A THEORETICAL ASSESSMENT OF PRIVATE PLACEMENTS UNDER RULE 506

SETH CHERTOK*

* Seth Chertok is a senior associate at Morrison & Foerster LLP, where he is a member of the Private Equity Fund Group and the Investment Management Group. Mr. Chertok graduated from the University of Pennsylvania Law School in 2005, where he was the recipient of the Lefever Prize for the best paper in law and economics. The views of Mr. Chertok in this article do not necessarily represent the views of Morrison & Foerster LLP. This article is based on an earlier draft of an article that appeared in the Journal of Private Equity. See Seth Chertok, Private Placements: A Theoretical Assement of SEC No-Action Letters, 14 J. PRIVATE EQUITY 61 (Winter 2010) available at http://www.iijournals.com/toc/jpe/14/1. Any similarity to the original article has been republished with permission from the Journal of Private Equity. The author would like to thank Ken Muller and Sangaran Sampanthan for their input.

I.
Introduction

Private placements are important to most private equity funds. Many private equity funds rely upon Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act) for investment company exemptions, each of which depends upon securing a valid private placement under the Securities Act of 1933 (Securities Act).[1]

1. Section 3(c)(1) of the Investment Company Act provides an exemption to "[a]ny issuer whose outstanding securities (other than short-term pa-

Section 4(2) of the Securities Act contains the exemption for private placements.[2]

Private equity funds exempt under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act seeking to obtain a private placement exemption usually rely upon Rule 506 under Regulation D, because Rule 506 is a safe harbor from the "private placement" exemption in Section 4(2) under the Securities Act.[3] Rules 504 and 505 under Regulation D were not promulgated under Section 4(2), but under the Commission's authority under Section 3(b) to adopt conditional exemptions for offerings not exceeding $5 million.[4] In one no-action letter, the SEC staff stated: "You may want to note that while offerings made in conformity with Rule 506 of Regulation D are deemed not to involve a public offering within the meaning of Section 3(c)(1), offerings made in compliance with, for example, Rule 505 are not necessarily non-public. . . ."[5] Therefore, Rules 504 and 505 should not be used to secure a private placement and should not be used by private equity fund sponsors that are relying upon the exemptions in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

As Rule 506 is a safe harbor, issuers failing to meet its requirements could always potentially achieve a valid private placement under Section 4(2) of the Securities Act. It is likely, especially in light of the U.S. Supreme Court's holding in *Ralston*, discussed below, that Section 4(2)'s criteria in certain instances would be less strict than Rule 506's criteria, which could be used as a fail safe if an issuer were somehow unable to qualify its offering under Rule 506. In Part II of this article,

---

per) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." Investment Company Act of 1940, 15 U.S.C. § 80a-3(c)(1) (2006). Section 3(c)(7)(A) thereunder provides an exemption to "[a]ny issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities." § 80a-3(c)(7)(A).

2. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (2006).

3. Regulation D, 17 C.F.R. § 230.506.

4. *See* Harold S. Bloomenthal, Securities Law Handbook §9:4 (2005 ed. 2005).

5. J.Y. Barry Arbitrage Mgmt., SEC No-Action Letter, 1989 WL 246531 (Oct. 18, 1989).

we therefore consider when a private placement can be achieved under Section 4(2) in light of SEC observations and judicial decisions. We note the view of the U.S. Supreme Court in *Ralston* is that a valid private placement under Section 4(2) generally hinges on suitability, on information considerations and on whether investors need the protection of the Securities Act.

In Part III of this article, we discuss the general requirements of the Rule 506 safe harbor. The most amorphous Rule 506 requirement is the requirement that there be no general solicitation or general advertising, and this requirement is the focus of this article.[6] Part IV therefore analyzes how the SEC staff has approached this issue through various no-action letters. This part attempts theoretically to ascertain how the SEC staff would view general solicitation and general advertising under Rule 506 according to a history of the SEC staff's no-action letters, focusing on issues that private equity fund sponsors will encounter. The purpose of this analysis is to create a theory of SEC staff no-action letters that can be relied upon by private equity fund sponsors when they engage in private placements under Rule 506, even though this article maintains that the SEC staff's approach, when granting no-action relief, has been too restrictive. Note that, in order to provide some context, Part III briefly discusses a few of the other requirements under Rule 506, but is not meant to be an exhaustive discussion of the other requirements. It should be noted that, as of the time of publication of this article, the SEC has been considering certain revisions to Rule 506. Furthermore, private placements under Rule 506 may be subject to FINRA rules, which are not the subject of this article.

Part V proceeds to analyze SEC enforcement proceedings and cases related to general solicitation and general advertising issues under Rule 506. On the whole, these enforcement proceedings and cases are less restrictive than the no-action interpretations of the SEC staff, and should provide considerable comfort to issuers. Readers should understand that the SEC has usually only brought enforcement action and federal courts have usually only found violations in comparatively egregious cases. Occasionally, a court has more readily found general solicitation violations, thereby illustrating the need for

6. 17 C.F.R. § 230.506; *see also* § 230.502.

a careful understanding of the theory of relevant SEC staff no-action letters. The fact that general solicitation and general advertisement violations are not typically found in SEC enforcement proceedings and court cases, except in egregious cases, suggests that the unavailability of no-action relief does not necessarily mean that a transaction would violate Rule 506. Nonetheless, an understanding of the SEC staff's implicit theory of private placements is helpful for providing transactional certainty when undertaking private placements.

Part VI contains a policy discussion of general solicitations and general advertising under Rule 506, and concludes that from a policy point of view, a weaker general solicitations and general advertising requirement is preferable, since it would provide more transactional certainty and better meet the policy goals of Rule 506. This conclusion is important, since in a letter dated April 6, 2011, SEC Chairman Schapiro advised an SEC staff review of whether the general solicitation ban should be revisited in light of the current technologies and capital raising trends.[7] If the Commission does revisit the general solicitation, this article recommends relaxing the general solicitation and general advertising restrictions.

Finally, Part VII summarizes our general conclusions on Section 4(2) and Rule 506.

II.
PRIVATE PLACEMENTS UNDER SECTION 4(2)

A. *SEC Observations*

In 1935, the SEC observed the following factors relating to the definition of a private placement: (1) the manner of the offering; (2) the relationship among offerees and offerees' relationship to the issuer; (3) the number of shares offered; and (4) the size of the offering.[8] The SEC has also stated that in its view Section 4(2) private placements are invalid if they result in general solicitation or general advertising.[9] While these fac-

7. Letter from Mary Schapiro, Chairman, SEC, to Rep. Darrell E. Issa, Chariman, U.S. H.R. Comm. on Oversight and Gov't Reform (Apr. 6, 2011), *available at:* http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

8. Securities Act Release No. 33,285, Fed. Sec. L. Rep. (CCH) ¶ 2740 at 2912 (Jan. 24, 1935).

9. *See, e.g.*, Proposed Rules for Nationally Recognized Statistical Rating Organizations, 73 Fed. Reg. 36,212, at 36,224 (June 25, 2008).

tors provide some guidance as to background principles that the SEC staff might consider in identifying a general solicitation, they create considerable uncertainty. Furthermore, very few judicial decisions have utilized this framework when analyzing the issue of private placements under Section 4(2).

B. *Judicial Decisions*

In 1953, the U.S. Supreme Court stated that the definition of a private placement may "turn on whether the particular class of persons affected needs the protection of the [Securities Act],"[10] which probably hinges on suitability considerations. The U.S. Supreme Court also indicated in that case that the number of offerees is not determinative of whether there is a public offering.[11] The court looked at whether the offerees have "access" to the same kind of information that registration would disclose and whether they are able to fend for themselves.[12]

Another test for determining if Section 4(2) is available has been laid out by the Ninth Circuit. The Ninth Circuit's test considers: "(1) the number of offerees, (2) the sophistication of the offerees, (3) the size and manner of the offering, and (4) the relationship of the offerees to the issuer."[13] This test is more restrictive than the U.S. Supreme Court's test, and should therefore not be followed.

