U.S. REGULATION OF OFFERS OF INVESTMENT ADVISORY SERVICES AND HEDGE FUND MARKETING OVER THE INTERNET

BY

MICHAEL G. TANNENBAUM, ESQ.[1]

As e-commerce expands into virtually every area of business life, it seems perfectly natural that the Internet has attracted the attention of investment advisers, hedge fund operators and sponsors. This chapter addresses the legal ramifications of Internet marketing by investment advisers and the use of the Internet for distributing hedge fund products.

The SEC Credo

According to its Release Number 33-7233 (October 6, 1995), the policy of the United States Securities and Exchange Commission (the "Commission") that seems to be the guiding force in dealing with Internet use in the context of hedge funds and securities sales is the following:

> The Commission appreciates the promise of electronic distribution of information in enhancing investors' ability to access, research, and analyze information, and in the provision of information by issuers and others. The Commission believes that, given the numerous benefits of electronic distribution of information and the fact that in many respects it may be more useful to investors than paper, its use should not be disfavored. Given the numerous benefits of electronic media, the Commission encourages further technological research, development and application. The Commission believes that the use of electronic media should be at least an equal alternative to the use of paper-based media. Accordingly, issuer or third party information that can be delivered in paper under the federal securities laws may be delivered in electronic format.

Full-page advertisements in the Wall Street Journal describing one's investment advisory prowess or advertising one's hedge fund for sale would, without doubt, trigger

---

[1] Partner, Tannenbaum Helpern Syracuse & Hirschtritt LLP, New York City. Mr. Tannenbaum heads up the law firm's financial services and derivatives practice which encompasses U.S. and non U.S. hedge funds, investment products and regulatory and tax matters relating to such areas. He is a frequent lecturer to industry groups and author of numerous articles on the subject of hedge funds, Internet development and new issues.

the full panoply of regulatory wrath. The unregistered adviser would be deemed to be improperly holding itself out to the public under the Investment Advisers Act of 1940, as amended, the fund would be deemed to be offering securities via a general solicitation in contravention of Regulation D (the private placement exemption) under the Securities Act of 1933, as amended, and an exemption from the Investment Company Act of 1940, as amended pursuant to Section 3(c)(1) or 3(c)(7), would fail by virtue of the public offering being made. The Internet, in a sense, is precisely the same as a full page ad in a global newspaper with instantaneous circulation and the analogy is useful when viewing Internet activities.

Our Sandbox

It is difficult or impossible to fully understand the issues raised for advisers to, or distributors of, hedge funds by the use of the Internet without the context of the underlying legal framework. This is the sandbox in which we play, like it or not. The Commission has been active in this area and, as will be seen, is rather enlightened when compared to similar regulatory bodies in other countries.

The essential legal framework for this discussion is found in several key statutory provisions that are common to advisers and hedge fund sponsors: the Investment Advisers Act of 1940, as amended (the “Advisers Act”), the Investment Company Act of 1940, as amended (the “40 Act”), the Securities Act of 1933, as amended (the "33 Act"), and the Securities Exchange Act of 1934, as amended (the “34 Act”). It is against this backdrop that the recent no-action letters of the Commission can be viewed to gain an understanding of the trends and direction in which the Commission and U.S. law are moving.

Further, it is essential to an understanding of the U.S. regulatory climate to continually note that the interest of the Commission is to regulate the *offer* of securities and the *offer* of advisory services – it is the process of the making and receiving of an *offer* to purchase or sell securities or services on which the regulatory scheme rests. This theme carries through the regulatory framework.

The Investment Company Act of 1940 (the “40 Act”)

A hedge fund operator is exempt from the provisions of the 40 Act if the fund can stay outside of the statutory meaning of an investment company subject to registration.[2] This is a definitional challenge. There is a list of exclusions from the definition of an investment company in the 40 Act and for hedge funds, of which the two most commonly used are found in Section 3(c)(1) and 3(c)(7) of the 40 Act.

[2] Why bother to be exempt from 40 Act registration? Because many attributes of a 40 Act registered mutual fund are inconsistent with hedge fund operation: required distributions to equity owners each year, the requirement of a majority of disinterested directors on such registered funds' board of directors, investment diversification rules, administrative costs, and more.

