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I. INTRODUCTION

"The chief cause of business failures—after management error—is lack of capital."[1] Because of the barriers facing small businesses in their quest for gaining additional capital, in 1992 the Securities and Exchange Commission (hereinafter called "the Commission") made numerous changes to its regulatory scheme regarding the issuance and sale of securities.[2] The most notable of these changes were the Commission's adoption of an integrated disclosure system for small business issuers,[3] its revisions to Rule 504 of Regulation D (offerings by small businesses of securities not in excess of $1 million),[4] and its revision of Regulation A offerings (offerings by businesses of securities not in excess of $5 million).[5]

Simultaneous to the Commission's reforms, the Internet was becoming a ubiquitous medium of advertising, e-commerce, and information promulgation. These two sets of events proved synergistic, for the Internet's cost-effective means of distributing information improved the ability of companies to directly and economically inform and interact with large groups of possible investors. The process used by a company directly offering its securities to the public is called a direct public offering (hereinafter "DPO").[6] "In a DPO, the issuer by-passes investment banks and underwriters and offers shares directly to potential investors via online resources, telephone or in-person marketing."[7] By coupling the available technology with the expanded opportunities for selling small amounts of securities without the traditional regulatory burdens of a reg-

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1. Mario P. Borini, *Give Small Businesses the Tax Break They Deserve*, BUS. WK., June 18, 1984, at 11.

2. *See* Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 33,442 (Aug. 13, 1992).

3. *See* 17 C.F.R. §§ 228.10-228.702 (2000).

4. *See* 17 C.F.R. § 230.504 (2000).

5. *See* 17 C.F.R. §§ 230.251-230.262 (2000).

6. Joseph Kershenbaum, *Securities Offerings Online by Small Nonpublic Businesses*, 25 VT. B. J. & L. DIG. 19 (1999).

7. *Id.*

istered offering, the process of a company undertaking a DPO minimized the offering's costs while maximizing the potential return.

Because there are significant benefits and cost savings to small businesses that directly sell their securities, this paper addresses the process by which a company may utilize Regulation A in the DPO context.[8]

II. INTRODUCTION TO REGULATION A

The Spring Street Brewing Company (hereinafter "Spring Street") offering is an example of how the Internet and the expanded opportunities for securities offerings were successfully combined to raise capital in the small business context.[9] Spring Street was a small microbrewery in New York that needed additional capital to expand its manufacturing capacity, but it was unable to attract an underwriter for a registered offering and was not willing to accept the terms of a venture capitalist.[10] Therefore, Spring Street elected to undertake a DPO. Spring Street applied for a Regulation A exemption from the Commission, and it subsequently posted its offering circular on an Internet site and included printed advertisements of the securities on its six-packs of beer.[11] "Spring Street completed the offering in March 1996, raising roughly $1.6 million by selling approximately 900,000 shares to some 3,500 investors at $1.85 per share."[12]

Regulation A was the best method for a company like Spring Street to raise the additional capital it needed. Regulation A offerings are unique in that they allow a prospective issuer to "test the waters" of the market to determine if there is sufficient interest in the company's securities before the prospective issuer commits the time and resources to filing an offering statement with the Commission.[13] In addition, the Regulation proved effective for Spring Street in part because there are virtually no restrictions on resale of securities and no special qualifications for initial investors to meet with respects to number or sophistication.[14] Furthermore, DPOs offer the issuer tremendous cost savings. By

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8. While the Commission permits an underwriter to participate in a Regulation A offering, this paper shall not discuss that option due to the rarity of such collaborations. Therefore, this paper shall focus only on the DPO process for Regulation A offerings.

9. *See* Daniel Everett Giddings, *Comment: An Innovative Link Between the Internet, the Capital Markets, and the SEC: How the Internet Direct Public Offering Helps Small Companies Looking to Raise Capital*, 25 PEPP. L. REV. 785, 786 (1998).

10. *See* William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 531 (2001).

11. *See id.* at 532.

12. *Id.* at 532.

13. *See* Giddings, *supra* note 9, at 793.

14. *See id.* Some Regulation D offerings, which are also non-registered, require that the number of purchasers be limited. For example, in a Rule 505 offering purchasers are limited to less than 35 non-accredited investors and an unlimited number of accredited investors. *See* HOWARD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 9.05, at 475 (2001).

cutting out the underwriter, accountants and printing and "roadshow"[15] costs, a company can "go public" at a cost of perhaps 6% of the total value of the issue, as opposed to a 13% average for an underwritten, registered offering.[16]

The following section of this paper addresses a range of issues regarding Regulation A: the scope of the exemption, Commission compliance obligations, state registration issues, broker-dealer regulations, advantages and disadvantages of such an offering, and strategy recommendations.

A. *Scope of The Regulation A Exemption*

The Commission has promulgated 17 C.F.R. §§ 230.251 through 230.263 (2000) to define the scope of the Regulation A exemption. The rules address issues ranging from who may be an issuer to offering conditions. The following are major issues regarding this exemption:

1. Who May Issue Securities Under Regulation A?

The Regulation A exemption assists small businesses in obtaining capital from the sale of securities.[17] The major eligibility requirements are:

- The issuer must be an entity organized and having its principal place of business in the United States or Canada;[18]
- The total value of the securities being offered cannot exceed $5 million,[19] "less the aggregate offering price for all securities" sold by the issuer during the previous twelve months in reliance on Regulation A[20]
- The issuer must not be subject to the reporting requirements of the Securities Exchange Act of 1934:[21]
- The issuer cannot be an investment company offering interests in oil or gas rights;[22] and

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15. A "roadshow" is the process by which a company's officers tour the country making presentations to groups of investors regarding their business and the attractiveness of their securities.

16. *See* Kerry Hannon, *Going Public to the Public: Small Businesses Can Bypass Underwriters and Save Big Money*, U.S. NEWS & WORLD REP., June 17, 1996, at 74.

17. *See* Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 36,442, 36,442 (Aug. 13, 1992).

18. 17 C.F.R. § 230.251(a)(1)(2000).

19. BLOOMENTHAL, *supra* note 14, § 7.02, at 388.

> A Regulation A offering by an issuer in the amount of $5 million...would make both Rule 504 and 505 unavailable to an issuer for a period of 12 months. On the other hand, a Rule 504 or 505 offering made immediately prior to the Regulation A offering would not affect the amount that can be offered pursuant to Regulation A. *Id.*

20. 17 C.F.R. § 230.251(b)(2001).

21. 17 C.F.R. § 230.251(a)(2)(2001).

- None of the issuer's officers or directors can be subject to a pending investigation by the Commission or have been convicted of any crime associated with the issuance or sale of securities within the past five years.[23]

Importantly, when issuing individual securities pursuant to the Regulation A exemption individual securities have no price floor or ceiling. "The Commission is persuaded that exclusion of legitimate small business operating companies from the exemption because of the trading price of their securities is not necessary for investor protection and would foreclose significant financing options to small developing companies."[24]

2. Testing the Waters: Gauging the Market's Interest in an Issuer's Securities[25]

The Commission under Regulation A permits a prospective issuer of securities to publish "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."[26] This provision is unique to Regulation A; the Commission normally does not allow issuers to disseminate advance information about prospective issues of securities in connection with registered offerings. Before publishing or broadcasting any advertisements in advance of a Regulation A offering, the prospective issuer must deliver or publish to the Commission a copy of the advertisement or script for a radio or television broadcast.[27] The written script or broadcast is required to do no more than the following:

- State that money is not yet being solicited and will not be accepted;
- State that no sales of the security will be made or commitment to purchase accepted until the investor is delivered an offering circular;
- Explain that an expression of interest by a prospective investor will not commit that investor to purchase the securities;
- Briefly explain the business and its products;

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22. 17 C.F.R. § 230.251(a)(5)(2001).

23. 17 C.F.R. § 230.262 (2000).

24. Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 33,442, 36,444 (Aug. 13, 1992).

