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MoFo Classics Series:
Private Placement Market Developments

Thursday, September 14, 2017
8:30 AM – 9:30 AM EDT
Morrison & Foerster Seminar

Presenter:
Anna Pinedo, Morrison & Foerster LLP

1. **Presentation**

2. **Solicitation of Comments by the Nasdaq Listing and Hearing Review Council about the Definition of Market Value for Purposes of Shareholder Approval Rules**

3. **FINRA Regulatory Notice 17-17 – Updated Private Placement Filer Form**

4. **SEC Opinion in *KCD Financial Inc.***

5. **SEC Advisory Committee Recommendations on Accredited Investor Definition**

6. **Recent SEC C&DIs Relating to Changes Made to Rules 144A and 506 Permitting General Solicitation**

7. **Practice Pointers on: Navigating the Securities Act's Prohibition on General Solicitation and General Advertising**

8. **Late Stage Private Placements: A Life Sciences Sector Survey**

9. **Confidentially Speaking, This Could be a Big Deal: The SEC's Approach to Confidential Submissions**

10. **Securities Offerings and Communications: Is the Integration Bogeyman Dead?**

11. **Infographic – PIPE Transactions 2016**

12. **Infographic – U.S. Late Stage Financings**

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Private Placements

September 2017

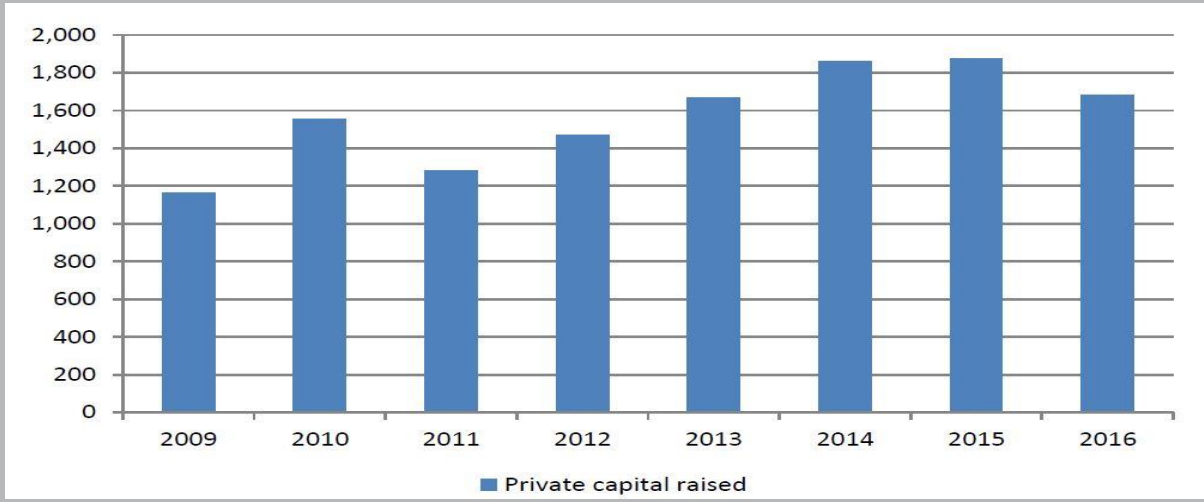
Reliance on Private or Exempt Offerings

- Pre-JOBS Act, based on various studies, it was already the case that more capital was being raised in reliance on Regulation D and Rule 144A (in aggregate) than in SEC-registered offerings—according to the SEC's Division of Economic Research and Analysis (DERA), in 2014, for example, the total raised in registered offerings was $1.35 trillion whereas the total raised through all private offerings was $2.1 trillion
  - Amounts raised in private offerings are likely to be understated given that many issuers fail to file Form Ds and amounts raised in 4(a)(2) offerings are not reported
  - The amounts raised in registered offerings include debt offerings, whereas the majority of Reg D offerings involve equity or "new capital"

Trends

- Total primary unregistered issuance dropped from a peak of $1.87 trillion in 2015 to $1.68 trillion in 2016
- Amounts raised through exempt securities offerings of debt and equity for 2012 through 2016 combined exceeded amounts raised through registered offerings of debt and equity over the same time period by approximately 26%

Capital raising through unregistered offerings (in $ billions)



Source: DERA analysis

Rule 506

- Offerings in reliance on Rule 506(b) and Rule 506(c) raised $4.23 trillion across over 71,000 deals

Capital raised through Rule 506(b) and Rule 506(c) offerings: September 23, 2013 - December 31, 2016

Rule	Form D Filings	Number of Amendment Filings	Total amount sold* ($ billions)	Mean amount sold ($ millions)	Median amount sold ($ millions)	Median offer size ($ millions)
506(c)	5,474	874	$108	$13	$0.7	$2.4
506(b)	65,772	33,430	$4,122	$26	$1.6	$2.2
All 506	71,146	34,304	$4,230	$25	$1.5	$2.3
Regulation D**	73,556	50,491	$4,232	$24	$1.4	$2.0

Source: DERA analysis

* Total amount sold includes incremental amounts reported to be raised in amended filings (Form D/As). Mean and median amounts sold based on initial (new) Form D filings only. Median offer size is based on offerings that report their amount of offering.
** Includes all four rules: Rules 504, 505, 506(b) and 506(c).

Rule 506(b) Versus Rule 506(c)

- Issuances claiming the Rule 506(c) exemption have accounted for 3% of the reported capital raised pursuant to Rule 506 since becoming effective in September 2013 through December 31, 2016
- The average amount reported sold in an initial Rule 506(c) offering ($13 million) is much smaller than the average amount reported sold in a Rule 506(b) offering ($26 million)
- From September 23, 2013, to December 31, 2014, approximately 398 continuing Regulation D offerings switched their exemption to Rule 506(c)
- "Repeat" issuers (issuers that used to access the Regulation D market via Rule 506(b) offerings) have switched their offering types from Rule 506(b) to initiate 447 Rule 506(c) offerings

“Privates” Have Become More Public

- Over the years, and not spurred by the JOBS Act, private placements and exempt offerings have become more “public”
  - The shortened Rule 144 holding period has helped increase liquidity for “restricted securities”
  - The prevalence of hybrid offering techniques has changed capital-raising
  - Relaxation of the prohibition on general solicitation
  - New financial intermediaries that rely principally on the internet
  - A broader universe of investors interested in investing in the securities of private companies and interested in participating in PIPE transactions

Changing Dynamics

- There has been continued focus on the ways in which companies can use the internet or broader means of communication in order to establish relationships with potential investors
- Also, given increased interest in general solicitation, some private placement exemptions that historically have received little attention, such as Rule 504 and “intrastate” crowdfunding (Rule 147), were recently modernized
- All of this is likely to lead to many more exempt offering alternatives for companies and more fluidity between private placements and public offerings

Section 4(a)(2) Versus Rule 506(b)

4(a)(2) or Rule 506

- Since adoption of the amendments to Rule 506, placement agents have been more focused on structuring private placements as Section 4(a)(2) offerings rather than Rule 506 offerings
- This is attributable largely to:
  - Sales being limited to institutional accredited investors;
  - Avoiding addressing bad actor disqualification provisions; and
  - Avoiding Form D filings
- However, the choice as between Section 4(a)(2) and Rule 506 should be addressed early in the process
- Certain firms will not deliver no-registration opinions in the case of Section 4(a)(2) private placements

Engagement Letter

- In addition to addressing the exemption or safe harbor for the offering, placement agents also should address a number of other matters in the engagement letter:
  - That no general solicitation will be used
  - That offers will be made only to "institutional accounts," institutional accredited investors, qualified purchasers and QIBs;
  - That the placement agent will be a third-party beneficiary of issuer and investor representations and warranties;
  - To the extent that the placement agent is not a named third-party beneficiary of investor representations, that the company will use its best efforts to assist the placement agent in obtaining "big boy" style representation letters from the investors
  - That the placement agent will be an addressee or may expressly rely on legal opinions delivered to the investors

Limiting the Offerees

- There are a number of reasons to limit the offers to institutional accounts, institutional accredited investors and QPs/QIBs
  - Sophistication and wherewithal to bear risk
  - No reliance on placement agent for diligence
  - Enforceability of big boy style representations and disclaimers of liability for the placement agent
  - An institutional account can make its own suitability determinations
  - If you are relying on Section 4(a)(2), the securities will not be covered securities for NSMIA
  - FINRA Rule 5123

- Even under circumstances in which the purchase price for the securities is sent directly to the company, for natural persons, FINRA expects that the placement agent will have undertaken KYC and AML

Limiting the Offerees, cont'd.

Materials

- For private placements for an already public company, typically only the company's Exchange Act filings will be used in connection with a private placement. From time to time, if there are special circumstances, an investor presentation will be used and, to the extent that the investor presentation contains MNPI, it will have to be included in the cleansing 8-K when the entry into definitive purchase agreements is announced
- For private placement for privately held companies and for foreign (non-U.S.) domiciled companies, often questions arise from the company as well as from the private placement team concerning the types of materials that can be used with potential offerees

- Generally, if offers are being made solely to institutional investors, institutional investors should be permitted to undertake their own diligence, and this can be facilitated by providing access to a data room
- If this is the case, materials should be limited to a "company presentation," rather than a PPM or CIM or the like
- The company presentation should be prepared by the company and reviewed by the placement agent and its counsel
- We are often asked, what about teasers?

Materials, cont'd.

- Private placements ***are*** subject to:
  - Section 17(a) (the antifraud provision) of the Securities Act
  - Section 10(b) (the antifraud provision) and Section 20(a) (the "control person" provision) of the Exchange Act
  - State securities laws ("Blue Sky" laws)
  - State common law of fraud and negligent misrepresentation
  - FINRA suitability, advertising and supervisory rules
- Who "made" the misstatement?
  - Under Rule 10b-5, it is unlawful for "any person, directly or indirectly, . . . [t]o make any untrue statement of material fact" in connection with the purchase or sale of a security

- In *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court held that the investment advisor to a mutual fund could not be held liable under Section 10(b) for alleged misstatements in the fund's prospectus because the investment advisor did not have "ultimate authority" over the statements
- "One 'makes' a statement by stating it . . . One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed. "
- In *Tobia v. United Group of Companies*, a federal court held that a placement agent for a private placement could not be held liable under *Janus* for misstatements in the PPM regarding the placement agent's compensation
  - BUT the court held that the placement agent could be held liable for related omissions in its Form ADV
- *Janus* does not apply to common law fraud claims
- In *King County v. IKB Deutsche Industriebank*, a federal court held that a placement agent in a private placement could be held liable for allegedly fraudulent credit ratings, even though Rating Agencies, and not the placement agent, "made" the misstatements

Materials, cont'd.

General Solicitation

Staff Guidance on General Solicitation

- The SEC Staff has issued various CDIs that reaffirm or restate existing principles and guidance related to the types of communications that constitute a general solicitation
  - General business communications made in the ordinary course are not a general solicitation
  - Communications on an unrestricted website constitute a "general solicitation"
  - Communications that are directed and bilateral do not constitute a general solicitation
  - Communicating with individuals or groups with whom the issuer or its agent has a pre-existing substantive relationship is not a general solicitation
    - Who can establish a pre-existing relationship?
    - What makes the relationship "substantive"?
    - How long does the relationship have to have existed?

No General Solicitation or Advertising

- Importance of preexisting substantive relationship with offerees
  - SEC Staff guidance has been provided through numerous no-action letters, including a recently issued no-action letter (*CitizenVC*)
  - The issuer or the issuer's agent (may include a broker-dealer or a registered investment adviser) must have developed an understanding of the offeree's sophistication and financial circumstances
  - Having a click box regarding the potential offeree's status is not sufficient, nor is having the potential offeree provide responses to a more detailed questionnaire, unless further inquiry or diligence is undertaken

Using General Solicitation

- In a transaction with a financial intermediary, the issuer, the financial intermediary and their counsel should discuss the types of communications that will be used, and all communications should be approved by the issuer and its counsel
  - This can be covered in the engagement letter and/or the placement agency agreement (if there is one) in a manner similar to that in which market participants address the use of test-the-waters materials or FWPs
- The issuer should establish its own media or communications policy and identify the officers that are permitted to speak on its behalf
  - The issuer will want to ensure that it controls the solicitation process and that employees and other unauthorized persons are not engaging in general solicitation on its behalf
  - The issuer will want to review its social media policy
  - An issuer that is a private fund or a CPO may be subject to more prescriptive rules relating to the content of the communications

- If a registered broker-dealer is participating in the offering, it will want to ensure that:
  - It has identified the group within the bank that will be involved
  - It has undertaken training to make certain that each member understands the requirements under FINRA Rule 2210 and FINRA Rule 5123
    - Under FINRA Rule 2210, most communications likely to be used in connection with general solicitation will be considered "retail communications"
    - Communications must be fair and balanced
    - Communications will be subject to review, filing with FINRA and recordkeeping requirements
  - It will want to remind bankers of the firm's social media policy
- FINRA already is focused on Regulation D offerings and recently announced a sweep on social media issues

Using General Solicitation, cont'd.

Integration

Integration and Rule 506(c)

- The Staff issued guidance in the form of a C&DI in November 2016, which is Question 256.34
- **Question**: An issuer has been conducting a private offering in which it has made offers and sales in reliance on Rule 506(b). Less than six months after the most recent sale in that offering, the issuer decides to generally solicit investors in reliance on Rule 506(c). Are the factors listed in the Note to Rule 502(a) the sole means by which the issuer determines whether all of the offers and sales constitute a single offering?
- **Answer**: No. Under Securities Act Rule 152, a securities transaction that at the time involves a private offering will not lose that status even if the issuer subsequently decides to make a public offering. Therefore, we believe under these circumstances that offers and sales of securities made in reliance on Rule 506(b) prior to the general solicitation would not be integrated with subsequent offers and sales

of securities pursuant to Rule 506(c). So long as all of the applicable requirements of Rule 506(b) were met for offers and sales that occurred prior to the general solicitation, they would be exempt from registration and the issuer would be able to make offers and sales pursuant to Rule 506(c). Of course, the issuer would have to then satisfy all of the applicable requirements of Rule 506(c) for the subsequent offers and sales, including that it take reasonable steps to verify the accredited investor status of all subsequent purchasers

- Prior to issuance of this C&DI, Rule 152 had been relied upon principally in the context of PIPE transactions, wherein the issuer enters into a definitive purchase agreement and subsequently files a resale registration statement
- Although the SEC has addressed integration safe harbors in the context of adopting the amendments to Regulation A and adopting Regulation CF, additional integration questions remain. It would be helpful for the SEC to revisit the area.

Integration and Rule 506(c), cont'd.

Accredited Investor Definition

"Accredited Investor" Reviews

- Dodd-Frank Act provides that, upon enactment and for four years following enactment, the net worth threshold for accredited investor status will be $1 million, excluding the equity value (if any) of the investor's primary residence
- One year after enactment, the SEC is authorized to review the definition of the term "accredited investor" (as it is applied to natural persons) and to adopt rules that adjust the definition, except for modifying the net worth threshold
- Four years after enactment, and every four years thereafter, the SEC must review the "accredited investor" definition as applied to natural persons, including adjusting the threshold (although it may not be lowered below $1 million)
- In December 2015, the SEC Staff issued its report on the review of the "accredited investor" definition

New Accredited Investor Definition

- A new accredited investor definition is likely to be among the first actions undertaken by the SEC
- The accredited investor study was delivered a few years ago, the overwhelming number of comment letters to the SEC regarding the definition support elements highlighted in the study and Commissioner Piwowar has been very outspoken on the standard
- The SEC's Advisory Committee on Smaller and Emerging Companies has put forward its recommendations, which include:
  - Holding the income/net worth standards at current thresholds
  - Make adjustments as needed for inflation
  - Regardless of income/net worth thresholds, include within the definition persons who have passed certain broker-dealer and CFA exams

- Other groups have strongly advocated adding “knowledgeable employees” to the accredited investor definition

New Accredited Investor Definition, cont’d.

Rule 5123

FINRA Rule 5123

- Rule 5123 provides that a member firm participating in a non-public offering submit to FINRA, or have submitted on its behalf by a designated member, a copy of any private placement memorandum, term sheet or other offering document, including any materially amended versions of those documents, used in connection with the offering within 15 calendar days of the date of first sale or indicate to FINRA that no such documents were used
- Rule 5123 provides exemptions from the filing requirement based on the type of purchaser and the type of offering, which effectively limit application of the rule to non-institutional private placements
- **Notice Filing Requirement**: Members selling securities issued by non-members in a private placement must file the private placement memorandum, term sheet or other offering documents with FINRA within 15 days of the date of the first sale of securities or indicate that there were no offering documents used
  - The notice filing requirement is for all member firms, not just the lead

- **Exemptions**: Exemptions for non-convertible debt or preferred; 3(a)(3) exempt securities; 144A/Reg S offerings or offerings solely to QPs/QIB, "institutional accounts" or certain types of institutional accredited investors under Rule 501(a)(1), (2), (3) or (7)
  - The principal type of unregistered offering that would be impacted by new Rule 5123 would be a "Regulation D" or "Section 4(2)" offering to individual investors
- **Confidentiality**: Confidentiality provisions similar to those included in Rule 5122.

FINRA Rule 5123, cont'd.

FINRA Private Placement Form

- To facilitate submission of the required information, FINRA developed the Private Placement Filer Form for the processing of specified private placement filings through FINRA's Firm Gateway, an abbreviated version of which has been in use since FINRA Rule 5123's effectiveness on December 3, 2012
- Member firms must complete and submit the Private Placement Form electronically through FINRA's Firm Gateway
- The Private Placement Filer Form requests the following information:
  - Identifying and contact information for the member and the issuer
  - Disclosure of any affiliate relationship between the member and the issuer or sponsor
  - Basic information about the nature of the offering (e.g., type of security, offering size, offering period, underwriting discounts/commission, etc.)

- On August 19, 2013, FINRA updated the Private Placement Filer Form to include six additional questions:
  - Is the offering a contingency offering?
  - Does the issuer have any independently audited financial statements for the issuer's most recent fiscal year?
  - Is the issuer able to use offering proceeds to make or repay loans to, or purchase assets from, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor or any of the issuer's affiliates?
  - Does the issuer have a board of directors comprised of a majority of independent directors or a general partner that is unaffiliated with the firm?
  - Has the issuer engaged, or does the member anticipate that the issuer will engage, in a general solicitation in connection with the offering or sale of the securities?
  - Has the issuer, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor or any of the issuer's affiliates been the subject of SEC, FINRA or state disciplinary actions or proceedings or criminal complaints within the last 10 years?

FINRA Private Placement Form, cont'd.

- In May 2017, FINRA updated the Private Placement Filer Form again; the amendments:
  - Add additional questions regarding the FINRA member and whether the placement agent is acting on an exclusive basis as well as whether there are any affiliations with the issuer
  - Add many more questions regarding the offering focused on the type of investors, whether the investors are non-accredited, whether there is a minimum purchase amount, whether there is a contingency, etc.

FINRA Private Placement Form, cont'd.

PIPE Market Trends

Market Trends

- Trends affecting the market for PIPE transactions include the following:
  - Most transactions now take the form of shelf takedowns
  - Most shelf takedowns are either pre-marketed (wall-crossed) offerings or marketed on an accelerated basis rather than traditionally marketed underwritten offerings
  - PIPE transactions have declined in number, but they remain useful under certain circumstances

PIPE Market Trends

	Number of Deals	*Dollars Raised*
2017, through 6/30/2017	642	$20.3 billion
2016	1,197	$50.9 billion
2015	1,097	$57.0 billion
2014	1,177	$34.6 billion
2013	1,099	$23.8 billion
2012	1,116	$36.1 billion
2011	1,246	$29.5 billion
2010	1,529	$38.8 billion
2009	1,272	$41.8 billion

**Data*: Total Placements/Total Dollars 01/01/2017 – 06/30/2017

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PIPEs by the Numbers 2017*

Security Type (# of Placements)		*Security Type ($ millions raised)*
Common Stock	439	$14,446
Preferred Stock: Convertible	62	$2,056
Preferred Stock: Non-Convertible	1	$19
Debt: Convertible	58	$1,662
Debt: Non-Convertible	15	$543
Other: Convertible	1	$3
Prepaid Warrant	25	$867
Equity Line	41	$714
Unknown	0	$0
Total:	**642**	**$20,310**

**Data*: Total Placements/Total Dollars 01/01/2017 –– 06/30/2017

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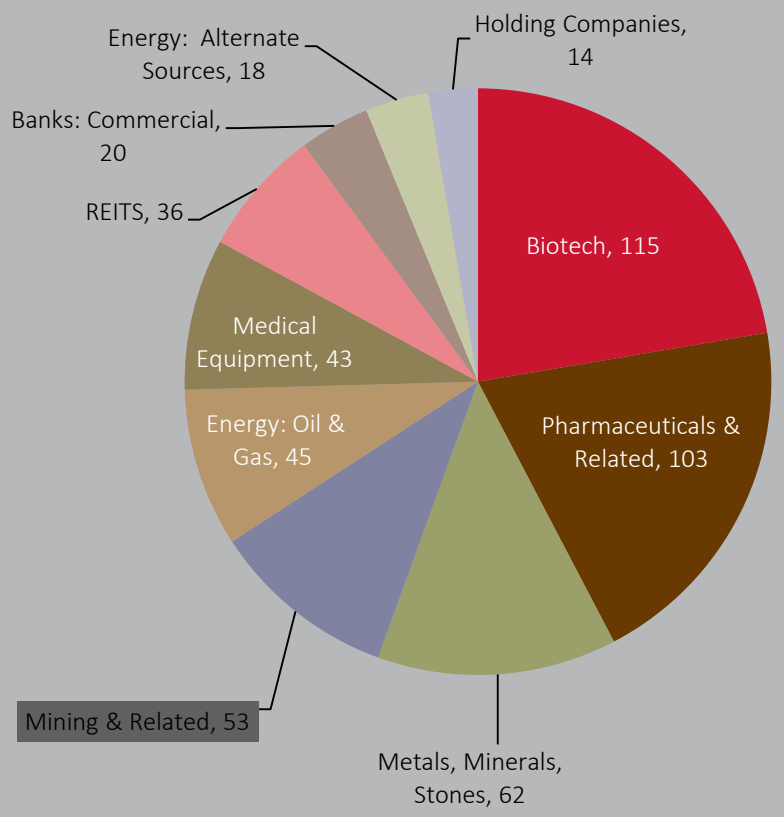
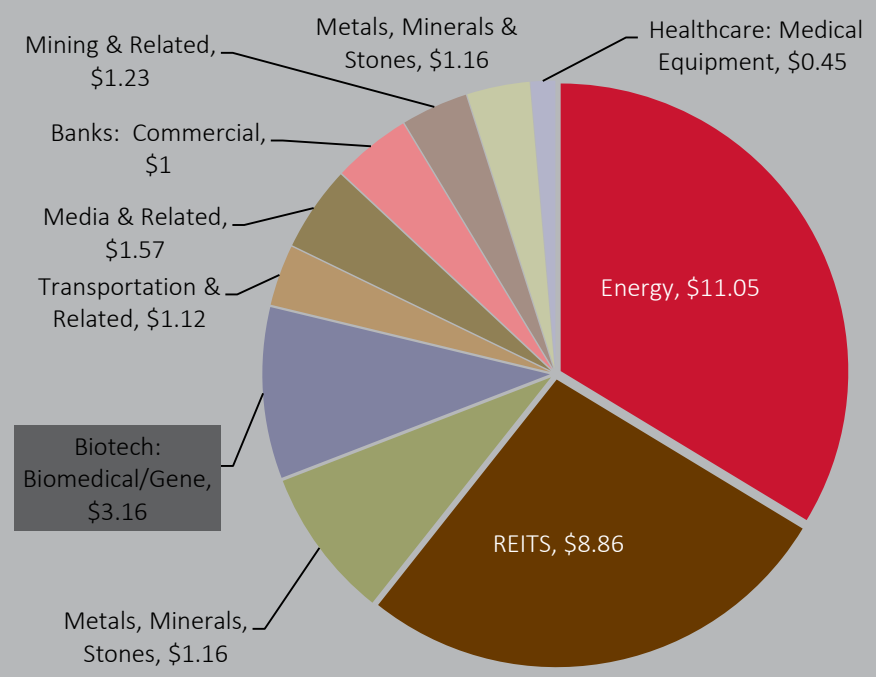
PIPE Market Trends by Industry, 2017*

Most Active Sectors by **Number of PIPEs**



Most Active Sectors by **$ Raised** (in Millions)



**Data*: Total Placements/Total Dollars 01/01/2017 – 06/30/2017

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Special Situations Call for a PIPE

VC/Private Equity PIPE

- Venture capital or private equity funds will often invest in public companies — either to increase their position or as a new investment if valuations make it attractive
- Often a VC or a PE fund will invest in a public company as part of a recapitalization transaction
- Why should these be structured as PIPE transactions?
  - Highly customized security
  - Usually the investor will want to do its own diligence and is likely to acquire material and non-public information that will not be capable of being disclosed by the issuer (so the VC/PE firm will continue to be restricted)
  - The investors will likely want other contractual protections (affirmative/negative covenants, information rights)
  - The investors may want board representation
  - The investors will not be as focused on their resale opportunities, or if they are insiders/control persons, will face other limitations

- These deals raise a host of issues that usually do not arise in other PIPE transactions:
  - Change of control issues:
    - Company's agreements
    - Poison pill/rights plan
    - NASDAQ and NYSE or other change of control provisions
  - Dilution for other shareholders and litigation risk
  - Change of control premium issues
  - Fiduciary duty and other governance issues
  - Fairness opinions

VC/Private Equity PIPE, cont'd.

PIPE to Finance an Acquisition

- Why a PIPE?
  - Marketing reasons:
    - It may be important to share with potential purchasers a fair bit of information about the acquisition (all material non-public information) and restrict their ability to trade for an extended period of time
    - Important to assess when this information will be shared broadly and/or when the information will become stale
    - How will investors be cleansed if the PIPE (and the acquisition) do not proceed?
  - Lack of "current information:"
    - Is the acquisition material?
    - Is pro forma information required to be filed?
    - Pro forma information may not be available
    - A comfort letter may not be available that could cover the financial information
    - **These considerations may make it impossible to do a registered offering**

- Big boy letters:
  - The investors should acknowledge receipt of information on target or the fact that they have not received combined financials
- Other considerations:
  - NASDAQ and NYSE or similar shareholder vote provisions may be triggered
  - Issuances that may exceed 20% of the total shares outstanding or voting power if made in connection with the acquisition of stock of another company
    - This applies to <u>both</u> above and below market issuances

PIPE to Finance an Acquisition, cont'd.

PIPE for Smaller Issuers

- Smaller issuers are subject to the 1/3 cap for primaries
- Unfortunately, the cap may not provide sufficient flexibility for the issuer to raise much needed capital
- An alternative for the issuer is to structure a PIPE or a 144A or other exempt offering alongside a take down off of a shelf (subject to the 1/3 cap)
- Things to consider:
  - General solicitation issues: an issuer contemplating a PIPE or other exempt offering in close proximity to a public offering should consider whether the public offering may have been a "general solicitation" that renders the offering exemption unavailable for the PIPE

- Integration issues:
  - Offering only to QIBs and no more than two or three large institutional accredited investors (in reliance on no-action letter guidance), or
  - Offering in reliance on Section 4(a)(2) and Regulation D
    - SEC C&DI Question 139.25 (Nov. 2008) clarified that under appropriate circumstances, there can be a side-by-side private offering under Section 4(a)(2) or Rule 506 with a registered public offering
    - C&DI focuses on how the investors in the private offering are solicited – whether by the registration statement or through some other means that would not otherwise foreclose the availability of the Section 4(a)(2) exemption, such as a pre-existing relationship with the issuer.
    - Is this C&DI applicable only in the context of an IPO and a concurrent private placement?

PIPE for Smaller Issuers, cont'd.

- In November 2016, the Staff issued a C&DI addressing concurrent private placements and public offerings for baby shelf issuers:
  - Question: An issuer with less than $75 million in public float is eligible to use Form S-3 for a primary offering in reliance on Instruction I.B.6, which permits it to sell no more than one-third of its public float within a 12-month period. May it sell securities to the same investor(s), with a portion coming from a takedown from its shelf registration statement for which it is relying on Instruction I.B.6 and a portion coming from a separate private placement that it concurrently registers for resale on a separate Form S-3 in reliance on Instruction I.B.3, if the aggregate number of shares sold exceeds the Instruction I.B.6 limitation that would be available to the issuer at that time?
  - Answer: No. Because we believe that this offering structure evades the offering size limitations of Instruction I.B.6, the securities registered for resale on Form S-3 should be counted against the issuer's available capacity under Instruction I.B.6. Accordingly, an issuer may not rely on Instruction I.B.3 to register the resale of the balance of the securities on Form S-3 unless it has sufficient capacity under Instruction I.B.6 to issue that amount of securities at the time of filing the resale registration statement. If it does not, it would need to either register the resale on Form S-1 or wait until it has sufficient capacity under that instruction to register the resale on Form S-3

PIPE for Smaller Issuers, cont'd.