Section 3(c)(1) provides that a fund falls outside of the definition of an investment company, and, therefore, need not register as an investment company, if it does not have more than 100 beneficial owners.[3] Under Section 3(c)(7), the fund is not an investment company required to be registered if *all* of its investors are "qualified purchasers" as that term is defined in the 40 Act.[4]

What is important to note in connection with these two exemptions is that in each case there is a second element that is not as frequently discussed as the first, namely, that the fund is neither making nor is planning to make a public offering. The notion of public (versus private) offering is a key to Internet use by advisers and hedge fund operators and is the axis around which this chapter revolves. Therefore, if a fund has less than 100 beneficial owners, or all of its owners are qualified purchasers, it is still required to register under the 40 Act if it has made or plans to make a public offering of the hedge fund interests. Moreover, the idea of a public offering, versus a private offering, is entwined with the principles of the 33 Act.

The Securities Act of 1933 (the "33 Act")

It is axiomatic in the U.S. that all securities sold in the U.S. are subject to registration with the Commission unless otherwise exempt. A key exemption is found is Regulation D, the private placement exemption relied on by so many securities issuers. Under Regulation D, securities need not be registered if (a) all but thirty-five (35) holders of such securities are "accredited investors" (a defined term) and (b) the securities are privately placed.

The Accredited Investor Financial Tests. Regulation D designates certain persons as sophisticated for the purpose of securities law transactions and calls them "accredited investors." In general, this includes a person with a net worth in excess of $1mm or with income of $200,000 ($300,000 joint income with spouse) in each of the prior two years with an expectation of earning the same in the current year. Issuers are required to use good faith in determining whether or not a potential subscriber is accredited and need not verify through financial statements or otherwise the accuracy of the financial data supplied unless it has reason to believe it is inaccurate.

[3] The focus here is the number of *U.S.* beneficial owners. See the Commission's Touche Remnant & Co. no-action letter (Aug. 27, 1984). And when counting the number of owners, it is not simply enough to count the number of subscribers. There is an important look-through rule that states that if an investor in a 3(c)(1) fund has also relied on Section 3(c)(1) or 3(c)(7) for its own exemption from registration (*i.e.*, it is itself a hedge fund), the number of beneficial owners of *that* investor are considered in determining the number of investors in the hedge fund if such investor owns 10% or more of the hedge fund. Note that the look-through rule applies to investments in 3(c)(1) funds only and not to investments in 3(c)(7) funds, which are referred to herein. Furthermore, a look-through is required when an investing entity is formed for the specific purpose of investing in a given 3(c)(1) fund.

[4] See Section 2(a)(51) of the 40 Act. Among the several categories of "qualified purchasers" are those investors who are natural persons that have $5mm or more of "investments" ("investment" being defined in the 40 Act as well) or are entities that have $25mm or more of investments under management.

The Notion of Private Placement. In order for a security to be deemed privately placed, the issuer - either directly or through a placement agent - must have a relationship with the offeree that predates the particular transaction. Going hand-in-hand with the pre-existing relationship requirement is the notion that the offering of the security must not have been the subject of a general solicitation or public circulation. In short, it needs to be privately placed – the investor must be known to the issuer and the distribution can not be by public means.

In the context of the Internet, then, all sorts of caution bells should sound. The financial test is an objective test that involves the investor - the test is either met or it is not. The private placement element is subjective and is based on the facts and circumstances surrounding the transaction.

Again, if the requirements of Regulation D are not met, then the exemption simply does not apply and the fund should register its offering with the Commission under the 33 Act. And if the offering does not have the benefit of the private placement exemption under Regulation D then it will likely also fail to be private under the 40 Act as well, meaning that the fund should register as an investment company under that statute. The sanctions for selling unregistered securities and for failing to register as an investment company under the 40 Act are serious indeed. The SEC is armed with many weapons and can bring serious charges against the issuer and exact fines and more severe penalties, depending upon the particular situation. Just as likely is a civil action by unhappy investors to rescind the investment and obtain a return of the investment plus a statutory rate of interest. In a fund that is a losing proposition, giving investors a put equal to the investment plus interest is disastrous.

The Investment Advisers Act of 1940 (the "Advisers Act")

Some further background is needed here. Under the version of Section 203(b)(3) of the Advisers Act that existed for many years prior to its amendment in 1996, an adviser was exempt from registration if, during the preceding 12 months it had fewer than 15 clients and it neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to a registered investment company (i.e., to a mutual fund).

