Bloomberg BNA

Securities Regulation & Law Report™

CAPITAL FORMATION

Can I Make You an (Unregistered) Offer? The SEC Does Some 'Pre-Existing Relationship' Counseling

BY STEPHEN M. GOODMAN

Until the JOBS Act[1] led to the adoption of Rule 506(c), under Regulation D[2] an issuer was prohibited from engaging in a ''general solicitation''[3] of investors if it wanted to avoid registration of an offering. The rapid evolution of the Internet as a tool for marketing unregistered securities offerings raised questions regarding what uses of the Internet might be regarded as a general solicitation. In response, the Securities and Exchange Commission (''SEC'') issued interpretive releases addressing some of these questions.[4]

More specifically, several no-action letters issued by the SEC staff have articulated the view that if issuers or their intermediaries only approach potential investors with whom they have ''pre-existing, substantive relationships,'' the staff would not consider these approaches to be general solicitations. However, these no-action letters left uncertainty as to when an issuer could view a relationship as ''pre-existing'' and what made a relationship with an investor ''substantive.'' In addition, because of the factual circumstances addressed in these no-action letters, the staff had only been asked to address procedures for establishing pre-existing, substantive relationships where the potential investors were all ''accredited investors''.[5]

[1] Pub L 112–106, 126 Stat 306 (April 5, 2012).

[2] 17 C.F.R. 230.500-508.

[3] Under Rule 502(c) of Regulation D, a ''general solicitation'' is (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 solicitation or general advertising.

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The author wishes to thank his colleagues, Bertram Fry and Michael Campoli, for their thoughtful comments to an earlier draft of this article.

[4] *See, e.g.*, examples 20 and 21 in *Use Of Electronic Media For Delivery Purposes*, Securities Act Release 33-7233 (1995), available at http://www.sec.gov/rules/interp/33-7233.txt; *Use of Electronic Media*, Securities Act Release 34-42728 (2000), available at http://www.sec.gov/rules/interp/34-42728.htm.

[5] ''Accredited investor'' is defined in Regulation D, Rule 501(a).

 ISSN 0037-0665

A more recent no-action letter, *Citizen VC, Inc.* (the ''Citizen Letter''),[6] refines some of the SEC staff's guidance regarding what constitutes a ''substantive relationship'' and when such a relationship is ''pre-existing'' while at the same time indirectly raising some additional questions. The Citizen Letter confirms that if a ''substantive'' relationship is established with a prospective investor at any time prior to providing the investor with offering materials, no particular waiting period is required in order to regard the relationship as ''pre-existing''. In addition, the Citizen Letter implies that if a pre-existing, substantive relationship with an investor is established (meaning that the issuer has sufficient information to determine, and actually does determine, that investments in private offerings are suitable for that investor), that investor can be approached by the issuer even if the investor is known to be non-accredited without causing the approach to be considered a general solicitation.

The Citizen Letter refers to and expands upon several earlier no-action letters: *Bateman Eichler, Hill Richards, Inc.*, *IPONET* and *Lamp Technologies*. In *Bateman Eichler, Hill Richards, Inc.*, a no-action letter that did not address use of the Internet,[7] a broker/dealer proposed to let some of its account executives make a mailing, including a questionnaire and a letter, to not more than 50 prospective investors. If questionnaires were returned, the account executives would review the responses to the questionnaire, and contact certain respondents to obtain additional financial information and personal data. The broker wished to consider the respondents as eligible to participate in those types of private placements in which they had expressed an interest and which the broker (or the account executive) deemed suitable for them. No offering materials would be sent to the investor for at least forty-five days following the original mailing.

Based on the broker's representation that the proposed solicitation was generic in nature and would not refer to any specific investment currently offered or contemplated, the SEC staff agreed with counsel's view that the solicitation of the information would not constitute an offer to sell securities and that subsequent offers of securities to the people identified in this manner would not be viewed as a general solicitation ''provided a substantive relationship has been established with the offeree between the time of the initial solicitation and the later offer.'' However, the staff noted that whether the relationship was ''substantive'' depended on whether the furnished information was sufficient ''to evaluate the prospective offeree's sophistication and financial circumstances.''

