CLEARY GOTTLIEB

ALERT MEMORANDUM

September 2, 2015 clearygottlieb.com

New SEC Staff Guidance on General Solicitation

On August 6, 2015, the SEC staff issued new guidance on what constitutes "general solicitation and general advertising."[1] "General solicitation" and "general advertising" are not new concepts—an issuer and its intermediaries have long had to determine that they did not engage in publicity to rely on the private placement exemption provided by Section 4(a)(2) of the Securities Act of 1933, as amended (the "Securities Act"), for "transactions by an issuer not involving any public offering." The Regulation D safe harbor under Section 4(a)(2) effectively defines publicity as "general solicitation or general advertising," which it prohibited until 2013. Neither the Securities Act nor its legislative history defines "public offering," "general solicitation" or "general advertising."

In 2013, pursuant to the JOBS Act, the SEC eliminated the prohibition on general solicitation and general advertising for securities offerings made in reliance on new Rule 506(c) under Regulation D. Rule 506(c) permits issuers to engage in general solicitation so long as they take reasonable steps to verify that all purchasers are "accredited investors" as defined in Rule 501(a) under Regulation D. Rule 506(b), on the other hand, prohibits general solicitation but allows sales to be made to investors the issuer "reasonably believes" are accredited investors and up to 35 non-accredited investors. In 2013, we predicted in our alert memo on the JOBS Act that the new permission to use general solicitation in Rule 506(c) offerings was likely to cause increased focus on exactly what constitutes "general solicitation" or "general advertising."

The August guidance for the most part is not new, but it confirms existing pronouncements in some respects and expands them in others, with one exception. We believe it should give greater comfort to issuers that certain types of offering-related communications will not preclude them from relying on Section 4(a)(2) or Rule 506(b) under Regulation D, as we discuss below under "Practical Applicability of the New Guidance."

Prohibited Publicity in Private Placements: Historical Guidance

In 1953, the Supreme Court in *SEC v. Ralston Purina Co.*[2] 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." The Court further commented that "the exemption question turns on the *knowledge* of the offerees" (emphasis added) and held that the number of offerees is not conclusive as to the availability of the exemption. Through various no-action letters and other guidance since then, including releases related to the adoption of predecessor rules to

[1] Commission Division of Corporation Finance Compliance and Disclosure Interpretations (August 6, 2015), available at https://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm.; *Citizen VC, Inc*. (avail. Aug. 6, 2015).

[2] *SEC v. Ralston Purina Co*., 346 U.S. 119 (1953).

Regulation D, the SEC and the staff have interpreted what constitutes a transaction not involving any public offering. The SEC's views have been consistent with the fundamental premise established in *Ralston Purina* that what constitutes a private offering does not necessarily turn on the size or scope of an offering, but requires consideration of all facts and circumstances, including in particular the relationship between the offerees and the issuer.[3]

Regulation D, adopted in 1982, required that there be no "general solicitation and general advertising" for securities offerings to qualify for the safe harbor. Regulation D identifies certain activities that definitively constitute general solicitation[4] but does not address every potential offering-related communication. Since 1982, the SEC and the staff have reiterated the general rule that the existence of a "substantive pre-existing relationship" by the issuer or its agent with a prospective investor is conclusive evidence that the investor was not attracted to an offering through general solicitation or general advertising that would make the offering a public one.[5]

- "Substantive:" The SEC staff has concluded that a substantive relationship exists if it "would enable the issuer (or a person acting on its behalf) 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."[6] Broker-dealers can use suitability questionnaires to establish a substantive relationship with a prospective investor.[7]

- "Pre-existing:" The SEC staff has concluded that a relationship established prior to the solicitation for the particular offering is a pre-existing relationship.[8] Prior to the new guidance, discussed below, sufficient time (generally understood to be 30 days after the *Lamp Technologies* letter in 1997) was required between establishing the relationship and commencing an offering.[9]

Commentary during the 1990s focused on developments in communications technology and on the increasing difficulty of determining whether "offers" or "solicitation" were inconsistent

[3] SEC Release No. 33-4552 (1962) ("[T]he number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available."); Rule 146 (1974 predecessor to Rule 506, which required the issuer to have reasonable grounds to believe that an offeree had certain knowledge and experience in financial and business matters sufficient to evaluate the risks of an investment).

