

# Securities Regulation in the Electronic Era: Private Placements and the Internet

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## INTRODUCTION

During the past decade, the use of the Internet has grown tremendously. The Internet presently has between 120 and 150 million users with approximately ninety million of those users in the United States.<sup>1</sup> As more and more households continue to buy computers, this number will continue to grow rapidly.<sup>2</sup>

With a greater number of Internet users, corporations seeking to issue securities (“issuers”)<sup>3</sup> will have a more efficient way to reach a larger number of investors than was possible through traditional methods.<sup>4</sup> The Internet may also allow smaller issuers to raise needed capital much more quickly while incurring lower costs. However, the Securities and Exchange Commission (“SEC”) has not readily embraced or praised the advantages the Internet has to offer.<sup>5</sup> The failure of the SEC to embrace the Internet may stem from the fact that it has a duty to uphold the principles of the 1933 Securities Act (“Securities Act”),<sup>6</sup> one of which is to ensure that adequate disclosure is provided to investors.<sup>7</sup>

The SEC has allowed issuers to use the Internet in limited instances with certain safeguards. However, the SEC’s ruling that placing offering materials on the Internet constitutes general solicitation has not been particularly favorable to smaller issuers who issue securities pursuant to exemptions for private placements.<sup>8</sup> While this ruling

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1. See Robert W. Price, “*Bricks and Mortar*” *Companies Must Learn to Do Business at Light-Speed*, ORANGE COUNTY REG., May 24, 1999, at B6; *The CommerceNet/Nielson Internet Demographic Survey* (visited Nov. 9, 1999) <<http://www.commerce.net/research/stats/april99.html>>.

2. See Phil Harvey, *LookSmart Promises to Clean up the Clutter on the Internet*, UPSIDE MAG., Oct. 1999, available in 1999 WL 20543208 (estimating the number of Internet users worldwide will be 350 million by 2003).

3. See 15 U.S.C. § 77b(a)(4) (Supp. III 1997). “The term ‘issuer’ means every person who issues or proposes to issue any security . . .” *Id.*

4. Traditional methods include advertisements on television or in newspapers, direct mailings, and so forth.

5. See Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, Fed. Sec. L. Rep. (CCH) ¶ 3200, at 3128 (Oct. 6, 1995).

6. 15 U.S.C. § 77 (1994).

7. See SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (“The design of the statute is to protect investors by promoting full disclosure of information thought necessary to [lead to] informed investment decisions.”).

8. See Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, Fed. Sec. L. Rep. (CCH) ¶ 3200, at 3131-7 (Oct. 6, 1995) (stating that Internet websites would

is consistent with the principles of the Securities Act, it is inconsistent with the trend of our society moving into the electronic era.<sup>9</sup>

The Internet is a medium that is different from anything our society has ever known.<sup>10</sup> Applying certain existing securities regulation concepts to the Internet is like trying to fit a square peg into a round hole. Once the SEC recognizes this and modifies certain existing federal securities regulation concepts, issuers will be able to reap the benefits offered by the Internet when issuing securities pursuant to Rule 506,<sup>11</sup> which provides an exemption from registration created under § 4(2).<sup>12</sup>

Even though this Note disagrees with the SEC's present treatment of some aspects of the Internet, it recognizes that use of the Internet will subvert the principles of the Securities Act unless certain safeguards are implemented to ensure that investors receive adequate information. This Note will discuss the limitations placed on private offerings by the prohibition against general solicitation and propose modifications to the current law that will enable issuers to use the Internet in offerings made pursuant to Rule 506. Part I of this Note will briefly discuss the difference between public and private offerings and the requirements of private offerings under § 4(2). Part II will discuss the creation of Regulation D<sup>13</sup> and the application of the term "general solicitation" to offerings made pursuant to Rule 506. Part III briefly discusses the SEC's current treatment of the Internet and argues that Rule 502(c)<sup>14</sup> should not be applicable to Internet offerings made pursuant to Rule 506. Additionally, Part III proposes a centralized website for private offerings made pursuant to Rule 506 that allows issuers to reap the advantages the Internet has to offer while ensuring that investors receive adequate information.

#### I. PRIVATE OFFERINGS UNDER § 4(2)

A general understanding of the nature of a private offering is necessary to comprehend the problem that the Internet poses for private offerings. This Part briefly explains the difference between public and private offerings and the factors courts use to determine whether an offering should be considered private in nature. Additionally, this Part illustrates the inconsistency with which courts have applied the factors considered important in a private offering.

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constitute general solicitation and exemptions from registration would be unavailable in offerings made pursuant to Rule 505 and Rule 506).

9. See John C. Coffee, Jr., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, 52 BUS. LAW. 1195, 1198 (1997) ("[T]he advent of the Internet also seems likely to hasten the obsolescence of legal concepts upon which federal securities regulation has pivoted for the last sixty-odd years, but which were clearly premised on a paper-based information technology."); Edward Wyatt, *Goldman Sachs to Take Stake in Wit Capital*, N.Y. TIMES, Mar. 30, 1999, at C1. ("[T]he Internet has changed almost everything about the way the securities industry does business.").

10. See, e.g., *ACLU v. Reno*, 929 F. Supp. 824, 830-44 (E.D. Pa. 1996), *aff'd*, 521 U.S. 844 (1997) (discussing the creation and operation of the Internet).

11. 17 C.F.R. § 230.506 (1999).

12. 15 U.S.C. § 77d(2) (1994).

13. 17 C.F.R. §§ 230.501-508.

14. *Id.* § 230.502(c).