PIPE for Selling Securityholders

- A significant securityholder or group of securityholders may wish to dispose of their securities
- These securities may be restricted securities or control securities because:
  - They were acquired in an exempt offering, or
  - The securityholders are affiliates of the issuer ("control stock")
- Why should these be structured as PIPE transactions?
  - Permits the securityholders to dispose of their securities in an organized manner without disrupting the market for the issuer's securities
  - Helps to avoid the downward pressure on the issuer's stock price as a result of alternative means of disposing of the securities, such as:
    - Dribbling out securities over a period of weeks
    - Dumping the issuer's stock in a block trade
  - The transaction is not announced until definitive purchase agreements are signed (the issuer's stock will not suffer the downward pressure associated with an overhang)

- How is this accomplished?
- By utilizing the Section 4(a)(1½) exemption:
  - Can be used by institutional investors to resell restricted securities purchased in a private placement
  - Can also be used by affiliates for the sale of control securities when Rule 144 is unavailable
- In a Section 4(a)(1½) transaction:
  - The seller must sell in a "private" offering to an investor that satisfies the qualifications (for example, sophistication, access to information, etc.) of an investor in a Section 4(a)(2) private offering, and
  - The investor must agree to be subject to the same restrictions imposed on the seller in relation to the securities (for example, securities with a restricted legend)
- Other considerations:
  - Requires the issuer's cooperation to effect the PIPE transaction
  - Purchase agreement contains both issuer and selling securityholder reps & warranties

PIPE for Selling Securityholders, cont'd.

Nasdaq Proposal

Nasdaq Request for Comment

- Over time, Nasdaq has not made significant changes to its shareholder approval rules
- In 2016, Nasdaq published a request for comment. The request for comment addresses various aspects of the shareholder approval rule, including change-of-control provisions, the warrant test, the private placement provisions and the acquisition rule
- Specifically, Nasdaq asked:
  - Whether the 20% threshold (i.e., requiring shareholder approval for issuances of 20% or more of pre-transaction total shares outstanding at a discount) is too restrictive?
  - Whether the percentage should be higher?
  - Whether there are other shareholder protection provisions that are sufficient?
  - Whether the insider interest in acquired assets test is still needed?
- The comment period closed February 15, 2016

Nasdaq Second Request

- In June 2017, Nasdaq solicited further comments on a narrower set of issues
  - Whether market value should reference the closing bid price
  - Whether a change from a single days' bid price to an average of closing prices would be appropriate
  - Whether Nasdaq should eliminate book value as part of its rule
- The comment period has closed, but Nasdaq has stated that it will continue to accept comment letters

Other FINRA Considerations

FINRA Communication Rules

- If a registered broker-dealer is participating in a private placement, it will want to ensure that:
  - It has identified the group within the bank that will be involved
  - It has undertaken training to make certain that each member understands the requirements under FINRA Rules 2210 and 5123.
    - Under FINRA Rule 2210, most communications likely to be used in connection with general solicitation will be considered "retail communications"
    - Communications must be fair and balanced
    - Communications will be subject to review, filing with FINRA and recordkeeping requirements
  - It will want to remind bankers of the firm's social media policy

FINRA and Due Diligence

- In the context of a Regulation D offering, FINRA Rule 2310 requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non-accredited investors that will take into account the investors' knowledge and experience
- FINRA issued Regulatory Notice 10-22 in April 2010, reminding broker-dealers of their diligence obligations in connection with Regulation D offerings
- In order to ensure that it has fulfilled its suitability responsibilities, a broker-dealer in a Regulation D offering should, at a minimum, conduct a reasonable investigation regarding:
  - The issuer and its management;
  - The business prospects of the issuer;
  - The assets held by or to be acquired by the issuer;
  - The claims being made; and
  - The intended use of proceeds of the offering

- The scope of the broker-dealer's investigation also will depend upon a number of factors, including the broker-dealer's affiliation with the issuer, its role in the transaction and other facts and circumstances of the offering, including whether the offerees are retail customers or more sophisticated institutional investors
- In addition, a firm that engages in Regulation D offerings also must have supervisory procedures under NASD Rule 3010 that are reasonably designed to ensure that the firm's personnel, including its registered representatives:
  - Engage in an inquiry that is sufficiently rigorous to comply with their legal and regulatory requirements;
  - Perform the analysis required by NASD Rule 2310;
  - Qualify their customers as eligible to purchase securities offered pursuant to Regulation D; and
  - Do not violate the antifraud provisions of the federal securities laws or FINRA rules in connection with their preparation or distribution of offering documents or sales literature

FINRA and Due Diligence, cont'd.

FINRA Enforcement

- FINRA enforcement actions suggest that FINRA is actively pursuing its regulatory priorities and indicate the types of violations that are likely to draw FINRA's attention, including:
  - Disclosing investment objectives that exceed or fail to accurately capture the objectives stated in the offering documents;
  - Making unsubstantiated or exaggerated claims, or statements that promise investment success;
  - Making unwarranted performance projections;
  - Failing to adequately disclose risk;
  - Providing materials with contradictory information;
  - Failing to provide a sound basis for evaluating the provided information; and
  - Violating applicable general solicitation rules

PIPE Enforcement Matters

- *In re Janney Montgomery Scott LLC* (SEC Exchange Act Release No. 64855 (July 11, 2011), the SEC settled charges that a broker-dealer failed to establish and enforce policies and procedures to prevent the misuse of material, nonpublic information
- Focusing on the period from January 2005 to July 2009, the SEC's findings include, among other things:
  - There were no relevant written policies until September 2005
  - The policies (the ECM Manual) issued in September 2005 were not revised over time
  - As of July 2009, the ECM Manual was incomplete
  - At least three compliance personnel left during the relevant period
  - Investment bankers and research analysts did not follow the chaperoning procedures in the ECM Manual
  - There was a failure to maintain and enforce the email communication firewall
- Settlement involved a $850,000 penalty for Section 15(g) violations; the broker-dealer must hire a consultant to develop policies and procedures

- On June 28, 2011, FINRA entered an Order Accepting Offer of Settlement from Midtown Partners & Co, LLC relating to Midtown Partners' failure to have reasonable written supervisory procedures or a reasonable system of supervision regarding information barriers, particularly in connection with the firm's role as placement agent for PIPE transactions, in violation of NASD Rules 3010.10 and 2110.11. As with the SEC Order, FINRA found that, over the relevant period, Midtown Partners:
  - Had no written supervisory procedures regarding creation or distribution of a watch list;
  - Failed to comply with its own existing procedures regarding its restricted list;
  - Did not monitor employee accounts or trading outside the firm; and
  - Had no procedures to restrict the flow of material, nonpublic information and, in fact, shared such information with unregistered individuals who were owners of the firm, including the details of investment banking contracts
- FINRA ordered sanctions of a censure and a fine of $30,000

- On September 27, 2012, the staff of OCIE published their Staff Summary Report on Examinations of Information Barriers.
- The report specifically cites concerns regarding the handling of unannounced deals, like PIPEs and CMPOs, and the handling of MNPI

PIPE Enforcement Matters, cont'd.

General Solicitation-Related Actions

- **SEC Opinion for Review of Disciplinary Action Taken by FINRA against KCD Financial Inc. (March 29, 2017)**
- The SEC affirmed FINRA's finding that representatives of KCD, an independent broker-dealer, engaged in the unregistered offering and sale of $2 million in securities as to which no exemption from registration applied
- KCD contended that the offers and sales were made pursuant to Rule 506(b). The SEC approved FINRA's censure and $73,000 fine
- A representative of KCD sent emails to approximately 1,200 individual accredited investors and registered investment advisors in KCD's database of preexisting investors, informing them that the new offering was available

- Before any interests in the fund were sold, two Dallas newspapers published articles about the fund based on a press release that was issued by Westmount Realty Finance, KCD's Dallas office, including quotes from Westmount officers. One article was subsequently published on Westmount's website, with an invitation for visitors to contact the company. Afterwards, the Westmount's attorney informed the company that the articles constituted a breach of the prohibition against general solicitation under Regulation D
- KCD's Chief Compliance Officer and Senior Vice President instructed representatives to inquire whether potential investors had a prior business relationship with KCD/Westmount and how they learned about the offering, and to exclude investment from any investor who had learned of the offering from the articles
- The SEC found that the newspaper articles constituted a general solicitation under Rule 502(c) since they were based on a press release issued by Westmount Realty Finance and were offers of securities designed to arouse public interest in the fund offering and the company's limitation of sales to only investors who did not see the newspaper articles did not change the SEC's view

General Solicitation-Related Actions, cont'd.

- ***SEC v. Diana P. Lovera* (June 2017)**
- Action involved the sale of millions of shares of Oxford City stock (a penny stock) generating $6.6m in proceeds through direct offerings to 150+ investors through phone, email and mail advertising
- Defendant contacted potential investors using numerous lead lists purchased from third parties and made no effort to inquire into the financial background or investing experience of potential investors
- The SEC held that these cold calls to prospective investors were "general solicitation"
  - Defendant did not vet investors for accredited status, ask questions concerning investors' sophistication or ask for documentation concerning such status

General Solicitation, cont'd.

- Due to these infractions and additional violations of Section 10(b) and Rule 10b-5(c) of the Exchange Act and Sections 5(a), 5(c), and 17(a) of the Securities Act, the Commission requested that the court enter (i) a permanent injunction restraining and enjoining Defendant from violating the federal securities laws, (ii) an officer and director bar against Defendant and (iii) a penny stock bar against Defendant.
- In July 2017, the Commission ordered that Ms. Lovera be barred from association with any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent or nationally recognized statistical rating organization

General Solicitation, cont'd.

June 14, 2017

SOLICITATION OF COMMENTS BY THE NASDAQ LISTING AND HEARING REVIEW COUNCIL ABOUT THE DEFINITION OF MARKET VALUE FOR PURPOSES OF SHAREHOLDER APPROVAL RULES

Nasdaq recently released its blueprint for revitalizing the U.S. capital markets: The Promise of Market Reform – Reigniting America's Economic Engine. In this white paper, Nasdaq called upon policy makers, regulators, market participants, companies, and investors to modernize rules and consider new approaches to help reinvigorate the U.S capital markets. Nasdaq recognizes that it also is not immune from the need to consider new approaches and that we must regularly reconsider whether our listing rules operate efficiently to provide meaningful protections to investors.

A year ago, Nasdaq, working with the Nasdaq Listing and Hearing Review Council,[1] solicited comments on potential updates to the shareholder approval rules. These rules were adopted in 1990 and have remained largely unchanged since then. But over the last 25 years, the capital markets and securities laws, as well as the nature and type of share issuances, have evolved significantly. The comment solicitation was designed to elicit views on whether the rules could be updated given these changes, without sacrificing the crucial investor protections they provide. However, neither Nasdaq, nor the Nasdaq Listing and Hearing Review Council, had made any determination that change was necessary or appropriate.

In response to the comment solicitation, Nasdaq received seventeen comment letters from Nasdaq-listed companies, investors and other market participants that expressed a wide range of views. Nasdaq staff also participated at a meeting of the SEC's Investor Advisory Committee to discuss the comment solicitation and engage in a dialogue about the rules. Nasdaq is grateful to all who took the time to respond and participate in this important matter. We continue to consider whether it is appropriate to enhance the protections provided by these rules and also whether there are ways that would ease compliance and eliminate burdens imposed by the rules that are not valuable to shareholders.

In that regard, it is important to note that the benefit from reducing the burden of compliance, if done with due regard for the public interest, affects not just the company but also its current investors. These burdens could include the costs of obtaining shareholder approval, but also potential lost opportunities from the delay in completing a transaction and higher costs arising from structuring a transaction using less equity, but at a higher overall cost, to avoid the

[1] The Listing Council is a standing independent advisory committee appointed by the Board of Directors of The Nasdaq Stock Market, whose mission is to review the application of Nasdaq's listing rules and public policy issues related to listing, and, where appropriate, suggest new or modified rules for consideration by the Board. The Listing Council is comprised of individuals with diverse credentials and each Listing Council member is a respected leader in his or her field, committed to working with Nasdaq to enhance investor protection and the integrity of the Nasdaq Stock Market.

requirement to obtain shareholder approval. To be clear, Nasdaq does not intend to weaken the shareholder approval rules simply to reduce costs; the focus, instead, is on whether the shareholder approval rules provide protections to existing shareholders in circumstances that are important to them, modernize the rules in cases where they do not, and enhance the rules in cases where they could provide greater protections to shareholders.

Many good suggestions were presented during the comment solicitation, some that would increase requirements and some that would relax them. Nasdaq and the Listing Council continue to consider these ideas and intend to engage with interested parties around the country to solicit further feedback.

One theme emerged in the comments received to date as an area for Nasdaq to initially review and consider changes. Listing Rule 5635(d) requires a company to obtain shareholder approval when issuing common stock or securities convertible into common stock equal to 20% or more of the shares outstanding at a price less than the greater of the book value or market value. Listing Rule 5005 defines "market value" as the closing bid price. Many commenters focused on the appropriateness of this definition of market value and the additional requirement for a company to obtain shareholder approval for issuances of common stock at a price less than book value.

In particular, several commenters expressed that bid price may not always be transparent to companies and investors and does not always reflect an actual price at which a security has traded. Generally speaking, the price of an executed trade is viewed as more reliable than a bid quotation; and the more shares executed, the more reliable the price. Further, it was noted by commenters that in structuring transactions, investors and companies often rely on an average price over a prescribed period of time for pricing issuances because it can smooth out unusual fluctuations in price.

Nasdaq and the Listing Council believe that a change from a single day's closing bid price to a five-day average of closing prices, as reflected on Nasdaq.com, may have merit in addressing the concerns raised by commenters, while also enhancing transparency and investor protections provided by the rule. Closing price is generally more transparent to investors and companies because it is reported on financial websites. In addition, Nasdaq notes that closing price will represent an actual sale and is generally at the same or greater price than the bid price because such sales typically take place between the bid and ask prices. Thus, determining whether shareholder approval is required based on the closing price is a more stringent requirement than the current closing bid price requirement.

In addition, because prices are displayed from numerous data sources on different web sites, to provide certainty about the appropriate price, Nasdaq and the Listing Council propose to codify within the rule that Nasdaq.com is the appropriate source of the closing price information. Nasdaq.com displays as a securities closing price the Nasdaq Official Closing Price, which is, typically, derived from the closing auction on Nasdaq and thereby reflects actual sale prices at one of the most liquid times of the day. The Nasdaq closing auction is designed to gather the

maximum liquidity available for execution at the close of trading, and to maximize the number of shares executed at a single price at the close of the trading day. The closing auction promotes accurate closing prices by offering specialized orders available only during the closing auction and integrating those orders with regular orders submitted during the trading day that are still available at the close. The closing auction is made highly transparent to all investors through the widespread dissemination of stock-by-stock information about the closing auction, including the potential price and size of the closing auction. The Nasdaq closing auction has proven to be a valuable pricing tool for issuers, traders, and investors alike; and Nasdaq continually works to enhance the experience for those that rely upon it.

Nasdaq and the Listing Council also observe that there are potential negative consequences to using a five-day average as the measure of whether shareholder approval is required. For example, in a declining market, the five-day average price will always be above current market price, thus making it difficult for companies to close transactions because the investors could potentially buy shares in the market rather than from the company at the higher five-day average price. Conversely, in a rising market, the five-day average price will appear to be a discount to the closing price, potentially allowing dilutive transactions without shareholder approval. In addition, if material news is announced during the five-day period, the average could be a worse reflection of the market value than the closing price after the news is disclosed. Nonetheless, Nasdaq and the Listing Council believe that these risks are already accepted in the market, as evidenced by the frequent use of an average price in transactions, notwithstanding the risk both to the new investor and to the company and its current shareholders concerning price movement during the period. Further, there are state law obligations and federal anti-fraud provisions that also protect against some of these concerns. However, as an added safeguard against the misuse of the average price provisions, Nasdaq and the Listing Council are also suggesting that any transaction of more than 20% of the company's shares outstanding also be approved by either a committee of independent directors (as defined in Listing Rule 5605(a)(2)) or a majority of the independent directors on the board, unless it is approved by the company's shareholders.[2]

Many commenters also suggested that it would be appropriate to eliminate the book value requirement from the shareholder approval rules and there was virtually no indication that this test is considered an important protection to existing shareholders. Commenters suggesting the elimination of this part of the rule note that book value is primarily an accounting measure and its calculation is based on historic cost. As such, book value is not an appropriate measure of the current value of a stock. The commenters also noted that book value is rarely, if ever, considered when pricing capital raising transactions, nor is it considered by shareholders when they are asked to vote to approve a proposed transaction. The existing book value test can also have a disproportionate impact on companies in certain industries and at certain times. For example, during the financial crisis in 2008 and 2009, many banks and finance-related

[2] This requirement could be satisfied, for example, by an independent pricing committee or financing committee.

companies traded below book value. Similarly, companies that make large investments in infrastructure may trade below the accounting carrying value of those assets. Thus, even if these companies are able to raise capital on attractive terms above their current trading prices, they would nonetheless be required to obtain shareholder approval under the current rule.

Finally, it has been suggested that Listing Rules 5635(d)(1) and 5635(d)(2) are duplicative in many respects (see attached rule text). As such, Nasdaq is considering combining these two paragraphs, but does not intend for this change to affect the substance of these rules.

For the foregoing reasons, Nasdaq and the Listing Council are considering whether to modify Rule 5635(d) as reflected in Exhibit A. However, given the variety of views reflected in our initial comment solicitation and its broad, non-specific nature, we believe it is appropriate to seek comment on these specific proposed changes. The comment period will run until July 31, 2017. Please send comments by email to comments@nasdaq.com.

Following review of the comments, if Nasdaq determines to proceed with a proposed rule change, that proposal will be subject to public notice and comment as part of the Securities and Exchange Commission's review and approval process. Please note that Nasdaq must include any comments provided in response to this comment solicitation as part of its filing with the SEC and therefore any comments submitted could become publicly available.

Nasdaq and the Listing Council express gratitude for your comments and attention to this important matter.

Exhibit A

Existing Rule 5635(d)

(d) Private Placements

Shareholder approval is required prior to the issuance of securities in connection with a transaction other than a public offering involving:

(1) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable for common stock) at a price less than the greater of book or market value which together with sales by officers, directors or Substantial Shareholders of the Company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; or

(2) the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the stock.

Draft of Proposed Revised Rule 5635(d)

(d) Private Placements

Shareholder approval is required prior to the issuance of securities in connection with a transaction, other than a public offering, involving the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable for common stock), which:

(1) alone or together with sales by officers, directors or Substantial Shareholders of the Company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; and

(2) (A) is at a price less than the average closing price of the common stock (as reflected on Nasdaq.com) for the five trading days immediately preceding the signing of the binding agreement for the issuance; or

(B) is not approved either by: (i) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate, or (ii) a committee comprised solely of Independent Directors.

Redline Showing Proposed Revisions to Rule 5635(d)

(d) Private Placements

Shareholder approval is required prior to the issuance of securities in connection with a transaction other than a public offering involving~~:~~

~~(1)~~ the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable for common stock), ~~at a price less than the greater of book or market value~~ which:

(1) alone or together with sales by officers, directors or Substantial Shareholders of the Company equals 20% or more of common stock or 20% or more of the voting power outstanding before the issuance; ~~or~~and

(2) (A) is at a price less than the average closing price of the common stock (as reflected on Nasdaq.com) for the five trading days immediately preceding the signing of the binding agreement for the issuance; or

(B) is not approved either by Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate or by a committee comprised solely of Independent Directors.

~~**(2)** the sale, issuance or potential issuance by the Company of common stock (or securities convertible into or exercisable common stock) equal to 20% or more of the common stock or 20% or more of the voting power outstanding before the issuance for less than the greater of book or market value of the stock.~~

Regulatory Notice 17-17

Updated Private Placement Filer Form

FINRA Updates Private Placement Filer Form Pursuant to FINRA Rules 5122 and 5123

April 2017

Notice Type
- Guidance

Suggested Routing
- Compliance
- Corporate Finance
- Legal
- Operations
- Registered Representatives
- Senior Management
- Private Placement
- Underwriting

Key Topics
- Private Placement
- Underwriting

Referenced Rules & Notices
- FINRA Rule 5122
- FINRA Rule 5123
- Regulatory Notice 13-26

Executive Summary

FINRA has updated the form that firms must use to file offering documents and information pursuant to FINRA Rules 5122 (Private Placements of Securities Issued by Members) and 5123 (Private Placements of Securities) (Filer Form). The updated Filer Form, which will be available in the FINRA Firm Gateway beginning May 22, 2017, includes new and updated questions that will facilitate review of the filed material and eliminates other questions.[1] *See* Attachment A for a copy of the updated Filer Form.

Questions regarding this *Notice* may be directed to:

- Minh Le, Director, Corporate Financing, at (240) 386-4638 or *Minh.Le@finra.org*; or
- Ryan Smith, Director, Corporate Financing, at (240) 386-4598 or *Ryan.Smith@finra.org*.

Background and Discussion

FINRA Rule 5122 establishes disclosure and filing requirements for firms that sell a private placement of an unregistered security issued by a broker-dealer or a control entity. Its companion rule, FINRA Rule 5123, requires firms that sell a private placement to file a copy of any offering documents with FINRA within 15 calendar days of the first sale, subject to various exemptions.[2] FINRA requires firms to submit the Filer Form that contains information about the firm selling the private placement securities, the issuer and the offering terms as well as any offering documents, if applicable, electronically through the Firm Gateway.[3] If more than one firm is selling, a firm can make the required filing on behalf of the others.

FINRA
Financial Industry Regulatory Authority

The Filer Form has three main components. The "Participating Member Information" section seeks information about the firms that are selling the private placement. The "Issuer Information" section captures basic information about the issuer. The "Offering Information" section seeks information about the offering.

On May 22, 2017, FINRA will begin using an updated Filer Form that adds, clarifies and eliminates questions or other information requested in each section. FINRA describes these changes below. Attachment A is a copy of the revised Filer Form.

Participating Member Information

FINRA will be adding questions to the Participating Member section of the Filer Form regarding whether the member making the filing (filing member) is the exclusive selling agent in the private placement and whether there is any affiliation between the issuer or sponsor of the private placement with any member participating in the offering upon whose behalf the filing member is submitting the Filer Form. This section will no longer require the title and email address for the contact person of the filing member or the contact name, title and telephone number for other members identified in the filing.

Issuer Information

FINRA is adding a question to the Issuer Information section of the Filer Form asking whether the issuer is a reporting company. This section will no longer require the filing member to enter the name, title and email address of the issuer's contact person.

Offering Information

FINRA is adding questions to the Offering Information section of the Filer Form regarding:

- the type of security the issuer is offering;
- whether the issuer raised capital within the preceding 12 months from any source (excluding loans or investments by affiliates);
- the minimum investment amount that the issuer will accept and whether the issuer can waive that minimum;
- whether the filing member sold or will sell the offering to any non-accredited investors;
- the exemption from the Securities Act of 1933 that the issuer is relying upon; and
- for contingency offerings, whether the contingency has been met as of the date of the filing.

The Offering Information section also will request the date on which the filing member first offered or sold the private placement and allow the filing member to indicate that sales have yet to commence. The Offering Information section will no longer include the requirements to provide the aggregate amount of non-commission compensation and the offering's conclusion date. This section also will no longer include the questions asking whether the firm used a term sheet, whether the issuer has any independently audited financial statements, and whether the issuer's directors are independent. In addition, the Offering Information section will clarify that the requirement to provide the stated or target rate of return is relevant only if an offering document states that the investment will provide an actual or target rate of return to investors. Finally, this section also will clarify the question regarding general solicitation only seeks information regarding whether the filing member or the issuer has, in fact, engaged in general solicitation in connection with the private placement at or before the time of filing.

Endnotes

1. *See* Securities Exchange Act Release No. 80321 (March 28, 2017); 82 FR 16245 (April 3, 2017) (Notice of Filing and Immediate Effectiveness of File No. SR-FINRA-2017-008).
2. Rule 5123(a) requires broker-dealers to "provide FINRA with the required documents or notification and related information, if known, by filing an electronic form in a manner prescribed by FINRA."
3. If a firm sells a private placement without using an offering document, the firm must state that fact.

Attachment A

5122 / 5123 Notification Filing

All fields are mandatory unless noted.

Identify Rule

Filing Under: ○ Rule 5122 ● Rule 5123

Participating Member Information

Firm Name: CRD:

Contact Name: Phone:

Relationship to Issuer or Sponsor: ○ Affiliate ○ Non-Affiliate

Is your Firm the exclusive selling agent in the offering? ○ Yes ○ No ○ Unknown

Identify any other r

List of Participati

Firm Name

Add Participating Member

Firm Name:

Firm CRD:

Relationship to Issuer or Sponsor: ○ Affiliate ○ Non-Affiliate ○ Unknown

Add Row Close

Add New 0 Row(s)

Issuer Information

Issuer Name:

Is the Issuer a reporting company? ○ Yes ○ No ○ Unknown

Issuer's Industry:

Street: City: State:

Postal Code: Country: UNITED STATES Phone:

Please provide the issuer CIK Number (when applicable): ☐ No CIK

Offering Information (Please complete based on the information contained in the offering document or if otherwise known by the firm.)

Maximum Amount to be Raised (in $): ☐ Unknown

Offering Commencement Date: ☐ Unknown

Type of security offered? ○ Debt ○ Equity ○ Unknown

Maximum Sales Commission (% rate): ☐ Unknown

Minimum investment amount accepted from an investor (in $): ☐ Unknown

Can the issuer waive the minimum investment amount? ○ Yes ○ No ○ Unknown

Do(es) the offering document(s) state that the investment will provide an actual or target rate of return for the investor? ○ Yes ○ No ○ Unknown

What exemption(s) from the Securities Act of 1933 is the issuer relying upon?

- ☐ Rule 504
- ☐ Rule 505
- ☐ Rule 506(b)
- ☐ Rule 506(c)
- ☐ Section 4(a)(2) of the Securities Act of 1933
- ☐ Unknown

Is the Form D filing information available? ○ Yes ○ No ○ Not Applicable

Did your firm use any offering documents in connection with any sales in the offering? ○ Yes ○ No

Date on which the member firm first sold Rule 5123 private placement ☐ Unknown

If sales have yet to commence, then please check here: ☐

Did your firm sell or will it sell this offering to any non-accredited investors? ○ Yes ○ No ○ Unknown

Has the issuer raised capital within the preceding 12 months from any source (excluding loans or investments by affiliates)? ○ Yes ○ No ○ Unknown

Is this a contingency offering? ◉ Yes ○ No ○ Unknown

If yes, has the contingency been met at this time? ○ Yes ○ No ○ Unknown

Is the issuer able to use offering proceeds to make or repay loans to, or purchase assets from, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor or any of the issuer's affiliates? ○ Yes ○ No ○ Unknown

Has the issuer, any officer, director or executive management of the issuer, sponsor, general partner, manager, advisor, or any of the issuer's affiliates been the subject of SEC, FINRA, or state disciplinary actions or proceedings or criminal complaints within the last 10 years? ○ Yes ○ No ○ Unknown

Has the firm or the issuer engaged in a general solicitation in connection with the offering? ○ Yes ○ No ○ Unknown

Please enter any additional information you would like to provide to facilitate FINRA's review (optional):

You have 3500 character(s) left.

Save | Print Preview | Submit

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 80340 / March 29, 2017

Admin. Proc. File No. 3-17512

In the Matter of the Application of

KCD FINANCIAL INC.

For Review of Disciplinary Action Taken by FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Registered securities association found that member firm engaged in the unregistered offer and sale of securities when no exemption was in effect. Association also found that firm failed to supervise its representatives' sales of those securities. *Held*, association's findings of violation and sanction imposed are *sustained*.

APPEARANCES:

Jill G. Fieldstein, P.C., for KCD Financial Inc.
Alan Lawhead, *Gary Dernelle*, and *Michael Garawski*, for FINRA.