25. The Commission holds that if a prospective issuer uses the "test the waters" provision permitted to Regulation A issuers, and then makes a good faith decision to have the securities issued under another registration process, the prior use of the "test the waters" provision will not disqualify the issuer from resorting to a registered offering. Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 33,442, 36,445 (Aug. 13, 1992).

26. 17 C.F.R. § 230.254(a)(2000).

27. *Id.* "Failure to file such sales literature can be the grounds for entry of a suspension order." BLOOMENTHAL, *supra* note 14, § 7.02, at 395.

- Identify the issuer's officers and directors.[28]

The advertisements "may include a coupon, returnable to the issuer, indicating interest in a potential offering revealing the name, address and telephone number of the prospective investor."[29]

After the Commission obtains copies of the advertisements,[30] the Commission permits a prospective issuer or its agents to communicate orally with interested investors.[31] However, once a prospective issuer has filed an offering statement, the first step in qualifying for a Regulation A exemption, the issuer can no longer promulgate further advertising.[32]

Unfortunately, the movement toward uniformity regarding securities regulation has removed cumulative blue-sky law regulatory requirements. A case on point is Colorado Rule 51-3.13(A) (2000) which places the following requirements upon prospective issuers who use the Commission's "testing the waters" provision:

- All solicitation of interest documents must be filed with the state securities regulation administrator no later than the date of its first publication;
- All solicitation of interest documents must include the following statement: This information is distributed under SEC Regulation-A and has been filed with the SEC and the Colorado Securities Division. Neither the SEC nor the Securities Division has reviewed or approved its form or content.[33]

While the added burdens imposed by state blue-sky laws are minimal in the Colorado context, the difficulty arises from multiplicity and divergence of separate state regulations regarding pre-filing advertisements. Therefore, a prospective issuer who plans on using the "testing the waters" provision should research the law of each state where it plans on advertising its prospective issuance so as to ensure compliance with state law.

3. How To Apply for a Regulation A Exemption

The Commission requires that all prospective issuers seeking to issue securities under the Regulation A exemption file seven copies of a

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28. 17 C.F.R. § 230.254(2)(iv)(2000).

29. 17 C.F.R. § 230.254(c)(2001).

30. Once the solicitation documents have been filed with the Commission, they need be refiled only if the advertisement is changed in a materially significant manner. *See* 17 C.F.R. § 230.254(b)(1)(2000).

31. 17 C.F.R. § 230.254(a)(2001).

32. 17 C.F.R. § 230.254(b)(3)(2000).

33. 3 COLO. CODE REGS. § 51-3.13(A)(2001). *See also* http://www.dora.state.co.us /securities/ttwoff.htm (explaining Colorado Rule 51-3.13(A) as it applies to the Federal "Testing the Waters" provision).

Form 1-A Offering Statement[34] in "the Commission's main office in Washington, D.C."[35] The offering statement must be signed by the issuer's Chief Executive Officer, Chief Financial Officer, a majority of the members of the issuer's Board of Directors, and any individual who is selling his or her privately held securities through the Regulation A process.[36]

Form 1-A allows a prospective issuer to supply the Commission with the required information in either of two formats: the traditional registration format, or the question and-answer format.[37]

Minor errors in an offering statement or the issuer's failure to comply with a particular term of Regulation A will not automatically destroy the issue's exemption if the issuer demonstrates to the Commission three points: that the error was not prejudicial to prospective purchasers of the security, that the error was insignificant, and that the issuer made a good faith effort to comply with the Commission's requirements.[38] Furthermore, the "Commission's safe harbor provisions relating to forward looking information have been specifically made applicable to Regulation A."[39]

It is common for the Commission's staff to send the prospective issuer a "comment letter" asking the issuer to clarify, correct, or supplement the information that it has provided. Unless the issuer seeks to have its offering statement's qualification delayed,[40] the offering statement will be designated as qualified, and sales of the securities may commence on the twentieth calendar day after the Commission deems the form completed and filed.[41]

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34. Some state jurisdictions, in accordance with the Commission's cooperation, allow prospective issuers to use Form U-7 to be submitted to both the Commission and respective state securities regulators for registration / qualification purposes. BLOOMENTHAL, *supra* note 14, at 1152. Use of Form U-7 is associated with an issuer seeking a SCOR state registration exemption, yet such an exemption is not advisable due to its limitations and conflicts with Regulation A. *See* discussion *infra* Part III(C).

35. 17 C.F.R. § 230.252(e)(2000).

36. 17 C.F.R. § 230.252(d)(2000).

37. *See* Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 33,442, 36,443-44 (Aug. 13, 1992).

38. *See* 17 C.F.R. § 230.260(a)(2001).

39. *See* Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 33,442, 36,444 (Aug. 13, 1992).

40. In some instances a prospective issuer may wish to delay the qualification date of its offering statement in order to promote the sale of the securities for more than the 20 days provided by the Commission. In those instances, the issuer needs to amend its preliminary offering circular to comply with Section 230.252(g). *See* 17 C.F.R. § 230.252(g)(2001).

41. 17 C.F.R. § 230.252(g)(2000).

4. Does the Prospective Issuer Need to Supply Audited Financial Statements?

A significant advantage for prospective issuers who utilize Regulation A is that they are not required to supply the Commission with audited financial statements, unless the issuer has audited financial statements otherwise available.[42] However, a number of states require certified financial statements; therefore, it is advisable for a prospective issuer to research the state law requirements for the jurisdictions where they plan on offering and selling their securities so as to ensure compliance.

5. Treatment of Confidential Information

Sometimes an issuer may desire to have some of the information contained in its Form 1-A application treated as confidential. Such information can range from trade secrets to projections of earnings. A prospective issuer can request that the Commission treat selected parts of its offering statement as confidential.[43] Once the Commission has received the offering statement, the Commission's staff will review its content to ensure that the information supplied complies with the requirements of Regulation A. If the material that the issuer seeks to withhold can be deleted from the offering statement without compromising its value to an investor, then the Commission should approve the issuer's petition.

6. What is an Offering Circular?

An offering circular is a document that the Commission requires to be delivered to all parties upon request, all prospective purchasers of a security, and all purchasers of a security issued under Regulation A.[44] There are two types of offering circulars: a Preliminary Offering Circular[45] and a Final Offering Circular.[46]

The Preliminary Offering Circular is required to bear on the outside front cover the caption "Preliminary Offering Circular," the date of issu-

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42. Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 33,442, 36,491-92 (Aug. 13, 1992). *See* UNITED STATES SECURITIES AND EXCHANGE COMMISSION, Form 1-A, Part F/S, *available at* http://www.sec.gov/divisions/corpfin/forms/1-a.htm.

43. The Commission has two standards for whether information submitted in a registration statement will be treated as confidential. Information that is required to be in the offering statement will be reviewed per Section 230.406. *See* 17 C.F.R. § 234.406 (2001). Information not required to be in the offering statement will be considered per section 200.83. *See* 17 C.F.R. § 200.83 (2001).

44. *See* Securities Act of 1933 § 5, 15 U.S.C. § 77e (2001) (providing rules regarding the limitations upon offers, confirmations, and sales of securities and the documentation required to be delivered to a purchaser or prospective purchaser during each respective period).

45. "Preliminary Offering Circular: The offering circular described in § 230.255(a)." 17 C.F.R. § 230.251(d)(2000). *See* 17 C.F.R. § 230.255(a).

46. "Final Offering Circular: The current offering circular contained in a qualified offering statement." 17 C.F.R. § 230.261(a).

ance of the circular, and a statement required by the Commission.[47] In addition, "[t]he Preliminary Offering Circular contains substantially the information required in an offering circular by Form 1-A, except that information with respect to offering price, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices, or other matters dependent upon the offering price may be omitted."[48]

A Final Offering Circular must include the narrative and financial information required by Form 1-A, the offering price of the security, the number of shares offered, the projected total amount of proceeds, and any dealer or underwriter discounts or commissions.[49] In addition, the Final Offering Circular must include a cover-page legend informing a prospective purchaser of the security that the Commission does not affirm the merits of the offering or the accuracy of the offering circular.[50]

7. When May an Issuer Offer to Sell Securities Under Regulation A?

No offer may be made to sell the securities to be issued under Regulation A until a Form 1-A offering statement has been filed with the Commission.[51] There is no waiting period between the time when an applicant files the Form 1-A, and the time when it may make oral and written offers, or even publish printed advertisements regarding the offer.

