

Testing the Waters-The Sec's Feet Go From Wet to Cold

Jeffrey A. Brill

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NOTE

“TESTING THE WATERS”—THE SEC’S FEET GO FROM WET TO COLD

Jeffrey A. Brill†

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INTRODUCTION

According to the Securities and Exchange Commission (“SEC” or “Commission”), its “mission is to administer Federal securities laws that seek to provide protection for investors.”¹ In particular, “[t]hese laws were designed to facilitate informed investment analyses and decisions by the investing public, primarily by ensuring adequate disclosure of material (significant) information.”² However, this goal of protecting investors often conflicts with the SEC’s policy objective of promoting capital formation.³ The Commission has struggled recently to balance these competing policies in its efforts to facilitate initial public offerings (“IPOs”).

The SEC has sought to encourage IPOs because they (i) frequently serve as the most effective means for corporate entities to

¹ SEC, *THE WORK OF THE SEC* 3 (1986). In 1992, SEC Chairman Richard Breeden explained:

When thinking about the missions of the SEC, the subject of investor protection is invariably the first thing that comes to mind. That is an appropriate reaction, for protection of the more than 40 million Americans who own securities directly—more than 50 million if you count participants in stock mutual funds—is unquestionably the first and foremost assignment of the SEC.

Richard C. Breeden, *Financing America’s Growth*, Remarks Before the National Press Club (Feb. 18, 1992), in [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,927, at 82,465, 82,465-66 (Feb. 18, 1992) [hereinafter *Financing America’s Growth*].

² SEC, *supra* note 1, at 3-4.

³ See, for example, section 2(b) of the Securities Act of 1933, as amended, which requires, for the purposes of the Act, that “[w]henver . . . the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.” 15 U.S.C. § 77b(b) (Supp. II 1996). For an example of the Commission’s efforts to promote capital formation, see *Small Business Initiatives*, Securities Act Release No. 6924, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,931, at 82,481 (Mar. 11, 1992) [hereinafter *Proposing SBIs Release*].

raise capital and (ii) benefit the capital markets and the economy.⁴ Unfortunately, the costs incurred in undertaking an IPO preclude many companies from pursuing this avenue of capital formation. As a result, the SEC has taken measures to reduce these costs to help companies launch IPOs.

"Testing the waters" represents such a step towards facilitating IPOs. Controversially introduced in 1992 via the Small Business Initiatives (the "SBIs Release" or "SBIs")⁵ in the form of Rule 254,⁶ the testing-the-waters rule enables small businesses to solicit indications of interest in a potential Regulation A offering before incurring the costs and burdens of preparing an offering statement and filing it with the SEC.⁷ The results of this solicitation would play a large role in the calculus that a small business uses in deciding whether to proceed with a Regulation A offering.

In June 1995, the Commission published a release entitled Solicitations of Interest Prior to an Initial Public Offering (the "Testing Release").⁸ In the Testing Release, the SEC heralded Rule 254 as a success and proposed new Rule 135d, which would extend the scope of testing the waters beyond Regulation A to registered IPOs.⁹ As proposed, Rule 135d would "allow companies [of all sizes] to gauge investor interest before incurring the significant expense required in the preparation of IPO disclosure documents."¹⁰ This proposed extension is controversial because it represents a radical departure from the fundamental policy embodied in section 5(c)¹¹ of the Securities Act of 1933, as amended ("Securities Act").¹² Section 5(c) protects investors by requiring, absent an exemption, the filing of a registration statement before an issuer, underwriter, or dealer may make any offer to sell or buy a security.¹³ The SEC has been committed to achieving section 5's goal of protecting investors from fraud and misrepresentation.¹⁴ In the Testing Release, the SEC reiterated its commitment "to

⁴ See *infra* Part II.A.

⁵ Small Business Initiatives, Securities Act Release No. 6949, 57 Fed. Reg. 36,442 (Aug. 13, 1992) [hereinafter SBIs Release].

⁶ 17 C.F.R. § 230.254 (1997).

⁷ See SBIs Release, *supra* note 5, at 36,470.

⁸ Solicitations of Interest Prior to an Initial Public Offering, Securities Act Release No. 7188, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,639, at 86,885 (June 27, 1995) [hereinafter Testing Release].

⁹ See *infra* note 379 and accompanying text.

¹⁰ See Testing Release, *supra* note 8, at 86,887.

¹¹ See 3A HAROLD S. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 6.09, at 6-30 (1996) (opining that "the Commission seems to be testing the waters itself").

¹² 15 U.S.C. § 77a *et seq.* (1994 & Supp. II 1996).

¹³ *Id.* §§ 77(d)(1), 77e(c).

¹⁴ See Financing America's Growth, *supra* note 1, at 82,466 (explaining that "[p]rotecting investors against fraud and manipulation is a task that is deeply ingrained in

assuring that the interests of investors are not compromised."¹⁵ Additionally, the Testing Release invited public comment on numerous provisions of, and issues in connection with, proposed Rule 135d; however, it posed two fundamental questions for commenters:

[First, is] the proposed "test the waters" rule . . . appropriate and in *investors'* interest in the context of registered IPOs[?] . . . [Second, w]ill the proposed process effectively accomplish the Commission's goal of allowing businesses to assess the capital market's potential interest in their businesses on a cost-effective basis, without causing *investors* to overlook the full disclosures mandated by the federal securities laws?¹⁶

In short, the SEC is concerned that the testing-the-waters proposal may strain the balance between protecting investors and promoting capital formation.

Although the SEC has been pleased with the results of the testing-the-waters amendment to Regulation A introduced in the SBIs Release,¹⁷ many states, as well as the North American Securities Administrators Association ("NASAA"),¹⁸ opposed Rule 254 because it inadequately protects small investors.¹⁹ Commentators have explained that the SEC needs the support of the states and NASAA for Rule 254 to succeed.²⁰ Proposed Rule 135d, which would enable businesses contemplating registered IPOs to test the waters, differs only slightly from Rule 254. Therefore, the SEC has tried to address the concerns of the states and NASAA regarding investors' vulnerability to fraud and misrepresentation.

The SEC apparently is struggling to solve the foregoing problems because the comment period for the Testing Release ended on September 8, 1995, and the Commission has yet to revise or adopt the testing-the-waters proposal.²¹ Even the passage by Congress in October 1996 of the National Securities Markets Improvement Act of

the traditions of the agency, and it is a mission that is every bit as important today as it was when the nation's federal securities laws were first enacted in the 1930s").

¹⁵ Testing Release, *supra* note 8, at 86,886.

¹⁶ *Id.* at 86,890 (emphasis added).

¹⁷ See *infra* text accompanying notes 341-43.

¹⁸ NASAA consists of securities regulators from all fifty states, the District of Columbia, Puerto Rico, Mexico, and certain Canadian provinces. See NASAA Comment Letter to SEC Secretary, Jonathan Katz, Regarding SEC Release 33-6924, on Small Business Initiatives, [1986-1993 Transfer Binder] NASAA Rep. (CCH) ¶ 9346, at 9372, 9373 n.1 (July 24, 1992) [hereinafter NASAA Comment Letter Regarding SBIs].

¹⁹ See *infra* Part III.B.1.

²⁰ See *infra* notes 289-93 and accompanying text.

²¹ Testing Release, *supra* note 8, at 86,885. By contrast, the SEC adopted the SBIs about six weeks after the end of the public comment period. See *infra* text accompanying notes 155-59. Cf. *infra* Part IV.D (offering reasons why the SEC has taken more time with proposed Rule 135d than with the SBIs).

1996²² (the "NSMIA"), which (i) exempted certain securities and securities transactions from state securities law registration requirements and (ii) granted the Commission general exemptive authority,²³ has not yet prompted the Commission to take action with respect to proposed Rule 135d. Nevertheless, the SEC still considers the adoption of the proposal a priority.²⁴ In short, after getting its feet wet in the Regulation A waters, the SEC currently has developed cold feet about extending the proposal to the registered IPO market.

This Note discusses the Regulation A testing-the-waters rule the SEC adopted in 1992 and the similar proposed Rule 135d currently under consideration. It focuses on proposed Rule 135d's likely impact on potential issuers, actual issuers, underwriters, investors, the registration process, and the capital markets.²⁵ Part I begins with a brief introduction to the statutory framework that governs public offerings. This historical perspective will set the stage for a discussion of the ways in which testing the waters appears to undermine the equilibrium between protecting investors and encouraging capital formation that section 5 of the Securities Act has maintained thus far.

Part II describes the need for a testing-the-waters rule. It summarizes the advantages of an IPO and the difficulties facing companies that aspire to go public. This Part explains the reasons underlying the SEC's decision to introduce the testing-the-waters initiative as part of the SBIs Release, thereby enabling only small businesses to benefit from testing the waters.

Part III begins with a detailed analysis of the testing-the-waters rule the SBIs Release introduced in 1992. It then surveys the reactions of scholars, practitioners, the private bar, states, NASAA, and the Commission to the testing-the-waters provisions, many of which also apply to the Rule 135d proposal in the Testing Release. Part III also addresses the problems posed by the lack of coordination between state securities laws and Rule 254. Additionally, this Part assesses the testing-the-waters rule, and discusses its impact since its enunciation in the SBIs Release. It concludes that testing the waters under Rule 254

²² Pub. L. No. 104-290, 110 Stat. 3416 (codified at 15 U.S.C. § 78a note (Supp. II 1996)) [hereinafter NSMIA].

²³ See *infra* Parts III.C.3, V.D; *infra* notes 226, 541-43.

²⁴ See *infra* text accompanying note 539.

²⁵ Many authorities maintain that after the close of trading, the stock of a company that has gone public usually underperforms. See, e.g., Christopher Farrell, *Should You Join the IPO Stampede?*, Bus. Wk., Dec. 18, 1995, at 72; Phillip L. Zweig & Leah Nathans Spiro, *Beware the IPO Market: Individual Investors Are at a Big Disadvantage*, Bus. Wk., Apr. 4, 1994, at 84, 88. While the performance of an issuer's stock after it has tested the waters and completed an IPO is relevant to an evaluation of a testing-the-waters rule, this Note does not focus in its analysis of proposed Rule 135d on the long-term performance of the stock of a company that has gone public because there are many reasons why a stock may underperform.

poses significant risks for investors, and that the SEC's declaration of the initiative's success was too hasty.

Part IV delineates proposed Rule 135d and proposed revisions to Rule 254 which the SEC introduced in the Testing Release. It compares proposed Rule 135d with Rule 254 and with the NASAA model implemented by states that participated in a two-year pilot program. Part IV also reviews the comment letters submitted in response to the Testing Release.

Part V assesses the testing-the-waters proposal currently before the SEC. This Note recognizes the need for testing the waters as well as the advantages of expanding its availability. However, it concludes that proposed Rule 135d is irreconcilable with the language and policy aims of section 5(c) of the Securities Act. Current Rule 254 does not adequately protect investors from making decisions to purchase securities solely or largely on the basis of the testing-the-waters solicitation, that is, without a careful review of an offering circular. Proposed Rule 135d does not go far enough beyond Rule 254 to provide adequate safeguards.

Although this Note finds that the proposal, as drafted, is potentially harmful to investors, Part V praises the Testing Release for increasing the availability of testing the waters. Rule 254 helped neither small businesses that sought to raise more capital than the \$5 million that Regulation A permits nor larger businesses whose needs typically prevent them from enjoying shelter under Regulation A. Proposed Rule 135d would enable larger issuers to test the waters prior to a registered IPO of any size. Therefore, proposed Rule 135d corrects the asymmetry the Commission created when it reserved the testing-the-waters rule only for issuers contemplating a Regulation A offering. This Note welcomes the Commission's effort to restore uniformity. It contends that this uniformity is justified because testing the waters before a registered IPO is actually less likely to expose investors to fraud and misrepresentation than testing the waters before a Regulation A offering.²⁶

Part V argues that as long as testing the waters remains permissible under Regulation A, it should also be available uniformly to issuers considering a registered IPO. But, as proposed, the Commission's Rule 135d insufficiently protects investors. This Note recommends collapsing Rule 254 and proposed Rule 135d into a single rule that would contain additional safeguards. These safeguards would enable potential issuers of any size to reap the benefits of testing the waters before either a Regulation A or registered IPO, while minimizing the risk that investors will make uninformed investment decisions. In this

²⁶ See *infra* Part V.E.3.

manner, the SEC could at least reconcile proposed Rule 135d with the policy goals of section 5(c) of the Securities Act.

I

STATUTORY FRAMEWORK

The Securities Act, enacted four years after the 1929 stock market crash, regulates and oversees securities offerings, including IPOs, with an eye towards protecting investors.²⁷ The Securities Act protects investors by requiring an issuer to register its securities, absent an exemption. An issuer must file with the Commission a registration statement that the SEC will review to ensure that investors receive adequate and accurate disclosure. Section 5(c) of the Securities Act, which prohibits gun-jumping, protects investors during the pre-filing period.²⁸

A. Gun-Jumping

The SEC has historically prohibited gun-jumping, which is the making of an offer, as defined in section 2(3) of the Securities Act, by an issuer, underwriter, or dealer,²⁹ before the issuer has filed a registration statement.³⁰ Section 5(c) of the Securities Act codifies this prohibition. Section 5(c) stipulates that “[i]t shall be unlawful for any person . . . to offer to sell or offer to buy through the use or medium

²⁷ See *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979) (explaining that “the 1933 Act was primarily concerned with the regulation of new offerings”); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752 (1975) (clarifying that the Securities Act is “chiefly concerned with disclosure and fraud in connection with offerings of securities—primarily, as here, initial distributions of newly issued stock from corporate issuers”). The SEC also considers the protection of investors its primary purpose. See *supra* notes 1-2 and accompanying text.

²⁸ 15 U.S.C. § 77e(c) (1994). This represents the period of time between when a company is “in registration” and the filing of its registration statement.

²⁹ Section 4(1) of the Securities Act states that section 5 does not govern “transactions by any person other than an issuer, underwriter, or dealer.” 15 U.S.C. § 77d(1).

³⁰ See generally 3A BLOOMENTHAL, *supra* note 11, § 6.09 (assessing the current status of the gun-jumping proscription); Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457, 492-511 (1989) (advocating the legalization of gun-jumping via, inter alia, a repeal of section 5(c) and a revision of the definition of “offer” in section 2(3) of the Securities Act); Nathan D. Lobell, *Revision of the Securities Act*, 48 COLUM. L. REV. 313, 320-22 (1948) (identifying gun-jumping as “one of the ‘classical’ problems that haunt Securities Act administration”); Morton A. Pierce, *Current and Recurrent Section 5 Gun-Jumping Problems*, 26 CASE W. RES. L. REV. 370 (1976) (discussing chronic gun-jumping problems); John K. Hoyns, *‘Gun-Jumping’ in Offering Securities*, N.Y. L.J., Dec. 9, 1996, at 7 (describing gun-jumping issues in connection with “stock-for-stock transactions”); Joseph P. Richardson & Joseph E. Reece, *Gun Jumping*, REV. SEC. & COMMODITIES REG., Jan. 13, 1993, at 1 (discussing gun-jumping in the context of IPOs without addressing testing the waters).

of any prospectus or otherwise any security, unless a registration statement has been filed as to such security."³¹ Under section 2(3),

[t]he term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell", "offer for sale", or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.³²

Section 2(10) defines a "prospectus" as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."³³ Therefore, commencement by an issuer, underwriter, or dealer of a "public sales campaign" through a notice issued before registration violates section 5 of the Securities Act.³⁴

The SEC further clarified in several releases that section 5(c) may proscribe pre-filing publicity that falls short of an "express offer."³⁵ The Commission therefore broadly construes the term "offer" in section 2(3). According to the Commission,

publicity efforts . . . made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.³⁶

³¹ 15 U.S.C. § 77e(c). For a discussion of liability arising from gun-jumping under the federal securities laws, see Chiappinelli, *supra* note 30, at 463-66.

³² 15 U.S.C. § 77b(3). However, section 2(3) states that "preliminary negotiations or agreements between an issuer . . . and any underwriter or among underwriters who are or are to be in privity of contract with an issuer" are outside the purview of these definitions and the term "offer to buy" in section 5(c). *Id.*

³³ *Id.* § 77b(10). Section 2(10)(b) exempts from this definition "a notice, circular, advertisement, letter, or communication in respect of a security" issued after registration that discloses (i) "from whom a written prospectus meeting the requirements of section 77j of this title may be obtained" and (ii) only certain limited information permitted by this section and by Rule 134. *Id.* § 77b(10)(b); see 17 C.F.R. § 230.134 (1997).

³⁴ Publication of Information Prior to or After Effective Date of Registration Statement, Securities Act Release No. 3844, 1 Fed. Sec. L. Rep. (CCH) ¶ 3250, ¶ 3254-56, at 3147, 3149-52 (Oct. 8, 1957) [hereinafter Publication of Information Release] (offering examples of pre-filing publicity that violated section 5(c)).

³⁵ *Id.* at 3149.

³⁶ *Id.* The Commission used essentially the same language in a controlling case regarding gun-jumping as its rationale for holding that a press release issued by an underwriter six weeks before filing a registration statement, which described the nature of a proposed public offering and the value thereof, "must be presumed to set in motion or to be a part of the distribution process and therefore to involve an offer to sell or a solicitation of an offer to buy such securities prohibited by Section 5(c)." Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 851 (1959); see also Guidelines for the Release of Information by Issuers Whose Securities Are in Registration, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192, at 80,578, 80,579 (Aug. 16, 1971) [hereinafter Guidelines Release] (explaining that "the publication of information and

The Commission and the courts thus have been concerned about the effects of pre-filing disclosure on investors.³⁷ When investors, who lack either a sufficient opportunity or capacity to determine the inherent risks of a public offering, participate in a transaction primarily as a result of sales-oriented, pre-filing publicity, the courts have deemed the publicity a violation of section 5(c). For example, in *Carl M. Loeb, Rhoades & Co.*, the Commission found that a pre-filing press release the underwriter issued “arous[ed] and stimulat[ed] investor and dealer interest” in the offering.³⁸ The SEC held that the press release constituted an illegal offer to sell and thus violated section 5(c) of the Securities Act.³⁹

The intent of the issuer or its agent is also a factor the Commission and the courts have considered in conducting a section 5(c) analysis of pre-filing publicity. The SEC has explained that pre-filing publicity that is “published by various means for the purpose of conveying to the public a message designed to stimulate an appetite for securities” may represent an offer under section 5(c).⁴⁰ In *Loeb, Rhoades & Co.*, the Commission found that the press release was “of a character *calculated*, by arousing and stimulating investor and dealer interest in [the] securities and by eliciting indications of interest . . . , to set in motion the processes of distribution.”⁴¹ In short, “the purpose of the release was [no] different from its effect—the stimulation of investor and dealer interest as the first step in a selling effort.”⁴² The intent of the underwriters, the content and timing of the release, and the manifest effect on investors led the Commission to conclude that the publicity violated the Securities Act.⁴³

The SEC’s Guidelines for the Release of Information by Issuers Whose Securities Are in Registration (the “Guidelines Release”)⁴⁴ reiterated that the “phrase ‘offer to sell’ [in section 5(c)] is broadly de-

statements, and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer in violation of the [Securities] Act”).

³⁷ See Guidelines Release, *supra* note 36, at 80,579 (emphasizing the significance of the “effect of conditioning the public mind or arousing public interest” in the issue).

³⁸ *Loeb, Rhoades & Co.*, 38 S.E.C. at 851. The Commission concluded that the press release was successful as a means of attracting the attention of interested investors. *Id.*

³⁹ *Id.* The Commission explained that the term “offer” must be construed broadly in order to achieve the legislative intent behind section 5. *Id.* at 848. See *infra* Part I.B for a discussion of the purposes of the gun-jumping prohibition. After comparing the press release with the prospectus, which the company circulated six weeks after the issuance of the press release, the Commission concluded that the press release contained material omissions that led investors to underestimate the risks involved in the financing. *Loeb, Rhoades & Co.*, 38 S.E.C. at 854.

⁴⁰ Publication of Information Release, *supra* note 34, ¶ 3255, at 3149.

⁴¹ *Loeb, Rhoades & Co.*, 38 S.E.C. at 851 (emphasis added).

⁴² *Id.* at 853.

⁴³ See *id.* at 853 n.20.

⁴⁴ See source cited *supra* note 36.

fined by the [Securities] Act and has been liberally construed by the courts and Commission."⁴⁵ Despite requests to "promulgate an all inclusive list of permissible and prohibited activities" under section 5(c), the SEC has declined to provide such a list because compliance with the statute is determined on a case by case basis.⁴⁶ Nevertheless, the Guidelines Release cautioned issuers that are in registration to "avoid . . . [i]ssuance of forecasts, projections, or predictions relating but not limited to revenues, income, or earnings per share . . . [and] [p]ublishing opinions concerning values."⁴⁷

Although the SEC was reluctant to publish a so-called "all inclusive list," the Second Circuit recognized that Rule 135⁴⁸ of the Securities Act serves this purpose with respect to the formal announcement of an offering.⁴⁹ The court conceded that "the line drawn between an announcement containing sufficient information to constitute an offer and one which does not must be to some extent arbitrary."⁵⁰ However, according to the court, Rule 135 sets forth a "checklist of features that may be included in an announcement which does not also constitute an offer to sell."⁵¹ The court encouraged interpreting Rule 135 as "an exclusive list."⁵² Pursuant to the provisions of Rule 135 most relevant to IPOs, an issuer may give notice that it seeks to undertake a public offering without violating section 5(c) if the notice is limited to: (i) an announcement that "the offering will be made only by means of a prospectus" and (ii) disclosure of only the identity of the potential issuer, the fundamental terms and timing of the offering, and a short statement regarding the nature and goal of the offering without identifying the underwriter.⁵³ Rule 135 thus establishes

⁴⁵ Guidelines Release, *supra* note 36, at 80,579.

⁴⁶ See *id.* at 80,580; see also *Loeb, Rhoades & Co.*, 38 S.E.C. at 853 n.20 (acknowledging that "[w]hether in any particular case publicity is an offer depends upon all the facts, and the surrounding circumstances including the nature, source, distribution, timing, and apparent purpose and effect of the published material").

⁴⁷ Guidelines Release, *supra* note 36, at 80,580.

⁴⁸ 17 C.F.R. § 230.135 (1997).

⁴⁹ See *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 574 (2d. Cir. 1970).

⁵⁰ *Id.* (holding that "the assigning of a value to offered shares constitutes an offer to sell"). The court reasoned that "[o]ne of the evils of a premature offer is its tendency to encourage the formation by the offeree of an opinion of the value of the securities before a registration statement and prospectus are filed." *Id.* The court recognized that a prefling announcement of a future sale of securities, coupled with "an attractive description of these securities and of the issuer," conveys information that would be found in a prospectus. *Id.* (citing *S.E.C. v. Arvida Corp.*, 169 F. Supp. 211 (S.D.N.Y. 1958)).

⁵¹ *Id.*

⁵² *Id.*

⁵³ 17 C.F.R. § 230.135 (1997). The Rule allows the notice of a proposed offering to contain additional information in the cases of rights offerings, exchange offerings, and offerings to employees. *Id.*

limits on the content of legal prefling publicity that announces an offering.

The SEC has liberally recognized that offers need not "take any particular legal form."⁵⁴ This position is consistent with the Commission's broad construction of the meaning of "offer" for the purposes of section 5(c) and its strict definition of the contours of legal prefling disclosure. "Offers" include a number of means of dissemination. For example, prefling announcements delivered via a speech, press release, advertisement, article, broadcast, the Internet, or electronic mail about an offering may constitute an illegal offer under section 5(c).

This treatment of all modes of communication as potential "offers" under section 5(c) has led to de-emphasis of the scope of the dissemination as a measure of whether a communication is an "offer." The SEC has not set forth a bright line test which would require that the publicity reach either a certain audience or a minimum number of those comprising that audience. In fact, publicity that is merely publicly available may still constitute gun-jumping.⁵⁵

In short, through sections 5 and 2(3) and Rule 135, "Congress has specified a period during which, and a procedure by which, information concerning a proposed offering may be disseminated to dealers and investors."⁵⁶ Further, the Commission has explained that "[t]his procedure is exclusive and cannot be nullified by recourse to public relations techniques to set in motion or further the machinery of distribution before the statutory disclosures have been made and upon the basis of whatever information the distributor deems it expedient to supply."⁵⁷

This limited statutory tolerance of prefling publicity reveals that the SEC could not broaden the availability of testing the waters to registered IPOs under the current federal securities laws. As Part V discusses, testing the waters, which allows prospective issuers to communicate an unlimited amount of information to potential investors,

⁵⁴ Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 849 (1959); see also Chiappinelli, *supra* note 30, at 467-69 (discussing the various forms "offers" can take).

⁵⁵ See Chiappinelli, *supra* note 30, at 468-69. Such publicity represents a "passive offer." *Id.* Of course, if the prefling publicity does not actually reach investors, a court may be less inclined to hold the issuer liable if it finds that the dissemination had little or no impact on investors. See *supra* notes 36-39 and accompanying text. However, this may be a difficult conclusion to draw because prefling publicity that does not directly reach the ultimate investors may affect the investors in other ways. For example, the publicity may influence the purchase price of the securities by driving away other investors or leading analysts and dealers to promote the offering to their customers. Consequently, investors, who cannot establish that they relied on the prefling communication, may still have a section 5(c) cause of action against an issuer.

⁵⁶ Loeb, Rhoades & Co., 38 S.E.C. at 850-51.

⁵⁷ *Id.* at 851.

would not find shelter from section 5 under current Rule 135.⁵⁸ Rules 135a-c currently exempt specific forms of publicity in particular circumstances from section 5, but none of these apply to the usage of testing-the-waters materials before a registered IPO.⁵⁹ In the Testing Release, the Commission seeks to add a new exemption: Rule 135d. The heart of the controversy underlying the testing-the-waters proposal remains that although the Commission may have “previously dr[awn] a not-always-clear line between those forms of preregistration publicity that were permitted and those that were not . . . , no doubt existed that direct attempts to solicit the investor would not be tolerated.”⁶⁰ The testing-the-waters proposal invites issuers to pursue such a direct solicitation.

B. The Purpose of the Statutory Prohibition of Gun-Jumping

As discussed above, Congress enacted the Securities Act to protect investors, and imbued the Commission with the responsibility of fulfilling this objective through the administration and supervision of the federal securities laws.⁶¹ The gun-jumping prohibition represents the primary safeguard protecting investors during the pre-filing period. The proscription of gun-jumping begins the “period of enforced silence” during which Congress, through section 5 of the Securities Act, comprehensively channels all communications from the issuer to prospective investors through the SEC.⁶²

Congress intended for section 5 to protect the public from misleading, fraudulent, illusory, or incomplete statements made by issuers or underwriters, who, in their efforts to persuade investors to participate in a financing, might fail to disclose material information.⁶³ The Securities Act sought to afford the public an opportunity to carefully examine the particulars of the issuer and its offering as

⁵⁸ See *infra* Part V.A.2.

⁵⁹ 17 C.F.R. §§ 230.135a-c (1997).

⁶⁰ John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1151-52 (1995) (footnote omitted). In addition to the disclosure permitted under Rules 135 and 135a-c, there are other forms of pre-filing publicity that the Commission currently appears to tolerate. See 3A BLOOMENTHAL, *supra* note 11, § 6.09, 6-14 to 6-21 (discussing the SEC’s liberal attitude towards the following types of pre-filing publicity: “product advertising and industry publicity,” “appearances before analysts,” and “research department publications”).

⁶¹ See *supra* notes 1-2, 27 and accompanying text.

⁶² Coffee, *supra* note 60, at 1151.

⁶³ See S. REP. NO. 83-1036, at 2 (1954); S. REP. NO. 73-47, at 1-2 (1933); H.R. REP. NO. 73-85, at 1-5 (1933); see also *Pinter v. Dahl*, 486 U.S. 622, 638 (1988) (stating that “[t]he primary purpose of the Securities Act is to protect investors by requiring publication of material information thought necessary to allow them to make informed investment decisions concerning public offerings of securities”) (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953); *A.C. Frost & Co. v. Coeur D’Alene Mines Corp.*, 312 U.S. 38, 43 & n.2 (1941)).

described in a prospectus the SEC had previously reviewed.⁶⁴ Prefiling publicity causes investors "to form . . . premature opinion[s] . . . without [the] benefit of the full set of facts contained in a prospectus," the accuracy of which the SEC can attempt to verify.⁶⁵ Professor Coffee candidly articulated why investors need protection and how the gun-jumping prohibition provides this protection:

The obvious premise to Section 5 was that if investors could receive glossy, promotional literature from the issuer, they might pay little attention to the dull, formalistic prospectus prepared in accordance with the rules of a government agency. Understandably, the government is not as slick, persuasive, or enticing as Madison Avenue, and thus, if its mandated disclosure document is to receive investor attention, the state needs a monopoly for at least a limited period on access to the investor. Section 5 essentially provides that monopoly. . . .⁶⁶

Prefiling publicity may have ramifications reaching far beyond the obvious harm to individual investors, which the gun-jumping prohibition seeks to address. For example, prefiling publicity may artificially interfere with the market price of the securities at the time of the offering.⁶⁷ Further, the Commission suggested in *Loeb, Rhoades & Co.* that investor reliance upon such publicity may endanger "the health of the capital markets."⁶⁸ When dealers or investors suffer losses as a result of a misleading statement made before the filing of a registration statement, they will be less likely to participate in similar offerings in the future. This threatens the success of future new issues.

C. Gun-Jumping as Applied to IPOs

The section 5(c) gun-jumping prohibition is particularly significant in the context of IPOs.⁶⁹ Prefiling publicity regarding an IPO

⁶⁴ See Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843, 849 (1959).

⁶⁵ *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 575 (2d Cir. 1970).

⁶⁶ Coffee, *supra* note 60, at 1151.

⁶⁷ See Publication of Information Release, *supra* note 34, at 3149.

⁶⁸ *Loeb, Rhoades & Co.*, 38 S.E.C. at 854.

⁶⁹ The legislature and the SEC often discuss gun-jumping in terms of a balancing dilemma. The Commission seeks to protect investors while simultaneously encouraging companies to disclose material information to its shareholders and the public. See, e.g., *id.* at 852. Full and fair disclosure to shareholders and the public represents the underlying purpose of the reporting requirements under the Securities Exchange Act. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-78 (1977) (explaining that the primary purpose of the Securities Exchange Act is to "implement[] a 'philosophy of full disclosure'"); S. REP. NO. 73-792, at 1-5 (1934); Guidelines Release, *supra* note 36, at 80,580; Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement Under the Securities Act of 1933, Securities Act Release No. 5009, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,744, at 83,705, 83,706 (Oct. 7, 1969); Publication of Information Release, *supra* note 34, at 3147. However, this Note does not flesh out this argument

may be more likely to have an effect on dealers and investors because there is much less information available to the public regarding private companies. Private companies are not subject to the reporting requirements prescribed by the Securities Exchange Act of 1934, as amended ("Exchange Act").⁷⁰ There is typically less public familiarity with private companies. Private companies, especially smaller companies, usually have fewer shareholders than their public counterparts. Moreover, analysts primarily track public companies. Therefore, because there is comparatively less information available about private companies to compete with pre-filing publicity, investors may need even more protection before an IPO than before a subsequent public offering by a seasoned issuer. In addition to this information gap, sellers of securities offered in an IPO may use exceedingly aggressive marketing tactics. Because the offering constitutes an issuer's first sale to the public, the issuer, especially eager to consummate the offering, may engage in puffing and overreaching to ensure the success of the offering.

The consequences of gun-jumping by small issuers who offer securities to the public pursuant either to Regulation A or another exemption may be even greater than those for registered IPOs. Smaller businesses that cannot afford a registered IPO may rely on Regulation A to conduct an offering via a short-form registration.⁷¹ Alternatively, these small issuers may choose to raise capital via an offering that is exempt from registration, for example, in reliance on Rule 504 of Regulation D.⁷² The aforementioned information gap may widen because businesses that contemplate these smaller public offerings often sell to investors who are less financially sophisticated.⁷³ Conversely, professional underwriters often market registered IPOs to institutional investors, mutual fund companies, and brokerage houses⁷⁴ which usually have more financial sophistication than the individual investors who are likely to purchase securities in a Regulation A or Rule 504 offering. Such investors are more susceptible to fraud and misrepresentation and thus need the protection of section 5(c).⁷⁵

Illegal pre-filing publicity before both registered and exempt IPOs poses the same systemic dangers discussed earlier in the context of

because it is not as relevant in the context of a private company considering an IPO. Private companies have far fewer shareholders and are not subject to the Securities Exchange Act.

⁷⁰ 15 U.S.C. § 78a *et seq.* (1994 & Supp. II 1996).

⁷¹ See *infra* Part II.B.2.

⁷² See *infra* Part II.B.3.

⁷³ See NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9374.

⁷⁴ See Zweig & Spiro, *supra* note 25, at 85-86.

⁷⁵ See Joel Seigman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 33-36 (1983) (discussing how fraud is more common in small issues).

registered IPOs. Such publicity can artificially inflate the market price and potentially harm the capital markets.⁷⁶

II

THE NEED FOR TESTING THE WATERS

The promotion of capital formation has been a parallel policy aim of the Securities Act.⁷⁷ Although there are a host of means by which a corporate entity can raise capital, public offerings, especially registered IPOs, offer issuers substantial benefits.⁷⁸ As a result, the SEC in 1995 proposed testing-the-waters legislation in the form of Rule 135d that should help issuers to undertake registered IPOs. But before attempting to promote registered IPOs in this way, the Commission in 1992 first introduced the testing-the-waters concept via Rule 254 to help small businesses raise capital under Regulation A.

A. Introduction to Registered IPOs

In a registered IPO, an issuer registers securities in compliance with federal and state securities laws and sells shares of its stock to the public for the first time. A company chooses to go public in order to avail itself of the advantages of public ownership.⁷⁹ After a successful IPO, a newly created public company has access to capital and gains financial flexibility with which it can accomplish many ends. For example, the company can use the funds to satisfy debts, expand production, increase inventory, promote research and development, acquire or merge with another entity using its liquid stock to pay the

⁷⁶ See *supra* text accompanying notes 67-68.

⁷⁷ See *supra* note 3 and accompanying text.

⁷⁸ See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.6, at 61-62 (3d ed. 1996); FREDERICK D. LIPMAN, *GOING PUBLIC: EVERYTHING YOU NEED TO KNOW TO SUCCESSFULLY TURN A PRIVATE ENTERPRISE INTO A PUBLICLY TRADED COMPANY* 5-9 (1994); CARL W. SCHNEIDER ET AL., *GOING PUBLIC: PRACTICE, PROCEDURE AND CONSEQUENCES* 2-3 (1995); Stanley J. Friedman, *Going Public: Some Basic Considerations*, in *HOW TO GO PUBLIC: AN INTRODUCTION TO THE SECURITIES LAWS*, at 13, 13 (PLI Corp. L. & Practice Course Handbook Series No. 38, 1970); Richard Salomon, *Second Thoughts on Going Public*, *HARV. BUS. REV.*, Sept.-Oct. 1977, at 126, 127; Ernest L. Ten Eyck, *Why Go Public*, in *FINANCING A SMALL BUSINESS IN THE SECURITIES MARKETS* 1993, at 95, 97-100 (PLI Corp. L. & Practice Course Handbook Series No. B-816, 1993); Robert L. Frome, *Going Public*, *N.Y. L.J.*, Apr. 1, 1992, at 3; John F. Olson & D. Jarrett Arp, *What Makes a Company a Good Candidate for Going Public? Criteria, Advantages, and Disadvantages Related To Going Public*, SB09 A.L.I.-A.B.A. 21, 25-29 (July 18, 1996); Philip W. Taggart et al., *Deciding Whether To Go Public*, *NATION'S BUS.*, May 1991, at 51, 51.

⁷⁹ For a discussion of the disadvantages of an IPO, see HAZEN, *supra* note 78, § 1.6, at 62-65; LIPMAN, *supra* note 78, at 9-13; SCHNEIDER ET AL., *supra* note 78, at 3-5; Friedman, *supra* note 78, at 13-14; Salomon, *supra* note 78, at 127-31; Ten Eyck, *supra* note 78, at 100-03; Olson & Arp, *supra* note 78, at 29-32; Harry L. Henning, *So Your Client Wants To Go Public*, *A.B.A. J.*, Mar. 1, 1986, at 58, 59-60; Roberta Maynard, *Are You Ready To Go Public?*, *NATION'S BUS.*, Jan. 1995, at 30, 32; *Private Lives*, *FORBES*, Dec. 5, 1994, at 184; Taggart et al., *supra* note 78, at 51-52.

purchase price, improve compensation, launch a marketing campaign, and make investments.⁸⁰ The offering also enables the company to diversify management's risks, yet retain its current managers.⁸¹

The establishment of a public market translates into liquidity for owners of the company.⁸² This is in stark contrast to the situation prior to the IPO, when shareholders, seeking to sell all or part of their shares, may find themselves without a ready market.⁸³ The listing of the company's stock on an exchange or national broker quotation system increases its net worth and enables management to turn to the public market in the future to raise capital through subsequent public offerings.⁸⁴ Furthermore, if the stock performs strongly, banks and other financial institutions will be more inclined to loan the company money.⁸⁵ Finally, the company's new public status enables the public, suppliers, and customers to become more familiar with the company.⁸⁶ This may trigger greater demand for a company's products and better sources of supply. An IPO can thus help a company both in the short term and in the long run.

The Commission encourages registered IPOs because scholars and industry experts recognize that IPOs benefit the capital markets and economy at large. According to an IPO expert, "[t]he IPO market is the most efficient allocator of capital ever devised in the world."⁸⁷ Although the IPO market concededly delivers much of its fruits to institutional investors, this does not undermine the benefits of the allocation. A successful IPO generates substantial capital for an issuer in a short period of time and gives investors an equity interest together with an opportunity for capital appreciation. Moreover, IPOs pave the road for entrepreneurs to fulfill their visions. James H. Clark, founder and Chairman of Netscape, which completed an astoundingly successful IPO in August 1994, commented that absent IPOs, startup companies would not exist.⁸⁸ Startups make important contributions to the economy, creating jobs, introducing new products into the marketplace, rejuvenating aging industries, spawning new industries, and injecting a fresh and energetic spirit into the market.