The statute was amended in 1996 such that currently federal registration with the Commission is required if the adviser has funds under management of $30mm or more and has more than 14 clients, holds itself out as an investment adviser to the general public or serves as an investment adviser to a registered investment company. Advisers who are not permitted to register are subject to the statutory scheme of the state wherein they do business.[5]

---

[5] For the state of Wyoming, where there is currently no registration scheme, such advisers may register with the Commission.

Note that the registration scheme has shifted: No federal registration is required, *nor in fact is federal registration allowed*, if the manager has less than $25mm under management.[6] Prior to the 1996 amendments (which were first effective in 1997), an adviser had to register if it held itself out to the public as an investment adviser regardless of the amount of assets under its management.

The question that has yet to be answered publicly by the Commission is this: does an investment adviser need to register if it does not have $30mm under management if it holds itself out to the public or has 15 or more clients? These elements do not seem to fit the current statutory scheme. The author is of the view that the answer is no. It is suggested that the holding out/limited client test only becomes relevant when an adviser is eligible to register. Following this logic, if an adviser has $30mm under management and holds itself out to the public as an adviser, then registration becomes mandatory even if the adviser has less than 14 clients.[7] Thus, the concept of "holding out" becomes a key element when viewing Internet usage by otherwise unregistered investment advisers whose assets under management exceed the threshold amount of $30mm.

The Key Commission Letters

Over the past few years, the Commission's pronouncements on the subject of the offering of securities and investment advisory services via the Internet have explored ways of regulating such offers and have gradually developed a workable set of principles. It bears repeating that the Commission's regulatory focus is on the *offer.*

IPONET. Issued on July 26, 1996, the SEC's no-action letter to IPONET introduces the notion of an investor suitability questionnaire and password-protected Internet sites. The IPONET situation involved a third-party hedge fund Web site, meaning that neither the issues of hedge funds' securities nor the advisers to such funds were maintaining the server or the Web site on which hedge fund data was made available (i.e., IPONET was run by others for a fee).[8] The viewer in IPONET would be directed to a screen and asked for information designed to allow the Web site operator to form a reasonable belief for determining the viewer's status as an accredited investor under Regulation D. The invitation to complete the accredited investor questionnaire and the questionnaire itself were generic in nature and without reference to any specific fund posted, or to be posted, on the site.

Once the Web site operator made a determination based on the facts disclosed in the questionnaire - and any other facts it knew, always acting in good faith – that the viewer was accredited, then a password would be issued to allow the holder to move deeper into the site. Those password holders would be allowed to see and review offerings. Moreover, in the IPONET letter, a password holder was only allowed to

[6] One point to aid in understanding: $25 mm means one can register but need not; $30 mm requires registration. The $5 mm "buffer" recognizes asset value fluctuation possibilities.
[7] As stated in the text, this is the author's view and is not reflected in the Commission's pronouncements.
[8] This is an important distinguishing characteristic which is discussed below under separate heading.

purchase issues listed on the Web site subsequent to the date of issuance of its password, not those listed before.[9]

IPONET charged a listing fee designed to cover the cost of design and graphics work at the site, technical consulting regarding the listing, and statistical popularity of the site (akin to the statistical tracking that goes on regarding the sales of magazines or newspapers). The listing fee was independent of the size of the offering or of the number of "hits" after the offering. Moreover, the Web site operator received nothing in the way of broker-dealer fees nor did it have an affiliation with, or any interest of any kind in, any issuer listed on the site prior to or at the time of the private offering. In this way, the 34 Act broker-dealer requirements were not triggered.

The Commission stated in the IPONET letter that if the foregoing procedures were observed, the offering of a security via the IPONET site would not involve any sort of general advertising or general solicitation and, therefore, the Regulation D and 40 Act private offering tests would be satisfied. That was as far as IPONET went, but 1996 is a long time ago in "Internet speak."

Lamp. About a year after IPONET, the first of two no-action letters were issued to Lamp Technologies, Inc.; a year after that, the second Lamp no-action letter was issued. These letters also involved a third-party Web site, a site sponsor sharing no affiliation with the issuers on its site and a site employing a password and investor questionnaire arrangement to avoid general solicitation and advertising.[10] What is introduced in Lamp is the notion that no longer is the investor restricted to purchasing issues posted after the date the password was issued. Pursuant to the Lamp letters, the subscriber may purchase any issue on the site regardless of when it was posted as long as it waits at least thirty (30) days before doing so.[11]

If the Lamp procedures are followed (questionnaire, password, waiting period) then the following is a fair summary of the regulatory result:

1. There is no public offering under the 33 Act (*i.e.,* the registration exemption otherwise available under Regulation D remains available and, thus, the security would not lose its privately placed status based on this factor alone).