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47. The required statement must read:

> An offering statement pursuant to Regulation A relating to these securities has been filed with the Securities and Exchange Commission. Information contained in this Preliminary Offering Circular is subject to completion or amendment. These securities may not be sold nor may offers to buy be accepted prior to the time an offering circular which is not designated as a Preliminary Offering Circular is delivered and the offering statement filed with the Commission becomes qualified. This Preliminary Offering Circular shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there by any sales of these securities in any state in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the laws of any such state.

17 C.F.R. § 230.255(a)(1)(2000).

48. 17 C.F.R. § 230.255(a)(2)(2000).

49. 17 C.F.R. § 230.253(a)(2000); 17 C.F.R. § 230.251(d)(2000).

50. The Commission requires that the following language be printed on the cover page of every final offering circular subject to Regulation A:

> 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 OTHER 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)(2000).

51. 17 C.F.R. § 230.251(d)(1)(i)(2000).

However, no sales of the securities can take place until the Commission has qualified the Form 1-A.[52]

8. Making Offers During the Waiting Period

There are three types of offers that can be made prior to the Commission qualifying a prospective issuer's offering statement: oral offers, written offers, and advertisements. All three of these types of offers are subject to one overriding limitation: An issuer or its agent cannot enter into a contract to sell any security before the Commission has qualified the issuer's offering statement.[53]

a. Oral Offers

An issuer or its agent may extend an oral offer to sell its securities to a prospective investor prior to the Commission's qualifying the offering statement provided that no binding transaction is entered into before the offerings statement's effective date.[54]

b. Written Offers

Written offers must comply with the restrictions articulated in 17 C.F.R. § 230.255. "Once an offering statement is filed, a written offer can be made only through the use of a preliminary or final offering circular."[55] The preliminary offering circular is required to bear on its cover page the caption "Preliminary Offering Circular," the date of its issue, and an explanatory statement concerning the nature of the offering.[56] The Preliminary Offering Circular must contain "substantially the information required in an offering circular by Form 1-A," except that it is not required to state the offering price, underwriter and dealer discounts, amount of proceeds, and other matters dependent upon the securities offering price; but it is required to give an estimate of the initial offering price for the security and the number of shares to be issued.[57] If information in the preliminary offering circular is later found to be inaccurate in any material[58] respect, a revised copy of either the preliminary offering circular or a final offering circular must be furnished to the investor at

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52. 17 C.F.R. § 230.251(d)(2)(i)(A)(2000).

53. *See* discussion *infra* Part II(A)(8)(a-c). *Compare* Securities Act of 1933 § 5, 15 U.S.C. § 77e (2001) (prohibiting the sale of any security before its associated registration statement becomes effective).

54. *See* 17 C.F.R. §§ 230.251(d)(1)(ii)(A), (d)(2)(i)(A).

55. *See* Small Business Initiatives, Exchange Act Release No. 33-6949, 57 Fed. Reg. 33,442, 36,445 (Aug. 13, 1992).

56. 17 C.F.R. § 230.255(a)(1)(2002).

57. 17 C.F.R. § 230.255(a)(2)(2000).

58. The term "material," used in reference to information subject to SEC regulations, is a term of art. *See* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (holding that a fact is "material" if there is "a substantial likelihood that the... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.").

least 48 hours prior to the mailing of any confirmation of sale to him or her.[59]

c. Print, Radio, and Television Advertisements

A prospective issuer may disseminate offers to the general public regarding a pending Regulation A offering if they state from whom the investor can acquire a preliminary or final offering circular, and contain no more than the following information: "(1) the name of the issuer of the security; (2) the title of the security, the amount being offered and the per unit offering price to the public; (3) the general type of the issuer's business; and (4) a brief statement as to the general character and location of its property."[60]

9. Does the Issuer Need to File Copies of its Sales Materials with the Commission?

The Commission requires that an issuer provide it with copies of all materials used in advertising its securities. "While not a condition to an exemption pursuant to this provision [Regulation A], seven copies of any advertisement or written communication, or the script of any radio or television broadcast, shall be filed with the main office of the Commission in Washington, D.C."[61] In addition, the issuer must provide the Commission with contact information for an individual who can respond to the Commission's questions about the advertising materials.[62] It is advisable for an issuer to comply with these rules, because a close working relationship with the Commission and its staff will facilitate amicable relations with the Commission's staff if questions or issues should arise with the current or a subsequent issuance. Such an amicable relationship will be helpful to the issuer that seeks the Commission's permission to advance the date on which its offering statement will be qualified, or at some later time seeks acceleration of the effective date of a registration statement.[63]

10. Selling Securities Once the Offering Statement is Qualified

The Commission prohibits the sale of securities until the Form 1-A offering statement has been qualified.[64] If a sale of the securities is made by either the issuer or a dealer, a preliminary offering circular or final

59. *See* 17 C.F.R. § 230.255(b)(2000).

60. 17 C.F.R. § 230.251(d)(1)(C)(2000).

61. 17 C.F.R. § 230.256 (2000).

62. Small Business Initiatives, Securities Act Release No. 33-6949, 57 Fed. Reg. 36,442, 36,445 (Aug. 13, 1992).

63. While securing an advancement of the qualification date of a Regulation A offering ordinarily is not critical, the success of a subsequent underwritten offering may depend on the Commission's willingness to accelerate the effective date of a registration statement.

64. 17 C.F.R. § 230.251(d)(2)(i)(A)(2000).

offering circular must be furnished to the purchaser at least 48 hours prior to the issuer's or its agent's mailing of the confirmation of sale.[65] Furthermore, a final offering circular "must be delivered to the purchaser with the confirmation of sale, unless it has been delivered to that person at an earlier time."[66]

11. How Long May an Issuer Sell the Securities?

Implicit in Regulation A is the premise that the issuer, once its offering statement is qualified, can continuously issue securities until either the issuer deems the offering closed or reaches the regulatory cap of $5 million. However, the issuer must update its sales materials and offering circular[67] at a minimum of every twelve months after the offering statement is qualified.[68] In addition, the issuer must submit any updated offering circular as an amendment to its offering statement.[69]

12. Reporting Sales to the Commission

Any issuer of securities under Regulation A is required periodically to file seven copies of Form 2-A at the Commission's main office in Washington, D.C.[70] This form reports to the Commission the total amount of funds raised by the offering and how the proceeds have been applied.[71] The Commission should be provided with this information every six months until "substantially all the proceeds have been applied," and "within 30 calendar days after the termination, completion, or final sale of securities in the offering, or the application of the proceeds from the offering, whichever is the latest event."[72]

13. Closing the Issuance of the Securities

In order to close a DPO, if the issuer is using a web page to facilitate its sales, the electronic version of the company's offering statement should include a link to a subscription agreement containing blanks for the prospective investor to designate the number of shares and total dollar amount of the purchase.[73] The investor then completes the form, encloses their payment, and mails the documents to the issuer's escrow

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65. 17 C.F.R. § 230.251(d)(2)(i)(B)(2000).

66. 17 C.F.R. § 230.251(d)(2)(i)(C)(2000).

67. "An offering circular for a continuous offering shall be updated to include, among other things, updated financial statements, 12 months after the date the offering statement was qualified." 17 C.F.R. § 230.253(e)(2)(2000).

68. The offering circular must be updated "whenever the information it contains has become false or misleading in light of existing circumstances, material developments have occurred, or there has been a fundamental change in the information initially presented." 17 C.F.R. 230.253(e)(1).

69. 17 C.F.R. § 230.253(e)(3)(2000).

70. 17 C.F.R. § 230.257 (2000).

71. *See* 17 C.F.R. § 239.91 (2000).

72. 17 C.F.R. § 230.257(a)-(b)(2000).