[4] This list includes "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio."

[5] Letters regularly cited include *Mineral Lands Research & Marketing Corp.* (avail. Mar. 21, 1985); *Bateman Eichler , Hill Richards, Inc*. (avail. Dec. 3, 1985); *E.F. Hutton & Co*. (avail. Dec. 3, 1985); and *H.B. Shaine & Co., Inc*. (avail. Mar. 31, 1987). *Kenman Corp*. (Order Instituting Proceedings and Making Findings, avail. Apr. 19, 1985) is also frequently cited.

[6] See *Mineral Lands Research & Marketing Corp.*

[7] See *E.F. Hutton & Co*. ("Substantive relationships may be established with persons who have provided satisfactory responses to questionnaires that provide [the issuer] with sufficient information to evaluate the prospective offerees' sophistication and financial circumstances."); *Bateman Eichler, Hill Richards, Inc.*

[8] See *E.F. Hutton & Co.*

[9] See *H.B. Shaine and Co., Inc*; *E.F. Hutton & Co. Inc.*

with private placements. The SEC requested comment in 1995[10] on whether it should modify or eliminate the prohibition on general solicitation under Regulation D, but no changes were made. In that 1995 release, the SEC stated unequivocally that placing offering materials on an unrestricted web site would not be consistent with the restriction on general solicitation. The SEC staff subsequently issued no-action letters expressing its views on other uses of the Internet in private offerings.

- In IPONET (avail. July 26, 1996) the staff stated that, under the circumstances described, the pre-qualification of accredited or sophisticated investors and the posting of a notice of a private offering in a password-protected page accessible only to pre-qualified members would not involve general solicitation. Lamp Technologies, Inc. (avail. May 29, 1997) reached a similar conclusion and extended it to the related issues under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940, but specified that no-action relief was conditioned in part on a 30-day waiting period imposed on subscribers before they could invest in an offering by a fund.

- In AgriStar Global Networks, Ltd. (avail. Feb. 9, 2004), on the other hand, the staff refused to provide no-action relief in connection with AgriStar's proposed establishment of a database of accredited investors for use in private offerings of its securities in the future (similar to the pre-qualification mechanisms in IPONET and Lamp). The staff did not give a reason for the departure from the relief granted in IPONET and Lamp, which has resulted in continued uncertainty regarding how an issuer can avoid general solicitation where making offers to a pre-established network of prospective investors, whether proprietary or belonging to a third-party agent.

In 2007, the SEC proposed revisions to Regulation D, including a new rule that would have permitted limited advertising of an offering so long as sales were limited to "large accredited investors" (a proposed new category of investors). The SEC emphasized in that proposal the difference between limited advertising and "unscrupulous" marketing of offerings to unsophisticated investors.[11]

The New Guidance

The new guidance provides as follows:

- The use of an unrestricted website to offer or sell securities constitutes general solicitation (Question 256.23). This reaffirms existing guidance.

[10] SEC Release No. 33-7185 (1995).

[11] SEC Release No. 33-8828 (2007). ("We believe that we may exempt certain offers and sales that may involve limited advertising … without compromising investor protection, due to the general increased sophistication and financial literacy of investors in today's markets, coupled with the advantages of modern communication technologies…Our proposal attempts to ease restrictions on limited offerings of securities in a manner that is cognizant of the potential harm of offerings by unscrupulous issuers or promoters who might take advantage of more open solicitation and advertising to lure unsophisticated investors to make investments in exempt offerings that do not provide all the benefits of Securities Act registration.")

- The dissemination of "factual business information" does not constitute general solicitation (Question 256.24). Factual business information does not, however, include predictions, projections, forecasts or opinions with respect to valuation of a security, nor for a continuously offered fund would it include information about past performance of the fund (Question 256.25). The prohibition on projections could have implications for public companies that publish earnings guidance, but we do not think the new guidance was meant to be interpreted this way (see "Practical Applicability of the New Guidance" below).