[9] The author can only imagine the discussion at the Commission regarding the pre-existing relationship principle. One can speculate that the pre-existing relationship test was deemed to have been met following the IPONET procedure because the investor was introduced to the site before a particular offering was made available to such investor and, judging from the exchange of letters made public, it appears that the idea was the Web site operator's idea, not that of the Commission. In any event, as will be seen, this requirement does not survive the issuance of later letters on the subject. See the Lamp discussion below.

[10] By the way, the questionnaire coverage was extended in the first Lamp letter to include "qualified eligible participant" status under Rule 4.7 of the Commodity Exchange Act rules governing futures pools.

[11] It would seem, therefore, that the pre-existing relationship notion is satisfied by the 30-day wait. Other interpretations would be difficult to make.

2. Because there is no public offering for Regulation D purposes, it follows that there is likewise no public offering for 40 Act 3(c)(1) (the 100 beneficial owner rule) or for 3(c)(7) (the qualified purchaser rule) purposes so that the exclusions from investment company registration remain otherwise available.

3. There is no holding out under the Advisers Act so that investment advisers whose products are disclosed on the site need not worry about that matter and registration is not triggered by that factor (provided that such advisers discuss only private-fund-related information on the site).

4. The participating hedge funds may include funds closed to new capital as well as those accepting new capital.

5. The fees paid to the Web site operator by the hedge fund, or any other party, still can not be related to the open or closed status of the fund, and can not be related to the performance of the fund or to the sales of interests in the fund.

6. The information posted on the site can be descriptive of the hedge fund and may display performance-related information.

7. Each registered manager using the site does need to undertake to make its Form ADV Part II or other required documentation available to the viewer following the dictates of SEC release 33-7289 dated May 9, 1996.

This amounts to a workable and reasonable set of principles insofar as third-party sites are concerned.

Offshore Activities

In 1998, the Commission issued a policy statement (the "Statement") regarding the use of the Internet to sell securities or offer investment services that by their terms are not made to U.S. Persons.[12] The Statement makes it clear that the application of the registration provisions of U.S. law depends upon whether the Internet offers, solicitation or other communications are targeted to the United States. According to the Statement, the Commission does not view issuers, broker-dealers, exchanges, and investment advisers that implement measures that are reasonably designed to guard against sales of securities, or the provision of investment advisory services, to U.S. Persons to have been targeted to persons in the U.S. That would mean that such postings, in and of themselves, would not result in a registration obligation. But what do the terms "reasonably designed" or "targeted to U.S. Persons" mean? These are factual matters and each case

[12] See Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore (Release Nos. 33-7516, 34-39779, IA-1710, IC-23071 (March 23,1998)). "U.S. Persons" is a defined term, the definition of which appears in Rule 902 of Regulation S under the 33 Act.

is different, but the Statement is helpful. And note that measures that are adequate for foreign issuers are not necessarily adequate for U.S. issuers, the latter required to be more restricted than the former.

Procedures Reasonably Designed to Avoid Targeting the U.S.

When offerors implement adequate measures to prevent U.S. Persons from participating in an offshore offer, the Commission does not view the offer as targeted to the United States and thus would not treat it as occurring in the United States for registration purposes. What constitutes adequate measures will depend on all the facts and circumstances of any particular situation. In general, the Commission would not consider an offshore Internet offer made by a non-U.S. offeror as targeted to the United States if the offshore Web site issuer can demonstrate at least the following:

- The Web site includes a prominent disclaimer making it clear that the offer is directed only to countries other than the United States. For example, the Web site could state that the securities or services are not being offered in the United States or to U.S. Persons, or it could specify those jurisdictions (other than the United States) in which the offer is being made; and

- The Web site offeror implements procedures that are reasonably designed to guard against sales to U.S. Persons in the offshore offering. For example, the offeror could ascertain the purchaser's residence by obtaining such information as mailing addresses or telephone numbers (or area code) prior to the sale. This measure will allow the offeror to avoid sending or delivering securities, offering materials, services or products to a person at a U.S. address or telephone number.