⁸⁰ See SCHNEIDER ET AL., *supra* note 78, at 2; Olson & Arp, *supra* note 78, at 25-26.

⁸¹ See generally Christopher Farrell et al., *The Boom in IPOs*, Bus. Wk., Dec. 18, 1995, at 64, 66 (citing the retention of management as the reason why "[g]oing public is the preferred route" of raising capital).

⁸² See SCHNEIDER ET AL., *supra* note 78, at 3.

⁸³ See *id.*

⁸⁴ See *id.* at 2.

⁸⁵ See *id.*

⁸⁶ See *id.* at 3.

⁸⁷ Zweig & Spiro, *supra* note 25, at 86.

⁸⁸ See Farrell et al., *supra* note 81, at 64.

There is a symbiosis between the economy and the IPO market. A strong economy, coupled with a bullish stock market, fosters IPOs.⁸⁹ Similarly, a successful IPO that transforms an undercapitalized startup into a thriving public company may, in turn, “have a catalytic effect on the economy.”⁹⁰ The last decade provides evidence that “[i]n the world of IPO capitalism, success feeds on success, and the pool of sophisticated investment money” continues to grow.⁹¹ This “entrepreneurial multiplier effect” has given rise to many startups in the past several years, and has propagated a record number of IPOs across many different industries.⁹² Professor Clifford Smith summed up the impact of initial issuances by declaring that “IPOs are a big part of what makes the whole capital market process possible[; they] allow[] the economy to tap into entrepreneurial zeal—and we’re all wealthier for it.”⁹³

B. Prelude to the SBIs

1. *IPOs and Small Businesses*

For the aforementioned reasons, many small, private businesses have wanted to go public in the 1990s via a registered IPO. Small businesses often lack other opportunities to raise capital. They experience difficulty because lenders are often reluctant to provide assistance to small businesses that lack a sufficient record of performance.⁹⁴ Private investors are similarly uneasy about providing capital.⁹⁵ Many small businesses prefer to avoid private financings which dilute equity to a greater extent than public offerings.⁹⁶ Hence, even though public offerings are generally more expensive than private financings, small businesses often seek to initiate IPOs.⁹⁷

However, a number of impediments hinder small businesses’ access to the registered IPO market. Huge financial and time commitments pose the most towering obstacles, and continue to be

⁸⁹ See *id.* at 65.

⁹⁰ *Id.* at 67.

⁹¹ *Id.* Even an unsuccessful IPO may benefit the economy because many entrepreneurs who lose in the IPO market will subsequently return to the arena and win. See *id.* at 72. Furthermore, in the wake of these inauspicious efforts to go public, a second wave of entrepreneurs will learn from their predecessors’ failures and prepare differently before entering the IPO market. See *id.*

⁹² *Id.* at 68.

⁹³ *Id.* at 66 (quoting Clifford Smith, Professor of Finance, University of Rochester).

⁹⁴ See *The Impact of the 1992 Small Business Initiatives*, 47 ADMIN. L. REV. 511, 512 (1995) [hereinafter *Impact of SBIs*].

⁹⁵ See *id.* at 512-13.

⁹⁶ See Ronald M. Loeb & Alison Whalen, *IPOs in the 1990’s: Company Counsel’s Role*, in ADVANCED SECURITIES LAW WORKSHOP 1995, at 309, 312 (PLI Corp. L. & Practice Course Handbook Series No. B-902, 1995).

⁹⁷ However, there is of course no guarantee that a small business will be able to find an underwriter willing to undertake an IPO.

particularly burdensome, for they do not subside after the IPO.⁹⁸ Therefore, small businesses often are wary of going public because of the increased operating costs and time requirements incurred in running a public company.

A small business considering a registered IPO must be prepared to pay dearly before it receives any capital from the financing. The miscellaneous costs of an IPO vary depending on the size, difficulty, and timing of the offering. A private business that seeks to launch a small \$5 million registered IPO can easily incur expenses of \$500,000 to \$750,000, or ten to fifteen percent of the offering price.⁹⁹ Compliance costs, the legal, accounting, printing, and other expenses associated with compliance with federal and state securities laws, comprise the major share of these costs. These costs are especially onerous for small businesses because they are disproportional to the amount of proceeds the offering generates.¹⁰⁰ Moreover, the company must pay these expenses before the actual offering begins.¹⁰¹

There are additional intangible costs. For example, a small business may not be able to afford the substantial diversion of management's time and attention from the operation of the company to the preparation for a registered IPO.¹⁰² The following figures estimate the average amount of time that management devotes to taking a company public: seventy-five percent of a chief financial officer's time, forty percent of a chief executive officer's time, and between twenty-five and thirty percent of other managers' time.¹⁰³

Following a registered IPO, a small public company continues to incur substantial costs.¹⁰⁴ Compliance with the Exchange Act's rigid reporting requirements is a costly undertaking: in total, after going public, a company incurs new expenses of approximately \$50,000 to

⁹⁸ See *infra* text accompanying notes 104-05.

⁹⁹ For estimates of the costs of going public, see LIPMAN, *supra* note 78, at 51-52; SCHNEIDER ET AL., *supra* note 78, at 38-43; Loeb & Whalen, *supra* note 96, at 312-13; Olson & Arp, *supra* note 78, at 29-30.

¹⁰⁰ See *Impact of SBIs*, *supra* note 94, at 512; Olson & Arp, *supra* note 78, at 23.

¹⁰¹ See Proposing SBIs Release, *supra* note 3, at 82,483-84.

¹⁰² See *The Entrepreneurial Investment Act of 1996: Hearings on H.R. 2981 Before the Subcomm. on Capital Mkts., Secs., and Gov't Sponsored Enters. of the House of Representatives Comm. on Banking and Fin. Servs.*, 104th Cong. 45, 48 (1996) (statement of Karl May, of Buckingham, Doolittle & Burroughs, on behalf of National Small Business United) [hereinafter *Hearings on H.R. 2981*] (explaining that as a result of the "enormous time spent on raising funds rather than concentrating on [running] the business[, o]ften the business suffers or deteriorates during the period that the owner is out seeking funds"). The cost to the business of the diversion of senior executives' time "cannot be easily translated to dollars, but is in many cases enormous." *Id.*

¹⁰³ See Loeb & Whalen, *supra* note 96, at 312. Charles R. Stuckey, Chief Executive Officer of Security Dynamics Technologies Inc., a company with 150 employees that went public in late 1994, reported to *Business Week* that he spent 40% of his time preparing for the IPO. See Farrell et al., *supra* note 81, at 69.

¹⁰⁴ See SCHNEIDER ET AL., *supra* note 78, at 4.

\$200,000 per year.¹⁰⁵ Management will in turn devote much of its time and energy to handling the day-to-day responsibilities of operating a public company.¹⁰⁶

IPOs are not only highly expensive, but also extremely risky ventures. Many IPOs are unsuccessful and the stock often plunges after the offering.¹⁰⁷ Therefore, a larger private company with greater resources is usually more willing and better prepared to weather the storm. Moreover, a larger firm with more shareholders is more likely to know its market, which is essential for gauging investor interest. A smaller company may have trouble assessing whether the market is interested in its IPO.¹⁰⁸ Furthermore, many small businesses cannot afford the regulatory costs necessary to determine if there is market interest.¹⁰⁹ Testing the waters is intended to address these latter two problems.

2. *Regulation A Before the SBIs*

In recognition of the formidable obstacles that preclude most small businesses from undertaking registered IPOs, the SEC has historically turned to Regulation A to help small issuers conduct public offerings.¹¹⁰ By exempting small businesses from the registration requirements of section 5 of the Securities Act, Regulation A helps small businesses to offer securities to the public.¹¹¹ When introduced in 1936, Regulation A exempted public offerings of only \$100,000 or less.¹¹² Over time, the SEC has increased this amount to adjust for inflation, and to make the exemption available to a greater number of small issuers.¹¹³ Prior to the SBIs in 1992, the ceiling for Regulation A exemptions was \$1.5 million.¹¹⁴

¹⁰⁵ *See id.*

¹⁰⁶ Mr. Stuckey, *see supra* note 103, reports that he currently spends 10% of his time "dealing with the demands of being a public company." Farrell et al., *supra* note 81, at 69.

¹⁰⁷ *See supra* note 25. In particular, small businesses have encountered considerable economic difficulties after going public. *See infra* text accompanying note 146.

¹⁰⁸ *See Hearings on H.R. 2981, supra* note 102, at 47; Proposing SBIs Release, *supra* note 3, at 82,483.

¹⁰⁹ *See Financing America's Growth, supra* note 1, at 82,467 (reporting that "a company may have to spend \$200,000 or more just to prepare the mandated disclosure forms and financial statements *without* knowing whether there would be any investor interest in the company").

¹¹⁰ *See Proposing SBIs Release, supra* note 3, at 82,485; An Analysis of the Use of Regulation A for Small Public Offerings, SEC, Directorate of Economic & Policy Analysis, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,207, at 85,052 (Apr. 1982). For the text of Regulation A before the SBIs, see 17 C.F.R. §§ 230.251-264 (1992). For the current provisions of Regulation A reflecting the SBIs revisions, see 17 C.F.R. §§ 230.251-263 (1997).

¹¹¹ 17 C.F.R. § 230.251 (1997).

¹¹² *See* 3 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1322 (3d ed. 1989).

¹¹³ *See id.* at 1322-27.

¹¹⁴ *See Proposing SBIs Release, supra* note 3, at 82,484 & n.52 (discussing the 1992 version of Rule 254(a), codified at 17 C.F.R. § 230.254(a) (1992)); Increase in Amount of

Regulation A's status as an exemption is somewhat misleading because an issuer seeking to commence a Regulation A offering must still prepare and file an offering statement with the SEC and deliver an offering circular to each purchaser.¹¹⁵ Commonly known as a "short form registration,"¹¹⁶ Regulation A simplifies the requirements of "registration" and reduces the concomitant costs small issuers incur.¹¹⁷ Prior to the SBIs, Rule 255(a), a Regulation A analogue to section 5(c), proscribed publicity before the filing of an offering statement with the SEC.¹¹⁸

Although Regulation A requires that an issuer prepare and file an offering statement, it helps small issuers by decreasing the amount of mandatory disclosure that must accompany the offering statement.¹¹⁹ Regulation A also minimizes expenses incurred after a public offering because it does not necessarily trigger subsequent annual and quarterly reporting requirements under the Exchange Act.¹²⁰ Finally, the offering materials, unlike those prepared for a fully registered offering, do not expose issuers to section 11 strict liability.¹²¹

Despite these benefits, few small issuers availed themselves of Regulation A in the decade before the adoption of the SBIs.¹²² This was because Regulation A limited issuers to an offering of \$1.5 million, an amount too low for many small issuers, especially in light of the compliance costs incurred in preparing and filing the offering statement with both federal and state regulatory agencies.¹²³ Potential issuers were also uncertain whether there would even be market

Small Offering Exemption, Securities Act Release No. 5977, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,710, at 80,877, 80,878-79 (Sept. 11, 1978).

¹¹⁵ See SCHNEIDER ET AL., *supra* note 78, at 45. The SEC added an exception for offerings of \$100,000 or less for which offering circulars were not required. See Proposing SBIs Release, *supra* note 3, at 82,484 n.54 (discussing the 1992 version of Rule 257, codified at 17 C.F.R. § 230.257 (1992)).

¹¹⁶ 3 LOSS & SELIGMAN, *supra* note 112, at 1319; SCHNEIDER ET AL., *supra* note 78, at 45.

¹¹⁷ See 3 LOSS & SELIGMAN, *supra* note 112, at 1335-36; SCHNEIDER ET AL., *supra* note 78, at 46.

¹¹⁸ 17 C.F.R. § 230.255(a) (1992).

¹¹⁹ See SCHNEIDER ET AL., *supra* note 78, at 46. In addition, a small issuer generally may attach unaudited financials covering a one-year period in a short form registration, whereas expensive, audited financials are required in a registered offering. See Proposing SBIs Release, *supra* note 3, at 82,484; SCHNEIDER ET AL., *supra* note 78, at 46.

¹²⁰ See Proposing SBIs Release, *supra* note 3, at 82,484 & n.55 (referring to 15 U.S.C. § 78o(d) (1988)).

¹²¹ See *id.* at 82,485.

¹²² See 3A BLOOMENTHAL, *supra* note 11, § 5.05, at 5-49. The SEC reported that there were only 44 Regulation A filings during the 1991 fiscal year. In fiscal 1981, there were 439. See Proposing SBIs Release, *supra* note 3, at 82,483. Professors Loss and Seligman refer to the "near-total eclipse" of Regulation A before the SBIs. 3 LOSS & SELIGMAN, *supra* note 112, at 1319.

¹²³ See 3A BLOOMENTHAL, *supra* note 11, § 5.05, at 5-49; Keith J. Mendelson & Cindy R. Shepard, *The SEC's Proposed Small Business Initiative: Bold Reform or Opportunity Forgone?*, INSIGHTS, July 1992, at 12, 17.

interest in their Regulation A offerings.¹²⁴ Further, underwriters, seeking higher profits, were unwilling to handle most short form registrations, and insisted instead upon full registration.¹²⁵

3. Regulation D Before the SBIs

As Regulation A offerings waned in the early 1990s, small businesses that were interested in public offerings, but lacked the resources for a registered IPO, were able to raise capital under Regulation D.¹²⁶ Rules 504, 505, and 506 of Regulation D have enabled many small issuers to conduct private placements.¹²⁷ For example, Rule 505 of Regulation D enables an issuer to sell \$5 million in securities within a period of twelve months without registering them.¹²⁸ In addition, after the initial sale of securities, an issuer need only file a "notice of sales" of securities pursuant to Regulation D.¹²⁹

Like Regulation A, however, Rule 505 contains certain drawbacks that reduce its utility to small issuers.¹³⁰ For instance, the issuer cannot be an investment company.¹³¹ Second, although an issuer may sell securities under Rule 505 to any "accredited investor," as defined in Rule 501(a), it cannot sell to more than thirty-five unaccredited investors, or "purchasers" as narrowly defined by Rule 501(e).¹³² Further, an issuer using Rule 505 or 506 cannot offer or sell the securities by means of "general solicitation or general advertising."¹³³ If an issuer offers securities to nonaccredited investors, it is required to pay for the preparation of audited financials.¹³⁴ Finally, small issuers may have difficulty finding investors for Rule 505 and 506 offerings because Rule 502 requires purchasers to wait until the Rule 144 holding

¹²⁴ See *supra* text accompanying note 108.

¹²⁵ See 3 LOSS & SELIGMAN, *supra* note 112, at 1320 & n.282 (reporting that underwriters handled only 10 of 104 Regulation A offerings in 1986); SCHNEIDER ET AL., *supra* note 78, at 46.

¹²⁶ See Mendelson & Shepard, *supra* note 123, at 17. For the text of Regulation D before the SBIs, see 17 C.F.R. §§ 230.501-508 (1992). For the current provisions of Regulation D reflecting the SBIs changes, see 17 C.F.R. §§ 230.501-508 (1997).

¹²⁷ See *Impact of SBIs*, *supra* note 94, at 521.

¹²⁸ See 17 C.F.R. § 230.505 (1992).

¹²⁹ *Id.* § 230.503(a).

¹³⁰ For further discussion of the limited practical availability of Regulation D to small issuers before the SBIs, see Rutheford B Campbell, Jr., *The Plight of Small Issuers (and Others) Under Regulation D: Those Nagging Problems That Need Attention*, 74 Ky. L.J. 127 (1985); Patrick Dougherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67 (1989).

¹³¹ See 17 C.F.R. § 230.505(a).

¹³² *Id.* §§ 230.505(b), 230.501(e). Compare § 230.505 (permitting sales of securities up to \$5 million to no more than thirty-five "purchasers"), with § 230.506 (permitting sales of securities in any amount to no more than thirty-five "purchasers," each of whom must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment").

¹³³ *Id.* § 230.502(c).

¹³⁴ See *id.* § 230.502(b).

periods have expired before reselling the securities without registering them.¹³⁵

Rule 504, which exempts public offerings up to \$1 million, has provided small businesses with another alternative to Regulation A.¹³⁶ Unlike Rules 505 and 506, Rule 504 does not limit small issuers' options by restricting the number or nature of purchasers eligible to buy the securities.¹³⁷ However, before the SBIs of 1992, Rule 504 imposed the same restrictions on general solicitation and advertising and resales by purchasers.¹³⁸ An issuer that is either a reporting company, pursuant to sections 13 or 15(d) of the Exchange Act, or an investment company cannot rely on Rule 504.¹³⁹ The most limiting aspect of Rule 504 was, and continues to be, that the exemption applies to only very small offerings, those for which the aggregate offering over a twelve-month period is priced at or below \$1 million.¹⁴⁰ As with Regulation A, small businesses that seek to raise capital via Rule 504 also incur considerable expenses which discourage potential issuers, especially when they do not even know that investors will be interested.¹⁴¹

4. *Intrastate Exemption*

Section 3(a)(11) of the Securities Act, which the SBIs did not amend, has provided another limited avenue for an exempt offering.¹⁴² An issuer may make an offering of any size to any number of purchasers, all of whom must reside in a single state or territory as long as the issuer (i) is incorporated in that particular state and (ii) conducts most of its operations in that state as well.¹⁴³ This intrastate exemption is thus of limited utility because it allows an issuer to offer securities only within its own state. In addition, issuers conducting an intrastate exemption offering must comply with the Rule 147 safe harbor for such offerings, and with Rule 147(e)'s restriction on resales by purchasers, which further detracts from the appeal of the exemption.¹⁴⁴

¹³⁵ *Id.* § 230.502(d).

¹³⁶ See Mendelson & Shepard, *supra* note 123, at 12.

¹³⁷ See Proposing SBIs Release, *supra* note 3, at 82,484; *supra* notes 132-33 and accompanying text.

¹³⁸ See Proposing SBIs Release, *supra* note 3, at 82,484; 17 C.F.R. § 230.504(b) (1992).

¹³⁹ See Proposing SBIs Release, *supra* note 3, at 82,484; 17 C.F.R. § 230.504(a)(1)-(2) (1992).

¹⁴⁰ See Proposing SBIs Release, *supra* note 3, at 82,484; 17 C.F.R. § 230.504(b)(2)(i) (1992).

¹⁴¹ See *supra* text accompanying note 108.

¹⁴² 15 U.S.C. § 77c(11) (1994).

¹⁴³ See *id.* Rule 147 outlines the specific requirements for both issuers and purchasers. 17 C.F.R. § 230.147 (1992).

¹⁴⁴ 17 C.F.R. § 230.147(e).

5. *Economic and Political Backdrop*

In light of the inadequacies of Regulation A, Regulation D, and the intrastate exemption, the prohibitive costs and demanding time commitments of going and remaining public via a registered IPO, the inherent risks of undertaking an IPO, and the uncertainty regarding the market's reception to an IPO, many small businesses in need of capital have not ventured into the IPO market.¹⁴⁵ Additionally, success has eluded most small businesses with annual sales below \$5 million that have attempted to go public.¹⁴⁶

These problems were particularly apparent in 1992. The U.S. economy was emerging from a recession, and small businesses were bearing the brunt of the economic downturn. The aforementioned obstacles denied small businesses access to the public markets. Further, small companies that were not prepared to go public had considerable difficulty obtaining private financing.¹⁴⁷

Nineteen ninety-two was also an election year. Members of both parties, including the two major presidential candidates, championed the cause of small business, and explained that the troubled state of small businesses was largely responsible for the recent sluggish economy.¹⁴⁸ The resuscitation of small business was seen as the key to creating new job opportunities and restoring the economy.¹⁴⁹ In addition, the Bush Administration repeatedly addressed the need to streamline the federal securities laws.¹⁵⁰ The SEC ultimately adopted the SBIs just before the Republican National Convention. Critics have

¹⁴⁵ See *Proposing SBIs Release*, *supra* note 3, at 82,483 (highlighting the decline in the number of small business IPOs between 1986 and 1991).

¹⁴⁶ See *Olson & Arp*, *supra* note 78, at 23; *Taggart et al.*, *supra* note 78, at 51.

¹⁴⁷ See *Proposing SBIs Release*, *supra* note 3, at 82,483 (noting, in particular, the decline in both venture capital and bank financing).

¹⁴⁸ See, e.g., *The Small Business Incentive Act of 1993: Hearings on S. 479 Before the Subcomm. on Telecomm. and Fin. of the House of Representatives Comm. on Energy and Com.*, 103d Cong. (1994); Carl W. Schneider, *Small Business Capital Raising—The Need for Further SEC Initiatives*, *INSIGHTS*, Feb. 1993, at 2, 2.

¹⁴⁹ See *Proposing SBIs Release*, *supra* note 3, at 82,482 (explaining that “[t]he approximately 20 million small businesses in the United States employ more than half of the domestic labor force, produce nearly half of the gross domestic product[,] and created the vast preponderance of new jobs during the period from 1988 through 1990”) (footnotes omitted) (citing U.S. SMALL BUSINESS ADMINISTRATION, *THE ANNUAL REPORT ON SMALL BUSINESS AND COMPETITION* (1990)); sources cited *supra* note 148.

¹⁵⁰ See *Leslie J. Levinson & Anthony De Toro, A Guide to the SEC's Small Business Initiative*, 17 *SETON HALL LEGIS. J.* 75, 75 (1993); *Guy P. Lander, SEC Adopts Guidelines on Raising Capital*, *N.Y. L.J.*, Dec. 7, 1992, at 9. President Bush called upon the SEC to “eliminate or revise those [securities laws] that clearly impose costs that exceed their benefits, and [to] ensure that other regulations are implemented in a cost-effective manner.” *Council of Economic Advisers, The Annual Report of the Council of Economic Advisers*, in *ECONOMIC REPORT OF THE PRESIDENT* 7, 191 (1992); see also *Financing America's Growth*, *supra* note 1, at 82,469 (commenting on a speech by President Bush in which he proposed measures to reduce regulatory costs).

commented that the political climate forced the SEC to hastily adopt the SBIs when additional time would have enabled the SEC to improve upon the proposed SBIs.¹⁵¹

Against this backdrop, the SEC proposed the SBIs in a release on March 11, 1992.¹⁵² In its Proposing SBIs Release, the SEC identified small businesses as "the cornerstone of the U.S. economy," and reiterated that "the Commission has historically recognized the distinct financing concerns of start-up and development stage businesses and companies newly entering the public markets."¹⁵³ The SEC then set forth the following objectives of the SBIs: "[F]acilitating access to the public market for start-up and developing companies, and . . . lowering the costs for small businesses that undertake to have their securities traded in the public market."¹⁵⁴ The prevailing economic and political pressures led to a foreseeable straining of the balance between encouraging capital formation and protecting investors. The testing the waters rule introduced in the SBIs strained this balance more than any of the other initiatives.

III

TESTING THE WATERS UNDER REGULATION A

The period for public comment on the Proposing SBIs Release ended on June 18, 1992.¹⁵⁵ The SEC received substantial comments from interested parties, many of whom expressed concerns regarding the SBIs.¹⁵⁶ The testing-the-waters initiative stimulated more concern

¹⁵¹ See, e.g., Amy L. Goodman, *A Farewell to Chairman Breeden*, INSIGHTS, May 1993, at 2, 2 (reflecting that the Chairman of the SEC "rushed through the [SBIs] before the November 1992 election, ignoring ongoing negotiations among the state securities regulators, the bar and the SEC to create an acceptable 'test the waters' approach"); Jonathan R. Laing, *Errors of Commission: On Several Counts, the SEC Is Putting the Investor at Risk*, BARRON'S, Sept. 7, 1992, at 8, 9 (describing the SBIs as a "political masterstroke," that is, "more a product of political grandstanding than genuine conviction and ameliorative intent"); Rosalyn Retkwa, *States Slap Roadblock on SEC's Small Business Initiatives*, CORP. CASHFLOW, Apr. 1993, at 37, 37 (quoting an observer who commented that the SBIs were intended "to put a small business feather in Bush's cap in preparation for the campaign"); Kevin G. Salwen, *State Regulators Criticize SEC Proposals*, WALL ST. J., July 28, 1992, at B2 (quoting Congressman Edward Markey who expressed concern regarding "election-year deregulatory proposals" that may undermine investor protection); see also *infra* notes 282, 285, 288 and accompanying text (discussing the views of NASAA and the SEC).

¹⁵² Proposing SBIs Release, *supra* note 3. The SEC also drafted and sent to Congress in April a bill, the Small Business Incentive Act of 1992, which similarly aimed to help small businesses through amendments to the Securities Act and the Investment Company Act of 1940. S. 2518, 102d Cong. (1992); H.R. 4938, 102d Cong. (1992).

¹⁵³ Proposing SBIs Release, *supra* note 3, at 82,482.

¹⁵⁴ *Id.* at 82,483.

¹⁵⁵ See *id.* at 82,481.

¹⁵⁶ For assessments of the SBIs, see *infra* note 206 and accompanying text. There were sixty-six comment letters filed with the SEC. See *SEC Adopts Small Business Package, Some Say It May Fall Short of Goals*, 24 Sec. Reg. & L. Rep. (BNA) 1139, 1139 (July 31, 1992) [hereinafter *SBIs May Fall Short*].

from commentators than any of the other proposals contained in the SBIs Release.¹⁵⁷ Nevertheless, only four months after the Proposing SBIs Release, the SEC adopted the SBIs with relatively few changes in response to public comments.¹⁵⁸ The SBIs became effective on August 13, 1992.¹⁵⁹

A. The SBIs

Before discussing the testing-the-waters initiative in detail, it is important to summarize briefly the other principal initiatives for four reasons. First, they show the SEC's commitment to assisting small businesses.¹⁶⁰ Second, one must not view the testing-the-waters initiative in a vacuum, for it would achieve little without the further support of these provisions. Third, they demonstrate, by contrast, the originality of the testing-the-waters initiative. Fourth, these other initiatives do not address the problem confronting small businesses that testing the waters was designed to address—uncertainty as to market interest.

1. Amendments to Regulation A

In addition to the testing-the-waters initiative, the Commission overhauled much of Regulation A to make it more useful for small issuers.¹⁶¹ Addressing the primary problem with short form registration under Regulation A, the SEC increased the ceiling for offerings in a twelve-month period from \$1.5 million to \$5 million.¹⁶²

New Rule 251, as revised, now prescribes the eligibility requirements for issuers.¹⁶³ Regulation A remains unavailable to issuers that are investment companies.¹⁶⁴ In addition, issuers that are reporting companies, "blank check" entities, or issuers of fractional undivided interests in oil or gas rights may not rely on Regulation A.¹⁶⁵ The SEC extended eligibility to Canadian issuers that meet the other eligibility

¹⁵⁷ See *infra* Part III.B.1.

¹⁵⁸ SBIs Release, *supra* note 5, at 36,442.

¹⁵⁹ See *id.*

¹⁶⁰ The SEC clarified in the SBIs Release what constitutes a small business. In ascribing a revenue-based definition to "small business issuer[s]," the SEC designed the SBIs to assist companies with revenues below \$25 million. *Id.* at 36,446; see also *infra* note 182 (defining "small business issuer" in greater detail).

¹⁶¹ See SBIs Release, *supra* note 5, at 36,442; see also LOSS & SELIGMAN, *supra* note 112, Supp. 1996, at 355 (responding that the SBIs represented another effort by the SEC "to breathe life into Regulation A").

¹⁶² See SBIs Release, *supra* note 5, at 36,443. The ceiling includes resales by purchasers of up to \$1.5 million. See *id.* The SEC also clarified that if small businesses availed themselves of other "'small issues' exemptions" such as under Rules 504 and 505 of Regulation D, it would not affect the ceiling. *Id.*

¹⁶³ *Id.* at 36,468 (codified at 17 C.F.R. § 230.251 (1997)).

¹⁶⁴ See *id.* (codified at 17 C.F.R. § 230.251(a)(4) (1997)).

¹⁶⁵ See *id.* at 36,443, 36,468 (codified at 17 C.F.R. § 230.251(a)(4)-(5) (1997)).

criteria stated in Rule 251.¹⁶⁶ Under revised Rule 251, otherwise eligible issuers that have violated Rule 262's "bad boy" provisions are disqualified from the Regulation A exemption.¹⁶⁷

The SEC also modified the disclosure requirements of short form registration.¹⁶⁸ Although issuers must still file an offering statement, they now have the opportunity to prepare the document in a "question-and-answer format."¹⁶⁹ This is significant because the abbreviated format is both cheaper and easier for many issuers. Regulation A issuers also now benefit from a safe harbor for forward-looking statements. The SBIs insulate Regulation A issuers from liability for fraud when they in good faith include forward-looking statements in offering statements.¹⁷⁰

At the same time, the SBIs retain important safeguards for investors. For example, an issuer may make a written offer only by means of an offering circular.¹⁷¹ The purchaser must receive the offering circular at least forty-eight hours before a broker or dealer is required to send the confirmation of a sale to the buyer.¹⁷² Sales of securities must await the "qualification" of the offering statement, which occurs twenty calendar days after the filing.¹⁷³ The SEC also eliminated Rule 257 of Regulation A, which authorized an issuer to make an offering up to \$100,000 without delivering an offering circular.¹⁷⁴

Lastly, the Commission introduced a "substantial and good faith compliance" standard to address circumstances when issuers fail to comply with the foregoing requirements.¹⁷⁵ Under the standard established in Rule 260, the SEC will not automatically prevent an issuer who failed to meet a requirement under Regulation A from relying on the exemption, so long as the issuer shows that (i) the particular rule was not in existence for the protection of such investor, (ii) the violation did not materially affect the offering at large, and (iii) it made a good faith effort to meet the requirements of the Regulation.¹⁷⁶

¹⁶⁶ See *id.* (codified at 17 C.F.R. § 230.251(a)(1) (1997)).

¹⁶⁷ See *id.* at 36,443 & n.51, 36,468 (codified at 17 C.F.R. § 230.251(a)(6) (1997)).

¹⁶⁸ See *id.* at 36,443-44.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 36,444.

¹⁷¹ See *id.*

¹⁷² See *id.*

¹⁷³ *Id.*

¹⁷⁴ See *id.* at 36,445; *supra* note 115. According to the Commission, this change was unlikely to affect adversely small issuers because (i) the modifications to Rule 504 rendered "Rule 257 unnecessary" and (ii) few issuers in the preceding three years took advantage of the Rule. SBIs Release, *supra* note 5, at 36,445 & n.63.

¹⁷⁵ *Id.* at 36,444, 36,471 (codified at 17 C.F.R. § 230.260 (1997)).

¹⁷⁶ See *id.* at 36,471 (codified at 17 C.F.R. § 230.260(a) (1997)). It is important to add that the "substantial and good faith compliance standard" does not protect an issuer who has failed to (i) qualify, (ii) file the requisite offering statement, or (iii) comply with the dollar ceilings. *Id.* at 36,443-44.

2. Rule 504 of Regulation D

The Commission also sought to eliminate the disadvantages of Rule 504 that rendered the exemption unappealing to small issuers.¹⁷⁷ The new Rule 504¹⁷⁸ removes the proscription of general advertising and solicitation that constrained small issuers.¹⁷⁹ Equally appealing to issuers, the SEC now permits purchasers, who are not affiliates of the issuer, to resell the securities immediately after the purchase.¹⁸⁰ In fact, an issuer who conducts an offering that does not exceed \$1 million within a one-year period is exempt from registering the securities with the Commission and from all federal securities laws except for antifraud and other civil liability requirements.¹⁸¹

3. Integrated Disclosure System for Registration and Reporting

The SBIs streamlined disclosure requirements for small issuers as well. The SEC implemented Regulation S-B, an "integrated disclosure system" which eligible small issuers can use to (i) register securities under the Securities Act, (ii) meet reporting requirements under the Exchange Act, and (iii) comply with qualification procedures for trust indentures under the Trust Indenture Act of 1939.¹⁸²

4. Testing the Waters—Rule 254

The revisions discussed in the preceding three subsections were intended to help small businesses tap the public market to raise capital by simplifying regulatory procedures and reducing compliance costs.¹⁸³ To the extent the SBIs discussed above succeed in achieving these results, small issuers should have increased confidence in their ability to access the public market. However, these measures do not provide a small issuer with sufficient information to conduct a proper cost-benefit analysis regarding whether to pursue a public offering. If an issuer's offering does not attract sufficient market interest, more lenient disclosure and procedural requirements and lower compliance costs are immaterial.¹⁸⁴ As mentioned earlier, a small issuer

¹⁷⁷ See *supra* Part II.B.3.

¹⁷⁸ 17 C.F.R. § 230.504 (1997).

¹⁷⁹ SBIs Release, *supra* note 5, at 36,473 (codified at 17 C.F.R. § 230.504(b) (1997)).

¹⁸⁰ *Id.* (codified at 17 C.F.R. § 230.504(b) (1997)).

¹⁸¹ See *id.* at 36,445.

¹⁸² *Id.* (codified at 17 C.F.R. § 228 (1997)). An eligible small issuer is defined in the SBIs as a domestic or Canadian company with revenues under \$25 million with a "public float," i.e., the total market value of voting stock that is held by nonaffiliates of the issuer, below \$25 million. See *id.* at 36,449-50 (codified at § 228.10(a)(1) (1997)); see also 17 C.F.R. § 230.405 (1997) (defining, among other terms, "small business issuer").

¹⁸³ See SBIs Release, *supra* note 5, at 36,442-43.

¹⁸⁴ The converse is also true—a small issuer's knowledge that there are investors keenly interested in its IPO is irrelevant if compliance with the federal securities laws is too overwhelming for a small business to undertake or if the costs are prohibitive.

often does not know, or cannot afford to assess, whether its offering will generate market interest.¹⁸⁵ In response to this problem, the SEC introduced the testing-the-waters initiative to assist a small issuer in assessing market interest and determining whether to go public.

The SEC explained the value of testing the waters in the Proposing SBIs Release. The Commission reported that the testing-the-waters proposals would

for the first time, [permit] an issuer relying upon the Regulation A exemption . . . to solicit indications of interest prior to filing the mandated offering statement. Under this "test the waters" provision, a Regulation A-eligible issuer could use a written statement to gauge investor receptiveness to a possible offering. The issuer should then be better able to determine whether to incur the expense of proceeding with a public offering of its securities under Regulation A or to follow some other capital-raising plan.¹⁸⁶

The Commission was thus concentrating on its responsibility to promote capital formation. However, after setting forth the proposals, the SEC addressed the second of its twin aims by "request[ing] comment on whether the 'test the waters' . . . propos[al] . . . provides adequate protection to prospective investors."¹⁸⁷

After reviewing the public comments, the SEC concluded that the proposal "is consistent with investor protection interests."¹⁸⁸ The Commission reconfirmed that testing the waters would facilitate capital-raising by eliminating the risk that a small issuer would incur "[t]he full costs of compliance . . . without knowing whether there will be any investor interest in the company."¹⁸⁹

Under Rule 254, an issuer that meets the Regulation A eligibility criteria may publish or deliver to potential investors a solicitation document to ascertain market interest, in its offering.¹⁹⁰ In addition, an issuer may prepare scripted advertisements on radio or television for the same purpose.¹⁹¹ An issuer must submit a copy of the written document or script of the advertisement to the appropriate regional or the main office of the Commission no later than the first day it uses the materials to solicit indications of interest.¹⁹² The copy must identify a person to whom queries about the document or script can be

¹⁸⁵ See *supra* text accompanying notes 108-09.

¹⁸⁶ Proposing SBIs Release, *supra* note 3, at 82,487.

¹⁸⁷ *Id.*

¹⁸⁸ SBIs Release, *supra* note 5, at 36,445.

¹⁸⁹ *Id.* at 36,444.

¹⁹⁰ See *id.* at 36,470 (codified at 17 C.F.R. § 230.254(a) (1997)).

¹⁹¹ See *id.* (codified at 17 C.F.R. § 230.254(a) (1997)).

¹⁹² See *id.* (codified at 17 C.F.R. § 230.254(b)(1) (1996)). The Commission has subsequently amended this provision to require small issuers to submit the testing materials to the main office of the SEC in Washington, DC. See *infra* note 444.

directed.¹⁹³ The materials may include any factually accurate information, but must state (i) that the issuer is not soliciting money or any other form of consideration; (ii) that a delivery of a detailed offering circular must precede any sale of securities or any purchase commitment; (iii) that a potential investor has no commitment whatsoever when he or she communicates interest; and (iv) the name of the issuer's chief executive officer as well as a brief description of the issuer's business practice and products.¹⁹⁴ However, a potential issuer is required to submit only materials that are substantively different from materials previously submitted.¹⁹⁵ The solicitation document or other materials submitted to the SEC become public documents.¹⁹⁶ Finally, after sending the solicitation materials to the SEC, an issuer may speak with potential investors and air other advertisements.¹⁹⁷ The antifraud regulations under the federal securities laws apply to all testing-the-waters communications.¹⁹⁸

An issuer may not make any solicitations of interest under Rule 254 after it has filed an offering statement.¹⁹⁹ Only after (i) the qualification of the offering statement and (ii) twenty calendar days after the latest publication, document delivery, or aired advertisement may an issuer begin selling the securities.²⁰⁰

Compliance with the foregoing requirements of Rule 254(b) is "not a condition to [the] exemption."²⁰¹ Nevertheless, although the rules appear to be somewhat liberal, the Commission in the SBIs Release encouraged issuers to comply by explaining that violations of Rule 254(b) are "grounds for Commission suspension of the exemption."²⁰²

The solicitation document can contain a coupon, which an interested, potential purchaser may return to the issuer with his or her name, address, and phone number for the purpose of expressing interest in a possible offering.²⁰³ But an issuer may neither solicit nor accept "money or other consideration" from a potential purchaser.²⁰⁴

¹⁹³ See SBIs Release, *supra* note 5, at 36,470 (codified at 17 C.F.R. § 230.254(b)(1) (1997)).

¹⁹⁴ See *id.* (codified at 17 C.F.R. § 230.254(b)(2) (1997)).

¹⁹⁵ See *id.* at 36,444-45 n.59 (codified at 17 C.F.R. § 230.254(b)(1) note (1997)).

¹⁹⁶ See *id.* at 36,444 n.59.

¹⁹⁷ See *id.* at 36,470 (codified at 17 C.F.R. § 230.254(a) (1997)).

