Also Visit – LawCast.com
The Securities Law Network

September 2, 2015

SEC Issues Guidance On General Solicitation And Advertising In Regulation D Offerings

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Effective September, 2013, the SEC adopted final rules eliminating the prohibition against general solicitation and advertising in Rules 506 and 144A offerings as required by Title II of the JOBS Act. The enactment of new 506(c) resulting in the elimination of the prohibition against general solicitation and advertising in private offerings to accredited investors has been a slow but sure success. Trailblazers such as realtymogul.com, circleup.com, wefunder.com and seedinvest.com proved that the model can work, and the rest of the capital marketplace has taken notice. Recently, more established broker-dealers have begun their foray into the 506(c) marketplace with accredited investor-only crowdfunding websites accompanied by marketing and solicitation to draw investors.

The historical Rule 506 was renumbered to Rule 506(b) and issuers have the option of completing offerings under either Rule 506(b) or 506(c). Rule 506(b) allows offers and sales to an unlimited number of accredited investors and up to 35 unaccredited investors, provided however that if any unaccredited investors are included in the offering, certain delineated disclosures, including an audited balance sheet and financial statements, are provided to potential investors. Rule 506(b) prohibits the use of any general solicitation or advertising in association with the offering. SEC interpretations and case law have established the principle that where there is a pre-existing, substantive relationship with offerees, offers will not be considered a general solicitation.

The new Rule 506(c) requires that all sales be strictly made to accredited investors and adds a burden of verifying such accredited status to the issuing company. In a 506(c) offering, it is not enough for the investor to check a box confirming that they are accredited. 506(c) offering allows the use of general solicitation and advertising in conjunction with soliciting potential investors. As it would be practically impossible to control who views an advertisement, there are no restrictions in the rule in that regard; rather, the restrictions are related to verifying accredited status prior to consummating the sale.

On August 6, 2015, the SEC updated its Division of Corporation Finance Compliance and Disclosure Interpretations (C&DI), adding 11 new C&DI to provide guidance related to general solicitation and advertising in Regulation D offerings. It is well established that an issuer may offer and sell securities to persons with whom it, or anyone acting on its behalf, has a pre-existing substantial relationship, without being deemed to have engaged in general solicitation or advertising as defined in Regulation D. Seven of the new C&DI are on the topic of pre-existing substantial relationships.

Also on August 6, 2015, the Division of Corporate Finance granted a no-action letter to Citizen VC, an online venture capital firm, agreeing with its procedures for creating online pre-existing substantial relationships with prospective investors such that subsequent offers and sales to such investors would not constitute general solicitation and advertising under the rules. As a result, Citizen VC can rely on the historical 506(b) without the necessity of verifying the investors' accredited status.

New Compliance and Disclosure Interpretations (C&DI)

The following is a summary of the 11 new C&DI.

Unrestricted Websites – The SEC confirms that unrestricted, publicly available websites that offer or sell securities constitute a general solicitation and accordingly, any offering on such website would need to comply with 506(c).

Allowable Communications – Not all communications that are widely disseminated are considered an offer or sale of securities such as to result in a general solicitation or advertisement for securities under Regulation D. A company may widely disseminate factual information regarding its company and products and, as long as such communications do not offer or sell securities or "condition the public mind or arouse public interest in a securities offering," it will not be considered a solicitation or advertisement under Regulation D.

What constitutes factual business information requires a facts and circumstances analysis. Generally, factual business information is limited to information about the company, its business, financial condition, products, services or advertisement of such products or services that do not reference securities or a securities offering. Factual business information generally does not include predictions, projections, forecasts or opinions or valuations of securities. Also, information related to past performance of a fund would be considered a securities offering if the fund was engaged in such offering at the time of issuance of the information.

Demo Day or Venture Fair – Participation in a demo day or venture fair does not automatically constitute general solicitation or advertising under Regulation D. If an issuer's presentation does not involve the offer of securities at all, no solicitation is involved. If the attendees of the event are limited to persons with whom either the company or the event organizer have a pre-existing, substantive relationship, or have been contacted through a pre-screened group of accredited, sophisticated investors (such as an angel group), it will not be deemed a general solicitation. However, if invitations to the event are sent out via general solicitation to individuals and groups with no established relationship and no pre-screening as to accreditation, any presentation involving the offer of securities would be deemed to involve a general solicitation under Regulation D.

Pre-existing Substantive Relationships – An offer of securities to a prospective investor with whom the company or someone acting on the company's behalf has a pre-existing, substantive relationship is not considered a general solicitation or advertisement under Regulation D. A "pre-existing" relationship is one that the company, or someone acting on the company's behalf such as through a broker-dealer or investment adviser, has formed with the prospective investor prior to the commencement of the offering.