C. *Relationship to Safe Harbor Rule 506*

Rule 506, which is discussed below, is a safe harbor to Section 4(2). As a result, in the event Rule 506 is unavailable, such as in the event a general solicitation or general advertisement occurs, it is possible that an issuer would be able to rely upon Section 4(2) if the above criteria were met. An introductory note to Regulation D states as follows: "Attempted compliance with any rule in Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of Rule 506 shall not raise any

10. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

11. *Id.*

12. *Id.*

13. Western Federal Corp. v. Erickson, 739 F.2d 1439, 1442 (9th Cir. 1984).

presumption that the exemption provided by Section 4(2) of the [Securities] Act is not available."[14] It is likely, especially in light of the U.S. Supreme Court's holding discussed above, that Section 4(2)'s criteria in certain instances would be less strict than Rule 506's criteria, which could be used as a fail safe if an issuer were somehow unable to qualify its offering under Rule 506.

III.
THE RULE 506 SAFE HARBOR

A. *Overview of Rule 506.*

In 1974, the Commission adopted safe harbor Rule 146 under the Securities Act, the predecessor to Rule 506. Rule 146 was an attempt to provide more clarity regarding the definition of a private placement. Most of its requirements are concrete and predictable, but, as discussed above, the precise boundaries of the prohibition against general solicitation and general advertisements are amorphous. The legislative history does not provide much guidance in this area.[15]

Rule 506 generally requires that (1) offers and sales be made by "issuers" only to "accredited investors" as defined in Rule 501 and to not more than 35 non-accredited investors who meet the sophistication requirements of Rule 506(b)(2)(ii); (2) restrictions on resale be observed under Rule 502(d); and most importantly (3) there be no "general solicitations" or "general advertisements" as defined by Rule 502 (c).[16]

Rule 502(c) includes a safe harbor that filing Form D online would not give rise to general solicitation and general advertising violations under Rule 502(c) if the information is provided in good faith and the issuer makes reasonable efforts to comply with the requirements of Form D.[17] Such a safe harbor would not be warranted if it merely shielded activity that is, in fact, intended to generate interest in the offering in violation of law. Similarly, Rule 502(c) includes a safe harbor from

14. Regulation D, 17 C.F.R. §§ 230.501-508, Preliminary Note 3.

15. Rule 146 – Transactions by an Issuer Deemed to not Involve any Public Offering - Adopted, 4 SEC NEWS DIG., no. 5, Apr. 23, 1974, at 2.

16. 17 C.F.R. § 230.506; see also §§ 230.501-2.

17. 17 C.F.R. § 230.502(c).

the prohibition on general solicitation and general advertising for a notification in compliance with Rule 135c of an unregistered offering by an issuer required to file reports under Section 13 or 15(d) of the Securities Exchange Act of 1934 (Exchange Act).[18] The information allowed to be included in a Rule 135C notification is limited to very basic identifying information about the issuer and the offering.[19]

Rule 502(c) also provides a safe harbor, which states that if the requirements of §230.135(e) are satisfied, providing any journalist with access to press conferences held outside of the Untied Stated, to meetings with issuer or selling security holder representatives conducted outside of the United states or to written press-related materials released outside the United States, at or in which a present or proposed offering of securities is discussed, will not be deemed to constitute general solicitation or general advertising.[20]

Under Regulation D, issuers must file a Form D with the SEC within 15 calendar days after the date of first sale of securities in the offering.[21] Issuers must also file Form D notices in each state where securities are offered. In addition, it is a good practice to provide all investors with disclosure through a Private Placement Memorandum (a "PPM").[22] Finally, issuers need to ensure that there are no integration problems that could compromise the availability of the Rule 506 exemption.[23]

18. 17 C.F.R. § 230.502(c)(2).

19. 17 C.F.R. § 230.135c(a)(3).

20. 17 C.F.R. § 230.502(c).

21. 17 C.F.R. § 230.503(a)(1).

22. Under Rule 10b-5 of the Exchange Act and Section 206 of the Advisers Act, the PPM disclosure documents should, among other matters, disclose risk factors and conflicts of interest. 17 C.F.R. § 240.10b-5 (2011); Investment Advisers Act § 206, 15 U.S.C.A. § 80b-6 (West 2011). In addition, fund sponsors may need to obtain approval of conflicts of interest under Section 206 of the Advisers Act, after full and fair disclosure thereof. *See* Investment Advisers Act § 206. Practitioners currently debate about whether such approval is needed. The type of disclosure that will satisfy applicable law will vary greatly from fund to fund. Counsel should be consulted.

23. *See* 17 C.F.R. § 230.502(a)(1).

B. *Issuer Requirement.*

Only issuers are permitted to rely upon Rule 506.[24] "Issuer," as defined in Section 2(a)(4) of the Securities Act, generally means "every person who issues or proposes to issue any security."[25] Control persons of issuers and other parties selling interests in secondary transactions would not be eligible to rely upon Rule 506. When trying to privately place securities, these persons are subject to the requirements of a hybrid exemption under the Securities Act called the Section 4(1)(1/2) exemption, which we do not consider in this article.[26]

C. *Accredited Investors and Sophisticated Investors.*

The term "accredited investor" has a different meaning depending on whether an investor is an individual or an entity. Following the recent enactment of the Dodd–Frank Wall Street Reform and Consumer Protection Act, an individual accredited investor is 1) a natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with his or her spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; or 2) a natural person whose individual net worth, or joint net worth with his or her spouse, exceeds $1,000,000 (as such amount is adjusted periodically by rule of the Commission), excluding the value of the primary residence of such natural person.[27] An entity accredited investor is "any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000."[28] However, the test varies for certain types of entities such as banks and trusts.

On January 25, 2011, in Securities Act Release No. 33-9177, the SEC proposed amendments to the accredited investor standards in its rules under the Securities Act to reflect the

---

24. 17 C.F.R. § 230.506(a).

25. Securities Act of 1933 § 2(a)(4), 15 U.S.C. § 77b(a)(4) (2006).

26. *See, e.g.*, Carl W. Schneider, *Section 4(1 1/2)—Private Resales of Restricted or Control Securities*, 49 OHIO ST. L. J. 501, 503-04 (1979).

27. 17 C.F.R. § 230.501(a)(5)-(6).

28. 17 C.F.R. § 230.501(a)(3).

requirements of Section 413(a) of the Dodd-Frank Act.[29] The focus of these proposed standards is to provide guidance for calculating net worth and determining the "primary residence." The SEC has not yet promulgated these proposed amendments.

Rule 506 also permits a fund sponsor, in addition to offering fund interests to accredited investors, to offer fund interests to up to 35 non-accredited investors, provided that each purchaser who is not an accredited investor has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.[30] In addition, when selling fund interests to non-accredited investors, the issuer is required to furnish specified information to purchasers under Rule 502(b).[31] For this reason, fund sponsors usually limit fund investors to "accredited investors."

D. *Restrictions on Resale.*

Securities that are privately placed under Rule 506 become restricted securities and cannot be resold without registration or an exemption therefrom.[32] Under the Securities Act, the definition of "sale" in Section 2(a)(3) encompasses more than just common law sales and includes most attempts to transfer, pledge, hypothecate, or otherwise dispose of interests.[33]

Under Rule 502(d), when making a Rule 506 offering, the issuer is required to exercise reasonable care to determine that purchasers of securities are not statutory underwriters.[34] The concept of a statutory underwriter is defined in Section 2(a)(11) of the Securities Act.[35] In general, a danger exists that any investor who transfers, pledges, hypothecates or oth-

29. Net Worth for Accredited Investors, Securities Act Release No. 3144, 76 Fed. Reg. 5307-01 (proposed Jan. 25, 2011).

30. 17 C.F.R. § 230.505(b). A purchaser representative's knowledge and experience can substitute for the investor's knowledge and experience. *Id.*

31. 17 C.F.R. § 230.502(b).

32. 17 C.F.R. § 230.502(d).

33. Securities Act of 1933, § 2(a)(3), 15 U.S.C. § 77b(a)(3) (2006).

34. 17 C.F.R. § 230.502(d).

35. 15 U.S.C. § 77b(a)(11).

erwise disposes of fund interests could be considered a statutory underwriter under the Securities Act. For this reason, many fund sponsors restrict "sales" of fund interests without the fund sponsor's consent. In addition, it is advisable to include a series of questions and representations in the investor's subscription agreement to make sure that an investor is not a statutory underwriter.