Appeal filed: August 29, 2016
Last brief received: December 6, 2016

KCD Financial Inc., a FINRA member, seeks review of FINRA disciplinary action. FINRA found that, between April 2011 and October 2011, representatives of KCD engaged in the unregistered offering and sale of at least $2 million in securities in transactions as to which no exemption from the registration requirements of the federal securities laws applied. FINRA found that this conduct violated FINRA Rule 2010's prohibition on conduct inconsistent with just and equitable principles of trade. FINRA further found that KCD failed to supervise the sales of those securities in violation of FINRA Rule 2010 and NASD Rule 3010 which required members to establish and maintain a supervisory system designed to achieve compliance with

applicable securities laws and regulations and applicable NASD rules.[1] Based on these violations, FINRA censured KCD, imposed a fine of $73,000, and assessed costs.

KCD admits that the offers and sales of the securities in question were not registered, but it contends that the offers and sales were made pursuant to Rule 506(b) of Regulation D under the Securities Act of 1933,[2] which, at the time, allowed the unregistered offer and sale of securities if, among other requirements, there had been no general solicitation in the offer or sale of the securities. KCD further argues that its supervision of the offering was appropriate. Based on our independent review of the record, we reject KCD's contentions and sustain FINRA's findings of violation and its imposition of sanctions.

I. Facts

A. KCD and its Dallas branch office

KCD is an independent broker-dealer headquartered in De Pere, Wisconsin. This case involves KCD's Dallas office, which also did business under the name Westmount Realty Finance LLC. Isaac Gregory was senior vice-president of capital markets for Westmount Realty Finance and branch manager of the Dallas office. He testified that Westmount Realty Finance had an "issuer side" that put together offerings and a "FINRA sales side" comprised of a "captive" team of registered representatives who sold no securities other than those offered by Westmount Realty Finance. The registered representatives in the Dallas branch office were supervised by KCD's home office and its chief compliance officer ("CCO"). Jeffrey Larson was KCD's CCO in early 2011; he was succeeded by Lori Rastall that fall.

B. Westmount Realty Finance and the WRF Distressed Realty Fund 2011, LLC

In early 2011, Westmount Realty Finance sponsored an offering of the WRF Distressed Residential Fund 2011, LLC (the "WRF Fund" or the "Fund"). The private placement memorandum ("PPM") for the WRF Fund, dated March 15, 2011, stated that the Fund would invest up to $10 million "to fund the bulk acquisition of distressed residential properties and related assets . . . at deep discounts." The minimum subscription amount was $1 million.

The PPM stated that the offer and sale of interests in the Fund were "being made in reliance on an exemption from the registration requirements" of the Securities Act and that interests in the Fund were being offered only to persons who were accredited investors as set forth in Regulation D. In a Notice of Exempt Offering of Securities it filed with the Commission

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[1] As a result of the consolidation of the regulatory functions of NASD and NYSE Regulation into FINRA and the development of a new consolidated FINRA rulebook, *see* Exchange Act Release No. 56148, 2007 WL 2159604, at *2 (July 26, 2007), KCD was subject to both FINRA and NASD Rules during the period at issue. The conduct rules that apply are those in effect at the time of the relevant conduct. *See, e.g.*, *John Joseph Plunkett*, Exchange Act Release No. 69766, 2013 WL 2898033, at *1 nn.3-4 (June 14, 2013) (applying both NASD and FINRA rules, depending on whether conduct occurred before or after consolidation).

[2] 17 C.F.R. § 230.506(b).

on August 24, 2011, the WRF Fund claimed that the offering was exempt pursuant to Rule 506 under Regulation D.

To qualify for the exemption under that rule at all relevant times, there could be no general solicitation or general advertising of the WRF Fund offering by the issuer or anyone acting on the issuer's behalf,[3] and the Fund interests could be sold only to accredited investors[4] and to no more than 35 other investors who satisfied specified criteria regarding knowledge and experience in financial and business matters.[5]

When the "issuer side" of Westmount Realty Finance completed its work on the PPM, the LLC agreement, and the subscription documents for the WRF Fund, Gregory sent them, along with sales and marketing documents, to KCD. On March 15, 2011, Larson signed a soliciting dealer agreement in which KCD agreed to solicit purchasers of membership interests in the WRF Fund. Shortly after this agreement was signed, KCD sent e-mails to approximately 1,200 individual accredited investors and registered investment advisors in KCD's database of preexisting investors, informing them that the new offering was available.

C. Newspaper articles about the WRF Fund

On April 26, 2011, before KCD's registered representatives had sold any interests in the WRF Fund, two Dallas newspapers published articles about the WRF Fund, based on a press release issued by Westmount Realty Finance. Both articles were generally available without restriction on the websites of the respective newspapers.

One article appeared in the Dallas Business Journal. The article reported that Westmount Realty Finance had announced "that it launched a $10 million real estate fund to acquire bank-owned residential properties and non-performing, discounted residential loans," that the fund would have a 12-month investment period, and that Westmount Realty Finance "expects to reinvest sales proceeds in additional assets during the period."

The second article, headlined "Dallas investor launches residential property investment fund," appeared in the Dallas Morning News. It reported that Westmount Realty Finance "has set up a special residential investment fund to acquire residential properties and non-performing

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[3] *See* Rule 506(b)(1), 17 C.F.R. § 230.506(b)(1) (2009) (stating that to qualify for an exemption under Rule 506 offers and sales were required to "satisfy all the terms and conditions of [Rules 501 and 502, 17 C.F.R.] §§ 230.501 and 230.502"); Rule 502(c), 17 C.F.R. § 230.502(c) (providing that "neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising").

[4] *See* Securities Act Rule 501(a), 17 C.F.R. § 230.501(a) (defining "accredited investor" for purposes of Regulation D); *see also* Section 2(15)(ii) of the Securities Act, 15 U.S.C. § 77b(15)(ii) (authorizing the Commission to prescribe qualifications of an accredited investor).

[5] *See* Rule 506(b)(2), 17 C.F.R. § 230.506(b)(2) (limiting the number of purchasers in an offering under Rule 506(b) to 35); Rule 501(e)(1)(iv), 17 C.F.R. § 230.501(e)(1)(iv) (excluding accredited investors from the calculation of number of purchasers under Rule 506(b)); Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (setting forth the knowledge and experience requirements for purchasers who are not accredited investors).

loans from lenders. The [Fund] will partner with firms that specialize in bulk purchases of distressed residential assets. The $10 million fund will focus on U.S. residential markets with high foreclosure rates." In the article, Westmount Realty Finance's chief investment officer said that the Fund saw "a steady stream of buying opportunities," and that "the U.S. [is] experiencing record-level foreclosure activity, [and] most industry experts aren't anticipating a slowdown for at least the next couple of years."

Shortly after these articles appeared, Westmount Realty Finance's securities attorney, who had drafted the PPM and knew that Westmount Realty Finance was relying on a Regulation D exemption, contacted Gregory to tell him that the Dallas Business Journal article was a "breach of the prohibition against general solicitation." It is unclear when Gregory learned about the Dallas Morning News article. The attorney warned Gregory not to post the Dallas Business Journal article on "the Westmount website," apparently referring to a website maintained by Westmount Realty Capital, LLC ("WRC"), an affiliate of Westmount Realty Finance.

Gregory promptly telephoned Larson to tell him about the attorney's concerns. Larson did not tell Gregory to have the registered representatives stop selling interests in the WRF Fund. Instead, Larson and Gregory decided to tell the representatives that if anyone who did not have a prior business relationship with Westmount Realty Finance or KCD contacted them about the WRF Fund, they should ask how that person learned about the offering. If the potential investor learned of the offering from a newspaper article, the representatives were not to let that person invest. At least one potential investor who had learned about the offering from the Dallas Morning News article was told by a representative that he could not participate in the offering.

Several days later, Gregory learned that the Dallas Business Journal article had been published on an unrestricted section of the WRC website. A link accompanying the article on the WRC website invited the visitor to the site to "contact us." At some point, Gregory learned that the Dallas Morning News article had also been published on WRC's website. A similar link appeared with that article. Gregory asked the Westmount technology team to remove the articles from the WRC website, but did not follow up to see whether the articles were removed.

During an FINRA examination of KCD in the fall of 2011, a FINRA examiner found that the articles were still posted on the WRC website. The examiner brought the articles to the attention of Rastall, who had succeeded Larson as KCD's CCO shortly before the examination. Rastall, like Gregory, thought that the articles were general solicitations, but she did not tell Gregory that the registered representatives must stop selling interests in the Fund.

KCD registered representatives first sold interests in the WRF Fund on May 5, 2011, nine days after the newspaper articles were published. Sales continued until at least October 2011. As of August 2011, KCD was the only broker-dealer that had sold interests in the Fund, it had raised at least $2 million, and it received sales compensation for its efforts.

II. Procedural History

On November 14, 2013, FINRA's Department of Enforcement filed a complaint against KCD. Enforcement alleged that KCD registered representatives sold WRF Fund securities that were neither registered nor qualified for an exemption from registration and therefore violated FINRA Rule 2010 "by virtue of acting in contravention of Section 5 of the Securities Act of 1933." Enforcement alleged further that KCD failed to reasonably supervise the unregistered securities offering in violation of NASD Rule 3010.

On August 3, 2016, FINRA found that KCD violated Section 5 of the Securities Act because it offered and sold interests in the WRF Fund in interstate commerce when no registration statement was filed or in effect as to those offers and sales and KCD failed to establish that the exemption from registration under Rule 506 of Regulation D, or any other exemption, was available. FINRA found that this conduct violated FINRA Rule 2010's prohibition against conduct inconsistent with just and equitable principles of trade. It also found that KCD's supervision of the sales of the WRF Fund was unreasonable because KCD failed to respond with reasonable supervisory steps after the securities attorney alerted KCD to the newspaper articles. FINRA censured KCD and imposed a $73,000 fine. This appeal followed.

III. Analysis

In reviewing disciplinary action by a self-regulatory organization ("SRO") like FINRA, we must determine whether the applicant engaged in the conduct found by the SRO, whether such conduct violates the SRO's rules as specified in the SRO's determination, and whether those rules are, and were applied in a manner, consistent with the purposes of the Securities Exchange Act of 1934.[6] We base our findings on an independent review of the record and apply a preponderance of the evidence standard to determine whether the evidence supports the SRO's findings.[7] As explained below, we find that KCD engaged in the conduct found by FINRA, that the conduct violated the rules that FINRA found violated, and that the rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.

A. KCD acted inconsistently with just and equitable principles of trade by offering and selling interests in the WRF Fund when no registration statement was filed or in effect and no exemption from registration was available.

1. A violation of Securities Act Section 5 is a violation of FINRA Rule 2010.

The Exchange Act authorizes FINRA to enact its own rules and enforce compliance with them.[8] FINRA Rule 2010, which we have long held is consistent with the purposes of the Exchange Act,[9] requires members to observe "high standards of commercial honor and just and equitable principles of trade." A violation of Rule 2010 may be based on any conduct, not simply conduct that violates the Exchange Act. To that end, we have sustained FINRA's findings that conduct unrelated to the purchase or sale of securities violates Rule 2010 and

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[6] 15 U.S.C. § 78(e)(1).

[7] *See Rani T. Jarkas*, Exchange Act Release No. 77503, 2016 WL 1272876, at *4 (Apr. 1, 2016); *Richard G. Cody*, Exchange Act Release No. 64565, 2011 WL 2098202, at *1, 9 (May 27, 2011) (citing *Seaton v. SEC*, 670 F.2d 309, 311 (D.C. Cir. 1982) (upholding preponderance of evidence standard in FINRA disciplinary proceeding)), *aff'd*, 693 F.3d 251 (1st Cir. 2012).

[8] Exchange Act Section 15A(b)(2), 15 U.S.C. § 78*o*-3(b)(2).

[9] *See, e.g.*, *Rani T. Jarkas*, 2016 WL 1272876, at *10.

subjects a member to discipline.[10] And we have found on multiple occasions that a violation of the *Securities Act*, including a sale of unregistered securities in violation of Section 5, violates Rule 2010.[11] That is because Rule 2010 "appropriately encompasses the myriad types of misconduct that may injure public investors and the marketplace," such as sales of unregistered securities without an exemption from registration;[12] indeed, we have held that such unregistered sales "harm[] investors and the marketplace by depriving investors of the full disclosure that would have allowed them to make informed investment decisions."[13]

2. FINRA Enforcement established a prima facie case of a Section 5 violation.

Section 5(a) of the Securities Act prohibits the sale of any security in interstate commerce "unless a registration statement is in effect."[14] Section 5(c) of the Securities Act prohibits the offer to sell any security in interstate commerce "unless a registration statement has been filed as to such security."[15] FINRA's Department of Enforcement could establish a prima facie case that KCD violated Section 5 by showing that (1) KCD directly or indirectly sold or offered to sell securities (2) through the use of interstate commerce or the mails (3) when no registration statement was in effect or filed for those securities.[16] Section 5 imposes strict liability on those who offer or sell securities in unregistered offerings without an exemption from registration, so there is no scienter requirement.[17]

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[10] *See, e.g.*, *Brian L. Gibbons*, Exchange Act Release No. 37170, 1996 WL 254664, at *3 & n.17 (May 8, 1996) (finding that "providing misleading and inaccurate information to [an SRO] is conduct contrary to high standards of commercial honor and is inconsistent with just and equitable principles of trade," rejecting argument that conduct must involve "broker client situations" or "trading situations," and citing cases) .

[11] *See, e.g.*, *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *46 n.63 (Jan. 20, 2012) (finding that a violation of Section 5 also violates NASD Rule 2110, predecessor to FINRA Rule 2010) (citing *Sorrell v. SEC*, 679 F.2d 1323, 1326 (9th Cir. 1982)); *see also Scottsdale Capital Advisors Corp. v. FINRA*, 844 F.3d 414, 422 (4th Cir. 2016) (finding plausible FINRA's view that "grounding violations of the Securities Act in its Rule 2010 is an exercise of its statutory authority to 'promote just and equitable principles of trade'") (citing 15 U.S.C. § 78*o*-3(b)(6)).

[12] *Protective Grp. Sec. Corp.*, Exchange Act Release No. 34547, 1994 WL 455492, at *6 (Aug. 18, 1994).

[13] *Gordon Brent Pierce*, Exchange Act Release No. 71664, 2014 WL 896757, at *23 (Mar. 7, 2014), *petition denied*, 786 F.3d 1027 (D.C. Cir. 2015).

[14] 15 U.S.C. § 77e(a).

[15] 15 U.S.C. § 77e(c).

[16] *SEC v. Big Apple Consulting USA, Inc*, 783 F.3d 786, 806-07 (11th Cir. 2015).

[17] *SEC v. Calvo*, 378 F.3d 1211, 1215 (11th Cir. 2004).

Enforcement established a prima facie case because there is no dispute that KCD representatives offered and sold interests in the WRF Fund by means of interstate commerce or the mail when no registration statement was filed or in effect.

3. KCD failed to establish a Rule 506 exemption.

Once a prima facie case has been established, the burden shifts to the applicant to show that the offers and sales of securities are exempt from the registration requirement.[18] Registration exemptions are strictly construed "to promote full disclosure of information for the protection of the investing public."[19] Because "public policy strongly supports registration," the burden of proof rests with the party claiming the exemption to establish its availability.[20]

To establish that the offers and/or sales of the WRF Fund were exempt under Rule 506(b) of Regulation D at the time KCD representatives made the offers and sales, KCD must show, among other things, that neither the issuer nor any person acting on its behalf offered or sold the securities by general solicitation or general advertising, that the securities were sold to no more than 35 purchasers who were not accredited investors, and that those purchasers who were not accredited investors met certain criteria regarding knowledge and experience.[21] We find that KCD offered interests in the WRF Fund by means of a general solicitation. This rendered the exemption unavailable regardless of the number of accredited investors or the knowledge and experience of the purchasers who were not accredited investors.[22]

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18 *SEC v. Cavanagh*, 445 F.3d 105, 111 n.13 (2d Cir. 2006).

19 *Id*. at 115.

20 *Quinn & Co. v. SEC*, 452 F.2d 943, 945-46 (10th Cir. 1971).

21 *See supra* notes 3-5 (discussing the prohibition against general solicitation for Rule 506(b) offerings as well as the requirements regarding purchasers).

22 *See, e.g.*, *Solicitations of Interest Prior to an Initial Public Offering*, Securities Act Release No. 7188, 1995 WL 385857, at *7 (June 27, 1995) (stating, with respect to Regulation D as it existed at the time of KCD's offering, that "under Rule 502(c) of Regulation D, any form of general solicitation or general advertising would preclude availability of the exemptions provided by Rules 505 and 506" and that if an issuer engaged in activity that "involved general advertising or other activities constituting general solicitation, it could not proceed directly to an offering relying on an exemption that precluded general solicitation, even if the parties expected to purchase in the exempt offering were accredited investors").

a. The newspaper articles posted on WRC's website were offers of securities.

Under Section 2(a)(3) of the Securities Act, an "offer" includes "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."[23] The Supreme Court has recognized that "Congress expressly intended to define" this term "broadly."[24] Its definition "extends beyond the common law contract concept of an offer."[25]

As long ago as 1964, we held that the statutory definition of "offer to sell" included "any communication which is designed to procure orders for a security," and that even a communication that did not on its face refer to a particular offering could nonetheless constitute an offer as long as it was "designed to awaken an interest" in the security.[26] We have also interpreted "offer to sell" to include "publicity efforts that may not be phrased expressly in terms of an offer but [that] . . . stimulate interest" in a securities offering.[27]

We find that the Dallas Business Journal and Dallas Morning News articles published on WRC's website were designed to arouse public interest in the WRF Fund offering and therefore constituted offers. The articles were based on a press release issued by Westmount Realty Finance, the promoter of the WRF Fund, and sought to draw attention to the Fund. They cast the Fund's objective in a favorable light, stating that the United States was "experiencing record-level foreclosure activity" and predicting a bright future for the Fund. The articles emphasized the expertise of the Westmount Realty Fund principals, who "ha[d] been in the property business in the area for more than 25 years" and mentioned their anticipated alliance with "several operators that specialize in bulk acquisition of distressed residential properties." They also reported on Westmount Realty Finance's current involvement in the relevant market, stating that

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[23] 15 U.S.C. § 77b(a)(3). FINRA made no finding as to the nature of the security at issue. KCD does not dispute that interests in the WRF Fund were securities, and we find that those interests were investment contracts, and as such fell within the definition of a security. *See* Securities Act Section 2(a)(1), 15 U.S.C. §77b(a)(1) (defining "security" to include "any . . . investment contract"); *see also, e.g.*, *Blair C. Mielke*, Exchange Act Release No. 75981, 2015 SEC LEXIS 3927, at *28 (Sept. 24, 2015) (defining "investment contract" as "'a contract, transaction, or scheme whereby a person invests his or her money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party'") (quoting *W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946)); *Johnny Clifton*, Exchange Act Release No. 69982, 2013 SEC LEXIS 2022, at *32 (July 12, 2013) (same).

[24] *United States v. Naftalin*, 441 U.S. 768, 773 (1979).

[25] SEC v. *Cavanagh*, 155 F.3d 129, 135 (2d Cir. 1998).

[26] *Gearhart & Otis, Inc.*, Exchange Act Release No. 7329, 1964 SEC LEXIS 513, at *59 (June 2, 1964), *aff'd on other grounds*, 348 F.2d 798 (D.C. Cir. 1965).

[27] *The Regulation of Securities Offerings*, Securities Act Release No. 7606A, 1998 SEC LEXIS 2858, at *227 n.276 (Nov. 13, 1998) (citing *Loeb, Rhoades & Co.*, Exchange Act Release No. 5870, 38 SEC 843, 1959 SEC LEXIS 413 (Feb. 9, 1959); *First Maine Corp.*, Exchange Act Release No. 5898, 38 SEC 882, 1959 SEC LEXIS 425 (Mar. 2, 1959)).

it had purchased "more than 350 distressed residential units" in just over a year and that it "continue[d] to see a steady stream of buying opportunities." Westmount adopted the articles by posting them on the WRC website, thereby rendering the content of the articles attributable to Westmount.[28]

KCD argues that the articles were "not even aimed at investors, but at owners of distressed residential properties from whom the WRF Fund sought to purchase investment properties." But even if the articles were designed in part to alert potential sellers of distressed properties to the WRF Fund's possible interest, that would not preclude the articles from also constituting offers.

KCD also argues that it did not use the articles to offer or sell securities because it took steps to insure that all sales were to accredited investors with whom the Firm had a prior relationship. But whether the purchasers were accredited or had a prior relationship to the Firm is irrelevant to whether or not the newspaper articles constituted a general solicitation for purposes of Regulation D.

b. The newspaper articles posted on WRC's website were a general solicitation.

"General advertising" and "general solicitation," as used in Rule 502(c), include "[a]ny . . . article, notice or other communication published in any newspaper, magazine, or similar media."[29] Publication on an unrestricted website can also constitute general advertising or general solicitation.[30] The articles published by the Dallas Morning News and Dallas Business Journal about Westmount Realty Finance constituted a general advertising and general solicitation under Rule 502(c)(1), since they were based on a press release issued by Westmount Reality Finance. The articles were published in the Dallas Morning News and Dallas Business Journal, and were posted on the newspapers' websites. Westmount Realty Finance also adopted them by posting them on the website of WRC. Since, as described above, the articles constituted offers and such offers were in the form of a general solicitation, KCD's offering of the interests in the WRF Fund on behalf of Westmount Realty Finance did not satisfy the requirements of Rule 502(c), and the offering did not qualify for the Rule 506 exemption.

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[28] *See Use of Electronic Media*, Securities Act Release No. 7856, 2000 WL 502290, at *10 (Apr. 28, 2000).

[29] 17 C.F.R. §230.502(c)(1).

[30] *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 9415, 2013 SEC LEXIS 2004, at *8 (July 10, 2013) (citing *Use of Electronic Media for Delivery Purposes*, Securities Act Release No. 7233; *Use of Electronic Media*, Securities Act Release No. 7856 (Apr. 28, 2000)); *see also, e.g., SEC v. Rabinovich & Assocs.*, 2008 U.S. Dist. LEXIS 93595, at *13 (S.D.N.Y. Nov. 18, 2008) (recognizing general solicitation of purchases of securities "by means of . . . a website available to the general public").

c. KCD's arguments that the Rule 506(b) exemption was available despite the offer in the form of a general solicitation lack merit.

KCD argues that the Rule 506 exemption still applies because KCD did not generally solicit any of the actual investors in the WRF Fund (*i.e.*, all of the investors in the WRF Fund were accredited investors with whom KCD had a prior relationship). KCD relies on *Joseph P. Doxey*,[31] which, it says, suggests that if the issuer could show that it had a prior relationship with the investor, there would be no general solicitation violation despite the issuance of press releases regarding the issuer. *Doxey* stands for no such proposition. In *Doxey*, the Commission addressed allegations that a company's press releases contained material misstatements as well as separate allegations that the company violated the registration provisions. The Commission did not find that the press releases constituted an "offer" to sell securities; the Commission's discussion of the press releases in *Doxey* was limited to the separate allegations of fraud in that matter.

Rather, the Section 5 issue in the case was whether the company's offer and sale of securities to another company was made by means of a general solicitation. The Commission stated that a "pre-existing substantive relationship" between the CEO of the company offering and selling the securities and the sole owner of the company purchasing the securities "would be a means of demonstrating compliance with the limitation on the manner of offering found in Rule 502(c)." This statement reiterated the "well-known principle" that "a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the *offerees*."[32] *Doxey* provides no support for the notion that the Rule 506(b) exemption is available despite press releases or, as here, newspaper articles posted on an issuer's unrestricted website that constitute an offer to sell securities in the form of a general solicitation as long as there was a pre-existing relationship with the *purchasers*.

KCD also relies on guidance the Commission issued in 1983.[33] But that guidance makes clear that whether the investors had a prior relationship to KCD or were all accredited is not the relevant inquiry. Under the guidance the Commission issued in 1983, the question is whether a general solicitation was "used by the issuer or by someone on the issuer's behalf to offer or sell securities."[34] Westmount Realty Finance *offered* securities in the WRF Fund to the general public by publishing the newspaper articles on an unrestricted part of WRC's website. Once it did so, it engaged in a general solicitation in violation of Rule 502(c) and the Rule 506

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[31] Exchange Act Release No. 7773, 2016 SEC LEXIS 1665, at *27-28 (May 5, 2016).

[32] *Use of Electronic Media*, 2000 WL 502290, at *12 (emphasis added).

[33] *Interpretive Release on Regulation D*, Securities Act Release No. 6455, 1983 SEC LEXIS 2288 (Mar. 3, 1983).

[34] *Id*. at *45-48 (setting forth two-part test to determine whether prohibition on general solicitation has been violated).

exemption was not available for any subsequent *sales* of the WRF Fund regardless of KCD's attempts to limit the sales only to investors who did not see the newspaper articles.[35]

KCD also argues that Commission guidance issued in 2007 supports its position. But the guidance the Commission issued in 2007 addressed only the narrow question of when a registration statement for a public offering constitutes a general solicitation or general advertising that would render the Section 4(2) exemption unavailable for a *concurrent* unregistered offering.[36] Here, there was no public offering for which a registration statement was filed and the question is whether the newspaper articles constituted a general solicitation of the unregistered private offering; we find that they did.

KCD further argues that a 2011 letter from former Chairman Mary Schapiro to Congressman Darrell E. Issa discussing a proposed private offering of Facebook by Goldman Sachs supports its position. According to KCD, Chairman Shapiro suggested in the letter that, despite the intense media scrutiny, Goldman Sachs would not have engaged in a general solicitation if it sold the unregistered securities only to investors who were not solicited by the media attention but rather were already clients of the firm.[37] KCD's reliance on this letter is misplaced.

The section of the letter KCD quoted occurs in a discussion concerning Commission guidance with respect to the scope of the ban on general solicitation and advertising. The Chairman prefaced the language KCD quotes with a reference to the 2007 guidance that she had cited in the previous paragraph. She was thus referring to sales to existing clients or those with a substantive, pre-existing relationship in the context of concurrent registered and private offerings. Again, that is not the situation here. The letter also noted that Goldman Sachs was "planning to *offer* . . . securities of Facebook to clients of Goldman Sachs" (emphasis added). As discussed above, a general solicitation may not be present where the *offerees* have a pre-existing relationship with the issuer or its broker; here, however, KCD does not argue that it had a pre-

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[35] Under amendments to Rule 506 adopted to implement Section 201(a) of the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313-14 (Apr. 5, 2012), an issuer who takes reasonable steps to verify that purchasers of an offering of securities are accredited investors and who sells the securities only to accredited investors may engage in general solicitation or general advertising and still claim an exemption under Rule 506(c). *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, 2013 SEC LEXIS 2004; *see also* Rule 506(c), 17 C.F.R. § 230.506(c). This exception to the general solicitation prohibition was not available before 2013. And even after 2013, sellers may not take advantage of Rule 506(c) unless they take reasonable steps to verify the accredited investor status of the purchasers in the offering. KCD does not argue that Rule 506(c) applies, or was satisfied, here.

[36] *Revisions of Limited Offering Exemptions in Regulation D*, Securities Act Release No. 8828, 2007 SEC LEXIS 1730, at *87-90 (Aug. 3, 2007). In the Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(c), Congress renumbered Section 4(2) as Section 4(a)(2).

[37] Letter from Mary Schapiro to Darrell E. Issa, dated April 6, 2011, at 8, available at https://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf.

existing relationship with all offerees but rather with all *purchasers*. In any event, the Chairman's letter, which refers repeatedly to the Chairman's own views, does not purport to be an official statement of Commission policy.

Finally, KCD argues that a letter from Commission staff stating that the staff did not intend to recommend enforcement action against Westmount Realty Capital after an investigation that allegedly encompassed the WRF Fund offering suggests that the staff determined that the WRF Fund investors were accredited and had a pre-existing relationship with KCD or Westmount Realty Finance.[38] As discussed above, whether the investors were accredited or had such a pre-existing relationship was irrelevant because Rule 506 was not available where, as here, there was a general solicitation. In any case, staff letters advising that an investigation has been terminated without recommending enforcement action do not establish that no violations of the securities laws occurred.[39]

* * *

Based on the foregoing analysis, we find that KCD engaged in the conduct that FINRA found and that its conduct violated FINRA Rule 2110 because it violated Securities Act Section 5. Because Exchange Act Section 15A(b)(6) requires that FINRA design its rules to "promote just and equitable principles of trade,[40] and because we have found that KCD's unregistered sale of securities without the benefit of an exemption from registration, in violation of Securities Act Section 5, was inconsistent with just and equitable principles of trade, we also find that FINRA Rule 2010 is, and was applied in a manner, consistent with the purposes of the Exchange Act.[41]

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[38] FINRA denied KCD's motion to introduce the letter and related documents during the appeal to the NAC, finding that the evidence was not material.