Moreover, the absence of a pre-existing relationship does not automatically make a communication a general solicitation or advertisement under Regulation D. For example, a company may solicit prospective investors they are introduced to who are members of an informal, personal network of individuals or investors, such as angel investor groups. As a rule of thumb, if all members of the group or network are sophisticated and experienced in the type of investment being offered, members can be solicited without triggering the solicitation and advertisement rules under Regulation D. Moreover, the higher the number of persons without financial experience, sophistication, or prior personal or business relationships with the company that are solicited, the greater the chance that it will be deemed a general solicitation of the offering.

Again, the existence of a pre-existing relationship depends on facts and circumstances. There is no set minimum amount of time that a relationship must exist to be considered pre-existing. However, to be considered pre-existing, the relationship must have been established prior to commencement of the offering.

In addition to relying on broker-dealer relationships, a company may rely on the relationships established by investment advisers. That is, if an investment adviser, upon making a determination that an investment is suitable, refers a client to a company, the company will not be deemed to have generally solicited such person or persons under Regulation D.

A "substantive" relationship is one in which the company, or someone acting on the company's behalf such as a broker-dealer, has sufficient information to evaluate, and in fact does evaluate, such prospective investors' financial circumstances and sophistication and established accreditation. Self-certifying by checking a box is not enough to establish a "substantive" relationship.

The SEC reminds us of its long-standing viewpoint as to the establishment of pre-existing relationships by republishing this comment originally published in April 2000:

Generally, staff interpretations of whether a "pre-existing, substantive relationship" exists have been limited to procedures established by broker-dealers in connection with their customers. This is because traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and, thus, implies that a substantive relationship exists between the broker-dealer and its customers. [The Commission has] long stated, however, that the presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case. Thus, there may be facts and circumstances in which a third party, other than a registered broker-dealer, could establish a "pre-existing, substantive relationship" sufficient to avoid a "general solicitation."

The C&DI continues by noting that in the absence of a prior business relationship or recognized legal duty to the prospective investor, it will be difficult for an issuer to establish a pre-existing substantive relationship once such issuer contemplates or engages in an offering over the internet. At a minimum, a company would need to consider whether they have sufficient information to properly evaluate the financial condition and sophistication of the prospective investor prior to commencing the offering.

Where the circumstances are questionable, it is advised that the issuing company rely on Rule 506(c) and take the extra steps of verifying the accreditation of investors.

Citizen VC No Action Letter

On August 3, 2015, Citizen VC, Inc. sought no action relief from the SEC related to its procedures for creating online pre-existing substantial relationships with prospective investors such that subsequent offers and sales to such investors would not constitute general solicitation and advertising under Regulation D. Citizen VC noted that online angel and venture capital sites vary widely in their methods for establishing pre-existing relationships. The SEC responded (very quickly) on August 6, 2015, confirming that if Citizen VC followed the procedures laid out in its August 3 correspondence, the SEC would agree that an offering by Citizen VC met the standards for Rule 506(b) and did not require the additional investor qualification and verification requirements under Rule 506(c).

Citizen VC operates an online venture capital investment platform. Citizen VC forms special purpose vehicles (SPV's) to aggregate accredited investors for particular investments in an issuing company either through direct new issuance or purchase of existing outstanding equity. The SPV's are formed for a particular investment and are not blind pool. Each SPV is managed by a manager that shall become a registered investment adviser under the Investment Advisers Act of 1940. An investment in an SPV is only offered to members of the Citizen VC platform. Citizen VC conducts its business using the internet and online technology, including delivering offering and investment documents to its members.

Its website is publicly accessible, and potential new members can find the site and make membership applications directly from the site. Particular offering documents and offering information and information about portfolio companies are password-protected and only available to members.

Citizen VC developed qualification policies and procedures to establish substantive relationships with, and confirm the suitability of, prospective investors using its website. In particular, to apply for membership, a person must first register and complete an online generic accredited investor questionnaire. If the questionnaire is satisfactory, Citizen VC continues with its "relationship establishment period." During this time, Citizen VC undertakes to connect with the prospective member and collect information related to their sophistication, financial circumstances, and ability to understand the nature and risks related to the types of investment Citizen VC undertakes.

