



# STATE REGULATION OF SECURITIES COMMITTEE NEWSLETTER

March 2017

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## Message from the Chair

The Blue Sky Bugle was supposed to be published before the first of the year but, as you can see, it was not. There is always that one person (commonly known as a deadbeat) who is responsible for delaying everything else. In this instance, I must take responsibility as that person.

As is often said, we live in interesting times and none more so than this year. Regardless of your political beliefs, I think we can all agree that this year will be one of major change in securities law and regulation. These changes could take many twists and turns and it is crucial that we all work together to ensure that what results is not necessarily more or less regulation, but regulation that goes neither too far nor not far enough.

We have to ensure the balance between investor protection and capital formation, for if it is the slightest bit out of balance, the system will falter. Perhaps this is a time to think outside of the box. I have been questioning our goals. Are they to protect the investor or to empower the investor? Are they to assist the investor to make decisions based on clear and concise disclosure, combined with the availability of guidance from licensed professionals who understand that an investor who does well will want to make additional investments? (Rather than a licensed individual who may not be as professional as his or her colleagues, but who would rather make a quick buck rather than build a long-term mutually beneficial relationship.)

My own current thinking is not investor protection, but investor empowerment combined with full and fair enforcement of those bad apples who taint the industry as well as the economy.

Let me take a moment to tell you of a recent event in which an individual wanted to purchase 2,000 shares of a company at a price of \$2.50/share. This individual was informed that he could not do so in his retirement account. He was told it was too risky. He pointed out that it was his account, his money, and his decision. Further, he stated that he understood the investment, had done his own research, could easily handle losing his entire investment and that he understood that the order would be marked "unsolicited" in accordance with FINRA rules. The response was an unequivocal "no". This was not permitted and thus he would have to purchase in a non-retirement account. This fellow proceeded to call a different bank at which he had another retirement account. The second bank executed the trade and now the funds from the first retirement account are being transferred to the second.

What lessons are to be learned from the above scenario? Perhaps first and foremost is that in some instances regulation, taken out of context, can paralyze a Bank/BD from servicing its clients. It should be noted that the first BD is part of a large well-known international investment bank. What does it say about legal and compliance departments and the regulations with which they need to comply when they believe the only way to comply is to prohibit investors from making their own investment decisions? Something went awry in this instance, but it happens day in and day out at this one large international investment bank as well as others.

The point is that we need well thought out regulation. Not regulation piled upon regulation. We need regulation that does not result in legal and compliance

paralysis. We do not need regulation that allows nefarious individuals to churn the retirement accounts of others who may lack the knowledge and/or sophistication to know better than to be taken-in by hucksters.

From chaos springs order. Let us all work together, practitioners, issuers, regulators, state and federal legislatures, in forming, if not a more perfect union, a more perfect legal and regulatory regime that does not solve occurrences of fraud by prohibiting investing, but rather, emphasizes enforcement and removes those individuals who harm investors as well as companies in need of capital.

Martin A. Hewitt  
Chair, State Regulation of Securities Committee

## Regulation A and state dealer registration requirements

*By Sara Hanks*

The Securities and Exchange Commission's ("SEC") amendments to Regulation A went into effect on June 19, 2015. Those amendments provided companies with greater access to capital through the ability to raise up to \$50 million in public offerings exempt from SEC registration, and an expanded ability to "test the waters" and ascertain investor interest.

Regulation A does not require that a company use an intermediary such as a broker-dealer to market the offering. However, companies issuing securities in a public offering without the involvement of a registered broker-dealer should be aware that the company itself may be required to register in certain states as an issuer-dealer.

Offerings made under Tier 2 of Regulation A are preempted from state review. Securities sold under Tier 2 are "covered securities" under Section 18 of the Securities Act of 1933, which provides that no state may require registration or qualification of covered securities or transactions in those securities.

However, this exemption is limited to the registration requirements for the offering of the securities. It does not impact the registration requirements for the people making the offering.

Currently, Arizona, Florida, New York, North Dakota, and Texas all require issuers to register as dealers in the state if they are not using a registered broker-dealer in an offering of securities. Additionally, Alabama and Nevada each require an agent of the issuer to register with the state. New York's Martin Act, as ever, is an outlier in this area, and the filing required is essentially a notice filing that will not hold up the progress of a Regulation A offering. The other four states requiring issuer-dealer registration, however, impose substantive requirements.

### **Registration as an issuer-dealer**

#### *Arizona*

Under Section 44-1801(9)(b) of the Arizona Revised Statutes, issuers are defined as dealers of securities. All dealers are subject to the registration requirements of Section 44-1941.

An issuer must submit a Form BD to the Arizona Securities Division along with a \$100 registration fee, audited financial statements, CPA consent, an affidavit that no sales have been made in the state, and evidence that the principals of the issuer have taken securities exams or have equivalent business experience.

Any officer or director responsible for making offers and sales of securities must also register as an agent of the issuer. Agents are required to submit certain

information in Form U-4, along with a \$45 filing fee, proof of passage of a written examination to determine the business experience of the applicant, fingerprints, and proof of lawful residence in the United States. In some cases, the issuer's officers and directors may be considered to have sufficient business experience by virtue of their positions.

#### *Florida*

Under Section 517.021(6)(a)(2) of the Florida Statutes, issuers are defined as dealers of securities. Under Section 512.12(1) no issuer may make offers or sales of securities unless the issuer has been registered with the Division of Securities as a dealer.

To register as an issuer-dealer in Florida, issuer must submit a Form BD through Florida's electronic filing system, as well as the Form OFR-DA-5-91: Issuer/Dealer Compliance Form, financial statements, corporate governance documents, and a \$200 filing fee.

The issuer must also register at least one associated person who must file a Form U-4 along with a \$50 registration fee per associated person. Issuers are allowed to register up to five associated persons who are then exempt from the usual examination process for associated persons of a dealer. Those persons must still submit fingerprints.

#### *North Dakota*

North Dakota utilizes a very broad definition of "broker-dealer" under Section 10-04-02 of the North Dakota Securities Act. As a result, any person that effects transactions of securities in the state for their own account meets the definition of broker-dealer.

Under North Dakota rules, issuers are required to submit North Dakota Form S-4, the constitutive documents of the issuer, Form U-2, Form U-2A, an Affidavit of Issuer/Dealer Activity, and a filing fee of \$200.

Officers and directors of the issuer are required to register as agents of the issuer in the state. To register, agents of an issuer-dealer must file the North Dakota Form S-5, and pay a filing fee of \$60. North Dakota allows for two officers or directors of the issuer to register as agents without being required to pass a written examination. Additional agents are required to pass the Series 63, or Series 66 and Series 7 exams.

#### *Texas*

Section 4(C) of the Texas Securities Act provides for the registration of issuers as dealers when offers and sales are not made through a registered dealer.

The specific registration requirements are found in Rule §115.2 of the State Securities Board. Issuers are required to file the Form BD, Form U-4 for a designated officer and each agent to be registered, copies of the constitutive documents of the issuer, audited financial statements, and a \$100 fee.

A designated officer is required to be registered. The issuer may be required to register agents as well if other officers and directors of the issuer are undertaking any selling activity. Rule §115.3 of the State Securities Board provides for the requirements for registration of such persons. In addition to the Form U-4 filed with the Form BD, each of these people are required to have passed a securities exam accepted by the State Securities Board. For officers and directors or issuers selling their own securities under Tier 2 of Regulation A, passage of the Series 63 or Series 66 exam, or passage of a state administered exam is required. The filing fee for each person is \$100.

#### **Conclusion**

Non-compliance with these states' issuer-dealer rules may result in both regulatory sanctions and investors suits. Issuers not choosing to use a broker to market their Regulation A offerings are faced with three options: pay a broker to act as "broker of record" in all states (since most brokers do not offer the option of acting as broker of record in a limited number of states) and pay broker fees for that service; go through the issuer-dealer registration process, including having an officer take the Texas exam; or chose not to make a Regulation A offering in these states. None of these options is optimal.

## M&A Brokers - No Safe Passage Through State Registration Requirements

*By Eliza Sporn Fromberg*

While the "M&A Brokers No-Action Letter," issued by the U.S. Securities and Exchange Commission (the "SEC") on January 31, 2014 and revised on February 4, 2014, was heralded as a sea-change for brokers facilitating private M&A transactions, the lack of a uniform exemption from broker-dealer regulation at the state level has taken the wind out of the sails of many brokers who might otherwise rely on the no-action letter.

Although the North American Securities Administrators Association adopted a "Model Rule Exempting Certain Merger & Acquisition Brokers From Registration" on September 29, 2015 (the "NASAA Model Rule"), the NASAA Model Rule has not yet been widely adopted by the states. State regulation of M&A advisers varies widely: some states require business brokers that engage in securities transactions to register with the state securities authorities, other states have adopted laws exempting brokers engaged in certain activities from state broker-dealer registration requirements, and in the absence of legislative action, a small number of state securities regulators have published no-action relief. Even if a state exemption exists, the scope of the relief may not precisely mirror the M&A Brokers No-Action Letter. For example, both the NASAA Model Rule and the no-action letter issued by the Pennsylvania Department of Banking and Securities on January 25, 2016, are more restrictive than the SEC's no-action letter in that they both require certain financial disclosures and "bad actor" disqualifications.