[39] *See Procedures Relating to the Commencement of Enforcement Proceedings and Termination of Staff Investigations*, Securities Act Release No. 5310, 1972 SEC LEXIS 238, at *7-8 (Sept. 27, 1972) (stating that if the staff advises a person under inquiry that its formal investigation has been terminated, "such advice . . . must in no way be construed as indicating that the party has been exonerated" in part because the staff's decision not to recommend enforcement action at that time "may be based upon various reasons, some of which, such as workload considerations, are clearly irrelevant to the merits of any subsequent action"). Because the letter "must in no way" be construed as showing that KCD did not engage in violative conduct, and because KCD does not contend that the letter is relevant to any other issue, we find that the letter is not material and therefore deny KCD's motion to admit the letter and related documents on appeal. Rule of Practice 452, 17 C.F.R. § 201.452 (allowing the Commission to allow additional evidence on appeal if, among other things, that evidence is material).

[40] 15 U.S.C. § 78*o*-3(b)(6).

[41] *See Notice of Filing of a Proposed Rule Change*, Exchange Act Release No. 58095, 2008 SEC LEXIS 1558, at *2, 4-5 (July 3, 2008).

B. KCD failed to reasonably supervise the offer and sale of interests in the WRF Fund.

NASD Rule 3010 required member firms to establish and maintain a supervisory system "reasonably designed to achieve compliance with applicable securities laws and regulations and with applicable NASD Rules."[42] It is well established that "[t]he presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not ensure compliance."[43]

The duty to supervise also "'includes the responsibility to investigate "red flags" that suggest that misconduct may be occurring and to act upon the results of such investigation.'"[44] "'[R]ed flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review.'"[45] Supervisors must respond with the utmost vigilance when there is any indication of irregularity,[46] and take decisive action when they are made aware of suspicious circumstances.[47] Whether supervision is "reasonable" depends on the particular circumstances of each case.[48]

KCD's procedures required that supervisors oversee private offerings. The procedures required those supervisors to perform reasonable due diligence and to check for compliance with Regulation D. Despite these procedures, KCD failed to exercise reasonable supervision.

Shortly after the publication of the article in the Dallas Business Journal, Westmount Reality Finance's securities attorney, who had drafted the PPM and knew that Westmount Reality Finance was relying on a Regulation D exemption, contacted Gregory and told him that the article was a "breach of the prohibition against general solicitation." Gregory promptly informed Larson of the call. As the hearing panel found, this call warning that the publication of

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42 NASD Rule 3010 was later superseded in relevant part by FINRA Rule 3110.

43 *Rita H. Malm*, Exchange Act Release No. 35000, 1994 WL 665963, at *4 n.17 (Nov. 23, 1994).

44 *ACAP Fin., Inc.*, Exchange Act Release No. 70046, 2013 WL 3864512, at *8 (July 26, 2013) (quoting *Michael T. Studer*, Exchange Act Release No. 50534A, 2004 WL 2735433, at *6 (Nov. 30, 2004), *petition denied*, 260 F. App'x 342 (2d Cir. 2008)).

45 *Id.* (quoting *John B. Busacca, III*, Exchange Act Release No. 63312, 2010 SEC LEXIS 3787, at *48 & n.56 (Nov. 12, 2010), *petition denied*, 449 F. App'x 886 (11th Cir. 2011)); *see also, e.g.*, *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at *10 (Dec. 19, 2008) ("'Once indications of irregularity arise, supervisors must respond appropriately.'") (quoting *La Jolla Capital Corp.*, Exchange Act Release No. 41755, 1999 SEC LEXIS 1642, at *21 (Aug. 18, 1999)).

46 *Consol. Inv. Servs. Inc.*, Exchange Act Release No. 36687, 1996 WL 20829, at *5 (Jan. 5, 1996); *Michael E. Tennenbaum*, Exchange Act Release No. 31984, 1982 WL 31984, at *6 (Jan. 19, 1982).

47 *George J. Kolar*, Exchange Act Release No. 46127, 2002 WL 1393652, at *4 (June 26, 2002).

48 *William J. Murphy*, Exchange Act Release No. 69923, 2013 WL 3327752, at *18 (July 2, 2013), *petition denied sub nom. Birkelbach v. SEC*, 751 F.3d 472 (7th Cir. 2014).

the article constituted a general solicitation "was more than a red flag; it was a red stop sign." KCD should have then directed its "prompt and full attention" to addressing the problem.[49] Yet neither Gregory nor Rastall (who succeeded Larson) instructed the registered representatives to stop the unregistered sale of interests in the Fund, which would have been the only acceptable response once the Rule 506 exemption was lost.

To the extent that KCD erroneously believed that it could continue to rely on the Rule 506 exemption by limiting the offering to certain investors, its supervisory responses were also unreasonable because KCD had no basis for this belief. KCD does not even assert that, at the time of the offering, it relied on the authorities that it cites here for its position that the Rule 506 exemption could still be available despite a general solicitation. Indeed, both Gregory and Rastall testified that at the time they were unaware of what they were required to do after a general solicitation occurred. At the least, they were required to investigate their obligations.[50] Their failure to do so was unreasonable.

We find that KCD engaged in the conduct that FINRA found and that its conduct violated NASD Rule 3010. Because we have "'long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme,'"[51] and because FINRA's application of Rule 3010 in this case was appropriate given the unreasonableness of the supervisory response here, we also find that NASD Rule 3010 is, and was applied in a manner, consistent with the purposes of the Exchange Act.

IV. Sanctions

Exchange Act Section 19(e)(2) requires us to sustain the sanctions FINRA imposed unless we find, with due regard for the public interest and the protection of investors, that they are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[52] As part of our review, we consider any aggravating or mitigating factors;[53] we also consider whether the sanctions are remedial or punitive.[54] While we are not bound by FINRA's Sanction Guidelines, we use them as a benchmark in conducting our review.[55]

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[49] *Busacca*, 2010 SEC LEXIS 3787, at *38.

[50] *See, e.g.*, *World Trade Fin. Corp. v. SEC*, 739 F.3d 1243, 1250 (9th Cir. 2014) (finding that ignorance of the law did not excuse failure to carry out supervisory duties).

[51] *Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 SEC LEXIS 558, at *62 (Feb. 13, 2015) (quoting *Order Granting Approval of a Proposed Rule Change to Adopt Rules Regarding Supervision in the Consolidated FINRA Rulebook, as Modified by Amendment No. 1*, Exchange Act Release No. 71179, 2013 WL 6794111, at *32 (Dec. 23, 2013)).

[52] 15 U.S.C. § 78s(e)(2). KCD does not claim, and the record does not show, that FINRA's action imposed an unnecessary or inappropriate burden on competition.

[53] *Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013).

[54] *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007).

[55] *See, e.g.*, *Plunkett*, 2013 WL 2898033, at *11.

For unregistered sales of securities, the Sanction Guidelines in effect when the NAC issued its decision recommended a fine of $2,500 to $73,000.[56] In egregious cases, they recommended a higher fine and suspension of the firm for up to 30 business days.[57] For a failure to supervise, the Guidelines recommended a fine of $5,000 to $73,000, plus limitations on the activities of the appropriate branch office for up to 30 business days, or a longer suspension or expulsion in egregious cases.[58] The Sanction Guidelines also recommended for both violations that disgorgement of any financial benefit derived from the misconduct be considered.[59]

In determining sanctions for the unregistered sales of securities, the Guidelines identified as principal considerations the share volume and dollar amount of the transactions involved; whether the respondent attempted to comply with an exemption from registration; whether the respondent had implemented reasonable procedures to ensure that it did not participate in an unregistered distribution; and whether the respondent disregarded red flags suggesting that an unregistered distribution had occurred.[60] In determining sanctions for a failure to supervise, the Guidelines similarly identified as principal considerations the nature, extent, and size of the underlying misconduct; the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls; and whether the respondent ignored "red flag" warnings that should have called forth additional supervisory scrutiny.[61] Additional relevant considerations include whether the respondent voluntarily and reasonably attempted, prior to detection and intervention by a regulator, to remedy the misconduct; whether the misconduct was the result of an intentional act, recklessness, or negligence; and whether the misconduct resulted in the potential for the respondent's monetary or other gain.[62]

A. The sanctions FINRA imposed are within the guidelines.

The censure and $73,000 fine that FINRA imposed are within the sanction guidelines for both the unregistered sale of securities and a failure to reasonably supervise. Here, KCD sold interests in the Fund totaling at least $2 million, and was compensated for its efforts. The violative offers and sales and the deficient supervision lasted for at least five months. Although KCD had procedures designed to keep it from participating in unregistered distributions, those procedures were not implemented in a way that led to meaningful supervisory action. And the phone call to Gregory from the securities attorney warning that the newspaper articles were a general solicitation was a major red flag. KCD's response to this red flag was entirely inadequate: no one sought authoritative advice about what should be done, the unregistered sales continued, and the attempts to have the articles removed from the WRC website were ineffective.

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56 Sanction Guidelines at 24 (March 2015).

57 *Id*.

58 *Id*. at 103.

59 *Id*. at 24 & n.1, 103 & n.2.

60 *Id*. at 24.

61 *Id*. at 103.

62 *Id*. at 6-7.

We agree with FINRA that KCD deserves some credit for its efforts to restrict sales of interests in the Fund to investors who had not learned about the offering from the articles. KCD also took this step on its own initiative, rather than in reaction to intervention by a regulator. Because KCD attempted to limit the impact of the general solicitation, we agree with FINRA that KCD's misconduct was reckless rather than intentional.

Under the circumstances, we find that FINRA's decision to impose a censure and a single $73,000 fine for these related violations was not excessive or oppressive. Indeed, FINRA could have ordered disgorgement or placed limitations on the firm for 30 days but did not. We further find that the sanctions are remedial because they will deter KCD and others from engaging in unregistered sales of securities and from failing to supervise such sales appropriately.

B. KCD has not shown that the sanctions are excessive or oppressive.

KCD argues that FINRA should have relied on the Sanction Guidelines that were in effect when this proceeding began rather than those adopted in March 2015, which increased the range of fines recommended for the violations from $5,000-$50,000 to $5,000-$73,000. KCD concedes that the March 2015 Sanctions Guidelines specifically state that they became "effective as of the date of publication, and apply to all disciplinary matters, including pending matters."[63] Nonetheless, it contends that it was unfair to characterize this matter as "pending" when the parties had filed their post-hearing briefs before the revised Sanction Guidelines were adopted.

KCD provides no support for this interpretation of "pending matters." The new guidelines were adopted before the hearing panel issued its decision. Indeed, KCD argued to the NAC that it should apply the earlier guidelines, which it could not have done if the proceeding was no longer pending. FINRA acted reasonably in rejecting this argument, finding that the proceeding was pending, and applying the revised guidelines. And as FINRA points out, the Guidelines in effect before the March 2015 revisions would have permitted a $100,000 total fine on KCD if FINRA had imposed separate fines for the Rule 2010 violation and the Rule 3010 rather than the unitary sanction it imposed here.

KCD argues further that the fine imposed is excessive because this matter involved at most a violation of Rule 502(c)'s ban against general solicitation rather than a more sweeping unlawful distribution of securities. It argues that the Commission regards general solicitations as having less of an impact on the public than do distributions, and accordingly merit lesser sanctions.[64] KCD's attempt to minimize the serious of its misconduct is inconsistent with the well-established principle that "'[t]he registration requirements are the heart' of the Securities Act,"[65] which was "designed 'to protect investors by promoting full disclosure of information

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[63] Sanction Guidelines at 8.

[64] KCD also attempts to downplay its misconduct by asserting that the FINRA examiner found that all WRF Fund sales were to customers for whom the investments were suitable. But the examiner looked at only a sample of customer records and reached no such conclusion.

[65] *ACAP Fin., Inc.*, 2013 WL 3864512, at *7 (quoting *Pinter v. Dahl*, 486 U.S. 622, 638 (1988)).

thought necessary to informed investment decisions.'"[66] Violating Section 5 of the Securities Act by conducting unregistered sales of WRF Fund securities when the Rule 506 exemption was not available undermined the investor protection purposes of these provisions.

KCD also argues that lower sanctions were imposed in certain settled cases. Those cases were Commission administrative proceedings rather than FINRA disciplinary proceedings. In any event, it is well established that "comparisons to settled cases are inappropriate because respondents who offer to settle may properly receive lesser sanctions than they otherwise might have."[67] KCD cites a litigated case, *Midas Securities*,[68] and argues that it should not be fined an amount "commensurate" with the $80,000 fine imposed on the firm in that case because the firm was a recidivist responsible for distributing unregistered shares into the public markets, unlike the private offering here. But the $80,000 fine imposed on the firm was only one element of the sanctions in that case, which also included a $50,000 fine and a two-year suspension for the firm's president and CEO based on his failure to supervise the sale of unregistered securities and to establish adequate written supervisory procedures.

Finally, KCD argues that the lack of harm to customers should be treated as a mitigating factor. Although the Sanction Guidelines recognize injury to other parties, including the investing public, as a suitable consideration in determining sanctions,[69] KCD points to no authority in which the absence of harm to customers has been found to be a mitigating factor, and there is authority to the contrary.[70] In any event, to the extent a lack of demonstrated harm is relevant, here we find that it is outweighed by the seriousness of the misconduct.

An appropriate order will issue.[71]

By the Commission (Acting Chairman PIWOWAR and Commissioner STEIN).

Brent J. Fields
Secretary

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66 *Id*. (quoting *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953)).

67 *Michael C. Pattison, CPA*, Exchange Act Release No. 67900, 2012 SEC LEXIS 2973, at *47 (Sept. 20, 2012).

68 *Midas Sec., LLC*, 2012 WL 169138.

69 Sanction Guidelines at 6.

70 *See id*. (noting that "the presence of certain factors may be aggravating, but their absence does not draw an inference of mitigation"); *Howard Braff*, Exchange Act Release No. 66467, 2012 SEC LEXIS 620, at *26 (Feb. 24, 2012) (finding the absence of customer harm not mitigating).

71 We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 80340 / March 29, 2017

Admin. Proc. File No. 3-17512

In the Matter of the Application of

KCD FINANCIAL INC.

For review of Disciplinary Action Taken by FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is ORDERED that the disciplinary action taken by FINRA against KCD Financial Inc. is hereby sustained.

By the Commission.

Brent J. Fields
Secretary

SECURITIES AND EXCHANGE COMMISSION

ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES

Washington, DC 20549-3628

July 20, 2016

The Honorable Mary Jo White
Chair
U. S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1070

Dear Chair White:

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

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

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

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

On behalf of the Advisory Committee, we are pleased to submit the enclosed recommendations regarding the definition of "accredited investor." These recommendations were discussed at an Advisory Committee meeting held on May 18, 2016 and approved by the members of the Advisory Committee present and voting at a meeting held on July 19, 2016.

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

Respectfully submitted on behalf of the Advisory Committee,

Stephen M. Graham
Committee Co-Chair

Sara Hanks
Committee Co-Chair

Members of the Advisory Committee
Robert Aguilar
Xavier Gutierrez
Brian Hahn
Kyle Hauptman
Jenny Kassan**
Catherine V. Mott
Jonathan Nelson*
Patrick Reardon
Lisa Shimkat
Tisha R. Tallman*
Annemarie Tierney
Gregory C. Yadley
Laura Yamanaka

Non-voting members
Michael Pieciak
Mark Walsh

* Not present at the meeting held on May 18, 2016.
**Not present at the meeting held on July 19, 2016.

Enclosure
cc: Commissioner Kara M. Stein
Commissioner Michael S. Piwowar
Keith Higgins
Elizabeth Murphy
Sebastian Gomez
Julie Davis

U.S. Securities and Exchange Commission
Advisory Committee on Small and Emerging Companies

Recommendations Regarding the Accredited Investor Definition

From the May 18, 2016 and July 19, 2016 Meetings

AFTER CONSIDERING THAT:

1. The Advisory Committee's objective is to provide the U.S. Securities and Exchange Commission (the "Commission") with advice on its rules, regulations and policies with regard to its mission of protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation, as they relate to, among other things, capital raising by emerging privately held small businesses ("emerging companies").

2. Emerging companies play a significant role as drivers of U.S. economic activity, innovation and job creation. Their ability to raise capital in the unregistered securities markets is critical to the economic well-being of the United States.

3. The exemptions from registration available in Regulation D under the Securities Act of 1933 are the most widely used transactional exemptions for securities offerings by issuers. In 2015, issuers utilizing Regulation D raised over $1.35 trillion, an amount comparable to what was raised in registered offerings.

4. The "accredited investor" definition is a centerpiece of Regulation D. It is intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary. Under Securities Act Rule 501(a), a natural person is accredited if that person:

    - earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or

    - has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

5. In March 2015, the Advisory Committee made recommendations to the Commission as the Commission staff reviewed the definition of accredited investor. At the core of those recommendations was the statement that "the primary goal should be to 'do no harm' to the private offering ecosystem."

6. If the individual income and net worth thresholds underlying the definition of accredited investor were raised significantly, it would considerably decrease the number of households that qualify as accredited investors. This decrease would have a disparate impact on those areas having a lower cost of living, and those areas already often coincide with regions of

lower venture capital activity. The Committee also is concerned that a decrease in the accredited investor pool would have a disproportionate effect on women and minority entrepreneurs.

7. Some commentators have urged that the accredited investor thresholds be increased in order to prevent fraud against investors who may be unable to fend for themselves. The Committee is not aware of any evidence suggesting that fraud in the private markets is driven or affected by the levels at which the accredited investor definition is set.

THE COMMITTEE RECOMMENDS THAT:

1. The core of the Advisory Committee's 2015 recommendation regarding the definition of "accredited investor" in Rule 501 remains the same: the overarching goal of any changes the Commission might consider should be to "do no harm" to the private offering ecosystem.

2. The Commission should not change the current financial thresholds in the definition except to adjust on a going–forward basis to reflect inflation.

3. The Commission should expand the pool of accredited investors to include individuals who have passed examinations that test their knowledge and understanding in the areas of securities and investing, including the Series 7, Series 65, Series 82 and CFA Examinations and equivalent examinations. The Commission also should explore ways to allow participation by potential investors with specific industry or issuer knowledge or expertise who would not otherwise be considered accredited investors.

4. The Committee would support expanding the definition to take into account measures of non-financial sophistication, regardless of income or net worth, thereby expanding rather than contracting the pool of accredited investors.

5. Simplicity and certainty are vital to the utility of any expanded definition of accredited investor. Accordingly, any non-financial criteria should be able to be ascertained with certainty.

6. The Commission should continue to gather data on this subject for ongoing analysis of what attributes best encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary.

RECENT COMPLIANCE AND DISCLOSURE INTERPRETATIONS RELATING TO CHANGES MADE TO RULES 144A AND 506 PERMITTING GENERAL SOLICITATION

September 18, 2015

SECURITIES ACT RULES

Section 138. Rule 144A — Private Resales of Securities to Institutions

Question 138.03

Question: Under Rule 144A, securities may be offered to persons other than qualified institutional buyers by means of general solicitation. Does the rule require that the general solicitation be conducted by only the issuer?

Answer: No. In Rule 144A offerings in which the securities were initially sold to financial intermediaries in transactions exempt under Securities Act Section 4(a)(2) or Regulation S, the general solicitation may be conducted by the issuer as well as initial purchasers involved in the Section 4(a)(2) or Regulation S transaction and other distribution participants. [Nov. 13, 2013]

Question 138.04

Question: Did the amendments to Rule 144A permitting the use of general solicitation change how directed selling efforts under Regulation S are analyzed in concurrent Rule 144A and Regulation S offerings?

Answer: No. [Nov. 13, 2013]

Section 255. Rule 501 — Definitions and Terms Used in Regulation D

Question 255.48

Question: If a purchaser's annual income is not reported in U.S. dollars, what exchange rate should an issuer use to determine whether the purchaser's income meets the income test for qualifying as an accredited investor?

Answer: The issuer may use either the exchange rate that is in effect on the last day of the year for which income is being determined or the average exchange rate for that year. [July 3, 2014]

Question 255.49

Question: Can assets in an account or property held jointly with another person who is not the purchaser's spouse be included in determining whether the purchaser satisfies the net worth test in Rule 501(a)(5)?

Answer: Yes, assets in an account or property held jointly with a person who is not the purchaser's spouse may be included in the calculation for the net worth test, but only to the extent of his or her percentage ownership of the account or property. [July 3, 2014]

Section 256. Rule 502 — General Conditions to be Met

Question 256.23

Question: Rule 502(c) prohibits an issuer or any person acting on the issuer's behalf from offering or selling securities by any form of general solicitation or general advertising when conducting certain offerings in reliance on Regulation D. Does the use of an unrestricted, publicly available website to offer or sell securities constitute a general solicitation for purposes of Rule 502(c)?

Answer: Yes. As the Commission stated in Securities Act Release No. 7856 (Apr. 28, 2000), the use of an unrestricted, publicly available website constitutes a general solicitation and is not consistent with the prohibition on general solicitation and advertising in Rule 502(c) if the website contains an offer of securities. However, Rule 506(c) — which does not require compliance with Rule 502(c) — may be available to issuers when offering or selling securities through unrestricted, publicly available websites or other forms of general solicitation. [August 6, 2015]

Question 256.24

Question: What information can an issuer widely disseminate about itself without contravening Rule 502(c)?

Answer: Information not involving an offer of securities may be disseminated widely without violating Rule 502(c). For example, factual business information that does not condition the public mind or arouse public interest in a securities offering is not an offer and may be disseminated widely. Information that involves an offer of securities through any form of general solicitation would contravene Rule 502(c). [August 6, 2015]

Question 256.25

Question: What is factual business information?

Answer: What constitutes factual business information depends on the facts and circumstances. Factual business information typically is limited to information about the issuer, its business, financial condition, products, services, or advertisement of such products or services, provided the information is not presented in such a manner as to constitute an offer of the issuer's securities. Factual business information generally does not 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. (Release No. 33-5180). [August 6, 2015]

Question 256.26

Question: Does an offer of securities in a Regulation D offering to a prospective investor with whom the issuer, or a person acting on the issuer's behalf, has a pre-existing, substantive relationship constitute a general solicitation in contravention of Rule 502(c)?

Answer: No. The existence of such a pre-existing, substantive relationship is one means, but not the exclusive means, of demonstrating the absence of a general solicitation in a Regulation D offering. *See* Securities Act Release No. 6825 (Mar. 15, 1989), at fn. 12. Accordingly, an offer of the issuer's securities to the person with whom the issuer, or a person acting on its behalf, has such a relationship would not constitute a general solicitation and, therefore, would not be in contravention of Rule 502(c). [August 6, 2015]

Question 256.27

Question: Are there circumstances under which an issuer, or a person acting on the issuer's behalf, can communicate information about an offering to persons with whom it does not have a pre-existing, substantive relationship without having that information deemed a general solicitation?

Answer: Yes. The staff is aware of long-standing practices where issuers and persons acting on their behalf are introduced to prospective investors who are members of an informal, personal network of individuals with experience investing in private offerings. For example, we acknowledge that groups of experienced, sophisticated investors, such as "angel investors," share information about offerings through their network and members who have a relationship with a particular issuer may introduce that issuer to other members. Issuers that contact one or more experienced, sophisticated members of the group through this type of referral 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. Whether there has been a general solicitation is a fact-specific determination. In general, the greater the number of persons without financial experience, sophistication or 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. [August 6, 2015]

Question 256.28

Question: Is someone other than a broker-dealer able to form a pre-existing, substantive relationship with a prospective offeree as a means of establishing that a general solicitation is not present in a Regulation D offering?

Answer: Yes. We believe investment advisers registered with the Securities and Exchange Commission may be able to form a pre-existing relationship with prospective offerees that are clients of the adviser. As fiduciaries, such advisers owe their clients the duty to provide only suitable investment advice. To fulfill the obligation, an adviser must make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objective, such that a substantive relationship could exist. [August 6, 2015]

Question 256.29

Question: What makes a relationship "pre-existing" for purposes of demonstrating the absence of a general solicitation under Rule 502(c)?

Answer: A "pre-existing" relationship is one that the issuer has formed with an offeree prior to the commencement of the securities offering or, alternatively, that was established through either a registered broker-dealer or investment adviser prior to the registered broker-dealer or investment adviser participation in the offering. *See, e.g.*, the *E.F. Hutton & Co.* letter (Dec. 3, 1985). [August 6, 2015]

Question 256.30

Question: Is there a minimum waiting period required for an issuer, or a person acting on its behalf, to establish a pre-existing, substantive relationship with a prospective offeree in order to demonstrate that a general solicitation is not involved?

Answer: No. While there is no minimum waiting period, the issuer must establish such a relationship prior to the commencement of the offering, or, if the relationship was established through either a registered broker-dealer or investment adviser, the relationship must be established prior to the time the registered broker-dealer or investment adviser began participating in the offering. The staff, however, has allowed a limited accommodation for offerings by private funds that rely on the exclusions from the definition of "investment company" set forth in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. This limited accommodation permits an individual who qualifies as an accredited or sophisticated investor to purchase, after the end of a waiting period, securities in private fund offerings that were posted on a website platform prior to the investor's subscription to the platform, in view of the fact that private fund offerings are made on a semi-continuous basis (quarterly or annually). *See* the *Lamp Technologies, Inc.* letter (May 29, 1997). [August 6, 2015]

Question 256.31

Question: What makes a relationship "substantive" for purposes of demonstrating the absence of a general solicitation under Rule 502(c)?

Answer: A "substantive" relationship is one in which the issuer (or a person acting on its behalf) has sufficient information to evaluate, and does, in fact, evaluate, a prospective offeree's financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investor. 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. [August 6, 2015]

Question 256.32

Question: Can anyone other than registered broker-dealers and investment advisers form a pre-existing, substantive relationship with a prospective offeree as a means of establishing that a general solicitation is not involved in a Regulation D offering?

Answer: Yes. The Commission has stated that:

Generally, staff interpretations of whether a "pre-existing, substantive relationship" exists have been limited to procedures established by broker-dealers in connection with their customers. This is because traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and, thus, implies that a substantive relationship exists between the broker-dealer and its customers. [The Commission has] long stated, however, that the presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case. Thus, there may be facts and circumstances in which a third party, other than a registered broker-dealer, could establish a "pre-existing, substantive relationship" sufficient to avoid a "general solicitation." [Securities Act Release No. 7856 (Apr. 28, 2000)]

The staff has also recognized particular instances where issuers have developed pre-existing, substantive relationships with prospective offerees. *See, e.g.*, the *Woodtrails — Seattle, Ltd*. letter (Aug. 9, 1982). However, in the absence of a prior business relationship or a recognized legal duty to offerees, we believe it is likely more difficult for an issuer to establish a pre-existing, substantive relationship, especially when contemplating or engaged in an offering over the Internet. Issuers would have to consider not only whether they have sufficient information about particular offerees, but also whether they in fact use that information appropriately to evaluate the financial circumstances and sophistication of the prospective offerees prior to commencing the offering. Issuers may therefore wish to consider whether conducting the offering under Rule 506(c) would provide greater certainty that an exemption may be available for the offering. [August 6, 2015]

Question 256.33

Question: Does a demo day or venture fair necessarily constitute a general solicitation for purposes of Rule 502(c)?

Answer: No. Whether a demo day or venture fair constitutes a general solicitation for purposes of Rule 502(c) is a facts and circumstances determination. Of course, if a presentation by the issuer does not involve an offer of a security, then the requirements of the Securities Act are not implicated. Where a presentation by the issuer involves an offer of a security, the presentation at a demo day or venture fair may not constitute a general solicitation if, for example, attendance at the demo day or venture fair is limited to persons with whom the issuer or the organizer of the event has a pre-existing, substantive relationship or have been contacted through an informal, personal network as described in Question 256.27. If potential investors are invited to the presentation by the issuer or a person acting on its behalf by means of a general solicitation and the presentation involves the offer of a security, Rule 506(c) may be available if the issuer takes reasonable steps to verify that any purchaser is an accredited investor and the purchasers in the offering are limited to accredited investors. [August 6, 2015]

Section 260. Rule 506 — Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering

Question 260.05

Question: An issuer commenced an offering in reliance on Rule 506 before September 23, 2013, the effective date of the new Rule 506(c) exemption, and filed a Form D notice for the offering. If, pursuant to the transition guidance in Securities Act Release No. 9415 (July 10, 2013), the issuer decides to continue that offering after September 23, 2013 in accordance with Rule 506(c), is the issuer required to file an amendment to the previously-filed Form D to indicate that the issuer is now relying on the Rule 506(c) exemption?