Rule 502 (d) sets forth further guidance on the exercise of reasonable care to determine that purchasers of securities are not statutory underwriters, which may be demonstrated by the following:

1. Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;
2. Written disclosure to each purchaser prior to sale that the securities have not been registered under the Securities Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available; and
3. Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Securities Act and setting forth or referring to the restrictions on transferability and sale of the securities.[36]

Rule 502 (d) states that while taking these actions will establish the requisite reasonable care, it is not the exclusive method to demonstrate such care.

E. *Cooling Off Periods.*

In the event a general solicitation or general advertising is made, some practitioners take the view that the issuer can impose a cooling off period where the issuer ceases all offering and sale activities until the cooling off period has ended.[37] Some practitioners believe that the cooling off period should be 30 calendar days, since Rule 155(c), which applies to a private offering following the abandonment of a registered offer-

36. 17 C.F.R. § 230.502(d).

37. *See, e.g.*, Federal Regulation of Securities Comm., ABA Bus. L. Section, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*, 66 BUS. LAW. 85, 121-22 (Nov. 2010).

ing, imposes a 30 calendar day cooling off period prior to undertaking the private offering.[38] Others believe a 45 calendar day cooling off period should be used. The SEC staff has not directly commented on how long a cooling off period would have to be.

F. *Integration of Regulation D Offerings.*

Under certain circumstances, the SEC can integrate multiple Regulation D offerings of an issuer in a way that would compromise the availability of the private placement exemption.[39] Rule 502(a) provides a safe harbor from integration for offers and sales more than six months before or after a Regulation D offering, so long as during those six-month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in Rule 405.[40] If an issuer fails to obtain the safe harbor, the SEC uses a subjective facts and circumstances analysis to determine whether or not to integrate, which includes the following five factors: (1) whether the sales are part of a single plan of financing; (2) whether the sales involve issuance of the same class of securities; (3) whether the sales have been made at or about the same time; (4) whether the same type of consideration is received; and (5) whether the sales are made for the same general purpose.[41] Not all factors need to be present for the SEC to integrate, and application of these factors is uncertain.

G. *Interaction with State Law.*

Rule 506 generally preempts state law registration requirements.[42] However, many states impose some or all of Form D notice filings, consents to service of process and filing fees. The Securities Act provides as follows:

Nothing . . . prohibits the securities commission (or any agency or office performing like functions) of any State from

38. 17 C.F.R. § 230.155(c).
39. 17 C.F.R. § 230.502(a)
40. *Id.*
41. *Id.*
42. Securities Act of 1933, § 18(b)(4)(D), 15 U.S.C. § 77r(b)(4)(D) (2006).

requiring the filing of any document filed with the Commission pursuant to this title, together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the state (if such sales data is not included in documents filed with the Commission), solely for notice purposes and assessment of any fee, together with a consent to service of process and any required fee.[43]

H. *Anti-Circumvention.*

Regulation D contains a preliminary note that prevents circumvention of its requirements:

In view of the objectives of these rules and policies underlying the [Securities] Act, Regulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the [Securities] Act. In such cases, registration under the [Securities] Act is required.[44]

I. *Relationship to Regulation S.*

Regulation D contains a preliminary note that explains the interaction between Regulation D and Regulation S:

Securities offered and sold outside the United States in accordance with Regulation S need not be registered under the [Securities] Act. See Release No. 33-6863. Regulation S may be relied upon for such offers and sales even if coincident offers and sales are made in accordance with Regulation D inside the United States. Thus, for example, persons who are offered and sold securities in accordance with Regulation S would not be counted in the calculation of the number of purchasers under Regulation D. Similarly, proceeds from such sales would not be included in the aggregate offering price. The provisions of this note, however, do not apply if the issuer elects to rely solely on Regulation D for offers or sales to persons made outside the United States.[45]

---

43. 15 U.S.C. § 77r(c)(2).

44. 17 C.F.R. §§ 230.501-508, Preliminary Note 6.

45. 17 C.F.R. §§ 230.501-508, Preliminary Note 7.

IV.
THE SEC STAFF'S INTERPRETATION OF GENERAL SOLICITATIONS AND GENERAL ADVERTISING UNDER RULE 506

A. *General Solicitations.*

1. *General Considerations Regarding General Solicitations.*

Without a doubt, the most difficult issue in private placements and the focus of this article is Rule 502(c). Rule 502(c) of Regulation D states that "[n]either the issuer nor any person acting on its behalf shall offer or sell the securities by means of any form of general solicitation or general advertising. . . ."[46] We note that placement agents and finders will usually be considered to be "acting on behalf" of the issuer and could create general solicitation or general advertising problems for the issuer.[47] Issuers would be well advised to ensure that any placement agents and finders comply with general solicitation and general advertising requirements, since their offering activities could potentially compromise the availability of a fund's private placement exemption.

Rule 502(c) notes that general solicitations and general advertising include, without limitation, the following: (1) any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.[48]

The SEC staff has noted in several no-action letters that identification of a general solicitation depends on all the facts and circumstances.[49] Thus, these factors do not provide concrete guidance for funds seeking to place their securities to investors. Determining what is a general solicitation or general advertising therefore requires an intricate facts-and-circumstances analysis. This article attempts to provide a theoretical framework of the history of SEC staff no-action letters in order

46. 17 C.F.R. § 230.502(c) (2011).

47. *See* Alaska Co., SEC No-Action Letter, 1978 WL 13695 (Oct. 10, 1978) (noting that a finder would have to comply with the general solicitation restrictions).

48. 17 C.F.R. § 230.502(c)(1)-(2) (2011).

49. *E.g.*, Randall S. Dalton, SEC No-Action Letter, 1984 WL 45369 (June 22, 1984).

to ascertain what activities are permissible in the view of the SEC staff without triggering general solicitation or general advertising problems.

The SEC staff has permitted several different types of relationships not to be considered general solicitations. In general, the SEC staff allows issuers or certain persons soliciting on behalf of issuers to solicit prospective investors on the basis of pre-existing substantive relationships. In general, when an issuer itself does not have a direct pre-existing substantive relationship with a prospective investor, an issuer may be able to rely upon the pre-existing substantive relationship of its officers, directors, general partners or investment advisors. More broadly, this article theorizes that an issuer can, under certain circumstances, triangulate relationships of its investment advisor, with portfolio companies or with registered investment advisers, with their clients or related persons. The no-action letters do not state whether an investment adviser could triangulate its relationship with an unregistered investment adviser with its clients or related persons. This manner of creating a limited solicitation, which we call triangulating, is our theoretical invention, based on our assessment of SEC staff no-action letters. Another type of pre-existing substantive relationship can be created by using the pre-existing substantive relationships of registered broker-dealers, even where the issuer itself does not have a relationship with the broker-dealer. One of the advantages of registered broker-dealers is that it appears, under limited circumstances, that they can create pre-existing substantive relationships through certain types of questionnaires. It is doubtful whether non-registered broker-dealers and issuers could qualify for limited solicitations by using questionnaires. Below, we first discuss the pre-existing substantive relationship requirement in more detail. We then consider general solicitation issues related to online offerings. In particular, we focus on the ability of the issuer and its agents to use online questionnaires to expand the scope of prospective offerees and the requirement that the issuer limit solicitation of prospective investors by having password-protected websites.

2. *Pre-existing "Substantive Relationships" of Issuer or Person Soliciting on Behalf of Issuer.*

a. Pre-existing Substantive Relationships in General.

> The SEC staff has broadly stated:
> The types of relationships with offerees that may be important in establishing that a general solicitation has not taken place are those that would enable the issuer [or 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.[50]

However, the precise boundaries of what constitutes a pre-existing substantive relationship are not well understood. Below, we track the theoretical boundaries of the pre-existing substantive relationship, utilizing an analysis of applicable SEC staff no-action letters.

b. Awareness of Financial Circumstances.

If the issuer and its agents are unaware of the financial circumstances or sophistication of the offerees, offering securities to individuals even within pre-existing substantive relationships would likely constitute a general solicitation.[51] Moreover, it would be advisable for the fund sponsor to determine that the prospective investor is an accredited investor and "has such knowledge and experience in financial and business matters that it he or she is capable of evaluating the merits and risks of the prospective investment."[52] This article assumes in its conclusions that the appropriate suitability determinations will always have been made.

