

GOING PUBLIC

*A GUIDE TO RAISE CAPITAL AND COMPLY
WITH FEDERAL AND STATE SECURITIES LAWS*

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FEDERAL SECURITIES LAWS GOVERNING PUBLIC COMPANIES

In the chaotic securities markets of the 1920s, companies often sold stocks and bonds on the basis of glittering promises of fantastic profits without disclosing any meaningful information to investors. These conditions contributed to the disastrous Stock Market Crash of 1929. In response, the U.S. Congress enacted the federal securities laws and created the Securities and Exchange Commission (SEC) to administer them. There are two primary sets of federal laws that come into play when a company wants to offer and sell its securities to the public.

- **Securities Act of 1933 (Securities Act)** The Securities Act, which covers new public companies, generally requires companies to give investors "full disclosure" of all "material facts," the facts investors would find important in making an investment decision. This Act also requires companies to file a registration statement with the SEC that includes information for investors. The SEC does not evaluate the merits of offerings, or determine if the securities offered are "good" investments. The SEC staff reviews registration statements and declares them "effective" if companies satisfy the SEC's disclosure rules.
- **Securities Exchange Act of 1934 (Exchange Act)** The Exchange Act requires publicly held companies to disclose information continually about their business operations, financial conditions, and managements. These companies, and in many cases their officers, directors and significant shareholders, must file periodic reports or other disclosure documents with the SEC. In some cases, the company must deliver the information directly to investors.

Types of SEC Registered Public Offerings

- **Form S-1** All companies can use Form S-1 to register their securities offerings. You should not prepare a registration statement as a fill-in-the-blank form, like a tax return. It should be similar to a brochure, providing readable information. If you file this form, your company must describe each of the following in the prospectus:
 - business
 - properties
 - competition
 - the identity of its officers and directors and their compensation
 - material transactions between the company and its officers and directors
 - material legal proceedings involving the company or its officers and directors
 - the plan for distributing the securities; and the intended use of the proceeds

Registration statements also must include financial statements audited by an independent CPA. In addition to the information required by the form, your company must provide any other information that is necessary to make your disclosure complete and not misleading. You also must clearly describe any risks prominently in the prospectus, usually at the beginning. Examples of these risk factors are:

- lack of business operating history
- adverse economic conditions in your industry
- lack of a market for the securities offered
- dependence upon key personnel

- **Form SB-1** (*To Raise \$10 Million or Less*) "Small business issuers" (see explanation on Page 10) offering up to \$10 million worth of securities in any 12-month period may use Form SB-1. This form allows you to provide information in a question and answer format, similar to that used in Regulation A offerings. Unlike Regulation A filings, Form SB-1 requires audited financial statements.
- **Form SB-2** (*To Raise Any Amount of Capital*) If your company is a "small business issuer," it may register an unlimited dollar amount of securities using Form SB-2, and may use this form again and again so long as it satisfies the "small business issuer" definition. One advantage of Form SB-2 is that all its disclosure requirements are in Regulation S-B, a set of rules written in simple, non-legalistic terminology. Form SB-2 also permits the company to provide audited financial statements, prepared according to generally accepted accounting principles, for two fiscal years. In contrast, Form S-1 requires the issuer to provide audited financial statements, prepared according to more detailed SEC regulations, for three fiscal years; and Include less extensive narrative disclosure than Form S-1 requires, particularly in the description of your business, and executive compensation.

Types of SEC Non-Registered Public Offerings

Your company's securities offering may qualify for one of several exemptions from the registration requirements. The most common ones are explained below. You must remember, however, that all securities transactions, even exempt transactions, are subject to the antifraud provisions of the federal securities laws. This means that you and your company will be responsible for false or misleading statements, whether oral or written. The government enforces the federal securities laws through criminal, civil and administrative proceedings. Some enforcement proceedings are brought through private law suits. Also, if all conditions of the exemptions are not met, purchasers may be able to obtain refunds of their purchase price. In addition, offerings that are exempt from provisions of the federal securities laws may still be subject to the notice and filing obligations of various state laws. Make sure you check with the appropriate state securities administrator before proceeding with your offering.

