Venture Exchanges:
Providing Liquidity to Small Cap Companies?
March 28, 2019

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The creation of venture exchanges has sometimes been proposed as a way of facilitating capital formation for smaller, growth-stage companies. The concept usually entails:

- A public trading venue (open to individual retail investors and functioning as an exchange, with some transparency in pricing);
- A commitment to smaller, growth-stage companies;
- The ability for existing investors to sell their shares to new investors on the exchange; and
- The ability of the issuer to raise capital in connection a decision to list the shares for secondary trading.

Having a venture exchange might make it easier and possibly less expensive for some companies to raise money, as investor funds would not be tied up indefinitely; investors could have some assurance that there would be a market for their shares. Employees and service providers who received options or shares as compensation would also have a market for their shares. Ordinary retail investors would be able to participate in this market, thereby giving them access to an asset class with potentially higher growth trajectories than the stock of larger and more fully developed companies.

The realization of this venture exchange model under the U.S. securities laws would require several layers of regulation. To summarize briefly, the company would most likely need to register the sale of the shares in the initial capital raising transaction under the Securities Act of 1933, as amended (the “Securities Act”), and to file periodic reports under the Securities Exchange Act of 1934, as amended (the “Exchange Act”); the trading venue would most likely need to register as an “exchange” or possibly as an “alternative trading system,” or ATS, under the Exchange Act; persons involved effecting transactions would need to register as brokers under the Exchange Act; a registered stock transfer agent would be required; and various other forms of regulation or reporting might be required depending on the circumstances.

Overview of Existing Markets

The United States does not really have a venture exchange as we have described it. This may be due in part to the burden of some of the regulation on smaller, growth-stage companies, but it may also be due to other factors, from the way public markets function to the robust supply of capital available in private placements.
What does exist are a variety of types of venues with some but not all of the features of a venture exchange. These venues include:

- The lower tiers of existing stock markets (the NYSE American and Nasdaq Capital Market), which include smaller public companies but are not really designed to be venture exchanges;
- The OTC Market, which is not typically viewed as providing the benefits of a venture exchange, even though it is open to smaller public companies (including, in its lower tiers, companies that are not SEC reporting companies, if other public information exists);
- Online offering platforms, which typically do not permit secondary sales of securities, but provide a venue for offerings under Regulation A, Rule 506 under the Securities Act or possibly crowdfunding transactions under Regulation CF under the Securities Act;
- Private company offering platforms which permit sales by existing shareholders, often employees of the issuer; and
- Platforms designed for trading of digital assets (which may exist mainly in the planning stages at present).

**Online Offering Platforms Used for Primary Sales by the Issuer**

*Rules 506(b) and (c).* Online offering platforms arose for offerings made under what is now Rule 506(b) under the Securities Act, which permits the sale of securities without registration to an unlimited number of “accredited investors” (as defined in Rule 501(a) under the Securities Act), but does not permit “general solicitation” or advertising. The online platform gets around this limitation by developing a “substantive relationship” with the potential investor prior to offering securities of any particular issuer to the investor. In the process of developing that relationship, the platform verifies that the potential investor is accredited.

Rule 506(c) was adopted under the “Jumpstart our Business Startups Act” or JOBS Act of 2012 and makes the process a little easier for online offering platforms, in that offers may be made to unaccredited as well as accredited investors, so long as all purchasers are accredited and there is adequate verification of each purchaser’s status as an accredited investor. There is no restriction on general solicitation.

Rule 506(b) and (c) are available only for primary offerings. A person who purchases securities issued by a private company under these rules acquires “restricted securities” (as defined in Rule 144 under the Securities Act) that are subject to a one-year holding period. Resale is also most likely restricted pursuant to contractual restrictions imposed by the issuer. While sales by the issuer are exempt from state “Blue Sky” qualification, re-sales of Rule 506(b) or (c) securities are not exempt from Blue Sky qualification requirements.

*Regulation A.* Online platforms are also used in offerings under Regulation A, an exemption that substantially increased in prominence as a result of the JOBS Act. Under Regulation A, a company may publicly offer its securities, so long as the company complies with the Regulation A requirements, including a review of the company’s offering documents by the SEC. Subject to certain restrictions, Regulation A securities may be offered to investors of all types. Regulation A issuers are subject to
certain continuing reporting requirements, and “Tier 2” Regulation A securities may be listed on a securities exchange if the issuer meets certain requirements, including registration of the class of securities under the Exchange Act.

While the issuance of “Tier 2” Regulation A securities is exempt from Blue Sky requirements, the re-sale of Tier 2 securities is not exempt from Blue Sky qualification requirements, unless the issuer decides to list the securities on a national securities exchange (such as either the NYSE American or the Nasdaq Capital Market, but not any tier of the OTC Market). In this respect, Regulation A securities are subject to the same constraints as securities that are registered under Section 5 of the Securities Act: unless the securities are listed on a national stock exchange, secondary sales are not exempt from Blue Sky qualification requirements in secondary sales. Although there are Blue Sky exemptions that may be available, such as a “manual” exemption that companies may apply for, the trading of Regulation A securities and SEC registered securities that are not listed securities is substantially inhibited by the need to check whether sales can be made under applicable Blue Sky law.

It is possible to register secondary sales under Regulation A, subject to certain limitations, and it is thus possible that Regulation A sales on an online portal might be sales by a selling security holder. Regulation A securities are also not “restricted securities” under Rule 144 under the Securities Act. Nevertheless, because of the Blue Sky restrictions and the lack of secondary trading if these securities are not listed on a national securities exchange, it is unlikely that Regulation A security holders will see themselves as holding liquid securities in a way that is comparable to listed securities.

Legal Issues Involving the Private Sale of Securities by Selling Stockholders

The “4(1-1/2)” Exemption. The cardinal rule of the U.S. securities laws is that every offer and every sale of securities must be either registered under the Securities Act or exempt from registration pursuant to an identifiable exemption. Privately negotiated sales of securities by a stockholder who is not an affiliate of the issuer and is not either an “underwriter” or a “dealer” (a person engaged in the business of offering or selling securities on behalf of others) did not historically fall within any statutory exemption. However, securities lawyers reasoned that a private sale by unaffiliated stockholder, if conducted along lines parallel to a private sale by an issuer, could not offend the Securities Act. Thus was born the practitioner-crafted “4(1-1/2) exemption” (sometimes referred to as the 4(a)(1-1/2) exemption, after the JOBS Act renumbered certain provisions of the Securities Act). This exemption is notionally located between Section 4(a)(1), which exempts transactions not involving an issuer, an underwriter or a dealer, and Section 4(a)(2), which exempts offerings by an issuer not involving a public offering. Practitioners look to factors such as the existence of adequate disclosure, the absence of general solicitation and (usually) the lack of a control relationship between the issuer and the proposed selling stockholder to determine that a sale by the stockholder does not require registration under the Securities Act.

The 4(a)(7) Exemption. Looking for greater certainty, online platforms engaged in the secondary sale of securities, which are described below, sought to codify the 4(1-1/2) exemption, so that transactions could be accomplished with greater speed and clarity. At the end of 2015, Congress
responded by enacting Section 4(a)(7), which indeed codifies the 4(1-1/2) exemption, but imposes extensive disclosure and other requirements that make the exemption difficult to use or rely on. Moreover, judgment is still required as to whether the statute has been satisfied for private company information.

Private Sales by Selling Security Holders on an Online Platform

If it is possible to sell securities privately on an online platform and it is possible for selling security holders to sell their securities pursuant to private offering exemptions, it stands to reason that secondary sales can be made on platforms for private securities offerings. But the devil is in the details.

Evidently, there has always been some trading of stocks of companies that are not reporting companies with securities registered under the Exchange Act. Section 12(g) of the Exchange Act, which requires Exchange Act registration once certain numbers of security holders have been attained, was originally enacted in response to concerns about trading in stocks about which little disclosure was available. Section 15c2-11 under the Exchange Act also responds to similar concerns, by requiring a broker to ascertain whether financial and other information is available about an issuer before trading in the issuer’s stock.