Answer: Yes. As the decision to continue the offering in reliance on Rule 506(c) represents a change in the information provided in the previously-filed Form D, the issuer must file an amendment to the Form D and check the Rule 506(c) box to indicate its reliance on this exemption. If the issuer decides to continue the offering in reliance on Rule 506(b), no amendment to the previously-filed Form D is required solely to reflect this decision. [Nov. 13, 2013]

Question 260.06

Question: An issuer takes reasonable steps to verify the accredited investor status of a purchaser and forms a reasonable belief that the purchaser is an accredited investor at the time of the sale of securities. Subsequent to the sale, it becomes known that the purchaser did not meet the financial or other criteria in the definition of "accredited investor" at the time of sale. Assuming that the other conditions of Rule 506(c) were met, is the exemption available to the issuer for the offer and sale to the purchaser?

Answer: Yes. An issuer does not lose the ability to rely on Rule 506(c) for an offering if a person who does not meet the criteria for any category of accredited investor purchases securities in the offering, so long as the issuer took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor at the time of the sale of securities. [Nov. 13, 2013]

Question 260.07

Question: An issuer intends to conduct an offering under Rule 506(c). If all of the purchasers in the offering met the financial and other criteria to be accredited investors but the issuer did not take reasonable steps to verify the accredited investor status of these purchasers, may the issuer rely on the Rule 506(c) exemption?

Answer: No. The verification requirement in Rule 506(c) is separate from and independent of the requirement that sales be limited to accredited investors. The verification requirement must be satisfied even if all purchasers happen to be accredited investors. Under the principles-based method of verification, however, the determination of what constitutes reasonable steps to verify is an objective determination based on the particular facts and circumstances of each purchaser and transaction. [Nov. 13, 2013]

Question 260.08

Question: An issuer chooses to verify the accredited investor status of a purchaser in a Rule 506(c) offering by using the net worth verification method provided in the rule and, as required under this method, reviews the relevant documentation dated within the prior three months. If, at the time the purchaser decides to purchase securities in the offering, the previously submitted documentation is not dated within the prior three months of the time of the sale of securities, may the issuer continue to rely on the net worth verification method provided in the rule?

Answer: No. An issuer may satisfy the verification requirement of Rule 506(c) by either using the principles-based method of verification or relying upon one of the specific, non-exclusive verification methods listed in the rule. Although use of the non-exclusive verification methods is not required, an issuer that chooses to use one of the methods must satisfy the specific requirements of that method. In order to comply with the net worth verification method provided in the rule's non-exclusive list, the relevant documentation must be dated within the prior three months of the sale of securities. If the documentation is older than three months, the issuer may not rely on the net worth verification method, but may instead determine whether it has taken reasonable steps to verify the purchaser's accredited investor status under the principles-based method of verification. [Nov. 13, 2013]

Question 260.09

Question: Does the third-party verification method in the non-exclusive list of verification methods in Rule 506(c) include written confirmations from an attorney or certified public accountant who is licensed or duly registered, as the case may be, in good standing in a foreign jurisdiction?

Answer: Yes. This method of verification is not limited to written confirmations from attorneys and certified public accountants who are licensed or registered in a jurisdiction within the United States. [Nov. 13, 2013]

Question 260.10

Question: Does the verification method for existing investors in the non-exclusive list of verification methods apply to new issuers that have the same sponsor as the issuer in which the investor purchased securities in a prior Rule 506(b) offering (for example, a new limited partnership organized by a general partner where the investor purchased securities of a prior limited partnership sponsored by the same general partner)?

Answer: No. This non-exclusive method of verification is, by its terms, limited to verification of existing investors who purchased securities in the same issuer's Rule 506(b) offering as accredited investors prior to September 23, 2013 and continue to hold such securities. [Nov. 13, 2013]

Question 260.11

Question: If an issuer commenced an offering intending to rely on Rule 506(c) but did not engage in any form of general solicitation in connection with the offering, may the issuer subsequently determine to rely on Rule 506(b) for the offering?

Answer: Yes, as long as the conditions of Rule 506(b) have been satisfied with respect to all sales of securities that have occurred in the offering. To the extent the issuer already filed a Form D indicating its reliance on Rule 506(c), it must amend the Form D to indicate its reliance on Rule 506(b) instead, as that decision represents a change in the information provided in the previously-filed Form D. [Nov. 13, 2013]

Question 260.12

Question: If an issuer commenced an offering in reliance on Rule 506(b), may the issuer determine, prior to any sales of securities in the offering, to rely on Rule 506(c) for the offering?

Answer: Yes, as long as the conditions of Rule 506(c) are satisfied with respect to all sales of securities in the offering. To the extent the issuer already filed a Form D indicating its reliance on Rule 506(b), it must amend the Form D to indicate its reliance on Rule 506(c) instead, as that decision represents a change in the information provided in the previously-filed Form D. [Nov. 13, 2013]

Question 260.13

Question: If the conditions of Rule 506(c) are not met in a purported Rule 506(c) offering, could the Securities Act Section 4(a)(2) private offering exemption be available to the issuer?

Answer: If the issuer has engaged in general solicitation, no. As stated in Securities Act Release No. 9415 (July 10, 2013), the mandate in the JOBS Act to permit general solicitation for a subset of Rule 506 offerings affects only Rule 506 and not Section 4(a)(2) offerings in general. The use of general solicitation continues to be incompatible with a claim of exemption under Section 4(a)(2). [Nov. 13, 2013]

Question 260.14

Question: When is an issuer required to determine whether bad actor disqualification under Rule 506(d) applies?

Answer: Rule 506(d) disqualifies an offering of securities from reliance on a Rule 506 exemption from Securities Act registration. Issuers must therefore determine if they are subject to bad actor disqualification any time they are offering or selling securities in reliance on Rule 506. An issuer that is not offering securities, such as a fund that is winding down and is closed to investment, need not determine whether Rule 506(d) applies unless and until it commences a Rule 506 offering. An issuer may reasonably rely on a covered person's agreement to provide notice of a potential or actual bad actor triggering event pursuant to, for example, contractual covenants, bylaw requirements, or an undertaking in a questionnaire or certification. However, if

an offering is continuous, delayed or long-lived, the issuer must update its factual inquiry periodically through bring-down of representations, questionnaires and certifications, negative consent letters, periodic re-checking of public databases, and other steps, depending on the circumstances. [Dec. 4, 2013]

Question 260.15

Question: If a placement agent or one of its covered control persons, such as an executive officer or managing member, becomes subject to a disqualifying event while an offering is still ongoing, could the issuer continue to rely on Rule 506 for that offering?

Answer: Yes, the issuer could rely on Rule 506 for future sales in that offering if the engagement with the placement agent was terminated and the placement agent did not receive compensation for the future sales. Alternatively, if the triggering disqualifying event affected only the covered control persons of the placement agent, the issuer could continue to rely on Rule 506 for that offering if such persons were terminated or no longer performed roles with respect to the placement agent that would cause them to be covered persons for purposes of Rule 506(d). [Dec. 4, 2013]

Question 260.16

Question: For purposes of Rule 506(d), does an "affiliated issuer" mean every affiliate of the issuer that has issued securities?

Answer: No. Under Rule 506(d), an "affiliated issuer" of the issuer is an affiliate (as defined in Rule 501(b) of Regulation D) of the issuer that is issuing securities in the same offering, including offerings subject to integration pursuant to Rule 502(a) of Regulation D. Securities Act Forms C&DIs 130.01 and 130.02 provide examples of co-issuer or multiple issuer offerings. [Dec. 4, 2013]

Question 260.17

Question: Are compensated solicitors limited to brokers, as defined in Exchange Act Section 3(a)(4), who are subject to registration pursuant to Exchange Act Section 15(a)(1), and their associated persons?

Answer: No. All persons who have been or will be paid, directly or indirectly, remuneration for solicitation of purchasers are covered by Rule 506(d), regardless of whether they are, or are required to be, registered under Exchange Act Section 15(a)(1) or are associated persons of registered broker-dealers. The disclosure required in Item 12 of Form D expressly contemplates that compensated solicitors may not appear in FINRA's Central Registration Depository (CRD) of brokers and brokerage firms. [Dec. 4, 2013]

Question 260.18

Question: Does the term "participating" include persons whose sole involvement with a Rule 506 offering is as members of a compensated solicitor's deal or transaction committee that is responsible for approving such compensated solicitor's participation in the offering?

Answer: No. [Dec. 4, 2013]

Question 260.19

Question: Are officers of a compensated solicitor deemed to be "participating" in a Rule 506 offering only if they are involved with the solicitation of investors for that offering?

Answer: No. Participation in an offering is not limited to solicitation of investors. Examples of participation in an offering include participation or involvement in due diligence activities or the preparation of offering materials (including analyst reports used to solicit investors), providing structuring or other advice to the issuer in connection with the offering, and communicating with the issuer, prospective investors or other offering participants about the offering. To constitute participation for purposes of the rule, such activities must be more than transitory or incidental. Administrative functions, such as opening brokerage accounts, wiring funds, and bookkeeping activities, would generally not be deemed to be participating in the offering. [Dec. 4, 2013]

Question 260.20

Question: Is disqualification under Rule 506(d) triggered by actions taken in jurisdictions other than the United States, such as convictions, court orders, or injunctions in a foreign court, or regulatory orders issued by foreign regulatory authorities?

Answer: No. [Dec. 4, 2013]

Question 260.21

Question: Is disqualification under Rule 506(d)(1)(v) triggered by all Commission orders to cease and desist from violations of Commission rules promulgated under Exchange Act Section 10(b)?

Answer: No. Disqualification is triggered only by orders to cease and desist from violations of scienter-based provisions of the federal securities laws, including scienter-based rules. An order to cease and desist from violations of a non-scienter based rule would not trigger disqualification, even if the rule is promulgated under a scienter-based provision of law. For example, an order to cease and desist from violations of Exchange Act Rule 105 would not trigger disqualification, even though Rule 105 is promulgated under Exchange Act Section 10(b). [Dec. 4, 2013]

Question 260.22

Question: If an order issued by a court or regulator provides, in accordance with Rule 506(d)(2)(iii), that disqualification from Rule 506 should not arise as a result of the order, is it necessary to seek a waiver from the Commission or to take any other action to confirm that bad actor disqualification will not apply as a result of the order?

Answer: No. The provisions of Rule 506(d)(2)(iii) are self-executing. [Dec. 4, 2013]

Question 260.23

Question: Does the reasonable care exception only cover circumstances where the issuer has identified all covered persons but, despite the exercise of reasonable care, was unable to discover the existence of a disqualifying event? Or could it also apply where, despite the exercise of reasonable care, the issuer (i) was unable to determine that a particular person was a covered person (for example, an officer of a financial intermediary that the issuer did not know was participating in the offering, despite the exercise of reasonable care) or (ii) initially determined that the person was not a covered person but subsequently determined that the person should have been deemed a covered person?

Answer: The reasonable care exception applies whenever the issuer can establish that it did not know and, despite the exercise of reasonable care, could not have known that a disqualification existed under Rule 506(d)(1). This may occur when, despite the exercise of reasonable care, the issuer was unable to determine the existence of a disqualifying event, was unable to determine that a particular person was a covered person, or initially reasonably determined that the person was not a covered person but subsequently learned that determination was incorrect. Issuers will still need to consider what steps are appropriate upon discovery of Rule 506(d) disqualifying events and covered persons throughout the course of an ongoing Rule 506 offering. An issuer may need to seek waivers of disqualification, terminate the relationship with covered persons, provide Rule 506(e) disclosure, or take such other remedial steps to address the Rule 506(d) disqualification. [Dec. 4, 2013]

Question 260.24

Question: Is there a procedure provided in Rule 506(e) for issuers to seek a waiver of the obligation to disclose past events that would have been disqualifying, except that they occurred before September 23, 2013 (the effective date of Rule 506(d))?

Answer: No. The disclosure obligation is not subject to waiver. [Dec. 4, 2013]

Question 260.25

Question: Does Rule 506(e) require disclosure of past events that would no longer trigger disqualification under Rule 506(d), such as a criminal conviction that occurred more than ten years before the offering or an order or bar that is no longer in effect at the time of the offering?

Answer: No. Rule 506(e) requires only disclosure of events that would have triggered disqualification at the time of the offering had Rule 506(d) been applicable. Because events outside the applicable look-back period and orders that do not have continuing effect would not trigger disqualification, Rule 506(e) does not mandate disclosure of such matters in order for the issuer to be able to rely on Rule 506. [Dec. 4, 2013]

Question 260.26

Question: In an offering in which the issuer uses multiple placement agents or other compensated solicitors, is the issuer required to provide investors with disclosure under Rule

506(e) only with respect to the particular compensated solicitor or placement agent that solicited those investors and its covered control persons (i.e., general partners, managing members, directors, executive officers, and other officers participating in the offering)?

Answer: No. Issuers are required to provide all investors with the Rule 506(e) disclosure for all compensated solicitors who are involved with the offering at the time of sale and their covered control persons. [Dec. 4, 2013]

Question 260.27

Question: In a continuous offering, is the issuer required to provide disclosure under Rule 506(e) for all solicitors that were ever involved during the course of the offering?

Answer: No. A reasonable time prior to the sale of securities in reliance on Rule 506, the issuer must provide the required disclosure with respect to all compensated solicitors that are involved at the time of sale. Disclosure with respect to compensated solicitors who are no longer involved with the offering need not be provided under Rule 506(e) in order for the issuer to be able to rely on Rule 506. [Dec. 4, 2013]

Question 260.28

Question: Is a shareholder that becomes a 20% beneficial owner by purchasing securities in an offering a covered person with respect to that offering?

Answer: Rule 506(d) looks to the time of each sale of securities, and provides that no exemption will be available for the sale if any covered person is subject to a bad actor triggering event at that time. A shareholder that becomes a 20% beneficial owner upon completion of a sale of securities is not a 20% beneficial owner at the time of the sale. However, it would be a covered person with respect to any sales of securities in the offering that were made while it was a 20% beneficial owner. [Jan. 3, 2014]

Question 260.29

Question: Is the term "beneficial owner" in Rule 506(d) interpreted the same way as under Exchange Act Rule 13d-3?

Answer: Yes, "beneficial owner" under Rule 506(d) means any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, under Exchange Act Rule 13d-3 has or shares, or is deemed to have or share: (1) voting power, which includes the power to vote, or to direct the voting of, such security; and/or (2) investment power, which includes the power to dispose, or to direct the disposition of, such security. [Jan. 3, 2014]

Question 260.30

Question: For purposes of determining 20% beneficial owners under Rule 506(d), is it necessary to "look through" entities to their controlling persons?

Answer: Beneficial ownership includes both direct and indirect interests, determined as under Exchange Act Rule 13d-3. [Jan. 3, 2014]

Question 260.31

Question: Some of the shareholders of a Rule 506 issuer have entered into a voting agreement under which each shareholder agrees to vote its shares of voting equity securities in favor of director candidates designated by one or more of the other parties. Are the parties to the agreement required to aggregate their holdings for purposes of determining whether they as a group are, or any single party is, a 20% beneficial owner of the issuer and, therefore, a covered person under Rule 506(d)?

Answer: Beneficial ownership of group members and groups should be analyzed the same as under Exchange Act Rules 13d-3 and 13d-5(b). Under that analysis, the shareholders have formed a group, and the group beneficially owns the shares beneficially owned by its members. In addition, the parties to the voting agreement that have or share the power to vote or direct the vote of shares beneficially owned by other parties to the agreement (through, for example, the receipt of an irrevocable proxy or the right to designate director nominees for whom the other parties have agreed to vote) will beneficially own such shares. Parties that do not have or share the power to vote or direct the vote of other parties' shares would not beneficially own such shares solely as a result of entering into the voting agreement. See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting CDI 105.06. If the group is a 20% beneficial owner, then disqualification or disclosure obligations would arise from court orders, injunctions, regulatory orders or other triggering events against the group itself. If a party to the voting agreement becomes a 20% beneficial owner because shares of other parties are added to its beneficial ownership, disqualification or disclosure obligations would arise from triggering events against that party. [Jan. 3, 2014]

Question 260.32

Question: Does an order issued by a court or regulator, in accordance with Rule 506(d)(2)(iii), waive the disclosure obligation set forth in Rule 506(e)?

Answer: No. The disclosure obligation in Rule 506(e) pertains to an issuer's obligation to provide investors disclosure of disqualifying events that would have triggered disqualification, except that these events occurred before September 23, 2013. Rule 506(d)(2)(iii) permits issuers to rely on the self-executing statement of a regulatory authority to avoid Rule 506 disqualification when that regulatory authority advises the Commission in writing or in its order, decree or judgment, that Rule 506 disqualification should not arise a consequence of a disqualifying event that occurred on or after September 23, 2013.

A regulatory authority such as a state securities commission may, however, determine that an order entered before September 23, 2013 would not have triggered disqualification under Rule 506(d)(1) because the violation was not a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before such sale. [Jan. 3, 2014]

Question 260.33

Question: An issuer commenced an offering in reliance on Rule 506 before September 23, 2013, the effective date of the new Rule 506(c) exemption. The issuer decides, at some point after September 23, 2013, to continue that offering as a Rule 506(c) offering under the transition guidance in Securities Act Release No. 9415 (July 10, 2013). In such circumstances, is the issuer required to take "reasonable steps to verify" the accredited investor status of investors who purchased securities in the offering before the issuer conducted the offering in reliance on Rule 506(c)?

Answer: No. For an offering that commenced before September 23, 2013 and that, pursuant to the Commission's transition guidance, the issuer continues in accordance with Rule 506(c) after that date, the issuer must take reasonable steps to verify the accredited investor status of only investors who purchase securities in the offering after the issuer begins to make offers and sales in reliance on Rule 506(c). The issuer must amend any previously-filed Form D to indicate its reliance on the Rule 506(c) exemption for its offering. *See* Securities Act Rules C&DI 260.05. [Jan. 23, 2014]

Question 260.34

Question: An issuer commenced a Rule 506 offering before September 23, 2013 and made sales either before or after that date in reliance on the exemption that, as a result of Securities Act Release No. 9415 (July 10, 2013), became Rule 506(b). The issuer now wishes to continue the offering in reliance on Rule 506(c). Can the issuer rely on the transition guidance in Securities Act Release No. 9415 that permits switching from Rule 506(b) to Rule 506(c) if it already sold securities to non-accredited investors before relying on the Rule 506(c) exemption?

Answer: Yes, as long as all sales of securities in the offering after the issuer begins to offer and sell in reliance on Rule 506(c) are limited to accredited investors and the issuer takes reasonable steps to verify the accredited investor status of those purchasers. [Jan. 23, 2014]

Question 260.35

Question: Rule 506(c)(2)(ii)(A) sets forth a non-exclusive method of verifying that a purchaser is an accredited investor by, among other things, reviewing any Internal Revenue Service form that reports the purchaser's income for the "two most recent years." If such an Internal Revenue Service form is not yet available for the recently completed year (*e.g.*, 2013), can the issuer still rely on this verification method by reviewing the Internal Revenue Service forms for the two prior years that are available (*e.g.*, 2012 and 2011)?

Answer: No, the verification safe harbor provided in Rule 506(c)(2)(ii)(A) would not be available under these circumstances. We believe, however, that an issuer could reasonably conclude that a purchaser is an accredited investor and satisfy the verification requirement of Rule 506(c) under the principles-based verification method by:

reviewing the Internal Revenue Service forms that report income for the two years preceding the recently completed year; and

obtaining written representations from the purchaser that (i) an Internal Revenue Service form that reports the purchaser's income for the recently completed year is not available, (ii) specify the amount of income the purchaser received for the recently completed year and that such amount reached the level needed to qualify as an accredited investor, and (iii) the purchaser has a reasonable expectation of reaching the requisite income level for the current year.

Where the issuer has reason to question the purchaser's claim to be an accredited investor after reviewing these documents, it must take additional verification measures in order to establish that it has taken reasonable steps to verify that the purchaser is an accredited investor. For example, if, based on this review, the purchaser's income for the most recently completed year barely exceeded the threshold required, the foregoing procedures might not constitute sufficient verification and more diligence might be necessary. [July 3, 2014]

Question 260.36

Question: A purchaser is not a U.S. taxpayer and therefore cannot provide an Internal Revenue Service form that reports income. Can an issuer review comparable tax forms from a foreign jurisdiction in order to rely on the verification method provided in Rule 506(c)(2)(ii)(A)?

Answer: No, the verification safe harbor provided in Rule 506(c)(2)(ii)(A) would not be available under these circumstances. In adopting this safe harbor, the Commission noted that there are "numerous penalties for falsely reporting information" in Internal Revenue Service forms. *See* Securities Act Release No. 33-9415 (July 10, 2013). Although the safe harbor is not available for tax forms from foreign jurisdictions, we believe that an issuer could reasonably conclude that a purchaser is an accredited investor and satisfy the verification requirement of Rule 506(c) under the principles-based verification method by reviewing filed tax forms that report income where the foreign jurisdiction imposes comparable penalties for falsely reported information.

Where the issuer has reason to question the reliability of the information about the purchaser's income after reviewing these documents, it must take additional verification measures in order to establish that it has taken reasonable steps to verify that the purchaser is an accredited investor. [July 3, 2014]

Question 260.37

Question: Under the non-exclusive verification method set forth in Rule 506(c)(2)(ii)(B), an issuer can verify that a purchaser is an accredited investor on the basis of net worth by reviewing certain documentation of the purchaser's assets and liabilities "dated within the prior three months." Tax assessments, which are one of the types of documentation listed in this provision of the rule, are often prepared annually. Would an issuer be able to rely on this non-exclusive verification method if it reviewed the most recent tax assessment that is available, even if it is dated more than three months?

Answer: No, the verification safe harbor provided in Rule 506(c)(2)(ii)(B) would not be available under these circumstances. Although the safe harbor is not available, we believe that an issuer could reasonably conclude that a purchaser is an accredited investor and satisfy the

verification requirement of Rule 506(c) under the principles-based verification method if it uses the most recently available tax assessment when determining whether the purchaser has the requisite net worth. For example, if the most recent tax assessment shows a value that, after deducting the purchaser's liabilities results in a net worth substantially in excess of $1 million, it may be sufficient verification that the purchaser has met the net worth test.

Where the issuer has reason to question whether the assessment reasonably reflects the value of the purchaser's assets, it must take additional verification measures in order to establish that it has taken reasonable steps to verify that the purchaser is an accredited investor. [July 3, 2014]

Question 260.38

Question: Under the non-exclusive verification method set forth in Rule 506(c)(2)(ii)(B), an issuer must review a consumer report from one of the "nationwide consumer reporting agencies" to determine the purchaser's liabilities. Would a consumer report from a non-U.S. consumer reporting agency that performs similar functions as a U.S. nationwide consumer reporting agency be sufficient for purposes of this verification method?

Answer: No, such a consumer report would not satisfy the requirements of the verification safe harbor in Rule 506(c)(2)(ii)(B). Although the safe harbor is not available, we believe that an issuer could reasonably conclude that a purchaser is an accredited investor and satisfy the verification requirement of Rule 506(c) under the principles-based verification method by reviewing this report and taking any other steps necessary to determine the purchaser's liabilities (such as a written representation from the purchaser that all liabilities have been disclosed) in determining whether the purchaser has the requisite net worth.

Where the issuer has reason to question the extent of the purchaser's liabilities after reviewing these documents, it must take additional verification measures in order to establish that it has taken reasonable steps to verify that the purchaser is an accredited investor. [July 3, 2014]

EXCHANGE ACT SECTIONS 13(d) AND 13(g) AND REGULATION 13D-G BENEFICIAL OWNERSHIP REPORTING

Section 105. Rule 13d-3 — Determination of Beneficial Ownership

Question 105.06

Question: Certain shareholders have entered into a voting agreement under which each shareholder agrees to vote the shares of a voting class of equity securities registered under Section 12 that it beneficially owns in favor of the director candidates nominated by one or more of the other parties to the voting agreement. Under Rule 13d-5(b), the shareholders have formed a group because they have agreed to act together for the purpose of voting the equity securities of the issuer. Under what circumstances is the beneficial ownership of a party to the voting agreement attributed to one or more other parties to the agreement?

Answer: The formation of a group under Rule 13d-5(b), without more, does not result in the attribution of beneficial ownership to each group member of the securities beneficially owned by other members. Under Section 13(d)(3) of the Exchange Act, the group is treated as a new "person" for purposes of Section 13(d)(1), and the group is deemed to have acquired, by operation of Rule 13d-5(b), beneficial ownership of the shares beneficially owned by its members. (Note that the analysis is different for Section 16 purposes. See Section II.B.3 of Exchange Act Release No. 28869 (February 8, 1991).)

In order for one party to the voting agreement to be treated as having or sharing beneficial ownership of securities held by any other party to the voting agreement, evidence beyond formation of the group under Rule 13d-5(b) would need to exist. For example, if a party to the voting agreement has the right to designate one or more director nominees for whom the other parties have agreed to vote, the party with that designation right becomes a beneficial owner of the securities beneficially owned by the other parties under Rule 13d-3(a), because the agreement gives that person the power to direct the voting of the other parties' securities. Similarly, if a voting agreement confers the power to vote securities pursuant to a bona fide irrevocable proxy, the person to whom voting power has been granted becomes a beneficial owner of the securities under Rule 13d-3. See Q & A No. 7 to Exchange Act Release No. 13291 (February 24, 1977). Conversely, parties that do not have or share the power to vote or direct the vote of other parties' shares would not beneficially own such shares solely as a result of entering into the voting agreement. Note, however, that a contract, arrangement, understanding or relationship concerning voting or investment power among parties to the agreement, other than the voting agreement itself, may result in a party to the voting agreement having or sharing beneficial ownership of securities held by other parties to the voting agreement under Rule 13d-3. [Jan. 3, 2014]

Practice Pointers on: Navigating the Securities Act's Prohibition on General Solicitation and General Advertising

The Jumpstart Our Business Startups Act (the "JOBS Act") included a measure directing the Securities and Exchange Commission (the "SEC" or "Commission") to relax the prohibition against general solicitation and general advertising pursuant to Rule 502(c) ("Rule 502(c)") under Regulation D ("Reg D") of the Securities Act of 1933, as amended (the "Securities Act"), for certain Rule 506 offerings. In July 2013, the SEC adopted final rules establishing that an issuer relying on Rule 506(c) may engage in general solicitation "provided that the sales are limited to accredited investors and an issuer takes reasonable steps to verify that all purchasers of the securities are accredited investors."[1]

Section 4(a)(2) of the Securities Act ("Section 4(a)(2)") provides an exemption from the registration requirements under Section 5 of the Securities Act for a transaction undertaken by an issuer that does not involve any public offering. An issuer may rely on Rule 506(b) under the Securities Act and/or Section 4(a)(2) if it does not use general solicitation. The JOBS Act did not address the meaning of "general solicitation" under the Securities Act. However, since the new rules required issuers and other market participants to consider whether in connection with a proposed offering they would rely on Section 4(a)(2)/Rule 506(b) or on the new Rule 506(c), renewed attention was placed on the types of communications that may constitute a "general solicitation."

The SEC has not explicitly defined the terms "general solicitation" or "general advertising" under Reg D. However, Rule 502(c) lists several examples of general solicitation and general advertising, including (1) "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio"[2] and (2) "any seminar or meetings whose attendees have been invited by any general solicitation or general advertising."[3] These are communications that are not targeted or directed to a specific individual or to a particular audience, but rather broad-based communications that may reach potential investors not known to the issuer or its financial intermediary. Over time, the SEC Staff has provided guidance, mainly through no-action letters and more recently through Compliance and Disclosure Interpretations ("C&DIs"), regarding the types of communications that would be viewed as a "general solicitation."

Below we summarize the guidance.

A. General solicitation

Pre-Existing, Substantive Relationships

A communication made by an issuer or its agent to an investor with which either has a pre-existing, substantive relationship would not constitute a "general solicitation."[4]

The Meaning of "Pre-Existing."

