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## REGULATION D AND THE INTERNET

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*The Securities Law Institute is a for profit corporation dedicated to implementing a system of disseminating material information relative to issuers and individuals involved in the ownership and management of public issuers.*

## Regulation D and the Internet

### *I. Introduction*

The Internet offers virtually instantaneous, worldwide access to millions of users. Used properly, the Internet also offers issuers the ability to conduct their capital-raising activities by reaching potential investors quickly and in a cost-effective manner.

The federal securities laws were enacted long before the advent of the Internet. The Securities and Exchange Commission (the "SEC"), however, generally has welcomed the growing significance of the Internet and the electronic distribution of information. In October 1995, the SEC published its interpretation (the "October 1995 Release") on the use of electronic media, including the Internet, to communicate with investors and potential investors and to deliver information under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act").<sup>(1)</sup> The October 1995 Release confirms that the rights and responsibilities of issuers, broker-dealers and others under the federal

securities laws are unaffected by the use of electronic means to satisfy the delivery requirements of the federal securities laws. As the SEC stated in the October 1995 Release, "[T]he liability provisions of the federal securities laws apply equally to electronic and paper-based media."<sup>(2)</sup>

The SEC has recognized that electronic distribution of information may be more useful to investors than paper-based distribution and has specifically stated that its use "should not be disfavored."<sup>(3)</sup> The SEC also recognizes that electronic communication permits companies "to disseminate information to more people at a faster and more cost-effective rate than traditional distribution methods, which have been largely paper-based."<sup>(4)</sup> The appeal to potential issuers of securities is readily apparent. The very nature of the Internet, however, with its access to millions of users worldwide, raises issues for issuers that wish to conduct an offering under Regulation D without the use of general solicitation or advertising.

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## II. Internet Offerings Under Rule 505 or Rule 506 of Regulation D<sup>(5)</sup>

### A. Prohibition against General Solicitation

The prohibition against “general solicitation or general advertising” in Rule 502(c) of Regulation D applies to offerings made in reliance on Rule 505 or Rule 506 of Regulation D and presents a significant obstacle for issuers attempting to rely on these commonly used exemptions from the registration requirements of the federal securities laws in connection with an Internet offering.<sup>(6)</sup>

### B. Avoiding General Solicitation by Establishing a Preexisting Substantive Relationship with Potential Investors

In determining whether a general solicitation has occurred, the SEC generally has focused on whether the issuer, or broker-dealer acting on behalf of the issuer, had a relationship with the offeree that was both “substantive” and “preexisting.”<sup>(7)</sup>

**1. Substantive Relationship.** For a relationship with an offeree to be

“substantive,” the issuer or the broker-dealer either must be able to determine the financial circumstances or sophistication of the person with whom the relationship exists or the relationship must be of some substance or duration. Preexisting business relationships, while important, are not conclusive in determining whether or not there was a preexisting substantive relationship between the issuer or the broker-dealer and the potential investor at the time of the offering.<sup>(8)</sup>

**2. Preexisting Relationship.** A relationship with an offeree will not be considered “preexisting” unless the relationship was established before the offering commenced or, in case of a broker-dealer participating in an offering, before the broker-dealer’s participation in the offering commenced. In the October 1995 Release, for example, the SEC stated that placing offering materials on an issuer’s Internet web site, even if the information about the financial position or sophistication of the person attempting to access the materials was required before the materials could be accessed, would not be consistent with the prohibition against general solicitation or advertising in Rule 502(c) of Regulation D.<sup>(9)</sup>

Accordingly, even if an issuer limits access to offering materials posted on its Internet web site or otherwise available through the Internet to those potential offerees that first provide information establishing their status as “accredited” or “sophisticated” investors prior to viewing the materials, a preexisting substantive relationship would not exist and the issuer would violate the prohibition regarding general solicitation or advertising. The same result would apply to a broker-

dealer that placed offering materials on its Internet web site, with access subject to the provision of information by the potential offeree. Simply gathering information on prospective investors as part of an offering is not sufficient to establish a preexisting substantive relationship. If, however, an issuer (or broker-dealer) locates prospective investors otherwise than through a general solicitation, it may deliver offering materials to them through the Internet. The delivery may be made either through proprietary computer services or to the recipient’s previously furnished e-mail address.

