**SEC Explains How to Form a Pre-Existing Relationship Using the Internet; New CDIs Issued**



By [Steve Quinlivan](https://www.dodd-frank.com/author/stevequinlivan/) on 08/06/2015

The SEC granted [no-action relief to Citizen VC, Inc.](http://www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm) which appears to state, although subject to facts and circumstances, a pre-existing relation can be formed with a person that first contacts a seller of securities over the internet.  It is important because offerings can be conducted without general solicitation and compliance with Rule 506(c) under Regulation D.

Citizen VC, Inc. is an online venture capital firm that owns and administers a website (https://citizen.vc) that facilitates indirect investment by its pre-qualified, accredited and sophisticated Members in seed, early-stage, emerging growth and late-stage private companies (“Portfolio Companies”) through SPVs organized and managed by the Manager. The SPVs are created to invest in specific Portfolio Companies and not as blind pool investment vehicles.

The Site is hosted on the publicly accessible Internet and CitizenVC is cognizant of the fact that prospective investors may search the Internet and land on its Site. CitizenVC wants to be prepared to accept membership applications from prospective investors with whom-a pre-existing relationship has not yet been formed, but with whom it will establish a relationship prior to offering Interests.

CitizenVC has developed qualification policies and procedures that it intends to use to establish substantive relationships with, and to confirm the suitability of, prospective investors that visit the Site. Upon landing on the homepage of the Site: a visitor that wishes to investigate the password protected sections of the Site accessible only to Members must first register and be accepted for membership. In order to apply for membership, CitizenVC requires all prospective investors, as a first step, to complete a generic online “accredited investor” questionnaire. The satisfactory completion of the online questionnaire is, however, only the beginning of CitizenVC’s relationship building process.

Once a prospective investor has completed the online questionnaire and CitizenVC has evaluated the investor’s self-certification of accreditation, CitizenVC will initiate the “relationship establishment period.” During this period, CitizenVC will undertake various actions to connect with the prospective investor and collect information it deems sufficient to evaluate the prospective investor’s sophistication, financial circumstances, and its ability to understand the nature and risks related to an investment in the Interests. Such activities include

* contacting the prospective investor offline by telephone to introduce representatives of CitizenVC and to discuss the prospective investor’s investing experience and sophistication, investment goals and strategies, financial suitability, risk awareness, and other topics designed to assist CitizenVC in understanding the investor’s sophistication,
* sending an introductory email to the prospective investor,
* contacting the prospective investor online to answer questions they may have about CitizenVC, the Site, and potential investments,
* utilizing third party credit reporting services to confirm the prospective investor’s identity, and to gather additional financial information and credit history information to support the prospective investor’s suitability,
* encouraging the prospective investor to explore the Site and ask questions about the Manager’s investment strategy, philosophy, and objectives, and
* generally fostering interactions both online and offline between the prospective investor and CitizenVC.

The duration of the relationship establishment period is not limited by a specific time period. After CitizenVC is satisfied that (i) the prospective investor has sufficient knowledge and experience in financial and business matters to enable it to evaluate the merits and risks of the investment opportunities on the Site, and (ii) it has taken all reasonable steps it believes necessary to create a substantive relationship with the prospective investor, only then will CitizenVC admit the prospective investor as a Member of the Site.

At the same time the CitizenVC no-action letter was issued, the SEC also issued a number of new compliance and disclosure interpretations, or CDIs.

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.

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.

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.

ABOUT STINSON LEONARD STREET

[Stinson Leonard Street LLP](http://www.stinsonleonard.com/) provides sophisticated transactional and litigation legal services to clients ranging from individuals and privately held enterprises to national and international public companies. As one of the 100 largest firms in the U.S., Stinson Leonard Street has offices in 14 cities, including Minneapolis, Mankato and St. Cloud, Minn.; Kansas City, St. Louis and Jefferson City, Mo.; Phoenix, Ariz.; Denver, Colo.; Washington, D.C.; Decatur, Ill.; Wichita and Overland Park, Kan.; Omaha, Neb.; and Bismarck, N.D.

The views expressed herein are the views of the blogger and not those of Stinson Leonard Street or any client.

POSTED IN [BROKER-DEALER](https://www.dodd-frank.com/category/broker-dealer/), [PUBLIC COMPANIES AND SECURITIES](https://www.dodd-frank.com/category/public-companies/), [UNCATEGORIZED](https://www.dodd-frank.com/category/uncategorized/)