The SEC Staff has explained that a "pre-existing" relationship is one that the issuer has formed with a prospective offeree prior to the commencement of the securities offering or, alternatively, that was "established through either a registered broker-dealer or investment adviser prior to the registered broker-dealer's or investment adviser's participation in the offering."[5]

In *E.F. Hutton & Co.*, the SEC Staff explained that whether a relationship was pre-existing hinged largely on whether there was "sufficient time between establishment of the relationship and an offer so that the offer is not considered made by general solicitation or advertising."[6] E.F. Hutton & Co. ("E.F. Hutton"), an investment bank, intended to send to certain prospective offerees pre-offering materials and/or private offering memoranda in accordance with specific investor selection procedures that it had developed.[7] These prospective offerees were those with whom E.F. Hutton had established a prior business relationship or whom had indicated in writing that they desired to form such a relationship. The SEC Staff found that E.F. Hutton had failed to address whether its relationships with the proposed offerees were pre-existing, because it was unclear whether the relationships were the result of general solicitation in connection with a current offering.[8] Similarly, in *Webster Management Assured Return Equity Management Group Trust*, the SEC Staff

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[1] Securities and Exchange Commission, "Eliminating the Prohibition on General Solicitation and General Advertising in Certain Offerings," SEC Open Meeting (July 10, 2013), *available at* https://www.sec.gov/news/press/2013/2013-124-item1.htm.
[2] 17 C.F.R. § 230.502(c)(1).
[3] 17 C.F.R. § 230.502(c)(2).
[4] *See* SEC Division of Corporation Finance Compliance and Disclosure Interpretations, Securities Act Rules (updated Aug. 6, 2015), at Question 256.26. *See also E.F. Hutton & Company*, SEC No-Action Letter (Dec. 3, 1985) ("In determining what constitutes a general solicitation the [SEC Staff] has underscored the existence and substance of prior relationships between the issuer or its agents and those being solicited") (referred to herein as "*E.F. Hutton & Co.*").
[5] C&DI, *supra* note 4 at Question 256.29.
[6] *E.F. Hutton*, *supra* note 4.
[7] *Id.*
[8] *Id.*

found that because a selling agent had contacted potential customers on behalf of a trust, customers with whom neither the selling agent nor the trust had formed any relationship prior to the commencement of the trust's securities offering, the arrangement constituted a general solicitation.[9]

The Meaning of "Substantive."

A relationship is "substantive" where the issuer (or its agent) "has sufficient information to evaluate, and does, in fact, evaluate, a prospective offeree's financial circumstances and sophistication, in determining his or her status as an accredited or sophisticated investor."[10] Self-certification by a person regarding his or her status as an accredited or sophisticated investor, alone, is not sufficient to establish a substantive relationship.[11]

In *Citizen VC, Inc.*, the SEC Staff asserted that the "quality of the relationship between the issuer (or its agent) and an investor" is the critical factor for evaluating whether a substantive relationship exists.[12] The SEC Staff indicated that the quality of the relationship depends on whether the issuer (or its agent) has sufficient information to evaluate a prospective offeree's financial circumstances and sophistication. The SEC Staff found that Citizen VC, Inc. ("Citizen VC") was able to establish a substantive relationship with prospective investors through the implementation of its policies and procedures, including the completion of a generic online "accredited investor" questionnaire (*i.e.*, a self-certification of accreditation) and a subsequent "relationship establishment period," both of which were designed specifically to evaluate the prospective investor's sophistication and ability to understand the nature and risks of the potential offering.[13]

In *E.F. Hutton & Co.*, the SEC Staff found that a substantive relationship had been partially created between E.F. Hutton and prospective investors, to whom E.F. Hutton intended to mail pre-offering materials and/or private offering memoranda related to real property investments. E.F. Hutton had put in place procedures that would ensure that the offering materials were sent only to prospective offerees with whom Hutton had established a prior business relationship in the past or had indicated (in writing) that they desired to enter into such a business relationship.[14] The SEC Staff determined that E.F. Hutton had failed to establish the existence of a substantive relationship with investors that had merely indicated in response to a questionnaire (the "Suitability Questionnaire") and new client intake form (the "New Account Form") that they desired to form such a relationship. While the information obtained from the Suitability Questionnaires and New Account Forms was relevant for evaluating the sophistication and financial circumstances of each client, the form relied entirely on the responses of the individual investor and, therefore, constituted self-certification.

Establishing a Pre-Existing, Substantive Relationship.

The SEC Staff has stated that there is no minimum waiting period required to demonstrate the existence of a relationship. The issuer must establish a relationship prior to the commencement of an offering. Where a relationship is established through either a broker-dealer or investment adviser, "the relationship must be established prior to the time the registered broker-dealer or investment adviser began participating in the offering."[15] Often private funds conduct "continuous offerings," and, in these cases, the pre-existing, substantive relationship would be established prior to the offering made to each investor, rather than the first offering made to the first investor. In *Lamp Technologies, Inc.*, the SEC Staff determined that the posting of private fund investment information on a password-protected website managed by Lamp Technologies, Inc. ("Lamp Technologies") did not constitute general solicitation.[16] Subscribers could only gain access to the private fund information on the website after (1) completing a generic questionnaire that would enable Lamp Technologies to form a reasonable basis on which to decide whether the prospective subscriber was an accredited investor and (2) paying a subscription fee to use the website. After satisfying these two requirements, a subscriber would receive a password granting him or her access to the information posted on the website. A subscriber would not be permitted to invest in any posted fund on the website for 30 days following the subscriber's qualification in order to ensure that the subscriber did not take part in an offering that was commenced prior to the establishment of a substantive, pre-existing relationship. In reaching its conclusion that the website did not constitute general solicitation, the SEC Staff noted that the 30-day waiting period would ensure that subscribers "[did] not join to invest in any particular private fund."[17]

In *Citizen VC*, the SEC Staff found that the policies and procedures set forth by Citizen VC to ensure that there was a pre-existing, substantive relationship were sufficient for purposes of satisfying the requirements under Rule 502(c), notwithstanding the fact that there was no waiting period required before prospective investors could utilize Citizen VC's website to make investments.[18] However, the SEC

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[9] *Webster Management Assured Return Equity Management Group Trust*, SEC No-Action Letter (Nov. 11, 1986).
[10] C&DI, *supra* note 4 at Question 256.31.
[11] *Id.*
[12] *Citizen VC, Inc.*, SEC No-Action Letter (Aug. 6, 2015).
[13] *Id.* For further information on the policies and procedures implemented by Citizen VC, please see the section titled "Use of Questionnaires and Electronic Media" below.
[14] *E.F. Hutton*, *supra* note 4.
[15] *Id.*
[16] *See Lamp Technologies, Inc.*, SEC No-Action Letter (May 29, 1997) (referred to herein as "*Lamp Technologies*").
[17] *Id.*
[18] *See Citizen VC*, *supra* note 12.

Staff noted that a prospective investor would only be presented with an investment opportunity after the investor had gone through Citizen VC's extensive vetting process.[19]

In *H.B. Shaine & Co., Inc.*, the SEC Staff determined that the distribution of a generic questionnaire to potential accredited and sophisticated investors by H.B. Shaine & Co., a registered broker-dealer ("H.B. Shaine"), for purposes of evaluating the prospective investors' ability to participate in future exempt offerings was neither general solicitation nor general advertising. The SEC Staff's conclusion was based partly on the fact that sufficient time would have passed between the completion of H.B. Shaine's questionnaire and the contemplation, or commencement, of any potential offering.[20]

Who May Establish a Pre-Existing, Substantive Relationship?

The existence of a pre-existing, substantive relationship often rests on whether appropriate procedures have been established by broker-dealers in connection with their customers.[21] As the SEC Staff has explained, this is due to the fact that "traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers and thus, implies that a substantive relationship exists between the broker-dealer and its customers."[22] Likewise, an investment adviser, as a fiduciary, would need to "make a reasonable determination that the investment advice provided is suitable for the client based on the client's financial situation and investment objective, such that a substantive relationship could exist."[23]

The SEC Staff, however, has affirmed that other third parties could establish a pre-existing, substantive relationship sufficient to avoid general solicitation.[24] For example, the SEC Staff determined in *Woodtrails – Seattle, Ltd.* that an issuer, Woodtrails – Seattle, Ltd. ("Woodtrails"), had developed pre-existing, substantive business relationships with its prospective offerees, because (1) such relationships were established within the last three years, and (2) the nature of those relationships was evidenced by (i) a determination (in part) by the general partner, at the time of the original investment, that the investors met specific suitability standards and (ii) the belief by Woodtrails that each of the proposed offerees was sophisticated and fully capable of evaluating the risks and merits of a potential investment.[25]

While an issuer, as opposed to a broker-dealer or investment adviser, may establish a pre-existing, substantive relationship with a prospective investor, the SEC Staff has noted that "it is likely more difficult for an issuer to establish a pre-existing, substantive relationship, especially when contemplating or engaged in an offering over the Internet."[26] Therefore, an issuer, in the context of an Internet-based offering, would need to consider whether it has sufficient information about particular offerees and use that information appropriately to evaluate the financial circumstances and sophistication of the prospective offerees prior to commencing the offering.

The Nature of the Communications

The Number of Offerees.

The availability of the private placement exemption is not based on the number of offerees; however, in assessing whether an issuer or its agent has engaged in general solicitation, the Commission and the SEC Staff have considered the breadth of the communications.[27] The SEC Staff has stated that, generally, the "greater number of persons without financial experience, sophistication or any prior personal or business relationship with the issuer that are contacted by an issuer [(or its agent)] . . . through impersonal, non-selective means of communication, the more likely the communications are part of a general solicitation."[28]

In *Woodtrails – Seattle, Ltd.*, the SEC Staff determined that Woodtrails did not generally solicit when it proposed to mail a written offer to approximately 330 persons who had previously invested in other limited partnerships sponsored by Woodtrails' general partner. Likewise, in *Michigan Growth Capital Symposium*, the SEC Staff determined that a symposium, sponsored by the University of Michigan's School of Business for the purpose of providing Michigan firms with efficient access to national private equity financing, did not involve general solicitation. In its letter to the SEC Staff, the Michigan Growth Capital Symposium noted that, like the 330 prospective investors in *Woodtrails – Seattle, Ltd*., "the number of invitees [to the Symposium] would not appear on its face to cause a

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[19] *Id.*
[20] *H.B. Shaine & Co., Inc.*, SEC No-Action Letter (May 1, 1987) (referred to herein as "*H.B. Shaine & Co.*").
[21] C&DI, *supra* note 4 at Question 256.32.
[22] *Id.*
[23] C&DI, *supra* note 4 at Question 256.28.
[24] *See* Securities Act Release No. 33-7856 (Apr. 28, 2000).
[25] *See Woodtrails – Seattle, Ltd.*, SEC No-Action Letter (Aug. 9, 1982) (referred to herein as "*Woodtrails – Seattle*").
[26] C&DI, *supra* note 4 at Question 256.32.
[27] *See* Securities Act Release No. 33-6339, n. 30 (Aug. 7, 1981) (". . . depending on the actual circumstances, offering[s] made to such large numbers of purchasers may involve a violation of the prohibitions against general solicitation and general advertising"). *See also* SEC, Staff Report, Implications of the Growth of Hedge Funds, at 15 n.44 (Sept. 2003), *available at* https://www.sec.gov/news/studies/hedgefunds0903.pdf (repeating the same caution, originally noted in the Regulation D proposing release, that offerings made to large numbers of purchasers may involve a violation of the prohibitions on general solicitation and general advertising).
[28] C&DI, *supra* note 4 at Question 256.27.

problem, given the characteristics of the attendees, their varied purposes, and sophistication and qualification of potential investors, and the unique nature of the presentations."[29]

Cold Calling.

The SEC Staff has offered guidance on whether "cold calling" will constitute general solicitation, irrespective of whether a pre-existing, substantive relationship has been established. For example, in *Mobile Biopsy, LLC*, the SEC Staff determined that a series of "cold" communications, in which Mobile Biopsy, LLC ("Mobile Biopsy"), and its affiliated limited liability companies would contact all physicians in North Carolina for the purpose of offering securities in a proposed venture, constituted general solicitation.[30] While Mobile Biopsy asserted that limiting contact to only surgeons and radiologists "who have an interest in treating breast cancer," as well as "the practice groups and medical facilities with which such doctors are associated," was a permitted "targeted approach" under Rule 502(c), the SEC Staff nevertheless viewed the solicitation as being directed generally toward a large group of investors.[31] Similarly, in *General Solicitation Under Rule 502(c) of SEC Regulation D*, the SEC Staff explained that it would not grant no-action relief under Rule 502(c) in the case of a "cold mass mailing" to broker-dealers, investment advisers, accountants, and attorneys of a brochure summarizing a private placement memorandum in connection with a potential Rule 505 or 506 offering.[32]

Use of Questionnaires and Electronic Media

As discussed below, both the Commission and the SEC Staff have affirmed that in certain circumstances, generic print questionnaires and forms of electronic media (*e.g.*, websites) may be used to assess investor suitability prior to presenting an investment opportunity.

Print Questionnaires.

The SEC Staff has offered guidance as to whether the use of generic questionnaires that target particular types of investors will constitute general solicitation. For example, in *H.B. Shaine & Co., Inc.*, the SEC Staff noted that the distribution of generic questionnaires by H.B. Shaine to prospective accredited and sophisticated investors for the purpose of evaluating their suitability for participating in Rule 505 and Rule 506 offerings did not violate Rule 502(c)'s prohibition on general solicitation.[33] The questionnaire used by H.B. Shaine was updated annually and collected specific information regarding a prospective investor's employment history, business experience, business or professional education, investment experience, income, and net worth, as well as whether the prospective investor had the "ability to evaluate the merits and risk of venture capital investments."[34] However, instead of merely allowing a prospective investor to self-certify as a suitable investor, H.B. Shaine evaluated each of the responses to determine the prospective investor's potential as an accredited investor.

Likewise, in *Bateman Eichler, Hill Richards, Inc.*, the SEC Staff found that the mailing of a letter and suitability questionnaire (to evaluate accreditation and sophistication) by Bateman Eichler, a broker-dealer, to a limited mailing list of professionals and businesspeople on a monthly basis did not violate Rule 502(c).[35] Bateman Eichler would follow up with each investor to obtain additional personal and financial information based on the responses provided in the investor's suitability questionnaire. A respondent who satisfactorily completed the "follow-up stage" would then be placed on a list of prospective investors for future exempt offers. The SEC Staff in *Bateman Eichler* based its determination on the fact that (1) the questionnaire would be generic in nature and would not make reference to any specific investment currently offered or contemplated for offering by Bateman Eichler and (2) that Bateman Eichler would implement procedures designed to ensure that persons solicited were not offered any securities that were offered or contemplated for offering at the time of the solicitation.

However, in *AgriStar Global Networks, Ltd.*, the SEC Staff did not grant no-action relief to AgriStar Global Networks, Ltd. ("AgriStar"), in connection with AgriStar's plan to establish a database of accredited investors.[36] AgriStar intended to distribute generic questionnaires to certain U.S. farms and their owners (or operators) in order to solicit information about investors' sophistication (*e.g.*, previous investment experience, net worth, and annual income) and status as accredited investors. Such information would then be placed in a database maintained by AgriStar for future offerings. The questionnaire itself would not specifically refer to any private offerings to be made by AgriStar in the future, and AgriStar would ensure a sufficient waiting period prior to providing any potential qualified investor with any information relating to a proposed offering of AgriStar securities.[37] Unlike in *H.B. Shaine & Co.* and *Bateman Eichler*, which

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[29] *Michigan Growth Capital Symposium*, SEC No-Action Letter (May 4, 1995). *But see Mineral Lands Research & Marketing Corporation*, SEC No-Action Letter (Dec. 4, 1985) (where the SEC Staff did not make a determination as to whether the fact that a class of offerees was limited to only 600 existing clients was material to determining if general solicitation had occurred).
[30] *Mobile Biopsy, LLC*, SEC No-Action Letter (Aug. 11, 1999) (referred to herein as "*Mobile Biopsy*").
[31] *Id.*
[32] *General Solicitation Under Rule 502(c) of SEC Regulation D*, SEC No-Action Letter (Jan. 16, 1990).
[33] H.B. Shaine & Co., *supra* note 20.
[34] *Id.*
[35] *Bateman Eichler, Hill Richards, Inc.*, SEC No-Action Letter (Dec. 3, 1985) (referred to herein as "*Bateman Eichler*").
[36] *AgriStar Global Networks, Ltd.*, SEC No-Action Letter (Feb. 9, 2004) (referred to herein as "*AgriStar*").
[37] *Id.*

involved similar questionnaires, AgriStar was operating in its capacity as an issuer and not a broker-dealer.

Electronic Media and Websites.

Both the Commission and the SEC Staff have clarified when use of electronic media and the Internet will constitute a general solicitation. In October 1995, the Commission explained that an offer conducted through an issuer's unrestricted, publicly available website would violate Rule 502(c), even if the website required various forms of information from a prospective investor prior to displaying any offering materials.[38] This was reaffirmed by the SEC Staff in August 2015.[39] However, in *IPONET*, the SEC Staff found that W.J. Gallagher & Company, Inc. ("Gallagher"), a registered broker-dealer, and its affiliate, IPONET, did not engage in general solicitation when Gallagher invited prospective investors to complete a questionnaire on IPONET's website for the purpose of building a customer base and database of accredited and sophisticated investors.[40] The SEC Staff noted that its conclusion was based on the fact that:

- 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 IPONET;
- IPONET's password-protected page would be available to a particular investor only after Gallagher made the determination that the particular potential investor was accredited or sophisticated; and
- a prospective investor could purchase securities only in transactions that were posted on the password-protected page of IPONET after the investor's qualification with IPONET.

In May 2000, however, the SEC Staff limited the scope of *IPONET*, noting that certain third-party service providers (that were neither registered broker-dealers nor affiliated with broker-dealers) had deviated substantially from the facts in *IPONET* by establishing websites that generally invite prospective investors to qualify as accredited or sophisticated as a prelude to participation; they also failed to require that prospective investors complete questionnaires needed to form a reasonable belief regarding their accreditation or sophistication.[41] Accordingly, the SEC Staff asserted that "these web sites, particularly those allowing for self-accreditation, raise significant concerns as to whether the offerings that they facilitate involve general solicitations."[42]

Notwithstanding these concerns, the SEC Staff again found in *Citizen VC* that a website could be used to both evaluate the suitability of prospective investors and provide investors with investment opportunities without contravening Rule 502(c).[43] Citizen VC intended to implement policies and procedures that would enable Citizen VC to thoroughly evaluate the sophistication of any potential investor before enabling him or her to use its website for investment opportunities. The policies and procedures included both an online questionnaire–which served the purpose of self-certification of accreditation–and a "relationship establishment period." As part of the relationship establishment period, Citizen VC would undertake several actions to establish a substantive relationship, including obtaining details related to the investor's prior investment experience and sophistication, and evaluating an investor's suitability and accuracy of information provided through the use of third-party credit reporting services. Accordingly, *Citizen VC* establishes that a website that solely requires self-certification of accreditation or sophistication will likely not satisfy the requirements under Rule 502(c). Instead, an issuer (or its agent) must also implement policies that ensure a comprehensive review of the accreditation and qualifications of any potential investor prior to making any offering through the use of a website or other form of electronic media.

Compilation of Information Related to Private Offerings

The SEC Staff has, on several occasions, articulated its views on whether the distribution of a compilation of information related to private issuers and offerings, including in the form of a newsletter, guide, magazine, or written analysis, constitutes general solicitation.

In *Richard Daniels*, the SEC Staff found that the dissemination of a newsletter on a subscription basis, which set forth information derived entirely from public records filed in the office of the Arizona Secretary of State concerning Arizona limited partnerships, would not violate Rule 502(c). Richard Daniels, the publisher of the newsletter, intended the newsletter to provide pertinent information contained in each certificate of limited partnership filed during the previous month, including: (i) the partnership name; (ii) names and addresses of general and limited partners; (iii) the type of partnership business; and (iv) the amount of initial and deferred capital contributions, as well as a summary of the previous month's limited partnership activity in Arizona (*e.g.*, the total number of limited partnerships formed and total capital raised). In reaching its conclusion, the SEC Staff noted that: (1) all Arizona limited partnerships would be included in the newsletter; (2) no analysis would be conducted of any issuer or any offering; and (3) neither the issuers listed in the newsletter nor any person acting on the issuers' behalf would be responsible for the preparation of or payment for the materials

[38] *See* Securities Act Release No. 33-7233 (Oct. 6, 1995).
[39] C&DI, *supra* note 4 at Question 256.23 (". . . the use of an unrestricted, publicly available website constitutes a general solicitation and is not consistent with the prohibition on general solicitation and advertising in Rule 502(c) if the website contains an offer of securities").
[40] *IPONET*, SEC No-Action Letter (July 26, 1996) (referred to herein as "*IPONET*").
[41] *See* Securities Act Release No. 33-7856 (May 4, 2000).
[42] *Id.*
[43] *See Citizen VC*, *supra* note 12.

included in the publication.[44]

In *Nancy Blasberg*, the SEC Staff determined that the distribution of a guide, which set forth information concerning outstanding securities of selected companies–derived mainly from public resources (*e.g.*, public research materials and public reports) and information on issuing companies provided in response to requests made to such issuing companies–would not violate Rule 502(c). The guide included the general "terms and features of most outstanding private-placed or closely-held preferred stocks of utility, financial and transportation companies."[45] The SEC Staff based its conclusion largely on the fact that the guide would only "contain certain limited information [on issuers]" and "in no case would [the guide's creator] be in the employ of, or acting as agent for, any issuer contained in the guide."[46]

However, in *Tax Investment Information Corp.*, the SEC Staff found that the Tax Investment Information Corporation's ("TIIC") distribution of a circular, the *Tax Investment Letter*, to practicing accountants and attorneys regarding private placement offerings in Louisiana constituted general solicitation.[47] Unlike in *Richard Daniels* and *Nancy Blasberg*, the SEC Staff found that TIIC's review and analysis of private placements in the *Tax Investment Letter* did not equate to the mere "assimilation of data and calculations."[48] On the contrary, TIIC's written analysis would specifically provide "background data on the principals involved in the offering, the marketability of the investment and any other additional comments felt pertinent to the economic and/or tax ramifications of the investment."[49] The SEC Staff reached a similar conclusion in *J.D. Manning, Inc.*, in which J.D. Manning, Inc. ("J.D. Manning") planned to publish a periodic newsletter containing a list and description of close-held businesses that may have expected to make exempt private securities offerings to raise capital in the future.[50] Businesses choosing to participate in the newsletter would prepare materials for inclusion and pay for its publication. Subscribers of the newsletter would consist primarily of prospective investors and support service firms (*e.g.*, accountants, attorneys, financial institutions, etc.). J.D. Manning would solicit subscribers through either the use of print media or personal sales/speaking engagements. The SEC Staff especially noted that the newsletter constituted general solicitation because it would contain "the estimated amount of capital which may be raised [by participating businesses] within 12 months following publication."[51] Therefore, although none of the participating businesses were in the process of offering securities at the time of publication, these businesses could still raise capital shortly thereafter, which made the publication a general solicitation.

The SEC Staff has at times also found that it was unable to make a determination as to whether a publication containing a compilation of information related to certain private offerings violated Rule 502(c). For example, in *Oil and Gas Investor*, the SEC Staff found that it was unable to determine whether *Oil and Gas Investor* magazine, a publication that would contain factual information relating to offerings, registered and unregistered, of securities in oil and gas drilling programs, constituted general solicitation.[52] The magazine would only contain "bare-bones factual information relating to available [oil drilling] programs, both public and private" (*e.g.*, unit price, minimum subscriptions, aggregate amount of the offerings, and terms of the offerings), based on the magazine publisher's review of SEC filings and direct inquiries of companies known to sponsor oil and gas programs.[53] The publisher attempted to distinguish the magazine from *Tax Investment Information Corp.*, because, unlike the *Tax Investment Letter*, *Oil and Gas Investor* magazine "[could not] be used to induce others to make an investment since it [did] not contain a recommendation or purpose to set forth an evaluation upon which to base an investment decision."[54] However, the SEC Staff concluded that it was unable to make a determination under Rule 502(c) because there were unanswered questions regarding "the exact language of particular published material" and the issuers' role, if any, "regarding the publication of information concerning the offering of its securities."[55]

Seminars, Demo Days, and Venture Fairs

The Commission and the SEC Staff have also offered guidance regarding an issuer's participation in a "seminar" and whether this would constitute a general solicitation. Prior to 2013, the SEC Staff's interpretation of what constituted a permissible "seminar" rested largely on its 1995 determination in *Michigan Growth Capital Symposium*.[56] In *Michigan Growth Capital Symposium*, the SEC Staff was asked to determine whether a symposium, co-sponsored by the University of Michigan and the Office for the Study of Private Equity Finance ("OSPEF") of its School of Business, which functioned as a vehicle to provide Michigan firms with efficient access to the national private equity finance markets, was engaged in general solicitation. Only private companies that were selected by the director of the OSPEF could present at the symposium. The SEC Staff found that the symposium did not violate Rule 502(c) because: (1) the symposium was publicized through targeted mailing to "known accredited investors, limited generic advertising in the Venture Journal

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[44] *Richard Daniels*, SEC No-Action Letter (Dec. 19, 1984) (referred to herein as "*Richard Daniels*").
[45] *Nancy Blasberg*, SEC No-Action Letter (July 12, 1986) (referred to herein as "*Nancy Blasberg*").
[46] *Id.*
[47] *Tax Investment Information Corp.*, SEC No-Action Letter (Dec. 19, 1984).
[48] *Id.*
[49] *Id.*
[50] *J.D. Manning, Inc.*, SEC No-Action Letter (Feb. 27, 1986).
[51] *Id.*
[52] *Oil and Gas Investor*, SEC No-Action Letter (Sept. 9, 1983).
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Michigan Growth Capital Symposium*, *supra* note 29.

and by word of mouth by prior attendees"; (2) the symposium did not arrange any prior contacts between presenter firms and attendees, no specific financing details were presented by any company, and no private placement materials were distributed; and (3) neither the symposium nor the director of the OSPEF (i) provided any other services, beyond limited consulting services, to any participating company or (ii) received any compensation from presenters or attendees of the symposium, including any conditional fees or brokerage-type commissions (except for fees associated with the conduct of the symposium).

In August 2015, the SEC Staff explained that an issuer's presentation may not constitute general solicitation if attendance at the demo day or venture fair is limited to persons with whom the issuer or the organizer has pre-existing, substantive relationships or who have been contacted through a personal network of individuals with experience investing in private offerings. [57]

Angel Investor Networks

The SEC Staff also addressed whether an issuer's interactions with an "angel investor network" would constitute a general solicitation. For example, sophisticated individuals, such as angel investors, share information about offerings through their network, and members who have a relationship with a particular issuer may introduce that issuer to other members of the network.[58] However, even where an issuer is unsure as to the level of sophistication of a particular offeree who is part of such a network, the SEC Staff noted that an issuer who interacts with members of the network through this type of referral 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. Nevertheless, whether an issuer's interaction with angel investor networks constitutes general solicitation will still be evaluated on a case-by-case basis.

B. General Advertisements

The SEC Staff has additionally provided helpful guidance as to when an advertisement constitutes "general advertising." In *Gerald F. Gerstenfeld*, the SEC Staff found that a syndicator's intention to publish an advertisement in the *Wall Street Journal*–for the purposes of indicating that the syndicator was selling securities in private placements and inviting members of the public to call or write to the syndicator for additional information–would constitute a general advertisement if published while the syndicator was in the process of offering and selling securities.[59] The general advertisement in *Gerald F. Gerstenfeld* was not limited to a targeted group of sophisticated investors, but instead would have been shown to the general public without limitation. The SEC Staff additionally noted that the advertisement would even constitute a prohibited general advertisement even if securities were not being sold at the time of the advertisement's publication, as long as the syndicator expected in the near future to offer and sell securities.

In *Alma Securities Corporation*, the SEC Staff assessed whether "tombstone" advertisements that merely announce the completion of private placements constitute general advertising.[60] While the SEC Staff did not express a definitive view, it did nevertheless provide several factors to consider. The SEC Staff affirmed that the critical determining factor is whether the tombstone advertisement is used to offer or sell securities.[61] An advertisement would likely violate Rule 502(c) where a sponsor or issuer conducts an ongoing program of private or limited offerings, and the tombstone announcements for the completion of each individual offering could be used to solicit investors to the program as a whole.[62] Conversely, the publication of a tombstone announcement in connection with an isolated offering where the advertisement would have no immediate or direct bearing on contemporaneous or subsequent offers or sales of securities would likely not constitute a general advertisement.[63]

In *Aspen Grove*, the SEC Staff found the proposed use of a promotional brochure, as well as a magazine advertisement by Aspen Grove, a limited partnership formed for the purpose of boarding, breeding, breaking, and training thoroughbred horses, constituted general solicitation and general advertising.[64] Aspen Grove intended to solicit interests in the limited partnership through (1) the mailing of a brochure to members of the Thoroughbred Owners and Breeders Association, (2) the distribution of brochures at a local sale for horse owners, and (3) the placement of an advertisement in *The Blood Horse*, a trade journal for readers specifically interested in race horses.[65] The SEC Staff found that the advertisement in *The Blood Horse* constituted a general advertisement because the journal was visible, without limitation, to any member of the public.