Further complicating the analysis, in facilitating the sale of a business, a business broker may be negotiating with multiple potential purchasers, located in different states. It is not always possible to determine which states' laws will apply to a business broker's activities until after the buyer and the seller have come to terms. Some states have business broker laws requiring a broker to register only if it has been engaged by a seller with a principal place of business in the state, More typically, state securities laws require registration in the state where the broker is effecting a transaction in securities; compliance may require analysis of the laws of the states where the buyer, the seller and the business broker are located.

Unlicensed business brokers may encounter surprises even when facilitating transactions in states that appear to have business broker-friendly laws. California has granted an exemption from the state's broker-dealer registration requirement for "any person who effects transactions in securities in this state only in connection with mergers, consolidations or purchases of corporate assets, and who does not receive, transmit, or hold for customers any funds or securities in connection with such transactions." 10 CCR § 260.204.5. However, an unlicensed business broker may be required to obtain a real estate broker license in California because the California Business and Professions Code ("BPC") defines the term "real estate broker" to include brokers of "business opportunities," which is defined to include the sale or lease of the business and goodwill of an existing business enterprise or opportunity. See BPC Section 10030.

In another twist, some states have specific business broker registration laws, and also require entities facilitating securities transactions to register under the state securities laws. Illinois requires business brokers to register with the Illinois Secretary of State Securities Department when the person engaging or seeking to engage the business broker is domiciled in Illinois or when the company or business sought to be sold has its principal place of business in Illinois. 815 Ill. Comp. Stat. 307/10-105. However, "business" is defined in the Illinois Business Brokers Act of 1995 as "an existing business, goodwill of an existing business, or any interest therein, or any one or combination thereof, where the transaction is not a securities transaction involving securities subject to the Illinois Securities Law of 1953." *Id.* at 307/10-5.15. As a result, intermediaries facilitating sales of businesses based in Illinois may need to register as business brokers in connection with asset sales and also find an available exemption from state broker-dealer registration when facilitating sales of securities. Luckily, the Illinois Securities Act has an institutional exemption which exempts from the Illinois dealer registration requirements, dealers that facilitate sales of securities to corporations, banks, insurance companies, and other institutions. *Id.* at 5/8(A).

The states' "institutional" exemptions vary widely and can be difficult to interpret. New Jersey excludes from the definition of "broker-dealer" a person who effects transactions in New Jersey exclusively with or through an "institutional buyer" - defined as including, but "not limited to a qualified institutional buyer as defined in SEC Rule 144A". See N.J.S.A 49:3-49(c)(5) and (t). The statute's language is unlikely to provide certainty to unlicensed brokers effecting transactions with buyers who do not meet the requirements to be a qualified institutional buyer. However, New Jersey also has a *de minimis* exemption for persons that do not effect more than 15 transactions (excluding transactions with institutional buyers) with persons located in New Jersey during any consecutive 12 month period. *Id.* at 49:3-56(b). New York's institutional exemption states that no person shall be deemed a "dealer" solely by reason of offering securities to any corporation (see N.Y. General Business Law §359-e), but fails to specify whether such broker might be deemed a "broker."

Given the significant differences among states' treatment of M&A brokers, unlicensed business brokers seeking to rely on the M&A Brokers No-Action Letter are in for a rocky ride for the foreseeable future.

## General Solicitation Under Rule 506(b) After Citizen VC

*By Richard M. Leisner*

On August 6, 2015, without fanfare, the SEC Division of Corporation Finance issued an interpretative letter to Citizen VC and posted several updates to the Division's Compliance and Disclosure Interpretations (the "Companion C&DIs"), all concerning the nuts and bolts of exempt private offerings, principally under Rule 506(b). The first wave of professional commentary was uniformly positive, applauding the SEC for providing helpful guidance.

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## Editorial

*By Andrew Stephenson*

The past few years have been an exciting time for securities law practitioners. At the federal level we have seen legislation from Congress, new and amended rules out of the SEC, and no-action letters that support innovative practices and

fundamentally alter the way in which issuers may undertake securities offerings.

Many of these actions have invited state response in the form of amendments to their own rules, or adoption of new notice filing requirements. However, one challenge that turns up far too often is the lack of information about changes to those state rules, or how new federal rules affect state requirements. While securities law practitioners will always appreciate a bit of extra work for their clients, small issuers that are tight on funds should not need to speak with a lawyer to know whether existing law requires that a notice filing to be made for an offering taking place under Regulation Crowdfunding, for instance. Now, with the SEC's adoption of Rule 147A and amendments to Rule 504, there is a chance that there will be a dramatic increase of small offerings filed with state regulators. Those regulators should ensure they make every effort to increase access to information for small issuers.

Many states have put in the effort to be more transparent for small issuers. On the websites of a number of state securities regulators, charts are provided that cover the various securities law exemptions, the required state filing, and the appropriate fee for those filings. One additional bit of helpful information would be where to send the filing fee, and to whom the check should be written (i.e., is it the State Treasurer or the Securities Division?). Other states are not so effective at supplying this information to small issuers. Merely identifying applicable code provisions will not help a small issuer without legal counsel. Additionally, there are some state regulators for which the publicly provided information is woefully out of date and does not account for the legislative changes from the JOBS Act of 2012.

As securities law practitioners, we have also seen changes in the demands of small issuers. With the use of the internet, even small offerings require multi-jurisdictional knowledge and practice. State regulators could do a better job of assisting by providing NASAA with information on their proposed rule changes and adoption of final rules. To be able to refer to one source to confirm whether state proposals impact our clients would be a wonderful thing.

I look forward to 2017 and what it could mean for small issuers of securities. The advantages and disadvantages of new rules are still being worked out, and there could be new rules yet from states in response to the SEC's action creating Rule 147A.

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**General Solicitation Under Rule 506(b) After Citizen VC:**  
*Clearer Guiding Principles Analyzed and Possible Future Best Practices Considered*

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May 26, 2016

On August 6, 2015, without fanfare, the SEC Division of Corporation Finance issued an interpretative letter to Citizen VC<sup>1</sup> and posted several updates to the Division's Compliance and Disclosure Interpretations (the "Companion C&DIs"<sup>2</sup>), all concerning the nuts and bolts of exempt private offerings, principally under Rule 506(b).<sup>3</sup> The first wave of professional commentary was uniformly positive, applauding the SEC for providing helpful guidance.

### Citizen VC Overview

Some commentators have reported that the *Citizen VC* guidance significantly changed the overall compliance landscape for a key requirement of Rule 506(b) private offerings – that under the requirements of Rule 502(c) offers and sales must be made without the use of "general solicitation or general advertising."<sup>4</sup> They see *Citizen VC* and the Companion C&DIs as a compliance roadmap for any issuer to contact an unlimited number of prospective investors via impersonal non-selective means (e.g., the internet) without jeopardizing Rule 506(b) compliance.

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<sup>1</sup> *Citizen VC* (August 6, 2015). The SEC's response letter is available at <https://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm> (last visited May 2, 2016); the incoming letter from the Boston office of Mintz Levin is available at <https://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502-incoming.pdf> (last visited May 2, 2016).

<sup>2</sup> Securities Act Rules, Questions of General Applicability (Last Update August 6, 2015), Section 256 Rule 502-General Conditions to be Met *et seq.* (available at <https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm> (last visited May 2, 2016), for convenience, the "Companion C&DIs."

<sup>3</sup> Rule 506(b) has been the most popular Regulation D securities registration exemption, particularly Rule 506(b) offerings in which all investors are required to be accredited investors. Such Rule 506(b) offerings have several attractive features: they may be made without the need to comply with the mandated disclosure requirements of Rule 502(b), there is no limit on the number of accredited investor purchasers and such accredited investor purchasers are not required to meet any investor sophistication requirement. In addition, securities issued in transactions satisfying the requirements of Rule 506(b) are "covered securities" under Section 18(b)(4) of the Securities Act of 1933, effectively preempting all substantive state securities registration requirements (but not form filing and fee payment requirements).

<sup>4</sup> Rule 502(c) of Regulation D governs Rule 506(b) offerings and provides in pertinent part:

Except as provided in [Rule 504 and Rule 506(c)], neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

- (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
- (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising . . . (*carve-outs for Rule 135, Form D filings and certain activities conducted outside of the United States omitted*).

When undertaken in accordance with the guidance in *Citizen VC*, such activities, they assert, will be deemed not to involve “general solicitation or general advertising” within the meaning of Rule 502(c).<sup>5</sup>

Others have a less expansive view about the general applicability of the *Citizen VC* and Companion C&DIs’ guidance to conventional issuers and companies other than registered broker-dealers or similar third-party financial intermediaries.

It is too soon to know the-long term compliance effects of *Citizen VC* and the Companion C&DIs. Today is a good time, however, for careful analysis of these recent SEC pronouncements and their underlying rationale and regulatory provenance.