<sup>(10)</sup>

### C. Establishing a Preexisting Substantive Relationship Through The Internet

In 1996, the SEC expanded its then-existing position allowing broker-dealers to use the Internet to contact prospective investors with which the broker-dealer already had a preexisting substantive relationship and, for the first time, permitted a broker-dealer to use the Internet to create the preexisting substantive relationship.<sup>(11)</sup>

**1. The IPONET Letter.** IPONET, an Internet web site of broker-dealer WJ Gallagher & Co., allows investors who are IPONET members to complete a questionnaire online (or to obtain a hard copy of the questionnaire by mail and complete and return the questionnaire by mail) that establishes their status as an accredited or sophisticated investor. The investors then receive a password that allows them to access the password-protected page on which IPONET posts private offerings.

*(Continued on page 3)*

In the IPONET Letter, the SEC stated that IPONET's activities will not amount to general solicitation or general advertising as long as IPONET satisfies the following three conditions.

- a. Both the invitation to complete the questionnaire and the questionnaire itself must be generic in nature and may not refer to any specific transaction or offering.
- b. The password-protected page containing offerings may become available to a particular investor only after the IPONET-affiliated broker-dealer determines that the particular investor is accredited or sophisticated.
- c. The potential investor may purchase securities only in offerings that are posted on IPONET after the point in time at which that investor has qualified as an accredited or sophisticated investor.

## **2. Effect of the IPONET Letter.**

As a result of the IPONET Letter, it is clear that broker-dealers can establish relationships with potential investors and, after establishing the relationships, contact the investors regarding the purchase of securities in a Regulation D offering without violating the prohibition against general solicitation or advertising. This, in turn, enables the issuer to employ these broker-dealers (either as a selling broker-dealer or a finder for a particular offering) and rely on the broker-dealers' preexisting substantive relationships to make its Rule 505 or Rule 506 offering without violating the prohibition of general solicitation or advertising.

## **3. Ability of an Issuer to Rely on the IPONET Letter.**

The IPONET Letter is not, by its terms, limited to permissible activities of a broker-dealer. In theory, if an issuer satisfies the conditions of the IPONET Letter, the issuer also should be able to establish a relationship with potential investors through the Internet.<sup>(12)</sup> The issuer then should be able to post offering materials to an Internet web site that is accessible only to those persons with which the issuer had established the required relationship prior to the time the offering commenced. Issuers should be aware, however, that the SEC instead may take the position that an issuer can never satisfy the condition of the IPONET Letter that investors be qualified before commencement of any particular offering.

## **D. Providing Written Offering Materials Satisfying the Requirements of Regulation D Through the Internet**

Rule 502(b) sets forth requirements for the delivery of information in an offering under Rule 505 or Rule 506 to any investor that is not an accredited investor. The information must be delivered "a reasonable time prior to sale."<sup>(13)</sup> The issue arises as to what constitutes delivery for purposes of satisfying this requirement of Regulation D.

Distribution through electronic means can satisfy the delivery requirements of the federal securities laws if the electronic distribution results in delivery to the intended recipient of information that is the "substantial equivalent" of the information the recipient would have received if the information were

delivered to him in paper form.<sup>(14)</sup>

In the October 1995 Release, the SEC identified the following three principles which should be considered in assessing the adequacy of electronic delivery as compared to paper delivery.

**1. Notice of Delivery.** The first factor is whether investors have notice of the delivery of the information that is comparable to the notice of paper delivery.

a. The SEC indicated that delivery to an investor's e-mail address is equivalent to receiving information through the mail.

b. Placement of information on an Internet site is insufficient to satisfy delivery requirements absent separate, more direct notice of the availability of the information at the site. In effect, this requires a prompting mechanism to ensure that the intended recipient is aware of the newly available information.

c. Providing an electronic document itself (for example, by delivering a computer disk or CD-ROM) is sufficient to satisfy delivery requirements.