---

50. Mineral Lands Research and Mktg. Corp., SEC No-Action Letter, 1985 WL 55694 (Dec. 4, 1985).

51. *See* E.F. Hutton & Co., SEC No-Action Letter, 1985 WL 55680 (Dec. 3, 1985) (concluding that even though an issuer had a pre-existing relationship, the specific suitability questionnaire used did not sufficiently establish a prospective offeree's financial circumstances and sophistication).

52. Woodtrails-Seattle, Ltd., SEC No-Action Letter, 1982 WL 29366 (Aug. 9, 1982) (noting that the SEC arrived at a no-action position with regard to a general solicitation issue because, in part, the general partner determined that the investors met certain suitability standards).

c. Offerees with whom there is a Pre-Existing Substantive Relationship Suggesting Other Offerees.

If an accredited offeree with whom there is a pre-existing substantive relationship suggests that the offering be made to an unidentified person who is also accredited, without any solicitation on the part of issuer or on behalf of issuer, the subsequent solicitation of the other person likely does not involve a general solicitation.[53]

d. Pre-Existing Substantive Relationships.

It should be noted that the SEC staff has not given very specific guidance as to the nature and extent of the relationship required in order for the relationship to be considered a pre-existing substantive relationship. In *Bateman-Eichler*, the SEC staff examined the extent to which a broker-dealer may mail offering materials that were not offered or contemplated for offering at the time a suitability questionnaire was distributed.[54] The broker-dealer sent the offering materials 45 days after the mailing of the suitability questionnaire, which the staff permitted.[55] In the issuer context, it is likely that the SEC staff would require a more extensive pre-existing relationship, since there are no no-action letters similar to *Bateman-Eichler* that apply to issuers. Furthermore, it is possible that the SEC staff would accept a shorter pre-existing relationship period, at least in certain contexts. For example, in *E.F. Hutton*, the SEC staff gave no-action relief to an investment bank whose pre-existing relationship with investors was established prior to the time the investment bank began participating in the Regulation D offering.[56]

Further, the SEC staff has suggested that a pre-existing relationship should not be too stale. In *Woodtrails-Seattle*, the SEC staff noted that it reached a no-action position because each proposed offeree had a pre-existing relationship with the gen-

53. See Arthur M. Borden, SEC No-Action Letter, 1978 WL 13723 (Oct. 6, 1978).

54. Bateman-Eichler, Hill Richards, Inc., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2918 (Dec. 3, 1985). This no-action letter is discussed in more detail later

55. Id.

56. *See* E.F. Hutton & Co., *supra* note 52.

eral partner of the issuer, which relationship was established within the prior three years.[57]

If an issuer by itself does not have a pre-existing substantive relationship with a prospective investor, the issuer has several options. The issuer can consider (1) using the pre-existing substantive relationship of its officers, directors, general partner, or investment advisors; (2) using the pre-existing substantive relationship of its broker-dealers; and (3) triangulating certain relationships. Each of these options is discussed below.

e. Pre-existing Substantive Relationship of Officers, Directors, General Partners and Investment Advisors.

An issuer may be able to use the pre-existing relationship of its officers, directors, general partners, and investment advisors. In *Mineral Lands*,[58] most of the investors would be solicited through one officer and director of the issuer. The SEC staff appeared to acknowledge that the relationship of the officer and director was the relationship of the issuer by stating that "the existence of relationships between an issuer and offerees is an important factor in determining whether offers violate Rule 502(c)." However, the SEC staff could not grant no-action relief due to the fact that insufficient financial information was known about the investors. Also, as discussed previously, in *Woodtrails-Seattle*, the SEC staff allowed a fund to use the pre-existing relationship of its general partner.[59] Furthermore, in *Quest*,[60] the SEC staff permitted a fund to use certain pre-existing relationships of its investment advisor. The ability to use the relationships of officers, directors, general partners and investment advisors is important, since it can potentially expand the types of offerees falling within a limited solicitation.

57. Woodtrails-Seattle, Ltd., *supra* note 53.

58. Mineral Lands Research and Mktg. Corp., *supra* note 51.

59. *See* Woodtrails-Seattle, Ltd., *supra* note 53.

60. Royce Exch. Fund Quest Advisory Corp., SEC No-Action Letter, 1996 WL 490692 (Aug. 28, 1996).

f. Pre-existing Substantive Relationships through Triangulations.

i. The Concept of Triangulations.

As just discussed, sometimes funds attempt to triangulate 1) the pre-existing relationship of the fund, its officers, directors, general partners, or investment advisors with persons and entities with whom such parties have a pre-existing substantive relationship and 2) the pre-existing relationship of those persons and entities with whom such parties have a pre-existing substantive relationship, with other persons and entities with whom they, in turn, have pre-existing substantive relationships. Triangulating business relationships raises complicated issues.

ii. Triangulating the Investment Advisor's Relationships with its Portfolio Companies, with its Portfolio Companies' Relationships with Related Persons of Portfolio Companies.

In Quest,[61] the SEC staff granted no-action relief to a fund's investment advisor that solicited investors for a fund where neither the fund nor the fund advisor had pre-existing relationships with proposed investors. The fund's investment advisor was able to triangulate its relationship with its portfolio companies so as to solicit certain related persons of such portfolio companies. The likely conditions of the no-action relief were as follows: 1) the investment advisor had a pre-existing relationship that lasted more than one year with the portfolio companies in which the investment advisor invested its clients' assets; 2) the investment advisor knew and had contact for more than one year through visits, analyst meetings, and telephone calls with at least one executive officer of each portfolio company; and 3) each portfolio company related person included present or former executive officers or directors of, and/or pre-initial public offering investors in, such company or a member of his or her immediate family, not a more distant relative or social or business acquaintance. In granting no-action relief, the SEC staff explicitly noted the nature and extent of each part of the triangulation, and also stated that a different set or class of investors could require a different con-

61. Id.

clusion. It is therefore unclear whether the SEC staff would reach similar conclusions in other kinds of triangulation fact patterns.

iii. Triangulating the Investment Advisor's Relationships with Other Registered Investment Advisors with the Other Registered Investment Advisors' Relationships with their Clients.

In Royce Quest,[62] the SEC staff allowed a fund advisor to solicit investors for a fund where neither the fund nor the fund advisor had pre-existing relationships with proposed investors. The fund's investment advisor was able to triangulate its relationship with certain other registered investment advisors so as to solicit clients of such registered investment advisors. The likely conditions of the no-action relief were as follows: 1) each registered investment advisor had been, for more than one year, a part of the fund's investment advisor's network of financial planners whose clients invested in shares of mutual funds managed by the fund's investment advisor; 2) each registered investment advisor managed or supervised client securities portfolios of more than $25 million; and 3) each registered investment advisor's relationship with its client existed for more than one year. In granting no-action relief, the SEC staff explicitly noted the nature and extent of each part of the triangulation, and also stated that a different set or class of investors could require a different conclusion. It is therefore unclear whether the SEC staff would reach similar conclusions in other kinds of triangulation fact patterns, and whether the SEC staff would reach similar conclusions if an investment adviser tries to triangulate its relationship with unregistered investment advisers and their clients or related persons. Where an issuer attempts to create pre-existing relationships through various types of triangulations, the above analysis demonstrates that generally the nature and extent of the requisite relationship with prospective offerees will be augmented. However, triangulations have the potential to expand the types of offerees falling within a limited solicitation.

62. Id.

iv. The One-year Theory.

Quest suggests that a triangulation may succeed where there is a close business relationship on each side of the triangulation that lasts for more than one year, since Quest provided no-action relief in two separate scenarios where these elements were met. However, whether the SEC staff would grant no-action relief in all situations where this one-year theory was met is unclear, and would depend on the facts and circumstances of the particular case.

g. Pre-existing Substantive Relationships of Registered Broker-dealers.

Broker-dealers can also allow issuers to expand the scope of potential offerees, while keeping the offering as a limited solicitation. As we will see, registered broker-dealers also have limited ability to qualify new offerees for private placements through the use of questionnaires. In general, the issuer does not have to have a pre-existing relationship with the registered broker-dealer.

i. Issuer's Ability to Use a Broker-dealer's Pre-existing Relationships without Having a Pre-existing Relationship with the Broker-dealer.