But the ascent of FaceBook (and similar companies) contributed to the development of online trading platforms for secondary sales of private company stock. Before the initial public offering of FaceBook, retail investors craved FaceBook’s common stock, believing that it would be worth much more once the company had gone public. At the same time, employees of FaceBook and similar tech companies, who had received shares as compensation, wanted to sell their shares, but had no liquid market. The online platforms—which were accustomed to facilitating private sales on behalf of issuers pursuant to Rule 506(b)—stepped up to accommodate these sales.

For these sales to comply with the 4(1-1/2) exemption (4(a)(7) had not yet been enacted) and to meet general compliance standards, the platforms needed assurance that (among other things):

- The individual sellers did not have inside information and were not affiliates of the issuer;
- There was adequate information available concerning the issuer;
- The sellers had the right to sell the shares under any applicable agreements with the issuer; and
- The purchasers would enter into appropriate agreements restricting their right to re-sell the shares.

Given these requirements, it soon became apparent that the cooperation of the issuer was needed. This led to a model under which the online platforms assisted issuers in allowing employees to re-sell their shares, which were often subject to contractual rights of first refusal under the issuer’s employee stock plan documents. The issuer controlled when the sales might take place, what information was made available to the prospective purchaser, what documentation would be signed by
the purchaser and often whether instead the issuer would exercise its right of first refusal, acquiring the securities instead of enabling them to sold to investors. In addition, issuers tended to want to control the price at which the shares were sold, as it might have an impact on the overall valuation of the issuer’s securities for other purposes.

A couple of potential issues raised by this model of “issuer sponsored liquidity” are:

- Does the issuer’s involvement raise questions as to its need to register as a broker-dealer? While there is little authority on this question, there is a possibility that an issuer that runs a market for its own securities held by employees or other investors may need to register as a broker-dealer. On the other hand, the involvement of the platform as a registered broker-dealer might resolve this concern.

- Does the issuer’s involvement mean that the issuer is “soliciting offers to buy” under Section 5(c) of the Securities Act? So long the offering was conducted as a compliant private sale, the issuer might be able to rely on a private placement exemption.

- What level of disclosure by the issuer is needed, to counteract information disparities between employees and investors? To resolve this concern, the issuer might want to control negotiations and limit the role of its employees in negotiating with the purchaser.

For a variety of reasons, many issuer sponsored liquidity programs now operate as issuer tender offers, or use other mechanisms that essentially give the issuer more control over timing, pricing and disclosure.

**Token Exchanges**

The business plan of many issuers of digital assets, or tokens, is to create and/or be traded on a platform for trading digital assets, which in turn would provide capital and liquidity to start-up businesses. This vision has not yet been achieved. If digital assets are securities, then the creation of such trading platforms involves all of the issues that would be involved for other securities platforms, with possibly an additional overlay of complexity because of the nature and uncertainties of digital assets.
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*Regulation A.* Online platforms are also used in offerings under Regulation A, an exemption that substantially increased in prominence as a result of the JOBS Act. Under Regulation A, a company may publicly offer its securities, so long as the company complies with the Regulation A requirements, including a review of the company’s offering documents by the SEC. Subject to certain restrictions, Regulation A securities may be offered to investors of all types. Regulation A issuers are subject to
certain continuing reporting requirements, and “Tier 2” Regulation A securities may be listed on a securities exchange if the issuer meets certain requirements, including registration of the class of securities under the Exchange Act.

While the issuance of “Tier 2” Regulation A securities is exempt from Blue Sky requirements, the re-sale of Tier 2 securities is not exempt from Blue Sky qualification requirements, unless the issuer decides to list the securities on a national securities exchange (such as either the NYSE American or the Nasdaq Capital Market, but not any tier of the OTC Market). In this respect, Regulation A securities are subject to the same constraints as securities that are registered under Section 5 of the Securities Act: unless the securities are listed on a national stock exchange, secondary sales are not exempt from Blue Sky qualification requirements in secondary sales. Although there are Blue Sky exemptions that may be available, such as a “manual” exemption that companies may apply for, the trading of Regulation A securities and SEC registered securities that are not listed securities is substantially inhibited by the need to check whether sales can be made under applicable Blue Sky law.

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SECURITIES AND EXCHANGE COMMISSION
ADVISORY COMMITTEE ON
SMALL AND EMERGING COMPANIES
Washington, DC 20549-3628

May __, 2017

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1070

Dear Chairman Clayton:

As you know, the Securities and Exchange Commission organized the Advisory Committee on Small and Emerging Companies to provide the Commission with advice on the Commission’s rules, regulations, and policies with regard to its mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation, as they relate to the following:

(1) capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization;

(2) trading in the securities of such businesses and companies; and

(3) public reporting and corporate governance requirements to which such businesses and companies are subject.

On behalf of the Advisory Committee, we are pleased to submit the enclosed recommendation regarding secondary market liquidity for Regulation A securities. This recommendation was discussed at Advisory Committee meeting held on February 15, 2017, and approved by the members of the Advisory Committee present and voting at a meeting held May 10, 2017.

We and the other members of the Advisory Committee are prepared to provide any additional assistance that the Commission or its staff may request with respect to these recommendations.

Respectfully submitted on behalf of the Advisory Committee,

Stephen M. Graham
Committee Co-Chair

Sara Hanks
Committee Co-Chair
Members of the Advisory Committee
Robert Aguilar
Xavier Gutierrez*
Brian Hahn
Jenny Kassan
Catherine V. Mott
Jonathan Nelson
Patrick Reardon
Lisa Shimkat
Annemarie Tierney
Gregory C. Yadley*
Laura Yamanaka

Non-voting members
Michael Pieciak
Michele Schimpp

* These members plus Co-Chair Stephen Graham were not present at the meeting held on February 15, 2017.
** These members were not present for the Advisory Committee discussion and vote held on May 10, 2017.

Enclosure
cc: Commissioner Michael S. Piwowar
Commissioner Kara M. Stein
Shelley E. Parratt
Elizabeth Murphy
Sebastian Gomez Abero
Julie Z. Davis
U.S. Securities and Exchange Commission
Advisory Committee on Small and Emerging Companies

Recommendation Regarding Secondary Market Liquidity for
Regulation A, Tier 2 Securities

AFTER CONSIDERING THAT:

1) The Advisory Committee’s objective is to provide the U.S. Securities and Exchange Commission (the “Commission”) with advice on its rules, regulations and policies with regard to its mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, as they relate to, among other things, capital raising by emerging privately held small businesses and publicly traded companies with less than $250 million in public market capitalization.

2) Secondary market liquidity is integral to capital formation. Small businesses trying to attract capital often struggle because potential backers are reluctant to invest unless they are confident there will be an exit opportunity. Capital is often more expensive or not available for issuers that are not able to provide investors with secondary market liquidity.

3) Limited possibilities for liquidity means investors’ capital may be locked up longer than they would like, hindering their ability to build portfolios with multiple, diverse investments. Liquidity limitations also prevent capital from being put to use in the next investment.

4) Regulation A provides for the preemption of state securities law registration and qualification requirements for securities initially offered or sold in Tier 2 offerings; however, secondary sales of these same Tier 2 Regulation A securities require compliance with disparate state law requirements. This means willing sellers and buyers in the secondary trading market must find exemptions on a state by state basis.

5) There are substantive differences in the various state exemptions. This lack of uniformity inhibits the development of a national secondary trading market.

6) One popular exemption for secondary trading is the “manual exemption,” which is currently available in 39 of the 54 U.S. jurisdictions. These provide an exemption for secondary trading by non-issuers through a broker dealer, if the issuing company has financial and other information published in a designated securities manual. The exemption is based on the availability in the manual of current information about an issuer that enables parties on both sides of the trade to make an educated investment decision.

