



SEC Guidance on General Solicitation Provides New Opportunities

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SEC Guidance on General Solicitation Provides New Opportunities

by Stanley Keller

The Securities and Exchange Commission’s Division of Corporation Finance recently provided helpful guidance on what activities do not involve “general solicitation or general advertising”¹ within the meaning of Rule 502(c) of Regulation D under the Securities Act of 1933 (Securities Act), either because those activities do not involve an “offer” or because there is a pre-existing, substantive relationship with the offerees. The absence of general solicitation is important in order to be able to rely on the exemption from registration under Rule 506(b) because compliance with the condition of Rule 502(c) that there be no general solicitation is an express requirement.² In addition, the absence of general solicitation avoids the need to comply with Rule 506(c), with its requirement to verify the status of all investors as accredited investors. Use of Rule 506(c) also forecloses the ability to sell to non-accredited investors. Moreover, although not an express requirement, the absence of general solicitation is significant for reliance on the statutory Section 4(a)(2) private offering exemption.³

The SEC guidance takes the form of several Compliance and Disclosure Interpretations (CDIs), namely CDIs §§256.23 - 256.33 (August 6, 2015),⁴ and a no action letter, *Citizen VC, Inc.* (August 6, 2015).⁵ This guidance is significant for practitioners advising clients on permissible fundraising activities, for operators of angel investor networks, for sponsors of both

¹ The term “general solicitation” is used throughout to include “general advertising.”

² This condition also applies to exempt offerings under Rule 504 that are not state registered and under Rule 505. Although the guidance is focused on Rule 506 offerings, presumably it can be applied more broadly.

³ The guidance is limited to Regulation D but it should be relevant to assessing the availability of an exemption under Section 4(a)(2) of the Securities Act. Since the so-called “4(1 1/2)” exemption for resales is based upon the Section 4(a)(2) exemption, the guidance also should be relevant to the exemption for private resales.

⁴ Avail. at <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>.

⁵ Avail. at <http://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm>.

physical and electronic investor platforms and for funds engaged in continuous offerings. Importantly, the ability of certain third-parties to establish a pre-existing, substantive relationship and of issuers to rely on networks of investors to avoid general solicitation is expanded. At the same time, the SEC guidance will require reexamining some of the fundraising practices of online investor platforms that have become common. Overall, by adding clarity and expanding what is permissible, the SEC guidance helps bring the private investment world truly into the electronic age and should contribute to facilitating capital formation.

Background

The concept general solicitation first explicitly came into use with the adoption of Regulation D in 1982. It substituted for the prior requirement to identify the number and nature of offerees as a key basis for distinguishing a private offering from a public offering. However, the principles underlying the ban on general solicitation as elements of a private offering existed at least as far back as the U.S. Supreme Court's *Ralston Purina* decision⁶ and even can be traced to a 1935 SEC General Counsel Letter.⁷ Under these principles, the knowledge of the investor and its relationship with the issuer were key factors in establishing a private offering.⁸

Regulation D does not define "general solicitation" but indicates in Rule 502(c) that it includes "any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio" or "any seminar or meeting whose attendees have been invited by general solicitation." This concept was later extended to internet activity.⁹

⁶ *SEC v. Ralston Purina Co.*, 345 U.S. 119 (1953).

⁷ Letter of General Counsel Discussing the Factors to be Considered in Determining the Availability of the Exemption from Registration Provided by the Second Clause of Section 4(1), SEC Release 33-285 (Jan. 24, 1935).

⁸ See SEC Release No. 33-4552 (1962) (relevance of "requisite association with and knowledge of the issuer").

⁹ See SEC Release No. 33-7185 (1995) and SEC Release No. 33-7856 (2000).