With this analytical foundation, this article suggests how best practices for conventional issuers might evolve for permissible general solicitation activities in future Rule 506(b) private offerings that will not violate the prohibitions of Rule 502(c).<sup>6</sup>

### **Citizen VC and Companion C&DIs in Detail**

Citizen VC’s counsel asked the Division of Corporation Finance to concur with counsel’s conclusion that certain planned policies and procedures in Rule 506(b) private offerings, conducted through a password-protected internet site, were not impermissible general solicitation prohibited under Rule 502(c).<sup>7</sup> Counsel explained the policies and procedures were aimed at establishing substantive, pre-existing relationships with prospective investors.

The Division’s staff<sup>8</sup> did not respond directly to counsel’s request for concurrence. Instead, the staff’s response letter reviewed and commented favorably on certain of the statements and analyses in Citizen VC’s incoming letter. Reading the incoming request letter, and the staff’s response and the Companion C&DIs *in pari materia* tell Citizen VC’s plans and also reveal the staff’s views about several of the most important issues:

- (1) The quality of the relationship between an issuer (or its agent) and an investor is the most important factor in determining if a “substantive” relationship exists;

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<sup>5</sup> For convenience, in this article “general solicitation” means “general solicitation and/or general advertising” as used in Rule 502(c).

<sup>6</sup> This article does not address compliance procedures in transactions intending to satisfy the requirements of Rule 506(c) which permits the use of general solicitation, provided other conditions of the exemption are satisfied. In addition, this article does not address the application of state securities registration exemption laws and rules regarding the issues discussed herein. There is no assurance that state regulators and courts will follow the SEC’s interpretative positions announced in *Citizen VC* and the Companion C&DIs.

<sup>7</sup> Unlike many request letters sent to the SEC staff, counsel to Citizen VC did not ask for a “no-action” response. Instead, counsel asked only to be advised that the staff “concurred” with counsel’s views about the planned activities. If Citizen VC had asked for a “no-action” response, any response other than a clear statement of “no-action” might have been seen as an unsuccessful encounter with the SEC. In *Citizen VC*, despite the fact that the staff declined to concur with counsel’s views, the tenor and content of the staff’s responses have been uniformly characterized as “favorable.” The attorneys who authored the incoming letter have since described the SEC staff response as a “no-action letter.”

<sup>8</sup> Unless noted to the contrary, references to the “staff” mean the staff of the SEC Division of Corporation Finance.

- (2) A “substantive relationship,” in the context of determining accredited investor status, is one in which the issuer (or its agent) has sufficient information to evaluate, and does evaluate, a prospective offeree’s financial circumstances and investment sophistication;<sup>9</sup>
- (3) A “pre-existing substantive relationship” is one that is established before the commencement of the offering of securities;<sup>10</sup>
- (4) Citizen VC’s proposed policies and procedures described in the incoming letter are designed to evaluate prospective investors’ investment sophistication, financial circumstances and ability to understand the nature and risks of the securities to be offered (but noting that whether such an evaluation has in fact occurred depends on the particular facts and circumstances);
- (5) There is no specific minimum amount of time required before a substantive relationship may be established;<sup>11</sup>
- (6) A single question self-accreditation document cannot be relied upon as the sole basis for establishing a substantive relationship;<sup>12</sup>
- (7) No investment opportunity would be presented to a prospective investor from the time of initial contact through the process of establishing a substantive relationship (becoming a “Citizen VC Member”); and
- (8) Any investment opportunity would only be presented after the prospective investor becomes a Citizen VC Member and any such investment would be in a particular company and not as an investment in a blind pool for a later-determined investment opportunity.

The simultaneous release of the Companion C&DIs reinforced several of the key *Citizen VC* principles and, in addition, addressed important general solicitation issues not specifically addressed in the facts of the *Citizen VC* request letter.<sup>13</sup>

Each of the important principles and concepts in *Citizen VC* and the Companion C&DIs had been expressed to some degree in prior no-action and interpretative letters or SEC releases, most of which had been issued decades before *Citizen VC* (collectively, as noted below, the

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<sup>9</sup> Companion C&DIs, Question 256.31.

<sup>10</sup> Companion C&DIs, Question 256.29.

<sup>11</sup> Companion C&DI, Question 256.30.

<sup>12</sup> Companion C&DI, Question 256.31.

<sup>13</sup> For example, Companion C&DI Question 256.28 commented favorably on the ability of registered investment advisers to establish pre-existing substantive relationships without engaging in impermissible general solicitation and Question 256.33 noted that venture fairs and demo days did not necessarily involve impermissible general solicitation because, in each instance, the ultimate determination about general solicitation was dependent on “all the facts and circumstances.”

“Legacy Interpretative Advice”).<sup>14</sup> Nevertheless, *Citizen VC* and the Companion C&DIs may be seen as a watershed in SEC staff interpretative advice regarding private offerings. In *Citizen VC* and the Companion C&DIs the staff provided helpful guidance in several important areas:

**First**, the staff confirmed the continuing vitality of certain key positions previously announced in the Legacy Interpretative Advice;

**Second**, the staff collected and re-introduced the most important of the principles from the Legacy Interpretative Advice in a single letter (along with the Companion C&DIs);

**Third**, the staff updated its views in the Legacy Interpretative Advice regarding impersonal, non-selective solicitations conducted via mass mailing and telephone cold calling, and applied such views to impersonal, non-selective solicitations conducted via the internet;

**Fourth**, the staff stated that, although it was difficult, it was possible that an entity other than a registered broker-dealer or similar third-party financial intermediary (i.e., a conventional issuer) could establish pre-existing substantive relationships with prospective investors without engaging in general solicitation in violation of Rule 502(c);<sup>15</sup>

**Fifth**, the staff confirmed that there was no minimum waiting period between the time that a pre-existing substantive relationship was successfully established and when an offer of securities could be made without violating the prohibition against general solicitation of Rule 502(c);<sup>16</sup>

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<sup>14</sup> See *Woodtrails-Seattle, Ltd.* (July 8, 1982) 1982 SEC No-Act. LEXIS 3288; SEC Release No. 33-6455, Interpretative Release on Regulation D (March 3, 1983) 48 FR 10045, 1983 SEC LEXIS 2288, III. Operating Conditions, C. Manner of Offering and Question 60, Lexis p. 16-17; *E.F. Hutton & Co.* (December 3, 1985) 1985 SEC No-Act. LEXIS 2917; *Bateman Eichler, Hill Richards, Inc.* (December 3, 1985) 1985 SEC No-Act. LEXIS 2918; *H.B. Shaine & Co., Inc.* (May 1, 1987) 1987 SEC No-Act. LEXIS 2004; SEC Release No. 33-7223, Use of Electronic Media for Delivery Purposes (October 6, 1995) 1995 SEC LEXIS 2662, Questions 20 and 21, Lexis p. 12; *IPONET* (July 26, 1996) 1996 SEC No-Act. 642; SEC Release No. 33-7516, Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore (March 23, 1998) 1998 SEC LEXIS 488; SEC Release No. 33-7856, Use of Electronic Media (April 28, 2000) 2000 SEC LEXIS 847, Lexis p. 17-18.

<sup>15</sup> Companion C&DIs, Question 256.27 and Question 256.32. At the 2015 American Bar Association Business Law Section Fall Meeting, Dialogue with the Director (November 6, 2015), David Fredrickson, Chief Counsel of the SEC Division of Corporation Finance, the official who signed the *Citizen VC* response letter, after noting the staff’s continuing support for the answer to Question 256.32, succinctly summed up his personal views about the ability of persons other than broker-dealers, investment advisers or other similar financial intermediaries (i.e., conventional issuers) to successfully engage in the required conduct: “It’s hard.” Mr. Fredrickson was reported to have expressed similar views in January 2016 at the Northwestern University Securities Regulation Institute (Mike Gettelman, “The Citizen VC No-Action Letter – ‘Pre-existing’ ?,” The Corporate Counsel Blog Post February 15, 2016, (available at [www.thecorporatecounsel.net](http://www.thecorporatecounsel.net), last visited April 25, 2016), for convenience “Gettelman February 15, 2016 Blog”)

<sup>16</sup> Companion C&DI, Question 256.30.

**Sixth**, the staff reaffirmed its long-standing position that the ultimate determination about pre-existing substantive relationships and the existence (or non-existence) of general solicitation were both dependent on “all the facts and circumstances”; and

**Seventh**, the staff provided definitions of the elements comprising a “pre-existing substantive relationship”: When, before any offer<sup>17</sup> to sell securities is made, there is sufficient information to evaluate a prospective investor’s financial circumstances and investment sophistication (and such evaluation actually occurs); but, such a relationship may not be established solely by a prospective investor’s self-certification (i.e., just “checking a box”).<sup>18</sup>

### **Pre-Existing Relationships – Before Citizen VC**

From the dawn of the federal securities laws, the relationship between the issuer and prospective investors has been seen as an important element – among all the facts and circumstances to be considered – in establishing compliance with the private offering exemption.<sup>19</sup> The issuer-investor relationship concept was further developed in the Legacy Interpretative Advice. It provides the regulatory provenance for the prior business or substantive relationship concept and its “no general solicitation” consequences discussed in *Citizen VC* and the Companion C&DIs.

It not clear how and when one of several important concepts in establishing an exempt private offering (the relationship between the issuer and prospective investors) was transformed to provide the basis for the staff’s current positions that: (1) impermissible general solicitation cannot occur if the appropriate substantive pre-existing relationship between the issuer and the prospective investor has been achieved and (2) impersonal general solicitation activities could be used to establish such relationships so long as no “offer” were made before establishing the relationship.