Accordingly, whether a communication made by a newspaper, news service, or other third party constitutes general advertising will largely depend on the involvement of the issuer (or its agent) and the timing of an offering. Where an issuer (or its agent) neither sponsors nor participates in an advertisement (*i.e.*, by offering information to be provided in the communication), and there is no concurrent or contemplated offering, the communication will likely not constitute general advertising. Moreover, an advertisement that

[57] C&DI, *supra* note 4 at Question 256.33.
[58] *Id.* at Question 256.27.
[59] *Gerald F. Gerstenfeld*, SEC No-Action Letter (Dec. 3, 1985).
[60] *Alma Securities Corporation*, SEC No-Action Letter (Aug. 2, 1982).
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Aspen Grove*, SEC No-Action Letter (Dec. 8, 1982).
[65] *Id.*

constitutes an ordinary-course business communication (*e.g.*, factual business information or an announcement of new products and services) will likely fall outside of the prohibition on general advertising.[66] Even where an SEC-reporting issuer is contemplating an unregistered offering, the SEC has carved out a safe harbor under Rule 135c under the Securities Act, which enables the issuer to publish a notice (*e.g.*, a news release or other written communication) concerning the offering to the public.[67]

C. Factual Information

In August 2015, the SEC Staff reaffirmed that issuers may widely disseminate information not involving an offer of securities and still comply with Rule 502(c), including "factual information" about the issuer that "does not condition the public mind or arouse public interest in a securities offering."[68] The SEC Staff explained that "factual information" will be evaluated on a case-by-case basis, but typically should be limited to general information about the issuer's: (a) business; (b) financial condition; (c) products; and/or (d) services, as well as advertisements of such products or services, provided that such information is not presented in such a manner as to constitute an offer of the issuer's securities.[69] However, such information does not generally include any: (1) predictions; (2) projections; (3) forecasts; or (4) opinions concerning value.[70] The meaning of "factual information" in the context of general solicitation can also be gleaned by analogizing to the safe harbors provided under Rule 168[71] and Rule 169[72] under the Securities Act. The SEC has established that both SEC-reporting and non-SEC reporting companies may, under Rule 168 and Rule 169, respectively, communicate "factual business information" (*e.g.*, factual information about the issuer and its financial developments and advertisements or information about the issuer's products) and "forward-looking information" (*e.g.*, projections of the issuer's revenues, income (loss), earnings (loss) per share, and dividends) to investors without being deemed an offer under Section 5 under the Securities Act, provided that certain requirements are satisfied.[73] Most notably, both rules contain a "regularly released" element, specifying that the "timing, manner, and form in which the [factual business or forward-looking] information is released or disseminated [must be] consistent in material respects with similar past releases or disseminations."[74] While the Commission has acknowledged that the safe harbors under Rule 168 and Rule 169 do not establish or require any minimum time period to be deemed "regularly released," the SEC has noted that one prior release or dissemination could be sufficient to establish a track record.[75]

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[66] *See* Section C, *infra*, for a discussion on "factual information."
[67] *See* 17 C.F.R. § 230.135c(a)-(c).
[68] C&DI, *supra* note 4 at Question 256.24.
[69] C&DI, *supra* note 4 at Question 256.25.
[70] *Id. See also* SEC Release No. 33-5180, 1971 WL 120474, at *2 (Aug. 20, 1971) ("Further, care should be exercised so that, for example, predictions, projections, forecasts, estimates and opinions concerning value are not given with respect to such things, among others, as sales and earnings and value of the issuer's securities.").
[71] *See* 17 C.F.R. § 230.168.
[72] *See* 17 C.F.R. § 230.169.
[73] *See generally* 17 C.F.R. § 230.168(a)-(d); 17 C.F.R. § 230.169(a)-(d).
[74] *See id.*
[75] *See* Securities Offering Reform, Release No. 33-8591 (July 19, 2015), at 64, *available at* https://www.sec.gov/rules/final/33-8591.pdf.

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LATE STAGE PRIVATE PLACEMENTS

A Life Sciences Sector Survey

May 2017

As many privately held companies choose to remain private longer and defer their initial public offerings (IPOs), these companies are increasingly reliant on raising capital in successive private placements. New categories of investors, including cross-over funds, sovereign wealth funds, and family offices, have become significant participants in late-stage (or mezzanine) private placements. Depending on the sector, a late-stage private placement may be an important step for a company. In the technology sector, a late-stage private placement may be an IPO alternative and provide growth capital that allows the company to continue to execute on its business strategy. However, in the life sciences sector, by contrast, a late-stage private placement may provide needed capital to allow the company to defer its IPO until there is an IPO window. Also, a late-stage private placement may serve to attract known sector investors to the company and provide important support to take the company through to a successful IPO. Often, the investors will express an interest in participating in a subsequent IPO and this may be important to the IPO's ultimate success. This may be important during periods of volatility and when the IPO market is unpredictable. While life sciences companies represented a significant percentage of IPO issuers in the last few years, and there appear to be improved prospects for IPOs in 2017, there might still be fewer healthcare deals as a percentage of the total number of IPOs.

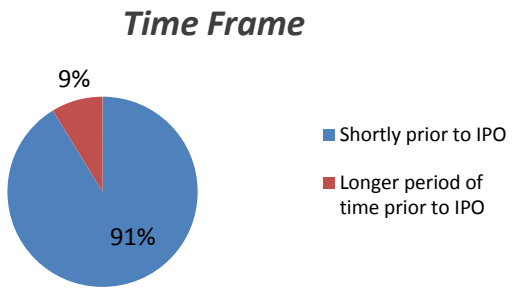
In this survey, we have examined the late-stage private placements that preceded life sciences IPOs undertaken in 2015 and in 2016. In 2015, there were 61 life sciences IPOs completed. Overall, in 2015, there were 185 IPOs completed. Life science IPOs represented approximately 33% of the IPOs for 2015. In 2016, there were 42 life sciences IPOs completed. Overall, in 2016, there were 117 IPOs completed. Life sciences IPOs represented approximately 36% of the IPOs for 2016.

LATE-STAGE PRIVATE PLACEMENTS

Explanatory Note: Unless otherwise indicated, our findings below regarding late-stage private placements also include private placements that were undertaken concurrently with the IPO.

How many months prior to the IPO was the last private placement completed?

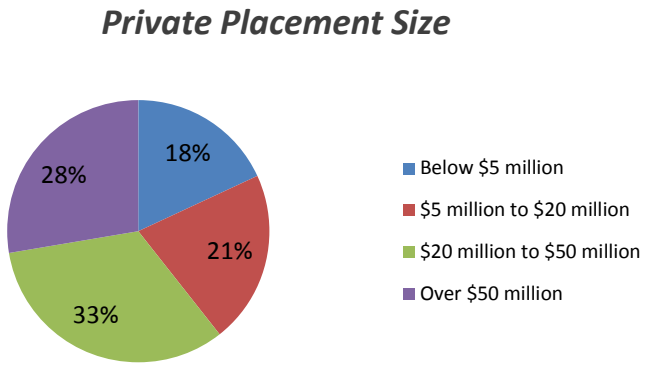
Approximately 91% (94/103) of the companies surveyed undertook a private placement shortly prior to their IPO.



For those companies that undertook a private placement shortly prior to their IPO, the average time period between the final private placement and the IPO was approximately 7.99 months and the range was from 1 to 45 months (excluding those private placements that were undertaken concurrently with the IPO).

What were the gross proceeds from the last private placement shortly prior to the IPO?

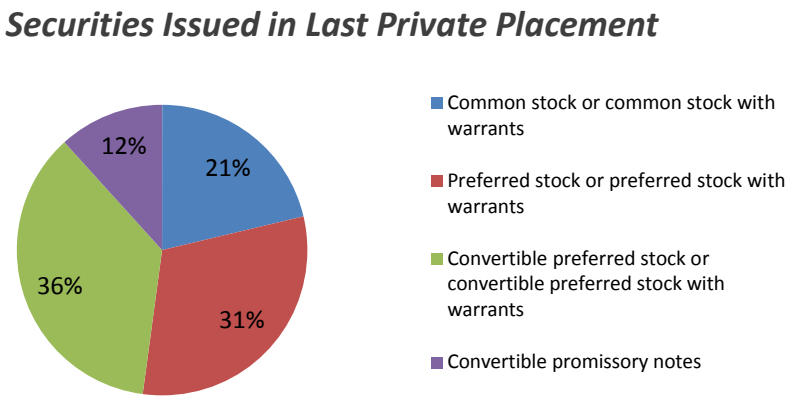
- Average gross proceeds: approximately $39.9 million
- Range: $0.01 million to $550 million
- Below $5 million: approximately 18% (17/94)
- $5 million to $20 million: approximately 21% (20/94)
- $20 million to $50 million: approximately 33% (31/94)
- Over $50 million: approximately 28% (26/94)



What type of security was offered in the last private placement before the IPO?

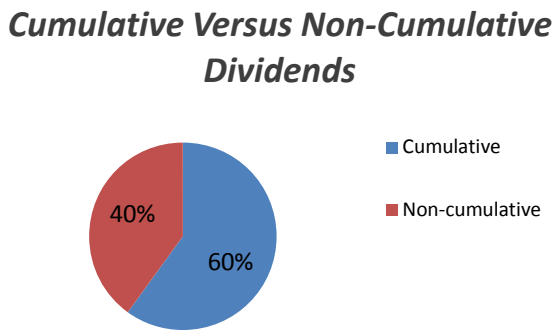
- Common stock or common stock with warrants: approximately 21% (20/94)
- Preferred stock or preferred stock with warrants: approximately 31% (29/94)
- Convertible preferred stock or convertible preferred stock with warrants: approximately 36% (34/94)
- Convertible promissory notes: approximately 12% (11/94)

There were no issuances of non-convertible promissory notes. One company that issued convertible promissory notes also issued warrants exercisable for common stock.



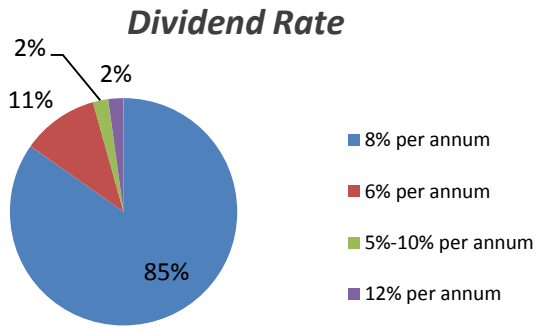
Did investors receive dividend rights? If so, were dividends cumulative?

Yes, investors in offerings of common stock, preferred stock and convertible preferred stock were entitled to receive dividends. Of the offerings of preferred stock and convertible preferred stock, 60% (30/50) specified cumulative dividends and 40% (20/50) specified non-cumulative dividends.



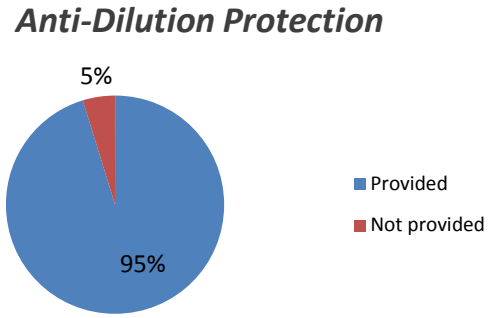
What was the specified dividend rate (for those companies that issued dividend-paying securities)?

Approximately 85% (39/46) of the companies specified a dividend of 8% per annum, one company specified a dividend of 12% per annum, one company specified a variable dividend ranging from 5%-10% per annum and five companies (approximately 11%) specified a dividend of 6% per annum.

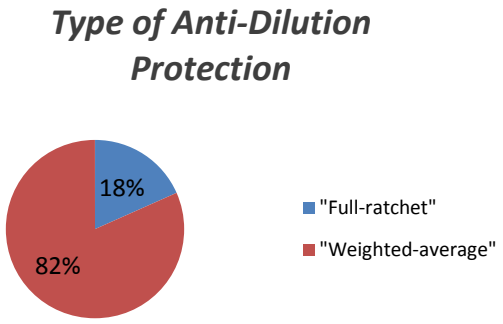


Did investors receive anti-dilution protection?

Approximately 95% (60/63) of the companies provided investors with anti-dilution protection and approximately 5% (3/63) did not.

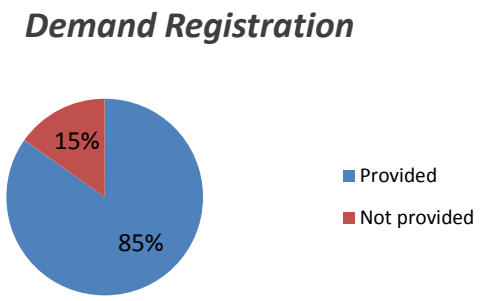


Of those companies that provided investors with anti-dilution protection, approximately 18% (11/60) provided "full-ratchet" anti-dilution protection and approximately 82% (49/60) provided "weighted-average" anti-dilution protection.

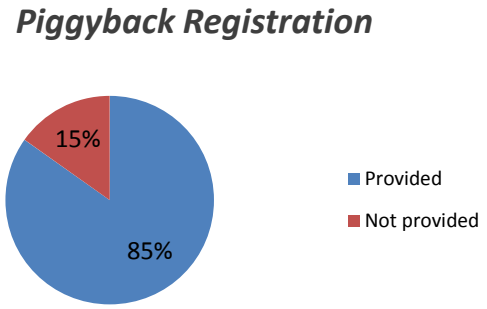


Did investors receive registration rights?

- Demand registration: Approximately 85% (67/79) of the companies provided investors with demand registration rights and approximately 15% (12/79) did not.

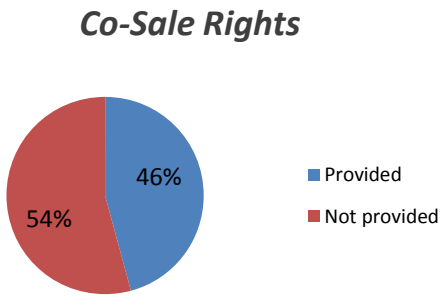


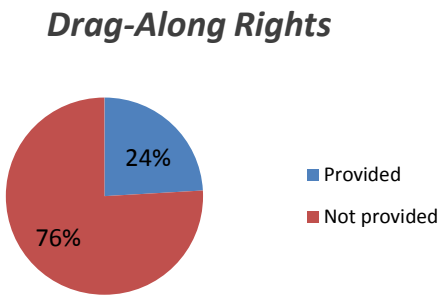
- Piggyback registration: Approximately 85% (67/79) of the companies provided investors with piggyback registration rights and approximately 15% (12/79) did not.



Did investors receive co-sale rights? Drag-along rights?

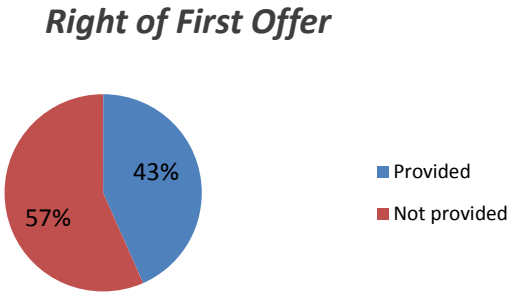
- Co-sale rights: Approximately 46% (38/83) of the companies provided investors with co-sale rights and approximately 54% (45/83) did not.
- Drag-along rights: Approximately 24% (20/83) of the companies provided investors with drag-along rights and approximately 76% (63/83) did not.



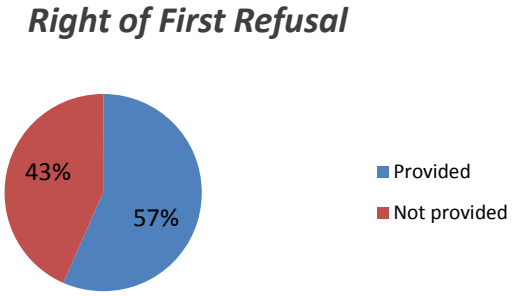


Did investors receive a right of first offer? A right of first refusal? Pre-emptive rights?

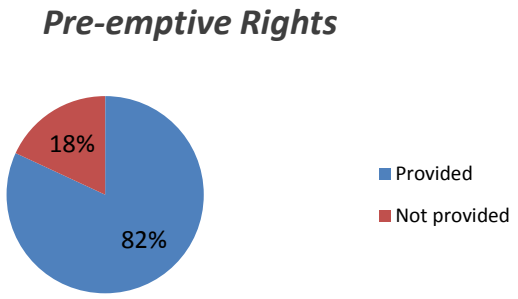
- Right of first offer: Approximately 43% (36/83) of the companies provided investors with a right of first offer and approximately 57% (47/83) did not.



- Right of first refusal: Approximately 57% (47/83) of the companies provided investors with a right of first refusal and approximately 43% (36/83) did not.



- Pre-emptive rights: Approximately 82% (68/83) of the companies provided investors with pre-emptive rights and approximately 18% (15/83) did not.

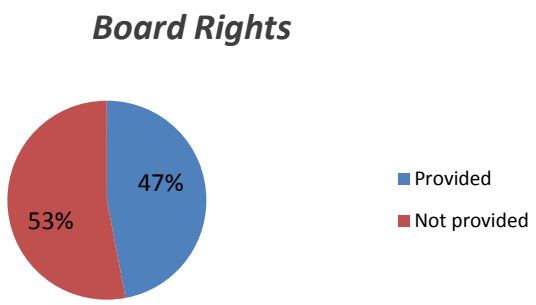


Did investors receive voting rights?

All of the companies issuing preferred stock or convertible preferred stock provided for voting as a separate class on certain matters (for example, board members) and voting with other common stockholders or other classes of preferred stock on general matters presented to stockholders.

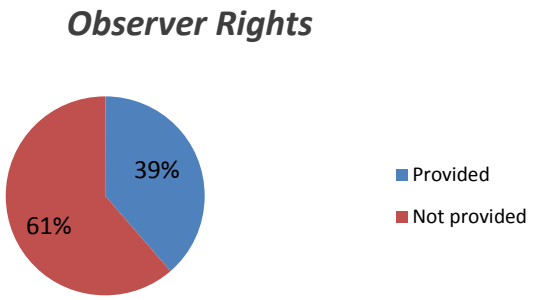
Did investors receive board rights?

Approximately 47% (39/83) of the companies provided investors with board rights and approximately 53% (44/83) did not.



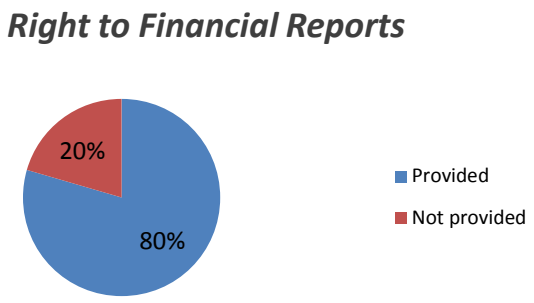
Did investors receive observer rights?

Of those companies that did not provide investors with board rights, approximately 39% (17/44) provided investors with observer rights, typically non-voting, and approximately 61% (27/44) did not.

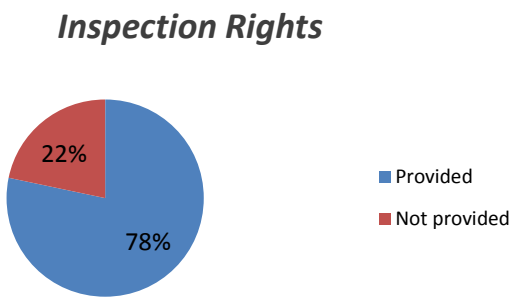


Did investors receive information rights?

- Right to financial reports: Approximately 80% (66/83) of the companies provided investors with a right to receive financial reports and approximately 20% (17/83) did not.



- Inspection rights: Approximately 78% (65/83) of the companies provided investors with inspection rights and approximately 22% (18/83) did not.

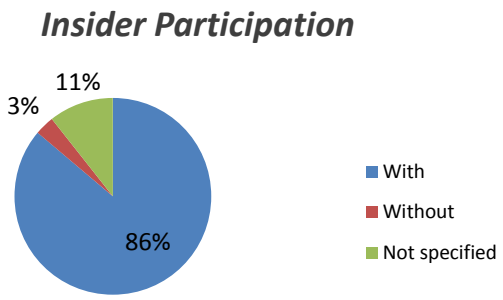


Did investors receive IPO price protection?

No. Unlike tech company late-stage private placements in which IPO price protection has become more common, none of the life sciences companies provided investors with IPO price protection.

Did insiders participate in the last private placement before the IPO? If so, what was the amount of their investment as a percentage of the gross proceeds of the private placement?

- Approximately 86% (81/94) of the companies had insider participation in their last private placement shortly prior to the IPO. Approximately 11% (10/94) of the companies did not disclose whether they had insider participation in their last private placement shortly prior to the IPO. Three companies (approximately 3%) did not have insider participation in their last private placement shortly prior to the IPO. "Insiders" refer to directors, executive officers, officers or employees with policy-making functions, and 10% beneficial holders.



- Of those companies that had insider participation in their last private placement:
  - The amount invested by insiders relative to the gross proceeds of the last private placement was on average approximately 75%.
  - The amount invested by insiders relative to the gross proceeds of the last private placement ranged from 5% to 100%.

IPOs

We also reviewed the IPOs following the last private placements in order to identify trends related to insider participation. Our findings are set forth below.

How many IPOs had insider participation?

Approximately 70% (72/103) of the IPOs had insider participation and approximately 30% (31/103) did not.

Insider Participation in IPO

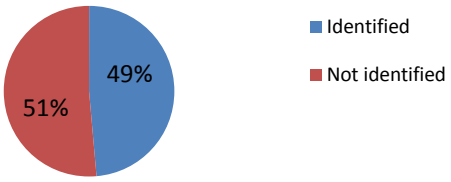
What types of insiders participated?

Insiders participating in the IPOs generally were 10% beneficial holders, including through an affiliation with a director or officer. "Insiders" refer to directors, executive officers, officers or employees with policy-making functions, and 10% beneficial holders.

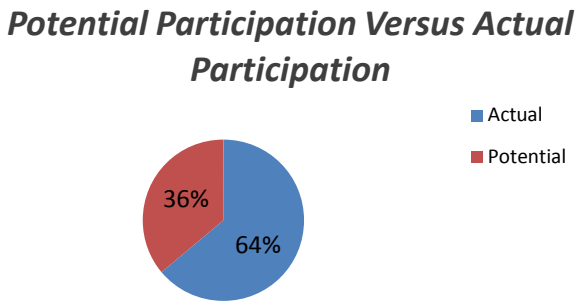
Did the IPO prospectuses include disclosure regarding the type of insider participation?

- Approximately 51% (37/72) of the IPO prospectuses did not disclose the names of those insiders participating in the IPO and approximately 49% (35/72) identified those insiders participating in the IPO.

Insiders Identified Versus Non-Identified



- Approximately 64% (46/72) of the IPO prospectuses disclosed the potential participation of insiders in the IPO and approximately 36% (26/72) disclosed the participation of insiders in the IPO.



For those IPOs with identified insider participation, what was the amount of insider investment as a percentage of the gross proceeds of the IPO?

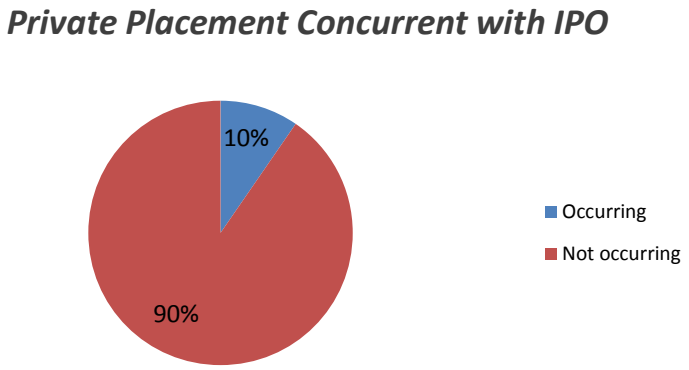
- Range: approximately 1% to 80%
- Average: approximately 32%

Was there a jump in valuation from the last private placement to the IPO?

Yes, typically there was a jump in valuation for life sciences companies from the last private placement to the IPO. This jump was slightly higher in 2015 (an average of approximately over 150%) compared to 2016 (an average of approximately under 110%).[1]

How many of the IPOs had a concurrent private placement?

Approximately 10% (10/104) of the IPOs had a concurrent private placement. Of those companies with a concurrent private placement, eight also had insiders indicating an interest in participating in the IPO.



[1] Data for 2016 only through June 30, 2016.

For those IPOs that had a concurrent private placement, what were the gross proceeds of the concurrent private placement relative to the gross proceeds of the IPO?

- Range: approximately 8% to 38%
- Average: approximately 26%

The IPO market has been improving as 2017 progresses. Also, given rising concerns about the trend of private companies increasingly deferring their IPOs and depending more heavily on private financing transactions, there are various proposed legislative measures introduced that aim to relieve the burdens associated with being a U.S. public company. To the extent that the IPO market continues to improve and some of the proposed measures are ultimately adopted, certain of the trends and dynamics we describe in this survey may change.

For more information regarding late-stage private placements, see our infographic: https://goo.gl/54tcdC.

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The Jumpstart Our Business Startups (JOBS) Act is intended to jumpstart capital-raising for emerging companies, as well as facilitate capital formation for existing public companies of all sizes. Given our longstanding commitment to serve emerging companies and the breadth of our capital markets and corporate practices, we are fascinated by the possibilities that the JOBS Act may turn into reality. So fascinated that we decided to supplement our dedicated JOBS Act webpage with this blog. Our Jumpstart blog is intended to provide entrepreneurs, domestic and foreign companies of all shapes and sizes, and financial intermediaries, with up to the minute news and commentary on the JOBS Act. Visit www.mofojumpstarter.com.

The Short Field Guide to IPOs.

In our recently updated IPO Field Guide we provide an overview of the path to an initial public offering and address a number of recent developments. Our guide is available here: https://goo.gl/Cvxa4S.

EGC Corporate Governance Practices.

In our survey, we consider the characteristics of

emerging growth companies ("EGCs") that completed IPOs and the corporate governance, compensation and other practices adopted by them. To access our survey, visit: https://goo.gl/tecAzW.

JOBS Act Quick Start.

JOBS Act Quick Start provides a comprehensive overview of the provisions of the JOBS Act, including the changes brought about in market practice as a result of the IPO on ramp provisions. This update describes the recent FAST Act improvements, the final rules relating to Regulation A, and the final rules implementing Regulation Crowdfunding.

To download your copy, click here. To request a hard copy, please e-mail tstarer@mofo.com.

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INITIAL PUBLIC OFFERINGS

Confidentially Speaking, This Could be a Big Deal
The SEC's Approach to Confidential Submissions

BY ANNA T. PINEDO AND JAMES R. TANENBAUM

Even amidst all the other news crowding the headlines these days, it would be hard to miss the many stories discussing the U.S. initial public offering (''IPO'') market. By now, the trends are well-reported. Many promising U.S. companies are choosing to remain privately held longer and defer their IPOs. The once well-defined stages in a company's funding life, from friends and family rounds to angel investor rounds to venture capital rounds to IPO have been disrupted. It is not uncommon for a company to remain private for ten to twelve years prior to pursuing an IPO or an M&A exit. As a result, generally, the companies that undertake IPOs are more mature and have a higher median market capitalization at the time of their IPOs than their predecessors in prior periods. There are fewer smaller IPOs. There now are many investors that are willing to invest in privately held companies, including family offices, sovereign wealth funds, venture and private equity funds, and cross-over funds. The valuations available to promising companies in private financing rounds often may be more attractive than the valuations that may result from an IPO. Some of these developments may account for the ''unicorn'' phenomenon. There are nearly 200 private companies valued by venture capital firms at $1 billion or more and few of these of these companies have taken the plunge and pursued IPOs. Studies indicate that the number of individual investors that own stocks directly has declined and institutional investors are disinclined to invest in small-cap and even smaller mid-cap stocks. Companies are experiencing much of their most significant growth while they are privately held, rather than in the years immediately following their IPOs, and institutional investors that participate in private funding rounds may stand to benefit most from this growth. In light of all of these changes, it is understandable that policymakers are focused on the ways to revive the U.S. IPO market and make regulatory changes that may remove some of the perceived impediments to pursuing public offerings.

Anna Pinedo, a partner in Morrison & Foerster LLP, concentrates her practice on securities and derivatives.

James Tanenbaum serves as chair of Morrison & Foerster's Global Capital Markets practice.