### A. The Difference Between Public and Private Offerings

A corporation seeking to implement innovative ideas or to expand operations needs capital to do so. It has a number of different options to obtain the needed capital. Some of the options available to the owners of the corporation include obtaining a loan from a bank, putting their own personal funds into the corporation, or deciding to sell securities in the corporation to investors. However, corporations need to decide which option is the easiest method of obtaining the capital while incurring the least amount of expense. If the corporation decides that selling securities is the best way to raise the needed capital, it must decide whether to sell the stock through either a public or private offering. The corporation's choice of a public or private offering will affect the cost of obtaining the needed capital.

#### 1. Public Offerings

If an issuer decides to sell its securities through a public offering, it becomes subject to an immense amount of regulation under state and federal laws. All securities offered by use of the mails or other channels of interstate commerce must be registered with the SEC pursuant to § 5 of the Securities Act.<sup>15</sup> When registering securities with the SEC, the issuer must file a document called a registration statement.<sup>16</sup> This registration statement must contain detailed information about the issuer including financial statements, a description of the security being offered, and the offering price of the security.<sup>17</sup> Only after this registration statement is filed can the issuer begin to offer its securities to the public.<sup>18</sup> While offering its securities to the public, the issuer must provide a prospectus to each investor to whom the securities are offered.<sup>19</sup> However, the issuer cannot sell any of its securities until the SEC declares its registration statement effective.<sup>20</sup>

While a public offering has many advantages, as compared to private placements, such as obtaining a better price, creating greater aftermarket interest in the securities,

15. 15 U.S.C. § 77e (Supp. III 1997). The relevant part of the statute is as follows:

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

*Id.* § 77e(a).

16. *See id.* § 77f.

17. *See id.* § 77g.

18. *See id.* § 77e(c).

19. *See id.* § 77e(b)(2). However, the prospectus that is given to each investor must meet the requirements of § 10 of the Securities Act. *See id.*; *see also id.* § 77j.

20. *See id.* § 77e(a)(2). Declaring a registration statement effective means that the SEC has reviewed the information submitted and it has complied with all the requirements. *See id.* § 77h(a).

and conveying an image that a company is successful, it has many disadvantages, too.<sup>21</sup> One disadvantage of a public offering is that the funds are realized a long time after preparation for registration begins since the approval process by the SEC usually takes a considerable period of time.<sup>22</sup> Another disadvantage is the cost involved.<sup>23</sup> Most of the costs are allocated to lawyers, accountants, investment banks, and others who help the issuer comply with the law and prepare the required disclosure documents. A final disadvantage is associated with the disclosure of information.<sup>24</sup> In addition to the disclosure provided in the registration statement, issuers are required by § 17(d) of the 1934 Exchange Act to periodically update this information.<sup>25</sup> Not only is it costly constantly to update disclosure documents, but issuers are forced to disclose information they may want to keep private.<sup>26</sup>

## 2. Private Offerings

Private offerings are exempt from the registration requirements of § 5 of the Securities Act.<sup>27</sup> These offerings are usually made to a small number of investors who have the backgrounds that provide them with the capability to judge the merits of an investment. In private offerings, offers and sales of securities can be made even though a registration statement has not been filed with the SEC.<sup>28</sup>

This provides a great advantage to issuers who choose to issue securities through private offerings. These securities can be issued much more quickly than in a public offering and the costs involved are not as high.<sup>29</sup> In most offerings, no formal disclosure documents need to be prepared. However, there are disadvantages to using private offerings. First, the price of privately offered securities is usually lower than the price of securities offered on the public market.<sup>30</sup> Second, the liquidity of these securities may be low due to the lack of aftermarket interest.<sup>31</sup> Finally, issuers may have to include incentives not normally found in public offerings, such as options or seats on the board of directors, to persuade investors to purchase the securities.<sup>32</sup> As evidenced, private and public offerings have their advantages and disadvantages and the issuer needs to balance these against one another to determine the method that best suits its needs.

### *B. The Development of Prohibiting Solicitation*

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21. See, e.g., 1 WILLIAM M. PRIFTI, *SECURITIES: PUBLIC AND PRIVATE OFFERINGS* § 1:13, at 53 (2d ed. rev. 1998).

22. See *id.* at 54.

23. See, e.g., LARRY D. SODERQUIST & THERESA A. GABALDON, *SECURITIES LAW* 26-27 (1998).

24. See *id.*

25. 15 U.S.C. § 78o(d) (1994).

26. See SODERQUIST & GABALDON, *supra* note 23, at 26-27.

27. See 15 U.S.C. § 77d(2) (1994).

28. See *id.*

29. See PRIFTI, *supra* note 21, § 6:03, at 5.

30. See *id.*

31. See *id.* at 6.

32. See *id.*

Section 4(2) of the Securities Act exempts “transactions by an issuer not involving any public offering” from the provisions of § 5.<sup>33</sup> While the Securities Act clearly defines the transactions exempt from registration, “public offering” is not defined anywhere in the Securities Act. Furthermore, neither the Act nor its legislative history states or implies that the use of solicitation is forbidden in private placements.<sup>34</sup> However, judicial decisions and SEC releases have addressed the absence of these definitions and concepts.<sup>35</sup>

The first attempt by the SEC to address the definition of a “public offering” occurred in 1935.<sup>36</sup> The release contained factors that were helpful in determining whether an offering should be considered a public offering or a private offering. If the offering was deemed private, the issuer enjoyed an exemption from registration provided by § 4(2). The factors to be considered are as follows: (1) the number of offerees; (2) their relationship to each other; (3) their relationship to the issuer; (4) the number of units offered; (5) the size of the offering; and (6) the manner of the offering.<sup>37</sup> However, the SEC failed to explain which “factor or factors, either alone or in combination with others, would be necessary or sufficient to assure compliance with Section 4(2).”<sup>38</sup>

While the 1935 Securities Act Release did not specifically mention any type of prohibition on solicitation, it provided certain situations where notions of solicitation would either destroy or validate the § 4(2) exemption. In one instance, it was determined that “negotiations or conversations with a substantial number of prospective purchasers would” cause the offering to become public in nature.<sup>39</sup> However, determining whether a substantial number of prospective purchasers are involved turned upon the manner in which the offerees were selected.<sup>40</sup> The SEC placed great importance on this and stated that

[a]n offering to a given number of persons chosen from the general public on the ground that they are possible purchasers may be a public offering even though an offering to a larger number of persons who are all the members of a particular

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33. 15 U.S.C. § 77d(2) (1994). Before being placed in § 4(2) by Congress in 1964, the private placement exemption had been included in § 4(1) of the Securities Act.