A fund can typically use a registered broker-dealer placement agent's pre-existing substantive relationships without establishing a pre-existing relationship with the placement agent, as would be the case for other triangulations. For example, in the context of Rule 146, the predecessor to Rule 506, the SEC staff stated that "Rule 146(c) does not proscribe the making of an offer through 'another broker-dealer as an intermediary' to qualified offerees located by such 'other broker-dealer,' assuming the broker-dealer intermediary solicits qualified offerees within the confines of Rule 146."[63] In reaching this conclusion, the SEC staff did not state that an issuer had to have a pre-existing relationship with a broker-dealer. Rather, it was sufficient that the broker-dealer solicited offerees with whom it had a substantive pre-existing relationship.

63. Borden, *supra* note 54.

ii. Placement Agent's Ability to Use its Substantive Pre-existing Relationships with Investors.

In E.F. Hutton,[64] an investment banking firm that acted as general partner and selling agent was able to offer to investors that had previously participated in public offerings and private placements sponsored or sold by the investment bank. The likely conditions of the no-action relief, based on the representations in the letter, were that 1) the investment bank solicited investors with whom it had a pre-existing relationship; 2) such investors invested with the investment bank in the three years prior to when the offering materials were sent; and 3) a suitability questionnaire was on file within 12 months prior to the offer and the investment bank had made a suitability determination.

In *E.F. Hutton,* the investment bank documented and maintained for five years after the sale of the securities the following types of information about each purchaser: 1) the source of contact or referral, 2) the nature of the relationship with offeree, 3) previous investments with the investment bank, 4) information distributed to offeree and 5) a copy of the most recent suitability questionnaire.

Fund sponsors that use broker-dealers may therefore want to ask for confirmation that they are maintaining these types of records and for proof that the broker-dealer has complied with the preceding conditions. In addition, fund sponsors will want to understand the broker-dealer's procedures for avoiding general solicitation problems.

iii. Ability of Broker-dealers to Establish Pre-existing Relationships through Questionnaires with Investors with whom the Broker-dealer Does Not Currently Have a Pre-existing Relationship.

In Bateman-Eichler, where a registered broker-dealer did not have pre-existing substantive relationships with prospective investors, the SEC staff granted no-action relief that permitted the registered broker-dealer to send questionnaires to establish suitability and pre-existing relationships.[65] The SEC staff noted that the particular conditions of the no-action relief

64. E.F. Hutton & Co., *supra* note 52

65. *See* Bateman-Eichler, *supra* note 55.

were that 1) the questionnaires were generic questionnaires that did not reference any specific investment currently offered or contemplated for offering by the broker-dealer; 2) the broker-dealer implemented procedures to ensure that persons solicited were not offered any securities that were offered or contemplated for offering at the time of the solicitation; 3) after reviewing responses to the questionnaires, the account executives would follow up to obtain additional personal and financial information about the respondents; and 4) the respondent provided a satisfactory response to a questionnaire with sufficient information that enabled the broker-dealer to evaluate the prospective offeree's sophistication and financial circumstances. Other circumstances that may have supported the no-action relief are as follows: 1) the questionnaire was mailed to a limited number of local professionals and businessmen (no more than 50 per broker-dealer account executive); 2) respondents who satisfactorily completed the follow-up stage would be placed on a list of prospective offerees for programs of the type in which the respondent indicated an interest and for which the respondent was deemed suitable in light of the program's suitability standards; and 3) offering materials were not sent for a minimum of 45 days after the mailing.

In *E.F. Hutton*, discussed above, the investment bank that acted as a sales agent also tried to use questionnaires to establish a pre-existing substantive relationship.[66] The SEC staff agreed that it was possible to use a questionnaire to establish a pre-existing substantive relationship, but noted that Hutton's questionnaire did not provide sufficient information to evaluate the prospective investor's sophistication and financial condition.

In *H.B. Shaine*,[67] the SEC staff "indicated that a satisfactory responses . . . to a questionnaire that provides a broker-dealer with sufficient information to evaluate the respondent's sophistication and financial situation" could be used to create a pre-existing relationship. The no-action letter contained similar conditions for relief as in *Bateman-Eichler* but also approved a form of questionnaire. Placement agents seeking to establish pre-existing substantive relationships with prospective inves-

66. *See* E.F. Hutton & Co., *supra* note 52.

67. H.B. Shaine & Co., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2004 (May 1, 1987).

tors should model their questionnaire after the *H.B. Shaine* questionnaire, which requested specific information concerning the respondent's employment history, business experience, business or professional education, investment experience, income, and net worth. In particular, the *H.B. Shaine* questionnaire asked about "income" as well as "adjusted gross income" as shown on the prospective investor's tax return in order to determine whether the prospective investor was an "accredited investor." The *H.B. Shaine* questionnaire asked the respondents to express their own opinion as to their ability to evaluate the merits and risks of investments. The SEC staff noted that while responses to *H.B. Shaine* questionnaires would establish a pre-existing relationship, they would not in themselves establish suitability.

h. Ability of Issuers to Establish Pre-existing Relationships through Questionnaires with Investors with whom the Issuer Does Not Currently Have a Pre-existing Relationship.

Although there is some uncertainty on this point, the issuer can attempt to use a questionnaire on its own initiative to create pre-existing substantive relationships, but any such attempt should comply with *E.F. Hutton, Bateman Eichler* and *H.B. Shaine.* In *Quest,*[68] the issuer, in footnote 8, suggested that *Bateman Eichler* was not limited to the broker-dealer context and could potentially be relied upon in the issuer context. The issuer stated:

> While these letters involved broker-dealers, broker-dealers in private placement transactions are acting as agents for issuers. However, Regulation D does not require an issuer to act through an agent. Moreover, under basic principles of agency law, the agent's authority derives from that of its principal and thus issuers must, *a fortiori,* have the same authority to conduct solicitation activities as their broker-dealer agents.

Furthermore, in footnote 5, the issuer noted that there need not be an actual business relationship between the issuer and its prospects if the issuer has information to evaluate the

68. Royce Exch. Fund Quest Advisory Corp., *supra* note 61.

prospective offeree's sophistication and financial circumstances.

However, in Release No. 33-7856, the SEC criticized issuers for attempting to establish pre-existing substantive relationships with prospective investors through websites without using broker-dealers as intermediaries and suggested that the previously discussed no-action letters were limited to the broker-dealer context.[69] The SEC also noted that many issuers using websites were not using questionnaires. In addition, the circumstances surrounding that Release suggest that general solicitations problems were more likely to arise in the online context where investors could be solicited in large numbers.

As a result, it is not necessarily the case that an issuer using questionnaires in the manner previously described should give rise to an invalid private placement. Nonetheless, due to the uncertainty involved in this area, issuers usually use broker-dealers when attempting to establish pre-existing substantive relationships with investors through questionnaires. Thus, if issuers desire to expand the scope of prospective offerees using questionnaires, it would be advisable to do so through registered broker-dealers.

i. Ability of Non-registered Broker-dealer Finders to Establish Pre-existing Relationships through Questionnaires with Investors with whom the Non-broker-dealer Finder Does Not Currently Have a Pre-existing Relationship.

Note that the no-action letters discussed in the broker-dealer context took place where a placement agent was a registered broker-dealer. The SEC staff never expressly stated when it described its conditions on no-action relief that the placement agent must be a registered broker-dealer as opposed to a non-registered broker-dealer finder. A finder is a type of placement agent that matches prospective investors with issuers. Note that many (or perhaps most) finders must register as broker-dealers, in which case they would theoretically be able to rely upon the broker-dealer no-action letters. Assuming that a finder was a non-registered broker-dealer that potentially fit into a narrow exemption from broker-dealer registration, such

69. Use of Electronic Media, Release No. 33-7856, 2000 SEC LEXIS 847 (Apr. 28, 2000).

as a pure introductory services finder that did not receive transaction-based commissions and met the other conditions necessary for an exemption, the rationale for permitting a registered broker-dealer to use its pre-existing relationships could theoretically also apply to a non-registered broker-dealer finder. Professor Louis Loss, the intellectual father of modern securities law, notes that "[i]n order to determine when a communication is a *general advertisement or general solicitation,* the SEC staff has broadly distinguished communications directed to persons with whom the issuer *or someone acting on its behalf* has a pre-existing business or substantive relationship from communications directed to others."[70] Professor Loss did not state that only registered broker-dealers would be considered persons acting on behalf of the issuer. In addition, even the SEC staff once suggested that a finder acts on behalf of the issuer.[71] Further, the plain language of Rule 502(c) does not state that only registered broker-dealers would be considered persons acting on behalf of the issuer.