The Statement makes clear that these procedures are not exclusive; other procedures that suffice to guard against sales to U.S. Persons also can be used to demonstrate that the offer is not targeted to the United States. In addition, regardless of the precautions adopted, the Commission had stated that it would view solicitations that appear by their content to be targeted to U.S. Persons as made in the United States and therefore subject to regulation. This could include, for example, a solicitation purportedly made offshore that emphasizes the investor's ability to avoid U.S. income taxes on an investment. Sham offshore offerings or procedures, or other schemes, will not allow issuers or promoters to escape their registration obligations under the U.S. securities laws. Therefore, offshore sites wishing to avoid Commission scrutiny should not:

- Post offering or solicitation material, or otherwise cause such material to be listed, on an investment-oriented Web site that has a significant number of U.S. clients or subscribers, or where U.S. investors could be expected to search for information about investment opportunities or services; or

- Arrange for direct or indirect hyperlinks from a third-party investment-oriented page to its own Web page containing the offering material.

The Commission may view an Internet offer as being targeted to U.S. Persons if the foreign fund is engaged in activities, either as part of or in addition to its Internet offer, that are designed to attract U.S. Persons to the Internet offer, such as advertising the existence of the foreign fund's Web site in a U.S. publication or on a U.S. Web site via a hyperlink mechanism. Moreover, a U.S. issuer must implement password type procedures that are reasonably designed to ensure that only non-U.S. Persons can gain access to its offer. Such viewer would have to demonstrate that it is not a U.S. Person to gain access to the site.

Foreign Funds Conducting Offshore and Private U.S. Offers

Often foreign funds conduct concurrently an offering offshore and private placement onshore. Here too the foreign issuer must take reasonable steps to safeguard against a public offering in the U.S. If the foreign fund that is making a concurrent private U.S. offering uses a disclaimer that reflects the existence of the two offerings and indicates that the Internet offer is not being made in each case, such would be a reasonable disclaimer and a reasonable safeguard. Such a disclaimer could state for example that the offer (*i.e.*, the Internet offshore offer) is not being made in the U.S. and that the offer and sale of securities in the U.S. is not permitted except pursuant to an exemption from registration. If the site provides information about how a U.S. Person might go about purchasing the securities offshore, or provides a hyperlink or otherwise directs the U.S. Person to another source that provides information about the private offering, such action can be an indication that the U.S. is being targeted for the offer.

Any disclaimer used in site would have to be meaningful. For example, the disclaimer could state "This offering is intended only to be available to residents of countries within the European Union." Because of the global reach of the Internet, a disclaimer that simply states, "The offer is not being made in any jurisdiction in which the offer would or could be illegal," however, would not, according to the Statement, be meaningful. In addition, if the disclaimer is not on the same screen as the offering material, or is not on a screen that must be viewed before a person can view the offering materials, the Commission may likely find that it is not meaningful.[13]

If a foreign fund wishes to provide information on its Web site relating to its private U.S. offer, it generally may do so without registering under the 40 Act if it adopts and implements password type procedures with respect to that information. This would mean employing the same type of financial screening (to ascertain accredited investor status) and password implementation that the Commission has described in the Lamp rulings.

[13] The fact that an Internet offeror posts offering materials in English even though it is based in a non-English speaking country will not, by itself, demonstrate that the offer is targeted at the United States.

In addition to implementing the type of precautionary measures previously discussed, foreign issuers could implement other procedures to prevent offshore Internet offers from being used to solicit participants for their U.S.-based exempt offerings, including:

- The Internet offeror could allow unrestricted access to its offshore Internet offering materials, but not permit persons responding to the offshore Internet offering to participate in its exempt U.S. offering, even if otherwise qualified to do so. In that situation, the offeror would keep a record of all persons responding over the Internet and all persons who otherwise indicate that they are responding to the offshore Internet offering.

- The Web site offeror could ensure that access to the posted offering materials is limited to those viewers who first provide their residence information and, in doing so, do not provide information such as a U.S. area code or address that indicates that they are a U.S. Person. Thus, U.S. Persons could obtain access only by misrepresenting their residence information.