34. See Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 71-72 (1989).

35. See *id.*

36. See Letter of General Counsel Discussing the Factors to Be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), Securities Act Release No. 285, Fed. Sec. L. Rep. (CCH) ¶¶ 2740-44, at 2911-13 (Jan. 24, 1935) [hereinafter 1935 Securities Act Release].

37. See Daugherty, *supra* note 34, at 72 (citing 1935 Securities Act Release, *supra* note 36, ¶¶ 2741-44, at 2911-12).

38. *Id.*

39. *Id.* (quoting 1935 Securities Act Release, *supra* note 36, ¶ 2741, at 2911).

40. See *id.*

class, membership in which may be determined by the application of some pre-existing standard, would be a non-public offering.<sup>41</sup>

However, the SEC made it quite clear that even offerings restricted to a certain class of people may still be considered a public offering if open to a sufficient number of people.<sup>42</sup>

In addition to the great weight given to the manner in which the offerees were selected, the SEC also regarded the relationship between the issuer and the offeree as being significant.<sup>43</sup> Therefore, offerings to a class of people who have special knowledge of the issuer are less likely to be considered public offerings than those offerings where the offerees do not have the same special knowledge.<sup>44</sup>

Another instance with implied notions of solicitation focused on the manner in which the offering was made. The SEC was clear in its position that the exemption would more likely be considered private if the offering were accomplished through direct negotiations by the issuer as opposed to using “the machinery of public distribution” to effect sales.<sup>45</sup> Therefore, the SEC seemed willing to concede that offerings in which the offerees were not selected at random through public means had a good chance of being deemed a private offering.<sup>46</sup>

At the time of its release, the 1935 Securities Act Release played an important role, due to the inflexibility of its standards, in determining whether an offering should be considered public or private. However, approximately twenty years later, in *SEC v. Ralston Purina Co.*,<sup>47</sup> the Supreme Court decided to refine and reinforce the random selection prohibition by focusing on the nature and characteristics of the offerees.<sup>48</sup> The standard that the Court set forth to determine whether an offering was private was “whether the particular class of persons affected need[ed] the protection of the [Securities] Act.”<sup>49</sup>

In determining whether a person needed the protection of the Securities Act, the Court stated that “[a]n offering to those [investors] who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”<sup>50</sup> However, the Court did not hold that the issuer was required to use any specific means to determine whether an offeree has the ability to fend for himself or herself.<sup>51</sup> Furthermore, the Court certainly did not hold that any type of preexisting relationship must exist

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41. 1935 Securities Act Release, *supra* note 36, ¶ 2741, at 2912.

42. *See id.*

43. *See id.*

44. *See id.*

45. *Id.* ¶ 2744, at 2912.

46. *See* Daugherty, *supra* note 34, at 73.

47. 346 U.S. 119 (1953).

48. *See* Daugherty, *supra* note 34, at 73.

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

50. *Id.*

51. *See* Daugherty, *supra* note 34, at 75.

between an issuer and offeree before the issuer can offer the securities to the offeree.<sup>52</sup> The only factor that seemed important to the Court was whether the offerees had the capacity for self-reliance.<sup>53</sup>

### C. From *Ralston Purina* to Regulation D

While the Supreme Court's decision in *Ralston Purina* shifted the examination from the nature of the offering to the nature of the offerees, courts have still persisted in using the factors set forth in the 1935 Securities Act Release.<sup>54</sup> Courts have at various times shortened and expanded the list of factors used to determine whether an offering should be considered private, but each court, in doing so, has acknowledged that the factors only assist in determining whether the investor needs the protection of the Securities Act.<sup>55</sup> However, the two factors courts have relied upon most have been the preexisting relationship between an issuer and offeree and the level of investor sophistication.

Several courts have held that offerings "characterized by personal contact between the issuer and offerees [that is] free of public advertising or intermediaries such as investment bankers or securities exchanges" are much more likely to satisfy the private offering requirements.<sup>56</sup> Using this standard, some courts have held offerings to be considered private when the issuer and the offeree have a preexisting relationship.<sup>57</sup> Other courts have found the exemption to be destroyed when the lack of a preexisting relationship is present.<sup>58</sup>

While some courts have focused on the preexisting relationship, other courts have focused on the need for investor sophistication. These courts first determine whether the investor should be considered sophisticated by examining the investor's intelligence, business background, and other factors that would establish that the

52. *See id.* A preexisting relationship can be evidenced by a previous business relationship between an issuer and investor that allows the issuer to determine whether the investor has sufficient financial capability and business acumen necessary to purchase the securities. *See Woodtrails-Seattle, Ltd., SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,342, at 78,285 (July 8, 1982).*

53. *See Daugherty, supra note 34, at 75.*

54. *See id.*

55. *See id.* at 76.

56. *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 900 (5th Cir. 1977); *see also Woolf v. S.D. Cohn & Co.*, 515 F.2d 591, 614 (5th Cir. 1975); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 689 (5th Cir. 1971).

57. *See Lively v. Hirschfeld*, 440 F.2d 631, 632 (10th Cir. 1971) (holding that the offering was private due to the issuer's previous business dealings and associations with the offerees); *Gilbert v. Nixon*, 429 F.2d 348, 354 (10th Cir. 1970) (holding that the offering was private because of the long standing association between the issuer and offeree); *Garfield v. Strain*, 320 F.2d 116, 119 (10th Cir. 1963) (holding that the issuer's and offerees' close relationship in addition to their past dealings justified the use of the private offering exemption).