73. *See* Sjostrom, *supra* note 10, at 561.

agent.[74] If the issuer is not using an Internet interface, it should mail a confirmation and final offering circular to the investor upon receipt of the investor's order. The investor signs the confirmation slip, encloses his/her payment and mails it to the issuer's escrow agent. Once the escrow agent receives the electronic or hard-copy forms, in addition to receiving and depositing "checks aggregating the minimum amount required to close on the offering, ...a closing will be held."[75] "The funds will be released to the company and sale confirmations will be sent to the registered investors."[76]

14. Can the Securities be Resold?

"Shares issued in reliance on Regulation A can generally be resold freely by investors unaffiliated with the company."[77]

15. How Can the Internet Help in Selling the Issuer's Securities?

There are five ways that the Internet can assist in the sale of securities issued under Regulation A.

a. Advertising

The "testing the waters" provision allows for the same types of advertisements to be made on a web page as are allowed in print media or on television or radio.[78] The "testing" provision is significant. Any other prospective issuer relying upon a different exemption to issue its securities is in violation of federal law by advertising an issuance unless the issuer is previously registered with the Commission.[79] VillageFax advertised its prospective issuance of securities on the internet to promote the sale of its securities, and its promotion sparked sufficient interest to raise $2.3 million in capital.[80]

b. Electronic Document Delivery

An issuer or its agent may gain telephonic consent from an investor to receive copies of the preliminary offering circular, final offering cir-

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74. *See id.*

75. *Id.*

76. *Id.* "Under federal law, both confirmations and stock certificates for Regulation A and federally registered DEPs must be accompanied or preceded by a final offering circular/prospectus." *Id. See* 17 C.F.R. § 230.251(d)(2)(i)(2000); 15 U.S.C. § 77e(b)(2)(2000).

77. Sjostrom, *supra* note 10, at 543.

78. Small Business Initiatives, Securities Act Release No. 33-6949, 57 Fed. Reg. 36,442, 36,444 (Aug. 13, 1992).

79. *See* Giddings, *supra* note 9, at 793. *See also* James E. Grand & Gary Lloyd, *Internet IPOs: A Potential Oasis for Small Companies*, UPSIDE , July 01 1996, at 92 (highlighting the benefits of the 'test the waters' provisions for small issuers).

80. *See* Juan Hovey, *Working the Web for New Capital*, L.A. TIMES, Jan. 26, 2000, at C6.

cular, or confirmation of sale[81] via e-mail.[82] This allows distribution of the information to the prospective purchaser in a cost-effective and expedient manner.

A final offering circular can be delivered electronically, provided three requirements are met: notice, access and evidence of delivery. The SEC has established these requirements to ensure that information distributed through electronic means [will] result in investors receiving substantially equivalent information as they would have received had the information been delivered to them in paper form... An easy way for a DPO company to comply with the... offering circular/prospectus delivery requirements is to include a provision in the subscription agreement to the effect that by signing the subscription agreement the investor agrees to accept delivery of documents via e-mail or the company's website.[83]

c. Posting Sales Literature On-Line

Supplemental sales literature may be posted on the issuer's web site once the Commission has qualified the issuer's offering statement.[84] "Under the 'envelope theory,' supplementary selling literature posted on a web site [will] be considered as accompanied by a final prospectus if a hyperlink to the sales literature is in close proximity to a hyperlink to the final prospectus on the same web site menu or the sales literature contains a hyperlink to the final prospectus" or offering circular.[85]

d. Accepting Conditional Offers Electronically

Conditional offers to buy securities may be accepted via e-mail from prospective purchasers.[86] A prospective issuer can post on the Internet the preliminary or final offering circular, supplemental sales literature, and an electronic form for investors to fill out to express interest in

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81. The e-mailed confirmation of sale would be merely for the purchaser's informational benefit. It is strongly advised that the issuer have a confirmation of sale sent by the broker's clearing firm, if it has one, in order to comply with Rule 10b-10. The confirmation of sale should be sent via U.S. mail. *See* Wit Capital Corp., SEC No-Action Letter, [Transfer Binder 1999] Fed. Sec. L. Rep. (CCH) ¶ 77,577 at 79,907 (July 14, 1999).

82. *See* Use of Electronic Media, Securities Act Release No. 33-7856, 57 Fed. Reg. 25,843, 25,845-46 (May 4, 2000). "An issuer or market intermediary may obtain an informed consent telephonically, as long as record of that consent is retained." *Id.*

83. Sjostrom, *supra* note 10, at 562-3.

84. *See* Use of Electronic Media, 65 Fed. Reg. 25,843, 25,850 (May 4, 2000) (encouraging issuers to ensure compliance with Section 5 of the Securities Act in communicating over the Internet during a registration). *See generally* Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities and Exchange Commission Release No. 3844, (Oct. 8, 1957), 22 Fed. Reg. 8359 (1957) (providing conditions under which company information can be published).

85. Sjostrom, *supra* note 10, at 557.

86. *See* Wit Capital Corp., SEC No-Action Letter, [Transfer Binder 1999] Fed. Sec. L. Rep. (CCH) ¶ 77,577 at 78,907 (July 14, 1999).

the security. The conditional offers may be accepted after the Commission has qualified the offering statement and an offering price has been established for the security.[87] An important point to remember is that if a conditional offer to purchase securities was made prior to the security's price having been set, then the issuer must contact the prospective purchaser, inform him or her of the price, and await a re-confirmation of intent to purchase by the investor before the conditional offer can be accepted by the issuer.[88]

e. Electronic "Roadshows"

An issuer's web site may also include a "virtual roadshow."[89] Most companies that are making underwritten offerings of securities conduct tours of major American cities where the companies' executives make presentations to potential institutional investors. Such tours are very expensive in lost-opportunity and travel costs for the issuers' executives. The Internet allows a company to produce a "virtual roadshow," in which company executives and marketing staff present in video form information about the company's assets, business plan, and anticipated growth. The video presentation may be viewed by potential investors at any time, and can be updated to reflect changes in the issuer's outlook.[90]

f. State Blue-Sky Laws and Cyberspace Issues

While the Internet provides a substantial cost savings over other media, and increases the exposure a prospective issuer may have regarding its offering of securities, the non-uniformity of state blue-sky laws regarding electronic offerings warrants a cautionary note. To date, thirty two states have adopted the North American Securities Administrator Association (NASAA) Internet Resolution.[91] The resolution provides that a state securities administrator will not take action against a company offering securities via the internet if: (1) the website clearly states that the securities are not being offered to residents of that state, and (2) the offer is not specifically directed at any individual in a state.[92] An alternative exemption is also provided by the NASAA resolution whereby a prospective issuer using the "testing the waters" provision can offer their securities as long as "no sales are made until registration and

87. *See* Wit Capital Corp., SEC No-Action Letter, [Transfer Binder 1999] Fed. Sec. L. Rep. (CCH) ¶ 77,577 at 78,910 (July 14, 1999).

88. *See* Wit Capital Corp., SEC No-Action Letter, [Transfer Binder 1999] Fed. Sec. L. Rep. (CCH) ¶ 77,577 at 78,911 (July 14, 1999).

89. *See* Hovey, *supra* note 80.

90. An example of a successful use of a "virtual roadshow" is VillageFax, which issued securities pursuant to Regulation A, placed advertisements for the stocks on the Yahoo, Bloomberg, and Microsoft web sites, and raised $2.3 million from 350 investors. *See* Hovey, *supra* note 80.

91. BLOOMENTHAL, *supra* note 14, § 24.11, at 1175.

92. BLOOMENTHAL, *supra* note 14, § 24.11, at 1175.

prospectus delivery have been effected."[93] In order to minimize potential regulatory intrusion by any of the eighteen states that have not formally adopted the NASAA Internet Resolution, it is recommended that a prospective issuer contact the respective state securities administrators outlining the proposed offering and request a "no-action" letter.[94] Hopefully, the move toward uniformity regarding state blue-sky laws will reduce the number of non-conforming states from eighteen to zero over the next several years.

