

# “It’s Complicated”: Establishing “Preexisting Relationships” with Prospective Investors

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In my [last post](#), I blogged about online funding platforms. In that post, I described the typical model of indirect investing through a special purpose vehicle (“SPV”) with the platform sponsor taking a carried interest in the SPV’s profits

from the portfolio company and no



transaction fee, as a

means of avoiding broker-dealer regulation. I also discussed the concept of a pre-screened password protected member-only website as a means of establishing a

preexisting  relationship

with prospective investors and thus avoiding the use of any act of “general solicitation,” which would otherwise violate the rules of the registration exemption under Rule 506(b).



In a no-action letter

dated August 6, 2015 entitled *Citizen VC, Inc.*, the SEC has provided important guidance on the procedures needed for an online funding platform to establish the kind of preexisting relationship needed to avoid being deemed to be engaged in general solicitation. As an aside, the concern over

general solicitation and preexisting relationships is relevant to offerings under new Rule 506(b), but not under Rule 506(c). Despite the creation in 2013 of an exemption under new Rule 506(c) pursuant to the JOBS Act for general solicitation offerings in which sales are made only to accredited investors, most online funding platforms continue to prefer to conduct portfolio company offerings indirectly through SPVs under Rule 506(b), despite the prohibition on general solicitation, primarily because of the additional requirement under Rule 506(c) that issuers use reasonable methods to verify accredited investor status.

In its [request for a no-action letter](#), Citizen VC described itself as an

**[citizen.vc](#)** online venture

capital firm that facilitates indirect investment in portfolio companies (through SPVs) by pre-qualified, accredited and sophisticated “members” in its site. It asserted to

have qualification procedures intended to establish substantive relationships with, and to confirm the suitability of, prospective investors that visit the website. Anyone wishing to investigate the password protected sections of the site accessible only to members must first register and be accepted for membership. To apply for membership, prospective investors are required to complete an “accredited investor” questionnaire, followed by a relationship building process in which Citizen VC collects information to evaluate the prospective investor’s sophistication, financial circumstances and ability to understand the nature and risks related to an investment. It does so by contacting the prospective investor by phone to discuss the prospective investor’s investing experience and sophistication, investment goals and strategies, financial suitability, risk awareness, and other topics designed to assist Citizen VC in understanding the investor’s sophistication, utilizing third party credit reporting services to gather additional financial

information and credit history information and other methods to foster online and offline interactions with the prospective investor. In the request letter, Citizen VC asserted that the relationship establishment period is not limited by a specific time period, but rather is a process based on specific written policies and procedures created to ensure that the offering is suitable for each prospective investor.

Citizen VC stated in its request letter that prospective investors only become “members” and are given access to offering information in the password protected section of the site after Citizen VC is satisfied that the prospective investor has sufficient knowledge and experience and that it has taken reasonable steps necessary to create a substantive relationship with the prospective investor. Once a sufficient number of qualified members have expressed interest in a particular portfolio company, those members are provided subscription materials for investment in the SPV formed by Citizen VC to aggregate such

members' investments, the sale of interests of such SPV is consummated and the SPV then invests the funds, and becomes a shareholder of, the portfolio company.

In its request letter, after providing the foregoing background, Citizen VC asked the SEC staff to opine that the policies and procedures described in the letter are sufficient to create a substantive, pre-existing relationship with prospective investors such that the offering and sale on the site of interests in an SPV that will invest in a particular portfolio company will not constitute general solicitation.



In its no-action letter,

the SEC staff concluded that Citizen VC's procedures were sufficient to establish a preexisting relationship and do not constitute general solicitation. It stated that the quality of *the* relationship between an issuer and an investor is the most

important factor in determining whether a “substantive” relationship exists and noted Citizen VC’s representation that its policies and procedures are designed to evaluate the prospective investor’s sophistication, financial circumstances and ability to understand the nature and risks of the securities to be offered. The staff went on to say that there is no specific duration of time or particular short form accreditation questionnaire that can be relied upon solely to create such a relationship, and that whether an issuer has sufficient information to evaluate a prospective offeree’s financial circumstances and sophistication will depend on the facts and circumstances of each case. The staff also based its conclusion on Citizen VC’s representation that an investment opportunity is only presented after the prospective investor becomes a “member” in the site.

An argument could be made that SPV-based online funding platforms represent the future of VC investing. The *Citizen VC* no-action letter

provides valuable guidance relating to the establishment of the kind of substantive relationship with prospective investors needed to enable the online funding platform to conduct Rule 506(b) offerings without being deemed to engage in general solicitation.