- An offer to a prospective investor with whom the issuer or its agent has a substantive pre-existing relationship does not constitute a general solicitation (Question 256.26). This reaffirms existing guidance.

- There are cases where an issuer may in the context of an offering approach prospective investors with whom it does not have a substantive pre-existing relationship, but who are part of private networks of investors (*e.g.*, "angel" investors) without engaging in general solicitation or general advertising (Question 256.27). This interpretation is based on SEC guidance in a 2000 release that the requisite substantive pre-existing relationship may be established by third parties other than broker-dealers.[12] As the guidance makes clear, "[i]ssuers that contact one or more experienced, sophisticated members of the group through this type of referral [*i.e.*, from a group member known to the issuer] may be able to rely on those members' network to establish a reasonable belief that other offerees in the network have the necessary financial experience and sophistication." The SEC staff does caution in response to Question 256.27 that "the greater number of persons without financial experience, sophistication *or* (emphasis added) any prior personal or business relationship with the issuer that are contacted by an issuer or persons acting on its behalf through impersonal, non-selective means of communication, the more likely the communications are part of a general solicitation." This cautionary language makes a critical distinction between an issuer approaching prospective investors to determine their financial sophistication where the issuer or a third party has a prior personal or business relationship with those investors, which is permitted, and situations where a proposed inquiry would be made to prospective investors and neither the issuer nor any third party has any such relationship. In the latter case, such an approach would almost always necessarily be impersonal and non-selective because there is no relationship on which the approach could be predicated.

- An investment adviser can form pre-existing relationships with prospective offerees that are clients of the adviser (Question 256.28). This interpretation similarly is predicated on the SEC 2000 guidance.

- A "pre-existing" relationship can be formed, depending on the facts and circumstances, immediately prior to the commencement of an offering, with no waiting period

[12] See SEC Release No. 33-7856 (2000) (noting that "one method of ensuring that general solicitation is not involved is to establish the existence of a 'pre-existing, substantive relationship'" and that "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'").

requirement (Questions 256.29 and 256.30). This interpretation eliminates what was previously understood to be a required 30-day waiting period between the formation of a relationship and the commencement of an offering.

- Checking a box as to investor status is not enough to create a "substantive" relationship (Question 256.31). Although the staff guidance speaks in terms of requiring actual evaluation of a prospective investor's financial circumstances and sophistication to establish a substantive relationship, we believe the staff has gone beyond the historical test here, which focused on the *ability* of an issuer to evaluate those matters and left the actual evaluation of those matters to be tested under the reasonable belief standard.

- Where past staff guidance has generally limited to broker-dealers the ability of a third party to establish substantive pre-existing relationships, under the new guidance third parties beyond broker-dealers or investment advisers can establish a substantive pre-existing relationship on the issuer's behalf. The analysis depends on the facts and circumstances (Question 256.32). This guidance too is predicated on the SEC 2000 guidance.

- Demo days will not constitute general solicitation if no offering of securities is made in connection therewith or, where offerings are discussed, if invitations are limited to persons with whom the issuer has a substantive pre-existing relationship (including through informal networks such as "angel" investor groups) (Question 256.33).

In the Citizen no-action letter, the SEC staff confirmed that offerings conducted via online platforms to pre-established networks of investors will not constitute general solicitation if sufficient procedures are followed to ensure that the relationship between the investor and the platform is substantive.[13] Citizen's procedures begin with a prospective investor completing an AI questionnaire and also include telephone contact to discuss the prospective investor's sophistication, a formal process to answer investor questions and verifying investor identity through third-party sources, among others.

Practical Applicability of the New Guidance

Guidance Not Limited to Regulation D Offerings

Although only Regulation D expressly prohibits "general solicitation and general advertising," the new guidance will also be helpful to issuers determining whether they have engaged in a "public offering" to rely on the exemption from registration under Section 4(a)(2) of the Securities Act.

[13] *Citizen VC, Inc*. ("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.")