16. Can the Commission Suspend the Sale of the Securities Once the Offering Statement is Effective?

The Commission may enter an order temporarily suspending a Regulation A exemption if it has reason to believe that: (1) the requirements of the exemption have not been complied with, (2) the offering statement or sales material is materially misleading, (3) the offer is fraudulent,[95] (4) one of the officers or directors of the issuer has been subject to a stop order or indictment related to the sale of securities, or (5) the issuer or its agents refuse to cooperate with the Commission's staff in an investigation of the offering.[96] If the Commission issues a stop order, the issuer may request a hearing within 30 days of the order's issue to review the validity of the order.[97] If the applicant fails to request a hearing, then the sale of the securities subject to the stop order becomes permanent on the thirtieth calendar day after its entry.[98]

17. Can the Issuer Withdraw its Offering Statement?

An issuer is not bound to continue with the offering once it has submitted the offering statement to the Commission. If none of the securities subject to the offering statement have been sold, an agent of the issuer merely needs to petition the Commission to have the offering statement withdrawn.[99] An example of the withdrawal of an offering statement can be found in the experience of Directonal Robotics. After doing extensive work to complete an Internet-based offering, Directional

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93. *Id.*

94. The term "no-action letter" is jargon of the securities industry whereby either the Commission or a state securities administrator produces a letter asserting that under the conditions described by the issuer that the agency will not recommend an enforcement action.

95. The definition of "fraud" in reference to the sale of securities is a term of art. For a starting point regarding what constitutes fraud according to the Commission, refer to § 17 of the Securities Act of 1933, 15 U.S.C. § 77q (2001).

96. 17 C.F.R. § 230.258(a).

97. 17 C.F.R. § 230.258(b)(2).

98. 17 C.F.R. § 230.258(c).

99. 17 C.F.R. § 230.259(a).

Robotics raised merely $200,000 of its $5 million target, and ultimately abandoned the DPO for an alternative method of raising capital.[100]

Another process for the withdrawal of an application is initiated by the staff of the Commission. When an application has been filed for nine months but has not been amended or become qualified, the Commission can, after notice to the applicant, *sua sponte* deem the offering statement abandoned and thereby withdrawn.[101]

B. *Conclusions Regarding Regulation A*

Regulation A's benefits, most notably its expanded marketing opportunities and diminished filing requirements, make it a useful tool for a small business seeking to raise additional capital. One concern regarding the DPO process is the effect of "disintermediation." In the context of an underwritten registered offering, the underwriter's prominence and collateral liability enhance the confidence investors have in the security. In the DPO context, however, there is no third party to use its contacts and reputation to market the security; therefore, the issuer faces the prospect of selling securities in a skeptical market environment without the advantages of an associated underwriter. The issuer can overcome this liability by aggressively marketing its securities, ensuring that its offering statement is accurate and persuasive, and marketing to its customer base and to individuals within its own community.

In addition to the Commission's requirements, the issuer must also take into consideration two other regulatory issues: state securities laws, also known as "blue-sky laws," and broker-dealer registration requirements. These issues are addressed in the two sections below.

III. COMPLIANCE WITH STATE REGISTRATION REQUIREMENTS[102]

In addition to complying with the Commission's federal mandates, an issuer must register its offering in each state in which it plans to offer or sell its securities.[103] While many large public offerings are exempt from state blue-sky laws[104], Regulation A offerings do not qualify for a

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100. *See* Michelle V. Rafter, *The Cutting Edge: Online IPO's Falling Short of Expectations*, L.A. Times, May 26, 1997, at D1.

101. 17 C.F.R. § 230.259(b).

102. This paper will not address Coordinate Review Programs which are not available for Regulation A offerings. *See* NASAA Coordinated Equity Review Program § 5, NASAA Rep. (CCH) ¶ 10,001, at 10,011 (giving an overview of such programs).

103. While all fifty states have their own securities laws, the following are notable examples of state statutory registration requirements: CAL. CORP. CODE § 25110 (Deering 2001); COLO. REV. STAT. ANN. § 11-51-301 (West 2000); TEX. REV. CIV. STAT. ANN. art. 581-7 (Vernon 2000).

104. Section 18 of the Securities Act of 1933 was amended by the National Securities Markets Improvement Act of 1996 to provide that no state law, rule, regulation or order "requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that is a covered security or will be a covered security upon completion of the transaction." National Securities Markets Improvement Act

blanket exemption from state blue-sky requirements.[105] Therefore, a prospective issuer has two choices. It could register its Regulation A offering in each state in which it intends to market the security, or it could structure the offering so as to qualify for an exemption in each state in which it intends to offer and sell its securities.[106] Both options have benefits and drawbacks.

Structuring an offering to qualify for an exemption in every state would be preferable to registering that offering in each state, because the prospective issuer would be able to "avoid the time and expense of preparing and filing the necessary state registration documents."[107] Yet it is not practical for a company planning a Regulation A offering to structure it to fall within an exemption in every state.[108] Exemptions from blue-sky laws are generally available only two contexts: (1) offerings to a limited number of sophisticated investors, or (2) for offerings below a certain dollar amount.[109] Therefore, "it is likely that a company engaging in a Regulation A offering will have to register its DPO in each state in which it intends to make offers or sales."[110]

A. *Registration by Notification*

Registration by notification is an exemption from the traditional state registration process that dramatically lowers the regulatory burden of a prospective issuer, yet the process varies significantly from state to state. Two archetypal examples of registration by notification are Utah and Colorado's procedures.

Utah's registration by notification is available for any issuer, regardless if the issuer is also eligible for registration by coordination,[111] who meets the following criteria:

- Continuous operation for at least five years;
- The issuer has not defaulted for the previous three years on any payment of principal, interest, or dividends on any security it has previously issued; and

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of 1996, 15 U.S.C. s 77r (a)(1)(A)-(B) (2001). *See also* 15 U.S.C. § 77r(b)(1)(A) (2001) (defining a "covered security" as a security listed or approved for listing on the New York Stock Exchange, or the American Stock Exchange, or admitted or approved for admission and trading on NASDAQ).

105. *See* Sjostrom, *supra* note 10, at 544-45.

106. *Id.* at 545.

107. *Id.*

108. *Id.*

109. *See id. See also* UNIF. SEC. ACT § 402(12) (amended 1998) (providing an important exemption for an issuer in a state if that issuer offers to sell, or sells, to no more than ten entities within that state. This exemption is apt for a Regulation A offering in which an investor in a state in which the issuer has not marketed the security expresses interest in purchasing that security).

110. *Id.* at 545-6.

111. *See infra*, Part III(B) (discussing Coordinated Equity Review).

- Issuer had net earnings over the past three years equaling at least 5% of the value of the outstanding securities (or if the issuer has not previously issued securities, then the net earnings for the past three years must equal at least 5% of the value of the issues to be issued).[112]

The exception is also available for an issuer who has previously used registration by notification for a prior distribution.[113]

Colorado's exemption for registration by notification exemplifies a less rigorous registration by notification process. Pursuant to Colorado statute 11-51-308(1)(p) (2000), a prospective Regulation An issuer must submit to the Colorado State Treasurer a minimal filing fee,[114] a copy of all the documents the issuer provided to the Commission, and a cover letter specifying a contact person for the issuer.[115] The offering usually will be qualified in the state simultaneous with the Commission's qualification of the offering statement.[116]

B. *Coordinated Equity Review (CER)*

Section 303 of the Uniform Securities Act provides another means of complying with state blue-sky laws by allowing registration with states via a process called "Coordinated Equity Review" (hereinafter "CER") or "Registration by Coordination."[117] To qualify for CER, a prospective issuer must provide the state administrator with three forms: (1) Form U-1, the Uniform Application to Register Securities, (2) Form U-2, the Uniform Consent to Service of Process, and (3) Form U-2A, the Uniform Form of Corporate Resolution authorizing the filing of a registration statement. Form U-1 requests the following information from a prospective issuer:

- The issuer's registration/offering statement and offering circular (including any revised copies that are subsequently issued);
- The amount of the securities offered in the state, a listing of all other states were the security will be offered, and any adverse orders or decrees entered regarding the offering; and

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112. *See* UTAH CODE ANN. § 61-1-8 (2001).