Neither the language of Regulation D nor its explanatory provisions that provide examples of improper general solicitation refers to the concepts of (1) “pre-existing substantive or business relationships” or (2) the “no general solicitation” conditional consequences once such relationships exist. There is no mention of any of these concepts in the 1982 Release adopting Regulation D or in the 1981 Proposing Release. To the knowledge of the author, published references to the concepts by the staff first occurred in 1982 in *Woodtrails-Seattle, Ltd.* (as a

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<sup>17</sup> Section 2(a)(3) of the Securities Act of 1933 defines the term “offer” broadly and the staff has found “offers” to exist in situations where facts would seem to be insufficient to establish an offer for contract law purposes. See note 44, *infra*.

<sup>18</sup> Companion C&DIs, Question 256.29 and Question 256.31. In practice, many subscription documents solicit far more personal information about prospective investors than “check-this-box-if you are an-accredited-investor.” Such information may include dollar amounts of actual net worth, past, current and anticipated annual income, liquidity (and illiquidity) of and other information about invested assets, value and lien status of principal residence, education, employment and investment experience and, in addition, could provide or lead to responsible third-party verification of key financial and investment information.

<sup>19</sup> Letter of SEC General Counsel dated January 24, 1935, 11 FR 10952, 1935 LEXIS 955, cited favorably at note 12 to *SEC v. Ralston Purina*, 346 U.S. 119, 1953 U.S. LEXIS 2688.

“pre-existing business relationship”) and were cited with approval in subsequently issued no-action letters and releases comprising the Legacy Interpretative Advice.

Regulation D was adopted in the spring of 1982. In 1983, the staff issued a detailed series of Q&A interpretations.<sup>20</sup> The staff stated that (1) general solicitation activities without any offer of an investment opportunity will not violate the restrictions of Rule 502(c) and (2) offers to sell securities to substantial numbers of persons with whom the issuer had a “pre-existing business relationship” also will not violate the restrictions of Rule 502(c). In the introduction to questions and answers about Rule 502(c), the staff put it this way:

The analysis of facts under Rule 502(c) can be divided into two separate inquiries. First, is the communication in question a general solicitation or general advertisement? Second, if it is, is it being used by the issuer or by someone on the issuer’s behalf to offer or sell the securities? If either question can be answered in the negative, then the issuer will not be in violation of Rule 502(c).

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In analyzing what constitutes a general solicitation [in *Seattle-Woodtrails*], the staff . . . underscored the existence and substance of the pre-existing business relationship between the general partner and those being solicited. The general partner represented that it believed each of the solicitees (*sic*) had such knowledge and experience in financial and business matters that he or she was capable of evaluating the merits and risks of the prospective investment. (*Citation to Seattle-Woodtrails omitted*).<sup>21</sup>

In the several decades following the Reg D 1983 Q&A Release, the SEC addressed general solicitation issues episodically in no-action and interpretative letters, formal releases and informal staff pronouncements (including materials identified as Legacy Interpretative Advice<sup>22</sup>). The 2000 Electronic Media Release provided a measure of clarity by collecting and summarizing the staff’s views on past releases and no-action letters. In this release, the staff announced the position that “general solicitation is not present” when the appropriate pre-existing business or substantive relationships exist between issuer and prospective investors.<sup>23</sup>

The collected components of the Legacy Interpretative Advice, while helpful, were still subject to a number of compliance uncertainties. In carefully reviewing the language in the staff’s periodic considerations of general solicitation issues that span more than 20 years, it is hardly surprising to find some inconsistencies. Word-search reviews of the documents

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<sup>20</sup> Interpretive Release on Regulation D, Rel. No. 33-6455 (March 3, 1983) 48 FR 10045, 1983 SEC LEXIS 2288 (for convenience, the “Reg D 1983 Q&A”).

<sup>21</sup> Reg D 1983 Q&A, p.16 in Lexis. Neither the Reg D 1983 Q&A nor *Seattle-Woodtrails* referred to the financial wherewithal of prospective investors as significant to Rule 502(c) determinations..

<sup>22</sup> Note 8, *supra*.

<sup>23</sup> Use of Electronic Media, SEC Release No. 33-7856, April 28, 2000, 2000 SEC LEXIS 847, \*58, LEXIS 17 (for convenience, the “2000 Electronic Media Release”), available at <https://www.sec.gov/rules/interp/34-42728.htm> (last visited May 2, 2016), citing to *Woodtrails-Seattle, Ltd.*, *supra*, *E.F. Hutton Co.*, *supra*, *H.B. Shaine & Co. Inc.*, *supra*, and *Bateman Eichler, Hill Richards, Inc.*, *supra*. See Note 8, *supra*.

comprising the Legacy Interpretative Advice reveal a variety of similar (but not identical) terms used to identify the appropriate relationships between issuers and prospective investors. A variety of adjectives are used, including, “existing, prior or pre-existing.” The adjectives modify nouns including “business relationship, business or personal relationship, substantive relationship, substantive business relationship and pre-existing substantive relationship.”

The author has found nothing in the Legacy Interpretative Advice to suggest that the varying terms were intended to have materially different meanings from the more clearly identified language – “pre-existing substantive relationship” – used in *Citizen VC* and the Companion C&DIs. However, the author found no consistent staff exposition in any of the Legacy Interpretative Advice documents of the criteria now detailed in *Citizen VC* and the Companion C&DIs as comprising the behavioral building blocks of “pre-existing substantive relationships.”

As noted above, in some instances in the Legacy Interpretative Advice, the appropriate relationship is identified as a “business relationship” (sometimes appearing along with the adjective “substantive”). However, neither *Citizen VC* nor any of the Companion C&DIs use the term “business” in conjunction with “relationship.”

Historically, the use in the Legacy Interpretative Advice of the term “business” in conjunction with the pre-existing relationship concept led many practitioners to be concerned that non-business relationships (e.g., churches, service or civic organizations or country clubs) might not provide a basis for establishing the appropriate relationships.

There is no pronouncement in either *Citizen VC* or the Companion C&DIs disavowing the requirement for the substantive relationships to be rooted in business relationships.<sup>24</sup> However, the total absence of the word “business” in conjunction with the definition of substantive relationship in these most recent pronouncements appears to have put the “business relationship” issue to rest. Accordingly, it should be safe for practitioners to advise that social, civic, religious and other “non-business” dealings are acceptable bases for establishing the appropriate substantive relationship with prospective investors.

Finally, it bears noting that financial wherewithal and investment sophistication of prospective investors – important elements in the current formulation of a pre-existing substantive relationship – were not consistently identified by the staff in the Legacy Interpretative Advice as important issues to establish the required relationships.

Some commentators have opined that *Citizen VC* and the Companion C&DIs are “nothing new” – not much more than modest (but welcomed) clarifications of well-established concepts and staff positions.

In the author’s opinion, such sanguine observations fail to consider, as discussed above, the important differences between the language and logic of the Legacy Interpretative Advice and *Citizen VC* and the Companion C&DIs. These most recent pronouncements use greater precision in both their terminology and substantive elements than are present in the Legacy Interpretative Advice. In addition, the absence of the need for the relationship to be a “business

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<sup>24</sup> In contrast, Companion C&DI Question 256.30 specifically disavows the requirement for any minimum time period to elapse before a pre-existing substantive relationship may be established.

relationship” and the addition of the need to determine appropriate financial wherewithal and investment sophistication is each a significant change. Finally, and possibly of greatest importance, the staff has issued a favorable interpretative letter to an entity other than a registered broker-dealer or investment adviser.

### **Pre-existing Substantive Relationships – Today**

*Citizen VC* and the Companion C&DIs cleared away several of the past uncertainties and inconsistencies in the Legacy Interpretative Advice. To start with, the staff consistently used the term “pre-existing substantive relationship.” In addition, as noted above, the term “business” had been removed from the formulation.

More significantly, the staff provided specific definitions for the key terms “substantive” and “pre-existing,” each as used to modify the term “relationship”:

A “**substantive**” relationship is one in which the issuer (or a person acting on its behalf) has sufficient information to evaluate, and does, in fact, evaluate, a prospective offeree’s financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investor. Self-certification alone (by checking a box) without any other knowledge of a person’s financial circumstances or sophistication is not sufficient to form a “substantive” relationship.<sup>25</sup>

A “**pre-existing**” relationship is one that the issuer has formed with an offeree prior to the commencement of the securities offering or, alternatively, that was established through either a registered broker-dealer or investment adviser prior to the registered broker-dealer or investment adviser participation in the offering. *See, e.g., the E.F. Hutton & Co. letter (Dec. 3, 1985). (emphasis added)*<sup>26</sup>

Today’s formulation of the “pre-existing substantive relationship” concept is the linchpin for the future application of the concepts and principles in *Citizen VC* and the Companion C&DIs. Conduct inside such a relationship benefits from an interpretative vaccination against being treated as impermissible general solicitation.

Activities undertaken to properly establish these relationships that are free from any “offer” to sell securities may use impersonal communications (e.g., open internet solicitations, mass mailings or cold calling campaigns). Indeed, such communications may be directed to an unlimited number of prospective investors who are total strangers to the issuer without running afoul of the general solicitation prohibition of Rule 502(c).