- **Regulation A** Section 3(b) of the Securities Act authorizes the SEC to exempt from registration small securities offerings. By this authority, the SEC created Regulation A, an exemption for public offerings not exceeding \$5 million in any 12-month period. If you choose to rely on this exemption, your company must file an offering statement, consisting of a notification, offering circular, and exhibits, with the SEC for review. Regulation A offerings share many characteristics with registered offerings. For example, you must provide purchasers with an offering circular that is similar in content to a prospectus. Like registered offerings, the securities can be offered publicly and are not "restricted," meaning they are freely tradable in the secondary market after the offering. The principal advantages of Regulation A offerings, as opposed to full registration, are:

- The financial statements are simpler and don't need to be audited
- There are no Exchange Act reporting obligations after the offering unless the company has more than \$10 million in total assets and more than 500 holders
- Companies may choose among three formats to prepare the offering circular, one of which is a simplified question-and-answer document; and
- You may "test the waters" to determine if there is adequate interest in your securities before going through the expense of filing with the SEC.

All types of companies which do not report under the Exchange Act may use Regulation A, except "blank check" companies, those with an unspecified business, and investment companies registered or required to be registered under the Investment Company Act of 1940. In most cases, shareholders may use Regulation A to resell up to \$1.5 million of securities. If you "test the waters," you can use general solicitation and advertising prior to filing an offering statement with the SEC, giving you the advantage of determining whether there is enough market interest in your securities before you incur the full range of legal, accounting, and other costs associated with filing an offering statement. You may not, however, solicit or accept money until the SEC staff completes its review of the filed offering statement and you deliver prescribed offering materials to investors.

- **Regulation D** establishes three exemptions from Securities Act registration.

Rule 504 provides an exemption for the offer and sale of up to \$1,000,000 of securities in a 12-month period. Your company may use this exemption so long as it is not a blank check company and is not subject to Exchange Act reporting requirements. Like the other Regulation D exemptions, in general you may not use public solicitation or advertising to market the securities and purchasers receive "restricted" securities, meaning that they may not sell the securities without registration or an applicable exemption. However, you can use this exemption for a public offering of your securities and investors will receive freely tradable securities under the following circumstances:

- You register the offering exclusively in one or more states that require a publicly filed registration statement and delivery of a substantive disclosure document to investors
- You register and sell in a state that requires registration and disclosure delivery and also sell in a state without those requirements, so long as you deliver the disclosure documents mandated by the state in which you registered to all purchasers
- You sell exclusively according to state law exemptions that permit general solicitation and advertising, so long as you sell only to "accredited investors," a term described in more detail below in connection with Rule 505 and Rule 506 offerings.

Even if you make a private sale where there are no specific disclosure delivery requirements, you should take care to provide sufficient information to investors to avoid violating the antifraud provisions of the securities laws.

Rule 505 provides an exemption for offers and sales of securities totaling up to \$5 million in any 12-month period. Under this exemption, you may sell to an unlimited number of "accredited investors" and up to 35 other persons who do not need to satisfy the sophistication or wealth standards associated with other exemptions. Purchasers must buy for investment only, and not for resale. The issued securities are "restricted." Consequently, you must inform investors that they may not sell for at least a year without registering the transaction. You may not use general solicitation or advertising to sell the securities.

Rule 506 is a "safe harbor" for the private offering exemption. If your company satisfies the following standards, you can be assured that you are within the Section 4(2) exemption:

- You can raise an unlimited amount of capital
- You cannot use solicitation or advertising to market the securities
- You can sell securities to an unlimited number of accredited investors and up to 35 other purchasers

Unlike Rule 505, all non-accredited investors, either alone or with a purchaser representative, must be sophisticated - that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment; It is up to you to decide what information you give to accredited investors, so long as it does not violate the antifraud prohibitions. But you must give non-accredited investors disclosure documents that generally are the same as those used in registered offerings.