7) While there used to be more, there is currently only one remaining designated securities manual (published by Mergent, formerly known as Moody’s). However, company information available on certain OTC Markets marketplaces is now recognized for purposes of the state blue sky manual exemption in 21 jurisdictions.
8) Complying with the manual exemption can be costly for companies, since issuers must pay to have their information disseminated. Additionally, there is not currently a centralized information portal accepted by all jurisdictions where investors can find that information.

9) Tier 2 Regulation A issuers are subject to initial and ongoing disclosure requirements that are greater than the information that is included in a manual.

10) The information in Tier 2 Regulation A ongoing reports is easily available to the public on EDGAR.

11) The SEC and the states have a collaborative, productive relationship, with a recent capital formation success in the adoption of the Commission’s Securities Act Rule 147A to help facilitate intrastate offerings.

THE COMMITTEE RECOMMENDS THAT:

1. The Commission take steps to help reduce friction in secondary trading by holders of Tier 2 Regulation A securities where the issuer is current in its ongoing reports.

2. The Commission collaborate with NASAA in this endeavor.

3. The Commission consider using its authority under Section 18 of the Securities Act to preempt from state regulation the secondary trading in securities of Tier 2 Regulation A issuers that are current in their ongoing reports. This approach would replicate what is the equivalent of a uniform manual exemption across all 54 jurisdictions, with EDGAR serving as the central repository.

[An alternative #3:

The Commission consider effectuating the equivalent of a manual exemption that applies nationally, with the ongoing reports filed in EDGAR by Tier 2 Regulation A issuers providing the information necessary for parties to make educated investment decisions.]
Securities Act of 1933  
Regulation D — Rule 502

Response of the Office of Chief Counsel  
Division of Corporation Finance

Re: Citizen VC, Inc.  
Incoming letter dated August 3, 2015

Based on the facts presented, the Division's views are as follows. Capitalized terms used in this response have the same meaning as defined in your letter.

You have requested the staff concur in your conclusion that the policies and procedures described in your letter will create a substantive, pre-existing relationship between CitizenVC and prospective investors such that the offering and sale on the Site of Interests in SPVs that will invest in a particular Portfolio Company will not constitute general solicitation or general advertising within the meaning of Rule 502(c) of Regulation D.

We agree that the quality of the relationship between an issuer (or its agent) and an investor is the most important factor in determining whether a "substantive" relationship exists. As the Division has stated before, 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. See, e.g., Bateman Eichler, Hill Richards, Inc. (Dec. 3, 1985). We note your representation that CVC's policies and procedures are designed to evaluate the prospective investor's sophistication, financial circumstances and ability to understand the nature and risks of the securities to be offered. We also agree that there is no specific duration of time or particular short form accreditation questionnaire that can be relied upon solely to create such a relationship. Whether an issuer has sufficient information to evaluate, and does in fact evaluate, a prospective offeree's financial circumstances and sophistication will depend on the facts and circumstances.

In expressing these views, we note your representation that the relationship with new Members will pre-exist any offering, consistent with the Division's previous guidance. In this regard, we note that a prospective Member is not presented with any investment opportunity when being qualified to join the platform. Any investment opportunity would only be presented after the prospective investor becomes a Member. Further, we understand that CVC creates SPVs for investment in particular Portfolio Companies and not as blind pools for a later investment opportunity.

Because this position is based on the representations in your letter, any different facts or conditions might require the Division to reach a different conclusion.

Sincerely,

David R. Fredrickson  
Chief Counsel

Incoming Letter:
The Incoming Letter is in Acrobat format.

August 3, 2015

David R. Fredrickson, Esq.
Chief Counsel
Division of Corporation Finance
U.S. Securities and Exchange Commission
100 F. Street, NE
Washington, DC 20549

Re: Citizen VC, Inc.

Dear Mr. Fredrickson:

Our client, Citizen VC, Inc. and its affiliates (collectively, “CitizenVC”), proposes to offer and sell from time to time, without registration, limited liability company interests (“Interests”) of special purpose vehicles (“SPVs”) established and managed by a wholly owned subsidiary of CitizenVC, Inc. (the “Manager”) in order to aggregate investments made by members (“Members”) of the CitizenVC online venture capital investment platform (the “Site”). The SPVs invest in seed, early-stage, emerging growth and late-stage private companies, and offer accredited investors the SPVs’ Interests in reliance upon the exemption provided pursuant to Rule 506(b) of Regulation D promulgated under the Securities Act of 1933, as amended (the “Securities Act”). CitizenVC does not intend to rely on the exemption from registration provided under Rule 506(c), and will not engage in any general solicitation or general advertising. In connection with, and prior to, the offering of the Interests of SPVs, CitizenVC intends to establish pre-existing, substantive relationships with prospective members of the Site in accordance with the policies and procedures described in this letter. We note that current practices among online venture capital and angel investing sites vary substantially in the methodology for establishing a pre-existing, substantive relationship for purposes of complying with Rule 506(b). It is our opinion that the policies and procedures described in this letter will be sufficient to create the necessary relationship between CitizenVC and prospective investors such that the offering and sale of Interests on the Site will not constitute general solicitation or general advertising within the meaning of Rule 502(c) of Regulation D.

On behalf of CitizenVC, we request that the staff of the Division of Corporation Finance (the “Staff”) concur with our conclusion.

Background

Citizen VC, Inc. is an online venture capital firm that owns and administers a website (https://citizen.vc) that facilitates indirect investment by its pre-qualified, accredited and sophisticated Members in seed, early-stage, emerging growth and late-stage private companies (“Portfolio Companies”) through SPVs organized and managed by the Manager. The SPVs are created to invest in specific Portfolio Companies and not as blind pool investment vehicles. Further, the SPVs will purchase equity interests either from the Portfolio Companies or from selling shareholders (subject to the consent of the Portfolio Companies).

CitizenVC is focused on technology, both its own and those of its portfolio companies, and desires to utilize the Internet and the Site to modernize and streamline traditionally offline venture capital
investing activities, including presenting Portfolio Company offering materials to its Members and consummating all transactions online.

The Site is hosted on the publicly accessible Internet and CitizenVC is cognizant of the fact that prospective investors may search the Internet and land on its Site. CitizenVC wants to be prepared to accept membership applications from prospective investors with whom a pre-existing relationship has not yet been formed, but with whom it will establish a relationship prior to offering Interests.

CitizenVC has developed qualification policies and procedures that it intends to use to establish substantive relationships with, and to confirm the suitability of, prospective investors that visit the Site. Upon landing on the homepage of the Site, a visitor that wishes to investigate the password protected sections of the Site accessible only to Members must first register and be accepted for membership. In order to apply for membership, CitizenVC requires all prospective investors, as a first step, to complete a generic online “accredited investor” questionnaire. The satisfactory completion of the online questionnaire is, however, only the beginning of CitizenVC’s relationship building process.

Once a prospective investor has completed the online questionnaire and CitizenVC has evaluated the investor’s self-certification of accreditation, CitizenVC will initiate the “relationship establishment period.” During this period, CitizenVC will undertake various actions to connect with the prospective investor and collect information it deems sufficient to evaluate the prospective investor’s sophistication, financial circumstances, and its ability to understand the nature and risks related to an investment in the Interests. Such activities include (1) contacting the prospective investor offline by telephone to introduce representatives of CitizenVC and to discuss the prospective investor’s investing experience and sophistication, investment goals and strategies, financial suitability, risk awareness, and other topics designed to assist CitizenVC in understanding the investor’s sophistication, (2) sending an introductory email to the prospective investor, (3) contacting the prospective investor online to answer questions they may have about CitizenVC, the Site, and potential investments, (4) utilizing third party credit reporting services to confirm the prospective investor’s identity, and to gather additional financial information and credit history information to support the prospective investor’s suitability, (5) encouraging the prospective investor to explore the Site and ask questions about the Manager’s investment strategy, philosophy, and objectives, and (6) generally fostering interactions both online and offline between the prospective investor and CitizenVC. Additionally, prospective investors will be advised that every SPV offering will have a significant minimum capital investment requirement for each investor, which will be not less than $50,000 per individual investment, and in some offerings significantly higher. All of the foregoing activities and interactions are specifically designed to create and strengthen a real, substantive relationship between CitizenVC and the prospective investor, and to verify and ensure that the offering of Interests is suitable for them.

