 (referencing Regulation S-B, Item 501(a)(4)).

to avoid the inclusion of Model A's legend could, therefore, simply choose to follow one of the latter two options.³³²

The second modification to Regulation A would be to require issuers to include a history of their financing efforts within their offering circulars. In this regard, the following types of questions would be answered. How has an issuer financed its operations to date? Has the issuer approached venture capital firms for financing? If so, what was the result? If venture capital firms declined to provide financing, did they provide the issuer with specific reason why? Similarly, has the issuer approached any investment banks to underwrite an offering? If so, what was the result? If the investment banks declined to underwrite an offering by the issuer, did they provide the issuer with specific reasons? The purpose of these questions is to inform potential investors that they could be the financing source of last resort, since the issuer may have been shot down by all other financing sources or intermediaries that it previously courted.³³³

CONCLUSION

The Internet and other electronic media now enable unseasoned businesses to directly and cost-effectively offer their securities to unpreferred retail investors pursuant to the small issue offering exemptions of Regulation A and Rule 504 of Regulation D. This development, however, raises issues relating to how suitable these securities are for many of these investors. Because existing securities laws and suitability standards do not address these issues, a new suitability standard needs to be fashioned and implemented to safeguard these investors.

This Article proposes a new suitability standard applicable to unseasoned issuers who conduct self-managed SIPOs targeting unpreferred retail investors. The standard is carefully tailored to ensure the proper chan-

332. See, e.g., SPRING STREET OFFERING CIRCULAR I, *supra* note 44, at Cover Page (no similar legend); SPRING STREET OFFERING CIRCULAR II, *supra* note 44, at Cover Page (no similar legend). Cf. Offering Circular of The Pathways Group, Inc., *supra* note 211, at Cover Page (including information required by Part I of Form SB-2 and voluntarily incorporating the following legend on its cover page: "The securities offered hereby involve a high degree of risk and should not be purchased by investors who cannot afford the loss of their entire investment.").

333. For example, a typical disclosure in this regard could take the following hypothetical form: On September 23, 1998, representatives of the issuer met with representatives of the investment banking firm of PaineWebber Incorporated. The purpose of the meeting was to gauge PaineWebber's interest in underwriting on a firm commitment basis an offering of the issuer's common stock designed to raise \$13 million in proceeds. The proceeds of the offering were earmarked for the repayment of debt and for capital expansion plans. However, PaineWebber declined to participate in such an offering based on its view of the issuer's future prospects, the issuer's lack of a track record in earnings growth, and the small size of the proposed offering.

neling of these issuers' securities into the portfolios of suitable investors while minimizing the disruption to these issuers' capital-raising efforts. Implementing this standard will both protect the most vulnerable segment of the investing public and enhance the reputation of the Internet as a viable means of capital formation.