As noted above, this regulatory vaccination against the presence of impermissible general solicitation is subject to two important provisos – First, the relationship cannot be established by self-certification **alone** (checking the box).<sup>27</sup> Second, the conduct establishing the relationship

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<sup>25</sup> Companion C&DIs, Question 256.31.

<sup>26</sup> Companion C&DIs, Question 256.29.

<sup>27</sup> See note 11, *supra*.

cannot involve an “offer” to sell securities. Neither of these provisos, as noted above, was viewed as a significant impediment by counsel to Citizen VC and experienced practitioners are likely to have similar views.

In any event, after the establishment of the appropriate pre-existing substantive relationship, Rule 502(c) places no limit on the number of properly qualified prospective investors that may be contacted or the means by which communications are had with them. In these circumstances, the conduct in question is “not general solicitation” prohibited by Rule 502(c).

Questions have been raised about the requirement that the substantive relationship has to be established “prior to the commencement of the offering,” and in the case of broker-dealers, before “participating” in the offering.<sup>28</sup> There is no reference in *Citizen VC* regarding the timing of the establishment of the substantive relationship with prospective investors and the “commencement” of a particular offering. There is no guidance in the Companion C&DIs about the operation of the phrases “commencement of the offering” and “prior to participating” in the offering vis-à-vis the establishment of substantive relationships. To date, there has been no formal staff guidance regarding these phrases. The concept of what particular conduct constitutes “commencement” is important in several securities law contexts, such as in IPOs, secondary offerings, rights offerings and tender offers (the consideration of which are beyond the scope of this article).

In the context of Rule 506(b) offerings, has an offering “commenced” if no prospective investor is offered an opportunity to invest but the contours of the offering have been determined and exist on the password-protected pages of a secure website? If this inquiry is answered affirmatively, compliance would have the effect of lengthening the offering process. The investor qualification process would have to be completed as to all prospective investors before establishing the terms of the subject offering and beginning to communicate with qualified prospective investors about investing in the offering. This interpretation would make the mechanics of Rule 506(b) offerings akin to a merry-go-round ride at the county fair: riders were allowed to get on the ride before the music started and the ride began to spin; once the ride began to spin, no additional riders were permitted.

Alternatively, the concept of “commencement” could be considered on a one-at-a-time basis for each prospective investor and be determined co-extensively with whether an “offer” has been made. Applying this interpretation, an offering would be seen as “commencing” for each prospective investor only when the elements of an offer are present.<sup>29</sup>

Current uncertainties concerning the operation of “commencement of the offering” and “participation in the offering” await further development.

### **Numbers, Numbers, Numbers**

Neither *Citizen VC* nor any of the Companion C&DIs focused on “actual numbers.” There is no discussion of how many prospective investors might be contacted to begin with, how many might begin the qualification process or the actual number that might ultimately be

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<sup>28</sup> Companion C&DIs, Question 256.29 and Question 256.30.

<sup>29</sup> For discussion of this issue, see Gettelman February 15, 2016 Blog, note 15, *supra*.

presented with investment opportunities. The same is generally true for the Legacy Interpretative Advice no-action letters. The reason for this lack of concern with “numbers” is simple: In each situation, the conduct in question was believed not to involve impermissible general solicitation, allowing solicitation of an unlimited number of prospective investors.

Particularly before *Citizen VC*, most conventional issuers and their advisers seeking to raise capital in Rule 506(b) all accredited investor private transactions found themselves in a regulatory environment that did not allow them to take advantage of the general solicitation relief afforded in the Legacy Interpretative Advice to registered broker-dealers. As a result, conventional issuers had to be concerned with “actual numbers.”<sup>30</sup>

Before the adoption of Regulation D, private offering exemption compliance applied investor qualification criteria to offerees as well as investors. This requirement necessitated keeping track of each individual offeree to confirm satisfaction of the applicable qualifications (e.g., wealth and investment sophistication). Regulation D removed all offeree qualification criteria and allowed contact to be made with an unlimited number of offerees, subject to one “small” caveat – that no form of general solicitation be used in connection with the offer or sale of securities.

Despite the fact that offerees do not “count” under Regulation D generally, and in particular, in an all accredited investor offering under Rule 506(b), the prohibition against general solicitation compels conventional issuers to have a continuing concern with “numbers.”

Offerees “count” in determining if there has been impermissible general solicitation, assuming that each offeree has been solicited to consider purchasing the securities that are the subject of the offering. Even if offerees no longer had to be qualified as to financial wherewithal or investment sophistication, contacting “too many” offerees risked being found to constitute impermissible general solicitation under Rule 502(c). Concerns with “numbers” among practitioners did not abate even if offerees were contacted one-at-a-time or even if there was relative certainty that every member of a large group of offerees was an accredited investor (such as an annual meeting of the partners of a national accounting firm).<sup>31</sup> How many would be too many, of course, would depend on the particular facts and circumstances. Careful practitioners advise that the number would almost certainly be smaller if the prospective investors were not personally known to the issuer or if impersonal means of solicitation were used (i.e., mass mailings, cold calls or internet emails).

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<sup>30</sup> Of course, there are “numbers” in Regulation D: both Rule 505 and Rule 506(b) provide there may be no more than 35 non-accredited investors; however, both exemptions are still subject to the prohibition against general solicitation in Rule 502(c). Accordingly, these “numbers” limits are not conclusive in addressing the “numbers” issue to avoid impermissible general solicitation in all accredited investor Rule 506(b) transactions. Depending on the facts, solicitations to 35 prospective investors could violate the proscriptions of Rule 502(c).

<sup>31</sup> The 1981 Release proposing Regulation D reflected a then current concern with the absence of any limit on the number of accredited investors that might participate in an exempt offering under Regulation D:

[P]ursuant to the accredited investor concept in Regulation D, offerings could theoretically be made to an unlimited number of accredited investors. The Commission cautions issuers, however, that depending on the actual circumstances, offerings made to such large numbers of purchasers may involve a violation of the prohibitions against general solicitation and general advertising. Release No. 33-6339, August 18, 1981, Lexis 46 FR 41791, n. 30 \*13.

From the earliest days of using Regulation D in 1982, experienced counsel had little difficulty reminding clients to avoid the activities well understood to involve impermissible general solicitation, such as open meetings attended by large numbers of unqualified prospective investors or advertisements in newspapers, on TV or in other mass media and, of course, after the mid-1990s, impersonal internet-based solicitations.<sup>32</sup>

From the prospective issuer's point of view, advising against conduct certain to violate Rule 502(c) often leaves unanswered issuer clients' typical "numbers" questions:

*In specific numbers, how many prospective investors may be contacted without engaging in general solicitation prohibited by Rule 502(c)?*

*If 10 personal friends are OK, but 300 acquaintances are too many, how about 30 relatively close friends?*

*How about 50 slightly less close friends?*

Careful practitioners answer "Once you have more than 10 personal friends, it depends on all the facts and circumstances."

Consider several typical "numbers" scenarios clients may ask about and think what your responses might be if you were this issuer's counsel:

- **Two dozen golfing buddies.** How about the wealthy client who suggests one-on-one contacts with two dozen long-time golfing buddies who all belong to the same exclusive country club?

For a variety of reasons, most practitioners would be comfortable with the "numbers" in this golfing buddy hypothetical. The absolute number is not great; there is a relationship that pre-dates any securities offering; the prospective investors are likely to be as wealthy as the client and, based on what your client knows from years of informal discussions in the locker room, reasonably likely to be sophisticated when it comes to investments. A short conversation with the client about other "facts and circumstances" can be expected to increase counsel's comfort level.

When clients modify fact scenarios, counsel is pushed toward "it depends on all the facts and circumstances" answers.

- **400 Country Club Members.** What if the two dozen golfing buddies are expanded a bit to include all 400 members of the exclusive country club, most of whom the client says he knows "fairly well," either socially or through business dealings?
- **1,000 Congregants.** How about the 1,000+ members of the church or synagogue attended by the issuer's CFO? Would it make any difference if the CFO was only a sometimes attendee, but the CFO's non-employee

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<sup>32</sup> This conduct was specifically identified in the explanatory text of Regulation D as being impermissible general solicitation. Rule 502(c)(1) and (2).

brother-in-law is a very active congregant and offers to take the client's senior officers to meet all the most important opinion leading congregants?

- **1,000 Best Customers.** What about the 1,000 best customers of the client's chain of 150 women's high-end retail clothing stores? Would it make any difference if the client's business was manufacturing and directly selling large bulldozers and other earth-moving devices, each costing several hundred thousand dollars?
- **This is not an offer.** Would it make any difference if, in each of the foregoing scenarios, the client made sure that all face-to-face discussions with prospective investors omitted specifics about price and terms for the securities and simply asked if prospective investors were interested in finding out more about the client's business? What if all written communications (internet emails) omitted any reference to the nature of the securities, size of the offering, price, etc. and included a bold legend to the effect that the communications were not an offer to sell securities and offers could only be made after the prospective investor met certain criteria?