The duration of the relationship establishment period is not limited by a specific time period. Rather, it is a process based on specific written policies and procedures created to ensure that the offering

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1 The publicly accessible homepage contains only generic information about CitizenVC. There is no information accessible on the publicly accessible homepage about any of the current SPVs, Portfolio Companies, investment opportunities or offering materials. The publicly accessible homepage is designed so that no reasonable person could construe it as a solicitation for any particular offering.

2 As such term is defined under Rule 501(a) of Regulation D.

3 Applicants who cannot attest to their status as “accredited investors” are denied access to the password protected areas of the Site and are not permitted to continue the membership application process.

4 See Lamp Technologies, Inc. No Action Letter (publicly May 29, 1997). In Lamp, the Staff implicitly endorsed a waiting period of 30 days between the satisfactory completion of an accreditation questionnaire and the ability of an agent of the issuer to offer securities to such investor without violating the prohibition on general solicitation.
of Interests is suitable for each prospective investor.

After CitizenVC is satisfied that (i) the prospective investor has sufficient knowledge and experience in financial and business matters to enable it to evaluate the merits and risks of the investment opportunities on the Site, and (ii) it has taken all reasonable steps it believes necessary to create a substantive relationship with the prospective investor, only then will CitizenVC admit the prospective investor as a Member of the Site. Thereafter, CitizenVC will provide the new Member access to the password protected sections of the Site, where the new Member can investigate investment opportunities curated by CitizenVC and the offering materials related thereto. The relationship with a new Member will exist prior to any offering of securities to such new Member.5

Once a sufficient number of qualified Members have expressed interest in the private placement investment opportunity of a particular Portfolio Company, those Members will be provided subscription materials for investment in the SPV formed by CitizenVC to aggregate such Members' investments, which materials shall include additional risk disclosure and detailed "accredited investor" certifications and representations. Thereafter, the offering and sale of Interests of such SPV will be consummated. The SPV will then invest such funds in, and become an equity holder of, the Portfolio Company. Each SPV will be managed by the Manager, which shall become a registered investment adviser as required under the Investment Advisers Act of 1940, as amended (the "IAA").6

Legal Analysis

Section 5 of the Securities Act prohibits the sale of securities by an issuer in the United States without registration or an available exemption, and Section 4(a)(2) of the Securities Act provides an exemption from registration for offerings that do not involve a "public offering". In interpreting what constitutes a "public offering", the Supreme Court in SEC v. Ralston Purina Co. established that the standard for determining whether an offering is public or private turns on "whether the particular class of persons affected need[ed] the protection of the [Securities] Act", and further elaborated that "an offering to those [investors] who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'"7 Over the years, courts have upheld the general proposition that offerings should be considered private when the issuer and the offeree(s) have a pre-existing relationship.8

Rule 506(b) of Regulation D provides a safe harbor for issuers to engage in private placements. Private placements undertaken pursuant to Rule 506(b) are limited, however, by Rule 502(c) of Regulation D, which imposes as a condition on offers and sales under Rule 506(b) that "... neither the

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5 This is consistent with previous SEC guidance. See Bateman Eichler, Hill Richards, Inc. No Action Letter (publicly available December 3, 1985); H.B. Shaine & Co., Inc. No Action Letter (publicly available May 1, 1987); and IPOnet No Action Letter (publicly available July 26, 1996).
6 The Manager will register as an investment adviser with the SEC once it has assets under management of $150,000,000, unless such entity can rely on the venture capital fund adviser exemption (or other applicable exemptions) (see Sections 203(l) and 203(m) of the IAA, and Rules 203(l)-1 and 203(m)-1 promulgated respectively thereunder). The Manager will also comply with any applicable state registration requirements and regulations related to investment advisers. Citizen VC, Inc., the parent of the Manager, is not an investment adviser subject to registration under the IAA or any applicable state registration requirements related to investment advisers. Additionally, each SPV will be exempt from registration under the Investment Company Act of 1940, pursuant to Section 3(c)(1) or Section 3(c)(7), as the case may be.
8 See Lively v. Hirschfeld, 440 F.2d 631 (10th Circuit 1970) (holding that offering was private because of the long standing association between issuer and offeree), and Garfield v. Strain, 320 F.2d 116 (10th Cir. 1970) (holding that private offering exemption was justified by issuer and offeree's close relationship and past dealings).
issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising...”

Since the adoption of Regulation D, the Staff has issued various interpretive letters (“No Action Letters”) that have further clarified the contours of the regulation and established the “important and well-known principle...[that] a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its [agent], and the offerees.”

Through these No Action Letters, the Staff has endorsed the position that an issuer, through its agent (generally, registered brokers-dealers), may establish a pre-existing, substantive relationship with the use of a questionnaire that, once completed by the investor, provides such agent sufficient information to evaluate the investor’s sophistication or accreditation. It is less clear from the guidance, however, whether an issuer itself can rely solely on a questionnaire that relates only to “accredited investor” status (particularly in an online transaction) to establish the necessary pre-existing relationship without a waiting period or additional policies and procedures that would establish a pre-existing and substantive relationship. Many of the No Action Letters appear to interpret the use of questionnaires by registered broker-dealers, acting as agents of issuers, as merely one way to collect “sufficient information to evaluate the prospective offeree’s sophistication and financial circumstances.” But in Mineral Lands Research & Marketing Corp. No Action Letter, the Staff elaborated that the types of relationships that may be important in establishing that a general solicitation has not taken place are those that would enable “[the issuer or its agent] to be aware of the financial circumstances or sophistication of the persons with whom the relationship exists or that otherwise are of some substance and duration.”

Conclusion

We interpret the Staff’s No Action Letter guidance to mean that the quality of the relationship between an issuer and an investor is the most important factor to be considered in determining whether a pre-existing, substantive relationship has been established for purposes of offerings made in private placements pursuant to Rule 506(b) of Regulation D. It is our opinion that the No Action Letter guidance of the Staff points to establishing a process for issuers to develop substantive relationships with previously unknown investors, and that this process can be undertaken in a manner that will not contravene the prohibition of general solicitation and general advertising under Rule 502(c). The relationship between issuer and investor is not built through a specific duration of time or a short form accreditation questionnaire. Rather, it can be established by adhering to specific policies and procedures both online and offline (where appropriate), which enable the issuer to evaluate the prospective investor’s financial sophistication, circumstances, suitability, and his or her ability to understand the nature and risks of the Interests to be offered. It is this substantive relationship that is necessary to execute an offering of securities online in a password protected area that does not violate Rule 502(c).

We understand that issuers and/or their agents relying on Rule 506(b) will have to take additional steps beyond the circulation of a brief accreditation questionnaire in order to create a substantive

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10 See, e.g., Bateman; E.F. Hutton & Co.

11 Bateman. It is important to note that later No Action Letters endorsed the use of questionnaires delivered to investors online where access to offering materials is restricted to a password protected area of a website. See Lamp and IPOnet.

relationship with their prospective investors. We believe that CitizenVC has developed the appropriate specific policies and procedures through which it will investigate, engage, and communicate with prospective investors to get to know them, understand their financial sophistication, and evaluate whether they are suitable for the investment opportunities available in the password protected areas of the Site. It should be noted that we are not seeking guidance on whether CitizenVC’s processes and procedures described herein satisfy all the other elements of a valid Rule 506(b) offering, including, without limitation, whether a particular SPV reasonably believes that the prospective investors participating in such SPV’s offering of Interests are accredited investors.

It is our opinion that the substantive relationship building policies and procedures developed by CitizenVC and described in this letter establish a pre-existing, substantive relationship between CitizenVC and its prospective investors such that granting access to such prospective investors in a password protected area of the CitizenVC Site to materials related to the offering of unregistered Interests in SPVs will not involve any form of general solicitation or general advertising, and will enable CitizenVC to offer Interests online without contravening Rule 502(c). We respectfully request the Staff’s concurrence with our opinion.