113. *See* UTAH CODE ANN. § 61-1-8(b)(2001).

114. *See* COLO. REV. STAT. § 11-51-308. *See also,* Colorado Department of Regulatory Agencies, Divisions of Securities, http://www.dora.state.co.us/securities/ttwoff.html (laying out the filing requirements for obtaining an exemption from Registration for public offerings which are relying on Regulation-A at the Federal (SEC) level. As of December 4, 2001, the filing fee is $75).

115. *See* Colorado Department of Regulatory Agencies, Divisions of Securities, http://www.dora.state.co.us/securities/ttwoff.html.

116. *Id.*

117. Sjostrom, *supra* note 10, at 547.

- Should the state administrator require, a copy of the issuer's articles of incorporation, bylaws, underwriter agreement, specimen of the security, and any other information filed with the Commission.[118]

CER permits individual states to impose merit requirements upon offerings proposed for distribution within their jurisdiction.[119] While merit standards vary from state to state, the Uniform Securities Act Section 306 defines four primary standards for denying an application due to merit concerns:

- Does the offering tend to work a fraud upon the investor?
- Are the underwriting and selling expenses unreasonable?
- Are the promoter's profits or participation unreasonable?
- Are there unreasonable options as to amount or their terms?[120]

In order to ensure that a prospective issuer complies with a state's merit requirements, the corporation's counsel should research the merit standards for each jurisdiction in which the issuer seeks to offer and sell its securities.

This process is available for Regulation A offerings in just nine states: Alaska, Idaho, Kentucky, Montana, Ohio, Pennsylvania, Tennessee, Utah and Washington.[121] The state registration statement will become effective simultaneous with or subsequent to the Commission's qualification of the offering if the Commission has not issued a stop order and if the registration statement has been on file with the state administrator for at least ten days.[122]

C. *Small Company Offering Registration (SCOR)*

The Small Corporate Offering Registration (SCOR) process was adopted by the North American Securities Administrators Association in order to simplify state registration requirements, promote uniformity

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118. Uniform Application to Register Securities (Form U-1), 1 Blue Sky L. Rep. (CCH) ¶ 5115 at 1013 (1997); *available at* http://www.nasaa.org/nasaa/library/uniform_forms.asp. *See also*, UNIF. SEC. ACT § 303(b) (amended 1998) (setting out the basic requirements for registration by coordination).

119. *See* BLOOMENTHAL, *supra* note 14, § 24.01, at 1126.

120. UNIF. SEC. ACT § 306(a)(2)(E)-(F)(amended 1998).

121. ALASKA STAT. § 45.55.090 (Michie 2000); IDAHO CODE § 30-1420 (Michie 2000); KY. REV. STAT. ANN. § 292.360 (Banks-Baldwin 2000); MONT. CODE ANN. § 30-10-204 (2000); OHIO REV. CODE ANN. § 1707.091 (West 2000); PA. STAT. ANN. TIT. 70 § 1-205 (West 2000); TENN. CODE ANN. § 48-2-105 (2000); UTAH CODE ANN. § 61-1-9 (2000); WASH. REV. CODE § 21.20.180 (2001).

122. UNIF. SEC. ACT § 303(c) (amended 1998).

among states, and reduce registration costs.[123] The SCOR application, Form U-7 which is a simplified registration statement in a question-and-answer format, "is designed to be used by Companies, the attorneys and accountants for which are not necessarily specialists in securities regulation."[124] While the simplified application process is appealing, there are four limitations upon registered offerings that use the SCOR process. First, while SCOR is available for Regulation A offerings, the total value of securities that can be sold via a SCOR registration is limited to $1 million.[125] Second, the offering price of the securities must be $5 or more.[126] Third, there can be no pre-effective date selling efforts and all "free writing"[127] must be filed and cleared with the state securities regulation administrator prior to use.[128] Finally, the SCOR application process generally requires that independent certified accountants audit financial statements for the preceding year.[129] These four requirements curtail the main advantages of the Commission's $5 million cap, no per-unit restrictions, the Commission's "testing the waters" provision, and the waiver of audited financial statements. Therefore, the SCOR process is not recommended for Regulation A offerings.

If an issuer wishes to pursue a SCOR state registration, the prospective issuer must complete Form U-7, consent to service of process within each state where it plans to sell its securities, and then submit its application materials to one of four regional review programs.[130] The registration application is reviewed by the region's Program Administrator state, in addition to each state where the offering will be made available, for compliance with the SCOR program's disclosure requirements and any

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123. *See* G. Michael Stakis & Jean E. Harris, *Simplifying Registration of Small Corporate Offerings: Form U-7 "SCORs,"* INSIGHTS, July 1992, at 13; Sjostrom, *supra* note 10, at 551.

124. *Instructions for filing for SCOR,* Instruction I, *available at* http://www.nasaa.org/nasaa/corpfin/SCOR.doc.

125. *See e.g.*, CAL. CORP. CODE § 25113(b)(2)(B) (West 2000); OR. ADMIN. R. 441-065-0225 (2000); WASH. ADMIN. CODE § 460-17A-030(2)(e) (2000). *See also* Bloomenthal, *supra* note 14, § 24.07, at 1152.

126. *Instructions for filing for SCOR,* Instruction II-C, *available at* http://www.nasaa.org/nasaa/corpfin/SCOR.doc.

127. Informal trade term referring to supplemental sales literature. *See* J. Dormer Stephen III, *Gustafson: One Small Step (backward) for Private Plaintiffs, One Giant Leap (backwards) for The Securities Bar*, 49 OKLA. L. REV. 425, 453-54 (1996) (defining "free writing" as "selling literature...allowed to be sent to prospective purchasers, as long as [it] has been preceded or accompanied by a section 10(a) statutory prospectus.").

128. *Instructions for filing for SCOR,* Instruction III-J, *available at* http://www.nasaa.org/nasaa/corpfin/SCOR.doc.

129. *Instructions for filing for SCOR,* Instruction IV-K, *available at* http://www.nasaa.org/nasaa/corpfin/SCOR.doc.

130. *See* BLOOMENTHAL, *supra* note 14, § 24.07, at 1153-54. The Western Regional Review Program (whose territory includes Alaska, Arizona, Nevada, Colorado, Idaho, Montana, Utah, New Mexico, Oregon, Wyoming and Washington) also reviews Regulation A offerings. *Id.*

merit review standards a given state may have.[131] All entities offered the opportunity to purchase the securities must be provided a copy of the final version of the Form U-7[132] effective in that state.[133]

D. *Registration by Qualification*

If an issuer is not eligible for registration by notification, SCOR, or CER, then it must file a full registration with each state in which it plans to offer or sell securities.[134] The full registration process is generally called "registration by qualification."[135] To register by qualification, an issuer must file a registration statement that substantively mirrors the company's Regulation A filings with each state.[136] The Uniform Securities Act also requires that the state administrator be informed of the amount of securities being offered within the state, other states where a registration statement has been filed, and any judgments or injunctions against the issuer regarding the issuance or sale of securities.[137] The Act also requires the submission of a form documenting that the issuer agrees to specify an entity for service of process within that state.[138] In all states but New York, the state administrator then reviews the filing to ensure that it is complete in all material respects, and meets the state's disclosure requirements, merit standards, and anti-fraud provisions.[139] Section 306 of the Uniform Securities Act provides that a state administrator may

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131. *See* http://www.dfi.wa.gov/sd/registration.htm (offering an illustrative overview of the registration, licensing and examination standards for registering securities in the state of Washington).

132. Every prospective investor who receives a copy of the issuer's U-7 form will see on its cover page the following legend in boldface type: "Investment in a small business is often risky. You should not invest any funds in this offering unless you can afford to lose your entire investment. See Item 1 for a discussion of the risk factors that management believes present the most substantial risks to you." Small Corporate Offering Registration Form (Form U-7), 1 Blue Sky L. Rep. (CCH) ¶ 5124 at 1049-21 (1997).