This analysis was applied to Internet solicitations in *IPONET*,[8] where the staff concluded that, under the circumstances described, the posting of a notice of a private offering on a web site would not be deemed a ''general solicitation'' or ''general advertising''. In that case, interested investors were granted access to private offering material only after completing a questionnaire posted on IPONET's web site. IPONET stated that the questionnaire was intended ''as a means of building a customer base and database of accredited and sophisticated investors.'' Once an investor had qualified and had opened an account with IPONET's affiliated broker, the member was issued a password which enabled access to a website page containing a notice of a private offering. In addition, the IPONET site allowed a qualified investor access only to offerings which were posted subsequent in time to the date on which they were deemed qualified. Under these circumstances, the staff concurred that the website operator had taken sufficient steps to establish a relationship with the prospective investor that was both ''pre-existing'' and ''substantive'' and therefore no general solicitation was taking place.

In *Lamp Technologies*,[9] the staff of the Division of Investment Management also agreed that the posting of private investment fund information on a web site would not constitute a public offering of securities ''based on the use of procedures designed to limit access to the web site information to a select group of accredited investors.'' The letter also reports the view of the Division of Corporation Finance that ''the qualification of accredited investors in the manner described and the posting of a notice concerning a private fund on a web site that is password-protected and accessible only to subscribers who are pre-determined by Lamp to be accredited investors would not involve a 'general solicitation' or 'general advertising' within the meaning of Rule 502(c) of Securities Act Regulation D.''

Relying on *Lamp* and its predecessors, various web site operators have adopted procedures to ensure that use of their sites to conduct private offerings will not violate the prohibition on general solicitation. Generally, pursuant to these procedures, (1) the issuer or broker dealer gathers information on a potential investor by means of a generic questionnaire that does not refer to a specific transaction, (2) a password-protected page containing offerings is only made available to a particular investor after the issuer or affiliated broker-dealer determines an investor is accredited, (3) a potential investor is permitted to purchase securities only after the investor is qualified by the issuer or affiliated broker dealer as accredited, and (4) a ''period of time'' has passed after this investor is qualified.

Citizen, like other similar Internet platforms, sought to pre-qualify investors to ensure that only accredited investors would gain access to private offerings made available through its web site. It then wished to proceed under the exemption from registration afforded by Rule 506(b) (which does not permit general solicitations) to offer to its members securities in special purpose vehicles (SPVs), each formed to invest in a particular issuer. Counsel for Citizen requested that the staff concur with its conclusion that ''the policies and procedures described in this letter [for pre-qualifying its members] will be sufficient to create the necessary relationship between Citizen VC and prospective investors such that the offering and sale of Interests [in the SPVs] on the Site will not constitute general solicitation or general advertising within the meaning of Rule 502(c) of Regulation D.''

[6] *Citizen VC, Inc.* (August 6, 2015), available at http://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm.

[7] *Bateman Eichler, Hill Richards, Inc.* (Dec. 3, 1985).

[8] *IPONET* (avail. July 26, 1996).

[9] *Lamp Technologies* (avail. May 29, 1997), available at https://www.sec.gov/divisions/investment/noaction/1997/lamptechnologies052997.pdf.

   ISSN 0037-0665

Citizen proposed that, before allowing any visitor to its website to access any offering materials on the site, it would implement a series of procedures, including:

> (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.

Citizen also represented that ''the relationship with new Members will pre-exist any offering, consistent with the Division's previous guidance.'' Counsel for Citizen stated its view that ''[t]he 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 of Interests is suitable for each prospective investor.''

In its response, while the staff indicates that it concurs with much of the analysis presented by Citizen's counsel regarding the requirements for establishing a ''pre-existing relationship'', it never confirms that the specific procedures described are sufficient to demonstrate that ''the offering and sale of Interests on the Site will not constitute general solicitation or general advertising''. Instead, the staff merely states, ''Whether an issuer [i.e., of securities offered by or through the platform] 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.'' (Emphasis added.)

By refusing to endorse Citizen's specific procedures, the staff seems to be emphasizing that there is no simple formula for determining whether a ''substantive'' relationship has been established. Issuers and brokers must evaluate whether they have the required substantive relationship with the investor under the particular facts and circumstances before soliciting investment in particular securities.

Interestingly, the staff states that the issuer must have enough information to determine if the prospective offeree is ''accredited *or* sophisticated.'' (Emphasis added.) The use of ''or'' in this phrase seems to imply that pre-qualification may allow for solicitation of both accredited and non-accredited (but sophisticated) investors without violating the prohibition on general solicitations if there is a pre-existing, substantive relationship.

A remaining question is what extent a platform sponsor is obligated to update the qualifications of its prequalified members who seek to invest in a specific investment opportunity made available by the sponsor. How long can the sponsor continue to claim that it has a ''substantive'' relationship based on the prequalification? Are additional steps necessary between the offer and the sale of securities to that investor?