Please contact the undersigned at (212) 692-6223 if you require additional information or would like to discuss these matters further.

Very truly yours,

Daniel I. DeWolf, Esq.
SECURITIES

Guidance & Interpretation

No-Action Letter

July 26, 1996

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF CORPORATION FINANCE

Re: IPONET

Incoming letter dated July 23, 1996

Based on the facts presented, the Division’s views are as follow:

(1) The reference in Rule 134(d) to “an enclosed or attached coupon or card, or in some other manner” would be equally applicable to the acceptance of indications of interest via electronic coupon or card as well as paper coupon or card by W.J. Gallagher & Company, Inc. (“Gallagher”). In this regard, we note your representation that the other requirements of Rule 134(d) will be satisfied in connection with the acceptance of such indications of interest.

(2) The qualification of accredited or sophisticated investors in the manner described and the posting of a notice of a private offering in a password-protected page of IPONET accessible only to IPONET members who have qualified as accredited investors would not involve any form of “general solicitation” or “general advertising” within the meaning of Rule 502(c) of Securities Act Regulation D. In reaching this conclusion, we note that (a) both the invitation to complete the questionnaire used to determine whether an investor is accredited or sophisticated and the questionnaire itself will be generic in nature and will not reference any specific transactions posted or to be posted on the password-protected page of IPONET; (b) the password-protected page of IPONET will be available to a particular investor only after Gallagher has made the determination that the particular potential investor is accredited or sophisticated; and (c) a potential investor could purchase securities only in transactions that are posted on the password-protected page of IPONET after that investor’s qualification with IPONET. In this regard, we take no position as to whether the information obtained by Gallagher is sufficient to form a reasonable basis for believing an investor to be accredited or sophisticated.

Because these positions are based on the representations made to the Division in your letter, it should be noted that any different facts might require a different result.

Sincerely,

Joseph Babits
Special Counsel

Securities Act of 1933, as amended, Sections: 2(10), Rule 230.134

Regulation D, Section 502(c)
Office of Chief Counsel  
Division of Corporation Finance  
Securities and Exchange Commission  

Washington, D.C. 20549  

Re: IPONET  

Ladies and Gentlemen:  

I am submitting this request for a No Action Letter pursuant to Release No. 33-6269. Accordingly, please find enclosed seven copies of this letter, together with the original.  

Summary of Request  

The specific requests for no action assurance are set forth in detail later in this letter. As an introduction, IPONET seeks assurance on the following issues:  

1. Indications of Interest may be Accepted Electronically. In connection with a public offering, W.J. Gallagher & Company, Inc., may accept indications of interest via electronic coupon or card as well as a paper coupon or card, if the requirements of Rule 134(d) are otherwise met.  

2. The Posting of a Notice of a Private Offering in a Password-protected Page of IPONET Accessible Only to IPONET Members Who Have Previously Qualified as Accredited Investors Does Not Involve Any Form of General Solicitation or General Advertising Within the Meaning of Regulation D Section 502(c). W.J. Gallagher & Company, Inc., through the IPONET [*2] web site, will solicit individuals who meet the "accredited investor" or sophisticated investor standards of Regulation D to register as "Accredited Investors" as a means of building a customer base and data base of accredited and sophisticated investors for W.J. Gallagher & Company, Inc. After an individual has been determined to meet the requirements of an Accredited Investor, the Accredited Investor may review offers for private offerings of securities from companies that have posted private offerings with IPONET in accordance with the rules otherwise applying under Regulation D. The solicitation for Accredited Investors will be independent of and will not be linked to or made specifically with reference to any pending private offering. Accredited Investors may not invest in private offerings that were posted on IPONET before the Accredited Investor registered. Under these circumstances, an offer of securities otherwise satisfying the requirements of Regulation D to accredited or sophisticated investors who have been independently and previously solicited as customers of W.J. Gallagher & Company, Inc. will not constitute a general solicitation or general advertising within the meaning of Regulation D Section 502(c).  

The Facts  

1. IPONET is a sole proprietorship, wholly owned by Leo J. Feldman ("Feldman"), an individual. W.J. Gallagher & company has established and will maintain a system to supervise the activities of Feldman, including those pursued through IPONET, that is reasonably designed to achieve compliance with all applicable securities laws and regulations, and the rules of the NASD and any other applicable self-regulatory organization.  

2. Feldman is a registered principal of W.J. Gallagher & Company, Inc. W.J. Gallagher & Company, Inc., conducts a general securities business, including participation in public offerings as a "selected dealer."  

3. IPONET has established a home page and other linked pages (collectively "Site") on the World Wide Web located at http://www.zanax.com/iponet. IPONET intends to post on its Site "tombstone" advertisements meeting the requirements of Rule 134, together with the red herring prospectus meeting the requirements of Rule 430. Such "tombstone" advertisements and the red herring prospectus will set forth the names of the underwriters. In cases where W.J. Gallagher & Co., Inc. will not act as an underwriter, the name of W.J. Gallagher & Company, Inc., will not appear on the "tombstone" or on the red herring prospectus. The distribution of the "tombstone" advertisement and the red herring prospectus by the issuer and its underwriters through the Site will be in accordance with Release No. 33-7233, dated October 6, 1995. The Site will also set forth a separate statement substantially as follows: "The securities offered by [Name of Issuer] pursuant to the Preliminary Prospectus dated [insert date] are available through W.J. Gallagher & Company, Inc." In addition, in the case where W.J. Gallagher & Company, Inc., will not act as an underwriter, the Site will contain a statement substantially as follows: "W.J. Gallagher & Company, Inc., is not an underwriter of the securities of [Name of Issuer], but is [13] authorized to accept customer orders for the purchase of the securities." In such cases, W.J. Gallagher & Company, Inc., will not purchase any of the securities from the Issuer for resale, will not participate in any such undertaking directly or indirectly, will not participate in the management of the distribution of the issue or any part of the issue, and will not perform any function normally performed by an underwriter in a traditional underwriting syndicate. IPONET is not asking for the Division's view on whether IPONET or W.J. Gallagher & Co., Inc., is acting as an underwriter, since such determinations are made on a case by case basis.
4. The IPONET Site will also link to any "tombstone" advertisements or red herring prospectus the following statements from Rule 134(b)(1) and (d), respectively:

"A registration statement relating to these securities has been filed with the Securities and Exchange Commission but has not yet become effective. These securities may not be sold nor may offers to buy be, accepted prior to the time the registration statement becomes effective. This communication shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any State in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such State."

"No offer to buy the securities can be accepted and no part of the purchase price can be received until the registration statement has become effective, and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at any time prior to notice of its acceptance given after the effective date. An indication of interest in response to this advertisement will involve no obligation or commitment of any kind."

5. The Site will also contain an electronic "coupon" or "card" linked to each red herring prospectus. A visitor to the Site will be invited to complete and send this electronic "coupon" or "card", via e-mail or communications link in the Site itself or by printing the coupon or card and sending it by regular carrier, indicating an interest in purchasing the security.

6. In cases where W.J. Gallagher & Company, Inc., will not act as an underwriter, but the securities will be sold through W.J. Gallagher & Company, Inc., as one of the "selected dealers", W.J. Gallagher & Company, Inc., will receive a commission which will not exceed the usual and customary distributors' or sellers' commission.