58. *See MacClain v. Bules*, 275 F.2d 431, 435 (8th Cir. 1960) (holding that placing the term "private offering" in a document does not control application of the statute); *Shimer v. Webster*, 225 A.2d 880, 885 (D.C. 1967) (holding that a preexisting relationship did not exist where there were impersonal relationships, limited or nonexistent investor experience, and no past dealings).

investor can fend for himself or herself.<sup>59</sup> Once the court establishes sophistication, it must determine if the investor was either (1) given adequate disclosure or (2) given access to information that provides the same information disclosure would have provided.<sup>60</sup> Once this determination has been favorably made, the private placement exemption should be upheld under the *Ralston Purina* standard because the investors do not need the protection afforded by the Securities Act.<sup>61</sup>

The sophistication analysis is not dependent on the existence of a preexisting relationship that an offeree has with an issuer.<sup>62</sup> However, when the relationship exists it provides two important benefits. First, the relationship may show that the offeree either (1) already has some type of knowledge about the issuer or (2) may have access to the necessary information.<sup>63</sup> Second, the preexisting relationship can help the issuer to determine whether the offeree is sophisticated.<sup>64</sup> Therefore, a preexisting relationship should be viewed as helpful but not necessary to a private offering under § 4(2).<sup>65</sup>

## II. THE ADOPTION OF REGULATION D

Regulation D<sup>66</sup> was introduced to set forth clear requirements for issuers to meet. In doing so, the SEC created some confusion with the term “general solicitation” and its application. This Part briefly explains the need for Regulation D and the SEC staff’s interpretation of the actual meaning of “general solicitation.”

### A. *The Development of a Clearer Standard*

As Part I illustrates, there is no way for issuers to ensure that they have complied with the requirements of a private offering. In response to this concern, Congress adopted Regulation D, which is a series of rules with clearly defined requirements.<sup>67</sup> If the requirements of these rules are met, the offering is exempt from registration. However, if the requirements are not met, issuers still have the opportunity to argue that the offering was not public in nature under the traditional analysis of a § 4(2) exemption.

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59. See 7C J. WILLIAM HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 11.08(2)(b), at 113-25 (1st ed. rev. 1999) (discussing the factors used to determine investor sophistication).

60. See Daugherty, *supra* note 34, at 80.

61. See *id.*

62. See *id.*

63. See *id.*

64. See *id.*

65. See *id.* at 82.

66. 17 C.F.R. §§ 230.501-.508 (1999).

67. See Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6339, 23 SEC Docket 446 (Aug. 7, 1981).

As a response to the capital formation problems that had been plaguing small businesses, Regulation D was divided into essentially two parts.<sup>68</sup> While Regulation D consists of Rules 504, 505, and 506, the exemption of offerings made pursuant to Rules 504 and 505 was predicated on the exemptive authority given to the SEC by § 3(b) of the Securities Act.<sup>69</sup> Under Rules 504 and 505, the offering amounts cannot exceed \$1,000,000 and \$5,000,000 respectively.<sup>70</sup> However, offerings made pursuant to Rule 506 are based on the exemptive authority given to the SEC by § 4(2) of the Securities Act.<sup>71</sup> An offering made pursuant to Rule 506 has no ceiling on the amount of money that can be raised.<sup>72</sup> Therefore, Rule 506 can be used by large and small businesses to raise unlimited amounts of capital.

*B. "General Solicitation" As a Term of Art*

While no offering limit is placed on offerings made pursuant to Rule 506, the SEC has placed several other restrictions on the offerings.<sup>73</sup> Most notably, issuers are prohibited from using "general solicitation" in selling the securities by Rule 502(c).<sup>74</sup> "General solicitation" is a term of art that is found in Rule 502(c). Rule 502(c) defines "general solicitation or general advertising [as] including but not limited to . . . (1) [a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television; and (2) [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising."<sup>75</sup>

While Rule 502(c) seems to define "general solicitation" rather clearly, determining the type of conduct that constitutes "general solicitation" or "general advertising" is not a task that can be easily accomplished.<sup>76</sup> Some examples of clear violations are evidenced by staff letters that hold almost any use of the media to offer securities will

68. See Consideration of the Impact of the Small Business Investment Incentive Act of 1980 on Certain Exemptions from the Registration Provisions of the Securities Act of 1933, Securities Act Release No. 6274, 46 Fed. Reg. 2631 (Jan. 12, 1981).

69. 15 U.S.C. § 77c(b) (1994). Section 3(b) in its entirety is as follows:

The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$5,000,000.

*Id.*

70. See 17 C.F.R. § 230.504(b)(2) (1999); see also *id.* § 230.505(b)(2).

71. See *id.* § 230.506(a).

72. See *id.* § 230.506.

73. See *id.* § 230.506(b).

74. *Id.* § 230.502(c). Rule 502(c) is also applied to offerings made pursuant to Rule 505 and to most offerings made pursuant to Rule 504. See *id.* § 230.505(b)(1). However, the application of Rule 502(c) to Rules 504 and 505 is beyond the scope of this Note.

75. *Id.* § 230.502(c)(1)-(2).