133. *Instructions for filing for SCOR,* Instruction III-G, *available at* http://www.nasaa.org/nasaa/corpfin/SCOR.doc.

134. *See* Sjostrom, *supra* note 10, at 548.

135. *Id.*

136. The information required to be submitted includes: (1) the name of the company making the issuance and a listing of all its subsidiaries, (2) its directors and officers and their respective remuneration, (3) listing of any stockholders owning in excess of 10% of the company's outstanding shares, (4) prospective promoters of the securities, (5) agents selling the security who are not employed by the issuer, (6) the company's capitalization structure, (7) specifying the securities offered, their price, and any underwriting information, (8) proposed use of proceeds from the issuance, (9) available options to investors, (10) significant contracts, (11) pending litigation, (12) sales literature used by the issuer, (13) examples of the security, (14) the issuer's articles of incorporation, (15) its bylaws, (16) opinion of counsel that the issuance is legal, (17) consent of experts, (18) financial statements (need not be audited) and (19) additional information required by each respective state. *See* UNIF. SEC. ACT § 304 (amended 1998). A state administrator may waive any of these requirements. UNIF. SEC. ACT § 305(e)(amended 1998).

137. UNIF. SEC. ACT § 305(c)(amended 1998).

138. UNIF. SEC. ACT § 304(b)(amended 1998).

139. *See* Sjostrom, *supra* note 10, at 548.

deny effectiveness to a registration statement if the administrator finds that denying the registration's effectiveness would be in the public interest and:

- The registration statement is incomplete in a material respect;
- Any rule or condition imposed by the act is willfully violated by a person associated with the issuer;
- If the prospective issuance is subject to an injunction by a court or administrative agency;
- The prospective issuer's business includes illegal activities; or if
- The offering would constitute a fraud upon investors, includes unreasonable underwriter or dealer discounts, or is "being made on terms that are unfair, unjust, or inequitable."[140]

After a state administrator's review of the registration materials, he or she typically sends a comment letter to the issuer to request additions, clarifications, or deletions from the materials.[141] The issuer then resubmits the registration materials with the requested modifications, and the state either accepts the materials or requests further changes.[142] If the issuer fails to make the specified adjustments to its registration statement, the state will not allow sales of the securities within its jurisdiction.

E. *Conclusions Regarding Blue Sky Law Registration Procedures*

A simple way for an issuer to comply with a state's blue-sky laws is to use the SCOR process. Unfortunately, SCOR exposes a number of limitations upon the issuance which limit the unique strengths of a Regulation A offering. Most issuers will not be able to use Registration by Coordination because few states permit its use. Registration by Notification is an attractive alternative; however, because sixteen states do not offer this process, it is unlikely to be available in all the states in which an issuer hopes to market its securities. Therefore, in a multi-state offering many companies will have to resort to the Registration by Qualification, in conjunction with Registration by Notification where available, in order to comply with blue-sky law requirements. In light of this fact, corporate counsel should consult with the company's board and officers to select the states in which to market the securities so as to minimize the issuer's regulatory burden.

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140. UNIF. SEC. ACT § 306(a)(A)-(F) (amended 1998).
141. *See* Sjostrom, *supra* note 10, at 550.
142. *See id.*

IV. FEDERAL AND STATE BROKER-DEALER REGISTRATION REQUIREMENTS

An additional regulatory issue that will arise in a Regulation A offering is whether the party selling the securities on behalf of the issuer will be considered as a "broker" under federal or state law.

A. *Federal Law Regarding Broker-Dealer Registration in the DPO Context*

In the context of Regulation A issues, or other types of DPOs, the Commission has created a non-exclusive "safe harbor" wherein "associated persons" that participate in the sale of an issuer's securities will not be considered a broker/dealer under federal law.[143] To meet the "safe harbor" requirements, the associated person must meet the following six conditions:

- The party cannot have been barred from the sales of securities;
- The person can not be a partner, member or employee of a broker or dealer;
- The party cannot be paid commission based on sales of the security;
- The party must perform substantial duties for the issuer aside from selling securities;
- The party cannot have been a broker-dealer within the past twelve months, and
- The party cannot have participated in sales of the company's securities within the past twelve months.[144]

The "safe harbor" provision is limited and the final condition may cause problems for companies that have sold other types of securities within the previous year. If the issuer is unable to meet the requirements of the "safe-harbor" provision, it can hire a broker-dealer to market the securities, or it can form a subsidiary that is a registered broker dealer.[145]

B. *State Law Regarding Broker-Dealer Registration in the DPO Context*

There is also a "safe harbor" provision for Regulation A and other DPO issuers under state law. Per the Uniform Securities Act, neither a DPO company nor its agents are required to register as broker-dealers.[146]

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143. *See* Sjostrom, *supra* note 10, at 564; Securities Exchange Act of 1934, 17 C.F.R. § 3a4-1 (2002).

144. *See*, 17 C.F.R. §§ 240.3a4-1(a), 3a4-1(c)(1); *see also* Sjostrom, *supra* note 10, at 564.

145. *See* BLOOMENTHAL, *supra* note 14, § 19.02, at 893.

146. *See* UNIF. SEC. ACT § 202 (amended 1998).

However, some states specifically include a company or its agent selling securities in a DPO within their definition of "broker-dealer"; therefore, counsel for a prospective DPO issuer should research the laws of the specific states in which the securities will be marketed in order to determine whether the issuer's agent needs to be registered.[147]

V. ADVANTAGES AND DISADVANTAGES OF ISSUING SECURITIES PER REGULATION A

There are many advantages and disadvantages of going public either through a traditional registered offering or through the Regulation A exemption. It is important for the legal counsel of any prospective issuer of securities to discuss the relative advantages and disadvantages and to triangulate what option is the most advantageous for the particular issuer.

A. *Advantages of Going Public*

There are three primary advantages to having a company "go public" by selling its securities: raising capital, liquidity, and credibility.

1. Lower Cost for Capital

The essential reason for a company to sell securities is to raise additional capital. A company's ability to issue securities in exchange for cash provides vital liquid assets for the company at a much lower price than would a traditional bank loan or investment by a venture capitalist.[148] The influx of capital empowers the company to expand production, hire more staff, increase research and development funding, and acquire new assets. In addition, the sale of securities in the form of stocks allows current management to retain control of the strategic and day-to-day operations of the company, thanks to the traditional legal division between ownership and management in American corporate law. Furthermore, a successful DPOs benefits to the company's financial situation will make the company's subsequent attempts to gain either private or public equity financing, or access to loans, easier.[149] Yet it is important to remember that companies can only raise a maximum of $5 million in funds when issuing securities pursuant to Regulation A, so that means of going public probably will not meet most businesses' long-term capital needs.[150]

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147. *Compare* CAL. CORP. CODE. § 25004 (2001) (requiring registration of a broker-dealer in the DPO context) *with*, COLO. REV. STAT. § 11-51-201(14) (1990) (giving broker-dealers in the DPO context a registration exemption).

148. *See* Ann Moceyunas and John C. Yates, *Counseling Internet Start-Ups: One Year After the Bubble Burst*, 637 PRACTICING LAW INST. 655, 793-4 (2000).

149. *See id.* at 794.

150. *See* 17 C.F.R. § 230.251(b)(2000) (setting the aggregate offering price for a Regulation A offering at $5,000,000).

2. Liquidity for Shareholders

Liquidity in the context of securities "refers to the ease with which the shares can be bought or sold."[151] It is possible for an owner to "liquidate" some part of his or her share of a company by selling it to a third party, but the issuance of stocks facilitates the sales process and reduces its legal complexity. Liquidity allows for founders and/or initial investors to sell all or part of their interest in the company and secure those assets in other investment opportunities.[152] In addition, the issuance of stock may act as an employee recruitment tool[153] and provide some tax advantages.[154] On the other hand, it is important to recognize that ordinarily there is a very limited market for securities issued under Regulation A. The limited secondary market is due to the small number of shares available and the limited value of the issuance as a whole. Compounding the problem is the fact that there are only a handful of sites on the Internet that facilitate the sale of these small-issue securities. Therefore, the liquidity advantages associated with going public are not generally present in the DPO context.[155]

3. Enhancing the Issuer's Credibility

The process of going public may attract attention from analysts, the business press, and other investors; this attention may assist in promoting the issuer's product sales, ability to gain additional capital, and enhance the company's reputation.[156] This increased visibility may also enhance the bargaining power that the company has with customers and suppliers.[157] Yet, Regulation A offerings are unlikely to attract a great amount of publicity due to their small size, and the increasing frequency of the exemption's use. Therefore, this general advantage to the process of "going public" is only marginally realized in the DPO context.