Many businesspeople believe none of the examples noted above involve "real" general solicitation. The author has been told by more than one client, "It's not as if I am taking out an ad in *The Wall Street Journal* offering to sell common stock in my company for \$10 per share."

Careful counsel, for Rule 502(c) purposes, might find "issues" with each of the hypothetical scenarios outlined above that dealt with more "numbers" than the initial two dozen golfing buddies hypothetical. In responding, counsel would want to develop more facts and circumstances. In this regard, careful attorneys are ever mindful that violation of the Rule 502(c) prohibition on general solicitation destroys the exemption for all investors in the affected offering, not just the investors who were improperly solicited. When in doubt, most securities attorneys advise against conduct in the "gray areas" of general solicitation.

### **Should it Matter Who Makes the Solicitation?**

Before *Citizen VC*, the pre-existing business relationship pathways of permissible general solicitation, despite the obvious benefits and advantages, were not widely traveled by conventional issuers. The problem was not so much satisfying the elements to build the appropriate relationships but rather limitations on the entities that could travel the pathways.

Before *Citizen VC*, with rare exception, only registered broker-dealers, their affiliates or other similar financial professionals were recipients of favorable general solicitation no-action or interpretative letters.<sup>33</sup> The favorable Legacy Interpretative Advice no-action and interpretative

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<sup>33</sup> Non-broker dealer sponsors of private investment funds did receive favorable no-action letter responses from the SEC Division of Investment Management in *Lamp Technologies, Inc.* 1998, May 29, 1998, SEC No-Act. LEXIS 615 *Royce Exchange Fund, Quest Advisory Corp.*, August 28, 1998, 1996 SEC No-Act. LEXIS 706. The staff of the Division of Corporation Finance, as noted *infra*, made it clear that the logic in these letters would not be extended to actions by conventional issuers.

letters were issued to broker-dealers or similar third-party financial professionals.<sup>34</sup> To the author's knowledge, prior to *Citizen VC* no conventional issuer had received a favorable letter.<sup>35</sup> Informally, senior staffers echoed the negative responses received by conventional issuers and reinforced the logic for limiting favorable letters to registered broker-dealers and other financial professionals.

The activities of broker-dealers or similar intermediaries were seen by the staff as a buffer between prospective investors and the issuers of securities. The SEC's 2000 Electronic Media Release commented on permissible activities in conducting Regulation D private offerings.<sup>36</sup> After first noting that "a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the offerees," the SEC focused on the special role played by financial intermediaries:

"[T]raditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and, thus, implies that a substantive relationship exists between the broker-dealer and its customers."<sup>37</sup>

For registered broker-dealers, part of their normal dealings with customers would be gathering facts regarding prospective customers' financial wherewithal and investment sophistication.<sup>38</sup> From the staff's perspective, such required regulatory broker-dealer factual inquiries could be undertaken without making an "offer" to sell securities to the customer. Conventional issuers were not subject to these regulatory obligations.

Following the guidance in the first several favorable no-action letters in the Legacy Interpretative Advice, broker-dealers refined their use of impersonal non-selective general solicitation activities such as "cold-calling" and impersonal direct mail campaigns to solicit prospective investors to establish substantive relationships.

The author has received many "cold calls" from broker-dealers pursuing this scenario. The broker introduces herself (or himself) and almost immediately announces "I don't want to sell you anything; I just want to find out a bit more about you and your investment objectives."

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<sup>34</sup> Note 8, *supra*.

<sup>35</sup> For an example of a negative staff response to a no-action request with facts not dissimilar to those in *Citizen VC*, see *Agristar Global Networks, Ltd.* (February 9, 2004) 2004 SEC No-Act. LEXIS 203. Also, for other negative staff responses, see *Gerald F. Gerstenfeld* (December 3, 1985) 1985 SEC No-Act. LEXIS 2790; *Mineral Lands Research & Marketing Corporation* (December 4, 1985) 1985 SEC No-Act. LEXIS 2811; *Webster Management Assured Return Equity Management Group Trust* (February 7, 1987) 1987 SEC No-Act. LEXIS 1595; and *Circle Creek AquaCulture V, L.P.* (March 26, 1993) 1993 SEC No-Act. LEXIS 524.

<sup>36</sup> 2000 Electronic Media Release, "Private Offerings Under Regulation D."

<sup>37</sup> *Ibid.*

<sup>38</sup> Under applicable FINRA (and previously, NASD) rules, broker dealers are subject to "fair dealing" (Rule 2010), and "suitability" obligations (Rule 2111) and, in addition to the obligations noted above, the further regulatory obligation to "know your customer" (Rule 2090), available at <https://www.finra.org/industry/finra-rules> (last visited April 11, 2016).

After the initial contact, the broker-dealer could use additional telephone calls and mail exchanges (and after the mid-1990s, the internet and email) to obtain information about the financial wherewithal and investment sophistication of the prospective investor, thereby successfully establishing the substantive (business) relationship before making an offer to sell securities. After the establishment of the substantive (business) relationship, future securities offering communications with prospective investors would not be treated as general solicitation prohibited by Rule 502(c).

In 1997 and 1998, the Division of Investment Management, joined by the Division of Corporation Finance, provided favorable no-action letters to Lamp Technologies, a data processing and web site developer involved in the investment fund industry that was not registered as a broker-dealer.<sup>39</sup> Lamp Technologies planned to use a password-protected internet site to provide information about private investment funds to prospective investors in such funds. The prospective investors were to be prequalified as accredited investors before being granted access to the website. The staff agreed that the proposed activities would not constitute impermissible general solicitation prohibited by Rule 502(c).

Two years later, the SEC issued the 2000 Electronic Media Release on April 28, 2000, providing staff guidance on the interaction of the internet and other new technologies with the federal securities laws. The Release comprises 28 single-spaced pages of 10 pt. type. Although fewer than two pages are devoted to private offerings, several of the Legacy Interpretative Advice letters are mentioned in the text or footnotes, including the *Lamp Technologies* letters.

The several years between the *Lamp Technologies* letters and the 2000 Electronic Media Release afforded the staff a prescient opportunity to consider the possibility of extending to other non-broker-dealers the procedures endorsed in the *Lamp Technologies* letters.<sup>40</sup> Instead, in criticizing unprotected websites purporting to comply with the requirements noted in favorable no-action letters (including *Lamp Technologies*), the staff emphatically limited the application of the *Lamp Technologies* letters to their particular circumstances:

We understand that securities lawyers may have interpreted staff responses to Lamp Technologies, Inc. as extending the “pre-existing, substantive relationship” doctrine to solicitations conducted by third parties other than a registered broker-dealer. . . . We disagree. In the *Lamp Technologies* no-action letters, the staff of the Divisions of Investment Management and [the Division of] Corporation Finance recognized a separate means to satisfy the “no general solicitation” requirement solely in the context of offerings by private hedge funds that are excluded from regulation as investment companies pursuant to Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. (*Citations to statutes and Lamp Technologies letters omitted.*)<sup>41</sup>

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<sup>39</sup> *Lamp Technologies, Inc.* 1997 SEC No-Act. LEXIS 638 (May 29, 1997) and *Lamp Technologies, Inc.* 1998 SEC No-Act. LEXIS 615 (May 29, 1998). In 1996, the Division of Corporation Finance issued a favorable no-action letter to another non-broker dealer on permissible general solicitation involving investors in private investment funds; *Royce Exchange Fund, Quest Advisory Corp* 1996 SEC No-Act. LEXIS 706 (August 28, 1996).

<sup>40</sup> Indeed, when the *Lamp Technologies* letters were first issued, many practitioners interpreted the letters as the staff’s endorsement of the use by conventional issuers of the broker-dealer approved permissible general solicitation procedures.

<sup>41</sup> 2000 Electronic Media Release, Note 88.

Standing in bizarre juxtaposition to its narrow reading of the *Lamp Technologies* letters, the staff offered its views about the ability of non-broker-dealers to successfully create pre-existing substantive relationships without engaging in prohibited general solicitation:

We have long stated . . . that the presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case. Thus, there may be facts and circumstances in which a third-party, other than a registered broker-dealer, could establish a “pre-existing, substantive relationship” sufficient to avoid a “general solicitation.” (*footnotes omitted*)<sup>42</sup>

Regrettably, the staff did not offer any examples of what “facts and circumstances” would allow a non-broker-dealer to successfully create a pre-existing substantive relationship. In these circumstances, as far as careful securities lawyers were concerned, there was little practical value in the staff’s theoretical insistence that non-broker-dealers could successfully establish pre-existing substantive relationships with prospective investors.

For careful securities lawyers advising conventional issuers, the staff’s positions vis-à-vis the *Lamp Technologies* letters meant that all but the most limited communications programs might be deemed to run afoul of the general solicitation prohibitions of Rule 502(c). Certainly, it would be too risky to advise a conventional issuer that it could solicit prospective investors following the procedures the staff approved for registered broker-dealers and Lamp Technologies.

In May 2003, the staff was presented with an opportunity to consider the proposed interactions of a conventional issuer with prospective investors. Counsel to Agristar Global Networks, Ltd. requested a no-action letter and related interpretative advice regarding certain proposed activities.<sup>43</sup> In view of the similarities to those outlined by Citizen VC nearly a dozen years later, the details of the *Agristar* incoming letters are worthy of careful consideration.