76. See Daugherty, *supra* note 34, at 91.

constitute general solicitation.<sup>77</sup> However, these letters do not completely preclude the use of the media in offerings made pursuant to Rule 506. The SEC staff has allowed use of the media where the advertising and solicitation are limited in scope.<sup>78</sup>

While there is no statutory provision that clarifies the meaning of "limited in scope," the offeror must have a preexisting relationship with any offeree that it solicits or else the solicitation will be considered general in nature.<sup>79</sup> This requirement has been developed through a series of no-action letters and has kept Rule 506 consistent with the holding found in the 1935 Securities Act Release. The requirement is viewed as being so important that the SEC has never granted a no-action letter where a preexisting relationship is absent.<sup>80</sup>

The requirement for a preexisting relationship was first discussed in the Woodtrails-Seattle, Ltd. No-Action Letter.<sup>81</sup> In the offering, the issuer proposed to mail written offers to persons who had previously invested in limited partnerships that had been sponsored by its general partner.<sup>82</sup> The SEC agreed with the issuer that the conditions of Rule 502(c) would not be violated since every offeree had a "pre-existing business relationship" with the general partner that dated back several years and was evidenced by determinations that had been previously made about the investors' abilities to purchase the securities.<sup>83</sup>

The Mineral Lands Research & Marketing Corp. No-Action Letter<sup>84</sup> took the preexisting relationship one step further. In the offering, the issuer planned to send offers to those people who were, at the time, clients of an officer who also happened to be an insurance salesman. While the issuer was not in a position to determine whether the offerees were either "accredited investors" or "sophisticated," counsel for the issuer contended that Rule 502(c) did not require this finding.<sup>85</sup> In response to the letter, the SEC stated that

[t]he types of relationships with offerees that may be important in establishing that a general solicitation has not taken place are those that would enable the issuer . . .

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77. See Aspen Grove, SEC No-Action Letter, *available in* 1982 WL 29706 (S.E.C.) (Nov. 8, 1982) (refusing to recommend no-action to the enforcement division in an offering involving an advertisement placed in a trade journal); Trust Mortgage and Loan Servs., Inc., SEC No-Action Letter, *available in* 1979 WL 13222 (S.E.C.) (Nov. 27, 1979) (refusing to recommend no-action to the enforcement division when the offering involved newspapers that circulated in Washington, Oregon, and California).

78. See Daugherty, *supra* note 34, at 104.

79. *Id.*

80. See *id.* at 107.

81. Woodtrails-Seattle, Ltd., SEC No-Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,342, at 78,285 (July 8, 1982).

82. See *id.*

83. *Id.*

84. Mineral Lands Research & Marketing Corp., SEC No-Action Letter, *available in* 1985 WL 55694 (S.E.C.) (Mar. 21, 1985).

85. *Id.*

to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration.<sup>86</sup>

Based on the SEC's statement, it would appear that an issuer must comply with either of two alternatives to establish that a solicitation is not general. First, an issuer can show that a relationship is of "some substance and duration."<sup>87</sup> Second, a solicitation should not be considered general if the issuer can show that the relationship helps the issuer determine the "financial circumstances or sophistication" of the investors.<sup>88</sup> However, this interpretation is incorrect, according to the SEC, no matter how logical it may seem. The relationship cannot be any type of relationship, but must be a preexisting one.<sup>89</sup> Therefore, issuers are limited in their ability to raise capital from a large number of people unless preexisting relationships exist.

### III. A PROPOSAL FOR AMENDING THE CURRENT REGULATORY SYSTEM TO ALLOW ISSUERS TO USE THE INTERNET EFFECTIVELY IN OFFERINGS MADE PURSUANT TO RULE 506

With the substantial growth that the Internet has gone through over the last five years, it is inevitable that our society will eventually move away from paper-based systems. The securities industry is slowly partaking in the trend, but the SEC has not been willing to become a full participant. This Part explains the SEC's current treatment of the Internet and proposes a system that will help the SEC modify some of its existing regulations into those suitable for the electronic era.

#### *A. Current Treatment of the Internet*

As the Internet grew, the SEC believed the time had come to take a stand on the issues that the Internet presented. In a release issued in late 1995, the SEC embraced the Internet for its ability to effectuate rapid disclosure to investors.<sup>90</sup> However, the SEC did not as readily embrace the use of the Internet in private offerings. In an example provided in the 1995 Securities Act Release, the SEC stated that "[t]he placing of the offering materials on the Internet would not be consistent with the prohibition against general solicitation or advertising in Rule 502(c) of Regulation D."<sup>91</sup> Therefore, the use of the Internet in private offerings would make the exemption provided by Rule 506 unavailable.

Following the 1995 Securities Act Release, the SEC made some concessions through a series of no-action letters. One concession allowed private offerings to be posted on websites that are password protected provided that access is only permitted

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86. *Id.*

87. *Id.*

88. *Id.*

89. See Daugherty, *supra* note 34, at 106.

90. See Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, Fed. Sec. L. Rep. (CCH) ¶ 3200, at 3128 (Oct. 13, 1995).

91. *Id.* ¶ 3200, at 3131-7.

for those investors who were prequalified.<sup>92</sup> Another concession has been to allow issuers to conduct Regulation A offerings over the Internet.<sup>93</sup> Finally, the SEC has also permitted prospective investors to view roadshows that are transmitted over the Internet.<sup>94</sup> However, none of these letters permit issuers to reap the full advantages that the Internet has to offer. This is primarily due to the fact that the concessions have been made for rules not subject to the ban on general solicitation.

### *B. A Glimpse into the Future*

The Internet gives issuers the opportunity to reach a large number of investors and to disseminate and display information to these investors at a cost lower than traditional methods of publication.<sup>95</sup> It would be more cost effective for an issuer to display one document on a Web page that can be viewed by an unlimited number of people than it would be to print 500,000 copies of the same document and then distribute it through the mails to investors. However, the roadblock to this cost reduction is the prohibition against general solicitation.

Many arguments have been made that support the elimination of the prohibition on general solicitation. One argument is that the rule is interpreted in a "facts and circumstances" manner and provides no clear guidance for issuers.<sup>96</sup> Another argument is the notion that general solicitation, on its own, can destroy private offerings.<sup>97</sup> The idea of general solicitation is inconsistent with the *Ralston Purina* test, which focused not on the manner of the offering but on the sophistication of the investor and his or her ability to access information.<sup>98</sup> Finally, "the public interest is best served by deregulating the capital formation process for small business to the fullest extent possible without unduly diminishing investor protection."<sup>99</sup>

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92. See IPONET, SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252, at 77,270 (Sept. 10, 1996).