- If you provide information to accredited investors, you must make this information available to the non-accredited investors
- You must be available to answer questions by purchasers
- Financial statement requirements are the same as for Rule 505
- Purchasers receive "restricted" securities and may not freely trade the securities in the secondary market after the offering

- **SCOR (Small Company Offering Registration)** A SCOR offering is a stock or debt offering, performed in compliance with Rule 504 of Regulation D of the Securities Act of 1933, using form U-7. This form is a simplified disclosure statement created by the American Bar Association and the NASAA and is recognized by 45 States. A SCOR offering has the following characteristics:

- companies can raise up to \$ 1 million in a 12 month period
- there is no limitation on the number or type of investors
- the offering can be carried forward with general solicitation or advertising
- companies cannot be blank check issuers
- the securities received in the offering are not "restricted securities"
- form D notice should be filed with SEC within 15 days after the sale of securities

- although there is no specific disclosure that must be provided to investors, sufficient information should be provided to meet full disclosure obligations existing under the antifraud provisions of securities laws
 - the company has to prepare and file Form U-7 in each of the states where the offer will be performed and comply with each States' "blue sky" laws
 - offerings above \$500,000 require audited financial statements
 - there may be specific requirements unique to each State, such as the use of the net proceeds, limitations on the type of business, price level of the securities, etc.
- **Intrastate Offering Exemption** Section 3(a)(11) of the Securities Act is generally known as the "intrastate offering exemption." This exemption facilitates the financing of local business operations. To qualify for this exemption, your company must:
 - be incorporated in the state where it is offering the securities
 - carry out a significant amount of its business in that state; and
 - make offers and sales only to residents of that state

There is no fixed limit on the size of the offering or the number of purchasers. Your company must determine the residence of each purchaser. If any of the securities are offered or sold to even one out-of-state person, the exemption may be lost. Without the exemption, the company could be in violation of the Securities Act requirements. If a purchaser resells any of the securities to a person who resides outside the state within a short period of time after the company's offering is complete (the usual test is nine months), the entire transaction, including the original sales, might violate the Securities Act. Since secondary markets for these securities rarely develop, companies often must sell securities in these offerings at a discount. It will be difficult for your company to rely on the intrastate exemption unless you know the purchasers and the sale are directly negotiated with them. If your company holds some of its assets outside the state, or derives a substantial portion of its revenues outside the state where it proposes to offer its securities, it will probably have a difficult time qualifying for the exemption. You may follow Rule 147, a "safe harbor" rule, to ensure that you meet the requirements for this exemption. It is possible, however, that transactions not meeting all requirements of Rule 147 may still qualify for the exemption.

- **Private Placement Offering Exemption** Section 4(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering." To qualify for this exemption, the purchasers of the securities must:
 - have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment (the "sophisticated investor"), or be able to bear the investment's economic risk
 - have access to the type of information normally provided in a prospectus; and agree not to resell or distribute the securities to the public

In addition, you may not use any form of public solicitation or general advertising in connection with the offering. The precise limits of this private offering exemption are uncertain. As the number of purchaser's increases and their relationship to the

company and its management becomes more remote, it is more difficult to show that the transaction qualifies for the exemption. You should know that if you offer securities to even one person who does not meet the necessary conditions, the entire offering might be in violation of the Securities Act. Rule 506, another "safe harbor" rule, provides objective standards that you can rely on to meet the requirements of this exemption.

- **Accredited Investor Exemption** Section 4(6) of the Securities Act exempts from registration offers and sales of securities to accredited investors when the total offering price is less than \$5 million. Like the exemptions in Rule 505 and 506, this exemption does not permit any form of advertising or public solicitation. There are no document delivery requirements. Of course, all transactions are subject to the antifraud provisions of the securities laws.
- **California Limited Offering Exemption** SEC Rule 1001 provides an exemption from the registration requirements of the Securities Act for offers and sales of securities, in amounts of up to \$5 million, that satisfy the conditions of §25102(n) of the California Corporations Code. This California law exempts from California state law registration offerings made by California companies to "qualified purchasers" whose characteristics are similar to, but not the same as, accredited investors under Regulation D. This exemption allows some general solicitation prior to sales.
- **Employee Benefit Plan Exemption** The SEC's Rule 701 exempts sales of securities if made to compensate employees. This exemption is available only to companies that are not subject to Exchange Act reporting requirements. You can sell at least \$1,000,000 of securities under this exemption, no matter how small your company is. You can sell even more if you satisfy certain formulas based on your company's assets or on the number of its outstanding securities. If you sell more than \$5 million in securities in a 12-month period, you need to provide limited disclosure documents to your employees. Employees receive "restricted securities" in these transactions and may not freely offer or sell them to the public.