New Policy

Against this backdrop, in June 2017, the Securities and Exchange Commission (the ''Commission'' or ''SEC'') announced a new policy to make the confidential submission process for registration statements more broadly available. The Jumpstart Our Business Startups Act (the ''JOBS Act'') allowed a new category

of issuers, emerging growth companies (''EGCs''), to submit their IPO registration statements for the Commission's confidential review. The confidential submission and review process has been one of the most popular aspects of the JOBS Act. Approximately 90% of EGCs have submitted their IPO registration statements on a confidential basis in the last two years. The ability to make a confidential submission enables an issuer to avoid the glare of publicity for a time while the issuer assesses whether an IPO will be well-received by investors. An EGC can engage in test-the-waters meetings with institutional investors to gain meaningful insight on valuation issues and assess market conditions. Also, an EGC also can address any accounting or other comments made by Commission Staff during the confidential phase. Should the market not prove hospitable to an IPO, the issuer can choose not to file publicly without the stigma often associated with a ''failed'' or a ''withdrawn'' offering. Of course, during the confidential phase, an issuer also can evaluate M&A opportunities. While it is unlikely that the ability to submit an IPO registration statement for confidential review can be attributed to any increased willingness on the part of companies to pursue IPOs, confidential submissions may ease the path to an offering. For the last several years, legislators have introduced bills that would have extended many of the accommodations made available to EGCs by the JOBS Act to issuers generally. These bills, often termed ''JOBS Act 2.0,'' have failed to gain bipartisan approval in the deeply divided Congress.

The Commission took the initiative. Since July 10, 2017, all companies, including foreign private issuers and Canadian issuers that rely on the Multijurisdictional Disclosure System, may submit draft IPO registration statements for confidential review. Foreign private issuers may elect to benefit from this new guidance, the procedures available to EGCs (if they so qualify) or the Division of Corporation Finance staff guidance issued on May 30, 2012. As is the case for EGC IPO issuers, any issuer that avails itself of the confidential submission process for its IPO must publicly file its registration statement at least 15 days before the date on which the issuer conducts a road show, as such term is defined in Securities Act Rule 433(h)(4). A foreign private issuer that relies on the accommodations available to EGCs or on this new policy will have to comply with the requirement to file publicly at least 15 days prior to commencement of its roadshow, which would not apply under the Staff's 2012 guidance. The Commission did not extend any of the other JOBS Act benefits (i.e., the ability to test the waters or reduced disclosure requirements) to non-EGC IPO issuers. However, the new policy does permit an IPO issuer to omit financial information that the issuer reasonably believes will not be required at the time that the registration statement is publicly filed. Perhaps signaling more changes ahead, shortly after announcing this new policy, the Commission Chair noted in public remarks that the Commission remains willing to consider requests made pursuant to Regulation S-X Rule 3-13 to modify financial reporting requirements to the extent that certain required disclosures are burdensome and their omission would not affect adversely the total mix of information available to investors. Also in public comments, representatives of the Commission, including the Chair, reiterated the Commission Staff's disclosure effectiveness initiative, which is intended to identify disclosure requirements that may be repetitive or redundant, outdated, or otherwise unnecessary.

Following its announcement, the Staff of the Division of Corporation Finance released frequently asked questions related to the new confidential submission process. As a result of the JOBS Act, there is a specific provision in the Securities Act relating to confidential submissions made by EGCs that protect these submissions from disclosure under the Freedom of Information Act. While the actual process for submission of draft registration statements through the Commission's EDGAR system will be the same for submissions made in reliance on the new procedures, the Staff noted that issuers may seek confidential treatment when submitting responses to Staff comments on draft registration statements. The FAQs note that an issuer should consider requesting confidential treatment under Rule 83 for its draft registration statements and comment letters. In addition, the FAQs addressed public communications made in connection with the submission of draft registration statements. The Staff noted that the Securities Act Rule 134 safe harbor for public communications is not available until the issuer files a registration statement that satisfies the requirements of Rule 134. The issuer may make a public communication about its draft registration statement in reliance on Securities Act Rule 135, but a public statement about its offering may affect whether the Commission can withhold the draft registration statement in response to a request under the Freedom of Information Act.

It is not clear that making confidential submissions more broadly available to IPO issuers will have a prompt or discernible impact on the U.S. IPO market. The Chair of the Commission alluded to disclosure burdens weighting the balance in favor of companies choosing to stay private longer. However, most private companies and their founders seem more keenly focused on the fact that the advantages once associated with being a public company may no longer be so compelling, especially given the availability of private capital. Research coverage, secondary market liquidity, the short-term focus of many investors and the resulting lack of flexibility for management teams to focus on long-term goals, and litigation risks may be more significant issues than disclosure requirements.

Follow-On Offerings

The Commission also extended the ability to make confidential submissions for EGCs and other issuers in connection with offerings undertaken within the first twelve months after the issuer has become an SEC-reporting company. In the case of a follow-on offering within the first twelve months following the effective date of the IPO or a Section 12(b) registration statement, the issuer must file publicly at least 48 hours prior to any requested effective time and date. An issuer relying on the confidential submission process for follow-on offerings cannot file amendments on a confidential basis, it can only make the first submission of the follow-on registration statement on a confidential basis. The ability to submit a follow-on registration statement for confidential review in the period immediately following an IPO is an important development. The U.S. capital markets have undergone significant changes in recent years. Almost all follow-on offerings are now undertaken as takedowns off of effective shelf

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registration statements (once issuers become eligible to use a shelf registration statement) and involve only abbreviated ''public'' marketing. Most follow-on offerings are structured as confidentially marketed public offerings or as accelerated marketed offerings in order to avoid subjecting issuers to shorting activity in their stocks. As we have previously noted in our writings, while ''private'' offerings have become more public, public offerings have become more ''private.'' In the period during which an issuer has not yet become eligible to file a shelf registration statement and cannot undertake a confidentially marketed public offering, this new ability to submit a follow-on registration statement for confidential review allows issuers to avoid subjecting themselves to stock price volatility for an extended period. An issuer can make a confidential submission in respect of its follow-on registration statement and plan the timing of the follow-on offering once it understands whether the registration statement will be subject to Staff review. It is easy to envision that the issuer, the underwriters, and their advisers will work together to plan the timing of investor outreach and marketing with the 48-hour period in mind once a review or no-review determination has been made.

Direct Listings

Finally, and perhaps most important, the Commission also now will permit an issuer to submit for confidential review a registration statement filed to register a class of securities under the Securities Exchange Act of 1934 (the ''Exchange Act''), such as a registration statement on Form 10 for a U.S. issuer or a Form 20-F for a foreign private issuer. An issuer must publicly file an Exchange Act registration statement at least 15 days prior to seeking its effectiveness. For certain classes of issuers, and given changes in market structure, the ability to pursue a ''direct listing'' may be very meaningful. The traditional path to becoming an SEC-reporting company always has been an IPO, which entails volitionally filing a registration statement under the Securities Act and raising capital while contemporaneously listing a class of securities on a national securities exchange. Of course, an issuer also could become subject to the Commission's Exchange Act reporting requirements if the issuer has crossed the Exchange Act Section 12(g) threshold based on revenues and the number of holders of record. Finally, an issuer can choose to register a class of its securities under the Exchange Act and list its securities on an exchange without undertaking a capital raise. Often referred to as a ''backdoor IPO'' or a ''Form 10 IPO,'' this approach was little used. Some life sciences companies have undertaken listings during periods in which the IPO window was closed. However, for small and mid-cap companies, this approach of undertaking a listing without having undergone an IPO and without the sponsorship of underwriters that subsequently support aftermarket trading and provide research coverage, has yielded mixed results.

So what's changed that may now make direct listings appealing? The answer as to micro-cap and small-cap companies is likely not much. However, for larger companies, the answer is probably different. As discussed above, attractive privately held companies and especially unicorns are able to raise capital in the private markets at attractive valuations. For such companies, pursuing an IPO may no longer be about raising capital since they can accomplish that more efficiently in private placements. Even if they no longer need to undertake IPOs to raise capital, these companies may nonetheless be interested in having a class of securities listed on a national securities exchange. Stock-based compensation remains important to tech-based companies. Recruiting and retaining talented employees often entails providing a path to liquidity opportunities so that these employees can monetize their holdings. Private secondary markets help, but may not be the most desirable long-term solution. For companies with an acquisition strategy having an acquisition currency in the form of a class of listed securities may be an important factor. The investors in private rounds also may seek liquidity opportunities that may only come with having a class of securities listed on a securities exchange.

The challenges that biotech Form 10 issuers encountered likely would not arise for unicorns undertaking direct listings. Unicorns tend to have fairly dispersed holders that are sophisticated investors. These companies are well-followed by investment banks and in the press already, even without their having undertaken IPOs. A unicorn, advised by financial intermediaries acting as advisers (not underwriters), likely will be able to attract the attention of additional or new institutional investors that might purchase its securities in the secondary market. These same financial intermediaries, or others familiar with the company, might provide research coverage following the listing of its stock on a securities exchange. As a result, it is possible that for a sufficiently large and well-recognized company, a direct listing might yield many of the same benefits of an IPO perhaps with reduced costs and with greater control in the hands of the company. A unicorn that has raised capital in successive private rounds also may be sensitive to valuation considerations. It is possible that a company undertaking a direct listing might begin trading at a price closer to the price at which it completed its immediately prior round of private financing. For a foreign private issuer that already has a class of securities listed on a securities exchange in its home country or on another exchange that has limited liquidity, a direct listing on a securities exchange in the United States also may be an effective alternative to a traditional IPO. While it is impossible to predict with any accuracy whether direct listings may be the new route to public company status for unicorns, it is certainly helpful that the Commission is facilitating the possible new approach.

Conclusion

In the three decades during which we have been focused on the U.S. equity capital markets, we have seen enormous changes. There is no reason to expect that enormous changes will not continue to occur. The Commission's recently announced policy of expanding the confidential submission process has the potential to change the way in which securities are offered in follow-on transactions and influence the way in which issuers become SEC-reporting companies.

Securities Offerings and Communications: Is the Integration Bogeyman Dead?

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Morrison Foerster

In our Practising Law Institute treatise *Exempt and Hybrid Securities Offerings*, we refer to the concept of "integration" under the securities law as a bogeyman of sorts for practitioners. In this day and age of tweets and posts, and where public and "private" offerings are hard to distinguish from one another, is the concept of integration antiquated? Or is it perhaps due for a comprehensive re-examination by the Securities and Exchange Commission? As we discuss below, many of the fundamental principles of integration of offerings, aggregation of offerings for purposes of securities exchange rules, and communications issues like "gun-jumping" and "quiet periods" may have been so eroded as to no longer be meaningful.

Integration Principles and the "Five-Factor Test"

It is well understood that an issuer should not be able to circumvent the registration requirements arising under section 5 of the Securities Act of 1933 by conducting a series of smaller offerings separately and thereby evading registration. An issuer must consider each proposed financing and assess whether such financing meets all of the requirements for an exemption from the registration requirements. Also, an issuer must assess whether a series of financings conducted in close proximity to one another form part of the same plan of financing and ought to be integrated and considered as a single offering that either is exempt from registration or subject to the registration requirements. It is, of course, possible that even if a series of separate exempt offerings was considered part of a plan of financing, or "integrated," that there may still be a valid exemption for the offering as a whole. Offerings occurring in close proximity to one another may not be required to be integrated or considered together if each such offering meets the applicable

conditions for its exemption and is a separate offering. Related to these questions, practitioners often consider as part of the same inquiry whether communications made in connection with one proposed offering may vitiate the exemption sought to be relied upon in connection with a subsequent offering. For example, would communications that are considered a "general solicitation" made in connection with a proposed public offering render unavailable the section 4(a)(2) statutory private placement exemption under the Securities Act. Or would discussions relating to a potential private placement be viewed as "jumping the gun" in connection with a subsequent, but not-yet-launched, public offering? While not necessarily central to the fundamental integration question, communications issues seem inextricably linked to many of the fact patterns that we regularly encounter.

The SEC formally articulated the "five-factor test" almost sixty years ago. The test requires that, in considering whether various offerings of securities should be integrated, a practitioner evaluate whether:

1. the offerings are part of a single plan of financing;
2. the offerings involve the issuance of the same class of securities;
3. the offerings are made at or about the same time;
4. the same consideration for the offerings is expected to be received; and/or
5. the offerings are for the same general purposes.[1]

This test has been applied by numerous courts; however, despite the many applications of the test, it remains remarkably ambiguous. For example, a couple of the factors are rarely helpful. Most sales of securities are for cash consideration, so as a practical matter, it is difficult to distinguish one offering from another based on the type of consideration. Particularly in the case of growing companies, most offerings are made to raise growth capital, so it is often impossible to distinguish the "purpose" of one offering versus that of another. The "purpose" prong also seems quite similar to the "single plan of financing" prong. Therefore, practitioners tend to place most weight on the time that has elapsed between one offering and another and on whether the offered security is the same. As far as the relevant time period, the staff has focused on offerings that occur within six months of one another, which is the relevant period for now.

In light of the fluidity of financings and the increased reliance by issuers on exempt offerings, including exempt offerings that have characteristics associated with public offerings, such as the use of general solicitation, it may be time to reevaluate the utility of the five-factor test. As discussed below, as a result of a number of safe harbors, practitioners are relegated to reliance on the five-factor test in only a limited number of circumstances. The five-factor test remains most useful in connection with evaluating various exempt offerings occurring in close proximity to one another. The number of factors, to the extent deemed relevant today, should be pared down. Perhaps more important, the six-month time period should be shortened to thirty days.

> It may be time to reevaluate the utility of the SEC's five-factor test.

Safe Harbors

Practitioners tend to prefer reliance on one of the many integration safe harbors that have been adopted over the years. Many of the safe harbors were adopted years ago and are somewhat prescriptive. These merit close review. As further discussed below, over time, especially in recent years, the Commission has adopted specific safe harbors at the time that it has adopted new, or amended existing, offering exemptions, such as Rule 147, Rule 147A, Regulation A, and Regulation CF. The staff also has provided guidance regarding various integration questions in the form of Compliance and Disclosure Interpretations. In order to rationalize the approach to integration, it may be prudent to assess whether to continue to adopt individual safe harbors, whether to consolidate all integration safe harbors in one release, or whether to take a more principles-based approach to integration issues.

Changing Offering Formats

There are two integration safe harbors, Rule 152 and Rule 155, which address moving to or from a registered offering to an exempt offering, whether sequentially or as the result of an abandonment of an offering in favor of a different financing approach.

Rule 152. Rule 152 provides that the phrase "'transactions by an issuer not involving any public offering' in section 4(2) [now 4(a)(2)] shall be deemed to apply

to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement." Over time, through various no-action letters, the staff has interpreted the Rule 152 safe harbor to make clear that a proposed public offering, even one contemplated at the time a private placement is undertaken, need not be integrated with the private placement provided that the conditions for the exempt offering have been met. In the two no-action letters that once were so important to any integration discussion, the Black Box letter and the Squadron, Ellenoff letter, the staff further expanded its interpretation of the safe harbor to permit contemporaneous private and public offerings subject to the private offering having been limited in character. We rely on Rule 152 in connection with traditional PIPE transactions, wherein a public company enters into definitive securities purchase agreements relating to private sales made in reliance on section 4(a)(2) and/or Rule 506 of Regulation D to certain institutional or accredited investors and subsequent to the entry into such agreements files a registration statement covering the resale from time to time by such PIPE purchasers of the securities purchased in the PIPE transaction. The Rule 152 safe harbor is helpful generally in connection with any completed private placement (as such term is understood under the securities laws) followed by a public offering. Recently, the staff has interpreted the Rule 152 safe harbor to be applicable in the case of a private placement completed in reliance on Rule 506(b), which does not involve general solicitation, followed by an exempt offering made in reliance on Rule 506(c), which involves public offers albeit not a public offering made pursuant to a registration statement. The Rule 152 construct also could be expanded to address a completed private placement followed by any number of other exempt offerings that are "public" in nature. The safe harbor also could be expanded to address offerings of convertible securities, including securities that are immediately convertible.

Rule 155. The Rule 155 safe harbor was adopted to provide more flexibility for issuers seeking to complete a financing transaction amid changing market conditions. The safe harbor addresses the circumstances under which an issuer may abandon a private offering made in reliance on section 4(a)(2) and/or Rule 506(b) to commence a public offering and the circumstances under which an issuer may commence a private offering after having abandoned a public offering. The safe harbor addresses certain sequential offerings, but not contemporaneous or even completed sequential offerings. In order to rely on Rule 155(b), an issuer that abandons a private offering in order to commence a registered public

offering must meet all of the conditions of the safe harbor. The private placement must have been a bona fide private placement; no securities can have been sold in the private placement; all offering activity relating to the private placement must have been terminated; a period of thirty days must have elapsed between the termination of the private placement and the filing of the registration statement; and the public offering prospectus must contain certain disclosures relating to the abandoned private placement. Rule 155(c) provides a safe harbor for an issuer that abandons a public offering in favor of commencing a private placement. The issuer must satisfy all of the conditions for the safe harbor, including that: no securities have been sold in the public offering; the registration statement is withdrawn; the issuer wait thirty days after the effective date of the withdrawal of the registration statement before commencing the private placement; and the issuer make certain disclosures to offerees in the private placement. The conditions of Rule 155 are quite prescriptive and presume that there are bright lines between "private" and "public" offerings. While at the time that Rule 155 was adopted there may have been clearer lines demarcating a private placement from a public offering, this is no longer the case. Furthermore, an issuer may not be willing to wait thirty days given that market conditions often change quickly. Also, an issuer may be reluctant to announce the "abandonment" or "termination" of a proposed offering. In the absence of relying on Rule 155 in the case of a switch from private to public offering or public offering to private placement, an issuer would be relegated to relying on the ambiguous five-factor test or the guidance that focuses on how offerees were identified and solicited. It also is not clear whether, given the availability of information, it is necessary for investor protection purposes to continue to require the specified disclosures as a condition to the safe harbor under Rule 155.

Offering-Specific Safe Harbors

There are a number of safe harbors that address specific offerings, including the following:

- The Regulation D six-month safe harbor establishing a safe harbor for Regulation D offerings made more than six months apart;
- The Rule 701 safe harbor providing a safe harbor for offerings contemporaneous with stock-based compensation issuances made in reliance on the exemption from registration provided by Rule 701;

- The Regulation A safe harbor providing that a Regulation A offering will not be integrated with prior offers or sales of securities, subsequent offers or sales of securities made pursuant to a Securities Act registration statement, made in reliance on Rule 701, made pursuant to an employee benefit plan, made in reliance on Regulation S, made in reliance on the section 4(a)(6) exemption for crowdfunded offerings, or offerings made more than six months apart;
- An offering made pursuant to section 4(a)(6) will not be integrated with another exempt offering that precedes the crowdfunded offering, that takes place concurrently, or that takes place subsequent to completion of the first such offering provided that the issuer has satisfied as to each such offering the conditions for the exemption that it is claiming for the applicable offering;
- The Rule 147 and Rule 147A safe harbors providing that offers and sales made pursuant to these intrastate exemptions will not be integrated with prior offers or sales of securities, with Securities Act registered offerings, Regulation A offerings, Rule 701 issuances, Regulation S offerings, crowdfunded offerings, or offerings made more than six months apart;
- The Regulation S safe harbor providing that offshore offerings will not be integrated with contemporaneous private placements; and
- The Rule 144A safe harbor providing that resales made in reliance on Rule 144A will not affect the availability of any exemption or safe harbor relating to a prior or subsequent offering of securities by the issuer.

Following enactment of the JOBS Act and the final rules relaxing the prohibition on general solicitation in connection with Rule 506(c) and Rule 144A offerings, the staff has provided some guidance in the form of Compliance and Disclosure Interpretations, which guidance has focused principally on the types of communications that would be deemed to constitute "general solicitation." In the adopting releases relating to Regulation A and Regulation Crowdfunding, the Commission also provided guidance regarding the analysis that should be undertaken in connection with Rule 506 offerings as well as Regulation Crowdfunding offerings conducted in close proximity to Regulation A offerings or even concurrently. However, many questions remain, especially in light of the various types of exempt offering formats that involve "general solicitation."

Who Was Solicited and How Solicitations Were Made

In 2008, the staff of the Commission affirmed certain interpretive guidance through the issuance of Compliance and Disclosure Interpretations relating to concurrent private and public offerings. Under appropriate circumstances, an issuer may conduct a concurrent private and public offering, without the need to limit the private offering to institutional investors that are either qualified institutional buyers as defined in Rule 144A or institutional accredited investors as suggested by prior no-action letters. In the 2007 proposing release relating to amendments to Regulation D, which amendments were never adopted, and in the subsequent Compliance and Disclosure Interpretation, the focus was on how the offerees were identified. If the issuer can meet the conditions for the applicable private offering exemption and the offerees were not solicited by means of the registration statement, the issuer may complete a private placement concurrent with a registered public offering. The registered public offering will not be viewed as a general solicitation that would render unavailable the private placement exemption if, for example, the issuer or the financial intermediary acting on the issuer's behalf had a preexisting substantive relationship to the offerees in the private placement. The staff of the Commission's Division of Corporation Finance has recently provided guidance regarding the manner in which a pre-existing and substantive relationship may be established. This guidance, which re-affirmed views expressed over many years in various no-action letters, is helpful in light of the increased reliance on Internet-based communications and the number of exempt offerings that involve "public offerings." Presumably, this approach of assessing whether the issuer has a preexisting relationship with offerees and the manner in which offerees are solicited can be applied to other contemporaneous offerings. In addition, in the period following the JOBS Act, when so many issuers undertaking IPOs rely on confidential submissions, a potential "general solicitation" is deferred until the IPO registration statement is actually filed, so many of the concurrent offering questions are obviated. It is worth considering whether we need many of the other specific integration safe harbors if the relevant question to be considered is how an offeree is contacted.

Communications Issues

As discussed above, while "gun jumping" questions are different from, and separate from, integration questions, they are often inextricably related. To the extent that an issuer is perceived to have jumped the gun and through its com-

munications engaged in solicitations in a private placement that it subsequently abandons in favor of a registered public offering, one must consider whether the private placement discussions related to a bona fide offering. Were discussions related to a purported private placement a means of conditioning the market for the issuer's securities? Similarly, an issuer that sought to conduct a public offering (using general solicitation) may not be able to make a private placement immediately after abandoning the public offering to investors that became aware of the investment opportunity by having received the registration statement. The ability to test the waters and contact institutional investors in connection with an IPO by an emerging growth company is specifically excluded from the definition of an "offer" under the Securities Act. Is the concept of "gun jumping" still relevant? Should the analysis rely on the 2008 Compliance and Disclosure Interpretation discussed immediately above?

Since establishing whether a communication constitutes an "offer" is often important to identifying whether an offering exemption is available or whether offerings should be integrated, a careful review should be undertaken of the communications related safe harbors under the Securities Act. Securities offering reform in 2005 focused principally on easing communications restrictions for the largest issuers, well-known seasoned issuers (WKSIs), premised on the view that these issuers were widely followed by research analysts, professional investors, and others and there was current public information available to investors about WKSIs. The availability of current, reliable information about these issuers mitigated any investor protection concerns that might arise in relation to communications undertaken in proximity to securities offerings. Given the availability of information generally, it may be prudent to revisit whether additional safe harbors and communications flexibility could be made available to other categories of issuers.

Finally, it may be time to acknowledge officially the death of the "quiet period" immediately following completion of an issuer's IPO. Issuers rely on social media and other channels in ways that were unanticipated when restrictions on communications were adopted. There is little purpose to be served by creating artificial information barriers or imposing gag orders on issuers.

Conclusion

The Financial CHOICE Act contains a number of provisions that are designed to encourage capital formation. In fact, some of these provisions have been referred to as comprising a "JOBS Act 2.0." There are also ongoing discussions relating to reviving the U.S. IPO market. However, absent from the proposed legislation and from the IPO dialogue is any consideration of the need to revamp the securities integration and communications regulatory framework. As practitioners who counsel companies often trying to navigate volatile markets and seize financing opportunities, we believe that rethinking or at least modernizing integration and communications safe harbors should feature prominently in any capital formation initiatives.

Anna T. Pinedo and James R. Tanenbaum are authors of PLI's Exempt and Hybrid Securities Offerings.

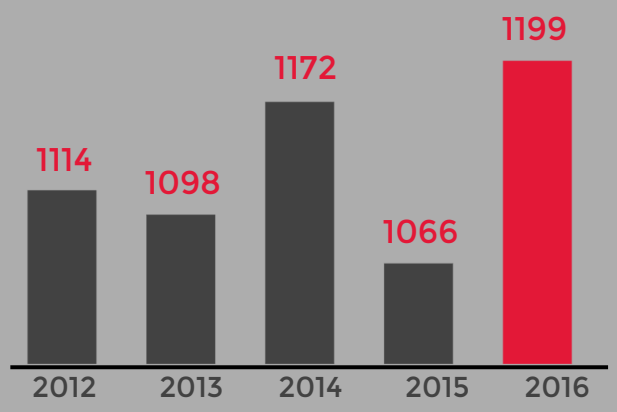
NOTES

1. *See* 17 C.F.R. § 230.502(a).

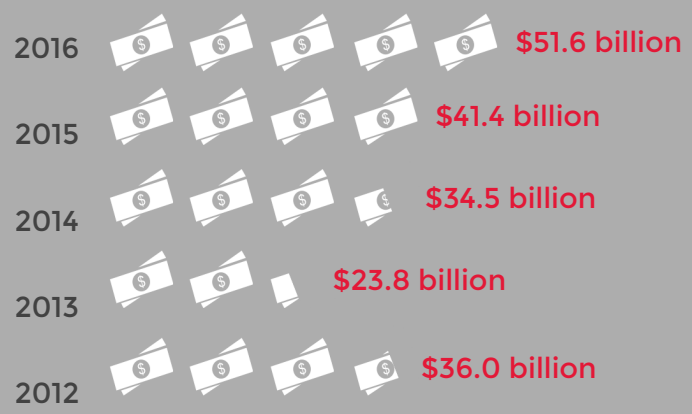
PIPE TRANSACTIONS 2016

What are "PIPEs"? A PIPE (Private Investment in Public Equity) refers to a private placement of securities of an already-public company that is made to selected accredited investors (usually to selected institutional accredited investors). In a typical PIPE transaction, investors enter into a purchase agreement that commits them to purchase securities and usually requires the issuer to file a resale registration statement covering the resale from time to time of the privately purchased securities.

Number of PIPE Transactions

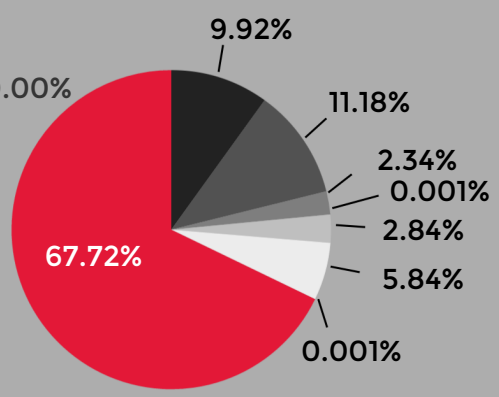


Dollars Raised in PIPE Transactions



Instruments Issued in PIPE Transactions in 2016

Common Stock...67.72%
Preferred Stock: Convertible...9.92%
Preferred Stock: Non-Convertible...0.00%
Debt: Convertible...11.18%
Debt: Non-Convertible...2.34%
Other: Convertible...< 0.01%
Prepaid Warrant...2.84%
Equity Line...5.84%
Unknown...< 0.01%



Average Deal Size

$43 million

Top Five Most Active Sectors

Biotech: Biomedical/Gene	Pharmaceutical & Related	Mining & Related	Metals, Minerals & Stones	Energy: Oil & Gas
14.0%	12.3%	8.9%	8.4%	7.7%

Data Source: PrivateRaise

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For more information about PIPE transactions, see our FAQs on PIPEs: https://goo.gl/7PBlKD

U.S. LATE STAGE FINANCINGS

As privately held companies choose to remain private longer and defer their initial public offerings or other liquidity opportunities, these companies are focused on raising capital in private placements made principally to institutional investors, cross-over funds and strategic investors. Late stage private placements have almost become a prerequisite to an IPO, or perhaps they are the new IPOs.

$41.3 billion	2016 $23.6 million [avg. deal size]	**1,750 Deals**
CAPITAL RAISED	- - - -	NO. OF DEALS COMPLETED
$44.9 billion	2015 $28.9 million [avg. deal size]	**1,548 Deals**

VOLUME BY INDUSTRY GROUP IN 2016

[by deal count]

- Software 30.9%
- Healthcare 11.2%
- Commercial Services 9.7%
- Pharma./ Biotech 9.6%
- Comm. & Networking 5.9%
- Commercial Products 3.6%
- Hardware 3.4%
- Media 2.9%

Other sectors: 19.6%

In the technology sector, there were 740 late stage deals completed, which raised $24.7 billion.

In the biotech sector, there were 80 late stage deals completed, which raised $1.1 billion.

UNICORNS

"Unicorns" are private companies valued at $1 billion and above.

As of January 2017 there were a total of 100 Unicorns in the United States valued at over $363 billion.

For more information about late stage financings, visit: goo.gl/QFR9tE

"Late Stage" references Series B through Series Z+ rounds.

Sources: Pitchbook, CB Insights

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