93. See Spring St. Brewing Co., SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,201, at 77,001 (Apr. 17, 1996).

Regulation A permits certain domestic and Canadian companies to make exempt offerings not exceeding \$1.5 million in amount, provided certain specified conditions are met, including the prior filing of a simple "notification" with the appropriate regional office of the Commission and the use of an offering circular containing certain basic information in the sale of the securities.

3 HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW § 1.50 (2d ed. 1999).

94. See Net Roadshow, Inc., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,367, at 77,849 (Sept. 8, 1997) (granting a no-action request where prospective investors are qualified in advance and only have access to the roadshow through an underwriter). Roadshows "are audio.video presentations describing the company and its prospects delivered by company executives at various forums." 3B BLOOMENTHAL & WOLFF, *supra* note 93, § 8.39.

95. The term "traditional methods of publication" refers to documents in print.

96. Daugherty, *supra* note 34, at 124.

97. See *id.*

98. See *id.* at 125.

99. *Id.*

Abolishing Rule 502(c) would eliminate the inconsistencies present in many staff interpretations and would make Rule 506 much more predictable and useful since the limitations would be clearly defined.<sup>100</sup> In addition to the current arguments against the ban on general solicitation, the advantages offered by the Internet make the need to abolish the application of Rule 502(c) to Rule 506 Internet offerings much more compelling. Some of the advantages that can be utilized in the regulatory system proposed by this Note include the relative ease with which investors can access information about the issuer and the offering, the reduction of costs incurred by the issuer in locating prospective investors and disseminating information to them, and the ease with which the SEC can detect and take action against fraud.

### 1. The Creation of a Centralized Home for Private Offerings

Instead of expressing its sentiments and concerns on the problems and advantages that the Internet presents, the SEC needs to take a more hands-on approach than it is presently doing. In taking a more hands-on approach, the SEC has two options. First, using the general exemptive authority given to it by Congress in § 28 of the Securities Act,<sup>101</sup> the SEC can abolish the application of Rule 502(c) to offerings made on the Internet pursuant to Rule 506 while leaving the remaining offering restrictions in place. In making this change, the SEC must leave all the restrictions of Rule 506, including the prohibition against general solicitation, in place for non-Internet offerings. Second, the SEC can use the § 28 exemptive authority to create a new exemption for private offerings that are made on the Internet. This option would not have any effect on the existence of Rule 506 and would also give issuers the option to use the exemption they feel best suits their needs. If either of these changes is made, it would have to be made in conjunction with the North American Securities Administrators Association<sup>102</sup> to ensure that issuers would not be in violation of any state's blue sky laws.

100. *See id.* at 127.

101. 15 U.S.C. § 77z-3 (Supp. III 1997). Section 28 in its entirety is as follows:

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

*Id.*

102. The North American Securities Administrators Association is a voluntary association with a membership consisting of the 65 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Canada, Mexico, and Puerto Rico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for grass-roots investor protection and efficient capital formation.

*North American Securities Administrators Association* (visited Sept. 16, 1999) <<http://www.nasaa.org/whowear>>. The need for coordination exists to ensure that states modify their securities laws to mirror the changes in the federal laws. This will assure issuers, who are in full compliance with federal securities laws, that they will not be in violation of any state securities laws.

The better choice for the present would be to eliminate the application of Rule 502(c) to offerings made pursuant to Rule 506 and leave the remaining offering restrictions in place. By making the recommended amendment to Rule 506, the SEC will be able to test the effectiveness of the amended rule on a trial basis. If the proposed system poses too many problems, the SEC can choose to reapply Rule 502(c) to Rule 506. If the SEC finds that the system is beneficial to both issuers and investors but is unworkable under the amended rule's conditions, the SEC can create a new exemption using the exemptive authority under § 28 that incorporates the advantages of the new system while modifying the conditions that hampered its effectiveness.

Issuers will not be allowed to use the Internet without some trade offs. The first trade off would be that the SEC or an agency appointed by the SEC would create a centralized website for listing the private offerings made pursuant to the amended Rule 506. This centralized website will provide advantages for the issuers, investors, and the SEC.

## 2. Location: An Advantage for Investors and Issuers

The main advantage for investors and issuers is location. If there were no centralized website for these offerings, investors would have to search the Internet to find the offerings. This would require investors to use search engines to find offerings in which they may be interested. However, many people are not familiar with using these search engines and may not be willing to take the time to learn how to search the Internet. Even if the investors were willing to learn how to search the Internet, they would still have to have an idea of where to look or know which issuers placed offerings on the Internet. This would require issuers to inform investors through advertisements that their offerings are posted on the Internet. However, this method would not be very cost effective for any issuers and would be very time-consuming for investors.

A centralized website eliminates these problems. Instead of searching the Internet for private offerings, investors would only have to type in one website address and every private offering on the Internet would be located at that site. This approach would be much less time-consuming, much easier to understand for those investors who are not well versed in the Internet, and much more passive than requiring each investor to take the initiative and use search engines to seek out investment opportunities. The only effort required by the investors would be to turn on the computer, connect to the Internet, type in an address, and point and click.

## 3. A Web in Which to Catch Fraud

The advantages that a centralized website would provide the SEC can be found in the way the website is constructed. Corporations seeking to raise money through Rule 506 will have to petition the SEC for the offering to be listed on the new website. While many will raise concerns that SEC approval for private offerings is not presently necessary and should never be, this will be one of the trade offs that issuers will have to make in exchange for the elimination of the ban on general solicitation in private offerings. However, it is necessary to note that the approval process by the SEC is intended to be more of a cursory review than an arduous approval process.