**2. Access to Information.** The second factor is whether investors have access to the information that is comparable to the access available for information presented in paper format. Depending on the manner in which the securities are being offered and sold, either the issuer or broker-dealer should make the information accessible. The information should not be more burdensome to read than

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paper documents and certainly should not be so burdensome that the intended recipients cannot effectively access the information. In addition, the investor should be able to retain a permanent copy of, or have ongoing access to, the information. This requirement can be satisfied, for example, by providing the investor with the ability to download or print the information delivered electronically in order to retain a permanent record. The information must be accessible for as long as any delivery requirements apply.

Any issuer using the Internet to deliver information must have the ability to make paper versions of all electronically delivered documents. An investor must be able at any time to request paper copies of documents. In addition, an investor must have the right to revoke the investor's consent to receive documents electronically and, beginning at the time of revocation of the consent, to receive the documents in paper format.

**3. Evidence of Delivery.** The third factor is whether there is evidence of delivery comparable to the evidence of delivery of paper-based materials. The SEC accepts several methods for satisfying this factor.<sup>(15)</sup>

a. An electronic mail "return receipt" or equivalent confirmation that investors have accessed, downloaded or printed the information would satisfy this factor.

b. Receipt of a revocable informed consent<sup>(16)</sup> from an investor to receive specific types of information through a particular means for a particular time period, coupled with ensuring that the

investor has appropriate notice and access, would satisfy this factor as well.

c. The SEC also has stated that in most cases where a request for information is made electronically, consent to receive the requested information by electronic means may be presumed.

d. If an investor accesses a document that contains a hyperlink to a document that is required to be delivered to investors, or uses forms or other materials that are available electronically only if the investor has accessed the required document, then delivery of the required document can be presumed.

For example, if Company X places its offering materials or other required materials (assuming no general solicitation or general advertising concerns are involved) on its Internet web site, it must then send additional notice to its investors informing them that this information has been placed on the Internet site along with the Internet location of the site. Company X should receive some form of confirmation that the information has been downloaded, printed or otherwise accessed by each investor, or should have in its records a revocable, informed consent from each investor to receive through an Internet site the specific type of information being provided. Company X should then mail paper copies of the information to any investor for which it does not have electronic confirmation of delivery or consent to electronic delivery.

## **E. Satisfying the Right of Potential Investors to Ask Questions**

Under Rule 502(b) (2) of Regulation D, the issuer must provide each potential investor in the offering with the right to ask questions and receive answers regarding the terms and conditions of the offering and to obtain additional information. It should be possible to satisfy this requirement electronically through the use of e-mail. In general, the issuer (or broker-dealer who is making the offering on the issuer's behalf) should inform potential investors of their right to ask questions and state that the questions will be answered by e-mail to the potential investor. Although it is not required, it may be advisable to deliver the questions and answers to all potential investors in order to assure them equal access to any information that is generally available to another investor.

### ***III. Offerings Under Rule 504 of Regulation D***

#### **A. Lack of Prohibitions on General Solicitation in Certain Offerings under Rule 504**

Unlike offerings conducted in compliance with Rules 505 or 506 of Regulation D, there are three types of offerings that may be made in compliance with Rule 504 even if the offers or sales of the securities are made using general solicitation or general advertising.

**1. Offerings Exclusively in States Requiring Registration.** If all offers and sales of securities in a particular offering are made (i) exclusively in one or more states that provide for the registration of the securities and that

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require public filing and delivery to investors of a “substantive disclosure document” prior to the sale of the securities, and (ii) in accordance with the registration provisions of the state or states in which the offering is made, then there is no prohibition on general solicitation or general advertising. <sup>(17)</sup>

## **2. Offerings in which Only Certain States Require Registration.**

Even if offers and sales of securities in connection with a particular offering are made in one or more states that do not provide for registration of the offering or the public filing or delivery of disclosure documents prior to completing any sales in connection with the offering, general advertising or general solicitation are permitted in connection with the offering if (i) the offering of the securities is registered in at least one state that provides for registration and public filing and delivery of a disclosure document, (ii) offers and sales are made in that state in accordance with those provisions, and (iii) the required disclosure document is delivered, prior to sale of the securities, to purchasers in *all* states in which the offering is made (including those states in which delivery of a disclosure document is not required).