¹⁹⁸ See *id.* (codified at 17 C.F.R. § 230.254(a) (1997)). References herein to the antifraud provisions under the federal securities laws refer to section 17(a) of the Securities Act and section 10(b) of the Exchange Act. See 15 U.S.C. §§ 77q(a), 78j(b) (1994).

¹⁹⁹ See SBIs Release, *supra* note 5, at 36,470 (codified at 17 C.F.R. § 230.254(b)(3) (1997)).

²⁰⁰ See *id.* (codified at 17 C.F.R. § 230.254(a), (b)(4) (1997)).

²⁰¹ *Id.* (codified at 17 C.F.R. § 230.254(b) (1997)).

²⁰² *Id.* at 36,445; see 17 C.F.R. § 230.258 (1997).

²⁰³ See SBIs Release, *supra* note 5, at 36,470 (codified at 17 C.F.R. § 230.254(c) (1997)).

²⁰⁴ *Id.* (codified at 17 C.F.R. § 230.254(a) (1997)).

Finally, Rule 254(d) addresses the situation where an issuer, after testing the waters, decides in good faith to pursue a registered offering instead of a Regulation A offering. Under these circumstances, an issuer must wait thirty calendar days after its last solicitation before it files an offering statement in order to avoid the integration of the testing-the-waters activity with the registered offering.²⁰⁵

A small issuer has no commitment to prospective investors after testing the waters. If an issuer decides that there is a lack of interest in its offering or that it no longer wishes to launch an offering for any other reason, the issuer is not required to (i) proceed with the offering, (ii) file further documentation with the SEC, or (iii) further correspond with interested investors.

B. Assessing the Testing-the-Waters Rule

1. Analysis of Rule 254

The testing-the-waters rule received mixed reviews from the public.²⁰⁶ Reactions to Rule 254 varied because of the disparate interests and concerns of scholars, practitioners, small businesses, the states, NASAA, bar associations, and other interested parties. However, most agreed that in contrast to the other SBIs, testing the waters was both an "innovative"²⁰⁷ and "controversial"²⁰⁸ means of helping small issuers to raise capital.

²⁰⁵ See *id.* (codified at 17 C.F.R. § 230.254(d) (1997)). Rule 251(c) governs integration of Regulation A offerings with other securities offerings or sales. 17 C.F.R. § 230.251(c) (1997). An issuer that tests that waters under Rule 254 must wait six months to avoid integration with a Regulation D offering. See 17 C.F.R. § 230.502(a) (1997). Therefore, integration will probably force an issuer that wants to commence a Rule 505 or 506 private placement after relying on Rule 254 to wait six months, because the issuer will have presumably violated the general solicitation prohibition in Rules 505 and 506. 17 C.F.R. §§ 230.502(c), 230.505(b), 230.506(b) (1997); see *infra* note 431 and accompanying text.

²⁰⁶ A discussion of reactions to, and an assessment of, the SBIs as a whole is beyond the scope of this Note. For a critical assessment of the SBIs, see *Impact of SBIs*, *supra* note 94; Ralph S. Janvey, *The SEC's Small Business Initiatives: Regulatory Reform or Shabby Conduct?*, 21 SEC. REG. L.J. 4 (1993); Levinson & De Toro, *supra* note 150; Marc I. Steimberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395 (1993); Priscilla S. Johnson, Note, *The SEC's Small Business Initiatives and Regulation A: New Life for an Old Exemption?*, 13 J.L. & COM. 157, 162 (1993); John M. Allen, Jr. et al., *New Regulation Helps Small Business*, NAT'L L.J., Sept. 21, 1992, at 17; Stanley Keller, *SEC Small Business Initiatives: New Opportunities Created*, INSIGHTS, June 1993, at 15; Laing, *supra* note 151; Lander, *supra* note 150; Herrick K. Lidstone, Jr., *SEC's Small Business Initiatives*, 21 COLO. LAW. 2553 (1992); Mendelson & Shepard, *supra* note 123; Retkwa, *supra* note 151; Mark A. Sargent, *No More Tinkering!*, BUS. L. TODAY, July-Aug. 1992, at 5; Schneider, *supra* note 148.

²⁰⁷ See, e.g., 3A BLOOMENTHAL, *supra* note 11, § 5.05, at 5-65; *Impact of SBIs*, *supra* note 94, at 517, 520; Johnson, *supra* note 206, at 167; Keller, *supra* note 206, at 16; Mendelson & Shepard, *supra* note 123, at 17; Schneider, *supra* note 148, at 2.

²⁰⁸ See, e.g., *Impact of SBIs*, *supra* note 94, at 517; Levinson & De Toro, *supra* note 150, at 79; Retkwa, *supra* note 151, at 37.

The SEC itself recognized in the Proposing SBIs Release that the testing-the-waters initiative was innovative.²⁰⁹ The Commission explained that the proposed changes to Regulation A would allow small issuers "for the first time" to test the waters before filing an offering statement to assess interest in its public offering.²¹⁰ Prior to the SBIs, old Rule 255(a), the Regulation A equivalent to section 5(c) of the Securities Act, proscribed prefilng publicity.²¹¹ With the introduction of Rule 254, the SEC needed to introduce new Rule 251(d)(1)(i) to exclude testing materials from the requirements regarding prefilng offers.²¹² Thus, Rule 254 afforded small issuers an opportunity formerly unavailable to issuers of any size.

In essence, Rule 254 permits gun-jumping. Testing-the-waters measures constitute an offer to sell under section 2(3) of the Securities Act.²¹³ Rule 254 enables issuers to make an offer to sell prior to the filing of an offering statement with the Commission. Such conduct is quintessential gun-jumping.²¹⁴ The SEC historically has not tolerated direct solicitations of investors before the filing of a registration statement.²¹⁵ Testing the waters under Rule 254 epitomizes the Commission's traditional concern that "although not couched in terms of an express offer, [prefiling publicity] may in fact contribute to conditioning the public mind or arousing public interest in the [issue] in a manner which raises a serious question whether the publicity is not in fact part of the selling effort."²¹⁶

However, in reality, issuers that test the waters under Rule 254 do not commit gun-jumping because (i) Regulation A issuers are exempt from the Securities Act registration requirements including section 5(c), and (ii) after the SBIs, Rule 251(d)(1)(i) specifically allows issuers to test the waters before filing an offering statement without violating Rule 251(d).²¹⁷ Nevertheless, the testing materials still trigger the same concerns regarding investor protection. As discussed below, Rule 254 is controversial because critics are worried that it seriously exposes investors to misrepresentation and fraud.²¹⁸

²⁰⁹ Proposing SBIs Release, *supra* note 3, at 82,487.

²¹⁰ *See id.*

²¹¹ *See supra* text accompanying note 118.

²¹² *See* 17 C.F.R. § 230.251(d)(1)(i) (1997).

²¹³ *See* Testing Release, *supra* note 8, at 86,892; Additional Small Business Initiatives, Securities Act Release No. 6996, [1992-1993 Transfer Binder] Fed. Sec. L Rep. (CCH) ¶ 85,134, at 84,118, 84,123 (Apr. 29, 1993) [hereinafter Additional SBIs Release]; Janvey, *supra* note 206, at 45. For the language of section 2(3), *see supra* note 32 and accompanying text.

²¹⁴ *See* Part I.A.

²¹⁵ *See supra* note 60 and accompanying text; *infra* Part V.A.2.

²¹⁶ Publication of Information Release, *supra* note 34, at 3149; *see supra* note 36 and accompanying text.

²¹⁷ 17 C.F.R. § 230.251(d)(1)(i) (1997); *supra* text accompanying notes 111, 212.

²¹⁸ *See infra* notes 229-57 and accompanying text.

Others have not found that Rule 254 controversially helps issuers at the expense of investors. Although there was a consensus that testing the waters represented an innovative approach that should help small businesses to cost-effectively determine whether to undertake a public offering, some critics maintain that Rule 254 does not assist potential issuers enough. These critics acknowledge that Rule 254 reduces the onerous cost and burden of disclosure; however, they conclude that small issuers must still incur considerable expenses to test the waters.²¹⁹ For example, an entrepreneur would still need to discuss with an attorney how to test the waters and how to comply with the antifraud provisions of the federal securities laws that apply to the solicitation materials.²²⁰ Furthermore, the costs of preparing and distributing the testing materials may prevent or deter small issuers from relying on Rule 254. Identifying these and other costs, members of the Federal Regulation of Securities Committee of the American Bar Association ("ABA") argued that small issuers should be able to speak with prospective investors before preparing the solicitation document.²²¹

Another shortcoming of Rule 254 is its limited scope. Commentators have suggested that the Commission should extend testing the waters beyond Regulation A so that small issuers contemplating private placements, other exempt offerings, or registered public offerings can test the waters.²²² After the SBIs, an issuer may rely on Regulation A for offerings up to \$5 million. This is considered a small offering, one that investment banks are often reluctant to underwrite.²²³ Although the SEC defined a "small business issuer" as a company with revenues under \$25 million,²²⁴ Rule 254 currently provides no assistance to a small business interested in undertaking a public offering in excess of \$5 million. A small business considering a public offering of more than \$5 million will then need to choose between (i) conducting a smaller offering that will raise less funds than it requires to take advantage of Rule 254, and (ii) forgoing the testing-the-waters

²¹⁹ See Separate Statement of [Former] Commissioner Fleischman on Small Business Initiatives, Securities Act Release No. 6925, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,932, at 82,575 (Mar. 11, 1992) [hereinafter Fleischman Statement] (making seventeen recommendations to reduce compliance costs for small issuers); Mendelson & Shepard, *supra* note 123, at 17-18.

²²⁰ See Fleischman Statement, *supra* note 219, at 82,577; SEC Proposes Rules, Legislation Aimed at Helping Small Business, 24 Sec. Reg. & L. Rep. (BNA) 331, 332 (Mar. 13, 1992); Mendelson & Shepard, *supra* note 123, at 18.

²²¹ See Letter from John F. Olson, Chairman, Committee on Federal Regulation of Securities, to Richard C. Breeden, Chairman, SEC (Feb. 28, 1992), *quoted in* Mendelson & Shepard, *supra* note 123, at 18.

²²² See Mendelson & Shepard, *supra* note 123, at 18; Schneider, *supra* note 148, at 4.

²²³ See SCHNEIDER ET AL., *supra* note 78, at 11.

²²⁴ See *supra* note 182.

opportunity to pursue a larger offering. Similarly, a small business interested in immediately commencing a Regulation D or other exempt offering that wishes to test the waters is forced to instead conduct a Regulation A offering.²²⁵ In addition, a larger private company, uncertain of its market appeal, may wish to test the waters before conducting a public offering. However, unless the company is content with a Regulation A offering below \$5 million, it may not rely on Rule 254.²²⁶

In fact, the limited utility of Rule 254 might lead small businesses to abuse the testing-the-waters privilege. As discussed above, Rule

²²⁵ Rule 502(a)'s integration requirements and the general solicitation prohibition that applies to Rule 505 and 506 offerings make it very difficult for an issuer to offer securities under Regulation D after testing the waters. *See supra* note 205.

²²⁶ A possible solution to these problems is to raise the current Regulation A ceiling. Similar to the sentiment before adoption of the SBIs, *see supra* text accompanying notes 123, 162, there has been an outcry since 1992 to raise the current \$5 million Regulation A ceiling. *See, e.g.,* Capital Markets Deregulation and Liberalization Act of 1995, H.R. 2131, 104th Cong. 26 [hereinafter Fields Bill] (introducing legislation in section 7(a) to amend section 3 of the Securities Act in order to raise the ceiling prescribed therein to \$15 million). In order to raise the Regulation A ceiling, Congress must first amend section 3(b) because the SEC's authority to promulgate Regulation A derives from this section. *See* 15 U.S.C. § 77c(b) (1994) (authorizing the SEC to pass rules and regulations that exempt from registration "any class of securities" for which compliance with section 5 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"); Securities Act Release No. 627, 1936 WL 3434 (S.E.C.), at *1 (Jan. 21, 1936). The Fields Bill gave rise to the NSMIA, which added new section 28 to the Securities Act and corresponding new section 36 to the Exchange Act. NSMIA, *supra* note 22, at 3424. Section 28 grants the Commission general exemptive authority:

The Commission, by rule, regulation, or order, 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 title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

Id. at 3424 (codified at 15 U.S.C. § 77z-3 (Supp. II 1996)).

After the passage of the NSMIA, some observers concluded that section 3(b) is no longer significant. *See, e.g.,* Mary E.T. Beach, *Unregistered Offerings of Corporate Securities, in PRIVATE PLACEMENTS 1997*, at 45, 49 (PLI Corp. L. & Practice Course Handbook Series No. B-983, 1997). The SEC can now adopt the section 3(b) exemptions under new section 28, and therefore either eliminate or alter section 3(b)'s current \$5 million ceiling which has circumscribed its ability to raise the cap under Regulation A. *See id.* Section 7(a) of the Fields Bill suggests that an increase of the Regulation A ceiling (as well as those for other exempt offerings) to as much as \$15 million may be forthcoming. *See* Fields Bill, *supra*, at 26; Martha L. Cochran & David F. Freeman, *Securities Regulatory Reform Legislation, in 28TH ANNUAL INSTITUTE ON SECURITIES REGULATION*, at 299, 335 (PLI Corp. L. & Practice Course Handbook Series No. B-962, 1996); Richard H. Rowe, *The Capital Formation Provisions of the 1996 Act*, INSIGHTS, May 1997, at 8, n.4.

If the Commission raises the Regulation A ceiling, it would entitle many more small issuers to test the waters pursuant to Rule 254. For an analysis of why this development should not dissuade the SEC from adopting proposed Rule 135d, *see infra* Part V.E.3. *See infra* text accompanying notes 541-44 for a discussion of how the NSMIA affects the Commission's efforts to adopt proposed Rule 135d.

254(d) addresses the situation where an issuer tests the waters and then decides in good faith to pursue a registered offering instead of a Regulation A offering.²²⁷ This allows an issuer to benefit from testing the waters when it would have lacked such an opportunity, if it had conducted a registered offering from the outset. It is uncertain whether the good faith standard and the threat of integration are strong enough to prevent issuers, who originally intend to conduct a registered offering, from profiting from Regulation A's testing-the-waters exemption. In addition, Rule 254(d) only contemplates issuers that subsequently pursue registered offerings. However, issuers may test the waters, purportedly in preparation for a Regulation A offering, and then sell securities, for example, via the intrastate exemption to purchasers found as a result of testing the waters. Such purchasers may be particularly susceptible to fraud and misrepresentation because under federal securities law, issuers are not required to provide disclosure for this type of offering, unlike in a Regulation A or other public offering. The limited utility of Rule 254 is the initiative's largest drawback for issuers, and as discussed below in Part IV, this concern gave rise to the Testing Release.²²⁸

Although there is support for the proposition that Rule 254 did not do enough to help small businesses, the greater concern is that the Rule does not provide investors with adequate protection.²²⁹ Rule 254 is often characterized as "controversial" because many believe that it tilts the balance, previously maintained by old Rule 255(a), in favor of raising capital and away from protecting investors.²³⁰ The states, which have a compelling interest in guarding the interests of their resident investors, and NASAA, which represents the states, were the loudest proponents of this view.

Both state securities administrators and NASAA legitimately opposed Rule 254 because it left investors vulnerable. For example, they were concerned that Rule 254 did not provide any guidance regarding how businesses can test the waters.²³¹ Moreover, because no rule requires the distribution of materials, entrepreneurs or their agents could file the testing materials with the SEC and then immediately begin cold calling.²³² State regulators also warned of a greater danger: that issuers may actually sell their securities while they are testing the waters.²³³ In short, the states expressed concern that rather than test the waters, "unscrupulous operators will 'boil' the waters" by excit-

227 See *supra* note 205 and accompanying text.

228 See *infra* notes 380-81 and accompanying text.

229 See *SBIs May Fall Short*, *supra* note 156, at 1139.

230 See *supra* text accompanying note 118; *supra* note 208 and accompanying text.

231 See Retkwa, *supra* note 151, at 37-39.

232 See *id.* at 37.

233 See *SBIs May Fall Short*, *supra* note 156, at 1139.

ing prospective investors who will then ignore the disclosure in the offering circular.²³⁴

Such practices give rise to two significant concerns. First, investors may become more susceptible to fraud and misrepresentation, which are more common in smaller issues.²³⁵ Investors lost a primary defense against these harms, the threat of section 12(a)(2) liability for issuers who made misrepresentations in prospectuses,²³⁶ when the SEC in April 1993 amended Rule 254 to effectively exempt written testing materials from section 12(a)(2).²³⁷ The SEC added Rule 254(e), which establishes that written testing materials distributed to the SEC in compliance with Rule 254 "shall not be deemed to be a prospectus as defined in section 2(10) of the Securities Act."²³⁸ Therefore, because section 12(a)(2) only applies to prospectuses, it does not apply to testing-the-waters materials, given that Rule 254(e) provides that these materials fall outside the definition of a "prospectus." Second, Rule 254 may cause systemic problems such as a "misallocation of capital."²³⁹ The SBIs encourage eager small businesses, which have not yet developed careful business plans, to approach investors hastily.²⁴⁰ As a result, investors who suffer losses may be reluc-

²³⁴ Retkwa, *supra* note 151, at 37-39 (discussing the danger that "unethical operators will 'drop the hook' with an oral pitch, and investors won't pay attention to the written disclosure documents that arrive later"). A state securities regulator described the obvious

"outcome when a roomful of unsophisticated investors are hit with the dog-and-pony show of an adept salesman. The sale will be made long before the investors ever get their hands on the SEC offering circular, which carefully delineates the company's business and its risks. Most investors won't even bother reading the prospectus."

Laing, *supra* note 151, at 21 (quoting the then president-elect of NASAA and director of the Massachusetts Securities Division).

²³⁵ See "Testing the Waters' Rules Still Troubling State Regulators, 24 Sec. Reg. & L. Rep. (BNA) 1642, 1642 (Oct. 23, 1992) [hereinafter *Testing Rules Still Trouble States*]; *supra* text accompanying note 75.

²³⁶ See 15 U.S.C. § 77l(a)(2) (1994).

²³⁷ See *infra* note 238 and accompanying text. However, an oral solicitation made pursuant to Rule 254 can still trigger section 12(a)(2) liability. See Additional SBIs Release, *supra* note 213, at 84,123 n.46.

²³⁸ 17 C.F.R. § 230.254(e) (1997); see also Additional SBIs Release, *supra* note 213, at 84,122-23 (stating that written testing-the-waters material is not a prospectus); 3A BLOOMENTAL, *supra* note 11, § 5.05, at 5-70 (same); *SEC Adopts Rules Further Relaxing Small Business Disclosure Requirements*, 25 Sec. Reg. & L. Rep. (BNA) 619, 620 (Apr. 30, 1993) [hereinafter *SEC Adopts Further Rules*] (same). The language of Rule 254(e) excludes from the section 2(10) definition of a prospectus, and the Supreme Court's interpretation of this definition, written testing materials that (i) comply with Rule 254 and (ii) have been submitted to the SEC. The Supreme Court held in 1995 that a "prospectus," for the purposes of the federal securities laws, "refer[s] to a document that describes a public offering of securities by an issuer or controlling shareholder." *Gustafson v. Alloyd Co.*, 513 U.S. 561, 584 (1995).

²³⁹ *Testing Rules Still Trouble States*, *supra* note 235, at 1642.

²⁴⁰ See *id.*

tant or unwilling to invest in small businesses in the future.²⁴¹ This would defeat the purpose of the SBIs because it would ultimately make it more difficult for small businesses to obtain capital.²⁴²

NASAA reiterated the concerns of state securities regulators. In a caustic comment letter, NASAA remarked that the Commission's "attempt to assist small business issuers by removing investor protection is short sighted."²⁴³ NASAA was particularly concerned about small investors, noting that "the Commission has become too eager to favor small business concerns over those of the small public investor."²⁴⁴ Although NASAA indicated its support for the Commission's intended goal for testing the waters, it found "virtually no safeguards" in Rule 254.²⁴⁵ The small investor, often lacking financial sophistication, is especially vulnerable because Rule 254 allows issuers to orally solicit potential investors after merely filing testing materials that lack the more comprehensive disclosure provided in the forthcoming offering circular.²⁴⁶ NASAA's comment letter explained that the SEC was "embarking on an attempt to facilitate the sale of the riskiest securities in the market to the least sophisticated of buyers."²⁴⁷

There are few safeguards built into Rule 254. For example, although the issuer must file a solicitation document, the Rule does not impose any content restrictions other than requiring the accuracy of all statements.²⁴⁸ In contrast, the SEC has explained that "Rule 254(b)(2)(iv) sets forth the minimum amount of information that must be provided."²⁴⁹ As a result, prospective issuers may make exceedingly optimistic projections that would mislead small investors. Further, the requirement of "publication or delivery" of the solicitation document is ineffective because an issuer is not required to deliver the document to investors.²⁵⁰ Thus, issuers may contact investors who have not read the solicitation document prepared in compliance

²⁴¹ See *id.* (identifying "a diversion of capital from better run enterprises" as a consequence of the SBIs that will harm small businesses).

²⁴² See *id.*

²⁴³ NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9374.

²⁴⁴ *Id.*

²⁴⁵ *Id.* at 9379.

²⁴⁶ See *id.* at 9376-78. In fact, after publication or delivery of the solicitation document, an issuer is free to communicate with an investor who has not read the document. See *id.* at 9378.

²⁴⁷ *Id.* at 9374. NASAA's reaction was largely influenced by the rampant penny stock fraud in the years before the adoption of the SBIs that harmed many individual investors who lost up to \$2 billion per year. See 3A BLOOMENTHAL, *supra* note 11, § 5.05, at 5-68; Steinberg, *supra* note 206, at 410 & nn.71-72; *Testing Rules Still Trouble States*, *supra* note 235, at 1642.

²⁴⁸ See NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9379.

²⁴⁹ Michael I. Keller Enterprises, Ltd., SEC No-Action Letter, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,952, at 78,752 (Dec. 1, 1994) [hereinafter Keller Enterprises No-Action Letter].

²⁵⁰ NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9379.

with Rule 254.²⁵¹ Rule 254(b)(4)'s so-called "cooling-off" period similarly fails to shield investors sufficiently from oral representations.²⁵² Rule 254(b)(4) requires the postponement of sales "until [twenty] calendar days after the last publication or delivery of the document or radio or television broadcast."²⁵³ However, there is no cooling-off period between the final oral solicitation and the sale of the securities.²⁵⁴ In fact, Rule 254(b), which explains that noncompliance with the provisions thereof does not preclude an issuer from relying on the exemption, undermines the effectiveness of the few safeguards that are in place.²⁵⁵ Finally, Rule 254(a) prescribes the antifraud provisions as the liability standard, while Rule 254(e), in effect, precludes the application of section 12(a)(2) as the liability standard for testing materials.²⁵⁶ The prescription of the antifraud provisions of the securities laws as the basis of liability inadequately protects investors because recent case law and the Private Securities Litigation Reform Act of 1995 have made it exceedingly difficult for plaintiffs to bring and prevail in section 10(b) and Rule 10b-5 private actions.²⁵⁷

NASAA suggested that issuers may also suffer under Rule 254. Testing the waters may "raise[] false hopes for many persons eager to

²⁵¹ See *id.*

²⁵² See *id.*

²⁵³ 17 C.F.R. § 230.254(b)(4) (1997).

²⁵⁴ See NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9379.

²⁵⁵ See *supra* text accompanying notes 201-02.

²⁵⁶ See *supra* notes 198, 236-38 and accompanying text. NASAA and some scholars have argued that the antifraud standard inadequately protects investors. See, e.g., NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9379; Steinberg, *supra* note 206, at 409.

²⁵⁷ See Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3 (1996) ("describ[ing] the entire gauntlet a plaintiff now must run [to bring a private cause of action under Rule 10b-5] based on recent developments in substantive securities law, in judicial measures to stem and manage any flood of litigation, and in the [Private Securities Litigation Reform Act of 1995]"). In particular, only actual purchasers and sellers can recover in a private Rule 10b-5 claim. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55 (1975). The statute of limitations for a Rule 10b-5 claim is very short: one year following discovery with a three year limitation after the violation. See *Lampf v. Gilbertson*, 501 U.S. 350, 364 (1991). There is also a scienter requirement for a Rule 10b-5 claim. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214-15 (1976). The heightened pleading requirements under section 21D(b)(2) of the Exchange Act that section 101 of the Private Securities Litigation Reform Act of 1995 (the "PSLRA") codified, see PSLRA, Pub. L. No. 104-67, 109 Stat. 737, 747 (codified at 15 U.S.C. § 78u-4(b)(2) (Supp. I 1995)), have also made it very difficult for plaintiffs to prove section 10(b) liability in a private action. Furthermore, under section 21D(b)(3)(A), a failure to meet the heightened pleading requirements may be grounds for a defendant's motion to dismiss. *Id.* (codified at 15 U.S.C. § 78u-4(b)(3)(A) (Supp. I 1995)). Section 21D(b)(3)(B), which prescribes a stay of discovery "during the pendency of any motion to dismiss," also undermines plaintiffs' efforts to litigate a Rule 10b-5 claim. *Id.* (codified at 15 U.S.C. § 78u-4(b)(3)(B) (Supp. I 1995)).

start businesses . . . who are not really suited to raise capital from the public."²⁵⁸

2. *The "Coordination" Problem*

The rift between the SEC, on the one hand, and the states and NASAA, on the other, was serious because the federal securities laws, including Regulation A, did not trump state securities laws, known as blue sky laws.²⁵⁹ Both the Securities and Exchange Acts recognized until the adoption of the NSMIA in 1996 that the federal securities laws did not preempt state laws.²⁶⁰ Blue sky laws in most states differ from federal securities laws in that they paternalistically provide investors with greater protection.²⁶¹ Although the federal securities laws and the SEC primarily emphasize disclosure obligations,²⁶² some states additionally impose "merit regulation" which securities administrators apply to determine whether an offering is "fair, just[,] and

²⁵⁸ NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9378. In response to these myriad problems with Rule 254, NASAA proposed further safeguards intended to protect investors without adding substantially to issuers' costs. *Id.* at 9380-81. See *infra* Part III.C.1 for a discussion of the NASAA model, which incorporates many of these proposed safeguards.

²⁵⁹ For a discussion of the relationship between federal and state securities laws before the NSMIA, see Rutheford B Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985); Francis J. Facciolo & Richard L. Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 COLUM. BUS. L. REV. 525; Marianne M. Jennings et al., *Federalism to an Advantage: The Demise of State Blue Sky Laws Under the Uniform Securities Act*, 19 AKRON L. REV. 395 (1986); Roberta S. Karmel, *Blue Sky Merit Regulation: Benefit to Investors or Burden on Commerce?*, 53 BROOK. L. REV. 105 (1987); Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991); Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471 (1993); Steinberg, *supra* note 206; Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495 (1984); Brian J. Fahrney, Comment, *State Blue Sky Laws: A Stronger Case for Federal Pre-emption Due to Increasing Internationalization of Securities Markets*, 86 Nw. U. L. REV. 753 (1992). Several of these articles suggest that blue sky law is obsolete and unnecessary. Since the adoption of the SBIs, Congress in 1996 passed the NSMIA which preempts state securities laws for many types of securities and securities transactions. See *infra* Parts III.C.3, V.D.

²⁶⁰ See section 18 of the Securities Act ("Nothing in this subchapter shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.") (codified at 15 U.S.C. § 77r (1994)); section 19(c)(3)(C) of the Securities Act ("Nothing in this chapter shall be construed as authorizing preemption of State law.") (codified at 15 U.S.C. § 77s(c)(3)(C) (1994)); section 28 of the Exchange Act ("Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.") (codified at 15 U.S.C. § 78bb(a) (1994)). In October 1996, Congress essentially repealed this language in section 18 of the Securities Act and section 28 of the Exchange Act by passing the NSMIA. For a discussion of how the NSMIA has affected issuers' capacity to test the waters under Rule 254, see *infra* Part III.C.3.

²⁶¹ See Sargent, *supra* note 259, at 486.

²⁶² See *supra* text accompanying note 2.

equitable.”²⁶³ If an offering does not meet these “substantive standards,” an issuer cannot compensate by providing more detailed disclosure.²⁶⁴ Rather, merit regulation prohibits the issuer from conducting the offering in the state.²⁶⁵

Prior to 1996, many issuers were bound by the blue sky laws of most states which required issuers seeking to offer or sell securities in their state to register the securities with the state’s securities division unless the state’s laws provided an exemption.²⁶⁶ The most common means of state securities registration are qualification, notification, Small Corporate Offering Registration (SCOR), and coordination.²⁶⁷ Coordination is the simplest and least expensive for most issuers, because it allows an issuer to coordinate the filing of both state and SEC registration statements.²⁶⁸ However, virtually no states permit Regulation A issuers to register through coordination because such an issuer is registering securities with the Commission via an offering statement—not by means of a registration statement.²⁶⁹ Similarly, the most widely available exemptions under the various blue sky laws do not aid a Regulation A issuer.²⁷⁰

Therefore, an issuer interested in offering securities pursuant to Regulation A in states that do not allow coordination must register the securities, via either qualification or notification, in every state in which it intends to offer or sell securities. In addition, a Regulation A issuer may have to meet the aforementioned merit criteria in multiple states.²⁷¹ Compliance with federal and state requirements is very expensive and often confusing for issuers because federal securities laws

²⁶³ Sargent, *supra* note 259, at 473.

²⁶⁴ Rutheford B Campbell, Jr., *Blue Sky Laws and the Recent Congressional Preemption Failure*, 22 J. CORP. L. 175, 177 (1997); *see also* Sargent, *supra* note 259, at 487 (noting that in merit regulation, “the individual’s disadvantages cannot be offset by eliminating informational asymmetries through government-mandated disclosure”). Although many states followed the merit standards prescribed in section 306(a)(2)(A) of the Uniform Securities Act, a significant problem with merit regulation lay in that many states had standards that differed from those adopted by other states. *See* Campbell, *supra*, at 186.

²⁶⁵ *See* Campbell, *supra* note 264, at 177; Sargent, *supra* note 259, at 486.

²⁶⁶ *See* Campbell, *supra* note 264, at 185.

²⁶⁷ *See id.* at 185-86.

²⁶⁸ *See id.* at 186. Notification is actually cheaper than coordination; however, few issuers qualify because of strict earnings criteria.

²⁶⁹ *See* SCHNEIDER ET AL., *supra* note 78, at 46; Campbell, *supra* note 264, at 186, 193; Keller, *supra* note 206, at 18.

²⁷⁰ *See* Campbell, *supra* note 264, at 193. For an explanation of why the small offering exemption, the Uniform Limited Offering Exemption (ULOEE), the national securities exchange exemption, and the Uniform Securities Act exemptions are inapplicable to Regulation A offerings, *see id.* at 187-90.

²⁷¹ In the case of private and limited offerings exempt from registration under the federal securities laws, such as Regulation D offerings, many states have exempted these offerings from their strict merit regulation. *See* Sargent, *supra* note 259, at 476-77. Similarly, states could exempt Regulation A offerings from merit scrutiny.

often differ from blue sky laws.²⁷² As a result, testing the waters under Rule 254 may not be cost-effective for many small issuers because they still must pay the costs of compliance with both federal and state securities laws.

Given that there are only a small number of states that require the coordination of state law with federal securities law,²⁷³ the remaining states may enact laws that diverge from federal securities laws. The result is that "[t]he state regulators' sovereign ability to superimpose upon offerings in their jurisdictions additional, inconsistent or even prohibitory criteria means that they indeed have the last word, and that they can reduce the best-intentioned federal reforms to practical insignificance."²⁷⁴ In the case of Rule 254, issuers will not be able to test the waters effectively in states that do not either adopt Rule 254 or engage in corresponding rulemaking.²⁷⁵

Congress recognized the importance of coordinating federal and state securities laws and decreed section 19(c) of the Securities Act, which authorizes the SEC to work with associations of state securities regulators, to "assist in effectuating greater uniformity in Federal-State securities matters."²⁷⁶ The Commission's efforts to adopt Rule 254 constituted a "violat[ion of] the spirit of Section 19(c)."²⁷⁷ According

²⁷² See Campbell, *supra* note 264, at 193-94.

²⁷³ See *Testing Rules Still Trouble States*, *supra* note 235, at 1642. In a few states, state securities regulators must take measures such as holding hearings in order to deviate from federal law. See *id.*; *Colo. Initiates Rulemaking Aimed at SEC Small Business Rules*, 24 Sec. Reg. & L. Rep. (BNA) 1529, 1529 (Sept. 25, 1992) [hereinafter *Colorado Initiates Rulemaking*].

²⁷⁴ Sargent, *supra* note 206, at 8.

²⁷⁵ See Mendelson & Shepard, *supra* note 123, at 18. Lack of coordination threatens not only the effectiveness of Rule 254, but also of a number of the other SBIs.

²⁷⁶ 15 U.S.C. § 77s(c)(1) (1994). The statute endorses "greater Federal and State cooperation in securities matters" in order to promote the (i) highest regulatory effectiveness, (ii) greatest regulatory uniformity in federal and state laws, (iii) minimum regulatory intrusion upon efforts to raise capital, (iv) raising of capital by issuers, especially small businesses, through a significant decrease in the requisite paperwork and compliance costs, and (v) minimization of the costs of government administration. *Id.* § 77s(c)(2). In addition, Congress intended to foster cooperation between the Commission and state and other securities regulators in the (i) exchanging of information concerning issuers' application for registration or exemption of issues within the states, and (ii) establishment of uniform forms, procedures, and an exemption for small issues. See *id.* § 77s(c)(3).

²⁷⁷ NASAA Comment Letter to SEC Secretary, Jonathan Katz, Regarding SEC Release Nos. 33-6950, 34-30969, 39-2288, [1986-1993 Transfer Binder] NASAA Rep. (CCH) ¶ 9349, at 9390, 9390 (Oct. 5, 1992) [hereinafter *NASAA Comment Letter Regarding Additional SBIs*] (referring to additional SBIs); see also Richard H. Rowe, *Financing Small Business in the Securities Markets: An Overview*, in *FINANCING A SMALL BUSINESS IN THE SECURITIES MARKETS* 9, 66 (PLI Corp. L. & Practice Course Handbook Series No. B-816, 1993) (rhetorically questioning whether the Commission's adopted version of Rule 254 represents a "break down of [section] 19(c) [p]olicy?"). But see Johnson, *supra* note 206, at 175 (explaining that the SEC's consultation with securities regulators of the states and NASAA and its provision of a three-month comment period demonstrate that it complied with section 19(c)). The SEC's conduct prior to the SBIs is important to discuss because it differs significantly from that leading up to the promulgation of the Testing Release. See *infra* Part IV.A, D.

to NASAA, representatives of the Association, staff members of the SEC, and members of the American Bar Association worked together for two years to develop uniformity under Regulation A.²⁷⁸ Apparently nearing "a concrete proposal," NASAA complained that the SEC staff "unilaterally and without explanation terminated the[] deliberations in the fall of 1991."²⁷⁹ NASAA ultimately learned that the SEC planned to publish the SBIs from an article in the *Wall Street Journal*.²⁸⁰

The Commission's conduct made coordination improbable. In reaction to the SEC's unwillingness to work with the states, NASAA insisted that despite section 19(c), the Commission was not interested in working with the states to develop a coordinated approach to small businesses' issuances.²⁸¹ NASAA concluded that the Commission's political concerns were greater than its concern for small businesses.²⁸² In response, Richard Breeden, then Chairman of the SEC, contended that "[t]he states have set themselves up with a stranglehold on capital formation with the very types of companies that have traditionally provided the backbone for growth of the American economy."²⁸³

Although the states, NASAA, and certain commentators have complained that the Commission's "unilateral" and "political" action destroyed an opportunity for coordination, certain scholars have noted that because the SEC sought to implement "bold reforms," there was not in reality a strong likelihood that the Commission and the states would find common ground.²⁸⁴ According to this view, if the SEC had waited for full coordination with the states, it may not have adopted the SBIs at all.²⁸⁵ An additional problem confronting the SEC during the discussions was that the securities administrators of the states did "not 'always speak with one voice.'"²⁸⁶ Furthermore, cooperation was further complicated because the SBIs "mak[e] transactions harder to track," which in turn "make the state regulators' jobs 'more difficult,'" and thus partially explains their opposition.²⁸⁷ However, these explanations are insufficient. Richard Roberts, former

²⁷⁸ NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9373.

²⁷⁹ *Id.*

²⁸⁰ *See id.*

²⁸¹ *Id.*

²⁸² *Id.*; see Goodman, *supra* note 151, at 2.

²⁸³ Salwen, *supra* note 151, at B2. Breeden added that the SEC did not exist "to simply take suggestions from a trade association of state bureaucrats." *Id.*

²⁸⁴ *Impact of SBIs*, *supra* note 94, at 524-26 & n.105.

²⁸⁵ *See id.* at 525. Forced to choose between "a 'carrot or stick' approach toward coordinating regulation with state officials," the Commission pursued its agenda with the expectation that the states would follow its lead. *SBIs May Fall Short*, *supra* note 156, at 1139.

²⁸⁶ *SBIs May Fall Short*, *supra* note 156, at 1139.

²⁸⁷ Bradford McKee, *Simpler Offerings for Smaller Firms*, *NATION'S BUS.*, July 1993, at 33, 34.

Commissioner of the SEC, offered a further explanation, conceding several months later that the political climate had forced the agency to depart from the coordinated rulemaking necessary for Rule 254 to succeed.²⁸⁸

After adoption of the SBIs, most observers and interested parties identified the absence of coordination as the greatest threat to the success of testing the waters under Rule 254. For example, scholars and practitioners certainly understood that cooperation between the Commission and the states as well as coordination of federal and state securities laws were prerequisites to the success of the SEC's testing the waters rule.²⁸⁹ This is particularly significant because coordinating Regulation A offerings with blue sky laws has historically been problematic.²⁹⁰ The ABA echoed the views of commentators that without cooperation with the states and coordination of federal and state securities laws, "[a]ny simplification of the federal requirements will be both illusory and frustrating to the intended purposes of encouraging small business investment."²⁹¹ Likewise, the SEC subsequently admitted that state adoption of testing the waters is essential.²⁹² Not surprisingly, the states and NASAA also identified the absence of state and federal coordination as particularly worrisome.²⁹³

C. Aftermath of the SBIs

1. *The States and NASAA*

The contentious relations between the Commission, on the one hand, and the states and NASAA, on the other, continued after adoption of the SBIs.²⁹⁴ Some states immediately announced that they would not make corresponding amendments to their securities laws to conform them to the revised Regulation A rules because the SBIs provided investors with inadequate protection.²⁹⁵ For example, Colorado, one of the states whose securities laws are required to mirror those of the federal government, immediately expressed its dissatisfac-

²⁸⁸ *Roberts Says More Effort Needed To Reduce Overlapping Regulations*, 25 Sec. Reg. & L. Rep. (BNA) 520, 520-21 (Apr. 9, 1993) [hereinafter *More Effort Needed*].