Shortly after the adoption of Regulation D, the SEC staff made clear that the existence of a pre-existing, substantive relationship negated that the investor was attracted through general solicitation¹⁰ and indicated ways that such a relationship could be established.¹¹ The SEC staff subsequently indicated how the internet could be used in certain circumstances to establish the requisite relationship.¹² The new SEC guidance is an extension of this prior guidance, and recognizes developments in use of the internet and current offering practices.

Guidance on General Solicitation

The SEC guidance confirms and amplifies prior SEC positions on what constitutes general solicitation. It begins by confirming that the use of an unrestricted website to offer and sell securities is general solicitation (CDI 256.23). It then identifies activities that are permissible.

Offers

The SEC guidance makes clear that if there is no “offer” of a security, there cannot be general solicitation (CDI 256.24). Thus, providing factual business information, even if widely disseminated (for example, on a website), is not an offer if it is not used to condition the market. In the SEC’s view, such information typically is limited to information about the issuer and its industry and generally does not include projections and, in the case of funds that continually offer interests, statements of past performances (CDI 256.25).¹³

¹⁰ See, e.g., *Mineral Lands Research & Marketing Corp.* (Mar. 21, 1985); *Bateman Eichler Hill Richards, Inc.* (Dec. 3, 1985); *E.F. Hutton & Co.* (Dec. 3, 1985); and *H.B. Shaine & Co.* (Mar. 31, 1987).

¹¹ *E.F. Hutton & Co.* and *Bateman Eichler* indicated that broker-dealers could establish a relationship with a customer through the account-opening process.

¹² See *IPONET* (July 26, 1996) and *Lamp Technologies, Inc.* (May 29, 1997); but see *AgriStar Global Networks, Ltd.* (Feb. 9, 2004). See also, *Michigan Growth Capital Symposium* (May 4, 1995) (venture fair did not involve general solicitation) and *Woodtrails-Seattle, Ltd.* (Aug 9, 1982) (no general solicitation for offers to existing investors).

¹³ The limitation on use of projections and other forward-looking information should be read as applying in the context of determining if there has been a general solicitation and should not be read to restrict otherwise permissible activities, such as information provided in reliance on Rule 168.

Pre-Existing, Substantive Relationship

The SEC guidance reaffirms that there is no general solicitation if there is a pre-existing, substantive relationship with the investors (CDI 256.26). However, it also confirms that this is only one way to avoid a general solicitation, and that a pre-existing, substantive relationship is not required for the exemption to be available.

A relationship is “pre-existing” if it is formed prior to the offering or, if formed by a third-party such as a broker-dealer, prior to that party’s participation in the offering (CDI 256.29). A relationship is “substantive” if sufficient information is obtained to evaluate the person’s status as an accredited or sophisticated investor (CDI 256.31). Self-certification alone is not sufficient for this purpose. The guidance then addresses how a pre-existing, substantive relationship can be formed.

Forming a Pre-Existing, Substantive Relationship

Earlier SEC guidance had made it clear that a registered broker-dealer can create a relationship with an investor and then use that relationship to make an offer as placement agent for an issuer without that offer being a general solicitation.¹⁴ This is the so-called “two call” rule that permits making an investor a customer with one call and then to follow up with a second call offering a specific investment opportunity. An issuer, however, ordinarily cannot create that relationship using the two-call approach, although it can have a pre-existing, substantive relationship with an investor through various other means, such as the person being an existing investor or having a business relationship as a customer or supplier.

The SEC guidance expands how a pre-existing, substantial relationship can be created in several ways. First, the SEC makes clear that registered investment advisers can form the

¹⁴ See note 11, *supra*.

requisite substantive relationship the same as registered broker-dealers (CDI 256.28).¹⁵

Significantly, under certain circumstances, other third parties also can form the requisite relationship with investors, including (as discussed below) operators of angel investor networks and investor platforms.