7. The Site contains a section entitled "Accredited Investor". Persons who have previously registered as a member of IPONET are invited to request registration with IPONET as an "Accredited Investor". These Accredited Investors will be added to W.J. Gallagher & Company, Inc.'s customer and data base. In order to register, the member must complete an on-line questionnaire substantially in the form of Exhibit A, which is designed to allow W.J. Gallagher & Company, Inc., and any potential issuer to determine, or to have a basis for a [*4] reasonable belief that a member is an "accredited investor" within the meaning of Regulation D, Rule 501(a) or a sophisticated investor under Rule 506. The questionaire may be completed on-line in a secured manner or printed out and returned in hard copy. W.J. Gallagher & Company, Inc., will verify the information in the questionnaire to determine if the member is an Accredited Investor. Once a Member is qualified and registered as an "Accredited Investor", then the Accredited Investor will be given a password which will allow the Accredited Investor to access a password-protected page where private offerings will be posted and the Accredited Investor may access further information. However, the IPONET site will only allow an Accredited Investor access to those private offerings which are posted subsequent in time to the Accredited Investors qualification with IPONET. If the Accredited Investor has consented, then IPONET may contact the Accredited Investor in the future about new private offerings that are posted on IPONET.

8. The name of the Accredited Investor will be kept confidential by IPONET and W.J. Gallagher & Company, Inc., and will not be released to the issuers making the private offerings unless the Accredited Investor specifically consents to such release to a particular issuer. This consent may be given on-line.

9. Private issuers may post their private offerings in the password-protected section of IPONET. No mention or description of the issuer of any nature will be available on IPONET to any person, other than those who have previously qualified as Accredited Investors, who must use their password to enter the password-protected part of IPONET.

10. In cases where W.J. Gallagher & Company, Inc., is not acting as a broker-dealer, IPONET will charge a "listing fee" of a set amount. The listing fee will cover such items as design and graphics work, technical consulting regarding the listing, and historical popularity of the Site (analogous to the circulation history of newspapers). The listing fee will be independent of the size of the private offering, any investment made by Accredited Investors, and the number of hits to the Site after listing. (In such cases, W.J. Gallagher & Company, Inc., will be completely independent of the issuer and W.J. Gallagher & Company, Inc., will receive no compensation of any nature.) In cases where W.J. Gallagher & Company, Inc., is acting as a broker-dealer, IPONET will still receive only the listing fee and nothing more. Neither W.J. Gallagher & Company, Inc., nor IPONET will have an affiliation with or any interest of any kind in the issuer prior to or at the time of the offering of the private offering.

11. An Accredited Investor may invest only in private offerings which are posted on IPONET subsequent in time to the registration of the Accredited Investor with IPONET, and then only after a sufficient time has elapsed between the IPONET member's registration as an Accredited Investor and the inception of a private offering so that the registration as an Accredited Investor is not deemed to be solicitation for a particular private offering.

12. Each issuer desiring to list a private offering with IPONET will covenant to [*5] issues securities in a private offering in strict accordance with Regulation D. The obligation to assure compliance with Regulation D will rest upon the issuer.

Legal Analysis

Rule 134(d) provides as follows:

(d) A communication sent or delivered to any person pursuant to this rule which is accompanied or preceded by a prospectus which meets the requirements of Section 10 of the Act at the date of such communication, may solicit from the recipient of the communication an offer to buy the security or request the recipient to indicate, upon an enclosed or attached coupon or card or in some other manner (emphasis added), whether he might be interested in the security, if the communication contains substantially the following statement:

"No offer to buy the securities can be accepted and no part of the purchase price can be received until the registration statement has become effective, and any such offer may be withdrawn or revoked, without obligation or commitment of any kind, at any time prior to notice of its acceptance given after the effective date. An indication of interest in response to this advertisement will involve no obligation or commitment of any kind."

As described above in Facts, paragraphs 3 and 4, the Site will contain the notices required by Rule 134(b)(1) and (d) linked to any tombstone advertisement and red herring prospectus.

Rule 134(d) specifically contemplates that indications of interest may be accepted by a "coupon or card, or in some other manner". IPONET’s electronic "coupon" or "card" may be sent directly from the Site or independently via e-mail, or printed in hard copy and sent via regular carrier. An electronic or e-mail indication of interest described should qualify as a card or coupon in harmony with Release No. 33-7233, October 6, 1995, and certainly qualifies under the phrase "some other manner" and is entirely consistent with the 1933 Act and the Rules thereunder. See the excerpt from Release No. 33-7233 set forth below.

2. The Posting of Notice of a Private Offering in a Password-protected Page of IPONET Accessible Only to IPONET Members Who Have Previously Qualified as Accredited Investors Does Not Involve Any Form of General Solicitation or General Advertising Within the Meaning of Regulation D Section 502(c).

[*6] In H.B. Shane & Co., Inc. No Action Letter dated May 1, 1987, the staff indicated that distribution by Shane of questionnaires to prospective accredited and sophisticated investors to determine their suitability to participate in private offerings would not be deemed a "general solicitation or general advertisement". This view was premised upon several factors, including the use of a generic questionnaire and upon the elapse of a sufficient period of time between the completion of the questionnaire and the contemplation or inception of any particular offering.

As described above in Facts, paragraphs 7-11, W.J. Gallagher & Company, Inc. will follow substantially the same procedure as Shane. The primary distinction appears to be simply that the questionnaire will be distributed electronically through the IPONET Site and the questionnaire may be returned either electronically through a link in the Site, through e-mail, or by hard copy, and one assumes that Shane sent and received the questionnaires through traditional means. Similarly, the documents relating to a private offering to the Accredited Investors would be distributed electronically through the IPONET Site password protected page available only to Accredited Investors. The No Action Letter did not address the means of communication.

In Release No. 33-7233, the Commission stated:

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

Accordingly, since W.J. Gallagher & Company, Inc., will be soliciting questionnaires for Accredited Investors and will be distributing information on private offerings electronically that it could otherwise properly do by paper, the posting of private offerings in a password protected page of IPONET would not involve general solicitation or general advertisement within the meaning of Rule 502(c) under the circumstances discussed above.

Conclusion.

We request that you concur with the conclusions set forth above. If you have questions or comments, please contact me directly.

[*7] Very truly yours,

Russell M. Frandsen, of
RADCLIFF, FRANDSEN, TRICKER & DONGELL
RMF: kn
Public Statement

Statement on Digital Asset Securities Issuance and Trading

Division of Corporation Finance, Division of Investment Management, and Division of Trading and Markets

Nov. 16, 2018

In recent years, we have seen significant advances in technologies – including blockchain and other distributed ledger technologies – that impact our securities markets. This statement[1] highlights several recent Commission enforcement actions involving the intersection of long-standing applications of our federal securities laws and new technologies.

The Commission's Divisions of Corporation Finance, Investment Management, and Trading and Markets (the "Divisions") encourage technological innovations that benefit investors and our capital markets, and we have been consulting with market participants regarding issues presented by new technologies.[2] We wish to emphasize, however, that market participants must still adhere to our well-established and well-functioning federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain.

The Commission's recent enforcement actions involving AirFox, Paragon, Crypto Asset Management, TokenLot, and EtherDelta's founder,[3] discussed further below, illustrate the importance of complying with these requirements. Broadly speaking, the issues raised in these actions fall into three categories: (1) initial offers and sales of digital asset securities (including those issued in initial coin offerings ("ICOs"); (2) investment vehicles investing in digital asset securities and those who advise others about investing in these securities; and (3) secondary market trading of digital asset securities. Below, we provide the Divisions' views on these issues.

Offers and Sales of Digital Asset Securities

The Commission has brought a number of actions involving offerings of digital asset securities. To date, these actions have principally focused on two important questions. First, when is a digital asset a "security" for purposes of the federal securities laws?[4] Second, if a digital asset is a security, what Commission registration requirements apply?[5] The importance of these and related issues is illustrated by several recent Commission enforcement actions involving digital asset securities. In particular, the remedial measures in two of these matters demonstrate a way to address ongoing violations by issuers that have conducted illegal unregistered offerings of digital asset securities.

Today, the Commission issued settled orders against AirFox and Paragon in connection with their unregistered offerings of tokens. Pursuant to these orders, AirFox and Paragon will pay penalties and also have undertaken to register the tokens as securities under Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act") and to file periodic reports with the Commission. They have also agreed to compensate investors who purchased tokens in the illegal offerings if an investor elects to make a claim. The registration undertakings are designed to ensure that investors receive the type of information they would have received had these issuers complied with the registration provisions of the Securities Act of 1933 ("Securities Act") prior to the offer and sale of tokens in their

respective ICOs. With the benefit of the ongoing disclosure provided by registration under the Exchange Act, investors who purchased the tokens from the issuers in the ICOs should be able to make a more informed decision as to whether to seek reimbursement or continue to hold their tokens.[6]

These two matters demonstrate that there is a path to compliance with the federal securities laws going forward, even where issuers have conducted an illegal unregistered offering of digital asset securities.