²⁸⁹ See, e.g., 3A BLOOMENTHAL, *supra* note 11, at 5-68.1 to 5-69; Janvey, *supra* note 206, at 45; Keller, *supra* note 206, at 18; Lander, *supra* note 150, at 9; Mendelson & Shepard, *supra* note 123, at 18; Sargent, *supra* note 206, at 8; *SBIs May Fall Short*, *supra* note 156, at 1139.

²⁹⁰ See *supra* text accompanying note 269.

²⁹¹ *SBIs May Fall Short*, *supra* note 156, at 1139 (alteration in original).

²⁹² See *More Effort Needed*, *supra* note 288, at 520.

²⁹³ See *SBIs May Fall Short*, *supra* note 156, at 1139.

²⁹⁴ See, e.g., NASAA Comment Letter Regarding Additional SBIs, *supra* note 277, at 9390.

²⁹⁵ See Rowe, *supra* note 277, at 66; *Testing Rules Still Trouble States*, *supra* note 235, at 1642.

tion with the testing-the-waters rule.²⁹⁶ Colorado securities regulators held a hearing and adopted a testing-the-waters rule that differed somewhat from Rule 254.²⁹⁷

In September 1992, NASAA announced that it was attempting to develop a model for a testing-the-waters rule that would satisfy the states' concerns regarding investor protection and harmonize with Rule 254.²⁹⁸ On April 25, 1993, the members of NASAA passed a resolution to launch a two-year pilot project inviting states to test its model.²⁹⁹ NASAA sought to determine whether it could achieve "the policy objectives underlying the testing-the-waters exemption" and "adequately ensure that investors are protected."³⁰⁰ The NASAA testing-the-waters model, however, lacked legal effect until the states passed legislation adopting the model.³⁰¹ NASAA published its "Statement of Policy on Solicitation of Interest (Test the Waters)" to facilitate uniform state implementation of the program, and to assess the feasibility of a testing-the-waters rule that does not sacrifice investor protection.³⁰²

The NASAA testing-the-waters model retained many of the provisions of Rule 254, but incorporated several new safeguards to protect investors. For example, the model gave a state the opportunity to reject a potential issuer's bid to test the waters.³⁰³ The model achieved this by requiring, in section (1) (c), that a potential issuer file a "Solicitation of Interest Form"³⁰⁴ or any other soliciting materials with a securities administrator ten business days prior to the first solicitation of

²⁹⁶ See *Colorado Initiates Rulemaking*, *supra* note 273, at 1529.

²⁹⁷ See *id.* The Colorado rule requires that the solicitation document contain a statement that the sales of securities will not begin until after (i) the registration of the offering with the Colorado Securities Commissioner and (ii) the delivery of a qualified offering circular. See *id.* The Rule also requires issuers to file its solicitation document with the state securities commission before delivery to prospective investors. See *id.*

²⁹⁸ *New NASAA Chief Calls for Split in Regulation of Smaller Offerings*, 24 *Sec. Reg. & L. Rep.* (BNA) 1528, 1528 (Sept. 25, 1992).

²⁹⁹ See *Testing Release*, *supra* note 8, app. at 86,894-98 (setting forth the Resolution of the North American Securities Administrators Association, Inc., Regarding the Testing-the-Waters Exemption).

³⁰⁰ *Id.* at 86,894.

³⁰¹ See *Keller*, *supra* note 206, at 18.

³⁰² Proposed Statement of Policy on Solicitation of Interest (Test the Waters), [Current Transfer Binder] NASAA Rep. (CCH) ¶ 4141, at 2541 (Apr. 25, 1993) [hereinafter NASAA Proposed Statement of Policy]. The SEC attached this Proposed Statement of Policy to the Testing Release as an appendix. *Testing Release*, *supra* note 8, app. at 86,895.

³⁰³ See State Regulation of Securities Committee, *Review of Developments in State Securities Regulation*, 50 *BUS. LAW.* 343, 385 (1994) [hereinafter *1994 Review of Developments*].

³⁰⁴ For the format of the Solicitation of Interest Form, see Solicitation of Interest Form, [Current Transfer Binder] NASAA Rep. (CCH) ¶ 4142, at 2545, 2545-46 (Apr. 25, 1993) [hereinafter *Solicitation of Interest Form*].

interest.³⁰⁵ In contrast, Rule 254 requires only that an issuer file the solicitation document or broadcast script as of the day it solicits interest.³⁰⁶ In addition, section (1)(d) of the NASAA program stipulates that issuers must submit any new or revised materials to the administrator five days before it uses them to test the waters—as opposed to Rule 254's requirement that issuers need only file substantively different materials.³⁰⁷ The NASAA model also provides in section (1)(f) that a prospective issuer must deliver to a potential investor whom it intends to contact a current Solicitation of Interest Form no later than five days after the issuer establishes contact.³⁰⁸ This provides prospective investors with more information about the company.

The Solicitation of Interest Form under the NASAA model calls for more disclosure than the Rule 254 solicitation document by providing more comprehensive disclosure regarding the company, the business, use of proceeds, and key personnel.³⁰⁹ Although the NASAA plan prescribes only minimum disclosure requirements,³¹⁰ sections (1)(c) and (1)(d), which enable administrators to review all materials before solicitation, and the threat of liability under the antifraud provisions of the federal and state securities laws³¹¹ are intended to help protect investors from fraud and misrepresentation. The NASAA model also protects investors by introducing in section 1(i) a bad boy disqualification provision.³¹²

Section (1)(h), which provides that an issuer may not sell securities until seven days after delivering a prospectus to the investor, is another significant requirement that does not exist under Regulation A.³¹³ This cooling-off period, lacking under Rule 254, is designed to give investors more time to review the prospectus before selling efforts begin. Section (3)(b) further insulates a prospective investor by prohibiting an issuer from selling securities until twenty calendar days

³⁰⁵ See NASAA Proposed Statement of Policy, *supra* note 302, at 2541. Section 1(e) prohibits an issuer from using a Solicitation of Interest Form or other material that a securities administrator has informed the issuer is unacceptable. *Id.*

³⁰⁶ 17 C.F.R. § 230.254(b)(1) (1997).

³⁰⁷ NASAA Proposed Statement of Policy, *supra* note 302, at 2541; *cf.* 17 C.F.R. § 230.254(b)(1) note (1997). Section (1)(d) of the NASAA proposal exempts materials sent to a potential purchaser by request. NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

³⁰⁸ NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

³⁰⁹ Solicitation of Interest Form, *supra* note 304, at 2545-46.

³¹⁰ *Id.* at 2545.

³¹¹ Despite its earlier concern regarding the prescription in Rule 254, as amended, of the antifraud provisions as the liability standard, *see supra* note 256 and accompanying text, under the NASAA model, “[m]aterials filed . . . will be judged under anti-fraud principles.” NASAA Proposed Statement of Policy, *supra* note 302, at 2544 cmt. 2.

³¹² NASAA Proposed Statement of Policy, *supra* note 302, at 2542-43. For a comparison with the Regulation A bad boy disqualification provision, *see infra* text accompanying notes 713-18.

³¹³ *Id.* at 2541.

after its last contact with the investor rather than twenty calendar days after the final publication or delivery of the testing materials.³¹⁴ This, together with section (3)(b)'s prohibition of testing-the-waters communications with potential investors after the filing of an offering statement with the state³¹⁵ and section (1)(h)'s "seven day cooling-off" period,³¹⁶ should mitigate the danger of investor reliance on issuers' oral representations.

The NASAA model also differs from Rule 254 in its treatment of an issuer's failure to comply with its requirements. As discussed above, compliance with Rule 254(b) is "not a condition to [an] exemption."³¹⁷ Rather, an issuer's failure to meet any of the requirements of Rule 254(b) entitles the Commission to suspend the exemption.³¹⁸ Although this approach protects issuers, it leaves investors vulnerable because it does not preclude an issuer from further testing the waters, and does not automatically bar an issuer from proceeding with the offering. In contrast, the NASAA model accords different treatment depending on which provision an issuer has violated.³¹⁹ In addition, section (4) of the NASAA model provides some flexibility by permitting state securities administrators to waive any of the requirements of the exemption at the request of an offeror who has demonstrated cause.³²⁰

Further, the NASAA model addresses the problem that occurs when issuers test the waters and then decide to conduct a private placement under section 4(2) of the Securities Act. Under section (6) of the model, an issuer that has tested the waters must wait six months after its final contact with a potential investor before it may offer or sell securities pursuant to a private placement.³²¹

Although the NASAA model introduces many much needed safeguards, it also has its flaws. Because the plan focuses disproportionately on investor protection, its adoption by the states may exacerbate the problems facing small issuers discussed above with respect to Rule 254.³²² The NASAA plan is more complex and imposes more demanding disclosure requirements than Rule 254. If the states enact the NASAA model,³²³ a potential issuer that tests the waters must comply both with the state procedure, which would follow the NASAA

³¹⁴ *Id.* at 2543-44; *cf.* 17 C.F.R. § 230.254(b)(4) (1997).

³¹⁵ NASAA Proposed Statement of Policy, *supra* note 302, at 2543-44.

³¹⁶ *Id.* at 2541.

³¹⁷ *See supra* text accompanying note 201.

³¹⁸ *See supra* text accompanying note 202.

³¹⁹ NASAA Proposed Statement of Policy, *supra* note 302, at 2543.

³²⁰ *Id.* at 2544.

³²¹ *Id.*

³²² *See supra* text accompanying notes 219-21.

³²³ The more likely outcome is that only some states will enact laws that mirror the NASAA model. Other states may design their own rules. In that case, a small issuer that

model, and with Rule 254. The inconsistencies between Rule 254 and the NASAA model render compliance confusing and burdensome for small issuers. Such issuers would incur considerable expenses and would still need a lawyer to ensure compliance with both sets of laws. These burdens and high costs of compliance may discourage small businesses from testing the waters. Further, the model has limited utility. The model's scope is broader than that of Rule 254—section 1(b) provides that it also applies to Rule 504 offerings—however, the model is available only to potential issuers contemplating Regulation A and Rule 504 offerings.³²⁴ The model also does not alleviate NASAA's concern that small businesses, armed with the opportunity to test the waters, will develop unreasonable expectations regarding the offering.³²⁵ It also threatens to give rise to the same systemic problems that state securities regulators warned of with respect to Rule 254—a poor allocation of capital and skepticism toward investing in small companies.³²⁶

As of September 11, 1995, eight states participated in NASAA's pilot program.³²⁷ Of these states, Massachusetts, Vermont, Virginia, and Washington adopted laws that mirror the NASAA plan.³²⁸ Kansas, Oregon, Pennsylvania, and Wyoming enacted statutes that enable small issuers to test the waters; however, their laws differ slightly from the NASAA model.³²⁹ Colorado and Oklahoma implemented their own testing-the-waters procedures.³³⁰ As of November 1995, Arizona

seeks to test the waters in multiple states is confronted with the daunting task of compliance with several different sets of procedures.

³²⁴ NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

³²⁵ See *supra* text accompanying note 258.

³²⁶ See *supra* text accompanying notes 239-42.

³²⁷ See NASAA Comment Letter to Jonathan G. Katz, Secretary, SEC, Regarding the Rule on Solicitation of Interest Prior to an Initial Public Offering, [Current Transfer Binder] NASAA Rep. (CCH) ¶ 13,029, at 13,052, 13,052 (Sept. 11, 1995) [hereinafter NASAA Comment Letter Regarding Testing Release].

³²⁸ See State Regulation of Securities Committee, *Review of Developments in State Securities Regulation*, 51 BUS. LAW. 223, 291 (1995) [hereinafter *1995 Review of Developments*].

³²⁹ See *id.* For a discussion of how the testing-the-waters rules adopted by these states differ from the NASAA program, see *id.*

³³⁰ See Michael E. Flowers, *Small Business and Small Offerings: Developments in SEC and State Regulation*, 28 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 201, 259-60 (Feb. 16, 1996); *supra* notes 296-97 and accompanying text.

In 1994, California introduced a new exemption that permits eligible issuers to make solicitations that resemble testing the waters. See CAL. CORP. CODE § 25102(n) (West Supp. 1997). Under section 25102(n), offerings by California issuers, among others, who market securities to certain qualified purchasers, are exempt from state registration requirements. *Id.* § 25102(n)(1)-(2). The rule also allows eligible issuers to publish and distribute general solicitations regarding a potential offering. *Id.* § 25102(n)(5). According to the SEC, "[t]his general announcement process is modeled on the 'test the waters' concept being used by several of the states and by the Commission in [the form of Rule 254]." Small Business Registration Exemption, Securities Act Release No. 7285, [1996-97 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,803, at 88,006, 88,008 (May 1, 1996) [hereinafter

authorized the codification of a testing-the-waters rule based on the NASAA example.³³¹ In August 1996, Indiana adopted a testing-the-waters rule.³³² North Dakota also passed testing-the-waters legislation in April 1997.³³³

The NASAA pilot project yielded unimpressive results. Participating states reported the following numbers of testing-the-waters filings: Kansas (none), Massachusetts (none), Oregon (three to five), Pennsylvania (one); Vermont (one, but disqualified), Virginia (one or two), and Washington (eight to ten).³³⁴ In Colorado, between twenty and thirty issuers relied on the testing-the-waters rule, while in Oklahoma, only one issuer tested the waters.³³⁵ These statistics are insufficient to provide a basis for a definitive conclusion regarding the project.³³⁶ NASAA conceded that it had "captured very little data [from the pilot project] due to the small number of filings."³³⁷ Nevertheless, after the two years, NASAA did conclude that *under its model*, testing the waters did not appear to "compromise . . . investor protection."³³⁸ A larger number of filings may have cast doubt on this conclusion.

2. *The Commission*

Confronted with the prospect of an ineffective Rule 254, the Commission set out in 1993 to secure its acceptance by the states.³³⁹

California Exemption Release] (footnote omitted). Much like the SEC's hopes for Rule 254, California intended for section 25102(n) to help small businesses raise capital. *See id.* at 88,007.

In May 1996, the Commission, relying on its authority under section 3(b) of the Securities Act, adopted new Rule 1001. *See id.* at 88,009. Rule 1001 exempts from section 5 offers and sales of securities not exceeding \$5 million that section 25102(n) of the California Corporations Code exempts from registration. 17 C.F.R. § 230.1001(a) (1997); California Exemption Release, *supra*, at 88,009. Therefore, Rule 1001 provides a federal exemption for offerings that qualify for the exemption in California. *See California Exemption Release, supra*, at 88,009. Rule 1001, which endorses the general announcement provision of section 25102(n), should encourage more eligible issuers to rely on California's rule.

³³¹ *See 1995 Review of Developments, supra* note 328, at 291.

³³² *See Regulatory Briefs: Indiana*, 28 Sec. Reg. & L. Rep. (BNA) 1014, 1015 (Aug. 16, 1996).

³³³ *See Legislative Briefs: North Dakota*, 29 Sec. Reg. & L. Rep. (BNA) 581, 581 (Apr. 25, 1997).

³³⁴ *See Flowers, supra* note 330, at 259-60.

³³⁵ *See id.*

³³⁶ *See infra* Part III.C.4.

³³⁷ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,052. The numbers of filings in states that have adopted testing-the-waters rules, *see supra* text accompanying notes 334-35, were reported in February 1996, five months after NASAA wrote its comment letter. Therefore, these low figures are probably even higher than those that NASAA was aware of when it acknowledged that it had "captured very little data."

³³⁸ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,052 (emphasis added).

³³⁹ *See More Effort Needed, supra* note 288, at 520-21.

Foreshadowing increased cooperation, the Director of the Division of Corporation Finance praised NASAA for its model and recognized that the "states' response has been 'constructive' in the rulemaking process."³⁴⁰ Nevertheless, the SEC did not wait until the end of the NASAA two-year pilot project to assess the impact of testing the waters. At an ABA State Regulation of Securities Committee meeting in September 1993, Richard Wulff, Chief of the Corporation Finance Division's Office of Small Business Policy, announced that the Commission considered the SBIs "a 'very successful revision.'"³⁴¹ He reported that as of September 27, 1993, thirty small issuers, representing many different industries, had tested the waters.³⁴² Five of these issuers, the so-called "success stories," subsequently began Regulation A offerings.³⁴³ The SEC concluded that Rule 254 was a success.

3. *The National Securities Markets Improvement Act*

The NSMIA does not increase the likelihood that Rule 254 will be a success.³⁴⁴ In order to reduce issuers' costs and the burden of complying with expensive, excessive, and at times inconsistent, blue sky laws,³⁴⁵ Congress amended section 18 of the Securities Act and section 28 of the Exchange Act to authorize federal preemption of certain state securities laws regarding "covered securities" or securities that will be "covered securities" after a transaction.³⁴⁶ The NSMIA signals the end of blue sky registration of and qualification requirements for, as well as merit regulation of, offerings of covered securities.³⁴⁷ Congress defined four levels of covered securities in section 18. The first level consists of "nationally traded securities," which are those listed or approved for listing on the New York or American Stock Exchanges, the NASDAQ National Market System, or an exchange that the Commission deems to have equivalent listing requirements.³⁴⁸ Second, covered securities include securities issued by investment

³⁴⁰ *SEC Adopts Further Rules*, *supra* note 238, at 620.

³⁴¹ *SEC Pleased with SBI, Agency Official Declares*, 25 Sec. Reg. & L. Rep. (BNA) 1341, 1341 (Oct. 8, 1993) [hereinafter *SEC Pleased with SBI*].

³⁴² *See id.* at 1342.

³⁴³ *Id.*

³⁴⁴ However, if the Commission relies on new section 28 of the Securities Act to raise the Regulation A ceiling, then more small issuers should test the waters. *See supra* note 226.

³⁴⁵ *See supra* text accompanying notes 271-75.

³⁴⁶ NSMIA, *supra* note 22, at 3417-19 (codified at 15 U.S.C. § 77r (Supp. II 1996)), 3422 (codified at 15 U.S.C. § 78bb(a) (Supp. II 1996)). To review the text of section 18 of the Securities Act and section 28 of the Exchange Act prior to the NSMIA, see *supra* note 260.

³⁴⁷ *See Rowe*, *supra* note 226, at 8. However, the states will retain their authority to investigate and enforce violations of state antifraud laws and illegal broker-dealer conduct, permit notice filings, and collect existing fees. *See NSMIA*, *supra* note 22, at 3419-20 (codified at 15 U.S.C. § 77r(c) (Supp. II 1996)).

³⁴⁸ *Id.* at 3418 (codified at 15 U.S.C. § 77r(b)(1) (Supp. II 1996)).

companies registered, or with registration statements filed, under the Investment Company Act.³⁴⁹ Third, securities offered to so-called "qualified purchasers" are covered.³⁵⁰ Finally, securities offered or sold pursuant to the following Securities Act exemptions are covered: (i) sections 4(1) and 4(3), if by an issuer that has reporting obligations under the Exchange Act; (ii) section 4(4); (iii) section 3(a) excluding subparagraphs (4) and (11);³⁵¹ and (iv) section 4(2).³⁵²

The passage of the NSMIA should make it easier and less expensive for many issuers to offer and sell securities.³⁵³ However, the NSMIA does not provide any assistance to issuers seeking to rely on Regulation A. New section 18(b) of the Securities Act does not include securities offered or sold pursuant to Regulation A in its definition of covered securities.³⁵⁴ Consequently, the states retain jurisdiction over Regulation A offerings.³⁵⁵ As a result, small businesses interested in testing the waters under Rule 254 must still comply with the duplicative, expensive, and often inconsistent blue sky laws of all states in which it seeks to offer or sell securities under Regulation A.³⁵⁶ As discussed earlier, most issuers are effectively unable to test the waters in many states.³⁵⁷ The NSMIA thus leaves the coordination problem largely unresolved and has not increased accessibility to Rule 254.

There is hope that Congress, or the Commission, will preempt state securities laws regarding Regulation A offerings, or at least testing the waters before such offerings. Section 102(b) of the NSMIA includes a note to new section 18, requiring the SEC to assess the extent to which the states have taken steps to achieve "uniformity of State regulatory requirements for securities or securities transactions . . . for securities that are not covered securities" and to report to Congress on the results of this review no later than October 11, 1997.³⁵⁸ In addition, the NSMIA authorizes the Commission to subse-

³⁴⁹ See *id.* (codified at 15 U.S.C. § 77r(b)(2) (Supp. II 1996)).

³⁵⁰ See *id.* (codified at 15 U.S.C. § 77r(b)(3) (Supp. II 1996)).

³⁵¹ Municipal securities, exempt under section 3(2), which are offered or sold in the state where the issuer is located, are not covered. See *id.* at 3418-19 (codified at 15 U.S.C. § 77r(b)(4)(C) (Supp. II 1996)).

³⁵² See *id.* (codified at 15 U.S.C. § 77r(b)(4) (Supp. II 1996)).

³⁵³ See Rowe, *supra* note 226, at 8.

³⁵⁴ See NSMIA, *supra* note 22, at 3418-19 (codified at 15 U.S.C. § 77r(b)(4) (Supp. II 1996)). Securities offered or sold pursuant to Rules 504 and 505 are also excluded from section 18(b). See *id.* (codified at 15 U.S.C. § 77r(b)(4) (Supp. II 1996)).

³⁵⁵ See OFFICE OF THE GENERAL COUNSEL, SEC, THE SEC SPEAKS IN 1997, at 9, 451 (PLI Corp. L. & Practice Course Handbook Series No. B-980, 1997); Campbell, *supra* note 264, at 205.

³⁵⁶ See *supra* text accompanying notes 261-75.

³⁵⁷ See *supra* text accompanying notes 269-75.

³⁵⁸ NSMIA, *supra* note 22, at 3420 (codified at 15 U.S.C. § 77r note (Supp. II 1996)).

quently amend the definition of "qualified purchasers."³⁵⁹ This authority may enable the Commission to expand the definition of covered securities to include Regulation A, thereby preempting state securities laws concerning the offering or sale of securities pursuant to this exemption.³⁶⁰ If the Commission does exercise this authority, new section 18(b)(3) of the Securities Act requires the Agency to ensure that this expansion is "consistent with the public interest and the protection of investors."³⁶¹

4. *Synthesis*

The SEC's declaration of the success of the testing-the-waters rule only thirteen months after its adoption³⁶² was a hasty conclusion to draw. As with the NASAA pilot program, only a small number of potential issuers tested the waters. Yet in contrast to NASAA's appropriate circumspection, the Commission was quick to trumpet the success of Rule 254. Instead of waiting until the end of NASAA's pilot program, meeting with members of the Association to discuss the results under both testing-the-waters procedures, and issuing a joint statement, the SEC once again chose to proceed on its own.

There are several possible reasons why the SEC was anxious to proclaim Rule 254 a success. The Commission ultimately recognized that it had erred in abandoning the states and NASAA in order to force through the SBIs.³⁶³ The SEC thus had a very strong interest in the success of Rule 254, because of criticism it would receive if the Rule failed. Success could help to justify the agency's overt discontinuation of its negotiations with the states and NASAA. Further, successful testing-the-waters filings might encourage more states to adopt testing-the-waters legislation. After NASAA launched its pilot project, the SEC had an even greater interest in the success of its testing-the-waters rule. States that adopted rules based on Rule 254, rather than the NASAA model or entirely different legislation, would reduce both compliance costs for small issuers and the confusion of inconsistent securities laws. The SEC may have also felt pressure because of the continued politicization of the small business cause.

As of June 27, 1995, the Commission reported that sixty-one small businesses had filed solicitation documents and twenty-six of these issuers had taken steps to offer securities.³⁶⁴ The SEC reiterated that Rule 254 was a success.³⁶⁵ But, like the representation in September

³⁵⁹ *Id.* at 3418 (codified at 15 U.S.C. § 77r(b)(3) (Supp. II 1996)).

³⁶⁰ *See* Campbell, *supra* note 264, at 207.

³⁶¹ NSMIA, *supra* note 22, at 3418 (codified at 15 U.S.C. § 77r(b)(3) (Supp. II 1996)).

³⁶² *See* SEC Pleased with SBI, *supra* note 341, at 1341.

³⁶³ *See* More Effort Needed, *supra* note 288, at 520-21.

³⁶⁴ *See* Testing Release, *supra* note 8, at 86,886.

³⁶⁵ *See id.*

1993 that Rule 254 was a success,³⁶⁶ this report was premature, for Rule 254 helped only a fraction of small businesses.³⁶⁷

There are a number of plausible explanations for the low number of testing-the-waters filings. Rule 254 had been on the books for only three years. Further, it has been available only to nonreporting companies seeking to raise up to \$5 million in capital, many of which may have been ignorant of the opportunity. In addition, most states' blue sky laws have not exempted Regulation A offerings by small issuers from registration with state regulators.³⁶⁸ The costs of compliance with blue sky laws, especially those incurred in pursuit of registration, have been prohibitively expensive for many small issuers.³⁶⁹ Moreover, most states have not adopted testing-the-waters rules, thereby precluding small issuers from soliciting indications of interest in those states. Section 18, as currently amended by the NSMIA, will not encourage more small issuers to test the waters under Rule 254 because it does not apply to Regulation A.³⁷⁰

Another problem is that the Commission addressed only the number of Rule 254 solicitations and Regulation A filings.³⁷¹ To determine whether Rule 254 has succeeded, one must take other factors into account. For example, the Commission must consider the success of the ultimate offering. If the ultimate Regulation A offering fails to raise sufficient capital for the issuer, then Rule 254 should not necessarily be considered a success. In such a case, testing the waters may have failed to introduce enough actual investors to the issuer. A tremendous response to an issuer's solicitation of interest is insignificant if investors do not purchase the securities.

Similarly, the SEC has not focused on the small businesses that test the waters, and decide not to undertake a Regulation A offering because of a lack of interest. For such companies, however, Rule 254 was a success, for it saved them considerable expense. At the meeting of the ABA's State Regulation Committee, Richard Wulff mentioned the significance of the twenty-five small businesses who tested the waters, yet did not conduct Regulation A offerings, only after a lawyer in attendance noted that these were the "real success stories."³⁷² In fact,

³⁶⁶ See *supra* text accompanying notes 341-43.

³⁶⁷ See *Impact of SBIs*, *supra* note 94, at 520 n.81; *supra* text accompanying note 364.

³⁶⁸ See *supra* note 270 and accompanying text.

³⁶⁹ See *supra* text accompanying note 272.

³⁷⁰ See *supra* text accompanying notes 354-57.

³⁷¹ The SEC has reported that between 1991 and 1994, the value of Regulation A filings rose from \$40 million to \$290 million. See *Regulatory Flexibility Act Provisions of H.R. 99, The Job Creation and Wage Enhancement Act of 1995: Hearings Before the House Comm. on Small Bus.*, 104th Cong. (1995).

³⁷² *SEC Pleased with SBI*, *supra* note 341, at 1342. The SEC has subsequently emphasized how Rule 254 can help small issuers when it dissuades them from an offering. See, e.g., Arthur Levitt, Remarks at the California Capital Access Forum (May 2, 1996), available

one must take the analysis a step further. The SEC should have contacted the twenty-five small businesses to learn why they did not pursue public offerings. If they chose not to proceed because testing the waters revealed that there was not enough interest to raise sufficient capital under Regulation A, then Rule 254 helped these companies. Alternatively, if they decided not to proceed with the offering for other reasons,³⁷³ testing the waters under Rule 254 may not have influenced their decision.

The success of Rule 254 also requires that testing the waters not have an adverse effect on investors. Neither the SEC nor NASAA have said much beyond their naked declarations that testing the waters under their respective models did not appear to harm investors. In fact, the Commission has conceded that it "had seen more 'puffing' than had been expected."³⁷⁴ These reports suggest that Rule 254 may need stricter requirements regarding the content of solicitation materials in order to protect inexperienced investors from puffing by issuers.

The SEC and NASAA should contact investors who received solicitations of interest and purchased securities in a Regulation A offering to ask them about their experiences with either Rule 254, the NASAA model, or other testing-the-waters rules that any of the states have adopted. Without such an effort, the Commission or NASAA would presumably learn that testing the waters has harmed investors only from investors' complaints or lawsuits. However, the absence of reported complaints or lawsuits does not necessarily lead to the conclusion that Rule 254 does not harm investors. It is conceivable that Rule 254 has harmed investors who have not resorted to either of these courses of action. Furthermore, investors may not recognize that they suffered as a result of testing the waters. For example, they may have reviewed the offering circular, but relied primarily on excessively optimistic projections conveyed orally by the issuer in a Rule 254 solicitation of interest. The effect of testing the waters is thus very difficult to measure. Rule 254 had not been in existence long enough for the SEC to make a fair determination of its impact on investors. Admit-

in 1996 WL 222411 (S.E.C.), *5-*6 [hereinafter Remarks by Arthur Levitt] (recalling how a particular small business tested the waters, discovered that its customers, whom it solicited, would not be able to help the company raise a sufficient amount of capital under Regulation A, and then conducted a very successful registered IPO with the assistance of an underwriter).

³⁷³ For example, a company might not begin a public offering if it received a loan from a bank or decided to remain private because it was uncomfortable with the disclosure requirements that arise in preparation of and following an offering.

³⁷⁴ Leonard J. McGill, *Innovative New California Transactional Exemption for Sales to Qualified Purchasers*, INSIGHTS, May 1995, at 23, 24. In California, the Department of Corporations conducted an independent analysis of testing the waters and agreed with this finding. *See id.*

tedly, SEC discussion of issuers who declined to offer securities or of investor protection does not constitute publicity that rivals stories of small businesses that have tested the waters and then undertaken Regulation A offerings.³⁷⁵ Nevertheless, an analysis that takes these two factors into account is critical to accurately determine if testing the waters has been a success. A careful evaluation will help the Commission make any necessary revisions to the Rule and will shed light on the wisdom of expanding the availability of testing the waters.

A proper conclusion that Rule 254 does not harm investors could give rise to three outcomes, all of which would help small issuers.³⁷⁶ First, the SEC could exercise its authority under new section 28 to increase the Regulation A ceiling.³⁷⁷ Second, the Commission may have the authority to add the Regulation A exemption to new section 18's definition of covered securities, and thereby preempt state securities laws regarding securities offered or sold pursuant to the Regulation A exemption.³⁷⁸ Third, more states, encouraged by NASAA, might exempt Regulation A offerings or adopt testing-the-waters rules based on, or coordinated with, Rule 254.

Small businesses that lack a market for their stock need a testing-the-waters rule to enable them to make a rational business decision whether to conduct a Regulation A offering. In theory, testing the waters either under Rule 254 or the NASAA model should help small businesses. However, the NASAA model appears to strike a better balance than Rule 254 between facilitating capital formation and protecting investors. Nevertheless, like the three-year period that followed the adoption of the SBIs, the two-year trial period was inadequate to properly determine the impact of testing the waters on investors.

IV

TESTING THE WATERS BEFORE REGISTERED IPOs UNDER PROPOSED RULE 135D

A. Background to the Testing Release

The foregoing criticism of the SEC's hasty conclusion is significant because the SEC proposed an extension of testing the waters to

³⁷⁵ See *supra* text accompanying note 343.

³⁷⁶ Section 106(b) of the NSMIA requires that when the SEC is making rules, pursuant to the NSMIA, that require consideration of the effect on the "public interest," it must take into account "the protection of investors" as well as "whether the action will promote efficiency, competition, and capital formation." NSMIA, *supra* note 22, at 3424 (codified at 15 U.S.C. § 77b(b) (Supp. II 1996)). However, SEC Chairman Levitt has subsequently explained that investor protection is the most important of these considerations. See *Market Issues Weighed in Rulemaking; Investor Protection Is First, Levitt States*, 29 Sec. Reg. & L. Rep. (BNA) 297, 297 (Mar. 7, 1997) [hereinafter *Investor Protection Is First*].

³⁷⁷ See *supra* note 226.

³⁷⁸ See *supra* text accompanying notes 359-61.

registered IPOs based on its determination that Rule 254 helped small businesses.³⁷⁹ Thus, if the SEC drew an improper conclusion, the foundation of the Testing Release is weak.

As discussed earlier, certain critics of the SBIs argued that Rule 254, available only to businesses considering Regulation A offerings, has very limited utility.³⁸⁰ For instance, small issuers seeking to raise more than \$5 million could not test the waters, for such an offering would exceed the Regulation A ceiling. These critics proposed the extension of the testing-the-waters rule to other types of offerings that would benefit small businesses.³⁸¹

In 1995, politics dictated neither the scope of the Testing Release nor the pace of its adoption to the same extent as before the SBIs Release.³⁸² Rather, the remarkable success of the IPO market during the 1990s, which enabled issuers in the first four and one-half years of this decade to raise \$114.8 billion, prompted the Commission to propose extending testing the waters to registered IPOs.³⁸³ The Commission thus recognized the advantages registered IPOs offer companies in need of capital; however, it also understood that the prohibitive costs of going public and operating a public company preclude many businesses from pursuing this means of raising capital.

In contrast to its approach in the SBIs Release, the Commission incorporated some of the views of NASAA into the Testing Release. For example, the Testing Release discussed the NASAA pilot project and contrasted it with Rule 254.³⁸⁴ In addition, the SEC attached NASAA's resolution regarding testing the waters and its Proposed Statement of Policy on Solicitation of Interest as an appendix to the

³⁷⁹ See Testing Release, *supra* note 8, at 86,886. The SEC reported that:

Experience under Regulation A suggests that the "test the waters" initiative provides issuers of small offerings a useful and cost effective means of assessing whether there is sufficient potential interest in the company as an investment to proceed with a Regulation A offering. To date [June 27, 1995], these solicitations do not appear to have raised significant investor protection concerns. Accordingly, the Commission today is soliciting comment on the appropriateness of providing a similar "test the waters" option for registered IPOs.

Id.; see also *SEC Proposes Four Initiatives Aimed at Helping Small Businesses*, 27 Sec. Reg. & L. Rep. (BNA) 980, 980-81 (June 30, 1995) (discussing the Testing Release).

³⁸⁰ See *supra* notes 222-28 and accompanying text.

³⁸¹ Two such proposals that particularly influenced the SEC were a July 8, 1993 comment letter from members of various committees of the ABA on the SBIs and a March 31, 1995 report by the Subcouncil on Capital Allocation of the Competitiveness Policy Council. See Testing Release, *supra* note 8, at 86,886 & nn.13-14.

³⁸² See *supra* notes 148-51 and accompanying text; text accompanying notes 282, 288.

³⁸³ See Testing Release, *supra* note 8, at 86,887 (explaining that "[t]he IPO market is one of the great strengths of the U.S. capital markets, and its breadth and depth is [sic] unique").

³⁸⁴ *Id.* at 86,886.

Testing Release.³⁸⁵ The SEC took these measures because it knew that for this proposal to succeed, it would need the support of the state securities regulators. In sum, the SEC had learned from its experience in 1992.

B. The Testing Release

The SEC issued the Testing Release on June 27, 1995, and the period for public comment was to end on September 8, 1995.³⁸⁶ The Commission's primary inquiry for commenters was whether its proposed new Rule 135d, entitled "Solicitation of Interest Document for Use Prior to an Initial Public Offering,"³⁸⁷ would help businesses reasonably ascertain the market's interest in their IPOs without leading investors to disregard the disclosure they would subsequently receive pursuant to the federal securities laws.³⁸⁸

1. Proposed Rule 135d

Under proposed Rule 135d, written, published, broadcasted, or oral solicitations of interest that comply with the Rule do not represent an offer of securities for the purposes of section 5 of the Securities Act.³⁸⁹ The Rule is not available to an issuer who is (i) a reporting company under the Exchange Act, (ii) a development stage or blank check company, (iii) a penny stock issuer, (iv) an investment company under the Investment Company Act of 1940,³⁹⁰ (v) an issuer of asset-backed securities, or (vi) a partnership, limited liability company, or other "direct participation investment program" following the IPO.³⁹¹ The proposal prescribes five requirements for the solicitation document or script of the radio or television broadcast.³⁹² First, the issuer must state that the solicitation of interest does not constitute an offer to sell securities, which will be made only via a future detailed prospectus available from the issuer.³⁹³ Second, the issuer must explain that it is not soliciting any consideration, which, if paid, will be re-

³⁸⁵ See *id.* at 86,894-98.

³⁸⁶ *Id.* at 86,885. The SEC did not treat this as a firm deadline. See, e.g., *infra* note 533 and accompanying text.

³⁸⁷ Testing Release, *supra* note 8, at 86,893.

³⁸⁸ *Id.* at 86,886-87.

³⁸⁹ See *id.* at 86,893 (proposed 17 C.F.R. § 230.135d(a)).

³⁹⁰ 15 U.S.C. § 80a-1 *et seq.* (1994).

³⁹¹ See Testing Release, *supra* note 8, at 86,893 (proposed 17 C.F.R. § 230.135d(a)(1)). In the Testing Release, the Commission proposed new Rule 100(a)(8) which would define a direct participation program as: "any program (other than an investment company . . .) that provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution, including, but not limited to, partnerships, limited partnerships, real estate investment trusts . . ., and limited liability companies." *Id.* (proposed 17 C.F.R. § 230.100(a)(8)).

³⁹² See *id.* (proposed 17 C.F.R. § 230.135d(a)(2)).