## **3. Offerings in States Pursuant to Exemptions that Permit General Solicitation and General Advertising.**

If (i) all offers and sales of securities in connection with a particular offering are made exclusively under state law exemptions from registration that allow general solicitation and general advertising, and (ii) the sales are made only to accredited investors, then general solicitation or general advertising is permitted in connection with the

offering.

## **B. Prohibitions on General Solicitation in Other Offerings under Rule 504.**

Offerings conducted pursuant to Rule 504 that do not meet the conditions set forth in Section III. A. are subject to the same prohibitions and face the same issues regarding general solicitation and general advertising as Rule 505 or Rule 506 offerings, as explained in Section II.

## **C. General Limitations on Offerings under Rule 504**

### **1. Limitation on Type of Issuer.**

Rule 504 generally is available only to issuers that do not file reports with the SEC under Sections 13 or 15 of the Exchange Act.

### **2. Limitations on Size of Offering.**

Rule 504 may not be used for sales of securities with a dollar value in excess of \$1 million (including, for purposes of determining the amount available for sale under Rule 504, the dollar amount of securities sold within the 12 months before the start of, and during, the offering if the securities are sold (i) under Rule 504, (ii) under any other exemption under Section 3(b) of the Securities Act, such as sales made in reliance on Rule 505, or (iii) in violation of Section 5(a) of the Securities Act). Due to these dollar limits, the utility of Rule 504 is somewhat limited.

## **D. Electronic Road Show**

It should be permissible to undertake an electronic road show in connection with a Rule 504 offering that is not subject to the prohibition on general

solicitation or general advertising because the restrictions which apply to registered offerings do not apply to exempt offerings (including offerings under Regulation D). <sup>(18)</sup>

In 1996, Primary Care Centers of America prepared an Internet road show for a \$1 million offering exempt under Rule 504. <sup>(19)</sup> The road show included interviews with management, a “virtual” tour of the issuer’s headquarters, a slide show relating to the issuer and its history, and the offering documents. The road show required significant coordination with the state securities authorities of the states in which the road show was made available to investors. As part of that process, it was agreed that a frame would remain visible on the screen at all times during the road show making certain disclaimers about the presentation and urging investors to read the offering documents.

## **E. Providing Offering Materials in a Rule 504 Offering**

A Rule 504 offering is not subject to any specific requirements relating to the preparation or delivery of offering materials. As a result, an issuer making a Rule 504 offering that is not subject to the prohibition on general solicitation or general advertising is entitled to post any offering materials to its Internet web site without jeopardizing its ability to comply with the conditions for the availability of the exemption provided by Rule 504.

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#### **IV. State Regulation and Internet Offerings**

##### **A. Access May be Deemed an Offer**

While the SEC has done much to clarify the extent to which offers and sales of securities may be made through the Internet in reliance upon the exemption from registration in Regulation D, the use of the Internet also raises issues at the state level. To the extent that offering materials are accessible to any person in a particular state, an offer to sell securities within that state may be deemed to have been made. For example, an issuer or broker-dealer who sends an offering document by e-mail clearly has made an offer to sell securities in the state in which the e-mail is received. Further, an issuer who posts offering materials to its Internet web site (as may be permitted under Rule 504) may be deemed to have made an offer in every state.

##### **B. Rule 506 Offerings and NSMIA**

Fortunately for issuers considering a Regulation D offering using the Internet, the National Securities Markets Improvement Act of 1996 (“NSMIA”) preempts state regulation of Rule 506 offerings, except for notice filing requirements substantially similar to those under Regulation D (*i.e.*, within 15 days of the first sale) and collection of filing fees. As a result, issuers making offerings in reliance upon Rule 506 do not have to consider the implications of state securities laws beyond making the filing required by any state in which a sale is made. In addition, the antifraud provisions of the state securities laws continue to apply.

#### **C. Rule 505 and Rule 504 Offerings**

**1. Applicability of State Securities Laws.** Issuers relying in the exemption from federal securities registration in Rule 505 or Rule 504 continue to be subject to regulation at the state level. Limited offering exemptions vary from state to state and may restrict the number of offerees, purchasers or holders of a security, either solely within the state or on an aggregate basis wherever located. In addition, many state limited offering exemptions restrict the use of “general solicitation or general advertising” in the same manner as Rule 502(c) of Regulation D.