The corporations will be required to register the name of the corporation, the corporation's business address, and some basic information about the corporation's incorporators and officers. In addition to the previous information, companies will also have to provide a limited amount of financial information to prove the corporation is actually doing business and a statement describing the intended use of the funds received.<sup>103</sup> In the case of a start-up business with no financial records, more detailed information about the people involved in the offering will be required. However, no investigation will be undertaken by the SEC to determine the truth of any financial information or other nonfinancial information provided for the purpose of being placed on the website.

This approval process will place the burden on the issuer to prove that the corporation has an intended purpose for seeking funds through Rule 506. It will also allow the SEC to do some very preliminary investigation of the company to determine if there is any fraudulent intent present, such as issuing securities in fictitious companies. Finally, the centralized aspect of these private offerings will make SEC enforcement an easier and less time-consuming task.

Presently, the SEC has Enforcement Division personnel surfing the Internet to determine if private offerings are being posted and whether any fraud is occurring.<sup>104</sup> One of the biggest problems facing the Enforcement Division personnel after instances of fraudulent offerings are discovered is tracking down the wrongdoer since the wrongdoer can conceal his or her identity.<sup>105</sup> Since the identity of the wrongdoers cannot be discovered without great difficulty, it is not possible for the Enforcement Division to institute any type of legal recourse against the wrongdoer. However, the centralized aspect of the private offering website will help to remedy this problem.

While the SEC will not make any determination regarding the truth of any information submitted to it or posted on the website, it will have the identity of the issuers which will give the Enforcement Division a defendant or multiple defendants in any enforcement action taken. This process will help the SEC to ensure that investors are better protected from the fraud concerns that the Internet presents. However, to ensure that investors do not think the information has been reviewed by the SEC, it will be necessary to place notices on each page notifying the investor that the SEC has not verified the truthfulness of any of the information posted on the website. These notices can be similar to the legends that are required to appear in bold letters on all registration statements and prospectuses.<sup>106</sup>

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103. The SEC, through Regulation S-K, presently requires a use-of-proceeds section in all registration statements. See 17 C.F.R. § 229.504 (1999).

104. See Alexander C. Gavis, *The Offering and Distribution of Securities in Cyberspace: A Review of Regulatory and Industry Initiatives*, 52 BUS. LAW. 317, 345-46 (1996).

105. See Coffee, *supra* note 9, at 1222-23; Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 80-83 (1998).

106. See 17 C.F.R. § 228.501(a)(5) (1999).

#### 4. A Preliminary Determination of Accreditation for the Assignment of Passwords

Once SEC approval is given, the offering will be posted on the website and categorized according to the nature of the issuer.<sup>107</sup> Investors can then access the website and scroll through the listed offerings. However, before viewing the posted offerings, investors will be required to complete questionnaires to determine if they can be classified as “accredited investors.”<sup>108</sup> This determination is necessary because accredited investors will receive passwords that grant them more privileges and

107. “The nature of the issuer” refers to the products or services produced by the issuer. For example, computer companies would be placed in the technology category while pharmaceutical corporations would be placed in the biomedical category.

108. “Accredited investor” is defined as follows:

*Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank . . . or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act . . . ; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees . . . ;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;

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

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;

(6) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in § 230.506(b)(2)(ii); and

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

17 C.F.R. § 230.501(a) (1999) (emphasis in original). The importance of this requirement is that the safe harbor will be unavailable if the number of nonaccredited purchasers exceeds thirty-five. *See id.* § 230.506(b)(2)(i).

greater access than will be given to nonaccredited investors. These questionnaires used to determine whether an investor can be classified as accredited should be similar to the ones that are currently used by broker-dealers and approved by the SEC to determine whether the investor is accredited.<sup>109</sup> The questionnaire will determine accreditation pursuant to the requirements set forth in Rule 501(a).<sup>110</sup>

Determining if an investor receives a password as an “accredited investor” or a nonaccredited investor is a task that can be accomplished through the use of an independent entity. An independent entity will need to be created or hired to review the questionnaires to determine the password that an investor receives based on whether he or she meets the requirements of Rule 501(a).<sup>111</sup> The investigation performed by the independent entity will only be a preliminary one and the entity will issue passwords once it is satisfied that the accreditation requirements have been met. It will only issue passwords that grant greater access to those individual investors whose assets create no doubt as to their net worth. If the value of a listed asset may be questionable, the burden will shift to the investor to provide documentation that his or her valuation is reasonable.

While an entity that performs these investigations will raise cost concerns, the costs can be borne by the issuers using the website. The SEC can charge issuers a fee each time they post an offering on the website. Although many will argue that this will raise costs for issuers, it is another trade off that issuers must make to gain access to a larger number of investors at a lesser cost.

While issuers may be tempted to rely on the determination made by the independent entity as to accreditation, it must be made clear to the issuers that their duty to determine whether an investor is accredited cannot be delegated to the independent entity. The entity exists only to determine the password that an investor receives based on the information supplied. The issuer must possess a reasonable belief that each “accredited investor” actually meets the requirements set forth in Rule 501(a).<sup>112</sup> If an issuer fails to make its own reasonable investigation, the number of nonaccredited purchasers may exceed the limit set forth in Rule 506(b)(2) and destroy the offering exemption. Issuers failing to make an independent determination as to an investor’s accreditation should be prohibited from using the system for a period of time. Issuers would not fall subject to this type of discipline if they can establish that they conducted a reasonable investigation to determine the accreditation of the investor. In addition to this type of “bad boy” disqualifier, the issuers should be required to pay enforcement action costs along with any other fines that would be deemed reasonable. These fines could be used for maintaining and updating the private offerings website.