Furthermore, there is no reason why registered broker-dealers should be able to market to their pre-existing substantive relationships, but non-registered broker-dealer finders should not be able to market to their pre-existing substantive relationships. In analyzing general solicitation problems, the theoretical focus should be on the pre-existing substantive relationships of the issuer or anyone acting on its behalf, and the awareness of the financial circumstances or sophistication of the persons with whom the relationship exists. Nonetheless, due to uncertainty, future no-action writers will likely need to seek clarification on this issue. Therefore, issuers that plan to expand the scope of prospective offerees will likely want to use registered broker-dealers to do so.

3. *Online General Solicitation Issues.*

In *IPONET* and *Lamp Technologies,* the SEC staff extended the logic of its no-action letters that permit broker-dealers to establish pre-existing relationships through questionnaires to

70. 3 Louis Loss et. al., Securities Regulation 351 (4th ed. 2008).

71. *See* Alaska Co., *supra* note 48 (noting that a finder would have to comply with the general solicitation restrictions).

the online context.[72] One advantage of using registered broker-dealers when attempting to expand the scope of prospective offerees is registered broker-dealers may make it easier to conduct online offerings as well.

In *IPONET*[73], an affiliate of a broker-dealer set up a website to build pre-existing relationships with prospective investors through online questionnaires. The online questionnaires were only made available to persons who had registered as members of the website and had requested access to the questionnaires. Following a suitability determination based on the questionnaires, the prospective investors would receive access to a password-protected portion of the website that contained offering materials. The SEC staff granted no-action relief subject to the following conditions: 1) both the invitation to complete the questionnaire and the questionnaire itself would be generic in nature and would not reference any specific transactions posted or to be posted on the password-protected page of the website; 2) the password-protected page of the website would be available to a particular investor only after the broker-dealer had made the determination that the particular potential investor is accredited or sophisticated; and 3) a potential investor could purchase securities only in transactions that were posted on the password-protected page of the website after that investor's qualification with the website.

In *Lamp Technologies*[74] , a website that was operated by a web operator unaffiliated with any investment advisors intended to post information about fund offerings. In order to obtain access to the offering information on the website, prospective investors were required to complete a questionnaire. The website operator would then make a suitability determination. Prospective investors that qualified would receive access to a password-protected website with offering information. The SEC staff granted no-action relief and noted conditions

72. IPONET, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 642 (July 26, 1996); Lamp Tech., Inc., SEC No-Action Letter, 1997 SEC No-Act. LEXIS 638 (May 29, 1997) [hereinafter 1997 Lamp Tech. Letter]; Lamp Tech., Inc., SEC No-Action Letter, 1998 SEC No-Act. LEXIS 615 (May 29, 1998) [hereinafter 1998 Lamp Tech. Letter].

73. IPONET, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 642 (July 26, 1996).

74. 1997 Lamp Tech. Letter, *supra* note 73; 1998 Lamp Tech. Letter, *supra* note 73.

similar to what it noted in *IPONET*, but added an additional waiting-period condition that required subscribers to agree not to invest in any posted fund (other than funds in which the subscriber or its affiliates already invests, has already been solicited for, or is already actively considering an investment in) for 30 days following the subscriber's qualification. The waiting period in *Lamp Technologies* differed because *Lamp Technologies* involved a situation where there were semi-continuous offerings and it was not practical to purchase securities only in offerings that were posted after the investor's qualification with the website.

IPONET and *Lamp Technologies* do not address whether issuers without broker-dealers could undertake online offerings on password-protected web-sites with prospective investors with whom the issuer had substantive pre-existing relationships following a suitability determination. As discussed above, Release No. 33-7856 noted that it disfavors the idea of an issuer using questionnaires to create pre-existing relationships in the online context, particularly where third party services provide who are neither registered broker-dealers nor affiliated with registered broker-dealers establish such web sites. This Release does not address the idea of whether an issuer by itself could undertake an online offering on a password-protected website with investors with whom it had a substantive pre-existing relationship irrespective of the questionnaires.[75]

In *IPONET*, the SEC staff appeared to allow a broker-dealer to build an accredited investor database subject to the conditions and in the manner previously described. However, in *Agristar*,[76] the SEC staff declined no-action relief when a communications company attempted to build an accredited investor database. In *Agristar*, the communications company would have sent questionnaires to build pre-existing relationships to approximately 7,500 prospective investors, which number was probably too broad for the SEC staff to grant no-action relief. Furthermore, the communications company would have attempted to build the accredited investor database without a broker-dealer.

---

75. Use of Electronic Media, *supra* note 70.

76. Agristar Global Networks, Ltd., 2004 SEC No-Act. LEXIS 203 (Feb. 9, 2004).

This suggests that issuers should use broker-dealers in the online offering context, and should ensure that the broker-dealers do not attempt to create relationships with too many prospective offerees. One way of controlling access to questionnaires would be only to make questionnaires available to prospective investors that registered on a website.

As a related issue, the SEC has expressed its view that placing offering materials on a web site, without sufficient procedures to limit access only to accredited investors, is inconsistent with the prohibition against general solicitation or general advertising in Rule 502(c).[77]

B. *General Advertisements.*

1. *General Concept.*

As previously discussed, under Rule 502(c), "general advertisements" includes, among other things, "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio."

2. *Tombstone Advertisements.*

The SEC staff has stated in a no-action letter that a tombstone advertisement announcing the completion of an offering would fall within the scope of a general advertising, unless the tombstone advertisement would have no immediate or direct bearing on contemporaneous or subsequent offers or sales of securities. This could occur, for example, following the completion of an isolated Regulation D offering.[78]

---

77. *See, e.g.*, Proposed Rules, supra note 9, at 36,224.In the context of international offerings, the SEC has expressed the position that offering materials posted on a web site would not be viewed as a general solicitation in the U.S. so long as the offeror implements precautionary measures that are reasonably designed to ensure that the Internet offer is not targeted to persons in the United States or to U.S. persons. *See* Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, 63 Fed. Reg. 14,806, at 14,809 (Mar. 27, 1998) (discussing such precautionary measures).

78. Alma Securities Corp., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2647 (Aug. 2, 1982).

3. *Syndicator Advertising.*

The SEC staff has stated that institutional advertising relating to a syndicator (but not to a limited partnership that it syndicated) would violate Rule 502(c) if it were published while the syndicator was offering and selling securities, or if the syndicator expected to offer or sell securities in the near future.[79] As a result, fund sponsors take risks when they undertake syndicator advertising while the offering is in place or when the offering is contemplated in the near future.

4. *Broker-dealer Advertising.*

In *ENI Corporation*,[80] the SEC staff gave no-action relief with respect to a broker-dealer's general advertisement. The SEC staff emphasized that the advertisement related only to certain tax-sheltered investments in general (rather than to specific programs offered), did not relate to programs offered by a specific sponsor, and did not invite prospective interested offerees to request additional information. However, if the broker-dealer were an affiliate of the issuer, the SEC staff would likely conclude that the broker-dealer advertisement was a general advertisement.[81]

5. *Third-party Publications.*

Third-party publications that appear not to be advertisements can be considered general advertisements. In *J.D. Manning* [82], a third-party publisher sought to publish a periodic newsletter containing a list and description of closely held businesses that expected to raise capital in future private placements. Participating businesses prepared material for inclusion in the newsletter and paid for publication. The SEC staff

79. *See, e.g.*, Gerald F. Gerstenfeld, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2790 (Dec. 3, 1985).

80. ENI Corp., SEC No-Action Letter, 1975 SEC No-Act. LEXIS 2438 (Dec. 3, 1975).

81. *See* J. WILLIAM HICKS, LIMITED OFFERING EXEMPTIONS: REGULATION D, §§ 3:57, 3:60 (Westlaw); Remco Sec. Co., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2455 (Aug. 20, 1985).