B. *Disadvantages of Going Public*

There are three disadvantages to going public: expense, increased exposure to civil liability, and lost opportunities for alternative methods of raising capital.

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151. Sjostrom, *supra* note 10, at 573.

152. *See* Moceyunas & Yates, *supra* note 148, at 793.

153. *See* Kristopher D. Brown, *Emerging Growth Companies: Financing and Strategic Alliance Transactions*, 1244 PRACTICING LAW INST. 9, 48 (2001).

154. *See* Sjostrom, *supra* note 10 at 574.

155. *See id.*

156. *See id.* at 575.

157. *See* Moceyunas & Yates, *supra* note 148, at 793.

1. Expense

The process of going public is very expensive. In a traditional registered offering, the underwriter's commission can be as much as 13%; and "legal, accounting and filing" fees can range from $300,000 to $500,000.[158] In the Regulation A DPO context, the issuer saves money by avoiding the commission and audit costs and reducing legal fees.[159] On the other hand, the company will still bear the burden of the Commission's fees, state registration fees, and broker fees.[160] Even if the company decides to abandon its effort after "testing the waters," the time that the company's executive, legal, and marketing staffs have put into the project will represent thousands of dollars and indeterminate opportunity costs.[161]

2. Exposure to Civil Liability

The exposure of the company and its directors and officers to potential liability is less in the case of a Regulation A DPO than in the case of a registered offering. In the case of a Regulation A offering, the company may be held liable for false or misleading statements in the offering documents.[162] However, in the Regulation A context, "the company's directors and executive officers are not expressly exposed under federal law unless they participate in the offering."[163] State blue-sky laws may also expose the company to liability through their antifraud provisions. Furthermore, under the Uniform Securities Act, officers and directors are equally liable with the company for any errors or omissions that make any aspect of the offering statement or circular materially misleading.[164]

3. Loss of Collateral Monitoring

While venture capitalists, business angels, and some financial institutions extract a significant price for their investment of capital,[165] they also offer benefits that are not present in the public-offering context.

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158. *See* Sjostrom, *supra* note 10 at 575-6.

159. *See id.* at 576.

160. *Id.*

161. *See id.* at 577.

162. *See id.* at 578.

163. *Id.* Section 11(a) of the 1933 Act does not apply to unregistered offerings, such as Regulation A offerings. *Id* at 577-78.

164. *See* UNIF. SEC. ACT § 101 (amended 1988) ("It is unlawful for any person, in connection with any offer, sale or purchase of any security, directly or indirectly . . . to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading."). *See also* UNIF. SEC. ACT § 410(b)(amended 1998) (dictating the use of joint and several liability for "[e]very person who directly or indirectly controls a [liable] seller").

165. Examples of conditions placed upon contributions of capital include: representation on the board of directors, oversight of strategic planning, oversight of day-to-day operations, or numerous types of financial constraints.

Most venture capitalists and business angels contribute business expertise, market analysis, and management experience; these types of contributions can be the difference between success and failure for a small business. Furthermore, once a company has gone public, it may prove difficult to attract these types of investors due to financial and management constraints.

4. Loss of Control

Public ownership of a company diminishes the exclusive decision making powers enjoyed by private equity holders.[166] Furthermore, shareholders and analysts may subject management to pressure to increase the value of the stock regardless of what the original business plan that the founders of the company might have developed.[167] Furthermore, depending upon the amount of shares sold and their representative value in relation to ownership of the company, a majority shareholder may wrest control of the company's board of directors from the company's original management.[168]

VI. STRATEGY ISSUES FOR A REGULATION A DPO

The key to a successful effort by a private entity to raise capital is to balance the benefits and liabilities of its possible choices, and then to craft an offering scheme that maximizes the opportunities while minimizing the opportunity costs.

The analysis of benefits and liabilities requires a prospective issuer to engage in a comprehensive review of its options. The small business must weigh the costs and benefits associated with going public against the advantages and liabilities of private equity financing, business angels, or bank loans. If the small business determines that going public is the most favorable option, then it must determine whether it is eligible for underwriting or should pursue a DPO. If the decision tree leads the prospective issuer to opt for a DPO, then it should review what its capital needs are and determine if one of the Commission's exemptions to registration is available. If the capital needs of the small business are less than $5 million, and if it meets the Regulation's other qualifying criteria, then Regulation A is an attractive path for a small issuer to take. In designing a plan to issue securities under Regulation A, the issuer should consider the recommendations below.

First, it is imperative for the issuer to use Regulation A's "testing the waters" provision. This tool provides two key opportunities: It allows an issuer to gauge the market's interest in the contemplated offering and it can enhance the market's response to a prospective issue by sparking

166. *See* Moceyunas & Yates, *supra* note 148, at 796.
167. *See* Brown, *supra* note 153, at 48.
168. *See* Moceyunas & Yates, *supra* note 148, at 796.

interest in the enterprise. The key to using the "testing the waters" provision is to focus upon those segments of the investment community that would be interested in the issuer's business and strategy. If the first attempt at marketing the prospective issue does not succeed, then the issuer should reevaluate its chances of making a successful offering. Furthermore, it should reexamine who are the members of its likely investment community and refine its marketing efforts to reach them. By using the "testing" provision to its maximum effectiveness, the issuer may find that there is enough interest in its securities to warrant an underwritten, registered offering. Thus, a good-faith initial exploration of a Regulation A offering can provide invaluable insight into the market without precluding the prospective issuer from pursuing alternative paths if they prove more attractive.

Second, before filing the company's offering statement, a prospective issuer must analyze the responses gained from "testing the waters" to determine the geographic locations of the company's likely investors. If there are merely a handful of potential investors in a given state, the issuer may be able to seek their investments without registering in that state.[169] In any event, the issuer can lighten its regulatory burden by registering in a handful of states instead of all fifty.

Third, upon devising a registration strategy, the prospective issuer should invest adequate executive and legal resources to ensure the production of a materially complete and factually accurate offering statement and circular. The sophistication, accuracy, and persuasiveness of these documents are essential to generating the interest in the investment community and minimizing the company's potential liability.

Fourth, the issuer's directors and officers need to ensure the company's compliance with the Commission's requirements. The issuer should conduct monthly meetings with key officers, managers, and legal counsel to monitor the company's progress in its sale of the securities and to ensure adequate training of the issuer's staff regarding the Commission's mandates.

Finally, the company's board and officers must have predetermined goals for the offering and set dates by which to achieve them. If those goals are not met, then the company's management must reexamine its objectives and be prepared to stop the offering and pursue an alternative path. Not all Regulation A offerings are successful, and management needs to anticipate problems and react to them quickly and appropriately.

VII. CONCLUSION

Regulation A can be a powerful and cost-effective tool for a small business attempting to raise capital via a DPO. The key to success in an

169. *See* UNIF. SEC. ACT § 402(b)(9)(amended 1998).

offering of this type is to ensure compliance with the Commission's requirements, state registration requirements, and broker-dealer requirements. It is critically important for an issuer to retain counsel with sufficient expertise to ensure that the issuer can make intelligent choices regarding what exemptions to pursue and in what states to sell the securities. Finally, effective use of the marketing tools allowed by the Commission can make the difference between success and failure in the company's capital-raising effort. By combining an effective offering statement, strategic state registration, and aggressive marketing, a small business can use Regulation A to raise sizable sums of money without the costs associated with using an underwriter or the burdens associated with private equity financing.