SEC Reporting Obligations of Public Companies

Once the SEC declares your company's Securities Act registration statement effective, the Exchange Act requires you to file reports with the SEC. The obligation to file reports continues at least through the end of the fiscal year in which your registration statement becomes effective. After that, you are required to report the following company information:

- operations of the company
- officers, directors, and certain shareholders, including salary, various fringe benefits, and transactions between the company and management
- the financial condition of the business, including financial statements audited by an independent certified public accountant; and
- its competitive position and material terms of contracts or lease agreements

All of this information becomes publicly available when you file your reports with the SEC. As is true with Securities Act filings, small business issuers may choose to use small business alternative forms for registration and reporting under the Exchange Act. Even if your

company has not registered a securities offering, it must file an Exchange Act registration statement if:

- it has more than \$10 million total assets and a class of equity securities, like common stock, with 500 or more shareholders; or
- it lists its securities on an exchange such as NASDAQ

Your company is not required to file this information if it has fewer than 300 shareholders of the class of securities offered; or if your company has fewer than 500 shareholders of the class of securities offered and less than \$10 million in total assets for each of its last three fiscal years.

- **Proxy Rules** A company with Exchange Act registered securities must comply with the SEC's proxy rules whenever it seeks a shareholder vote on corporate matters. These rules require the company to provide a proxy statement to its shareholders, together with a proxy card when soliciting proxies. Proxy statements discuss management and executive compensation, along with descriptions of the matters up for a vote. If the company is not soliciting proxies but will take a vote on a matter, the company must provide to its shareholders an information statement that is similar to a proxy statement. The proxy rules also require your company to send an annual report to shareholders if there will be an election of directors. These reports contain much of the same information found in the Exchange Act annual reports that a company must file with the SEC, including audited financial statements. The proxy rules also govern when your company must provide shareholder lists to investors and when it must include a shareholder proposal in the proxy statement.
- **Beneficial Ownership Reports** If your company has registered a class of its equity securities under the Exchange Act, persons who acquire more than five percent of the outstanding shares of that class must file beneficial owner reports until their holdings drop below five percent. These filings contain background information about the beneficial owners as well as their investment intentions, providing investors and the company with information about accumulations of securities that may potentially change or influence company management and policies.
- **Tender Offers** A public company with Exchange Act registered securities that faces a takeover attempt, or third party tender offer, should be aware that the SEC's tender offer rules would apply to the transaction. The same is true if the company makes a tender offer for its own Exchange Act registered securities. The filings required by these rules provide information to the public about the person making the tender offer. The company that is the subject of the takeover must file with the SEC its responses to the tender offer. The rules also set time limits for the tender offer and provide other protections to shareholders.
- **Reporting By Officers, Directors And Some Shareholders** Section 16 of the Exchange Act requires directors, officers, and shareholders who own more than 10% of a class of equity securities to report their transactions to the SEC. Section 16 also establishes mechanisms for a company to recover profits an insider realizes from a purchase and sale of a company security within a six-month period.