Offers of Foreign Advisory Services Under the Advisers Act

The issue raised by a foreign investment adviser's use of the Internet is whether and, if so, under what circumstances, the foreign adviser may provide information about its advisory services over the Internet without being considered to be holding itself out as an investment adviser in the United States. A foreign adviser providing advisory services over the Internet generally would be holding itself out as an investment adviser, so the issue is how to avoid doing so to the public – the same issue as relates to the U.S. adviser – or if to the public, at least not to U.S. Persons. This means that the adviser must implement measures reasonably designed to guard against directing information provided on the Internet about its advisory services to U.S. Persons. The following discussion of this issue is premised on the supposition that an adviser is eligible to register as such with the Commission.

What constitutes measures reasonably designed to guard against an adviser holding itself out as an investment adviser in the United States will depend on all of the facts and circumstances. Such measures might include

- The Web site includes a prominent disclaimer making it clear to whom the site materials are (or are not) directed.

- The adviser implements procedures reasonably designed to guard against directing information about its advisory services to U.S. Persons (*e.g.*, obtaining sufficient residency information such as mailing addresses or telephone numbers prior to sending further information), other than to its fourteen or fewer U.S. clients.

Other measures also may provide adequate assurance that a foreign adviser is not holding itself out as an investment adviser in the United States.

Broker-Dealers

Broker-dealers must register with the Commission if they are physically present in the United States, or if, regardless of their location, they effect, induce, or attempt to induce securities transactions with investors in the United States. The issue, therefore, is whether the Commission would deem a broker-dealer's Web site to be an attempt to induce securities transactions with U.S. Persons. Broker-dealer Web sites may offer market information and investment tools, real-time or delayed quote information, market summaries, research, portfolio management tools, and analytic programs. Some sites also include information on commissions and other fees, branch office locations, and instructions on how to contact the broker-dealer. In essence, Web sites advertise the broker-dealer's services to potential investors with the intent of attracting securities business.

The Commission will not consider a foreign broker-dealer's advertising on an Internet Web site to constitute an attempt to induce a securities transaction with U.S. Persons if the foreign broker-dealer takes measures reasonably designed to ensure that it does not effect securities transactions with U.S. Persons as a result of its Internet activities. Under our general principles, as applied in the broker-dealer context, a foreign broker-dealer generally would be considered to have taken measures reasonably designed to ensure it does not effect securities transactions with U.S. Persons as a result of its Internet activities if it:

- Posts a prominent disclaimer on the Web site either affirmatively delineating the countries in which the broker-dealer's services are available, or stating that the services are not available to U.S. Persons; and

- Refuses to provide brokerage services to any potential customer that the broker-dealer has reason to believe is, or that indicates that it is, a U.S. Person, based on residence, mailing address, payment method, or other grounds.

As a means to implement the latter procedure, the broker-dealer should require potential customers to provide sufficient residence information.

Rule 15a-6 Exemption

The Commission has exempted foreign broker-dealers that effect transactions with U.S. customers from registering in the United States if these customers initiated transactions with the foreign broker-dealers outside of the United States without solicitation. Specifically, Rule 15a-6 of the 34 Act currently provides an exemption from U.S. broker-dealer registration for foreign broker-dealers that effect transactions in securities with or for persons that they have not solicited. Foreign broker-dealers that

solicit transactions with U.S. Persons, however, are required to register as broker-dealers in the United States.

Foreign broker-dealers that have Internet Web sites and that intend to rely on Rule 15a-6's "unsolicited" exemption should ensure that the "unsolicited" customer's transactions are not in fact solicited, either directly or indirectly, through customers accessing their Web sites. In particular, these broker-dealers could obtain, as a precaution reasonably designed to prevent that result, affirmative representations from potential U.S. customers that they deem unsolicited that those customers have not previously accessed their Web sites. Alternatively, a broker-dealer could maintain records that are sufficiently detailed and verifiable to reliably determine that such U.S. customers had not obtained access to its Web site.

To identify those persons who are responding to the Internet offer, the Web site could provide telephone numbers, contact persons, or addresses that differ from those used in the offeror's other, more traditional offering materials. Under an approach suggested in staff no-action letters, the offeror could communicate with U.S. Persons on the list to determine whether they are accredited investors with a view toward permitting their participation in separate, future exempt U.S. offerings by the issuer or, where the Web site offeror is an intermediary, other issuers.[14] Likewise, any investor solicited by the issuer or underwriter prior to or independent of the Web site posting could participate in the private offer, regardless of whether the investor may have viewed the posted offshore offering materials.