If Predictions are General Solicitation, What About Companies that Publish Guidance?

Factual business information permitted to be posted on a website or otherwise disseminated without violating the prohibition on general solicitation does not include predictions, projections, forecasts or opinions with respect to valuation of a security (Question 256.25). While we believe this interpretation was meant to apply to funds and private companies, read literally, it would preclude a public company from making a private offering after having published earnings guidance, which undoubtedly is a "forecast" with respect to "valuation of a security." We do not believe the SEC staff intended the new guidance to have the effect of limiting a public company's ability to, for example, sell equity securities privately (e.g., in "PIPE" investments) if it routinely publishes guidance (and there is no change in the manner in which that guidance is published), and we do not expect market practice will change in this respect. [14]

Can an Acquiring Company Reach Out to a Target Company's Shareholders without Violating the Prohibition on General Solicitation?

Where an acquirer wishes to issue stock consideration to shareholders of the target company without registration under the Securities Act, we believe the staff's guidance referencing substantive pre-existing relationships established by third parties other than broker-dealers or investment advisers in Question 256.32, particularly when coupled with Question 256.27, confirms that the predicate relationship can be of a third party such as an acquisition target. The staff's previous guidance generally focused only on relationships established by broker-dealers, suggesting to some that broker-dealers were the only third parties that could establish these substantive pre-existing relationships on behalf of an issuer. We believe an acquirer may now without question reach out to shareholders of either a public or private target with whom neither the acquirer nor its agents (*e.g.*, financial advisers) have a direct relationship to determine whether they are accredited investors without violating the prohibition on general solicitation. The target company-shareholder relationship is sufficient to address the staff's concern about an issuer using "impersonal, non-selective means of communication" to find prospective investors.

The guidance does not, however, address whether a company ipso facto has a "substantive" relationship with its shareholders by virtue of the company-shareholder relationship. As the staff's guidance reiterates, it is a matter of facts and circumstances whether an issuer, itself or through a third party, has a relationship with a prospective investor sufficient to obtain information necessary to form the reasonable belief regarding accredited investor status required by Rule 502(b) and thus has the requisite substantive relationship. The relationship between a private company and its shareholders may, without more, be sufficient.[15] In the case of a public company target, it is likely the acquirer will need to do more, such as

[14] See Rule 168 under the Securities Act. Our interpretation is predicated on an analogy to Rule 168, which permits dissemination of forward-looking statements, including projections, without contravening the prohibition on gun jumping in the context of public offerings so long as the issuer disseminates that type of information regularly and the timing and manner of the dissemination are consistent with past practice.

[15] *Woodtrails-Seattle, Ltd*. (avail Aug. 9, 1982).

using an accredited investor questionnaire.[16] The staff cautions in Question 256.31 that "self-certification" alone (by checking a box) without any other knowledge of a person's financial circumstances or sophistication is not sufficient to form a substantive relationship.[17]

Is the Elimination of a Waiting Period a Significant Change?

The SEC's pronouncement that no waiting period is required to establish a substantive pre-existing relationship may have more of an impact on secondary market trading than on primary offerings (see below). The elimination of the waiting period should facilitate capital-raising for start-ups and smaller private companies that are less likely to use broker-dealers as placement agents, but for more substantial private companies, and for public companies, access to a broker-dealer's pre-established network/database of investors should generally continue to suffice. Where a company needs to reach out to investors directly—for example, to its own shareholders or to target shareholders in the acquisition context, the ability to move quickly once a substantive relationship is established will be helpful. The elimination of the waiting period would have been more significant if it applied to continuous offerings by hedge funds or private equity funds, but the guidance clearly states that investors who develop relationships with fund issuers must still wait 30 days before investing in already commenced and continuing offerings by those fund issuers.

4(1)(1/2) Resales: Is Secondary Market Trading the Real Winner?