Most importantly, the SEC indicates that an issuer can rely on the relationship established by others, when that reliance is justified (CDI 256.27 and 256.32). Thus, an issuer can make offers to investors introduced by a broker-dealer or an investment adviser even if that introducing party is not acting as an agent of the issuer, as a placement agent would. In addition, depending upon the facts and circumstances, an issuer may be able to rely on investors within a network typically understood to be comprised of sophisticated investors to establish the pre-existing, substantive relationship. This network may be members of a formal angel investor organization or an informal network of persons experienced investing in private offerings. An issuer will need to take care to satisfy itself that it is entitled to rely on these arrangements and relationships in order to avoid general solicitation and establish a reasonable belief regarding the status of the investors as accredited or sophisticated. For example, it would likely be easier for an issuer to get comfortable with an established angel investor network that subscribes to a code of conduct regarding its membership¹⁶ than it would be with an informal network of acquaintances.¹⁷

Also of importance, the SEC makes clear that the quality of the substantive relationship is more important than any waiting period (CDI 256.30). It has been common, although not

¹⁵ Broker-dealers have had little difficulty establishing the requisite relationship because of the information they need to obtain to satisfy their duties as regulated persons. The same is true of investment advisers. Therefore, issuers can most easily rely on relationships established with investors introduced by these regulated entities.

¹⁶ See, e.g., Angel Capital Association *Member Code of Conduct*, avail. at <http://www.angelcapitalassociation.org/data/Documents/ACAIndividualCodeofConduct.pdf>.

¹⁷ The SEC staff cautions in CDI 256.27 that “the greater the number of persons without financial experience, sophistication or any prior personal or business relationship with the issuer that are contacted by an issuer or person acting on its behalf through impersonal, non-selective means of communication, the more likely the communications are part of a general solicitation.”

universal, under the two-call approach to require a waiting period of as much as 30 days from establishing the relationship before an investor is invited to invest in a specific offering.

Although a waiting period may still be useful in some situations to establish that the relationship was created before an offering or participation in an offering commenced, the SEC guidance provides that no minimum waiting period is required if a sufficient substantive relationship is created. Thus, an intermediary or platform operator may create a relationship with an investor by obtaining sufficient information about the investor and then immediately make an investment opportunity available (see the discussion of the *Citizen VC* letter below). As an exception to the requirement that the relationship be formed prior to the offering, the SEC, in recognition of its position in *Lamp Technologies*,¹⁸ will permit a private fund (i.e., one relying on the exclusion in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940) engaged in a continuing offering to create the relationship after the offering commenced so long as there is a reasonable waiting period before the actual investment (CDI 256.30).

Demo-Days, Pitch Events and Venture Fairs

Much ink has been spent on trying to distinguish between demo-days and pitch events and figuring out where venture fairs fit. Demo-days are events where companies make presentations about their company to a group of interested persons, typically investors, but without discussing a specific financing. Pitch events are similar but with an express effort to raise money. Venture fairs are usually events sponsored by some credible organization, like a university, that can be either of the foregoing. The problem, of course, is that even demo-days are designed to raise money with discussions often taking place after the presentation — or as Captain Renault said to Rick in *Casablanca*: “I’m shocked, shocked to find that gambling is going on here.”

¹⁸ See note 12, *supra*.

The SEC guidance attempts to cut through this by providing a practical roadmap for dealing with these events, indicating that such an event does not necessarily involve a general solicitation (CDI 256.33). First, the guidance provides that there may not be an offer at all if the presentation is appropriately structured to avoid there being an “offer” (as discussed above). Next, even if there is an offer, the event may not involve a general solicitation under a facts and circumstances analysis — for example, if the attendees are limited to persons with whom the issuer or the event organizer has a pre-existing, substantive relationship or who have been contacted through a network that the issuer or event organizer can rely upon to create that relationship. Finally, even if the invitations to the event are widely disseminated so that there is a general solicitation, the issuer may then be able to use Rule 506(c).