³⁹³ See *id.* (proposed 17 C.F.R. § 230.135d(a)(2)(i)).

turned.³⁹⁴ Third, the issuer must state that it will neither sell securities nor accept an offer to purchase until the Commission declares a filed registration statement effective, or after the issuer properly relies on an exemption from registration.³⁹⁵ Fourth, the issuer must assert that if a potential investor expresses interest, he or she does not incur any obligation.³⁹⁶ Fifth, the document or script must name the issuer's chief executive officer and broadly discuss its business and product line.³⁹⁷ These represent only the minimum requirements; issuers may provide any other information such as pricing information, unaudited financial statements, and forward-looking statements.³⁹⁸ All representations in the solicitation materials must be accurate, for the antifraud provisions of the federal securities laws apply to them.³⁹⁹

In addition, an issuer may send a coupon along with the solicitation document through which a prospective investor can convey interest in a registered IPO by returning the coupon to the issuer.⁴⁰⁰ The coupon must reiterate that its completion does not commit a prospective investor to purchasing the securities and that the prospective investor should not send money.⁴⁰¹ Further, the coupon may ask for the prospective investor's name, address, and telephone number, but may not inquire as to his or her financial status.⁴⁰²

The issuer must submit a copy of its testing materials to the Commission before it can rely on proposed Rule 135d.⁴⁰³ An issuer may submit the copy either in paper format or electronically, via EDGAR.⁴⁰⁴ The main office of the SEC must receive the copy no later than the first day on which the issuer uses the materials to solicit indications of interest.⁴⁰⁵ The submitted copy is then available for public inspection.⁴⁰⁶ The submitted copy must include the name and telephone number of an individual who can respond to inquiries regarding the testing materials.⁴⁰⁷ Finally, the issuer is required to submit only material that is substantively different from materials that an issuer has previously submitted to the Commission.⁴⁰⁸

394 *See id.* (proposed 17 C.F.R. § 230.135d(a)(2)(ii)).

395 *See id.* (proposed 17 C.F.R. § 230.135d(a)(2)(iii)).

396 *See id.* (proposed 17 C.F.R. § 230.135d(a)(2)(iv)).

397 *See id.* (proposed 17 C.F.R. § 230.135d(a)(2)(v)).

398 *See id.* at 86,888.

399 *See id.* at 86,894 (proposed 17 C.F.R. § 230.135d(a)(4) note).

400 *See id.* (proposed 17 C.F.R. § 230.135d(b)).

401 *See id.* (proposed 17 C.F.R. § 230.135d(b)).

402 *See id.* (proposed 17 C.F.R. § 230.135d(b)).

403 *See id.* at 86,888, 86,893 (proposed 17 C.F.R. § 230.135d(a)(4)).

404 *See id.* at 86,889 n.38.

405 *See id.* at 86,893 (proposed 17 C.F.R. § 230.135d(a)(3)).

406 *See id.* at 86,889 n.38.

407 *See id.* at 86,893-94 (proposed 17 C.F.R. § 230.135d(a)(3)).

408 *See id.* at 86,894 (proposed 17 C.F.R. § 230.135d(a)(3) note).

An issuer may speak directly with prospective investors after submitting its solicitation materials to the SEC.⁴⁰⁹ Proposed Rule 135d imposes many of the same restrictions on oral communications that it does on written materials. An issuer may neither solicit nor accept any form of consideration from an investor.⁴¹⁰ Moreover, during the course of oral communications, an issuer cannot accept a commitment from a potential investor to purchase.⁴¹¹ Finally, barring an exemption from registration, an issuer may not orally sell securities until the SEC declares its registration statement effective.⁴¹² As with written materials and scripted broadcasts, the antifraud provisions of the federal securities laws apply.⁴¹³

The Testing Release explains that the proposal in no way restricts the "means of dissemination of the 'test the waters' solicitation."⁴¹⁴ Communication via any print, broadcast, telephone, facsimile, or electronic medium, including the Internet, is permitted.⁴¹⁵ An issuer must meet all of the requirements of proposed Rule 135d for each communication, publication, or broadcast.⁴¹⁶ In fact, the Testing Release explains that an issuer must meet all of the requirements of proposed Rule 135d to rely on the Rule.⁴¹⁷ After an issuer has tested the waters, it has no obligation to interested investors should it decide not to proceed with an offering.

Following the filing of a registration statement with the Commission, an issuer may no longer test the waters.⁴¹⁸ In addition, sales pursuant to a registration statement may not be made until twenty calendar days after the final publication or delivery of the written document or radio or television broadcast.⁴¹⁹

Proposed subparagraph 135d(c), modelled after Rule 254(e), provides that written materials, submitted to the Commission and meeting the other requirements of Rule 135d, would not fall within the meaning of a prospectus under section 2(10) of the Securities Act.⁴²⁰ This protects issuers from potential section 12(a)(2) liability.⁴²¹

⁴⁰⁹ *See id.* (proposed 17 C.F.R. § 230.135d(a)(4)).

⁴¹⁰ *See id.* (proposed 17 C.F.R. § 230.135d(a)(4)).

⁴¹¹ *See id.* (proposed 17 C.F.R. § 230.135d(a)(4)).

⁴¹² *See id.* (proposed 17 C.F.R. § 230.135d(a)(4)).

⁴¹³ *See id.* (proposed 17 C.F.R. § 230.135d(a)(4) note).

⁴¹⁴ *Id.* at 86,888.

⁴¹⁵ *See id.*

⁴¹⁶ *See id.*

⁴¹⁷ *Id.* at 86,890.

⁴¹⁸ *See id.* at 86,894 (proposed 17 C.F.R. § 230.135d(a)(5)). An issuer's receipt of a coupon from a prospective investor, in accordance with proposed Rule 135d(b), after it has filed a registration statement does not violate this provision. *See id.*

⁴¹⁹ *See id.* (proposed 17 C.F.R. § 230.135d(a)(6)).

⁴²⁰ *Id.* (proposed 17 C.F.R. § 230.135d(c)).

⁴²¹ *See id.* at 86,889.

2. *Proposed Amendments to Rule 254*

The Commission also proposed revisions to Rule 254 in the Testing Release that would enable an issuer to conduct a Regulation A offering after it has tested the waters under proposed Rule 135d in contemplation of a registered IPO.⁴²² A proposed revision to Rule 254(b)(4) would preclude issuers from selling securities via an offering circular or a registration statement until twenty calendar days after the final publication or delivery of the written document or broadcast on radio or television "pursuant to this rule or pursuant to [proposed Rule 135d]."⁴²³ In addition, the Commission proposed removing from Rule 254(d) the restriction on an issuer's ability to undertake a registered IPO until thirty days after testing the waters in good faith under Regulation A's Rule 254.⁴²⁴

3. *Application of Proposal to Other Exempt Offerings*

As discussed above, proposed Rule 135d does not limit the means by which an issuer may disseminate testing materials before a registered IPO.⁴²⁵ However, the Commission warned in the Testing Release that "[i]f an issuer wants to maintain full flexibility to proceed with an offering under Regulation D and Section 4(2) of the Securities Act, the means of dissemination of the 'test the waters' solicitation would have to be consistent with the limitations under the regulation and statute."⁴²⁶ Of particular importance is the Rule 502(c) prohibition of general solicitations and advertising.⁴²⁷ The Commission published a release concurrently with the Testing Release which proposes, among other things, the elimination of the Regulation D prohibition of general solicitations.⁴²⁸ Unless the SEC adopts this proposal, an issuer may not subsequently offer securities under Rules 505 or 506 if "its testing the waters activity was done in a way that involved general

⁴²² *Id.* at 86,890.

⁴²³ *Id.* at 86,894 (proposed 17 C.F.R. § 230.254(b)(4)).

⁴²⁴ *Id.* (proposed 17 C.F.R. § 230.254(d)). When an issuer in good faith changes its intention and registers an offering after testing the waters, current Rule 254(d) provides that Regulation A's "exemption . . . will not be subject to integration with the registered offering, if at least 30 calendar days have elapsed between the last solicitation of interest and the filing of the registration statement with the Commission, and all solicitation of interest documents have been submitted to the Commission." 17 C.F.R. § 230.254(d) (1997). The Testing Release proposes to remove the thirty-day waiting requirement. Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.254(d)).

⁴²⁵ See *supra* text accompanying notes 414-15.

⁴²⁶ Testing Release, *supra* note 8, at 86,888 n.35.

⁴²⁷ 17 C.F.R. § 230.502(c) (1997); *supra* text accompanying note 133. For discussion of the ban on general solicitation, see Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. FLA. L. REV. 1 (1986); Dougherty, *supra* note 130.

⁴²⁸ Exemption for Certain California Limited Issues, Securities Act Release No. 7185, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,636, at 86,871 (June 27, 1995).

advertising or other activities constituting general solicitation."⁴²⁹ The Commission would have to make this determination on a case-by-case basis.⁴³⁰

The SEC explained in the Testing Release that an issuer seeking to offer securities under Rules 505 or 506 cannot allow an integration of the exempt offering with solicitation activity.⁴³¹ The Commission expressed concern that such an integration might reduce the utility of proposed Rule 135d.⁴³² In the Testing Release, the Commission asked commenters about the viability of another approach: the creation of "a special integration safe harbor for private placements following a Rule 135d 'test the waters' solicitation."⁴³³ The Commission elaborated, proposing that an issuer would be required to wait twenty days after its final delivery or broadcast of a solicitation, and then could proceed with a private placement.⁴³⁴

4. *Comparison of Proposed Rule 135d with Rule 254 and the NASAA Model*

The language of proposed Rule 135d is, unsurprisingly, very similar to that of Rule 254. Nevertheless, the rules differ in important respects. Proposed Rule 135d did not borrow much from the NASAA model. As a result, the differences between proposed Rule 135d and the NASAA model reflect essentially the same differences that exist between Rule 254 and the model.⁴³⁵

Proposed Rule 135d goes beyond Rule 254 by permitting more issuers to test the waters.⁴³⁶ By making testing the waters available to

⁴²⁹ See Testing Release, *supra* note 8, at 86,890. However, if the issuer avoids making general solicitations and otherwise complied with Rules 505 or 506, it can immediately proceed with an offering under these Rules instead of a registered IPO. Moreover, an issuer that has made general solicitations during the course of its testing-the-waters activity could immediately conduct an offering under Rule 504, assuming it otherwise complies with Rule 504, because, after the SBIs, the general solicitation prohibition no longer applies to Rule 504. See *id.* at 86,889 n.50.

⁴³⁰ See *id.* at 86,890 n.58.

⁴³¹ *Id.* at 86,890-91. An issuer can avoid integration by either (i) relying on Rule 502(a), thereby waiting six months after it has tested the waters before it conducts its exempt offering, or (ii) taking measures that will enable the issuer to demonstrate that the two transactions were sufficiently different that the "five-factors" test would not compel integration. See *id.* at 86,891. For enumeration of the five-factors test, see Non-Public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2770, ¶ 2781, at 2918, 2921 (Nov. 6, 1962).

⁴³² Testing Release, *supra* note 8, at 86,891.

⁴³³ *Id.*

⁴³⁴ *Id.*

⁴³⁵ See *supra* Part III.C.1.

⁴³⁶ However, the proposal precludes issuers of asset-backed securities as well as partnerships, limited liability companies, and similar direct participation investment programs. See *supra* note 391 and accompanying text. The Commission explained the exclusion of these issuers on the ground that they "appear unsuited to a 'test the waters' concept, given the complex and contractual nature of the issuer." Testing Release, *supra* note 8, at 86,887.

issuers contemplating registered IPOs, proposed Rule 135d enables larger issuers and small issuers that seek to raise more than \$5 million to test the waters. Although Regulation A is reserved for American and Canadian issuers, proposed Rule 135d does not deny foreign issuers access to testing the waters in the United States.⁴³⁷ In addition, unlike Rule 251(a)(6) and section 1(i) of the NASAA model, proposed Rule 135d does not contain a bad boy disqualification provision.⁴³⁸ In the Testing Release, the SEC solicited comments regarding the appropriateness of the exclusions proposed Rule 135d(a) prescribes.⁴³⁹ The Commission considered removing some of these exclusions and extending them to other types of issuers.⁴⁴⁰ In fact, the SEC even requested comment on whether it should add to Rule 135d(a) those issuers that NASAA excluded under its model.⁴⁴¹ In a troubling step backwards, the Commission also asked commenters if it should limit availability of the Rule to small business issuers.⁴⁴²

Proposed Rule 135d also requires that an issuer submit a copy of its solicitation materials to the Commission's main office.⁴⁴³ In contrast, Rule 254 originally gave an issuer the option of submitting a copy to the regional SEC office in the area in which the issuer conducts or plans to conduct its principal business operations.⁴⁴⁴ Proposed Rule 135d also contains language that necessarily differs from that of Rule 254 to reflect the differences between short form registration pursuant to Regulation A and full registration. For example, proposed Rule 135d(a)(2)(i) requires that the written document or scripted broadcast state that an issuer will make any public offering via a prospectus.⁴⁴⁵ Rule 254(b)(2)(ii) has different language because a Regulation A issuer must deliver an offering circular rather than a prospectus.

Another important difference is that under proposed Rule 135d, full compliance with the provisions of the Rule is a precondition to reliance on the Rule.⁴⁴⁶ In contrast, compliance with the require-

⁴³⁷ See *Regulation Update: Testing the Waters*, INVESTOR REL., Sept. 1, 1995, available in 1995 WL 10825895.

⁴³⁸ See *supra* text accompanying notes 167, 312. For a recommendation that the Commission adopt such a provision, see *infra* Part V.F.3.

⁴³⁹ Testing Release, *supra* note 8, at 86,887-88.

⁴⁴⁰ *Id.*

⁴⁴¹ *Id.*

⁴⁴² *Id.* at 86,888; see also *infra* Part V.E.3 (discussing why this would be a misstep).

⁴⁴³ See *supra* text accompanying note 405.

⁴⁴⁴ See *supra* text accompanying note 192. Effective as of January 21, 1997, the Commission requires that small issuers submit Rule 254 testing materials to the main office of the SEC in Washington, DC. See Revisions to Forms SB-1, SB-2, and Regulation A, Securities Act Release No. 7373, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,867, at 88,768-69, 88,771 (Dec. 16, 1996) (codified at 17 C.F.R. § 230.254(b)(1) (1997)).

⁴⁴⁵ Testing Release, *supra* note 8, at 86,893 (proposed Rule 135d(a)(2)(i)).

⁴⁴⁶ See *supra* text accompanying note 417.

ments of Rule 254(b) is “not a condition to [the] . . . exemption.”⁴⁴⁷ For example, submission of the solicitation document or scripted broadcast to the Commission does not constitute a condition to testing the waters under Rule 254.⁴⁴⁸ Pursuant to the guidance offered in the SBIs Release and Rule 258(a),⁴⁴⁹ failure to meet the requirements of Rule 254(b) is grounds for “[t]he Commission . . . [to] enter an order temporarily suspending a Regulation A exemption.”⁴⁵⁰ Conversely, in order to exempt a solicitation from section 5, an issuer seeking to solicit indications of interest under proposed Rule 135d must submit the materials to the Commission and meet all other requirements the Rule prescribes.⁴⁵¹ This also differs from the more complicated provisions of the NASAA model regarding compliance.⁴⁵²

Although the Commission followed Rule 254 rather than NASAA’s model rule in drafting proposed Rule 135d, it did give NASAA’s model serious consideration. Throughout the Testing Release, the SEC asked commenters to consider various revisions to proposed Rule 135d, many of which were part of NASAA’s testing-the-waters program.⁴⁵³ In most of these instances, the SEC failed to mention that these proposals were included in the NASAA rule and in effect in some states.⁴⁵⁴ Nevertheless, the Commission was clearly trying to appease NASAA and coordinate federal and state securities laws.

C. Reactions to the Testing Release

1. *Déjà Vu*

Given that the SEC modelled Rule 135d on Rule 254, the proposal, unlike its antecedent, was not regarded as innovative. Familiarity with the concept of testing the waters and anticipation that the Com-

⁴⁴⁷ SBIs Release, *supra* note 5, at 36,470 (codified at 17 C.F.R. § 230.254(b) (1997)).

⁴⁴⁸ See Testing Release, *supra* note 8, at 86,889.

⁴⁴⁹ 17 C.F.R. § 230.258(a) (1997).

⁴⁵⁰ *Id.*

⁴⁵¹ See Testing Release, *supra* note 8, at 86,890.

⁴⁵² See *supra* text accompanying note 319.

⁴⁵³ See, e.g., Testing Release, *supra* note 8, at 86,887-88 (soliciting comment as to whether “any of the exclusions [regarding types of issuers] in the NASAA draft policy statement [should] be specifically incorporated into the proposal”); *id.* at 86,888 (asking commenters “whether additional information should be required in the soliciting material, such as that required by the NASAA draft policy”).

⁴⁵⁴ See, e.g., *id.* at 86,890 (soliciting comment on whether the Commission should grant investors more time to review the prospectus when an issuer has tested the waters—this idea originated in section (1)(h) of NASAA’s model, see *supra* text accompanying note 313); *id.* at 86,889 (seeking comment on whether the Rule should require issuers to deliver a copy of the solicitation document to each person from whom they solicit indications of interest—this suggestion derives from section 1(f) of the NASAA model, see *supra* note 308 and accompanying text).

mission would extend the concept beyond Regulation A may explain why few commenters submitted letters in response to the Testing Release, and why there has been a dearth of scholarly work written about the proposal since its introduction in June 1995.⁴⁵⁵ Nevertheless, the comments submitted to the SEC are important because they, in part, have contributed to the SEC's extended review of its proposal. Before the Testing Release, the Commission noted that its proposal to extend testing the waters to registered IPOs had received mixed reviews.⁴⁵⁶ As with Rule 254,⁴⁵⁷ responses to the proposal after the Release's publication were mixed.

2. *Controversial?*

Although not innovative, proposed Rule 135d, as with Rule 254 when the Commission introduced it, is extremely controversial. The Testing Release suggests that the SEC knew its proposal was controversial and expected the public comments to question its authority to adopt a rule that would introduce such sweeping change to the Securities Act. The Commission recapitulated the relevant language of sections 5(c) and 2(3) of the Securities Act, explaining how proposed Rule 135d constituted an exception to the gun-jumping prohibition.⁴⁵⁸ The SEC acknowledged that it was "cogizant that rulemaking in [the testing-the-waters] area is circumscribed by the statute's prohibition of conduct constituting an 'offer' prior to the filing of a registration statement."⁴⁵⁹ In addition, the SEC explained that under Rule 254, testing-the-waters measures constitute offers under section 2(3).⁴⁶⁰ The Commission also reiterated language from a 1957 release in which it had explained that prefiling publicity that is not "couched in terms of an express offer," but "contribute[s] to conditioning the public market or arousing public interest in an issuer or its

⁴⁵⁵ Commenters submitted thirteen responses, including two actiongrams, which briefly indicate a commenter's support of, or opposition to, the proposal. See Comment Letter File for S7-18-95 (on file with the SEC). By contrast, there were sixty-six comment letters submitted in response to the SBIs Release. See *supra* note 156. The more comprehensive nature of the SBIs may explain why that Release prompted more responses.

⁴⁵⁶ See *SEC Advisory Committee Moves Agenda Toward Model for Company Registration*, 27 Sec. Reg. & L. Rep. (BNA) 708, 709 (May 12, 1995) [hereinafter *Toward Model for Company Registration*].

⁴⁵⁷ See *supra* note 206 and accompanying text. It is important to recognize that the commenters have various personal and professional interests that help explain their positions regarding the Testing Release. Furthermore, the comments do not necessarily reflect the views of an individual commenter's entire organization, association, or firm. Unless the letter suggests otherwise, one should attribute the views to the individual who wrote the letter, or the committee to which the individual belongs.

⁴⁵⁸ Testing Release, *supra* note 8, at 86,891-92.

⁴⁵⁹ *Id.* at 86,891.

⁴⁶⁰ *Id.* at 86,892; see *supra* text accompanying note 213.

securities" may violate section 5(c).⁴⁶¹ In support of its authority to adopt proposed Rule 135d, the Commission cited its past experience in adopting rules such as Rules 135 and 135a-c, and in taking "interpretive positions" in releases regarding "application of the statute to other types of public communications made prior to the filing of a registration statement."⁴⁶² The SEC concluded by stating its intention to review the relevant statutory language as well as its past interpretations "in considering the historical scope of permissible 'test the waters' activities and the appropriateness of the provisions of proposed Rule 135d."⁴⁶³

Despite the undoubtedly controversial nature of the proposal, few public commenters, including NASAA, either questioned the Commission's authority or addressed the inherent difficulty of reconciling proposed Rule 135d with sections 5(c) and 2(3) of the Securities Act. Only one comment letter discussed this problem. Marc Steinberg, Professor of Law at Southern Methodist University and a former SEC attorney, responded that "proposed Rule 135d . . . is in contravention of [s]ection 5(c) of the Securities Act" and "'amounts to an effective administrative repeal of [section] 5(c) in the case of IPOs."⁴⁶⁴ According to Professor Steinberg, testing the waters under proposed Rule 135d represents an illegal offer to sell.⁴⁶⁵ Professor Steinberg added that the Rule allows an issuer to "'condition the market,' adversely affect[ing] unsophisticated investors."⁴⁶⁶

3. *Necessary?*

A few commenters expressed doubts as to whether proposed Rule 135d was necessary. According to this view, testing the waters before a registered IPO is unnecessary because professional underwriters work with the issuer to assess the viability of an IPO.⁴⁶⁷ Because an issuer usually needs an underwriter to conduct a registered IPO, this view suggests that rather than testing the waters, an issuer should let the

⁴⁶¹ Testing Release, *supra* note 8, at 86,891-92; *see supra* note 36 and accompanying text. The Commission posited the idea of testing the waters via a "simplified registration procedure" as a means of navigating around the gun-jumping problem. Testing Release, *supra* note 8, at 86,892.

⁴⁶² Testing Release, *supra* note 8, at 86,891 & n.66.

⁴⁶³ *Id.* at 86,892.

⁴⁶⁴ Comment Letter from Marc I. Steinberg, Rupert and Lillian Radford Professor of Law, Southern Methodist University School of Law, to Jonathan G. Katz, Secretary, SEC I (Aug. 30, 1995) [hereinafter Steinberg Comment Letter] (on file with the SEC) (quoting John C. Coffee, Jr., *Is the Securities Act of 1933 Obsolete? The SEC Increasingly Appears To Believe So But Has Not Yet Adopted a Consistent Policy To Replace It*, NAT'L L.J., Sept. 4, 1995, at B4).

⁴⁶⁵ *Id.*

⁴⁶⁶ *Id.*

⁴⁶⁷ *See* Comment Letter from Gary P. Kreider, Partner, Keating, Muething & Klekamp, to Jonathan G. Katz, Secretary, SEC I (July 24, 1995) [hereinafter Keating Comment Letter] (on file with the SEC).

underwriters assess the viability of an IPO.⁴⁶⁸ As a result, proponents of this position have commented:

It is difficult to imagine an issuer of the type involved in a normal IPO gaining anything from the "test the waters" concept. Regardless of the degree of advertising involved in this manner, an underwriter would make its own judgment as to the success of a real offering. The procedure would . . . be of benefit only to the most marginal of offerings, ones that could not normally make it in [the] regular IPO scenario.⁴⁶⁹

In the same vein, a school of thought argues that "the opportunity to test the waters for an IPO by floating promotional materials isn't necessary for mainstream companies whose products have already found a market; those firms . . . can get ample advice on the marketability of their stocks from investment bankers."⁴⁷⁰ Proposed Rule 135d would therefore be detrimental because it "would mainly benefit 'marginal companies' that pose riskier prospects for investors."⁴⁷¹

Similarly, there were commenters who questioned the need for proposed Rule 135d on the ground that the Commission was mistaken in thinking that small businesses incur considerable costs conducting IPOs that fail.⁴⁷² In support of this position, the Capital Markets Committee of the Securities Industry Association ("SIA"), a trade association representing over 700 securities firms in North America, maintains that only a few issuers have withdrawn their registrations after filing registration statements in preparation for an IPO.⁴⁷³ According to SIA, underwriters serve as "filters" that prevent an issuer from incurring substantial expenses if the IPO appears unlikely to succeed.⁴⁷⁴ Unlike attorneys and accountants, underwriters' compensation is contingent on consummation of the offering.⁴⁷⁵ Therefore, as a result of this "no consummation, no compensation" custom, underwriters are unlikely to underwrite an IPO that is unpromising.⁴⁷⁶ Furthermore, a failed IPO is also detrimental to an underwriter's reputation.⁴⁷⁷ These disincentives of zero compensation and negative

⁴⁶⁸ An issuer could attempt to self-underwrite a registered IPO, but this would be extremely difficult. See *infra* text accompanying notes 594-95.

⁴⁶⁹ Keating Comment Letter, *supra* note 467, at 1.

⁴⁷⁰ Jeffrey Taylor, *SEC To Approve Plan Permitting IPO Promotions: Firms Could Test Markets Before Formal Process; Critics Fear Risky Plays*, WALL ST. J., June 27, 1995, at A4.

⁴⁷¹ *Id.*

⁴⁷² See Comment Letter from Perry L. Taylor, Jr., Chairman, Capital Markets Committee of the Securities Industry Association, to Jonathan G. Katz, Secretary, SEC 2 (Sept. 19, 1995) [hereinafter SIA Comment Letter] (on file with the SEC).

⁴⁷³ *Id.* at 1 n.1, 2.

⁴⁷⁴ *Id.* at 2.

⁴⁷⁵ See *id.* at 3.

⁴⁷⁶ *Id.*

⁴⁷⁷ See *id.*

publicity render an underwriter a “gate keeper,” who carefully assesses “which private companies are ready for [public] markets and . . . prevent[s] companies from incurring the expenses that are part of a public offering when the likelihood of success is inadequate.”⁴⁷⁸ An IPO specialist commented that the intended benefits of proposed Rule 135d do not justify the reduction of “investor protection” because IPOs “‘are easy to do.’”⁴⁷⁹ In contrast to underwriters and IPO firms, management or business owners usually lack the experience necessary to determine if the market will be interested in an IPO.⁴⁸⁰ SIA questioned an issuer’s ability to properly assess the extent of investor interest in an IPO.⁴⁸¹ In short, these critics disagree with the Commission, arguing that the compliance costs are prohibitive only for “slaky investment schemes” that should not consider IPOs in the first place—not for “substantial business enterprise[s].”⁴⁸²

In fact, testing the waters under proposed Rule 135d may still be expensive for an issuer. In order to ensure full compliance with the proposed Rule and state laws, understand the ramifications of testing-the-waters activity, and avoid liability under the federal and state antifraud provisions, an issuer should still consult a lawyer. Legal fees and the expenses incurred in preparing, submitting, and distributing or broadcasting the solicitation materials may prohibit or discourage some potential issuers from testing the waters under the proposal.

Commenters, questioning the need for proposed Rule 135d, also feared that the proposal may hurt the public markets.⁴⁸³ To the extent investors are misled by pre-filing solicitations or suffer as a result of an ill-conceived offering, “a dilution of confidence in [the United States] capital markets” may result.⁴⁸⁴

Despite these comments, Part V below argues that a testing-the-waters rule is necessary. In particular, the foregoing commenters failed to discuss how the Rule might help businesses that are not “mainstream” and “whose products have [not] found a market” who may, primarily as a result of a successful testing-the-waters experience, be able to retain an underwriter.⁴⁸⁵

⁴⁷⁸ *Id.*

⁴⁷⁹ Peggie Elgin, *SEC’s Test-the-Water Program Could Cut IPO Expenses*, CORP. CASHFLOW, Nov. 1995, at 14, 17 (quoting Kathleen Smith, Analyst, Renaissance Capital).

⁴⁸⁰ See SIA Comment Letter, *supra* note 472, at 2-3.

⁴⁸¹ *Id.*

⁴⁸² Keating Comment Letter, *supra* note 467, at 2.

⁴⁸³ See, e.g., *id.*

⁴⁸⁴ SIA Comment Letter, *supra* note 472, at 4.

⁴⁸⁵ Taylor, *supra* note 470, at A4.

4. *Benefits for Issuers*

Most commenters responded that the proposal would help small businesses. Commenters appreciated the proposal's easing of the regulatory burdens on issuers and the flexibility it affords small businesses that are frequently forced to conduct Rule 505 or 506 offerings instead of IPOs due to the uncertainty of investor response to a public offering.⁴⁸⁶ According to the New York State Bar Association ("NYSBA"), the proposal will provide easier access to the capital markets for private businesses who are reluctant to go public due to the "high initial costs" and the risky nature of an IPO.⁴⁸⁷ The ABA also appreciated the value of giving issuers a chance to solicit indications of interest in an IPO of greater value than that permitted by the Regulation A ceiling.⁴⁸⁸ The ABA acknowledged that issuers who can secure the services of an experienced underwriter for a "firm commitment" underwriting⁴⁸⁹ are unlikely to use proposed Rule 135d.⁴⁹⁰ However, the ABA supported proposed Rule 135d because, among other reasons, it (i) gives issuers the opportunity to assess market interest before meeting with underwriters, and (ii) may permit underwriters to test the waters on behalf of issuers, both of which would enable more issuers to secure firm commitment underwritings.⁴⁹¹ Further, in the case of a "best efforts" underwriting⁴⁹² or a self-underwritten offering, the proposal will authorize issuers both to

⁴⁸⁶ See, e.g., Comment Letter from D. Craig Nordlund, Chairman, Securities Law Committee of the American Society of Corporate Secretaries, to Jonathan G. Katz, Secretary, SEC 1-2 (Sept. 7, 1995) [hereinafter American Society of Corporate Secretaries Comment Letter] (on file with the SEC); Comment Letter from John V. Helmick, Attorney, Hershner, Hunter, Moulton, Andrews & Neill, to Jonathan G. Katz, Secretary, SEC 1 (Sept. 8, 1995) [hereinafter Hershner Comment Letter] (on file with the SEC).

⁴⁸⁷ Comment Letter from Michael Iovenko, Chair, Committee on Securities Regulation of the Business Law Section of the New York State Bar Association, to Jonathan G. Katz, Secretary, SEC 1 (Sept. 7, 1995) [hereinafter NYSBA Comment Letter] (on file with the SEC); see also Comment Letter from Sullivan & Cromwell, to Jonathan G. Katz, Secretary, SEC 1-2 (Sept. 22, 1995) [hereinafter Sullivan & Cromwell Comment Letter] (on file with the SEC) (discussing financial constraints of the registration process).

⁴⁸⁸ Comment Letter from John M. Liftin et al., Chairpersons, Committees on Federal Regulation of Securities, State Regulation of Securities, and Small Business Committee of the ABA, to Jonathan G. Katz, Secretary, SEC 21 (Oct. 25, 1995) [hereinafter ABA Comment Letter] (on file with the SEC).

⁴⁸⁹ In a firm commitment underwriting, the underwriter agrees to buy the securities offered and then resells the shares to the public. See LIPMAN, *supra* note 78, at 50; SCHNEIDER ET AL., *supra* note 78, at 31. For a discussion of the difference between "firm commitment" and "best efforts" underwritings, see LIPMAN, *supra* note 78, at 50-51; 1 LOSS & SELIGMAN, *supra* note 112, at 324-42.

⁴⁹⁰ ABA Comment Letter, *supra* note 488, at 21.

⁴⁹¹ *Id.*

⁴⁹² In a best efforts underwriting, the underwriter agrees to make its best efforts to sell the securities, but is not obligated to sell the securities unless it finds enough investors to buy all of the shares or an amount established in the underwriting agreement. See SCHNEIDER ET AL., *supra* note 78, at 31-32.

ascertain whether an IPO would sell and to tailor the offering to the wishes of the market before it must shoulder considerable expenses.⁴⁹³ In short, the proposal makes a registered IPO a more feasible avenue for raising capital.

In fact, several commenters advocated a further extension of the availability of testing the waters to help still more issuers. For example, the ABA recommended that proposed Rule 135d contain language expressly permitting underwriters and other agents to solicit indications of interest on an issuer's behalf.⁴⁹⁴ Sullivan & Cromwell, a large corporate law firm, opined that in light of the difficulties foreign companies face in determining market interest in the United States, the proposal should expressly permit foreign and sovereign issuers to test the waters.⁴⁹⁵ Some commenters suggested that the Commission remove certain types of issuers from proposed Rule 135d(a)(1)'s exclusionary provision to enable more issuers to test the waters.⁴⁹⁶ Finally, many commenters encouraged the Commission to extend the availability of testing the waters beyond the Regulation A and registered IPO markets. A common suggestion was to repeal or amend Rule 502(c)'s prohibition on general solicitation, facilitating issuers' ability to test the waters and subsequently conduct Rule 505 and 506 offerings.⁴⁹⁷ One commenter even advocated the expansion of test-

⁴⁹³ See ABA Comment Letter, *supra* note 488, at 21.

⁴⁹⁴ *Id.* at 22.

⁴⁹⁵ Sullivan & Cromwell Comment Letter, *supra* note 487, at 2.

⁴⁹⁶ See, e.g., ABA Comment Letter, *supra* note 488, at 20 (commenting that "the exclusion of 'direct participation investment programs' is unnecessary and, as proposed to be defined, is excessively broad and would unnecessarily deprive many legitimate operating companies of the benefits of the rule merely because they chose to organize in other than corporate form"); Comment Letter from Tony M. Edwards, Vice President and General Counsel, National Association of Real Estate Investment Trusts, to Jonathan G. Katz, Secretary, SEC 2-3 (June 6, 1996) [hereinafter NAREIT Comment Letter] (on file with the SEC) (maintaining that real estate investment trusts should not be excluded from the proposal); Sullivan & Cromwell Comment Letter, *supra* note 487, at 2 (responding that proposed Rule 135d should be available to all classes of issuers with the exception of blank check and penny stock issuers). *But see* Comment Letter from Michael S. Caccese, Senior Vice President, General Counsel & Secretary, Association for Investment Management and Research, to Jonathan G. Katz, Secretary, SEC 4 (Sept. 8, 1995) [hereinafter AIMR Comment Letter] (on file with the SEC) (finding that the Commission's "exclusions are appropriate for the reasons set forth in the [Testing] Release"); NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,052-53 (recommending (i) exclusion of "businesses that engage in extractive industries," and (ii) inclusion of catch-all and bad boy disqualification provisions).

⁴⁹⁷ See, e.g., ABA Comment Letter, *supra* note 488, at 23-24; AIMR Comment Letter, *supra* note 496, at 3, 6-7; Hershner Comment Letter, *supra* note 486, at 1; NYSBA Comment Letter, *supra* note 487, at 3-4. NASAA has already indicated its willingness to permit issuers to test the waters before Rule 504 offerings. See *supra* text accompanying note 324.

ing-the-waters privileges to issuers considering an exempt offering abroad under Regulation S.⁴⁹⁸

5. *Investor Protection*

Some commenters were satisfied that proposed Rule 135d contained enough safeguards to protect investors.⁴⁹⁹ For example, the ABA concluded that the threat of liability under the antifraud provisions of the federal securities laws, the twenty-day waiting period, and cautionary language requirements for the solicitation materials provided prospective investors with sufficient protection.⁵⁰⁰ Furthermore, some commenters pointed out that investors would still enjoy protection not only under the regular registration process that would precede a public sale of securities, but also from the documentation distributed before any exempt offering.⁵⁰¹

Commenters generally approved of the Commission's decision to require issuers to make only limited disclosures in the solicitation materials while allowing issuers to disseminate any factually accurate information.⁵⁰² In light of the deterrent power of the general antifraud provisions, these commenters were not concerned that this would harm investors.⁵⁰³ Similarly, commenters supported the Commission's emphasis on permitting dissemination via a wide range of media.⁵⁰⁴ In fact, the responses of certain commenters suggest that the proposal may go too far in protecting investors. The NYSBA, for instance, proposed limiting application of the filing requirement to situations where an issuer commences an IPO after testing the waters.⁵⁰⁵ Both the Association for Investment Management and Re-

⁴⁹⁸ See, e.g., Sullivan & Cromwell Comment Letter, *supra* note 487, at 6-7. The SEC could accomplish such an extension by exempting solicitation materials from Regulation S's proscription of "directed selling efforts." *Id.*

⁴⁹⁹ See, e.g., ABA Comment Letter, *supra* note 488, at 21-22; AIMR Comment Letter, *supra* note 496, at 3-6; Hershner Comment Letter, *supra* note 486, at 1; NYSBA Comment Letter, *supra* note 487, at 1-2; Sullivan & Cromwell Comment Letter, *supra* note 487, at 3-6.

⁵⁰⁰ ABA Comment Letter, *supra* note 488, at 21-22.

⁵⁰¹ See, e.g., AIMR Comment Letter, *supra* note 496, at 3; Sullivan & Cromwell Comment Letter, *supra* note 487, at 3.

⁵⁰² See, e.g., ABA Comment Letter, *supra* note 488, at 22; Sullivan & Cromwell Comment Letter, *supra* note 487, at 4. *But see* AIMR Comment Letter, *supra* note 496, at 4-5 (advocating additional disclosure, but opposing inclusion of highly specific pricing information regarding the offering, unaudited financials, and forward-looking statements).

⁵⁰³ See ABA Comment Letter, *supra* note 488, at 22; Sullivan & Cromwell Comment Letter, *supra* note 487, at 4; *see also* NYSBA Comment Letter, *supra* note 487, at 2 (supporting the SEC's decision to rely on the antifraud provisions to protect investors).

⁵⁰⁴ See, e.g., AIMR Comment Letter, *supra* note 496, at 5; Sullivan & Cromwell Comment Letter, *supra* note 487, at 5-6.

⁵⁰⁵ NYSBA Comment Letter, *supra* note 487, at 3 (contending that "[t]he mere existence of the filing requirement may well negatively impact the desire of private companies, not subject to the jurisdiction of the SEC to so subject themselves prior to a determination to have an IPO").

search ("AIMR"), an international nonprofit organization comprised of more than 50,000 members and candidates employed in investment management, and Sullivan & Cromwell even went so far as to oppose proposed Rule 135d(a)(3)'s requirement that issuers submit a copy of the testing materials to the Commission before they use them to solicit indications of interest.⁵⁰⁶ AIMR also objected to the proposal's restrictions on the content of the coupon an issuer may include with its soliciting materials.⁵⁰⁷

However, as expected, other commenters' concerns regarding the proposal's insufficient protection of investors prompted them to oppose the entire proposal. Reflective of this position was the comment that "the cost to public investors of this proposal far outweighs any benefit to legitimate issuers."⁵⁰⁸ Many of these concerns echoed those made in response to Rule 254.⁵⁰⁹ For example, one commenter charged that proposed Rule 135d left investors too vulnerable to fraud and misrepresentation.⁵¹⁰ There was also concern that in "permitting IPO issuers to 'condition the market,'" proposed Rule 135d "adversely affects unsophisticated investors."⁵¹¹ The principals of potential issuers, unlike underwriters, generally lack experience in soliciting investors.⁵¹² Unfamiliar with federal and state securities laws and eager to promote their offerings, principals may "lack either the experience or self-restraint to ignore the sudden rush of interest in their companies and the opportunity for free advertising."⁵¹³ Therefore, during the solicitation process, such issuers may illegally sell securities or engage in overreaching and puffing; in short, critics of the proposal believe that issuers who test the waters under proposed Rule 135d may actually be "poisoning the waters."⁵¹⁴

In contrast, NASAA, a vociferous critic of Rule 254's inadequate investor protection, did not reject proposed Rule 135d due to its insufficient investor protection. NASAA submitted a brief comment letter in response to the Testing Release.⁵¹⁵ The Association reiterated its support for "the policy of facilitating capital formation by allowing

⁵⁰⁶ AIMR Comment Letter, *supra* note 496, at 1 n.1, 4-6; Sullivan & Cromwell Comment Letter, *supra* note 487, at 5.