TYPICAL QUESTIONS

- **What Is A Registration Statement?** If you decide on a registered public offering, the Securities Act requires a company to file a registration statement with the SEC before the company can offer its securities for sale. You cannot actually sell the securities covered by the registration statement until the SEC declares it "effective," even though registration statements become public immediately upon filing. Registration statements have two principal parts:
 - **Part I** is the prospectus, the legal offering or "selling" document. Your company - the "issuer" of the securities - must describe in the prospectus the important facts about its business operations, financial condition, and management. Everyone who buys the new issue, and anyone who is made an offer to purchase the securities, must have access to the prospectus.
 - **Part II** contains additional information that the company does not have to deliver to investors. Anyone can see this information by requesting it from one of the SEC's public reference rooms or by going to SEC Web site.
- **What Are Small Business Issuers?** A Small Business Issuer pertains to a United States or Canadian company that had less than \$25 million in revenues in its last fiscal year, and whose outstanding publicly held stock is worth no more than \$25 million. If your company falls under this cap you can choose to file your registration statement using one of the simplified small business forms.
- **What Is An Accredited Investor?**
 - a bank, insurance company, registered investment company, business development company, or small business investment company
 - an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million
 - a charitable group, company or partnership with assets exceeding \$5 million
 - a director, executive officer, or general partner of the company
 - a business in which all the equity owners are accredited investors
 - a person with a net worth of at least \$1 million
 - a person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year
 - a trust with assets of at least \$5 million, not formed to acquire the securities offered, and whose purchases are directed by a sophisticated person

It is up to you to decide what information you give to accredited investors, so long as it does not violate the antifraud prohibitions. But you must give non-accredited investors disclosure documents that generally are the same as those used in registered offerings. If you provide information to accredited investors, you must make this information available to the non-accredited investors as well. You must also be available to answer questions by prospective purchasers. Here are some specifics about the financial statement requirements applicable to this type of offering:

- Financial statements need to be certified by an independent CPA
 - If a company other than a limited partnership cannot obtain audited financial statements without undue effort or expense, only the company's balance sheet, dated within 120 days of the start of the offering, must be audited
 - Limited partnerships unable to obtain required financial statements without unreasonable effort or expense may furnish audited financial statements prepared under the federal income tax laws
- **Are There State Securities Law Requirements?** The federal government and state governments each have their own securities laws and regulations. If your company is selling securities, it must comply with federal and state securities laws. If a particular offering is exempt under the federal securities laws that do not necessarily mean that it is exempt from any of the state laws. Historically, most state legislatures have followed one of two approaches in regulating public offerings of securities, or a combination of the two approaches. Some states review small businesses' securities offerings to ensure that companies disclose to investors all information needed to make an informed investment decision. Other states also analyze public offerings using substantive standards to assure that the terms and structure of the offerings are fair to investors, in addition to the focus on disclosure.
 - **What Is Form U-7?** Form U-7 contains 50 questions about your business and, when completed, is very similar to a full business plan. It provides detailed information about your business, your future plans, as well as the risks of investment. Once the form has been declared effective by each State where the offer will be performed, it can be distributed to prospective investors. The form is designed to be filled out by the entrepreneur and to substantially lower the legal and accounting fees. The main purpose behind the form is to ensure that business owners have carefully considered their business plan and evaluated the risks, and to help protect investors
 - **What Are "Blue Sky" Laws?** "Blue Sky" laws are securities laws issued by each State. Their intent is to make sure that full disclosure of information is made to the investing public. They are stricter than federal laws and differ from state to state.
 - **What Is A Direct Public Offering (DPO)?** A DPO is an offering of company stock or debt, which is sold to investors without using an investment bank/underwriter. Traditionally, a company would hire an investment bank to underwrite its stocks or debt offering and then sell it through syndication via various other broker/dealers to retail investors. In a DPO the company skips the use of an intermediary to reach the retail investors and, through the use of direct marketing techniques (exceptions may apply for telephone and in-person marketing), sells the securities directly to them.
 - **What Company Is Suitable For A DPO?** In theory, any company including a start-up business is suitable for a DPO. In practice, companies should have a viable, carefully considered, and realistic business plans. Preferably, companies should be growing, and require an infusion of capital to expand further. Proceeds should be used for business operations and not as an exit strategy for existing shareholders. 'Blind pools' or 'blank checks' are not eligible and the company's industry should comply with each States' "Blue Sky" laws *Petroleum exploration or production, mining or other extractive industries are not allowed to perform DPOs.* It is also advisable for your company to have a strong and experienced management team, and not just a single entrepreneur,

to ensure growth of the business and profitability to the investors (profitable operations with a few years of success enhance their chances of a successful DPO). Your officers and directors should have a 'clean history', with no previous problems with the SEC in connection with other previous securities offerings.