**Investment Vehicles Investing in Digital Asset Securities**

The Investment Company Act of 1940 ("Investment Company Act") establishes a registration and regulatory framework for pooled vehicles that invest in securities. This framework applies to a pooled investment vehicle, and its service providers, even when the securities in which it invests are digital asset securities.[7]

On Sept. 11, 2018, the Commission issued the Crypto Asset Management Order, finding that the manager of a hedge fund formed for the purpose of investing in digital assets had improperly failed to register the fund as an investment company. The order found that the manager engaged in an unlawful, unregistered, non-exempt, public offering of the fund. By investing more than 40 percent of the fund’s assets in digital asset securities and engaging in a public offering of interests in the fund, the manager caused the fund to operate unlawfully as an unregistered investment company. The order also found that the fund’s manager was an investment adviser, and that the manager had violated the antifraud provisions of the Investment Advisers Act of 1940 ("Advisers Act") by making misleading statements to investors in the fund.

Investment vehicles that hold digital asset securities and those who advise others about investing in digital asset securities, including managers of investment vehicles, must be mindful of registration, regulatory and fiduciary obligations under the Investment Company Act and the Advisers Act.[8]

**Trading of Digital Asset Securities**

Commission actions[9] and staff statements[10] involving secondary market trading of digital asset securities have generally focused on what activities require registration as a national securities exchange or registration as a broker or dealer, as those terms are defined under the federal securities laws.

**Exchange Registration**

Advancements in blockchain and distributed ledger technology have introduced innovative methods for facilitating electronic trading in digital asset securities. Platforms colloquially referred to as "decentralized" trading platforms, for example, combine traditional technology (such as web-based systems that accept and display orders and servers that store orders) with new technology (such as smart contracts run on a blockchain that contain coded protocols to execute the terms of the contract). These technologies provide the means for investors and market participants to find counterparties, discover prices, and trade a variety of digital asset securities.

A platform that offers trading in digital asset securities and operates as an "exchange" (as defined by the federal securities laws) must register with the Commission as a national securities exchange or be exempt from registration. The Commission’s recent enforcement action against the founder of EtherDelta, a platform facilitating trading digital assets securities, underscores the Division of Trading and Markets’ ongoing concerns about the failure of platforms that facilitate trading in digital asset securities to register with the Commission absent an exemption from registration.[11]

According to the Commission’s order, EtherDelta—which was not registered with the Commission in any capacity—provided a marketplace for bringing together buyers and sellers for digital asset securities through the combined use of an order book, a website that displayed orders, and a smart contract run on the Ethereum blockchain. EtherDelta’s smart contract was coded to, among other things, validate order messages, confirm the terms and conditions of orders, execute paired orders, and direct the distributed ledger to be updated to reflect a trade.[12] The Commission found that EtherDelta’s activities clearly fell within the definition of an exchange and that EtherDelta’s founder caused the platform’s failure either to register as a national securities exchange or operate pursuant to an exemption from registration as an exchange.[13]
Any entity[14] that provides a marketplace for bringing together buyers and sellers of securities, regardless of the applied technology, must determine whether its activities meet the definition of an exchange under the federal securities laws. Exchange Act Rule 3b-16 provides a functional test to assess whether an entity meets the definition of an exchange under Section 3(a)(1) of the Exchange Act. An entity that meets the definition of an exchange must register with the Commission as a national securities exchange or be exempt from registration, such as by operating as an alternative trading system ("ATS") in compliance with Regulation ATS.

Notwithstanding how an entity may characterize itself or the particular activities or technology used to bring together buyers and sellers, a functional approach (taking into account the relevant facts and circumstances) will be applied when assessing whether a system constitutes an exchange.[15] The activity that actually occurs between the buyers and sellers—and not the kind of technology or the terminology used by the entity operating or promoting the system—determines whether the system operates as a marketplace and meets the criteria of an exchange under Rule 3b-16(a). For instance, the term "order" for purposes of Rule 3b-16 is intended to be broadly construed, and the actual activities among buyers and sellers on the system—not the labels assigned to indications of trading interest—will be considered for purposes of the exchange analysis.[16]

The exchange analysis includes an assessment of the totality of activities and technology used to bring together orders of multiple buyers and sellers for securities using "established non-discretionary methods" under which such orders interact.[17] A system "brings together orders of buyer and sellers" if, for example, it displays, or otherwise represents, trading interest entered on a system to users or if the system receives users' orders centrally for future processing and execution.[18]

A system uses established non-discretionary methods if it provides a trading facility or sets rules. For example, an entity that provides an algorithm, run on a computer program or on a smart contract using blockchain technology, as a means to bring together or execute orders could be providing a trading facility. As another example, an entity that sets execution priorities, standardizes material terms for digital asset securities traded on the system, or requires orders to conform with predetermined protocols of a smart contract, could be setting rules. Additionally, if one entity arranges for other entities, either directly or indirectly, to provide the various functions of a trading system that together meet the definition of an exchange, the entity arranging the collective efforts could be considered to have established an exchange.

Entities using blockchain or distributed ledger technology for trading digital assets should carefully review their activities on an ongoing basis to determine whether the digital assets they are trading are securities and whether their activities or services cause them to satisfy the definition of an exchange. An entity engaging in these types of activities should also consider other aspects of the federal securities laws (and other relevant legal and regulatory issues) beyond exchange registration requirements.

**Broker-Dealer Registration**

An entity that facilitates the issuance of digital asset securities in ICOs and secondary trading in digital asset securities may also be acting as a "broker" or "dealer" that is required to register with the Commission and become a member of a self-regulatory organization, typically FINRA. Among other things, SEC-registered broker-dealers are subject to legal and regulatory requirements that govern their conduct in the marketplace and that provide important safeguards for investors.

Section 15(a) of the Exchange Act provides that, absent an exception or exemption, it is unlawful for any broker or dealer to induce or attempt to induce the purchase or sale, of any security unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act. Section 3(a)(4) of the Exchange Act generally defines a "broker" to mean any person engaged in the business of effecting transactions in securities for the account of others. Section 3(a)(5) of the Exchange Act generally defines a "dealer" to mean any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. As with the "exchange" determination, a functional approach (taking into account the relevant facts and circumstances) is applied to assess whether an entity meets the definition of a broker or dealer, regardless of how an entity may characterize either itself or the particular activities or technology used to provide the services.[19]
The Commission's recent TokenLot Order illustrates the application of the broker-dealer registration requirements to entities trading or facilitating transactions in digital asset securities, even if they do not meet the definition of an exchange. According to the order, TokenLot was a self-described "ICO superstore" where investors could purchase digital assets, including digital asset securities, during or after an ICO, including in private sales and pre-sales. The parties' brokerage activities included marketing and facilitating the sale of digital assets, accepting investors' orders and funds for payment, and enabling the disbursement of proceeds to the issuers. They also received compensation based on a percentage of the proceeds raised in the ICOs, subject to a guaranteed minimum commission. TokenLot also acted as a dealer by regularly purchasing and then reselling digital tokens for accounts in TokenLot's name that were controlled by its operators.

Conclusion

The Divisions encourage and support innovation and the application of beneficial technologies in our securities markets. However, the Divisions recommend that those employing new technologies consult with legal counsel concerning the application of the federal securities laws and contact Commission staff, as necessary, for assistance. For further information, and to contact Commission staff for assistance, please visit the Commission's new FinHub page.

[1] This statement represents the views of the Divisions of Corporation Finance, Investment Management, and Trading and Markets. It is not a rule, regulation, or statement of the Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its content.