Prior to commencing an offering in reliance upon Rule 505 or Rule 504, an issuer should consider and address the securities laws of each state. This may be accomplished by (i) registering in the state (frequently required for Rule 504 offerings), (ii) determining that an exemption for offers and sales is provided in the state, or (iii) restricting the offering to states in which the offering is registered or exempt.

**2. NASAA Resolution.** In 1996, the North American Securities Administrators Association (“NASAA”) stated that an Internet communication is directed generally to each person who has access to the Internet. <sup>(20)</sup> NASAA also adopted a resolution in 1996, however, that permits certain Internet communications that otherwise might be deemed offers. <sup>(21)</sup> The resolution encourages states to exempt Internet offers from registration if (i) the Internet offer indicates, directly or indirectly,

<sup>(22)</sup> that the securities are not being offered to residents of a particular state and (ii) an offer is not otherwise specifically directed to any person in the state. The resolution also encourages the states to allow sales of securities that were the subject of an Internet offer if (i) in the case of a registered offering, no sales are made in the state until the offering has been registered and declared effective and the final prospectus has been delivered or (ii) the sales are exempt from registration. Under this resolution, an issuer of securities in a Rule 505 or Rule 504 offering may make offers through the Internet as long as it registers the offering or determines that an exemption from registration is available in a particular state prior to completing the sale of the security in that state. This permits an issuer to register in only a few states, post its offering on its Internet web site (subject to compliance with any prohibitions on general solicitation or advertising) and expand the offering later by registering in additional states if there is investor interest in those states. According to NASAA, 32 states have adopted some form of this resolution and 16 other states intend to adopt it. <sup>(23)</sup>

**3. Additional State Restriction on Internet Sales.** Of the 32 states that have adopted a version of the NASAA resolution, several have adopted a more restrictive form of the resolution. In these states, the Internet offer is exempt only if no sales are subsequently made in the state as a result of the offer. <sup>(24)</sup> This more restrictive form of the resolution retains the benefit of preventing an issuer from violating the securities laws of states in which it does not intend to make offers or sales. It does not, however,

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allow an issuer, after offers have been made, to expand an offering beyond the states in which the issuer initially identified prospective purchasers and registered the offering, even if the issuer subsequently determines that there are prospective purchasers in other states.

## ***V. Additional SEC Guidance Regarding Electronic Delivery***

### **A. Simultaneous Delivery Over the Internet**

In an example in the October 1995 Release, the SEC pointed out that it considered the placement of two pieces of information on the Internet connected by a hyperlink to be the equivalent of simultaneous delivery of the two pieces of information by mail. The SEC stated that sales literature could be the first information accessed by an investor on the Internet, as long as the sales literature was connected to the issuer's prospectus through a hyperlink, and the prospectus could be easily accessed by investors. <sup>(25)</sup>

In addition, it may be possible to treat two items of information as having been simultaneously delivered if the two items are accessible from the same menu or from an uncomplicated menu structure. <sup>(26)</sup> Similarly, the SEC has stated that delivery of two documents can be inferred if the investor would not need additional software to access both documents and also is not required to take burdensome steps to access one document from another. <sup>(27)</sup>

A link allowing "direct access" from one Internet web site to another has also been viewed as making the two web pages a single document. <sup>(28)</sup>

Similarly, delivering an offering document with links to another document causes the offering document and the other document to be treated as a single document. Accordingly, if an issuer, for example, links third-party reports relating to the issuer to other documents delivered or available to investors, the issuer may take on liability for the contents of those third-party reports.