Some Practical Considerations

Relationship of Rule 506(b) and Rule 506(c)

It is ironic that at a time when general solicitation can be undertaken by using Rule 506(c), with its manageable additional verification requirement, we now have guidance that can help to avoid general solicitation and the need to use Rule 506(c), in some cases by following a more rigorous process to establish a pre-existing, substantive relationship than that which satisfies the verification requirement of Rule 506(c). However, in the securities world, things turn slowly and there has been resistance in many quarters to using Rule 506(c).¹⁹ Some of that resistance may be justified due to the natural reluctance to undertake verification steps and to the limitation on sales to nonaccredited investors, not only in the particular offering but in any other offering that might be integrated. Consequently, the SEC guidance is helpful by providing added flexibility. In fact, it may have the effect of slowing the acceptance of Rule 506(c) by expanding

¹⁹ The SEC notes in several places in the CDIs that if the issuer cannot avoid general solicitation, Rule 506(c) may be available.

what safely can be done under Rule 506(b).

There are similarities between the steps necessary to form a pre-existing, substantive relationship and those necessary to establish (i.e., have a “reasonable belief”) or to verify accredited investor status. However, it is important to keep separate what is necessary to form the requisite substantive relationship to avoid general solicitation and what is necessary to establish or verify a purchaser’s accredited investor status. While self-certification might not be sufficient to create a substantive relationship to avoid general solicitation, it might, depending on the circumstances, be sufficient to establish a reasonable belief that an investor is accredited. If Rule 506(c) is being used, more will be necessary to verify the investor’s status as accredited, and there are specified safe harbors for natural persons that can be relied on, which also are likely sufficient to form the requisite substantive relationship. Thus, the SEC guidance on general solicitation should not change practice for dealing with accredited investor status, including under Rule 506(c).

Significance for Issuers and Their Counsel

The SEC guidance, as a practical matter, offers new opportunities for issuers to seek investors for Rule 506(b) offerings, as well as for Rule 504 offerings that are not state-registered and Rule 505 offerings. As noted above, it also should help when the statutory Section 4(a)(2) exemption is relied on. In addition, issuers will benefit from the increase in liquidity for their securities from the potential expansion of resale opportunities using the “4(1 1/2)” exemption. These new opportunities derive mostly from the expanded permissible activities of intermediaries and the ability to rely on networks of investors without triggering general solicitation. However, use of the new opportunities will require care on the part of issuers and their counsel because the determinations necessary to avoid general solicitation will be highly

facts and circumstances dependent. This will create a special challenge for counsel in giving no registration opinions when expanded offering activities are undertaken in reliance on the guidance.

In addition, issuers must realize that some of the activities that are permissible for third-parties may not be available to them. For example, while certain third-parties may establish the requisite relationship in contemplation of a securities offering, it would be extremely difficult for an issuer to do so because of the difficulty of separating its communications from the offering.

Significance for Angel Investor Networks

The SEC guidance validates many of the activities angel networks and angel investor groups have engaged in with some uncertainty. It thus provides clear ground rules under which they can operate and expand their activities. This in turn will help issuers with their capital raising. In particular, the guidance will allow reliance on the vetting activities of angel investor networks in admitting members. Because issuers will have to be satisfied that they can rely on these prequalification efforts, angel investor networks should continue their rigorous vetting processes.

The guidance also provides a roadmap that angel investor networks and other event sponsors can use to conduct their group activities in a way that will satisfy securities law requirements, whether they are structured as demo-days or pitch events.

Significance for Private Funds

Private funds have been given guidance that confirms their ability to engage in continuous private offerings using Rule 506(b) while avoiding general solicitation that would require use of Rule 506(c). Thus, a private fund can continue to establish the requisite substantive relationship even though its offering is ongoing, although in doing so it will have to

continue to impose a waiting period. On the other hand, although private funds can continue to broadly provide information about themselves without there being an offer, this information may not include reference to past performance because of concern over the promotional aspects of such information.