⁵⁰⁷ AIMR Comment Letter, *supra* note 496, at 5.

⁵⁰⁸ Keating Comment Letter, *supra* note 467, at 1; *see also id.* at 2 (concluding that the "proposal should be abandoned as being contrary to the interest of investors and the integrity of the public markets. It is a proposal not worthy of the Commission.").

⁵⁰⁹ *See supra* notes 229-58 and accompanying text.

⁵¹⁰ *See* Keating Comment Letter, *supra* note 467, at 2.

⁵¹¹ Steinberg Comment Letter, *supra* note 464, at 1.

⁵¹² *See* SIA Comment Letter, *supra* note 472, at 3-4.

⁵¹³ *Id.* at 3.

⁵¹⁴ *Id.*

⁵¹⁵ For discussion of NASAA's longer, more acrimonious comment letter submitted in response to the SBIs Release, *see supra* text accompanying notes 243-47, 278-82.

a company to make an early assessment of the public interest in the purchase of its securities."⁵¹⁶ However, NASAA added that it "believe[d] that, at least on the state level, there is a need for a regulatory structure that assures that those who utilize this process are not problematic and those investors that are solicited are not preconditioned to such an extent that the final document is meaningless."⁵¹⁷ The way to achieve these two elements of investor protection, according to NASAA, was to pattern proposed Rule 135d on the NASAA model rule, which contains safeguards protecting both investors and issuers.⁵¹⁸ After summarizing the key provisions of its model, NASAA concluded that "*within the structure of our Model Rule, we believe that expanding the opportunity to 'test the waters' beyond Regulation A to registered offering[s] will be beneficial to capital formation and will not compromise investor protection.*"⁵¹⁹

NASAA was thus satisfied with the provisions of proposed Rule 135d that resembled sections of its model rule or comported with its findings after the pilot project. For example, NASAA agreed with the Commission's decision not to limit what an issuer may disclose in the solicitation materials.⁵²⁰ Similarly, NASAA reached the same conclusion as the ABA and NYSBA that the antifraud provisions of the federal securities laws provide investors with adequate protection from fraudulent or misleading solicitations.⁵²¹ On the other hand, NASAA suggested ways in which the SEC could further protect investors. For example, the Association advocated that the Commission further restrict who may test the waters in reliance on the Rule.⁵²² In addition, NASAA recommended that proposed Rule 135d impose restrictions on cold calling, a means of dissemination that, as states in the pilot program discovered, was prone to abuse.⁵²³ NASAA also suggested that the SEC could further protect investors by incorporating a cooling-off period that resembles the seven-day period section (1) (h) of its

⁵¹⁶ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,052.

⁵¹⁷ *Id.*

⁵¹⁸ *Id.*; see *supra* Part III.C.1.

⁵¹⁹ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,053 (emphasis added).

⁵²⁰ *Id.*

⁵²¹ *Id.*; ABA Comment Letter, *supra* note 488, at 21-22; NYSBA Comment Letter, *supra* note 487, at 2. Therefore, NASAA, the ABA, and the NYSBA opposed the establishment of section 11 or section 12(a)(2) of the Securities Act as the "standard of liability." Imposition of the higher standard of liability under sections 11 or 12(a)(2) would dramatically increase the cost of testing the waters because an issuer would then certainly want to consult a lawyer before delivering, broadcasting, publishing, or transmitting its solicitation materials. See NYSBA Comment Letter, *supra* note 487, at 2; *infra* Part V.F.5.

⁵²² NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,052-53.

⁵²³ *Id.* at 13,053; see also Keating Comment Letter, *supra* note 467, at 2 (recommending a ban on telephone solicitation because of "policing" problems).

model rule prescribes.⁵²⁴ With respect to extending the testing-the-waters proposal to other exempt offerings, NASAA expressed its willingness to work with the Commission to reach an agreeable solution.⁵²⁵ On the ground that twenty days was too short a waiting period, NASAA opposed the Commission's proposal that twenty days after an issuer has ceased testing the waters, it could conduct a private placement.⁵²⁶ NASAA thus had concerns regarding investor protection, but appeared confident that if the Commission followed NASAA's model rule, it could cure the proposal's deficiencies.

6. Coordination

Before the NSMIA, coordination of proposed Rule 135d with blue sky laws was considered essential for the proposal to be effective.⁵²⁷ NASAA addressed the importance of coordination when it wrote, "We support any move toward making our two rules as uniform as possible. . . ."⁵²⁸ Nevertheless, a careful reading of NASAA's comment letter suggests that the state securities regulators may not support the proposal unless it incorporates more of the safeguards found in the NASAA model rule.⁵²⁹

Following publication of the Testing Release, the SEC began taking measures to align federal and state law with respect to testing the waters. For example, at the annual 1996 Conference on Uniformity of Securities Law attended by representatives of the Commission and NASAA, the testing-the-waters proposal was on the agenda.⁵³⁰ The conferees were scheduled to discuss how Rule 254 has affected issuers and investors through a "review [of] their experience with amended Regulation A and the use of 'test the waters' documents."⁵³¹

⁵²⁴ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,053. Investors currently have only forty-eight hours to review the prospectus before a broker or dealer is required to mail the confirmation of a sale. See Testing Release, *supra* note 8, at 86,890 (citing Rule 15c2-8, 17 C.F.R. § 240.15c2-8 (1997)). AIMR also commented that forty-eight hours was insufficient. AIMR Comment Letter, *supra* note 496, at 6.

⁵²⁵ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,053.

⁵²⁶ *Id.*; see also Keating Comment Letter, *supra* note 467, at 2 (recommending "[a] longer safe harbor, such as three to six months"). For discussion of the SEC's proposal, see *supra* text accompanying notes 433-34.

⁵²⁷ See, e.g., 3A BLOOMENTHAL, *supra* note 11, § 6.09, at 6-28. These concerns predated the NSMIA. For a discussion of how the NSMIA obviates most of these concerns, see *infra* Part V.D.

⁵²⁸ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,052. The Association also stated its amenability to working with the SEC on a possible change to the current prohibitions on general solicitation and advertising under Rules 505 and 506. *Id.* at 13,053.

⁵²⁹ See *supra* text accompanying note 519.

⁵³⁰ See Securities Uniformity; Annual Conference on Uniformity of Securities Law, Securities Act Release No. 7277, 61 Fed. Reg. 15,847, 15,849 (Apr. 9, 1996).

⁵³¹ *Id.*

D. The Commission's Response

1. *A Lengthy Review*

In stark contrast to its race to adopt the SBIs,⁵³² the SEC has taken its time considering the pros and cons of proposed Rule 135d. Although the comment period ended on September 8, 1995, the SEC continued to accept comment letters submitted much later.⁵³³ Perhaps the mixed reactions to the proposal have made the SEC hesitant. However, there was an even greater disparity of opinion regarding the SBIs which did not delay the Commission's adoption of Rule 254.⁵³⁴

There are a number of other possible reasons for the Commission's judicious delay in making a determination on testing the waters. While the IPO market has remained strong, its appeal cannot compare to the political pressure which drove the SEC to adopt the SBIs before the 1992 election.⁵³⁵ Unlike in 1992, the SEC, through a review of solicitations of interest in reliance on Rule 254, now has the opportunity to assess how testing the waters functions in practice. This has given the Commission a chance to tailor its proposal accordingly, work with NASAA to try to coordinate state securities regulations with the federal rule, and avoid criticism for hastily adopting a controversial proposal.

The controversial nature of the proposal has also contributed to the Commission's protracted review. Proposed Rule 135d is a more controversial proposal than Rule 254, for it directly clashes with section 5(c) of the Securities Act.⁵³⁶ Furthermore, the Commission acknowledged in the Testing Release that section 5(c) ties the agency's hands when it comes to rulemaking in connection with prefilings solicitations.⁵³⁷ The Commission's defense of its authority to make rules regarding prefilings publicity and its promise to consider other alternatives prompted a scholar to remark that "[i]n proposing Rule 135d with such unusual tentativeness, the Commission seems to be testing the waters itself."⁵³⁸

While this initial tentativeness has endured, the Commission's eagerness to extend testing the waters beyond Regulation A has not wavered. The Commission has repeatedly stated that an expansion of testing the waters remains a priority. For example, at a speech in late January 1997, one-and-a-half years after the SEC published the Testing Release, the Chairman of the SEC reiterated: "[W]e should permit

⁵³² See *supra* note 151 and accompanying text.

⁵³³ See, e.g., NAREIT Comment Letter, *supra* note 496 (dated June 6, 1996).

⁵³⁴ See Comment Letter File for S7-4-92 (on file with the SEC).

⁵³⁵ See *supra* notes 148-51 and accompanying text; text accompanying note 288.

⁵³⁶ See *infra* Part V.A.3.

⁵³⁷ See *supra* text accompanying note 459.

⁵³⁸ 3A BLOOMENTAL, *supra* note 11, § 6.09, at 6-30.

some form of 'testing the waters' in more offerings. . . . I don't want to make . . . this sound too easy; as always, the devil is in the details. But I believe that we can and should make progress in [this] . . . area[] soon."⁵³⁹ In addition to wrestling with these details and coordinating them with the states, the Commission has struggled with the issue of its authority. In the past, the SEC has asserted that it would welcome a grant of general "exemptive authority which would make it easier for the Commission to implement . . . the pending 'test-the-waters' proposal."⁵⁴⁰ Pursuit of general exemptive authority was undoubtedly a higher priority for the SEC in 1996 than the adoption of the Testing Release.

Enacted in October 1996, the NSMIA has accorded the Commission this general exemptive authority.⁵⁴¹ The SEC can rely on this authority to exempt issuers that test the waters from the section 5 requirements.⁵⁴² However, as discussed above, the Commission may exercise this authority only "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors."⁵⁴³ The SEC must therefore first establish both of these points, which will require an extensive inquiry.⁵⁴⁴ The Commission has not yet invoked its section 28 authority to adopt proposed Rule 135d.

2. *The Potential Disarmament of Section 5(c)*

The availability of this general exemptive authority may forebode the end of the section 5(c) gun-jumping prohibition.⁵⁴⁵ Critics of the gun-jumping prohibition and other scholars have discussed its "obsolescence,"⁵⁴⁶ "metaphysical" and "hyper-technical" nature,⁵⁴⁷ and its potential to lead to inconsistent results.⁵⁴⁸ Linda Quinn, former Director of the SEC's Division of Corporation Finance, has observed that in the modern age of technology, it may "no longer [be] possible . . . to expect that information flows to investors can be limited effec-

⁵³⁹ Arthur Levitt, Corporate Finance in the Information Age, Remarks at the Securities Regulation Institute (Jan. 23, 1997), available in 1997 WL 24362 (S.E.C.), at *6.

⁵⁴⁰ S. REP. NO. 104-293, at 15 (1996).

⁵⁴¹ See *supra* note 226.

⁵⁴² See Rowe, *supra* note 226, at 8.

⁵⁴³ NSMIA, *supra* note 22, at 3424 (codified at 15 U.S.C. § 77z-3 (Supp. II 1996)); see also *supra* note 226 (discussing the Commission's general exemptive authority).

⁵⁴⁴ See *infra* Part V.B-C.

⁵⁴⁵ See Rowe, *supra* note 226, at 8.

⁵⁴⁶ See Coffee, *supra* note 60, at 1150; Michael McDonough, Comment, *Death in One Act: The Case for Company Registration*, 24 PEPP. L. REV. 563, 598 (1997); Coffee, *supra* note 464, at B4; see also Chiappinelli, *supra* note 30 (arguing for the elimination of the gun-jumping prohibition).

⁵⁴⁷ McDonough, *supra* note 546, at 596, 598-602; Gerald S. Backman & Stephen E. Kim, *A Cure for Securities Act Metaphysics: Integrated Registration*, INSIGHTS, May 1995, at 18, 18.

⁵⁴⁸ See McDonough, *supra* note 546, at 600-02; Backman & Kim, *supra* note 547, at 18.

tively."⁵⁴⁹ The adoption of Rule 254 has ushered in a more liberal SEC attitude towards gun-jumping.⁵⁵⁰ As a distinguished scholar in the securities field concluded in September 1995, proposed Rule 135d represents such a radical departure from the Commission's historical prohibition on gun-jumping that it "can be understood only as reflecting an implicit judgment that Sec[tion] 5(c) has become obsolete and imposes regulatory costs in excess of its benefits."⁵⁵¹

The Commission thus has recently re-evaluated the utility of the gun-jumping prohibition.⁵⁵² A July 1996 report by the Advisory Committee on Capital Formation and Regulatory Processes (the "Advisory Committee") further hints that the SEC may be approaching this conclusion.⁵⁵³ The Advisory Committee Report even suggests that the gun-jumping prohibition may actually harm investors.⁵⁵⁴ According to the Advisory Committee,

[A]lthough the gun-jumping doctrine may serve to protect purchasers in the offering by hindering circumvention of the registration requirements, it also may chill or delay the disclosure of some company-related information that is beneficial to the marketplace. The Committee questioned whether the chilling effect of the gun-jumping doctrine serves investor protection when the issuer is required to supply the markets with extensive public disclosures on an ongoing basis through its Exchange Act filings.⁵⁵⁵

This argument closely resembles the Commission's traditional policy interpretation that the gun-jumping ban necessitates a balancing of the competing interests of encouraging disclosure and protecting investors.⁵⁵⁶ The difference is that the tone has changed. The Commission's historical deference to the gun-jumping prohibition appears to have given way to skepticism regarding its value.⁵⁵⁷ The testing-the-waters issue has precipitated debate challenging a part of the

⁵⁴⁹ Linda C. Quinn, *Reforming the Securities Act of 1933: A Conceptual Framework*, INSIGHTS, Jan. 1996, at 25, 28.

⁵⁵⁰ See Hoyns, *supra* note 30, at 9.

⁵⁵¹ See Coffee, *supra* note 464, at B4; see also McDonough, *supra* note 546, at 598-601 (agreeing with Professor Coffee's assessment).

⁵⁵² Coffee, *supra* note 464, at B6 (commenting that the "SEC is coming to view Sec[tion] 5 as antiquated and possibly an obstacle to efficient capital formation").

⁵⁵³ Report of the Advisory Committee on the Capital Formation and Regulatory Processes, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,834, at 88,403 (July 24, 1996) [hereinafter Advisory Committee Report].

⁵⁵⁴ *Id.* at 88,444.

⁵⁵⁵ *Id.*

⁵⁵⁶ See *supra* note 69.

⁵⁵⁷ See Coffee, *supra* note 60, at 1149-53 (explaining that even ten years ago, the gun-jumping prohibition was a "[s]tatutory norm[] . . . treated as inviolate," but recently it "has been disrupted by major SEC staff initiatives"); see also McDonough, *supra* note 546, at 600 (describing section 5(c) as one of the "basic concepts once considered indispensable to the Securities Act").

bedrock of the Securities Act. This debate may ultimately revolutionize the registration process, going far beyond helping small businesses launch registered IPOs.⁵⁵⁸ The SEC has perhaps shelved consideration of proposed Rule 135d until it can adopt the proposal as part of a broader reform of the Securities Act.⁵⁵⁹ The seriousness of this undertaking further explains the SEC's delay in proceeding with proposed Rule 135d.⁵⁶⁰

V

RESTORING THE BALANCE—AN ASSESSMENT OF THE TESTING-THE-WATERS PROPOSAL

A. Proposed Rule 135d and Section 5(c)

1. *The Authority Issue*

Although some observers have questioned the Commission's authority to adopt proposed Rule 135d,⁵⁶¹ the language of section 19(a)⁵⁶² of the Securities Act, in effect as of the publication of the Testing Release, suggests that the agency does in fact have such authority.⁵⁶³ Section 19(a) grants the Commission the "authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter [the Securities Act], including . . . defining accounting, technical, and trade terms used in this subchapter."⁵⁶⁴ The statute further provides that "[t]he rules and regulations of the Commission shall be effective upon publication in the manner which the Commission shall prescribe."⁵⁶⁵ Perhaps one could argue that the proposed rule is not "necessary to carry out the provisions" of the statute. However, as the ABA commented, the SEC has relied in the past on this grant of authority to make rules in which it has defined the terms "offer" and "prospectus."⁵⁶⁶ Proposed Rule 135d would refine the definition of

⁵⁵⁸ See *infra* Part V.B.4.

⁵⁵⁹ See *infra* notes 652-54 and accompanying text.

⁵⁶⁰ See NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9381.

[F]rom a broader perspective, it strikes us that this proposal may represent a major conceptual change in the Commission's implementation of the Securities Act by providing for vastly different treatment of offers and sales. While we cannot predict the possible consequences of such a fundamental change, we . . . think the Commission should proceed very carefully in tampering with a regulatory approach which has served us well for almost 60 years.

Id.

⁵⁶¹ See, e.g., 3A BLOOMENTHAL, *supra* note 11, § 6.09, at 6-29 to 6-30.

⁵⁶² 15 U.S.C. § 77s(a) (1994).

⁵⁶³ *Id.*

⁵⁶⁴ *Id.*

⁵⁶⁵ *Id.*

⁵⁶⁶ ABA Comment Letter, *supra* note 488, at 22; see, e.g., 17 C.F.R. §§ 230.134-230.139 (1997).

"offer" by excluding from the term's scope solicitations of interest made in accordance with the Rule. As Linda Quinn explained, "[T]he authority to define terms under the Securities Act has been used by the Commission over the past sixty years to take communications outside the scope of [s]ection 5 where it believed the basic purposes of the Securities Act would be served."⁵⁶⁷ This history, in conjunction with the express language of section 19(a), establishes that the Commission possesses the authority to draft and adopt the Rule.

If adopted, proposed Rule 135d, like Rules 135a-c, would enable an issuer that has fully complied with the Rule to disseminate certain pre-filing publicity without violating section 5. The Commission's proposal to exclude testing-the-waters activity from the definition of "offer" via the creation of Rule 135d is analytically sound and consistent with how it has previously chosen to legitimize pre-filing publicity under the securities laws.⁵⁶⁸ Therefore, if adopted, the proposal properly exempts solicitation materials from the requirements of section 5.

Enacted after the publication of the Testing Release, the NSMIA confers further authority on the Commission to adopt proposed Rule 135d. New section 28 of the Securities Act, which grants the SEC general exemptive authority, empowers the Agency to exempt issuers that test the waters from the requirements of section 5(c).⁵⁶⁹

Furthermore, the SEC has not abused its authority. The Commission has not unilaterally adopted a rule and foisted it upon the public. Rather, it has worked cooperatively to draft a rule that attempts to help issuers, protect investors, and strengthen the capital markets. The extensive comment period and consideration of NASAA's proposal exemplify the Commission's efforts to involve others in the rulemaking process. Demonstrating its careful deliberation, the Commission has still yet to act with respect to the proposal.

2. *Epitome of Gun-Jumping*

Skepticism as to the Commission's authority to promulgate Rule 135d perhaps arose because of the proposal's far-reaching implications. Soliciting indications of interest before an IPO is precisely the type of conduct that section 5(c) was designed to address. As Part I discussed, the Commission and the courts have interpreted the term "offer" very broadly.⁵⁷⁰ Section 2(3) "scarcely could define the term 'offer' more broadly than it does."⁵⁷¹ For the purposes of section 5,

⁵⁶⁷ Quinn, *supra* note 549, at 28.

⁵⁶⁸ See *supra* text accompanying notes 566-67.

⁵⁶⁹ See *supra* text accompanying notes 542-43.

⁵⁷⁰ See *supra* notes 32-55 and accompanying text.

⁵⁷¹ Coffee, *supra* note 464, at B4.

the courts and the SEC have construed an "offer" to include prefiling publicity that does not constitute an "express offer," but "contribute[s] to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer."⁵⁷² An issuer that tests the waters will not eschew "arousing public interest" in its issue, for a favorable reception to its potential offering is precisely what the issuer desires. It is difficult to conceive of how a well-prepared solicitation via a radio or television advertisement, a cold call, or a personal visit to a prospective investor would not have the effect of at least "conditioning the public mind," if not "arousing public interest." The coupon, which an investor can complete and return to the issuer, memorializes the "arous[al]" of its interest. Therefore, the proposal is inconsistent with section 5(c) of the Securities Act. The Commission clearly lacks the authority to adopt on its own a revision to section 5(c), which would require Congressional approval. The SEC was forced to adopt a testing-the-waters rule by a different avenue.

Furthermore, the current rules and regulations promulgated under the Securities Act do not provide a safe harbor for solicitations of indications of interest before a registered IPO. Rule 135, which allows issuers to publicize certain information without triggering section 5, cannot shield testing-the-waters activities. The testing-the-waters proposal establishes only minimum requirements for the solicitation materials, permitting an issuer to communicate or publicize unlimited information by any means available, including direct contact with investors, as long as the information is factually accurate.⁵⁷³ This goes far beyond the publicity that Rule 135 permits.⁵⁷⁴ Similarly, proposed Rule 135d authorizes an issuer to disseminate prefiling publicity that is much more detailed and potentially more harmful than that permitted under Rules 135a-c.⁵⁷⁵

3. *Effective Repeal of Section 5(c)*

Therefore, in order to adopt a rule that permits testing-the-waters before registered IPOs, the SEC needed to invoke its rulemaking authority⁵⁷⁶ to propose a new exception to the gun-jumping prohibition. The Commission justified this exception on the ground that it would

⁵⁷² Publication of Information Release, *supra* note 34, at 3149.

⁵⁷³ Rule 254, the NASAA model, and proposed Rule 135d all require issuers to make certain disclosures in the solicitation document or scripted broadcasts, but do not limit what they may impart to prospective investors via solicitation documents, broadcasts, or oral communications beyond the requirement of factual accuracy. See Keller Enterprises No-Action Letter, *supra* note 249, at 78,752 ("Rule 254(b)(2)(iv) does not limit the information that may be included in Rule 254 materials[;] . . . [i]nstead, Rule 254(b)(2)(iv) sets forth the minimum amount of information that must be provided.")

⁵⁷⁴ See *supra* notes 48-57 and accompanying text.

⁵⁷⁵ See *supra* text accompanying notes 59-60.

⁵⁷⁶ See *supra* text accompanying notes 562-64.

help many small businesses unable or unwilling to incur the substantial compliance costs and burdens of conducting a registered IPO without some confidence that its offering will sell.⁵⁷⁷ Despite the legitimacy of this claim, the broad definition of "offer" in section 2(3), case law, and SEC releases reviewed in Part I reveal that "in the past this rationale would not have justified a rule that amounts to an effective administrative repeal of Sec[ti]on 5(c) in the case of IPOs."⁵⁷⁸

The problem is that the exception has such broad ramifications that it swallows up the rule codified in section 5(c). The fundamental policy aim of the Securities Act is the protection of investors.⁵⁷⁹ Therefore, a proper exception to a rule can be justified only (i) if the exception represents a limited intrusion upon the policy underlying the rule or (ii) if the exception is adopted because a competing interest in certain cases justifies trumping the policy behind the rule.

In response to these two justifications for a proper exception to section 5(c), this Note begins with the assumption that the key to securities regulation, and to the success of the securities industry, is the maintenance of the balance between facilitating capital formation and protecting investors.⁵⁸⁰ Therefore, one must try to assess the proposal's impact on issuers and investors based on an analysis of the proposed rule, as drafted,⁵⁸¹ and on the empirical data regarding testing-the-waters activity under Rule 254 and other state-adopted rules.⁵⁸² If proposed Rule 135d (i) is unlikely to compromise investor protection, and (ii) is likely to effectuate the goal of improving small businesses' access to capital with only a minimal impact on investor protection, it is a proper exception to section 5(c). This Note concludes that testing the waters under proposed Rule 135d, as drafted, does not meet these two criteria. In short, proposed Rule 135d appears to tilt the balance too far in favor of issuers, which is neither a limited intrusion nor a satisfactory result, even if the proposal helps businesses raise capital. Consequently, testing the waters is not an exception to sec-

⁵⁷⁷ Testing Release, *supra* note 8, at 86,886.

⁵⁷⁸ Coffee, *supra* note 464, at B4. For a discussion of how a repeal of section 5(c) to allow testing the waters before registered IPOs may usher in other changes to the registration process, see *infra* Part V.B.4.

⁵⁷⁹ See *supra* note 63 and accompanying text.

⁵⁸⁰ The SEC believes in the same fundamental assumption. See, e.g., Proposing SBIs Release, *supra* note 3, at 82,483. As discussed above in Part IV.D.2, there is currently some skepticism with respect to the value of the gun-jumping proscription. The gun-jumping prohibition remains valuable only if it successfully protects investors. Skeptics contend that the ban on gun-jumping may harm investors by denying them access to significant information. See *supra* text accompanying note 555. Therefore, much like advocates of the gun-jumping prohibition, these skeptics emphasize the importance of this balance; however, they disagree as to the means to achieve it.

⁵⁸¹ See *infra* Part V.B.

⁵⁸² See *infra* Part V.C.

tion 5(c), but rather, a repeal of the statute, its related case law, and SEC rules and interpretive positions.⁵⁸³

B. The Impact of the Proposal on Paper

1. Issuers

The value of proposed Rule 135d to issuers varies depending on the nature of the issuer. For example, a large company that has an established customer base and a market following and is contemplating a registered IPO valued at \$15 million or higher probably does not need to test the waters.⁵⁸⁴ Such a company probably already knows the extent to which the market is interested in its IPO. Further, this larger business can engage an underwriter who has experience in ascertaining public interest.⁵⁸⁵ This company can probably also secure

⁵⁸³ A possible response to this claim that testing the waters under proposed Rule 135d is irreconcilable with section 5(c) is that the gun-jumping prohibition is obsolete, and therefore unnecessary. See *supra* note 546 and accompanying text. The Advisory Committee, for example, questioned the benefits to investors of the gun-jumping prohibition. See *supra* text accompanying notes 554-55. Although an assessment of the value of the prohibition is beyond the scope of this Note, it is important to show that this possible response may be infirm, for a determination that the gun-jumping ban is unnecessary does not necessarily translate into support for proposed Rule 135d. A careful reading of the Advisory Committee Report reveals that the Committee and similar skeptics should actually oppose proposed Rule 135d if it inadequately protects investors. The Advisory Committee was concerned that the prohibition may harm investors by "chill[ing] or delay[ing] the disclosure [by issuers] of some company-related information that is beneficial to the marketplace." Advisory Committee Report, *supra* note 553, at 88,444 (emphasis added). In the Advisory Committee Report, "[t]he Committee unanimously recommend[ed] that the Commission act promptly both to strengthen existing investor safeguards and to reduce the costs of corporate capital formation in the United States." *Id.* at 88,404 (emphasis added). Therefore, given that the Committee sought to improve investor protection, if proposed Rule 135d lacks enough safeguards that offer this protection, the Committee should oppose the proposal in spite of the likely reduction in the costs of capital formation.

Further, the Advisory Committee Report suggests that the Committee's skepticism largely does not apply to gun-jumping before a registered IPO. The Advisory Committee expressed its skepticism as to the need for the prohibition in light of issuers' mandatory "ongoing" disclosure responsibilities under the Exchange Act. *Id.* at 88,444. This argument does not apply to gun-jumping prior to a registered IPO because a private company considering a registered IPO is typically not required to comply with the Exchange Act until after the offering. The Advisory Committee Report does not discuss whether testing the waters under proposed Rule 135d represents impermissible gun-jumping because under the Advisory Committee's recommended "'company registration' [system an] eligible issuer is [technically] always in registration, and hence 'gun jumping' in violation of [section] 5(c) simply does not occur." John C. Coffee, Jr., *1933 Act Deregulation: A Guide for the Perplexed*, N.Y. L.J., Sept. 26, 1996, at 5, 6.

⁵⁸⁴ See Stephen I. Glover, *In Proposals Designed for Small Businesses, the SEC Would Permit Issuers to Test the Waters' and Would Shorten Holding Periods for Restricted Securities*, NAT'L L.J., Aug. 21, 1995, at B6; see also ABA Comment Letter, *supra* note 488, at 21 (explaining that issuers that can now obtain "a firm commitment from a responsible underwriter" will probably not use Rule 135d).

⁵⁸⁵ See Glover, *supra* note 584. For a discussion of the advantages of hiring an underwriter, see *supra* text accompanying notes 474-78.

a firm commitment underwriting whereby the underwriter agrees to buy the stock and resell it to the public.⁵⁸⁶

The proposal may also be unnecessary for a large private company with institutional shareholders because the company itself may be able to measure the likely appeal of a potential offering to these and other prospective institutional investors.⁵⁸⁷ Indications of interest by institutional investors are significant because such investors generally purchase the vast majority of the stock offered in an IPO.⁵⁸⁸ In addition, if a small company intends to conduct a larger IPO, then the company may be able to attract an underwriter if there is a strong likelihood that the offering will sell. As a rule of thumb, as a company's chances of engaging an underwriter increases, the necessity for testing the waters decreases.

Nevertheless, a company that can attract an underwriter may still want to test the waters before it invests considerable time and resources into planning to go public. For example, a business may want to test the waters among its customers and current private shareholders before shopping for an underwriter. If they do not express interest, the market is likely to be uninterested as well. In the case of a best efforts underwriting, a company would surely benefit from soliciting indications of interest in reliance on proposed Rule 135d⁵⁸⁹ because an underwriter is not obligated to sell the securities unless it finds enough purchasers to buy either all of the securities or an amount set forth in the underwriting agreement. The results of testing the waters may also give the company a comparative basis for evaluating the underwriter's views regarding market interest in an offering. In addition, if a company has tested the waters and received promising indications of interest, it may be able to negotiate a lower underwriting commission.

The proposal should be extremely helpful to a smaller company, lacking a market, that wants to avail itself of the advantages of going public.⁵⁹⁰ Regulation A, which exempts offerings up to only \$5 million, is of limited use to small businesses.⁵⁹¹ Rule 254 currently forces a small business to choose between either testing the waters and conducting an inadequately small offering, or depriving itself of the opportunity to test the waters and conducting an expensive, registered

⁵⁸⁶ See *supra* notes 489-90 and accompanying text.

⁵⁸⁷ See Elgin, *supra* note 479, at 14.

⁵⁸⁸ See Coffee, *supra* note 464; Zweig & Spiro, *supra* note 25, at 84 (reporting that institutions have the opportunity to purchase nearly sixty percent of the garden variety IPO, and around eighty percent of a "hot deal").

⁵⁸⁹ See ABA Comment Letter, *supra* note 488, at 21.

⁵⁹⁰ See Glover, *supra* note 584. For discussion regarding these advantages, see *supra* text accompanying notes 79-88.

⁵⁹¹ See *supra* text accompanying notes 222-26.

IPO that may prove unsuccessful. Rule 254 thus greatly restricts a small business's opportunity to test the waters.

Registration is very expensive and burdensome for small businesses.⁵⁹² Testing the waters under proposed Rule 135d should help a company make a cost-effective decision whether to take itself public. This is especially important because IPOs above Regulation A's ceiling of \$5 million, but below \$10 million are often too small to attract underwriters, particularly larger ones with established reputations.⁵⁹³ As a result, a company may consider self-underwriting the offering. Testing the waters should help a small company decide whether to proceed with a self-underwritten IPO,⁵⁹⁴ which is an exceedingly difficult undertaking for a small company. If a company does consummate a self-underwritten IPO, the stock may ultimately underperform because it "is likely to lack professional sponsorship in the financial community and may have a weak or inactive aftermarket."⁵⁹⁵ Alternatively, testing the waters may help those small businesses that are unable to engage an underwriter and intending to self-underwrite, because a favorable response may play a role in convincing an underwriter to sell the offering.⁵⁹⁶ In addition, a positive response to a company's testing-the-waters efforts may enable it to enlist the aid of a venture capital firm. Underwriters should be more willing to sell an IPO to which a venture capital firm has committed.

The argument that proposed Rule 135d is unnecessary because underwriters are available to evaluate market interest⁵⁹⁷ thus does not pass muster. As discussed above, even a company capable of engaging an underwriter may still wish to test the waters. Moreover, many small companies, which would benefit from underwriters' assistance, will be unable to secure the services of an underwriter. Principals of a business may lack the expertise to determine whether its IPO would sell; however, if a company cannot attract an underwriter, it has no choice but to try to test the waters itself. Similarly, the position that proposed Rule 135d would help only companies contemplating marginal offerings that are not worthy of the capital markets⁵⁹⁸ is untenable. This reasoning presupposes that any issue an underwriter does not agree to underwrite is marginal and ill-suited for the market. This generaliza-

592 See *supra* Part II.B.1.

593 See *supra* text accompanying note 223.

594 See Elgin, *supra* note 479, at 17.

595 SCHNEIDER ET AL., *supra* note 78, at 10.

596 See 3A BLOOMENTHAL, *supra* note 11, § 5.05, at 5-67 (discussing how Rule 254 may help an issuer attract an underwriter); Elgin, *supra* note 479, at 17 (quoting a lawyer with IPO expertise who commented, "Testing the waters could help, but the key is still finding an underwriter").

597 See, e.g., SIA Comment Letter, *supra* note 472, at 3-4.

598 See, e.g., Taylor, *supra* note 470; Keating Comment Letter, *supra* note 467, at 1.

tion, if taken to its logical conclusion, leads to the inequitable result that issuers unable to engage underwriters should not receive assistance to conduct registered IPOs.

Testing the waters should help both potential issuers, that is, businesses that do not proceed with a registered IPO, and actual issuers, which represent businesses that do. A potential issuer of any size benefits tremendously when it tests the waters under proposed Rule 135d and concludes, due to a poor response to its solicitation efforts, that it should not commence an IPO. The potential issuer has spent relatively little money to test the waters, and saved considerable time and money by deciding not to expend resources on an IPO with dubious prospects. If the SEC repeals the general solicitation prohibition, it will pave the road for an issuer to use the information it gains from testing the waters to offer securities pursuant to Rules 505 and 506.⁵⁹⁹ There are also the intangible benefits of communicating with current private shareholders, customers, and institutional investors. A company that tests the waters may learn where it has disappointed shareholders or customers, enabling it to improve its operations. Further, the company may take advantage of such input to restructure the offering so that it appeals to potential investors.⁶⁰⁰

An issuer that decides to proceed with an IPO would similarly profit from proposed Rule 135d. As a result of its testing-the-waters activities, an issuer can conduct a better cost-benefit analysis in considering whether to proceed with a registered IPO. Testing the waters may give an issuer the confidence it needs before commencing a registered IPO. As discussed earlier, a positive response to the issuer's solicitations may enable it to engage an underwriter or improve its bargaining power with an underwriter. Furthermore, testing the waters should help the underwriter (or the issuer in the case of a self-underwriting) to sell the securities more efficiently. The solicitation process and, in particular, the coupons interested investors return, should provide the issuer with a list of prospective investors who are already familiar with, and interested in, the offering. In addition, communicating with prospective investors may help an issuer or underwriter to price the offering⁶⁰¹ and to determine the appropriate size of the offering. Finally, like potential issuers, actual issuers enjoy

⁵⁹⁹ See *supra* text accompanying notes 427-30.

⁶⁰⁰ The Commission's determinations on the issue of integration and solicitation affect this potential opportunity. In its comment letter, the ABA looks forward to the opportunity when issuers can discuss the various ways to structure the offering with investors: "Particularly if the integration/general solicitation problem . . . is dealt with, it would permit issuers to engage in discussions with prospective institutional investors to determine whether a public offering, Rule 144A transaction, off-shore sale or conventional private placement would make the most sense." ABA Comment Letter, *supra* note 488, at 21.

⁶⁰¹ See Elgin, *supra* note 479, at 14.

the intangible benefits of communication with private shareholders, customers, and institutional investors.

In sum, businesses that lack an established market need a testing-the-waters rule to determine whether it is in their economic self-interest to undertake a registered IPO. Proposed Rule 135d was designed to, and should succeed in, giving many more issuers access to public markets, thereby raising much needed capital more cost-effectively.⁶⁰² Proposed Rule 135d expands upon the inadequate utility of Rule 254 by permitting foreign and domestic businesses of all sizes to test the waters. In addition, the proposed amendments to Rule 254 will enable more issuers to test the waters before a Regulation A offering. The proposal, as drafted, gives the prospective issuer substantial flexibility in determining how to test the waters. Moreover, the Commission insulated issuers by prescribing the antifraud provisions of the federal securities laws as the "standard of liability"⁶⁰³ rather than section 11 or 12(a)(2) liability.⁶⁰⁴ Compliance with the proposed rule imposes minimal burdens and costs on a prospective issuer. In short, proposed Rule 135d goes to great lengths to help issuers.

2. Underwriters

Underwriters' concerns regarding proposed Rule 135d clarify the Rule's potential impact on both issuers and investors. Investment bankers conveyed opposition to proposed Rule 135d before the Commission even published the Testing Release.⁶⁰⁵ The SIA comment letter suggests that underwriters are concerned that principals of companies, inexperienced in measuring the interest of the market, will be unable to test the waters accurately.⁶⁰⁶ Additionally, because of their eagerness to go public, these principals may find it difficult to be objective in assessing the level of investor interest.⁶⁰⁷ A solicitant may mistake potential interest for definite interest. Owners and managers of small businesses, unlike professional underwriters, are also typically unfamiliar with the numerous federal and state securities regulations with which they must comply.⁶⁰⁸ As a result of such an issuer's inability to test the waters with accuracy and objectivity, companies will decide whether to proceed with a registered IPO on the basis of possibly unreliable information. This may lead to unsuccessful offerings. If a company solicits indications of interest and fails to comply with a requirement of proposed Rule 135d or violates a securities law, it may

602 See NYSBA Comment Letter, *supra* note 487, at 1.

603 *Id.*

604 See *supra* text accompanying note 399.

605 See *Toward Model for Company Registration*, *supra* note 456, at 709.

606 SIA Comment Letter, *supra* note 472, at 3-4.

607 See *id.* at 4.

608 See *id.*

forfeit the opportunity to rely on the Rule or expose itself to substantial liability.