[5] Of course, if a security is being offered or sold, the anti-fraud protections of the U.S. securities laws apply. The Commission has filed a number of enforcement actions involving digital assets, including those alleging fraudulent ICOs. See https://www.sec.gov/spotlight/cybersecurity-enforcement-actions(listing digital asset-related enforcement actions).

[6] As discussed herein, activities relating to the offer and sale of digital asset securities can also raise other legal and regulatory issues and considerations under the federal securities laws, including, for example, broker and dealer registration considerations.
For a discussion of some questions that are relevant to registered investment companies that invest in

certain digital assets, see Staff Letter to ICI and SIFMA AMG: Engaging on Fund Innovation and Crypto-related


In addition, pooled investment vehicles not only invest in securities but also are themselves issuers of

securities. Although not addressed here, the requirements of the federal securities laws relating to an investment

vehicle’s offer and sale of securities apply to the same extent when those securities use new technologies, such as

blockchain, as when they do not.

See, e.g. Coburn Order and TokenLot Order.

See Divisions of Enforcement and Trading and Markets, Statement on Potentially Unlawful Online


statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

See id.

Coburn Order at 6-7.

As stated in the Coburn Order, the Commission’s findings were made pursuant to the respondent’s offer

of settlement and are not binding on any other person or entity.

The relevant legal and regulatory requirements discussed in this statement apply to natural persons or

entities. However, for ease of reference, this statement generally refers only to entities.

In its Regulation ATS adopting release, the Commission discussed what constitutes an exchange and

provided examples illustrating various applications of Rule 3b-16. See Regulation of Exchanges and Alternative


See generally id. at 70844.

See id. at 70852.

See id. at 70852.

There are other potential legal and regulatory issues and considerations under the federal securities laws

for entities engaging in digital asset securities activities, including clearing agency and transfer agent registration

considerations, among other things.
Public Statement

Statement on Potentially Unlawful Online Platforms for Trading Digital Assets

Divisions of Enforcement and Trading and Markets

March 7, 2018

Online trading platforms have become a popular way investors can buy and sell digital assets, including coins and tokens offered and sold in so-called Initial Coin Offerings ("ICOs"). The platforms often claim to give investors the ability to quickly buy and sell digital assets. Many of these platforms bring buyers and sellers together in one place and offer investors access to automated systems that display priced orders, execute trades, and provide transaction data.

A number of these platforms provide a mechanism for trading assets that meet the definition of a "security" under the federal securities laws. If a platform offers trading of digital assets that are securities and operates as an "exchange," as defined by the federal securities laws, then the platform must register with the SEC as a national securities exchange or be exempt from registration. The federal regulatory framework governing registered national securities exchanges and exempt markets is designed to protect investors and prevent against fraudulent and manipulative trading practices.

Considerations for Investors Using Online Trading Platforms

To get the protections offered by the federal securities laws and SEC oversight when trading digital assets that are securities, investors should use a platform or entity registered with the SEC, such as a national securities exchange, alternative trading system ("ATS"), or broker-dealer.

The SEC staff has concerns that many online trading platforms appear to investors as SEC-registered and regulated marketplaces when they are not. Many platforms refer to themselves as "exchanges," which can give the misimpression to investors that they are regulated or meet the regulatory standards of a national securities exchange. Although some of these platforms claim to use strict standards to pick only high-quality digital assets to trade, the SEC does not review these standards or the digital assets that the platforms select, and the so-called standards should not be equated to the listing standards of national securities exchanges. Likewise, the SEC does not review the trading protocols used by these platforms, which determine how orders interact and execute, and access to a platform’s trading services may not be the same for all users. Again, investors should not assume the trading protocols meet the standards of an SEC-registered national securities exchange. Lastly, many of these platforms give the impression that they perform exchange-like functions by offering order books with updated bid and ask pricing and data about executions on the system, but there is no reason to believe that such information has the same integrity as that provided by national securities exchanges.

In light of the foregoing, here are some questions investors should ask before they decide to trade digital assets on an online trading platform:

- Do you trade securities on this platform? If so, is the platform registered as a national securities exchange (see our link to the list below)?
• Does the platform operate as an ATS? If so, is the ATS registered as a broker-dealer and has it filed a Form ATS with the SEC (see our link to the list below)?
• Is there information in FINRA’s BrokerCheck® about any individuals or firms operating the platform?
• How does the platform select digital assets for trading?
• Who can trade on the platform?
• What are the trading protocols?
• How are prices set on the platform?
• Are platform users treated equally?
• What are the platform’s fees?
• How does the platform safeguard users’ trading and personally identifying information?
• What are the platform’s protections against cybersecurity threats, such as hacking or intrusions?
• What other services does the platform provide? Is the platform registered with the SEC for these services?
• Does the platform hold users’ assets? If so, how are these assets safeguarded?

Resources for Investors
Investor.gov Spotlight on Initial Coin Offerings and Digital Assets
Chairman Jay Clayton Statement on Cryptocurrencies and Initial Coin Offerings
Chairman Jay Clayton's Testimony on Virtual Currencies: The Roles of the SEC and CFTC
Report of Investigation Pursuant to Section 21(a) of the Securities and Exchange Act of 1934: The DAO
Investors can find a list of SEC-registered national securities exchanges here: List of Active National Securities Exchanges
Investors can find a list of ATSs that have filed a Form ATS with the SEC here: List of Active Alternative Trading Systems

Considerations for Market Participants Operating Online Trading Platforms
A platform that trades securities and operates as an "exchange," as defined by the federal securities laws, must register as a national securities exchange or operate under an exemption from registration, such as the exemption provided for ATSs under SEC Regulation ATS. An SEC-registered national securities exchange must, among other things, have rules designed to prevent fraudulent and manipulative acts and practices. Additionally, as a self-regulatory organization ("SRO"), an SEC-registered national securities exchange must have rules and procedures governing the discipline of its members and persons associated with its members, and enforce compliance by its members and persons associated with its members with the federal securities laws and the rules of the exchange. Further, a national securities exchange must itself comply with the federal securities laws and must file its rules with the Commission.

An entity seeking to operate as an ATS is also subject to regulatory requirements, including registering with the SEC as a broker-dealer and becoming a member of an SRO. Registration as a broker-dealer subjects the ATS to a host of regulatory requirements, such as the requirement to have reasonable policies and procedures to prevent the misuse of material non-public information, books and records requirements, and financial responsibility rules, including, as applicable, requirements concerning the safeguarding and custody of customer funds and securities. The overlay of SRO membership imposes further regulatory requirements and oversight. An ATS must comply with the federal securities laws and its SRO's rules, and file a Form ATS with the SEC.
Some online trading platforms may not meet the definition of an exchange under the federal securities laws, but directly or indirectly offer trading or other services related to digital assets that are securities. For example, some platforms offer digital wallet services (to hold or store digital assets) or transact in digital assets that are securities. These and other services offered by platforms may trigger other registration requirements under the federal securities laws, including broker-dealer, transfer agent, or clearing agency registration, among other things. In addition, a platform that offers digital assets that are securities may be participating in the unregistered offer and sale of securities if those securities are not registered or exempt from registration.

In advancing the SEC’s mission to protect investors, the SEC staff will continue to focus on platforms that offer trading of digital assets and their compliance with the federal securities laws.

Consultation with Securities Counsel and the SEC Staff
We encourage market participants who are employing new technologies to develop trading platforms to consult with legal counsel to aid in their analysis of federal securities law issues and to contact SEC staff, as needed, for assistance in analyzing the application of the federal securities laws. In particular, staff providing assistance on these matters can be reached at FinTech@sec.gov.

Resources for Market Participants
Regulation of Exchanges and Alternative Trading Systems

Select Commission Enforcement Actions
SEC v. Jon E. Montroll and Bitfunder
In re BTC Trading, Corp. and Ethan Burnside.
SEC v. REcoin Group Foundation, LLC et al.
SEC v. PlexCorps et al.
In re Munchee, Inc.
SEC v. AriseBank et al.