Significance for Investor Platforms

The combination of the CDI guidance and the *Citizen VC* letter gives operators of investor platforms a clear path for conducting their activities, especially with respect to online platforms. Citizen VC, an online investor platform, asked the SEC to confirm that it could rely on Rule 506(b) in connection with its online offering activities. Those activities involve selling interests in special purpose vehicles it forms for investing in independent private companies to investors with whom Citizen VC created a relationship by first evaluating an investor's self-certification through an online questionnaire and then following up through various actions to obtain information sufficient to evaluate the investor's sophistication, financial circumstances and ability to understand the nature and risks of an investment. The SEC staff confirmed that these procedures were sufficient to establish a pre-existing, substantive relationship that avoided general solicitation and that the quality of that relationship was what was important. The SEC staff added that no specific waiting period or particular short form questionnaire can be relied upon solely to create such a relationship, but that whether there is sufficient information to evaluate a potential investor's financial circumstances and sophistication is dependent on the facts and circumstances.

The SEC guidance could lead to an increase in the platforms that make investment opportunities available to investors, both for offerings by issuers and potentially for resales. The key benefit for investor platforms will be their ability to solicit potential investors widely to

become participants in the platform and then, once the requisite substantive relationship has been established, to be able to offer them separate investment opportunities without its being a general solicitation.²⁰ It should not matter whether the subsequent opportunities are for investment directly in the particular companies or, as in *Citizen VC*, through investment in a special purpose vehicle formed by the platform sponsor to invest in particular companies. If the quality of the substantive relationship that is established is sufficient, no waiting period would be required before investment opportunities are provided to the investor.²¹

The *Citizen VC* letter identifies procedures that online investor platforms can follow to establish the requisite substantive relationship. It begins with an investor questionnaire to establish accredited investor status followed by several pro-active steps to create a direct relationship to evaluate the investor's financial position, sophistication and investment objectives. The request letter to the SEC provides a list of possible steps that generally include a follow up contact with the investor, giving the investor an opportunity to ask questions, some external verification and meaningful thresholds on each offering. These are not mandatory but rather provide an indication of what might be done to create the relationship.

An open question is whether the traditional approach of obtaining information, typically online, about accredited investor status without further actions and then waiting a reasonable period before making an offer will still be acceptable. The CDI guidance and the *Citizen VC* letter put this practice, which has been followed by a number of online platforms, into question by indicating that self-certification and a waiting period alone is not necessarily enough to create

²⁰ It is important to remember that the investors will have to qualify as accredited or sophisticated investors when actual investments are made in reliance on Rule 506(b).

²¹ If an investor platform does more than provide a matching service but provides investment advice, it may have to register as an investment adviser under the Investment Advisers Act of 1940. If the investor platform also effects transactions, it may have to register as a broker-dealer, and depending on the nature of its activities even as an exchange, under the Securities Exchange Act. See *AngelList LLC* (Mar. 28, 2013) for circumstances when broker-dealer registration was not required for an investor platform.

the requisite relationship. A clear message from the SEC guidance is that online investor platforms will have to up their game if they are to widely solicit and enroll members without engaging in general solicitation. What actions, perhaps coupled with a waiting period if the actions are not as extensive as suggested in *Citizen VC*, will suffice is not clear. I expect that practice will evolve, ranging from use of procedures along the lines identified in the *Citizen VC* letter, with no specific waiting period, to a combination of certain actions and some waiting period that will be considered acceptable.

Conclusion

The SEC guidance on general solicitation provides welcome flexibility for conducting exempt securities offerings while avoiding general solicitation that would require use of Rule 506(c). This flexibility will benefit issuers raising capital, validate the activities of angel investor networks and create new opportunities for online investor platforms. It also might increase liquidity for investors of restricted securities if resale platforms develop. At the same time, practices followed before by some online investor platforms can be expected to be upgraded. The SEC staff is to be applauded for taking the sensible approach reflected in the guidance and recognizing existing practices and for bringing capital raising activities into the electronic age.