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109. See Lamp Techs., Inc., SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,359, at 77,804 (July 17, 1997); Angel Capital Elec. Network, SEC No-Action Letter, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,305, at 77,516 (Nov. 21, 1996) (granting a no-action letter that allowed a questionnaire to be filled out online to determine whether an investor was accredited).

110. See 17 C.F.R. § 230.501(a).

111. See *id.*

112. See *id.*

### 5. The Necessity of a Password-Protected System

After determining that an investor is an "accredited investor" pursuant to the requirements of Rule 501(a), the independent entity will supply the investor with a password that grants the investor special privileges and access. However, if the investor does not qualify as an "accredited investor," he or she will receive a different password that grants fewer privileges and less access than is given to accredited investors. The password-protected system is necessary for calculating the number of purchasers in the offering since Rule 506(b)(2) limits the number of nonaccredited purchasers to thirty-five.<sup>113</sup>

By giving different passwords to the two different classes of investors, issuers, along with the SEC, will be able to determine when the limit of thirty-five nonaccredited purchasers has been reached. Once the limit has been reached, the offering can be taken off the Web pages that nonaccredited investors have access to, but it may still remain on the pages that the accredited investors may access since they are not counted in calculating the number of purchasers.<sup>114</sup> This system will help issuers comply with the investor limit since these offerings may be removed from the Web pages available to nonaccredited investors as soon as the limit is reached. However, it will be necessary to allow issuers to choose whether or not they want their offering listed on the Web page to which nonaccredited investors have access.

### 6. The Advantages of Hypertext

Investors scrolling through the available offerings will be able to click on hypertext of the issuer and get a short description of the nature of the issuer's business, the purpose of the offering, and the amount of capital the issuer is seeking to raise.<sup>115</sup> If the investor decides that he or she may want to purchase the securities, he or she can link to another page that has more detailed information about the issuer.

The use of hypertext can also be very useful to issuers who choose to place their offerings on the pages to which nonaccredited investors have access. Using these links, the issuer can place any disclosure document that it may be required to give to nonaccredited purchasers on the Web.<sup>116</sup> Issuers will not have to provide disclosure in paper form and will thereby reduce production and reproduction costs. Furthermore, these disclosure documents can be updated instantaneously to correct errors or changes in the financial status of the issuer.

For issuers who choose to place their offering on the Web pages that nonaccredited investors can access, a determination must be made regarding the investor's level of sophistication pursuant to Rule 506(b)(2)(ii).<sup>117</sup> This determination can be made

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113. *See id.* § 230.506(b)(2).

114. *See id.* § 230.501(e).

115. Hypertext is "[a] system of writing and displaying text that enables the text to be linked in multiple ways, to be available at several levels of detail, and to contain links to related documents." *NetLingo: The Internet Language Dictionary* (visited Sept. 16, 1999) <<http://www.net-lingo.com/lookup.cfm?term=hypertext>>.

116. Rule 502(b) sets forth when information must be provided to investors along with the type of information that must be provided. 17 C.F.R. § 230.502(b)(1)-(2) (1999).

117. *See id.* § 230.506(b)(2)(ii). Rule 506(b)(2)(ii) in its entirety is as follows:

through the use of a questionnaire. In addition to the questionnaire, issuers can also use chat rooms, which are real time conversations on the Internet,<sup>118</sup> to obtain more information from the investor about his or her level of sophistication. Once the issuer reasonably believes that the investor is sophisticated, it may issue another password to the investor. This password can allow the investor to access other information not provided in the mandatory disclosure documents that the investor may believe is necessary to evaluate the merits of the investment. Access to this additional information can be made available by using another Web page that categorizes the information in hypertext form and instantaneously provides the investor the information if he or she decides to click on the text.

Since an issuer may not create hypertext categories for all the information that investors may want to view, it will be necessary to set up a chat room or a central e-mail address that will allow the investors with password access to request other types of information about the issuer. This information can then be posted through the creation of new hypertext or can be sent via e-mail directly to the investor who requested the information. If the information will be provided through the creation of new hypertext, it will be necessary to notify the requesting investor, through e-mail or another medium, that the information is now available. This type of system will also be very useful to accredited investors who are not provided with disclosure documents but would like additional information about the issuer before purchasing the securities.

#### CONCLUSION

As the number of people using computers in our society continues to grow, the use of the Internet will become as commonplace as watching television or reading the newspaper. It will also create a large base of potential investors that can be reached quickly at a low cost. Along with this new investor base comes an unlimited amount of capital that is waiting to be tapped. However, as evidenced by some of the existing securities regulations, businesses, particularly small ones, are not being allowed to reap the full advantages that the Internet has to offer.

By eliminating the application of Rule 502(c) to Rule 506 Internet offerings, issuers, investors, and the SEC will be better able to utilize the advantages provided by the Internet. A centralized website for Rule 506 offerings would make it easier to locate potential investors and to disseminate information to them at a low cost. Investors would be able to conveniently search for and locate offerings that pique their interest. They would also be able to instantaneously obtain information about the issuer and the offering. The SEC would be in a better position to detect fraud and bring actions

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Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

*Id.*

118. See *NetLingo: The Internet Language Dictionary* (visited Sept. 16, 1999) <<http://www.netlingo.com/lookup-.cfm?term=chat+room>>. Chat room is defined as “[a] site on the World Wide Web where any number of computer users can type in messages to each other (chat) in real time, creating an online conversation.” *Id.*

against wrongdoers. Most importantly, the SEC would be better able to ensure the protection of investors, which is one of the main principles of the Securities Act.

While the proposed system may have its flaws and may not be a final solution, it is a step in the right direction. At the very least, it creates the opportunity for investors, issuers, and the SEC to evaluate whether the potential of the Internet can ever be effectively tapped. However, even if the proposed system and subsequent modifications fail, at least we will have answered the question whether the use of the Internet can presently be reconciled with the governing principles of the Securities Act.