Although the staff has not explicitly said so, it is possible to read the Citizen Letter as imposing on sponsors who are not registered broker-dealers obligations similar to a broker's obligation to ''know your customer''.[10] It is a given that the ''facts and circumstances'' relating to a particular investor may change. For example, an accredited investor may cease to be accredited at any time. Perhaps such a change does not affect an issuer's ability to make offers of securities to that investor. However, sales are another matter.

A common practice by many issuers when effecting sales of their securities to pre-qualified investors is to have them simply sign a subscription agreement containing representations regarding the investor's financial circumstances, sophistication, and ability to understand the nature and risks of the offered securities. But the staff's emphasis in the Citizen Letter on the obligation of the platform sponsor and the issuer to evaluate particular facts and circumstances in assessing investor suitability raises a question as to whether self-certification in a subscription agreement is alone sufficient or whether extra steps must be taken to ensure that the investment is truly suitable for the investor.

While not directly applicable to a Rule 506(b) offering, certain statements in the SEC's 2013 release adopting amendments to Rule 506 (the ''Rule 506 Release'')[11] may be an indication that platform sponsors (and possibly issuers themselves) may have to do more even when relying on Rule 506(b). The amendments to Rule 506 adopted in the Rule 506 Release divided old Rule 506 into two alternative exemptions. If an issuer chooses to rely on Rule 506(b) (essentially old Rule 506), it is prohibited from engaging in a general solicitation, but it is free to sell its securities to not more than 35 non-accredited investors (all of whom have presumably been identified as suitable for the investment because of a ''pre-existing relationship'' with the issuer or an intermediary). However, if an issuer wishes to locate investors using a general solicitation without registering an offering, it must rely on new Rule 506(c), which prohibits selling offered securities to *any* investor that is not accredited. According to the Rule 506 Release and Rule 506(c), the issuer is obligated to take ''reasonable

[10] See FINRA Rule 2090, which states ''Every [FINRA] member shall use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer.'' See also FINRA's suitability rule (FINRA Rule 2111), which requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the firm's or associated person's familiarity with the security or investment strategy. A firm's or associated person's reasonable diligence must provide the firm or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy.

[11] ''Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings'', SEC Rel. No. 33-9415 (2013).

steps'' to verify that the purchaser is indeed an accredited investor.

The Rule 506 Release expressly rejects reliance on self-verified questionnaires as sufficient to support a ''reasonable belief'' that an investor is accredited where there is no ''pre-existing, substantive relationship'' because the investor was identified through a ''general solicitation'' offering securities. The release specifically states, ''We do not believe that an issuer will have taken reasonable steps to verify accredited investor status if it, or those acting on its behalf, required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status.'' As in the Citizen Letter, the Rule 506 Release states that ''reasonable steps'' involve evaluating the ''facts and circumstances'' surrounding the investor's decision to invest and forming a ''reasonable belief'' that the investor is in fact accredited.[12]

The release provides as examples of such ''reasonable steps'' actions similar to those which Citizen described in its qualification procedures. According to the staff, an issuer could take such steps as (1) obtaining copies of tax returns or other IRS-filed documents reflecting income, (2) obtaining other types of third party documents reflecting current assets and liabilities of a prospective investor or (3) obtaining a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a certified public accountant that the professional has recently taken reasonable steps to verify that the purchaser is an accredited investor and has actually verified that fact. The question is whether, if a platform sponsor already has taken steps sufficient to establish a ''pre-existing substantive relationship'' with an investor, can the issuer and the sponsor still simply rely on investors ''check[ing] a box in a questionnaire or sign[ing] a form'' when it actually sells them a security? Is that enough if six months or a year has passed since the pre-qualification of the investor? Does the sponsor or the issuer need to get new, relevant information on an ongoing basis, as a broker is legally obligated to do?

Following the Citizen Letter, sites which admit members without adopting robust pre-qualification techniques similar to those described in the Citizen Letter may find themselves under heightened regulatory scrutiny. However, even if such sites adopt substantive procedures such as those described in the Citizen letter in order to demonstrate a ''pre-existing relationship'' with an investor, the fact that such a pre-existing relationship exists may not excuse the need to update each investor's qualifications before the investor purchases securities in a particular offering. The Citizen Letter may open the possibility that a private offering exemption could be at risk if timely and ''substantive'' information about the investors in the offering is not obtained prior to closing the sale, beyond the representations in the subscription agreement.

[12] This effectively restates in more specific language the requirement contained in earlier no-action letters that the issuer ''determine an investor is sophisticated or accredited''. See *IPONET* and *Lamp Technologies*, referred to in footnote 9 above.

  SRLR ISSN 0037-0665