Agristar planned to offer satellite-based communications systems for farmers and ranchers. Agristar had access to an extensive database of information about the prospective service subscribers developed over several decades that included current detailed financial and other pertinent business information on approximately two million ranches and farms. In addition, Agristar had substantive business relationships with the database entities, many dating back more than 20 years. Agristar proposed soliciting the “top 1%” of entities in the database to complete detailed generic questionnaires aimed at determining the recipients’ accredited investor status. Based on the database information and years of experience with the database entities, Agristar believed even before sending out the generic questionnaires it had a reasonable basis to believe that the “top 1% entities” would be accredited investors. The questionnaires would not be accompanied by any offer to sell specific securities and there would be no solicitation of an offer to buy securities.

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<sup>42</sup> The staff’s policy of an “all the facts and circumstances” approach echoed language in a 1989 Release: “the staff has never suggested, and it is not the case, that prior relationship is the only way to show the absence of a general solicitation.” Securities Act Release No. 6825 (March 15, 1989) [54 FR 11369] n. 12.

<sup>43</sup> *Agristar Global Networks, Ltd.* 2004 SEC No-Act. LEXIS 203 (February 9, 2004).

Counsel to Agristar referred to the Legacy Interpretative Advice that had permitted the broad distribution of investor questionnaires not accompanied by an offer regarding a specific investment.<sup>44</sup> Counsel to Agristar augmented the information in its initial request with an additional letter in September 2003. In February 2004, without substantive explanation, the staff declined to issue the requested no-action letter or interpretative advice.

There has been no formal staff explanation for the differing results obtained in the *Citizen VC* and *Agristar* letters. The planned policies and procedures of both companies seem to be similar to one another. If anything, it appears that Agristar's plans to pre-select prospective investors to be solicited were significantly more selective than Citizen VC's plans to first interact with prospective investors with an open public website.

As noted above, one persuasive explanation for concluding that broker-dealers could gather information about prospective investors without engaging in prohibited general solicitation was that gathering information about customers was a normal and FINRA (*nee* NASD) mandated part of broker-dealers' day-to-day business. Citizen VC and Agristar, however, were alike in that neither had any regulatory obligations independent of complying with Rule 502(c) to gather information about prospective investors. Accordingly, this historical explanation was not available to differentiate the results in *Citizen VC* from those in *Agristar*.

Should their differing businesses alone account for differing SEC advice? Citizen VC planned to be an active participant in the financial services industry. In contrast, Agristar was a conventional issuer with an ongoing business separate from any participation in the financial services industry.

### **Which Communications are “Not Offers”?**

As noted above, one explanation for differentiating treatment of financial services intermediaries from that accorded to conventional issuers was that such intermediaries could solicit information from prospective investors without making an “offer” to sell securities. Broker-dealers and investment advisers had regulatory obligations to become informed about the net worth, investment objectives and investment sophistication of their clients, who were also their prospective investors. In contrast, according to this explanation, most conventional issuers would have “no reason” to communicate with prospective investors other than to offer the issuer's securities for sale.<sup>45</sup>

In the author's opinion, this logic is subject to two fatal flaws: First, it omits any opportunity to take into account “all the facts and circumstances” that may be present in the activities of a particular conventional issuer and, in so doing, assumes its own conclusion that an

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<sup>44</sup> *IPO Net, H.B. Shaine & Company, Inc., E.F. Hutton Company and Bateman, Eichler, Hill Richards, Inc., supra.*

<sup>45</sup> As additional support for the differing treatment of conventional issuers from that accorded to financial intermediaries it has been asserted that communications by financial intermediaries with prospective investors were free from an “offer” to sell securities because, at the time of the initial contact, the issuer and investment terms would not be disclosed to the prospective investor. In contrast, according to this explanation, prospective investors in communications with conventional issuers would “know” the identity of the likely issuer, making the existence of an “offer” in the initial communication almost unavoidable. Of course, in such initial communications, the conventional issuer could refrain from revealing the specific identity of the ultimate issuer (it could be an affiliate of the party making the communication) as well as the specific terms of the security that might later be offered for sale.

“offer” must be part of any issuer contact.<sup>46</sup> Second, it ignores the fact that the “only reason” the financial intermediary (or broker-dealer) is communicating with prospective investors is just the same as that ascribed to the conventional issuer – to sell a security to investors at some time in the reasonably foreseeable future.

If the SEC sincerely wishes to fairly implement the agency’s oft-repeated “all the facts and circumstances” standard, the ultimate objective of limited initial communications with prospective investors is but one fact to consider.<sup>47</sup> The ultimate objective to sell a security – whether the sale is later made indirectly through a broker-dealer or directly through a conventional issuer – should not reasonably compel a conclusion that communications free from the indicia of an “offer” must nevertheless be seen as impermissible “offers” made in violation of Rule 502(c).

In the author’s opinion, under *Citizen VC* and the Companion C&DIs, a careful conventional issuer should be able to use impersonal means of mass communication with prospective investors without making an “offer” in violation of Rule 502(c). The issuer’s initial communications with prospective investors would omit any details about the nature of the security that might be offered in the future and instead concentrate on the initial steps in establishing the required substantive relationship.

### **Current and Future Best Practices for Conventional Issuers**

To date, the staff has not endorsed the logic supporting the use by conventional issuers of “no offer” communications outlined above. As a result, conventional issuers and their advisers today are likely to conclude it is too risky to use *Citizen VC* and the Companion C&DIs as a template for general solicitation of prospective investors as a first step to establishing substantive relationships. However, the author expects that, over time, the uncertainties of the current environment for permissible general solicitation by conventional issuers will give way to more certain and more liberal best practices.

There are several likely sources for such improvements. First, the Division of Corporation Finance could issue a favorable no-action or interpretative letter to a conventional issuer. While it is true that, in the several decades since the adoption of Regulation D, no

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<sup>46</sup> The term “offer” has been broadly defined in statutory provisions, rules, interpretative releases and litigation (e.g., Section 2(a)(3) of the Securities Act of 1933). The SEC has issued rules narrowing the breadth of the statutory definition (e.g. Rules 135(a)-(e) under the Securities Act of 1933) that make “non-offers” of conduct and communications that would otherwise be “offers.” Ultimately, whether an “offer” has been made should depend on the particular facts and circumstances. See Reg D 1983 Q&A Release. More than two decades ago, Linda Quinn, long-time Director of the Division of Corporation Finance, in assessing the future of private offering regulation, suggested there may have been too much concern with regulating “offers” and that it was preferable instead to focus regulatory effort on protecting actual purchasers. “Reforming the Securities Act of 1933: A Conceptual Framework,” Speech at the Federal Regulation of Securities Committee of the Business Law Section of the American Bar Association 1995 Fall Meeting, *Insights*, January 1996, Section: From The Podium; Vol. 10, No.1; Pg. 25.

<sup>47</sup> Companion C&DI Question 256.32, citing to 2000 Electronic Media Release, which in turn cited to Securities Act Release No. 6825 (March 15, 1989) [54 FR 11369] n. 12.

conventional issuer received a favorable letter, there is, nevertheless, a basis for a bit of optimism.<sup>48</sup>

The staff has repeatedly said that facts and circumstances (not status as a broker-dealer) determine whether favorable no-action and interpretative letters were issued. In this regard, the absence of broker-dealer registration did not disqualify Citizen VC from receiving the same favorable staff advice as had registered broker-dealers in the Legacy Interpretative Advice.<sup>49</sup> This favorable result in *Citizen VC* must be seen as both a significant change in the regulatory environment and also as a harbinger of a possibly favorable result in the future for a conventional issuer with the “right facts and circumstances.” Perhaps the favorable results will be forthcoming if the staff is now presented with facts and circumstances similar to those in *Agristar*.

Another source for more liberal compliance best practices for conventional issuers would be one or more court decisions requiring the staff to take a less restrictive view of what behavior was an impermissible “offer” or constituted impermissible general solicitation.<sup>50</sup>

Finally, it is inevitable that custom and practice will experience gradual changes (sometimes pejoratively referred to as “exemption creep”). Compliance practices that might raise concerns today could be well accepted in general use in a decade.<sup>51</sup>

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<sup>48</sup> *Citizen VC* was issued more than dozen years after the unexplained negative response in the *Agristar* letter and some 15 years after the negative comments in 2000 Electronic Media Release about the inability of non-broker-dealers to model their conduct on the permissible general solicitation activities approved for broker-dealers and certain private hedge funds. For references to unsuccessful no-action and interpretative letters, see note 35, *supra*.

<sup>49</sup> Companion C&DI Question 256.28 stated that registered investment advisers could provide services similar to those of broker-dealers in establishing pre-existing substantive relationships without engaging in impermissible general solicitation.

<sup>50</sup> See *SEC v. Schooler*, 106 F. Supp. 3d 1157, 2015 U.S. Dist. LEXIS 67382, \*13 (May 19, 2015). The SEC does not always get its way regarding the scope of behavior proscribed by Rule 502(c):

Contrary to the SEC’s arguments, the Court finds that the evidence cited by the parties indicates a dispute of material fact as to whether the GP units were generally solicited or advertised by Western. . . . Indeed, the SEC has issued a no-action letter recognizing that offers to clients obtained through general solicitation may not constitute general solicitation if ‘sufficient time’ passes between establishment of the relationship and [the] offer. (*Citations omitted*).