### **B. No Requirement to Prove Substantial Equivalence**

The SEC requires electronic delivery to result in the receipt by investors of information substantially equivalent to information that would have been received through paper delivery. However, there does not appear to be any requirement that companies provide the SEC with the electronic form of the information they deliver to investors, even when the electronic form could be substantially different from the form of the information delivered to investors who either do not have access to the electronic form or request paper form or the form of the information filed with the SEC. In another example in the October 1995 Release, the SEC addressed the situation in which a company provided its investors with a CD-ROM version of its prospectus which included a movie illustrating the company's operations. Because the SEC does not yet have the facilities to accept a filing with this technological sophistication, the company would have to file with the SEC the script of the movie and a fair and accurate narrative description of the graphic or image material, as an appendix to the prospectus. Although the issuer has the obligation to ensure that the

electronic form of the prospectus was "substantially equivalent" to the paper form, the company did not have to provide the SEC with the CD-ROM to prove that the filing was in fact substantially equivalent to the electronic information being provided to investors.

Although the SEC did not address what should be provided to investors who do not have access to information contained in a CD-ROM, it appears as though providing these investors with a paper copy of what was filed with the SEC should suffice.

## Footnotes (cont.)

- 1 See "Use of Electronic Media for Delivery Purposes," Release No. 33-7233 (October 6, 1995). See also "Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples under the Securities Act of 1933, Securities Act of 1934, and Investment Company Act of 1940," Release No. 33-7288 (May 9, 1996).
- 2,3,4,9,10,14,15,25,26,27,28 See the October 1995 Release.
- 5 Offerings of Securities under Rule 505 are limited to sales aggregating no more than \$5 million (including, for purposes of determining the amount available for sale under 505, the dollar amount of securities sold under Rule 505 or under any other exemption under Section 3 (b) of the Securities Act, such as sales made in reliance on Rule 504) within the 12 months before the start of, and during, the offering. There is no dollar limit on the amount of securities that may be sold under Rule 506.
- 6 An issuer that is seeking an exemption from the registration requirements of the federal securities laws in connection with an offering of securities may choose to rely on Rule 505 or Rule 506, in preference to another exemption, because of the certainty provided by the safe harbor offered by Regulation D and the availability of exemptions at the state level.
- 7 Although the SEC has stated that the existence of a preexisting, substantive relationship is not the only means of demonstrating the absence of a "general solicitation" (Release No. 33-6825 (March 14, 1989), Footnote 12), it is the method most commonly discussed in SEC no-action letters on the topic.
- 8 See, e.g., Mineral Lands Research and Marketing Corporation (December 4, 1985).
- 11 See IPONET (No-Action Letter, July 23, 1996).
- 12 As a practical matter, any issuer which has a sufficient number of offerings that it continually must generate a list of potential investors should carefully consider whether it has an obligation either to register as a broker-dealer or to form an affiliate that would register as a broker-dealer.
- 13 Rule 502(b)(1) of the Securities Act.
- 16 Informed consent requires the issuer or the broker-dealer to advise the investor (i) as to the specific electronic medium or source through which the information will be available (for example, an Internet web site), (ii) that the investor may incur costs (such as on-line charges) in accessing the information, and (iii) the period of time during which, and for which documents, the consent is effective.
- 17 Rule 504(b)(1)(i) under the Securities Act.
- 18 In general, the electronic road shows are prohibited in connection with a registered offering because the only permissible written communications that may be made after the filing of a preliminary prospectus (other than the prospectus) are tombstone advertisements.
- 19 It should be noted that the Primary Care Centers of America offering in question took place before the 1999 amendments to Rule 504. Before these amendments, no Rule 504 offerings were subject to the prohibition on general solicitation and general advertising. The 1999 amendments subject offerings conducted pursuant to Rule 504 to the prohibitions on general solicitation and general advertising contained in Rule 502(c) of Regulation D (as discussed in II.A. above) unless certain conditions (described in III.A. above) are met. The Primary Care Centers of America offering may not have met these new conditions (in which case an electronic road show would not have been permissible).
- 20, 21, 23 See the NASAA website at <[www.nasaa.org/bluesky/guidelines](http://www.nasaa.org/bluesky/guidelines)>.
- 22 Certain states require a specific statement that no offer is being made within the state while others permit a general statement to the effect that no offers or sales will be made in any jurisdiction in which the offer or sale is not qualified or exempt.
- 24 See e.g., In re Offers But Not Sales Effected Through the Internet That Do Not Result in Sales in Pennsylvania, Commonwealth of Pennsylvania, Before the Pennsylvania Securities Commission (August 31, 1995) (last modified September 6, 1996).

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