These concerns also shed light on the impact the proposal may have on investors. Unsophisticated investors are at the mercy of companies that test the waters, especially by means of cold calls or personal visits. The risk that an investor will suffer from puffing or overreaching at the hands of a company testing the waters is much higher than if a professional underwriter is testing the market. An issuer's failure to comply with the Rule or other securities laws not only subjects the issuer to liability, but also exposes investors to fraud and misrepresentation. Investors may also lose in the long run. Consider a situation where the principals of a business have tested the waters, but solicited an insufficient number of prospective investors, focused only on individual investors rather than institutional investors, misconstrued the responses to the solicitation, or exaggerated the level of investor interest. Assume that these deficiencies in the solicitation process were careless or unintentional errors, reflecting only the inexperience or overeagerness of the solicitant. The company then proceeds with a self-underwritten (or perhaps even a best efforts underwritten) registered IPO on the basis of the response to its solicitations. The stock of the company may not sell, which would drive the price down, thus hurting investors who have already purchased shares. This may lead to "a dilution of confidence in capital markets."⁶⁰⁹

Proposed Rule 135d may have a limited effect on underwriters. A potential issuer will typically rely on an underwriter to prepare and sell the IPO if the issuer can engage one. In most cases, underwriters will still conduct their own analyses regarding market interest in light of the "'no consummation, no compensation' [industry] practice."⁶¹⁰ Therefore, an issuer's testing-the-waters activity may at best supplement an underwriter's analysis of investor interest. Although underwriters may be unhappy about competing with entrepreneurs over assessing market interest, they will not free ride on the results potential issuers report. This should better protect both issuers and investors because the combination of the results from an issuer's testing-the-waters measures and an underwriter's analysis is more likely to lead to an accurate determination of market interest than an underwriter's analysis alone. If a potential issuer's testing-the-waters efforts enable it to engage an underwriter, proposed Rule 135d benefits underwriters.

On the other hand, underwriters may suffer to a minor extent from proposed Rule 135d. It is possible that the proposal will lead to

⁶⁰⁹ *Id.*

⁶¹⁰ *Id.* at 3.

a greater number of self-underwritten offerings, if companies gain confidence in their ability to solicit indications of interest with accuracy. If many of these self-underwritten offerings are in fact ill-advised, then the greater number of failures of such IPOs may decrease confidence in the capital markets. This development, in turn, may harm underwriters. Further, if the proposal leads to a series of failed offerings, the fear of a failed offering may dissuade companies from conducting registered IPOs that would require the services of underwriters. Alternatively, unsuccessful self-underwritten offerings that follow testing the waters may encourage other issuers to engage underwriters.

Absent a testing-the-waters rule for registered IPOs, companies turn to underwriters or other professionals with similar expertise to determine market interest. Proposed Rule 135d gives issuers the opportunity to compete with underwriters in this evaluation.⁶¹¹ It would seem that underwriters' vast resources and experience would ensure that they are better equipped to gauge investor interest. However, in the case of a small business without a market, it is conceivable that the company's communications with its private shareholders and customers may yield accurate results. Underwriters' techniques for determining if an IPO will sell may be ill-suited to smaller offerings or offerings by companies in particular industries. Therefore, companies that test the waters under proposed Rule 135d may alter the current practices of underwriters. In sum, these possible effects on underwriters are somewhat attenuated; however, recognition of these effects highlights how the proposal may neither satisfy issuers nor investors.

3. *Investors*

A testing-the-waters rule necessitates some compromise of investor protection. Nevertheless, the Commission, in drafting proposed Rule 135d, attempted to avoid this compromise. Throughout the Testing Release, the Commission explained that it sought to maintain investor protection.⁶¹² Nonetheless, while the proposal provides investors with greater protection than Rule 254, it still leaves them too vulnerable.

⁶¹¹ For a recommendation that the Commission follow the ABA's suggestion to add language to the Rule that would expressly permit underwriters to test the waters on an issuer's behalf, see *infra* Part V.F.3. If the final rule does permit underwriters to test the waters for issuers, underwriters will certainly benefit from both the additional business and the higher likelihood of a successful offering.

⁶¹² See, e.g., Testing Release, *supra* note 8, at 86,886 (reiterating that "[i]n considering whether to provide a 'test the waters' process for registered IPO's [sic], the Commission is committed to assuring that the interests of investors are not compromised"); *id.* at 86,890 (seeking comment on "whether the proposed . . . rule is . . . in investors' interest in the context of registered IPOs"); *id.* at 86,892 (reiterating that the Commission designed the rule with an eye towards "not sacrificing investor protection").

For example, proposed Rule 135d improved upon Rule 254's provision of investor protection by introducing a full compliance standard.⁶¹³ The full compliance standard protects investors because it forces issuers to comply with the existing safeguards.

There are additional potential benefits to investors. Potential investors, including customers, private shareholders, and institutional investors, will learn of investment opportunities before the rest of the market. Although the public can inspect the solicitation document or script of the broadcast submitted to the SEC, oral communications with issuers may help solicited investors become aware of more valuable information. As a result, they may be in a better position to evaluate the offering's appeal. This is especially beneficial if the IPO looks destined to be a hot deal. In addition, if an investor returns a coupon to the issuer, he or she may have a better opportunity to purchase shares once the securities are offered.⁶¹⁴ Although, as mentioned previously, institutional investors purchase most of the shares offered in a registered IPO,⁶¹⁵ a completed coupon may help an individual investor buy into the offering.

Furthermore, the solicitation process may enable prospective investors to influence the price and structure of the offering.⁶¹⁶ This is particularly true in the case of institutional investors. After consulting with prospective institutional investors, an issuer may adjust the price and structure of the offering in order to cater to the preferences of interested investors. Current private shareholders and customers may benefit from the opportunity for increased interaction with management. In explaining the reasons for their interest or lack of interest in a registered IPO, shareholders and customers may induce the company to make changes that help them.⁶¹⁷

Despite these potential benefits, proposed Rule 135d is more likely to harm investors. Because the proposal is modelled on Rule 254, many of the potentially harmful effects on investors will sound familiar.⁶¹⁸ Issuers will solicit individuals, some of whom will be unsophisticated investors. These investors are those whom the SEC is primarily concerned with protecting. The susceptibility of unsophisticated investors is even greater in the case of an IPO where business owners or managers, who may also be somewhat unsophisti-

⁶¹³ See *supra* text accompanying notes 446-51.

⁶¹⁴ Of course, an issuer is not obligated to sell securities to an investor who has returned a coupon.

⁶¹⁵ See *supra* note 588 and accompanying text.

⁶¹⁶ See *supra* notes 600-01 and accompanying text.

⁶¹⁷ This is the mirror image of the argument that issuers can improve themselves through the closer interaction with current shareholders and customers that testing the waters necessitates.

⁶¹⁸ See *supra* Part III.B.

cated, are especially eager to sell the offering.⁶¹⁹ Solicitants may also lack familiarity with securities laws designed to protect investors.⁶²⁰ In fact, there is a genuine danger that the individuals who test the waters on behalf of potential issuers will sell the securities to investors.⁶²¹ Of course, this would directly violate section 5 because the solicitor will have sold the securities in advance of the effective date of a registration statement.

Nearly every provision of proposed Rule 135d that benefits issuers has a potentially harmful concomitant effect on investors. For example, the proposal's high level of accessibility to issuers may be detrimental to investors. The SEC could have further shielded investors by incorporating a bad boy disqualification provision.⁶²² Further, the tone of the Testing Release and the comments thereto suggest that the Commission may wish to extend testing-the-waters privileges to issuers contemplating Regulation D and other exempt offerings.⁶²³ In the case of a Rule 504 offering, for instance, a potential issuer will often solicit unsophisticated individual investors.⁶²⁴ Such investors are more susceptible to overreaching and puffing.

In addition, the flexibility of the proposed rule, while advantageous to issuers, may hurt investors. During the solicitation process, issuers may make any accurate statement.⁶²⁵ Extremely optimistic projections, for example, may not constitute a materially inaccurate or misleading statement that triggers antifraud liability. Therefore, there is the danger that those who test the waters "will unduly hype the issuer . . . or [engage in] . . . other abusive practices."⁶²⁶ The danger is that "allowing the issuer to attempt to pre-sell the deal invests enormous discretion in the one participant (the issuer) who is exempt from the suitability and other self-regulatory standards of the NASD and the stock exchanges, but who has the greatest incentive to cheat."⁶²⁷

Moreover, proposed Rule 135d(a)(2) requires only very limited disclosure.⁶²⁸ In most cases, investors will have very little information to review in determining whether they are interested.⁶²⁹ The proposal

619 See *supra* text accompanying notes 512-14.

620 See *Hearings on H.R. 2981, supra* note 102, at 48; *supra* text accompanying note 513.

621 See *supra* text accompanying note 514.

622 See, e.g., 17 C.F.R. § 230.262 (1997); NASAA Proposed Statement of Policy, *supra* note 302, at 2542; *infra* Part V.F.3.

623 Testing Release, *supra* note 8, at 86,887 n.19, 86,890-91.

624 See *supra* text accompanying note 247.

625 See *supra* text accompanying note 398-99.

626 Glover, *supra* note 584, at B6.

627 Coffee, *supra* note 583, at 6.

628 See *supra* text accompanying notes 392-98.

629 But see Advisory Committee Report, *supra* note 553, at 88,448 n.43 (conveying the sentiment of a Committee member who is "thoroughly convinced that a one-page pro-

also accords issuers substantial flexibility as to the means by which they may test the waters.⁶³⁰ Unsophisticated investors are especially vulnerable when they receive cold calls or personal visits, which the proposal permits. The SEC did not limit what an issuer may communicate in a solicitation by telephone or in person.⁶³¹ In addition, when an issuer tests the waters via a cold call or a personal visit, investors will usually not have a copy of the submitted testing materials to review during or after such a solicitation.⁶³²

As discussed above, in order to provide the maximum benefit to issuers, the proposal imposes minimal burdens and costs on an issuer seeking to test the waters.⁶³³ Once again, this benefit is at the expense of investor protection. For example, proposed Rule 135d(a)(3) requires the issuer to submit a copy of the solicitation materials only to the SEC.⁶³⁴ It does not require the issuer to "officially file[]" the materials with the Commission.⁶³⁵ Further, the proposal does not require the SEC to review the solicitation materials before an issuer utilizes them to solicit indications of interest.⁶³⁶ In fact, an issuer may wait to submit a copy to the Commission until the first day on which it uses the materials to test the waters.⁶³⁷ In addition, given that the proposed rule requires an issuer to submit only materials that are substantively different from those submitted in the past,⁶³⁸ there is an even greater chance that the SEC staff will not review the testing materials. In the absence of Commission review, an investor thus has little assurance, other than the threat of liability for fraud under the securities laws, that the materials are accurate or complete. The fact that an issuer need not deliver a copy of the solicitation document to a prospective investor whom it solicits compounds the problem.⁶³⁹ Investors thus may not have anything in writing to review. Moreover, an individual investor is unlikely to inspect a copy of the materials submitted to the Commission.

spectus would actually give investors more information and more protection and not less").

⁶³⁰ See *supra* text accompanying notes 414-15.

⁶³¹ The proposal also prescribes somewhat different disclosure requirements for written solicitation materials than for oral communications. See SIA Comment Letter, *supra* note 472, at 4-5.

⁶³² The proposed rule requires only that the issuer submit the written solicitation materials to the Commission to be available for public inspection. See Testing Release, *supra* note 8, at 86,889 & n.38.

⁶³³ See *supra* Part V.B.1.

⁶³⁴ See Testing Release, *supra* note 8, at 86,893 (proposed 17 C.F.R. § 230.135d(a)(3)).

⁶³⁵ *Id.* at 86,889 n.38 (emphasis added).

⁶³⁶ See *id.* at 86,888.

⁶³⁷ See *id.* at 86,893 (proposed 17 C.F.R. § 230.135d(a)(3)).

⁶³⁸ See *supra* text accompanying note 408.

⁶³⁹ See *supra* text accompanying notes 250-51 (discussing the solicitation materials in connection with Rule 254); *supra* notes 403, 632 and accompanying text.

The proposal also fails to fully protect investors after the issuer has tested the waters. Proposed Rule 135d(a)(5) protects investors by precluding an issuer from testing the waters after it has filed a registration statement.⁶⁴⁰ However, NASAA's concern regarding the cooling-off period between the final solicitation and the date on which an issuer can commence sales under Rule 254⁶⁴¹ also applies to proposed Rule 135d. The current proposal provides that an issuer must wait twenty calendar days after its final publication or delivery of solicitation materials before it can sell the securities.⁶⁴² Although oral communications probably pose the greatest danger to investors, proposed Rule 135d(a)(6) addresses only "publication or delivery,"⁶⁴³ seemingly not requiring issuers to wait twenty days after oral testing-the-waters solicitations. This omission in the cooling-off period provision increases the chances that an investor will decide whether to purchase securities on the basis of the issuer's oral representations.

Finally, the prescription of the antifraud provisions of the federal securities laws as the standard of liability ultimately compromises investor protection because of the difficulties confronting plaintiffs that seek to bring a Rule 10b-5 private action.⁶⁴⁴ By removing testing materials from the section 2(10) definition of a prospectus, proposed Rule 135d(c) insulates issuers from liability under section 12(a)(2) of the Securities Act.⁶⁴⁵ Only the antifraud provisions of the federal securities laws would protect investors. Imposition of liability under section 12(a)(2) might dissuade issuers from testing the waters without consulting with lawyers. Although this heightened standard would deter issuers from testing the waters, it would also reduce the likelihood of fraudulent, misrepresentative, or incomplete statements in the testing materials. Once again, there is a tradeoff.

These individual concerns regarding insufficient investor protection add up to the larger fear that investors will not read the prospectus, and specifically, the mandatory disclosure within it.⁶⁴⁶ The sales-oriented prefilling solicitation, which is designed to capture a potential investor's interest, in conjunction with the short forty-eight hour period reserved for investors to read the prospectus before brokers or dealers must mail a confirmation of sale, increases the danger that investors will disregard the prospectus. The drafters of the Securities

⁶⁴⁰ See Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.135d(a)(5)).

⁶⁴¹ See *supra* text accompanying notes 252-54.

⁶⁴² See Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.135d(a)(6)).

⁶⁴³ *Id.*

⁶⁴⁴ See *supra* note 257 and accompanying text.

⁶⁴⁵ See Testing Release, *supra* note 8, at 86,889, 86,894 (proposed 17 C.F.R. § 230.135d(c)).

⁶⁴⁶ See Coffee, *supra* note 60, at 1153.

Act intended for section 5(c) to prevent this very result.⁶⁴⁷ Proposed Rule 135d thus “represents a major retreat from the old orthodoxy, which insisted that the prospectus be the only selling document that the investor saw prior to the effectiveness of the registration statement.”⁶⁴⁸ If adopted, the proposal “seems likely to convert the prospectus into little more than a memento of the transaction.”⁶⁴⁹ The ultimate concern is that investors will decide to purchase securities based on the issuer’s sales-oriented prefiling solicitations rather than on a careful reading of the prospectus. If investors rely on prefiling solicitations, investors may be more susceptible to fraud and misrepresentation.

The foregoing discussion is not intended to suggest that the Commission modify every provision of the Rule that might harm investors.⁶⁵⁰ This would of course dissuade issuers from testing the waters. Rather, the foregoing assessment demonstrates that, in its current form, the proposal goes too far in sacrificing investor protection.

4. *The Registration Process—A Slippery Slope*

The proposal will not change the current registration process for a registered IPO.⁶⁵¹ The Commission reassured the public in the Testing Release that the proposal would preserve all of the safeguards that protect investors during full or short form registration.⁶⁵² This assurance rests on a key assumption: the investor will read the prospectus.

Nevertheless, the SEC is currently re-evaluating the relevance of the Securities Act, and appears to be leaning towards further deregulation of the registration process.⁶⁵³ For example, the Advisory Com-

⁶⁴⁷ See *supra* notes 63-66 and accompanying text.

⁶⁴⁸ Coffee, *supra* note 60, at 1153.

⁶⁴⁹ Coffee, *supra* note 583, at 6.

⁶⁵⁰ For example, this Note argues that the Commission adopted the proper standard of liability even though it does not protect investors as well as sections 11 or 12(a)(2). See *infra* Part V.F.5.

⁶⁵¹ See Testing Release, *supra* note 8, at 86,890; AIMR Comment Letter, *supra* note 496, at 3.

⁶⁵² Testing Release, *supra* note 8, at 86,890. According to the SEC, [the] proposal [] would not alter the type and amount of information available to investors in connection with an IPO. Issuers making use of the proposed “test the waters” procedure would continue to be subject to all the current IPO disclosure requirements, and IPO registration statements would continue to be subject to Commission staff review if the issuer determined to proceed with a registered offering after soliciting investor interest.

Id.
⁶⁵³ See Securities Act Concepts and Their Effects on Capital Formation, Securities Act Release No. 7329, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,843, at 88,598 (Sept. 12, 1996); Effect of 1933 Act Concepts on Capital Formation, Securities Act Release No. 7314, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,823, at

mittee recommended to the Commission the development of “a company-based registration system” that would dramatically change the registration process.⁶⁵⁴ This system would include, among other things, the elimination of the section 5(b)(2) prospectus delivery requirement.⁶⁵⁵ Proposed Rule 135d, if adopted, may be the first step towards further deregulation.

Although currently applicable only to registered IPOs, the Commission may ultimately extend testing-the-waters privileges under proposed Rule 135d to other issuers. In the Testing Release, the SEC already considered allowing a Regulation D issuer to test the waters.⁶⁵⁶ In the future, the Commission may permit any issuer contemplating a public offering to test the waters. For example, a small issuer, that went public in 1998 with relatively few shareholders and a very specialized practice may wish to access the public markets again some years later. Such a company may have difficulty assessing market interest. Therefore, the Commission may decide to allow it to test the waters.

The Commission thus may be proceeding down a slippery slope. With proposed Rule 135d, the SEC has begun chiseling away at the safeguards that the registration process currently provides to protect investors. The testing-the-waters proposal, as drafted, effectively repeals section 5(c) because it permits issuers to “offer” securities before filing a registration statement.⁶⁵⁷ A relaxation or elimination of the prospectus delivery requirement, which protects investors after an issuer has filed a registration statement during the waiting period, may follow. Such deregulation is more likely after the NSMIA. The grant of general exemptive authority and the authority to preempt state regulation of many securities offerings⁶⁵⁸ will enable the Commission to further deregulate the registration process for not only registered IPOs, but all public offerings.

5. *Capital Markets*

Proposed Rule 135d should benefit the capital markets to the extent issuers rely on the Rule and properly assess market interest while distributing accurate information to investors. The proposal should “prove beneficial to the capital raising markets due to the increased

88,279 (July 25, 1996); Advisory Committee Report, *supra* note 553; Coffee, *supra* note 60, at 1144; McDonough, *supra* note 546; Coffee, *supra* note 583; Quinn, *supra* note 549.

⁶⁵⁴ Advisory Committee Report, *supra* note 553, at 88,404.

⁶⁵⁵ See *id.* at 88,447-48. The Fields Bill also contained legislation that would, in effect, end the prospectus delivery requirements under the Securities Act. Fields Bill, *supra* note 226, at 25-26.

⁶⁵⁶ See *supra* text accompanying note 623.

⁶⁵⁷ See *supra* Part V.A.3.

⁶⁵⁸ See *supra* note 226; *supra* Part III.C.3.

efficiency that ought to follow its utilization.”⁶⁵⁹ If an issuer tests the waters and consummates a successful registered IPO, the capital markets have matched legitimate issuers with interested investors. The public markets benefit from the increase in investor confidence. Investors may in turn invest more money in the stock market. In addition, successful IPOs encourage other issuers to pursue this avenue of raising capital.⁶⁶⁰ In “potentially opening up those markets to more risk averse entities,”⁶⁶¹ the proposal may help startups in important growth industries such as technology to raise capital. This provides the public with a wider array of investment opportunities.

Even if a business decides, as a result of unenthusiastic investor response, not to conduct a registered IPO, the capital markets benefit. A company that cannot drum up interest among its customers and private shareholders is unlikely to enjoy greater success with outside investors. Therefore, proposed Rule 135d may prevent companies that are not ready for a registered IPO from attempting to raise capital via this route, filtering out poor offerings that ultimately may hurt the health of the capital markets.

Consequently, if the proposal fails to filter out inferior offerings, the capital markets may suffer.⁶⁶² If a company tests the waters, erroneously concludes that the market is interested in its offering, and then proceeds to offer the securities, this may lead to an unpopular offering that harms the capital markets. Further, if an issuer misrepresents information in its solicitation materials and purchasers invest in reliance on the issuer’s representations and incur substantial losses, investor confidence in public markets deteriorates.⁶⁶³ As Congress explained in 1980, “‘reform’ that results in undermining investor confidence in the integrity of the marketplace would have an effect precisely the opposite of its intended benefits on capital formation.”⁶⁶⁴ Pervasive fraud surrounding the capital markets “hurt[s] issuers every bit as much as investors.”⁶⁶⁵ The impact of the proposal on capital markets is thus largely a product of how well the Commission balances issuers’ needs with investors’ needs. If the Commission balances these respective interests, the capital markets will benefit from the facilitation of capital raising. However, given that the proposal appears to compromise investor protection, it may harm these markets.

⁶⁵⁹ NYSBA Comment Letter, *supra* note 487, at 1.

⁶⁶⁰ See *supra* notes 91-92 and accompanying text.

⁶⁶¹ NYSBA Comment Letter, *supra* note 487, at 1.

⁶⁶² See SIA Comment Letter, *supra* note 472, at 4.

⁶⁶³ See *id.*

⁶⁶⁴ S. REP. NO. 96-958, at 5 (1980).

⁶⁶⁵ NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9374.

6. *Synthesis*

Businesses, especially smaller enterprises, need the opportunity to test the waters. Proposed Rule 135d, on paper, appears likely to achieve its objective of enabling businesses to determine cost-effectively market interest in a registered IPO. This will improve access to the capital markets and facilitate the raising of capital. However, the proposal, as drafted, does not go far enough to ensure achievement of the second objective, namely, that the proposal must not "caus[e] investors to overlook the full disclosures mandated by the federal securities laws."⁶⁶⁶

C. The Impact of the Proposal in Light of Experience Under Rule 254 and Other Testing-the-Waters Rules

The above analysis of the proposal's "on paper" impact on issuers and investors represents only half of the requisite analysis. Since August 1992, small businesses have had the opportunity to test the waters in reliance on Rule 254. Similarly, several states have adopted or experimented with various testing-the-waters rules. Some states have adopted rules that conform to Rule 254, while others follow the NASAA model, and still others have rules that differ from both.⁶⁶⁷ Proposed Rule 135d closely resembles Rule 254. In order to properly assess the impact of proposed Rule 135d, the Commission must evaluate the impact Rule 254 and state-adopted testing-the-waters procedures have had on issuers and investors.⁶⁶⁸

I. *Postponement of Decision*

The Commission should not adopt a testing-the-waters rule until at least the end of 1997. This would afford the SEC, NASAA, and the states the opportunity to assess the impact of Rule 254 on issuers and investors over a five year period.

2. *Review of the Empirical Data*

Responses to the proposal suggest that businesses approve of the testing-the-waters rule.⁶⁶⁹ However, as of the Testing Release, relatively few small businesses had tested the waters either under Rule 254

⁶⁶⁶ Testing Release, *supra* note 8, at 86,890.

⁶⁶⁷ See *supra* notes 273-75, 327-33 and accompanying text.

⁶⁶⁸ See *supra* notes 327-33 and accompanying text. The SEC should also assess to what extent the "general announcement" provision of section 25102(n) of California's Corporations Code has helped issuers, and whether it has undermined investor protection. See *supra* note 330. A study of its impact after the SEC's adoption of Rule 1001 in May 1996 may be especially insightful. See *supra* note 330.

⁶⁶⁹ See Elgin, *supra* note 479, at 14; American Society of Corporate Secretaries Comment Letter, *supra* note 486, at 1-2.

or the NASAA model.⁶⁷⁰ In contrast to the SEC, NASAA at least recognized the insufficiency of the data.⁶⁷¹ The benefits may be insufficient to justify the extension of testing the waters because so few businesses have availed themselves of it so far. There may be important reasons why more small businesses have not relied on Rule 254, which, on paper, appears very appealing for small businesses.

There is little information available to the public to explain why Rule 254 "has generated only a lukewarm response."⁶⁷² Perhaps the lack of coordination of state securities laws with the federal Rule has precluded many small businesses from relying on Rule 254.⁶⁷³ Perhaps the Commission needs to market the availability of the Rule to small businesses. The Commission designed the Rule so that small business owners do not need to retain lawyers to solicit indications of interest. As a result, it is probable that most small business owners are unaware of the opportunity. The SEC must identify the reasons for Rule 254's unpopularity because the same reasons may discourage businesses from using proposed Rule 135d. If few issuers similarly rely on proposed Rule 135d, the potential risks to investors are difficult to justify.

In addition, the Commission should attempt to determine if businesses relying on Rule 254 were able to assess market interest with accuracy. This determination includes the very important assessment of whether testing the waters under Rule 254 dissuaded issuers from an offering that was likely to be unsuccessful.⁶⁷⁴ A proper appraisal of Rule 254's impact on issuers must go beyond an analysis of the rule "on paper," which suggests that Rule 254 should have helped more businesses.

The Commission must also attempt to better ascertain how Rule 254 and the states' testing-the-waters rules have affected investors. The SEC must probe deeper to learn if investors have suffered as a result of testing the waters.⁶⁷⁵ The Commission has apparently acknowledged that businesses that have tested the waters have engaged in an unexpectedly high amount of "puffing."⁶⁷⁶ Investors can easily

⁶⁷⁰ See *supra* text accompanying notes 334-37, 342-43.

⁶⁷¹ See *supra* text accompanying note 337.

⁶⁷² Glover, *supra* note 584, at B6.

⁶⁷³ A prepared statement by a representative of National Small Business United, an organization representing more than 65,000 American small businesses, states that "[b]oth federal and state securities laws make it difficult for a business owner to 'test the waters.'" *Hearings on H.R. 2981, supra* note 102, at 47. This statement suggests that the differences between the two sets of laws may have frustrated small issuers interested in testing the waters.

⁶⁷⁴ See *supra* notes 372-73 and accompanying text.

⁶⁷⁵ For a discussion of the difficulty of determining the impact of testing the waters on investors absent complaints or lawsuits, see *supra* Part III.C.4.

⁶⁷⁶ McGill, *supra* note 374, at 24.

suffer as a result of such conduct. If the Commission concludes that prefling solicitations under Rule 254 leave investors too vulnerable to fraud or misrepresentation or that they tend to supplant the offering circular as the controlling basis for purchasing securities, it must add further safeguards.

3. *Method*

The Commission can obtain the foregoing types of information only through careful cooperation with NASAA, state securities regulators, small businesses, and investors. The Commission should establish a committee with the responsibility of assessing the impact of Rule 254 on issuers and investors for the purposes of revising or adopting proposed Rule 135d. The Commission already moved in this direction when representatives of the SEC and NASAA discussed their reactions to testing the waters in April 1996 at the Annual Conference on Uniformity of Securities Law.⁶⁷⁷ The committee's objective would be to recommend a proposal that would best enable issuers to solicit indications of interest with accuracy with the least threat to investor protection.

4. *Summary*

The SEC should not adopt a testing-the-waters rule that applies to registered IPOs until it has scrupulously examined the empirical data regarding the various testing-the-waters rules.⁶⁷⁸ By the end of 1997, the Commission will have two more years of additional data to review. Until the SEC establishes the adequacy of Rule 254's safeguards, it should err on the side of investor protection.

In fact, in order to invoke its general exemptive authority under new section 28 of the Securities Act to exempt testing the waters before registered IPOs from the section 5 requirements, the Commission must demonstrate not only "that such exemption is necessary or appropriate in the public interest," but also that it "is consistent with the protection of investors."⁶⁷⁹ Therefore, the SEC should continue to resist the temptation to exercise this authority with respect to proposed Rule 135d until it has conducted a review approximating that outlined above.

For now, the proposal appears "appropriate in the public interest." However, it would seem that proposed Rule 135d does not go far enough beyond Rule 254 to ensure investor protection.

⁶⁷⁷ See *supra* text accompanying notes 530-31.

⁶⁷⁸ Once again, the SEC should also review data regarding issuers' and investors' experiences under the California exemption. See *supra* note 330.

⁶⁷⁹ NSMIA, *supra* note 22, at 3424 (codified at 15 U.S.C. § 77z-3 (Supp. II 1996)).

D. The Coordination Problem Revisited in Light of the NSMIA

As with Rule 254, there has been concern that a lack of coordination with state securities laws may render proposed Rule 135d ineffective.⁶⁸⁰ One authority maintains that the success of a testing-the-waters rule for registered IPOs is contingent on "the cooperation of NASAA and the blue sky administrators, or preemptive legislation from Congress."⁶⁸¹ In its comment letter, NASAA indicated its support for a testing-the-waters rule for registered IPOs, but one that conformed to its model.⁶⁸² Despite the SEC's efforts to fulfill its responsibilities under section 19(c) of the Securities Act,⁶⁸³ the two sides still stand apart.

The NSMIA constitutes the aforementioned "preemptive legislation."⁶⁸⁴ Under new section 18(a)(1)(B), no state securities "law, rule, regulation, or order, or other administrative action . . . requiring, or with respect to, registration or qualification of securities . . . or . . . securities transactions . . . shall directly or indirectly apply to a security that . . . will be a covered security upon completion of the transaction."⁶⁸⁵ Securities offered in a registered IPO will usually represent "covered securit[ies] upon completion of the transaction." After the completion of a registered IPO, the securities will typically fall within the first level of the definition of covered securities: securities that an issuer lists, or is authorized to list, on the New York or American Stock Exchanges, the NASDAQ National Market System, or a national securities exchange with equivalent listing criteria.⁶⁸⁶ Therefore, federal securities regulations preempt state regulations that apply to securities offered in a registered IPO that are to be listed, or authorized to be listed, on a national securities exchange, as required by section 18(b)(1).

While the NSMIA does not preempt state securities laws regarding testing the waters before a Regulation A offering,⁶⁸⁷ it thus resolves the coordination problem with respect to proposed Rule 135d. Nevertheless, the Commission should still seek the support of NASAA and the states. To the extent that states are in favor of proposed Rule 135d, more issuers are likely to avail themselves of the opportunity to test the waters. Opposition from the states could undermine the full

⁶⁸⁰ See 3A BLOOMENTHAL, *supra* note 11, § 6.09, at 6-28.

⁶⁸¹ *Id.*

⁶⁸² See *supra* text accompanying note 519; see also *supra* Part III.C.1 (comparing NASAA's model rule with Rule 254); *supra* Part IV.B.4 (comparing NASAA's model rule with proposed Rule 135d).

⁶⁸³ See *supra* note 276 and accompanying text.

⁶⁸⁴ See *supra* text accompanying note 681.

⁶⁸⁵ NSMIA, *supra* note 22, at 3417 (codified at 15 U.S.C. § 77r(a) (Supp. II 1996)).

⁶⁸⁶ See *id.* at 3418 (codified at 15 U.S.C. § 77r(b)(1) (Supp. II 1996)).

⁶⁸⁷ See *supra* Part III.C.3.

potential of the Rule. As a result, the SEC should consider adding further safeguards to its proposal to secure NASAA and state support.

E. Availability of Testing the Waters to Larger Businesses

1. *Asymmetrical Result Under Rule 254*

Because larger businesses generally need to raise more capital than the Regulation A ceiling permits, the restriction of the availability of testing the waters to Regulation A offerings effectively deprived larger businesses of this opportunity. If a large, private business seeks to tap the public markets to raise capital, it typically conducts a registered IPO. Therefore, given that (i) smaller businesses are much more likely to conduct a Regulation A offering than larger businesses and (ii) testing the waters under federal law is currently available only to issuers considering a Regulation A offering, small businesses currently have an advantage unavailable to larger businesses.

2. *Correction of Asymmetry*

Proposed Rule 135d corrects this asymmetrical result. In the Testing Release, the SEC explained that the proposal would help “persons that are small entities, as defined by the Commission’s rules.”⁶⁸⁸ However, the SEC elaborated that proposed Rule 135d would do more than help small businesses. According to the SEC, the proposal “would affect small entities in the same manner as other registrants. The proposed rule and amendments . . . are designed to decrease potential costs to *all* issuers, including small businesses.”⁶⁸⁹ Proposed Rule 135d thus departs from Rule 254’s focus on issue size and seeks to help issuers of any size determine whether conducting a registered IPO of any size is cost-effective.

3. *Approval of the Correction*

Despite its assertion that the proposal’s purpose is to help “all issuers,” the Commission has not ruled out the possibility of limiting access to the Rule to small business issuers. The SEC asked commenters if “the rule [should] be limited to small business issuers.”⁶⁹⁰ Such a limitation would be unwise.

The history of small businesses and Rule 254 demonstrates the merits of allowing larger issuers to test the waters. The Commission introduced a testing-the-waters rule in 1992 that applied only to Regu-

⁶⁸⁸ Testing Release, *supra* note 8, at 86,892; *see also* SEC, Initial Regulatory Flexibility Analysis (1995) (on file with the SEC) (explaining how the proposal will decrease costs for issuers).

⁶⁸⁹ Testing Release, *supra* note 8, at 86,892 (emphasis added); *see also* Initial Regulatory Flexibility Analysis, *supra* note 688 (assessing how the proposal will help issuers).

⁶⁹⁰ Testing Release, *supra* note 8, at 86,888.

lation A offerings because (i) the Commission was committed to re-vamping Regulation A, (ii) small businesses were struggling to raise capital, and (iii) Regulation A was considered the most cost-effective means of providing assistance. In contrast, registered IPOs were a more expensive avenue of capital formation that small businesses would find more difficult to pursue. Therefore, in 1992, the Commission adopted Rule 254 and not a corresponding rule that applied to registered IPOs. At the time, Rule 254 appeared to be an efficient way to help small businesses.

In the early 1990s, small businesses suffered while larger businesses were somewhat less vulnerable to the economic woes troubling the country⁶⁹¹ because larger businesses had capital-raising alternatives that were not as available to small businesses. In contrast to small businesses, larger companies usually have established customer bases and can therefore assess whether there is investor interest in the company before commencing an IPO. Further, larger businesses typically have more success than their smaller counterparts in attracting underwriters. In other words, the SEC adopted Rule 254 rather than a broader rule because small businesses considering Regulation A offerings experience far more uncertainty with respect to market interest than larger enterprises. The SEC's decision was a response to the troubles of small businesses; it did not reflect a generalization that small businesses, compared to large businesses, are less likely to harm investors when testing the waters.

In fact, small business owners who are overexcited, financially unsophisticated, and unacquainted with the miscellaneous securities regulations pose a greater risk to investors.⁶⁹² In addition, small business owners contemplating a Regulation A offering will usually first solicit friends, family, customers, suppliers, and current private shareholders.⁶⁹³ These types of prospective investors may be the most likely to disregard the prospectus and rely on oral representations. When small businesses test the waters, the potential impact on investors is not without its dangers.

In contrast, larger businesses are often more experienced in investment matters. They invariably have in-house counsel or outside

⁶⁹¹ See *supra* Part II.B.5.

⁶⁹² See SIA Comment Letter, *supra* note 472, at 3-4; *supra* text accompanying notes 511-14, 619-21.

⁶⁹³ See *Hearings on H.R. 2981*, *supra* note 102, at 46 (relating how entrepreneurs often go to family and friends for funds); Laing, *supra* note 151, at 21 (predicting that entrepreneurs who would test the waters were previously "unable to get friends [and] . . . relatives . . . to buy into their dreams"); Kevin G. Salwen, *SEC Acts To Aid Small Business on Financing*, WALL ST. J., Mar. 12, 1992, at A3 (explaining that small businesses that rely on Regulation A typically first try to raise funds from family and friends); Remarks by Arthur Levitt, *supra* note 372, at *5 (relating how a small business that relied on Rule 254 solicited indications of interest from its customers).

lawyers who provide advice regarding compliance with federal and state securities regulations. In preparing for a registered IPO, a larger company can usually engage a professional underwriter that should attempt to ensure that the company does not commit fraud, practice puffing, or misconstrue the market reaction to the solicitation.⁶⁹⁴ In addition, although a large business may solicit indications of interest from individual investors, institutional investors purchase the majority of shares in a registered IPO.⁶⁹⁵ Institutional investors are generally more sophisticated and, therefore, do not require the same level of protection as individuals. For example, a number of people beyond the person solicited will have input into the institutional investor's final decision.

Consequently, it is very difficult to justify the denial of testing-the-waters privileges to businesses (small or large) that are interested in conducting registered IPOs. As Section C of this Part explained above, the Commission must reevaluate Rule 254 to determine its impact on issuers and investors. If the Commission concludes that issuers should continue to have the opportunity to test the waters before Regulation A offerings, it should allow large businesses considering registered IPOs to test the waters even though they may not have as great a need to test the waters as small businesses before Regulation A offerings. This is especially true because it appears that testing the waters in advance of a registered IPO is less likely to harm investors than solicitations before a Regulation A offering. It is also conceivable that a large business in an obscure industry, for example, both lacks a steady customer base from which it can assess potential investor interest and cannot engage an underwriter. For such a business, testing the waters before a registered IPO could be very important. Furthermore, successful consummation of registered IPOs by large companies also benefit investors and capital markets.

For the foregoing reasons, even if the Commission, in reliance on section 28 of the Securities Act, raises the Regulation A ceiling,⁶⁹⁶ enabling potential issuers to test the waters before offerings of up to ten or fifteen million dollars, it should still permit larger issuers to test the waters prior to registered IPOs. Testing the waters benefits all issuers and, as the subsequent Section demonstrates, can be consistent with an adequate level of protection for investors.