Holders of restricted securities acquired in private placements may resell the securities publicly under Rule 144 subject to the restrictions of that rule. There is no corresponding rule, however, permitting *private* resales of securities without registration under the Securities Act. Over time, the practice of reselling securities in compliance with the restrictions that would otherwise apply to an issuer selling securities under Section 4(a)(2) has developed and has not been challenged by the SEC (and is referred to as Section "4(1)(1/2)" resale even though no such section exists in the Securities Act). We believe resellers of securities can rely on the August 2015 guidance and that the guidance, and particularly the elimination of the 30-day waiting period, will facilitate secondary market trading of private company equity through network-based platforms that establish substantive pre-existing relationships with accredited investors (and that may also execute trades).

Investor Networks Likely to Proliferate

Networks of accredited investors beyond broker-dealer investor databases are likely to proliferate as efficient mechanisms through which companies can find investors.[18] The new

[16] We note that public issuers routinely reach out to their debtholders when conducting private exchange offers, and the staff has also expressly permitted public companies to reach out to their own shareholders while still permitting those issuers to avail themselves of the safe harbor under Regulation D. See, e.g., *Silverton Resources, Ltd*., (avail. Feb. 4, 1985) (confirming that a Canadian, U.S. reporting company could conduct a rights offering in compliance with Regulation D after soliciting from its U.S. shareholders certification as to accredited investor status via subscription agreements). Public companies typically rely on Rule 135c to determine accredited investor status.

[17] The August 2015 guidance, however, does not address the nature of the information required to form a reasonable belief once a substantive relationship is established, which is fact dependent.

guidance resolves the conflict between the staff's guidance in IPONET and Lamp, on the one hand, and Agrinet, on the other, and leaves no doubt that using a proprietary or third-party agent's pre-established network to find investors for an offering is permissible. We expect that the number of such networks outside the broker-dealer community may increase. We also caution that the staff's favorable view of such networks may depend on whether they are either (1) formed around business and financial relationships, in the case of personal networks, or (2) developed based on established procedures to evaluate and communicate with investors, like the procedures sanctioned by the staff in the Citizen no-action letter, in the case of online databases of investors. While the Citizen procedures are not mandatory to form substantive pre-existing relationships with investors, we expect that they will be viewed as best practice, akin to a safe harbor for ensuring a substantive relationship exists with all investors in a network.

What's Really Left for Rule 506(c)?

Two years after its birth, the new avenue for private capital-raising created by Rule 506(c) has not been as successful as expected. While some have taken the view that the August guidance serves as a reminder (to funds, in particular) that Rule 506(b) is indeed limited by its prohibition on general solicitation, we believe the guidance actually confirms that, in practice, you really do know general solicitation when you see it. Because the guidance clarifies that a substantive pre-existing relationship is not terribly hard to form and can be used right away, we can be increasingly confident that only clear marketing or advertising tactics directed to a large and indiscriminate number of offerees constitutes general solicitation. We predict that in lieu of an increasing number of Rule 506(c) offerings, we will instead see an increase in the number of formal networks and platforms that pre-screen investors and serve as intermediaries to eliminate the need for issuers to go looking for investors.

Please feel free to call any of your regular contacts at the Firm or any of our partners and counsel listed under Capital Markets or Corporate Governance located in the "Practices" section of our website if you have any questions.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[18] A third party whose platform goes beyond maintaining investor lists to matching investors with certain companies or providing other investment advice may have to register as an investment adviser under the Investment Advisers Act of 1940. A third party that operates a website not only to maintain investor lists but also to effect the purchase and sale of securities for the account of others generally will be required to register with the SEC as a broker-dealer and comply with the laws and regulations applicable to broker-dealers. Securities Exchange Act of 1934, as amended, Sections 15(a)(1) and 15(b). See, e.g., *AngelList LLC* (avail. Apr. 3, 2013) (exempting AngelList from broker-dealer registration based in part on the fact that it will not handle actual trading; AngelList would assist investors in finding companies to invest in and accordingly registered as an investment adviser).

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Cleary Gottlieb Steen & Hamilton LLP
45th Floor, Fortune Financial Center
5 Dong San Huan Zhong Lu
Chaoyang District
Beijing 100020, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Abu Dhabi Global Market Square
Al Maryah Island, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099