This step could be accomplished in multiple ways. For example, when a person reaches the Web site and then attempts to move to a section that includes offering information, a screen could ask for the required residence information. After the user enters the information, the area code and address could be automatically and immediately screened to eliminate further access to those who match a U.S. area code or address. Alternatively, the offeror could require a password and not assign a password until it verifies that address information, or it could block access by using technology that recognizes the country from which the Web site is being accessed. Web site offerors must act in good faith to screen U.S. Persons from viewing offering information and there is no single “right answer"; any other equally effective procedure that obtains the appropriate result ought to pass regulatory muster.

What Lies Ahead? Changes are Inevitable

Understand how the Commission's no-action procedure operates: Facts are submitted as to a particular matter, the Commission considers the matter and it is hoped by the submitter that those facts will result in a letter stating that the Commission will take no-action as to the particular matter. The letter is “fact specific” to the submitter and

---

[14] See Commission no-action letters, Royce Exchange Fund (available Aug. 28, 1996); Bateman Eichler (available Dec. 3, 1985); E.F. Hutton & Co. (available Dec. 3, 1985); Woodtrails-Seattle (available Aug. 9, 1982).

can only be properly relied upon by it. The letter does not necessarily relate to other slightly different facts. For example, in Lamp the submitter was a third-party operator and had no hesitation in stating that the primary purpose of the Lamp site was efficient information transmission rather than marketing. What does that mean: the "primary purpose"? And what if, all else being equal, someone else's primary purpose is not identical to Lamp's primary purpose? Does the security purchaser own a different security if it buys via a site, the primary purpose of which is statistical as opposed to marketing? Are not they really the same? So, for example, as the Lamp rulings were issued to a third-party site operator, we are left to take a leap of faith when we infer by induction, or from subsequent clarifying releases issued by the Commission, that first-party sites abiding by the Lamp criteria are permissible as well.

Further examples of the dynamic state of these rules: In the first Lamp letter, Lamp premised its query for the Commission by stating that subscription fees were required to utilize the Lamp site. Is the SEC's silence on this matter in affirming Lamp's request for no-action an affirmation that such site operators must require subscription fees? Apparently not, because in the second Lamp letter, the fee requirement was deleted. In IPONET, the password holders were permitted to purchase only those securities sold pursuant to offerings that were posted subsequent to the issuance of the password. That requirement was changed in the Lamp rulings to allow investors to purchase any securities sold pursuant to offerings posted on the Lamp site after the expiration of an initial 30-day waiting period. But the 30-day wait was the submitter's idea, not that of the Commission. As a result, alternate requirements may be approved in response to a subsequent submission.

And what about "first-party" sites, namely sites operated by an adviser itself or an issuer itself? Lamp and IPONET involved sites operated by persons other than the adviser or the issuer of the securities of the funds listed on those sites. In fact, in all letters the representation was carefully made that the operator was not an affiliate of any fund listed on the site and was not otherwise operating in any traditional broker-dealer capacity. Going further, it was carefully noted that none of its employees were registered representatives of any registered broker-dealer and would not be involved in effecting the securities transactions or negotiating transactions in securities.

With the possible exception of the holding-out notion under the Advisers Act, the operation of the site by the hedge fund or by the adviser itself ought not be problematic as long as the same questionnaire and password approach is followed.[15] After all, in Lamp, each hedge fund manager had exclusive control over the content of information on the site and was permitted to delegate the mechanical data entry function to the Web site operator or to another service provider. This leads one to believe that a Web site operated by the issuer itself following the same procedures would lead the Commission to the

[15] It should be understood that the Commission might view a first-party site as a holding out by the adviser. Presumably, this would only be meaningful if the adviser has assets under management of $25 mm or more. If not, under current law, Commission registration is not only not required, it is not even permitted. State law ramifications are outside the scope of this chapter but should be considered as well.

same favorable result but it is not possible to determine this result with certainty. As to this issue, we will need to await futures Commission pronouncements.

The bottom line is that the interaction of the U.S. securities laws and the Internet can be expected to continue to evolve. As technology and practice develop, the Commission can be relied upon to revisit these and related issues. After all, the Commission has noted that regulators in many countries are attempting to administer their respective laws to preserve important protections provided by their regulatory schemes without stifling the Internet's vast communications potential and has publicly stated that it shares in this goal for the administration of the U.S. securities laws.