<sup>51</sup> For example, when Regulation D was first adopted, senior staffers categorically stated that self-certification by “checking a box” in a subscription agreement would not provide a “reasonable basis” for establishing accredited investor status under Rule 501(a). Initially, careful practitioners advised clients it was necessary to collect and retain information about prospective investors in addition to that provided in the subscription documents. Over time, practitioners modified subscription documents to require substantially more from prospective investors than merely “checking a box” asserting “I am an accredited investor.” The self-certification process today frequently requires prospective investors to “fill in” information, such as the specific type of accredited investor the prospective investor is, the actual dollar amount or level of annual income and net worth, the value of the investor’s principal residence and debts affecting such residence, investment experience and nature of investment portfolio. Today, most practitioners view self-certification via a reasonably detailed subscription agreement as meeting the reasonable belief requirement of Rule 501(a), particularly for prospective investors personally known to the issuer. Informally, the staff and Companion C&DIs warn against “checking the box” self-certification; however, such generic warnings of certain noncompliance from such simplistic self-certification ordinarily have not extended to the content of subscription documents eliciting significantly more fulsome information about prospective investors.

The discussion that follows below suggests certain hypothetical future best practices that might emerge through one or more of the change agents discussed above. The author cautions readers that neither the staff nor any court has endorsed the procedures reviewed below as the “right facts and circumstance” to avoid characterization as impermissible general solicitation in violation of Rule 502(c).

The “exemption creep” process may begin by conventional issuers and their advisers modeling interaction with prospective investors based on the content and mechanics of *Citizen VC* letter and website, the relevant Companion C&DIs and the Legacy Interpretative Advice.

An issuer could start with its publicly available web page and include a generic invitation to individuals and companies who might be “interested in finding out more about our company” and asking them to “tell the company more about you.” Interested visitors would fill out a general questionnaire that would be the first of several steps needed to establish the appropriate substantive relationship.

The crucial webpage design objective would be avoiding any content that might be seen as an “offer” to sell securities. The content of the Citizen VC website may prove helpful in avoiding any “offer.”

Given how well known Citizen VC has become since August 2015, it seems a fairly safe assumption that its publicly available web pages do not constitute impermissible “offers” of securities. If the public web page content did constitute “offers,” it is highly likely there would have been a well-publicized staff public comment or other public event.<sup>52</sup> Therefore, the content on Citizen VC’s publicly available web pages provides a useful disclosure template for conventional issuers desiring to interest prospective investors but avoid making any “offers.”

Consider the following excerpts from Citizen VC website at <http://citizen.vc/>.

On the home page:
Startup investment, simplified citizen.vc gives accredited investors direct access to private offerings from Silicon Valley's most promising startups

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<sup>52</sup> The term “offer” is broadly defined in Section 2(a)(3) of the Securities Act of 1933 and offers and solicitations of offers to buy have been found to exist in the context of enforcement proceedings. Such a broad definition of “offer” does not appear to have been applied to the Citizen VC website.

Under the “Invest” tab:

An alternative to traditional VC funds

Our Investment Criteria: We identify and cultivate opportunities exclusively in late- and growth-stage companies, C Round or later, with a 2-4 year time horizon to a liquidity event.

Additional investment criteria include underwrite opportunities that can at a minimum yield a 3x or better, an outstanding management teams, and a fertile marketplace for the company to deploy the investment for growth.

We source our own deal flow

We discretely source our own deals and only the best make it through our filter. Companies seeking to raise capital on our platform disclose all the due diligence information available to insiders, the larger institutional investors and venture capital firms.

Under the “Invest” and then “Our Platform” tabs:

Investing with citizen.vc

Citizen.VC clients enjoy exclusive access to investment opportunities through a proprietary web-based platform. With the Citizen.VC platform investors track available opportunities, transact and monitor each of their investments.

Citizen.vc is run by investment professionals for investment professionals

On the “Invest” and then “Qualify” tabs:

Only approved investors qualify to invest with us. If you would like to be considered for approval please fill out our questionnaire.

U.S. securities laws limit the types of investors who can invest with us. This questionnaire will help us determine whether you meet suitability requirements for future investments. Any information you provide here will be kept in strict confidence, but we reserve the right to present your completed questionnaire to parties that we, in our sole discretion, deem necessary in order to complete an investment on your behalf, or, if requested by a governmental or legal authority or required by any laws applicable to us.

Please click below to access our questionnaire:<sup>53</sup>

<sup>53</sup> At the time of the author’s last visit to the Citizen VC website, it was not possible to access a questionnaire. Clicking on the “questionnaire” button returned an error message rather than a questionnaire; clicking the “Login” tab returned the following message: “Access to citizen.vc is currently by invitation only.” Available at <http://citizen.vc/> (last visited April 19, 2016).

For a hypothetical conventional issuer’s website, the initial online invitation (and the website content) would include a clear “no offer” disclaimer similar to that used by Citizen VC. Nothing on the conventional issuer’s website or in communications taking place before the establishment of the substantive relationship would disclose any significant information about any planned offering.<sup>54</sup>

After processing the initial generic questionnaire, the follow up process could again model itself on the procedures outlined in *Citizen VC* and could include personal interviews via telephone and more detailed digital questionnaires. Among other things, such questionnaires would elicit detailed information about financial wherewithal (e.g., annual income, net worth, and investment portfolio makeup and liquidity) and investment objectives, experience and sophistication.<sup>55</sup>

The portions of the web pages that might include information about any planned or ongoing securities offering would be password-protected and passwords would be issued to prospective investors only after they had established the necessary substantive relationship with the issuer.

Although not deemed in the Companion C&DIs as mandatory, the hypothetical conventional issuer will be advised to impose a “cooling off” period of at least 30 days between the time when the substantive relationship is established and an “offer” is communicated to a prospective investor. Such a hiatus would harmonize with the assertion that no “offers” were involved in the initial communications and subsequent interchanges establishing the substantive relationship.

Only time will tell if the foregoing hypothetical best practices for conventional issuers based on the logic underlying *Citizen VC* become tomorrow’s generally accepted custom and practice for permissible general solicitation in Rule 506(b) offerings.

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### **Epilogue: Why Not Use Rule 506(c)?**

Substantial time and effort will be needed to comply with the foregoing hypothetical conventional issuer Rule 506(b) permissible general solicitation best practices. A fair reaction might be to suggest modifying the planned offering to qualify for compliance with Rule 506(c). Under Rule 506(c), unrestricted general solicitation is permitted.

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<sup>54</sup> Among the “non-disclosed information” would be the factual information that would typically accompany an offer to sell securities, including identity of the issuer, dollar amount to be raised, classification of the security or securities to be offered, whether common stock, preferred stock, or other equity security; or a debt security, conversion features for debt and preferred stock, anti-dilution provisions, interest and dividend rates for debt and preferred stock, negative covenants or other limitations on management operational discretion, duration of the offering, use of proceeds, information about capital structure, minimum purchase requirements and any investor suitability or financial wherewithal preconditions.

<sup>55</sup> Details for questionnaire content are generally beyond the scope of this article. For links to exemplars including the form and substance of such questionnaires and detailed instructions for use in compliance with applicable provisions of Regulation D and other securities laws, see *Practical Law Company Regulation D Private Placement Toolkit*, available at <http://us.practicallaw.com/4-543-3925#null> (last visited April 22, 2016).

There are several reasons why practitioners may prefer Rule 506(b). First, there are several decades of experience with Rule 506(b) transactions on which to draw. In contrast, Rule 506(c) has been available only since September 2013. In this regard, outside of safe-harbor procedures promulgated by the staff, many practitioners have not yet developed a comfort level with the steps needed to satisfy the Rule 506(c) compliance requirement to “take reasonable steps to verify” accredited status for all purchasers. Under Rule 506(b) accredited investor status is established under Rule 501(a) in either of two less challenging ways: (1) the prospective investor actually meets one or more accredited investor requirements or (2) there is a “reasonable belief” that the prospective investor meets such requirements.

If, for some reason, the Rule 506(c) exemption is lost, the admitted presence of “general solicitation” will make it very difficult if not impossible to qualify for a “fall back” federal exemption under the statutory private placement securities registration exemption of Section (4)(a)(2) of the Securities Act of 1933. General solicitation is simply incompatible with the federal statutory private placement registration exemption. If, however, a Rule 506(b) offering exemption is lost, in the author’s opinion, it will be a much less daunting task to qualify for the federal statutory private placement exemption, even if the non-compliance is alleged to have involved impermissible general solicitation.

There are no state securities registration exemptions that parallel Rule 506(c) and allow for general solicitation in exempt private offerings. Thus, for state securities law registration exemptions, practitioners in structuring Rule 506(c) transactions rely on the preemption of state securities law registration requirements provided by Section 18(b)(4) of the Securities Act of 1933. Similarly, the presence of general solicitation is incompatible with virtually every state securities law private placement exemption and the loss of federal preemption might make it impossible to satisfy applicable state securities registration exemptions, including some with which a Rule 506(b) offering could comply.



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