82. J.D. Manning, Inc., SEC No-Action Letter, 1986 WL 65354 (Feb. 28, 1986).

denied no-action relief.[83] In *Oil and Gas Investor*, the SEC staff suggested that purely factual information relating to offerings prepared by issuers and published with a magazine could result in an invalid private placement, particularly where the issuer played a large role and even where the newsletter received no consideration, although the SEC staff expressed no definite opinion on that point.[84] In addition, in *Tax Investment Information*, the SEC staff declined to give no-action relief where a company sought to quantify and summarize private placement memoranda data.[85]

However, *Nancy H. Blasberg* suggests that the SEC staff would not object if an unaffiliated publisher discussed private placements if it included very limited information obtained from public sources about completed offerings and if it did not act in the employ of or as an agent for the issuer.[86]

V.
SEC Enforcement Proceedings and Cases Relating to General Solicitation and General Advertisements Under Rule 506

A. *SEC Enforcement Proceedings.*

Readers should understand that the SEC has usually only brought enforcement actions with respect to general solicitations and general advertisements in comparatively egregious cases. This article surveys below most of the enforcement actions between the years 2000 and the present.

---

83. *See also* The Texas Investor Newsletter, SEC No-Action Letter, 1984 SEC No-Act. LEXIS 1582 (Jan. 23, 1984) (denying no action relief for circumstances similar to J.D. Manning, Inc.).

84. Oil & Gas Investor, SEC No- Action Letter, 1983 WL 28633 (Nov. 30, 1982).

85. Tax Inv. Info. Corp., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 1737 (Feb. 7, 1983).

86. Nancy H. Blasberg, SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2519 (July 12, 1986); *see also* Richard Daniels, SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2874 (Dec. 19, 1984) (a newsletter publishing information "derived totally from public records," where "all limited partnerships formed within the State of Arizona would be included, . . . no analysis . . . would be made, and . . . none of the issuers listed nor anyone acting on their behalf would be responsible for the preparation of or payment for the materials included in the publication" would not violate Rule 502(c) of Regulation D).

In *LeDay*, a private placement also failed because of general solicitation as a result of cold calling.[87] In *Prendergast*, the SEC concluded that a broker-dealer that placed an advertisement in a newspaper announcing a seminar on hedge funds resulted in a violation of Rule 502(c), the general solicitation and general advertising requirement related to Rule 506.[88] This was because the purpose of the advertisement was to whet interest in hedge funds, and the purpose of the seminar itself was to attract investors. In *Inorganic Recycling*, the SEC also brought a complaint where the issuer solicited more than 1,000 prospective investors.[89] Generally, most private equity funds have fewer than 500 investors in order to avoid registration under the Exchange Act, so this should be irrelevant to most private equity funds. In *Tier One*, the SEC found a violation when a broker-dealer engaged in a public solicitation on behalf of an issuer, and then the issuer solicited these public persons with whom neither party had a prior relationship.[90] In *Three Oaks*, the respondents mailed general solicitations that were unsolicited to individuals with whom it had no prior relationship.[91] The SEC found a private placement violation.

In *PriorityAccess*, the SEC found a violation of Rule 506 and Section 4(2) of the Securities Act when the issuer sent mass e-mails to individuals with whom it did not have a pre-existing substantive relationship without undertaking an appropriate suitability analysis.[92] In *Klein*, the SEC concluded that the offer, sale and operation of hedge funds were not exempt from the registration provisions of the Securities Act because of general solicitation through seminars, the radio and the In-

87. Jason LeDay, Securities Act. Release No. 8198, 2003 SEC LEXIS 491 (Feb. 28, 2003).

88. Prendergast, Exchange Act Release No. 44632, 2001 SEC LEXIS 1533 (Aug. 1, 2001).

89. SEC v. Inorganic Recycling Corp., Litigation Release No. 16322, 1999 SEC LEXIS 2075 (Sept. 30, 1999).

90. Tier One, Inc., Securities Act Release No. 8793A, 2007 SEC LEXIS 864 (Apr. 24, 2007).

91. Kenzie, Inc., Securities Act Release No. 7965, 2001 SEC LEXIS 579 (Mar. 28, 2001).

92. PriorityAccess, Inc., Securities Act Release No. 8021, 2001 SEC LEXIS 2056 (Oct. 3, 2001).

ternet.[93] In *Robinson*, the SEC filed a complaint alleging an invalid private placement under Regulation D when an issuer solicited investors on its website, in newspapers and in roadside billboards.[94] The trial judge subsequently upheld the SEC's position.[95] In *CGI Capital*, a private placement failed due to general solicitation because respondent sent e-mail messages to several thousand individuals, some of whom did not have any pre-existing relationship with the respondent, and the respondent also failed to conduct a suitability analysis.[96]

In *James F. Glaza*, the SEC concluded that when an issuer solicited only accredited investors, there was no general solicitation or general advertising.[97] The administrative tribunal did not consider any other issues.

Almost all of the enforcement proceedings between 2000 and the present involved situations where the issuer or the broker-dealer had no relationship with the offeree and the solicitation was truly public. This trend suggests that the standard of what is a general solicitation or a general advertising under Rule 506 is narrower than the theory used in SEC no-action letters, and that the private placement standard under Section 4(2) and Rule 506 is considerably broader than SEC no-action letters suggest. Furthermore, the *Glaza* proceeding potentially suggests that a private placement would be valid if only accredited investors were solicited. This view would be in conformity with the U.S. Supreme Court's view of private placements, which held that private placements may "turn on whether the particular class of persons affected needs the protection of the [Securities Act]."[98] It should be noted that since certain of these enforcement proceedings relating to online

93. In the Matter of Gerald Klein & Assoc., Inc. and Klein Pavlis Peasley Financial, Inc., Securities Act Release No. 8585, 2005 SEC LEXIS 1679 (July 8, 2005).

94. SEC v. Robinson, Litigation Release No. 16752, 2000 SEC LEXIS 2130 (Oct. 4, 2000).

95. SEC v. Robinson, No. 00-Civ.-7452 RMB AJP, 2002 WL 1552049, at *1, *4 (S.D.N.Y. July 16, 2002) (discussing the trial court's conclusions).

96. CGI Capital, Inc., Securities Act Rel. No. 7904, Exchange Act Release No. 43387, 2000 SEC LEXIS 2081 (Sept. 29, 2000).

97. James F. Glaza, Initial Decisions Release No. 293, 2005 SEC LEXIS 1798 (ALJ July 21, 2005).

98. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

offerings, the SEC has provided no-action guidance, as discussed above, which likely supplants certain of its prior enforcement proceedings relating to online offerings.

B. *Cases.*

Typically, federal courts have also only found general solicitations and general advertisements under Rule 506 in egregious cases. One federal court affirmed a finding of general solicitation under Rule 502(c) where the issuer solicited potential investors in a public library and advertised open meetings in a local newspaper.[99]

Another federal court held that a nationwide cold-calling campaign constitutes a form of general solicitation under Rule 502(c).[100] In 1991, one federal court found general solicitation within the meaning of Rule 502(c) where an issuer cold-called only two investors with whom it did not have a pre-existing relationship.[101] As a result of the occasional court more readily finding general solicitation problems, a solid understanding of SEC staff no-action letters helps to provide transactional certainty in Rule 506 private placements. However, a more recent federal court in 2011 suggested that cold calling would only involve a general solicitation if it were sufficiently broad.[102] Another court held that cold calling involved genuine issues of material fact on the issue of general solicitation when defendant maintained that the cold calling was designed merely to collect information to determine whether the issuer was speaking with accredited investors, and it was only after

99. Cheng Hsu v. PBIG Mgmt. Co., 291 F. App'x 809, 811 (9th Cir. 2008).

100. SEC v. Tecumseh Holdings Corp., No. 03 Civ. 5490 (SAS), 2009 U.S. Dist. LEXIS 119869, at *13 (S.D.N.Y. Dec. 22, 2009). In a different case, a federal court held that waiting one week before following up on the cold call was not sufficient to escape general solicitation. *See* SEC v. Credit First Fund, LP, No. CV05-8741 DSF (PJWx), 2006 U.S. Dist. LEXIS 96697, at *44 (C.D. Cal. Feb. 13, 2006).