- **How Much Stock Do I Have To Sell In A DPO?** The amount of equity to be sold to investors at the time of the offering depends on the valuation of the entire company. There are various valuation methods: some refer to your current sales and profitability, some consider your existing tangible and intangible assets, others estimate your projected future growth. Depending on your industry and the stage of your business, one of these methods is chosen. For instance, if your company's valuation is \$4 million, and you are trying to raise \$1 million, you will have to offer 25% of your company's equity. Normally, the range is between 10 to 30 %. The amount of equity offered and therefore the valuation of your business has to pass a "substantive fairness" review in most of the states where the offering is going to be registered.
- **What Are The Main Disadvantages Of A DPO?**
 - the company may have to publicly disclose proprietary information, such as developing technologies, salaries, key contracts, sales and/or profits
 - the company and its officers become accountable to investors for the use of investment proceeds and for correctly managing the business, thus they may be subject to class action law suits if the proceeds are misused
 - there may be additional legal and accounting fees following the offering, and more procedures, including board meetings, and board review of major decisions, limitations on salaries, etc., must be followed.
- **Is There Any Guarantee That A DPO Will Succeed?** No. There is no guarantee that a DPO will succeed in raising the full amount of the offering. There are no reliable sources of information on the success of the few DPO's performed in the last few years. Success will depend on the quality of your business and its management team, your company's history and products, and the viability of the marketing strategy for the DPO. Only a strong marketing strategy, which takes into consideration the target segments of investors, the best programs to reach them, and that makes good use of low cost on-line technologies, will make it possible for your company to complete the offer. Compliance with the securities laws boils down to a set of rules and guidelines, which cannot be ignored, but the creativity and sharpness of the strategic marketing program is what is going to make your DPO fail or succeed.
- **Is There Any Secondary Market For My Company's Stock?** Depending on the amount of capital that has been raised and on the strength of your balance sheet, your company may meet the minimum requirements for listing in the Pacific Stock Exchange, The Vancouver Stock Exchange, or other minor local exchanges. The Internet will also eventually provide secondary market options as "bulletin boards" arise, which allow investors to trade small company stocks without intermediaries.
- **Can We Sell The Stock To Anybody? Can I Use Direct Marketing?** In contrast to other financing options such as private placements, SCOR and Regulation A filings permit raising capital from non-accredited investors and through the use of any direct marketing venue. If telephone and in-person marketing is used, the persons involved may have to be registered as broker-dealers under state law.

- **What Marketing Strategies Are There For A DPO?** The most viable marketing strategies take into consideration three major potential target groups of investors:
 - suppliers, employees, and customers of the company who believes in the company and are willing to help financially. By raising capital through these audiences the company is able to gain a competitive advantage in the marketplace because of its strengthened relationships with its constituencies
 - private investors interested in start-up companies and /or IPO situations
 - professional institutional investors who may take an active role in the company
 - It is important to find "affinity groups" of investors who know the name of the company, or understand the business and would consider its offerings. The most successful DPO's are those of companies that have definable and reachable affinity groups with cash to invest in the business

- **What Are The Procedures In Preparing A DPO?** The "to-do" list for a company considering a DPO includes the following:
 - preparation or review of the business plan
 - preparation of Form U-7 and other legally required documentation
 - filing with each State and the SEC (depending on whether you have chosen a SCOR or Regulation A offering)
 - market research on potential investor audiences
 - preparation of a marketing plan for the DPO having considered the choice of target segments, media, and message
 - implementation of the offering plan

- **Can We Use The Internet To market A DPO?**

According to a NASAA resolution, which is being accepted by more and more states, an offering on the Internet is possible provided that no information is sent to people who are applying from a state different than the states where the offering is registered. Other SEC guidelines from regarding electronic delivery of information may apply. The Internet can be used provided that the way it is used is in compliance with State and SEC regulations. The Internet together with a direct mail campaign is the most effective way to reach potential investors.