⁶⁹⁴ Studies have confirmed that smaller issues have historically been greater sources of fraud than larger issues. See Seligman, *supra* note 75, at 33-36. For a discussion of reasons why an issuer may desire to test the waters even if it can hire an underwriter, see *supra* Part V.B.1.

⁶⁹⁵ See *supra* note 588 and accompanying text.

⁶⁹⁶ See *supra* note 226.

F. Proposed Safeguards

1. *Single Testing-the-Waters Rule*

As the preceding subsection suggests, the purpose of testing the waters, as well as the potential problems arising therefrom, remain the same for both Regulation A offerings and registered IPOs. As a result, this Note recommends that the Commission should work with NASAA to adopt a single testing-the-waters rule, codified both as new Rule 135d and revised Rule 254, applicable to both Regulation A and registered IPOs.

The idea of a single testing-the-waters rule has roots in the Testing Release. The Commission's proposed amendments to Rule 254 in the Testing Release foreshadow a linking of the two rules. The SEC asked commenters "whether proposed Rule 135d should be used for 'testing the waters' with a view to either a registered or a Regulation A offering, thus replacing Rule 254."⁶⁹⁷

The new rule should contain language that is appropriate for both registered and Regulation A offerings.⁶⁹⁸ The only difference that should remain between new Rule 135d and revised Rule 254 is the current first clause of Rule 135d(a), which reads, and should continue to read, "For purposes only of Section 5 of the Act."⁶⁹⁹ Rule 254 does not include this language because Regulation A offerings are exempt from section 5. The rule should create a safe harbor for pre-filing solicitations of indications of interest made in contemplation of either a Regulation A offering or registered IPO. If the SEC decides to permit issuers to test the waters before Regulation D offerings, the proposed single rule, which would require further revision, should also govern.

A single rule could facilitate the Commission's efforts to preempt state securities regulations regarding all testing-the-waters activities.⁷⁰⁰ The SEC could accomplish this goal by expanding the definition of "qualified purchasers" in new section 18(b)(3) to include all eligible purchasers who were offered securities to be sold pursuant to a Regulation A offering.⁷⁰¹ This definition would correct the current incon-

⁶⁹⁷ Testing Release, *supra* note 8, at 86,890.

⁶⁹⁸ For example, Rule 254(b)(3) currently provides that "[s]olicitations of interest pursuant to this provision may not be made after the filing of an offering statement." 17 C.F.R. § 230.254(b)(3) (1997) (emphasis added). On the other hand, proposed Rule 135d(a)(5) requires that "[s]olicitations of interest in reliance upon the provisions of this section are not made after the filing of a registration statement under the [Securities] Act." Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.135d(a)(5)) (emphasis added).

⁶⁹⁹ Testing Release, *supra* note 8, at 86,893 (proposed 17 C.F.R. § 230.135d(a)).

⁷⁰⁰ Currently, federal securities regulations do not trump state regulations regarding testing the waters before Regulation A offerings. See *supra* Part III.C.3.

⁷⁰¹ This definition would apply to testing the waters under Rule 254 because solicitations of indications of interest pursuant to Rule 254 constitute an offer. See *supra* text

sistency, which appears to retain blue sky laws with respect to testing the waters before a Regulation A offering, but not before a registered IPO.

The Commission and state securities regulators should therefore benefit from the adoption of a single testing-the-waters rule. A single rule should be more administrable than the present approach, which involves two distinct rules that are similar, but subtly different.⁷⁰² The casual observer may even overlook the differences. A single rule would eliminate the potential for any confusion and may also pave the road for further regulatory simplification. For example, it may lead to relaxation of the integration rules. It would also eliminate the need for the proposed revisions to Rule 254 which the Commission discussed in the Testing Release. In addition, the efficiencies that may result from the codification of a single testing-the-waters rule may encourage more states to support the rule.

Issuers and investors may also prefer a single testing-the-waters rule. Small issuers and their lawyers should appreciate the convenience of having all of the provisions of the rule before them, as opposed to searching for cross-referenced provisions.⁷⁰³ As a result, an issuer will never risk consulting the wrong rule regarding testing the waters. If the rule is successful, the Commission may extend its scope to cover other exempt offerings, such as Regulation D offerings.

2. *Background*

These proposed safeguards use proposed Rule 135d as a foundation. Proposed Rule 135d is preferable to Rule 254 as a base for a more balanced, accessible testing-the-waters rule because it provides slightly more protection than its Regulation A equivalent through its full compliance requirement.⁷⁰⁴ Proposed Rule 135d is also an all-inclusive rule. By contrast, Rule 254 has several cross-referenced provisions.⁷⁰⁵ Furthermore, proposed Rule 135d retains enough provi-

accompanying notes 213, 460. The definition does not need to include purchasers solicited in connection with a registered IPO because the national securities exchange/NASDAQ level of covered securities applies to the securities offered in most registered IPOs. See *supra* Part V.D. For a discussion of the Commission's authority to amend the definition of qualified purchasers, see *supra* text accompanying notes 359-61.

⁷⁰² For a comparison of proposed Rule 135d with Rule 254, see *supra* Part IV.B.4.

⁷⁰³ See *infra* note 705 and accompanying text.

⁷⁰⁴ See *supra* text accompanying notes 446-51.

⁷⁰⁵ For example, Rule 254(d) references integration under Rule 251(c). Similarly, Rule 251(a) identifies classes of issuers that cannot rely on Rule 254; the bad boy disqualification provision of Rule 251(a)(6) in turn refers the reader to Rule 262, which references numerous securities rules and regulations. 17 C.F.R. §§ 230.254(d), 230.251(c), 230.251(a)(6), 230.262 (1997).

sions of Rule 254 so that an empirical study of the effectiveness of those provisions is still valuable.⁷⁰⁶

This Section does not attempt to advance an entire alternative to the proposal. Moreover, it does not suggest additional incentives for issuers because the current proposal already disproportionately favors issuers. A fair and effective testing-the-waters rule needs further safeguards for investors beyond what either Rule 254 or proposed Rule 135d currently provides. These additional safeguards cannot be too onerous on issuers, for this would discourage them from testing the waters and would undercut the rule's goal. In fact, some of the proposed safeguards actually benefit issuers as well.⁷⁰⁷ This Section borrows heavily from NASAA's work in this area, returning to some of the provisions in its model rule.⁷⁰⁸ However, some of the proposed safeguards discussed below go beyond what NASAA has recommended.

3. *Eligibility of Issuers*

Proposed Rule 135d precludes a blank check company and a penny stock issuer from testing the waters in reliance on the Rule "because of the substantial abuses that have arisen in such offerings."⁷⁰⁹ The Commission asked commenters, "Are there additional classes of issuers that should be excluded . . . because of the . . . potential for abuse?"⁷¹⁰ The next question posed was "Should any of the exclusions in the NASAA draft policy statement be specifically incorporated into the proposal?"⁷¹¹ NASAA answered the first question in the affirmative, responding that, pursuant to section (1)(i) of the NASAA policy statement, the states had excluded bad boys from testing the waters.⁷¹² The standard for disqualification under section (1)(i) was whether "[t]he offeror does not know and in the exercise of reasonable care, could not know that" any of the aforementioned entities was subject to the specified remedies or sanctions.⁷¹³ In response to the Commission's first question, it is clear that such conduct constitutes "potential for abuse" especially if the bad boy has violated laws or regulations in

⁷⁰⁶ See *supra* Part V.C.

⁷⁰⁷ See, e.g., *infra* note 725 and accompanying text (recommending that the rule expressly permit underwriters to test the waters).

⁷⁰⁸ For a review of NASAA's model rule, see *supra* Part III.C.1.

⁷⁰⁹ Testing Release, *supra* note 8, at 86,887.

⁷¹⁰ *Id.*

⁷¹¹ *Id.* at 86,887-88.

⁷¹² NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,052-53. Section (1)(i) identified these bad boys as "the issuer or any of the issuer's officers, directors, ten percent shareholders or promoters" who are subject to any of the specified remedies or sanctions identified therein. NASAA Proposed Statement of Policy, *supra* note 302, at 2542. Violations of federal or state laws or securities regulations that resulted in these remedies and sanctions are of primary concern.

⁷¹³ NASAA Proposed Statement of Policy, *supra* note 302, at 2542.

connection with a securities offering. The answer to the second question is therefore also in the affirmative.

The SEC has adopted Rule 251(a)(6), disqualifying bad boys from conducting a Regulation A offering, which in turn prevents them from testing the waters under Rule 254.⁷¹⁴ Under Rule 262,

the issuer, any of its predecessors or any affiliated issuer . . . [or] any director, officer or general partner of the issuer, beneficial owner of 10 percent or more of any class of its equity securities, any promoter of the issuer presently connected with it in any capacity, any underwriter of the securities to be offered, or any partner, director or officer of any such underwriter

that is subject to any of the remedies or sanctions listed therein is disqualified from availing itself of the Regulation A exemption.⁷¹⁵ Rule 262 lists more conduct that triggers disqualification than section (1)(i) of the NASAA rule does. The standard Rule 262 prescribes is stricter than the one NASAA requires. Unlike section 1(i) of the NASAA model, under Rule 262, the Commission does not care whether the offeror was aware of the proscribed conduct or whether it reasonably should have known.⁷¹⁶ The rule under Regulation A is that if the issuer (or other person identified in the Rule) is subject to the specified remedies or sanctions, the issuer may not rely on the exemption.⁷¹⁷ However, the SEC can waive the disqualification "upon a showing of good cause and without prejudice to any other action by the Commission."⁷¹⁸

Both the Commission and NASAA thus recognized the importance of disqualifying small business issuers who were so-called bad boys or affiliates of bad boys. The concern is that investors and capital markets may suffer as a result of recurring improper conduct by these bad boys. NASAA correctly asserted, "We see no real need to limit this [bad boy disqualification provision] to small business issuers."⁷¹⁹ If the Commission has disqualified bad boys from testing the waters under Rule 254, it should similarly preclude them from testing the waters under proposed Rule 135d. Investors solicited before a registered IPO are as vulnerable to improper conduct as those solicited in advance of a Regulation A offering. The adoption of a bad boy disqualification provision will deny some issuers access to the rule. However, the considerable protection provided to investors and capital markets offsets this slight decrease in availability.

⁷¹⁴ 17 C.F.R. §§ 230.251(a)(6), 230.262 (1997).

⁷¹⁵ *Id.* §§ 230.262(a)-(b). The Rule also disqualifies bad boys from relying on a Rule 505 exemption. *Id.* § 230.505(b)(2)(iii).

⁷¹⁶ See *supra* note 715 and accompanying text.

⁷¹⁷ See 17 C.F.R. § 230.262 (1997).

⁷¹⁸ *Id.*

⁷¹⁹ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,053.

The Commission should therefore follow its example under Regulation A and adopt a bad boy disqualification provision. The provision should replicate Rule 262, prescribing its stricter standard rather than the more liberal section (1)(i) of the NASAA rule. The latter rule's focus on the offeror's knowledge or reasonable exercise of care emphasizes the wrong point. Even if an offeror did not know of an issuer's egregious violation of a federal securities regulation, that issuer, as opposed to the offeror, can still act in a manner that harms investors. A testing-the-waters rule is risky enough for investors; the Commission should reduce the potential risks by disqualifying issuers who in the past have acted, or been connected to others who have acted, unlawfully. The provision that gives the SEC discretion to waive the disqualification protects issuers from an inequitable result.⁷²⁰

The foregoing discussion hints at another problem with proposed Rule 135d's eligibility requirements which the SEC can cure by adding another safeguard. Proposed Rule 135d(a)(1) states the eligibility requirements for an *issuer* to test the waters.⁷²¹ Rule 251(a), which establishes the eligibility requirements for testing the waters under Regulation A, similarly speaks only of issuers.⁷²² On the other hand, the NASAA rule applies to "offer[s] . . . of a security made by or *on behalf of an issuer* for the sole purpose of soliciting an indication of interest in receiving a prospectus (or its equivalent) for such security."⁷²³ In addition, NASAA's bad boy disqualification provision speaks of the "offeror," as opposed to the issuer.⁷²⁴

This Note recommends that the final testing-the-waters rule permit issuers and their agents to test the waters before a Regulation A offering or registered IPO. One can imagine that the owner of a small business or a foreign firm may want to test the waters, but lacks the time or confidence to properly solicit indications of interest. The owner may prefer to hire another individual or firm to test the waters on his or her behalf. The rule should allow an issuer's agent, for example, a professional underwriter, to test the waters on behalf of the potential issuer.⁷²⁵

By incorporating language that enables an issuer's agent to test the waters, the rule would help issuers by allowing them to concentrate on running their businesses while deferring to the experience of professional underwriters and others to determine market interest. Underwriters currently conduct their own analyses to measure invest-

⁷²⁰ See *supra* text accompanying note 718.

⁷²¹ See Testing Release, *supra* note 8, at 86,893 (proposed 17 C.F.R. § 230.135d(a)(1)).

⁷²² 17 C.F.R. § 230.251(a) (1997).

⁷²³ NASAA Proposed Statement of Policy, *supra* note 302, at 2541 (emphasis added).

⁷²⁴ *Id.* at 2542.

⁷²⁵ The ABA recommended that the proposal expressly permit underwriters to test the waters on behalf of an issuer. See *supra* text accompanying note 494; *supra* note 611.

tor interest. If underwriters also test the waters, they are more likely to accurately assess the extent of market interest. Therefore, extending availability of testing the waters to underwriters would more efficiently and accurately indicate whether an issuer's offering will succeed, benefiting issuers and underwriters without imposing additional costs.

This recommended addition to proposed Rule 135d is not only a pro-issuer incentive, but also a safeguard that further protects investors. Underwriters are less likely than issuers to violate securities regulations or engage in other improper solicitation practices.⁷²⁶ Similarly, an independent agent who tests the waters may be less likely than a principal to make overzealous solicitations or to exaggerate the investor response to the solicitation. The combination of an underwriter's standard analysis and the results from its testing-the-waters efforts is more likely to filter out subpar offerings that will harm investors. The application of agency law ensures that investors will have a cause of action against the issuer if liability arises. Furthermore, many of the proposals discussed below will better enable investors to confirm and supplement oral representations an issuer's agent makes.⁷²⁷

4. *Content of Solicitation Materials*

The more demanding the disclosure requirements are for the solicitation materials, the less likely a potential issuer is to test the waters. Accordingly, there is much support for the argument that the testing-the-waters rule "would be most useful if the content of the solicitation material were left to the judgment of those involved in the solicitation."⁷²⁸ However, if an issuer makes only the minimum disclosures, prospective investors will lack sufficient information to make a reasonable decision about whether to indicate their interest.⁷²⁹ If an investor communicates his or her interest to an issuer on the basis of such limited disclosure, the response may be unreliable because the investor may lose interest once the issuer makes more complete disclosure. Therefore, indications of interest by investors may lead the issuer to conclude mistakenly that the market is interested in an offering when, in fact, investors are merely conveying preliminary interest which may not survive fuller disclosure. This can create an unsuccessful offering that harms both issuers and investors. On the other hand,

⁷²⁶ See *supra* Part V.B.2.

⁷²⁷ See *infra* Part V.F.7.

⁷²⁸ Sullivan & Cromwell Comment Letter, *supra* note 487, at 4.

⁷²⁹ As currently drafted, Rule 254 and proposed Rule 135d require an issuer only to make certain required statements discussing the nature and effect of the solicitation and to provide the name of the chief executive officer of the issuer and a brief general discussion of the issuer's business and products. See *supra* notes 194, 392-97 and accompanying text.

if issuers provide too much information in the testing materials, investors may mistake the solicitation document for a "solicitation in connection with a full-blown registered offering."⁷³⁰ The SEC must strike a balance between disclosing too little information and disclosing too much.

Consequently, this Note recommends that the final rule incorporate several changes to the requirements in proposed Rule 135d(a) (2) regarding the content of the solicitation materials. The rule should require a more precise description of the business.⁷³¹ Second, it should also provide that the issuer must disclose how it intends to use the proceeds.⁷³² These two additional requirements will provide prospective investors with valuable information that will enable them to make their indications of interest on a more informed basis. However, the rule should also limit the amount of permissible disclosure by not permitting an issuer to include pricing, detailed financial, or technical information regarding the potential offering.⁷³³ At present, the proposal allows issuers to include pricing information, unaudited financials, and forward-looking statements.⁷³⁴ However, these disclosures may be extremely speculative, especially in the case of a young startup company. Providing too much financial information may confuse and overwhelm investors. Further, the inclusion of highly specific information may lead investors to think that the solicitation document is a prospectus or an offering circular.⁷³⁵ The omission of pricing materials will make the testing materials somewhat less informative for potential investors. However, because the pricing information will certainly change by the time an issuer prepares a prospectus or offering circular and investors will have the opportunity to review the prospectus or offering circular, the omission of pricing information from the testing materials should not really deprive investors. In addition, the omission of pricing information should encourage interested investors to read the prospectus or offering circular, which will include pricing details. Finally, the rule should require issuers to include in the testing materials a statement that would inform investors that the SEC has neither reviewed the solicitation materials nor ap-

⁷³⁰ AIMR Comment Letter, *supra* note 496, at 5; *see also supra* note 629 (insisting that minimal disclosure benefits investors).

⁷³¹ *See* AIMR Comment Letter, *supra* note 496, at 4.

⁷³² *See id.*

⁷³³ *See id.* at 5.

⁷³⁴ *See* Testing Release, *supra* note 8, at 86,888. An issuer that tests the waters should consider excluding forward-looking statements from the testing materials in order to avoid triggering a possible duty to update these statements in the future should they become materially inaccurate or misleading. For a discussion of this duty to update, *see* Jeffrey A. Brill, Note, *The Status of the Duty to Update*, 7 CORNELL J.L. & PUB. POL'Y (forthcoming Winter 1998).

⁷³⁵ *See* AIMR Comment Letter, *supra* note 496, at 5.

proved of the offering contemplated therein.⁷³⁶ This statement, which should appear in the form of a legend emblazoned on the front page, should convey to investors the preliminary nature of the solicitation, reminding them that review by the Commission would be forthcoming once the issuer files a registration or offering statement.

The Commission should also require that if, after testing the waters, an issuer distributes a prospectus or offering circular to interested investors, it must include a separate section that identifies and explains any material statements in the prospectus or offering circular that differ from the representations in the testing materials that the issuer used. In this way, the prospectus or offering circular would alert investors to material misstatements or omissions in the testing materials, and would reduce the likelihood that investors will rely solely on these solicitations rather than on the prospectus or offering circular when considering the offering.

5. *Standard of Liability*

In accordance with Rule 254(a) and the note to proposed Rule 135d(a)(4), the solicitation materials would be subject to the antifraud provisions of the federal securities laws.⁷³⁷ Although this standard does not provide investors with as much protection as sections 11 or 12(a)(2),⁷³⁸ the ABA and NYSBA make convincing arguments for retaining this standard.⁷³⁹ The imposition of section 11 or section 12(a)(2) liability would deter issuers from making false, misleading, or incomplete statements in the solicitation materials. However, it would also discourage issuers from relying on the rule and would increase compliance costs because an issuer is almost certain to consult with an attorney to ensure that the solicitation does not render the issuer liable. In addition, after the NSMIA, the states, which have a compelling interest in protecting investors who are residents, retain jurisdiction to investigate and enforce violations of state antifraud regulations.⁷⁴⁰ In light of these considerations, “[a]t this stage, it makes sense to avoid over-regulation and allow issuers to experiment. If abuses develop, the SEC can take steps to reform the rule and eliminate problems.”⁷⁴¹

A requirement that an issuer include the solicitation materials as part of the prospectus or offering circular for the registered initial

⁷³⁶ For a consideration of whether the Commission should be required to review the solicitation materials before an issuer may use them, see *infra* Part V.F.6.

⁷³⁷ See 17 C.F.R. § 230.254(a) (1997); Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.135d(a)(4) note).

⁷³⁸ See *supra* note 257 and accompanying text.

⁷³⁹ See *supra* notes 503, 521 and accompanying text.

⁷⁴⁰ See *supra* note 347.

⁷⁴¹ Glover, *supra* note 584, at B6.

public or Regulation A offering is an example of a reform the SEC could adopt if abuses in fact develop.⁷⁴² This measure would protect investors because the testing materials would be subject to section 12(a)(2) liability⁷⁴³ since they would be included in a prospectus, as defined by section 2(10). For a registered IPO, the incorporation of the testing materials in the prospectus, which must be included in the registration statement, would thereby subject the materials to section 11 liability. This proposal would enable all interested investors to review the testing materials that an issuer used to solicit indications of interest. Investors originally solicited pursuant to the testing-the-waters rule would be aware of any material differences between the testing materials and the prospectus or offering circular because, as proposed above, this Note recommends that the final rule require issuers to disclose in the prospectus/offering circular any such differences.⁷⁴⁴ The filing of the solicitation materials as part of the prospectus/offering circular would marginally add to an issuer's costs. In most instances, the testing materials will not be lengthy, which means that the cost of including them in the prospectus/offering circular should be low. Moreover, this cost increase would affect only issuers who go on to pursue public offerings, not potential issuers who test the waters and decide not to offer securities.

6. *Regulatory Submission Requirements*

Determining the proper degree of regulation for testing the waters represents a dilemma for the Commission. Rule 254(b)(1) and proposed Rule 135d(a)(3) require an issuer to submit a copy of the solicitation materials to the SEC only on, or prior to, the first usage of the materials for solicitation.⁷⁴⁵ The Commission is not required to review the materials. Investors would enjoy much more protection if the final rule required issuers to file the testing materials with the Commission, which, in turn, must review the materials before an issuer can use them to test the waters.

This revision would lead to higher compliance costs for issuers, for the Commission would probably set a filing fee in order to recoup the costs of staff review and correspondence with issuers. This would prolong the length of the process, perhaps discouraging issuers that seek a quick exploration of market interest.

⁷⁴² The Commission considered in the Testing Release requiring an issuer to file the testing materials as part of the registration statement if it proceeds with a registered IPO. Testing Release, *supra* note 8, at 86,889.

⁷⁴³ *See id.*

⁷⁴⁴ *See supra* p. 571.

⁷⁴⁵ 17 C.F.R. § 230.254(b)(1) (1997); Testing Release, *supra* note 8, at 86,893 (proposed 17 C.F.R. § 230.135d(a)(3)).

In contrast, section (1)(c) of the NASAA model rule requires the offeror to file any materials intended for use as solicitation devices with the state securities administrator ten days before their first use.⁷⁴⁶ In a comment to the Proposed Statement of Policy, NASAA explained that “[t]he [Administrator] may or may not review the materials filed pursuant to this rule.”⁷⁴⁷ This would give states the discretion whether to review the materials. This proposal would also forbid an issuer or its agent from using any materials to test the waters that the state securities regulator finds do not comply with the final testing-the-waters rule or other securities regulation.⁷⁴⁸ Given that the NSMIA did not remove the states’ authority to collect filing fees,⁷⁴⁹ a rule that follows the NASAA example may be too costly, especially for issuers seeking to test the waters in many states.

The final testing-the-waters rule should borrow from both examples. It should require submission of materials to the main office of the SEC in Washington, DC ten days prior to usage. Applying an antifraud standard, the Commission’s staff would be entitled, but not required, to review the testing materials.⁷⁵⁰ If the issuer failed to comply in any respect with the final testing-the-waters rule or other regulation, it would not be permitted to use the materials. Ten days should afford the staff enough time to review the materials. Although the ten-day requirement may postpone issuers’ efforts to test the waters, the compliance costs would remain low because issuers would not need to wait for approval from the Commission and state securities regulators.

The final rule should also eliminate the notes to Rule 254(b)(1) and proposed Rule 135d(a)(3) which requires issuers to submit only testing materials that are substantively different from or additional to materials previously submitted.⁷⁵¹ This vague standard is unnecessarily confusing for issuers. Section (1)(d) of the NASAA model rule eliminates this provision, requiring offerors to submit any amended or additional materials with the state securities administrator five busi-

⁷⁴⁶ NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

⁷⁴⁷ *Id.* at 2544 cmt. 2 (second alteration in original).

⁷⁴⁸ *See, e.g.*, section (1)(e) of the NASAA model rule *in* NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

⁷⁴⁹ *See* NSMIA, *supra* note 22, at 3419-20 (codified at 15 U.S.C. §§ 77r(c) (Supp. II 1996)).

⁷⁵⁰ The Commission would also have the opportunity to review the solicitation materials if the final rule requires an issuer to file them as part of the prospectus/offering circular. *See supra* notes 742-44 and accompanying text. Furthermore, investors would know that the Commission has not necessarily reviewed the testing materials because of the legend recommended above. *See supra* text accompanying note 736.

⁷⁵¹ 17 C.F.R. § 230.254(b)(1) note (1997); Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.135d(a)(3) note).

ness days before the first use of the materials.⁷⁵² A requirement that issuers submit *all* testing materials to the Commission will further protect investors. The five-day period gives the SEC staff enough time to review the updated or new materials. This requirement will add to expenses only marginally, and it may encourage issuers to prepare the original testing materials with greater diligence.

7. *Delivery and Solicitation Procedures*

As proposed Rule 135d intends, the final rule should give issuers the opportunity to use a wide range of media to test the waters.⁷⁵³ The testing-the-waters rule needs further safeguards to protect investors when issuers or their agents solicit indications of interest via a telephone call or a face-to-face conversation. NASAA recommended limitations on cold calling because it learned of abuse.⁷⁵⁴ This would excessively restrict an issuer's ability to test the waters. Rather, a less restrictive solution is to provide investors solicited by telephone or in person with more information.

The final rule should require that an issuer deliver to an interested investor a copy of the solicitation document no later than seven days after soliciting that investor's interest via an oral communication.⁷⁵⁵ This may even be preferable to delivery at the time of or before the communication because, assuming there is not a follow-up oral solicitation, an investor will have the opportunity to read the written document shortly after hearing the oral solicitation. The written document, which an investor keeps and can later review, may become more memorable than the oral representations. Given that an SEC staff member may have reviewed the solicitation document and that the solicitation document is in writing, it is less likely to be inaccurate or misleading than an oral representation which the Commission cannot regulate.

In addition, the final rule should provide that during an oral solicitation, an issuer or its agent must, by the end of the communication, give the solicited investor the name of an individual who can answer any questions in the future or reconfirm any information the issuer's agent conveyed. This would be consistent with the current requirements under both Rule 254(b)(1) and proposed Rule 135d(a)(3) that the issuer must identify in the solicitation materials the name and telephone number of an individual who can answer

⁷⁵² NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

⁷⁵³ See Testing Release, *supra* note 8, at 86,888.

⁷⁵⁴ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,053.

⁷⁵⁵ Section (1)(f) of the NASAA model rule requires that the offeror provide the offeree with a current copy of the document no later than five days after a communication. NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

questions about the materials.⁷⁵⁶ This Note suggests that the final rule require the contact person to be the owner, a director, an officer, or a high level manager of the issuer. Although difficult to police, this provision would prompt solicitants to give prospective investors the name of a contact.

Finally, the testing-the-waters rule should add a requirement that an issuer must maintain on file a copy of the solicitation document for a specified period of time.⁷⁵⁷ Upon request from an interested investor, the issuer would be obligated to send a copy of the solicitation materials free of charge. This would provide investors with yet another means of obtaining a copy of the solicitation document. Although the requirement represents a minor inconvenience and expense for issuers, it is in their best interest to save a copy of the solicitation document as well.

8. *Cooling-Off Periods*

The ultimate goal of all of these safeguards is to ensure that investors make a well-reasoned investment decision. A careful review by the investor of the prospectus or offering circular contained in the registration or offering statement is the best basis for such a decision. In this way, the securities laws try to ensure that investors will have time to read the prospectus. Investors currently have only forty-eight hours to review the prospectus before brokers or dealers are required to send a confirmation of a sale.⁷⁵⁸ However, when an issuer or its agent has solicited investors, they may need additional time to cool off from the solicitation to review the prospectus. In the Testing Release, the Commission acknowledged this concern and "requested [comment] as to the need for additional procedures to assure investors a sufficient opportunity following a 'test the waters' solicitation to review and assess the full information about the issuer, its management, the securities and the offering provided by the registration statement and prospectus."⁷⁵⁹

Sufficient investor protection requires additional procedures. Section (1)(h) of the NASAA model rule provides for a cooling-off period, lasting seven days after delivery of the prospectus to investors, during which the issuer may not sell the securities.⁷⁶⁰ In its comment letter, NASAA reported that this cooling-off period has not been disadvantageous to issuers.⁷⁶¹ The final testing-the-waters rule should

⁷⁵⁶ See 17 C.F.R. § 230.254(b)(1) (1997); Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.135d(a)(3)).

⁷⁵⁷ See Sullivan & Cromwell Comment Letter, *supra* note 487, at 5.

⁷⁵⁸ See *supra* note 524 (discussing Rule 15c2-8).

⁷⁵⁹ Testing Release, *supra* note 8, at 86,890.

⁷⁶⁰ NASAA Proposed Statement of Policy, *supra* note 302, at 2541.

⁷⁶¹ NASAA Comment Letter Regarding Testing Release, *supra* note 327, at 13,053.

adopt a similar cooling-off period that would give investors a better opportunity to review the prospectus.

Finally, the current twenty day cooling-off periods under both Rule 254(b)(4) and proposed Rule 135d(a)(6)⁷⁶² are insufficient. In accordance with these Rules, an issuer may not sell securities pursuant to an offering or registration statement until twenty days after the final publication or delivery of the solicitation document or broadcast of the television or radio solicitation.⁷⁶³ The duration of the cooling-off periods is adequate; the problem is that the Rules, strangely, do not require an issuer to wait twenty days after an *oral* communication with an investor.⁷⁶⁴ Section (3)(b) of the NASAA model rule extends the cooling-off period to cover oral communications by proscribing issuers from selling securities "until at least twenty . . . calendar days after the last *communication* made in reliance on this rule."⁷⁶⁵ While NASAA did not reiterate in its comment letter regarding the Testing Release the need to expand the cooling-off period provision to include oral solicitations, AIMR advocated such an extension.⁷⁶⁶ In light of legitimate concerns regarding the lingering effects of oral solicitations, the final testing-the-waters rule should require issuers to wait twenty calendar days after its final communication of any sort in reliance on the testing-the-waters rule before it may begin to sell securities. This safeguard will protect investors should the Commission decide to revise Rule 254(b)(3) and proposed Rule 135d(a)(5) to permit issuers to test the waters after filing an offering or registration statement.

9. *Effect of Proposed Safeguards*

The aggregate effect of these proposed safeguards, bolstered by the full compliance standard, should provide investors with much greater protection at an essentially negligible cost to issuers. These added procedures also benefit issuers because they will enable them to obtain more accurate information from investors, and thus increase the likelihood of a successful offering. If an issuer solicits indications of interest in reliance on the rule (including the proposed safeguards) and declines to proceed with the offering, it will have spent little money relative to the potential expenditures of pursuing the of-

⁷⁶² 17 C.F.R. § 230.254(b)(4) (1997); Testing Release, *supra* note 8, at 86,894 (proposed 17 C.F.R. § 230.135d(a)(6)).

⁷⁶³ See sources cited *supra* note 762.

⁷⁶⁴ See AIMR Comment Letter, *supra* note 496, at 6; NASAA Comment Letter Regarding SBIs, *supra* note 18, at 9379.

⁷⁶⁵ NASAA Proposed Statement of Policy, *supra* note 302, at 2543-44 (emphasis added).

⁷⁶⁶ AIMR Comment Letter, *supra* note 496, at 5-6.

fering. Those issuers who consummate a successful Regulation A offering or registered IPO will recoup their costs.

The Commission would enjoy substantial benefits from adding these safeguards. A single testing-the-waters rule would dramatically improve the administrability of the process. Even more significantly, these safeguards should garner the support of NASAA and state securities regulators because they either resemble the NASAA model rule or otherwise improve investor protection. Therefore, a testing-the-waters rule that includes similar safeguards to those proposed in this Section may help to resolve the coordination problem confronting issuers seeking to offer securities under Regulation A. It should also increase the likelihood that issuers will test the waters under Rule 254 and proposed Rule 135d without harming investors in the process. Finally, a testing-the-waters rule containing these or similar safeguards should give the Commission greater confidence that the rule "is consistent with the public interest and the protection of investors."⁷⁶⁷ Such confidence would enable the SEC to exercise its apparent authority under new section 18 of the Securities Act to adopt legislation preempting state securities regulations regarding Regulation A offerings, which would give issuers the opportunity to rely on Rule 254 to test the waters in all states.⁷⁶⁸ This confidence would also enable the Commission to exercise its general exemptive authority under new section 28 to exempt issuers that test the waters prior to registered IPOs in reliance on proposed Rule 135d from section 5.⁷⁶⁹

CONCLUSION

Congress enacted and has amended the Securities Act to, among other things, protect investors before, during, and after IPOs. As SEC Chairman Arthur Levitt has explained, "investor protection is the SEC's most important priority."⁷⁷⁰ At the same time, the Commission seeks to facilitate the promotion of capital formation.

The Commission has struggled to maintain the balance between encouraging capital formation and protecting investors in its efforts to draft and adopt testing-the-waters rules. The innovative and contro-

⁷⁶⁷ NSMIA, *supra* note 22, at 3418 (codified at 15 U.S.C. § 77r(b)(3) (Supp. II 1996)).

⁷⁶⁸ *See id.*; *supra* text accompanying notes 359-61.

⁷⁶⁹ *See* NSMIA, *supra* note 22, at 3424 (codified at 15 U.S.C. § 77z-3 (Supp. II 1996)) (granting the Commission this authority "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors"); *supra* text accompanying notes 541-44, 569.

⁷⁷⁰ *Levitt Unveils Series of Proposals Designed To Improve Capital Formation*, 27 Sec. Reg. & L. Rep. (BNA) 671, 672 (May 5, 1995); *see also Investor Protection Is First*, *supra* note 376, at 297 (quoting SEC Chairman in March 1997 as stating that "[n]othing should come ahead of investor protection in terms of what the [C]ommission does or how it operates") (first alteration in original).

versial testing-the-waters concept permits a potential issuer to solicit indications of investor interest during the pre-filing period, that is, before it incurs the considerable compliance costs that often preclude or discourage smaller businesses from accessing the public markets. Both of the Commission's rulemaking efforts to introduce testing the waters have been problematic. Rule 254, adopted in August 1992, represents the Commission's first experience with testing the waters. Reliance on the Rule is limited to businesses, usually small entities, that are considering a Regulation A offering. Rule 254 has three primary shortcomings. First, the scope of the Rule is too limited, rendering it unavailable to many potential issuers. Second, the Rule appears ill-equipped to protect financially unsophisticated investors from the sales-oriented overtures of inexperienced and overeager principals of small businesses. Third, the utility of the Rule has been further limited because, in the absence of preemptive legislation regarding securities offered pursuant to Regulation A, the SEC has thus far failed to coordinate the Rule with the securities laws of most states.

After prematurely declaring Rule 254 a success, the Commission published the Testing Release in June 1995 in which it proposed to extend the availability of testing the waters to businesses contemplating registered IPOs. The Commission hoped to increase access to the booming IPO market. Proposed Rule 135d remedied the first problem experienced in practice under Rule 254. Under the proposal, many more issuers would be able to test the waters. The proposal deserves praise for extending to large businesses the opportunity to test the waters before registered IPOs, for there had been no rational justification for denying larger businesses access to testing the waters. However, the Commission made little progress in the area of investor protection. The controversial proposal currently caters to the needs of issuers at investors' expense. A testing-the-waters rule is needed to help businesses raise capital in a cost-effective manner. In the modern age, controlling the dissemination of information to investors is admittedly difficult.⁷⁷¹ Although some have maintained that this reality is grounds for further deregulation, the argument that more investor protection is necessary is more convincing. Moreover, the SEC may again encounter difficulties securing wide-scale approval from the states. Despite its authority to preempt blue sky laws regarding the offering of what would typically constitute covered securities under section 18, the Commission has neither adopted nor published an amended version of proposed Rule 135d.

Nevertheless, the Commission's continued enthusiastic support for a broader testing-the-waters rule and the availability of general ex-

⁷⁷¹ See Quinn, *supra* note 549, at 28.

emptive authority suggest that it will take measures to expand the availability of testing the waters in the near future. The SEC may have shelved adoption of proposed Rule 135d until the Agency can include it as part of a more comprehensive revision of the Securities Act, such as a company registration system. The Commission clearly has the authority to adopt a testing-the-waters rule. There is little doubt that in relying on this authority, the Commission has thus far attempted to draft a rule that would not compromise investor protection.⁷⁷² Current leading officials of the SEC staff remain committed to this goal.⁷⁷³

Proposed Rule 135d, as currently drafted, is irreconcilable with section 5(c) of the Securities Act because it poses substantial risks to investors that the potential benefits to issuers and the capital markets cannot justify. The proposal is such a broad rejection of section 5(c) that, if adopted, it would radically change how issuers prepare for an IPO during the prefilings period. Of perhaps still greater importance, the proposal may represent the first step toward further deregulation of the registration process. It is therefore especially necessary to install sufficient safeguards into a testing-the-waters rule, for further deregulation may leave investors even more vulnerable.

This Note recommends the adoption of a single testing-the-waters rule that would apply to both short form registration and registered IPOs. The principal distinction between this rule and proposed Rule 135d is the incorporation of additional safeguards that will protect investors without significantly discouraging issuers from availing themselves of the rule. These safeguards would help the SEC to achieve what should be its ultimate objective for testing the waters: to facilitate the matching of quality potential issuers with investors, who, after learning of an investment opportunity as a result of a prefilings solicitation of interest, will defer making investment decisions until they have reviewed the mandatory disclosures in the prospectus. In addition, these safeguards would help justify both an exercise by the Commission of general exemptive authority and further preemptive rulemaking. The former would further legitimize the adoption of the rule, and the latter would increase the likelihood of its success. An effective testing-the-waters rule will never be reconcilable with the interpretation of section 5(c) that has prevailed since 1933. However, if the final rule provides investors with greater protection through the inclusion of additional safeguards similar to those suggested in this Note, the rule will at least be consistent with the policy objectives guiding the Commission and underlying section 5(c).

⁷⁷² See *supra* note 612 and accompanying text.

⁷⁷³ See *supra* note 770 and accompanying text.