101. Johnston v. Bumba, 764 F. Supp. 1263, 1275 (N.D. Ill. 1991).

102. *See* Cobalt Multifamily Investors I, LLC v. Arden, No. 06 CV 6172 (KMW)(MHD), 2011 U.S. Dist. LEXIS 117097, at *4 (S.D.N.Y. Sept. 9, 2011) (stating that "there is no evidence of the breadth of the cold-calling campaign. Accordingly, it is unclear whether Cobalt's cold-calling campaign would exclude application of the Rule 505 and 506 exemptions. . ..).

determining that the investors were accredited that sales were solicited.[103]

One case also held that soliciting the public through a publicly available website was a general solicitation.[104]

Finally, it should be noted that one federal court denied a motion to dismiss where complainant alleged that the issuer widely distributed its business plan and approached a large number of potential investors in a fashion that likely constituted general solicitation or general advertising within the meaning of Rule 502(c).[105]

Almost all of the cases discussed, like the enforcement proceedings analyzed above, involved situations where the issuer or the broker-dealer had no relationship with the offeree and the solicitation was truly public. This trend suggests that the standard of what is a general solicitation or a general advertising under Rule 506 is narrower than the theory used in SEC no-action letters, and that the private placement standard under Section 4(2) and Rule 506 is considerably broader than SEC no-action letters suggest.

VI.
THEORETICAL APPROACH TO GENERAL SOLICITATION AND GENERAL ADVERTISEMENTS

Since the requirements of Rule 506 other than general solicitation and general advertisements are clear and concrete, the Commission should loosen its standard for granting no-action relief. Rule 506 builds in suitability considerations through the "accredited investor" standard, which is the main requirement for a private placement under *Ralston*, as articulated by the U.S. Supreme Court.[106] Furthermore, in the investment adviser context, most investment advisers charge performance fees and are therefore subject to the augmented

103. Nolfi v. Ohio Kentucky Oil Corp., Nos. 5:06CV260, 5:06CV506, 2008 U.S. Dist. LEXIS 39284, at *18 (N.D. Ohio May 12, 2008).

104. SEC v. Rabinovich & Assocs., LP, No. 07 Civ. 10547 (GEL), 2008 U.S. Dist. LEXIS 93595, at *13 (S.D.N.Y. Nov. 17, 2008).

105. Lopes v. Vieira, 543 F. Supp. 2d 1149, 1168-69 (E.D. Cal. 2008).

106. SEC v. Ralston Purina Co., 346 U.S. 119, 124-25 (1953) (the court states the applicability of the private placement exemption should turn on whether the investor requires the protection of the Act, permitting exemption for sophisticated, "accredited" investors).

"qualified client" suitability standards under the Advisers Act or applicable state law.

Whether an investor is a "qualified client" depends upon meeting certain dollar thresholds as set forth in Rule 205-3.[107] "Qualified clients" were generally defined to include (i) natural persons or companies that immediately after entering into the contract have at least $750,000 under management with the adviser ("Assets under Management Test") and (ii) natural persons or companies that the adviser reasonably believes, immediately prior to entering the contract, either have a net worth of more than $1,500,000 at the time the contract is entered into (together, in the case of a natural person, with assets held jointly with a spouse) ("Net Worth Test") or are "qualified purchasers," as defined in the Investment Company Act, at the time the contract is entered into.[108] The SEC recently announced its intention to revise the Assets under Management Test to $1 million and Net Worth Test to $2 million.[109] Thus, there is an even stronger argument today that Rule 506 investors do not need the protection of the Securities Act. Furthermore, certain investment advisors that advise Section 3(c)(7) exempt funds under the Investment Company Act market only to "qualified purchasers," an even higher standard of suitability.

Finally, it should be noted that the purpose of Rule 146, the predecessor of Rule 506, was to provide transactional certainty. The adopting notice stated:

The Commission believes that a rule creating greater certainty in the application of the Section 4(2) exemption is in the public interest for two reasons. First, such a rule should deter reliance on that exemption for offerings of securities to persons who are unable to fend for themselves in terms of obtaining and evaluating information about the issuer or of assuming the risk of investment. These persons need the protections afforded by the registration process. Second, such a rule should reduce uncertainty to the extent feasible and provide more objective standards upon which responsible business-

107. 17 C.F.R. § 275.205-3(d)(1).

108. *Id.*

109. Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Investment Advisors Act Release No. 3,236 at 3-4 (July 12, 2011).

men may rely in raising capital in a manner that complies with the requirements of the Act.[110]

The Commission staff's interpretations of general solicitation and general advertising run contrary to these policy goals, because they create standards that do not provide transactional certainty and deny investment advisers the opportunity to market to suitable investors. A weaker general solicitation and general advertising requirement would help to provide transactional certainty and to better achieve the policy goals of Rule 146.

This conclusion is important, since in a letter dated April 6, 2011, SEC Chairman Schapiro advised an SEC staff review of whether the general solicitation ban should be revisited in light of the current technologies and capital raising trends. If the Commission does revisit the general solicitation, this article recommends relaxing the general solicitation and general advertising restrictions.

VII.
CONCLUSION

This article has explained the Section 4(2) and Rule 506 safe harbor thereunder. As Rule 506 is a safe harbor, issuers failing to meet its requirements could always potentially achieve a valid private placement under Section 4(2) of the Securities Act. It is likely, especially in light of the U.S. Supreme Court's holding in *Ralston*, discussed above, that Section 4(2)'s criteria in certain instances would be less strict than Rule 506's criteria, which could be used as a fail safe if an issuer were somehow unable to qualify its offering under Rule 506. The view of the U.S. Supreme Court in *Ralston* is that a valid private placement under Section 4(2) generally hinges on suitability, on information considerations and on whether investors need the protection of the Securities Act.

Part III of this article briefly discussed the major general requirements of the Rule 506 safe harbor. The most amorphous Rule 506 requirement is the requirement that there be no general solicitation or general advertising. Part IV there-

110. Notice of Adoption of Rule 146 under the Securities Act of 1933 – "Transactions by an Issued Deemed not to Involve any Public Offering," Securities Act Release No. 33-5487, 4 SEC Docket 154, 156 (Apr. 23, 1974).

fore analyzed how the SEC staff has approached this issue through various no-action letters, and ascertained the theoretical boundaries of Rule 506 private placements with respect to general solicitations and general advertisements per the SEC staff, based on SEC staff no action relief. Based on the view of the SEC staff, this article explains how issuers can expand the scope of their prospective offerees without violating general solicitation prohibitions, even when they do not themselves have a relationship with the prospective investors. Triangulations and the utilization of registered broker-dealers are the principal tools that the SEC staff allows for expanding the scope of prospective investors. However, this article maintains that the SEC staff's approach, when granting no-action relief, has been too restrictive.

Part V analyzed SEC enforcement proceedings and cases related to general solicitation and general advertising issues under Rule 506. On the whole, these enforcement proceedings and cases are less restrictive than the no-action interpretations of the SEC staff, and should provide considerable comfort to issuers. Readers should understand that the SEC has usually only brought enforcement action and federal courts have usually only found violations in comparatively egregious cases. Occasionally, a court has more readily found general solicitation violations, thereby illustrating the need for a careful understanding of the theory of relevant SEC staff no-action letters. The fact that general solicitation and general advertisement violations are not typically found in SEC enforcement proceedings and court cases, except in egregious cases, suggests that the unavailability of no-action relief does not necessarily mean that a transaction would violate Rule 506. Nonetheless, an understanding of the SEC staff's implicit theory of private placements is helpful for providing transactional certainty when undertaking private placements.

Finally, we note that a weaker general solicitation and general advertising requirement would help to provide transactional certainty and better achieve the policy goals of Rule 146, the predecessor to Rule 506.[111] The SEC staff's overly stringent interpretations of general solicitation and general

111. A weaker general solicitation and general advertising requirement was proposed in Advisory Committee on Smaller Public Companies, Release Nos. 33-8666, 34-53385, 2006 SEC LEXIS 485 (Feb. 28, 2006).

advertising run contrary to these policy goals, because they create standards that do not provide transactional certainty and deny investment advisers the opportunity to market to suitable investors.

This conclusion is important, since in a letter dated April 6, 2011, SEC Chairman Schapiro advised an SEC staff review of whether the general solicitation ban should be revisited in light of the current technologies and capital raising trends. If the Commission does revisit the general solicitation, this article recommends relaxing the general solicitation and general advertising restrictions.