Citizen VC's "relationship establishment" procedures include (i) contacting the prospective member offline by telephone and having person-to-person discussions related to the prospective member's sophistication, financial circumstances and ability to understand the nature and risks related to the types of investment Citizen VC undertakes; (ii) sending an introductory e-mail; (iii) contacting the prospective member online to answer questions; (iv) utilizing third-party credit reporting services to confirm the member's identity and to gather additional financial information, including credit history; (v) encouraging the prospective member to explore the website and ask questions about Citizen VC's and a particular SPV manager's investment strategy, philosophy and objectives; and (vi) fostering both online and offline relationships between Citizen VC and the prospective member. Moreover, the prospective member is informed that SPV offerings have a minimum investment requirement of $50,000 or higher, with many of them significantly higher.

The relationship establishment period is not defined by a specific time period, but rather is based on specific written policies and procedures designed to ensure that a specific offering is suitable for each prospective investor. Citizen VC will only accept a member after the relationship establishment period and only after it is satisfied as to the qualification of such prospective member. Again, particular offers to invest in an SPV are only made to members.

In its legal analysis, Citizen VC concludes that it is the quality of a relationship rather than a specific time of the relationship that establishes a pre-existing substantive relationship. As such, a qualifying relationship can flow from establishing a process for issuers to develop substantive relationships with previously unknown prospective investors as long as that process does not otherwise violate the rules. The process must also result in the issuer being satisfied as to the sophistication, financial circumstances, and ability to understand the nature and risks related to the types of investment being offered, prior to making an offer of securities within the meaning of Regulation D.

Citizen VC requested that the SEC concur with its opinion that its process, as set out in the letter, does indeed result in the establishment of a pre-existing substantive relationship such that offers and sales of securities to its members would not constitute a general solicitation or advertisement under the securities laws.

On August 6, 2015, the SEC responded. The SEC's response states, "[W]e 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." The SEC continued, "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." Furthermore, the SEC states, "[W]e 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." Finally, the SEC confirms that its conclusion is predicated on the fact that only members, and not prospective members, will be presented with investment opportunities.

Brief Summary of 506(c)

Effective September 23, 2013, the SEC adopted final rules eliminating the prohibition against general solicitation and advertising in Rules 506 and 144A offerings as required by Title II of the JOBS Act. For a complete discussion of the final rules, please see my blog HERE.

Title II of the JOBS Act required the SEC to amend Rule 506 of Regulation D to permit general solicitation and advertising in offerings under Rule 506, provided that all purchasers of the securities are accredited investors. The JOBS Act required that the rules necessitate that the issuer take reasonable steps to verify that purchasers of the securities are accredited investors using such methods as determined by the SEC. Rule 506 is a safe harbor promulgated under Section 4(a)(2) (formerly Section 4(2)) of the Securities Act of 1933, exempting transaction by an issuer not involving a public offering. In a Rule 506 offering, an issuer can sell an unlimited amount of securities to accredited investors and up to 35 unaccredited sophisticated investors. The standard to determine whether an investor is accredited has historically been the reasonable belief of the issuer.

New Rule 506(c) permits the use of general solicitation and advertising to offer and sell securities under Rule 506, provided that the following conditions are met:

1. the issuer takes reasonable steps to verify that the purchasers are accredited;

2. all purchasers of securities must be accredited investors, either because they come within one of the categories in the definition of accredited investor, or the issuer reasonably believes that they do, at the time of the sale; and

3. all terms and conditions of Rule 501 and Rules 502(a) and (d) must be satisfied.

Rule 506(c) includes a non-exclusive list of methods that issuers may use to verify that investors are accredited. An issuer that does not wish to engage in general solicitation and advertising can rely on the old Rule 506 and offer and sell to up to 35 unaccredited sophisticated investors. An issuer opting to rely on the old Rule 506 does not have to take any additional steps to verify that a purchaser is accredited.

The Author

Attorney Laura Anthony
Founding Partner
Legal & Compliance, LLC
Corporate, Securities and Going Public Attorneys
LAnthony@LegalAndCompliance.com

Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

Contact Legal & Compliance, LLC. Inquiries of a technical nature are always encouraged. Follow me on Facebook, LinkedIn, YouTube, Google+, Pinterest and Twitter.

Download our mobile app at iTunes and Google Play.

Disclaimer

Legal & Compliance, LLC makes this general information available for educational purposes only. The information is general in nature and does not constitute legal advice. Furthermore, the use of this information, and the sending or receipt of this information, does not create or constitute an attorney-client relationship between us. Therefore, your communication with us via this information in any form will not be considered as privileged or confidential.

This information is not intended to be advertising, and Legal & Compliance, LLC does not desire to represent anyone desiring representation based upon viewing this information in a jurisdiction where this information fails to comply with all laws and ethical rules of that jurisdiction. This information may only be reproduced in its entirety (without modification) for the individual reader's personal and/or educational use and must include this notice.

© Legal & Compliance, LLC 2015