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Comments by Thomas E. Vass, Owner/Manager of The Private Capital Market, Inc., A Crowd Funding Website, on Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings.

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Note to readers: Italicized text is SEC text from current and historical documents related to the proposed rules.

The proposed rules on general solicitation continue a confusing commingling by the SEC staff that misapplies rules associated with the 1934 Securities Exchange Act, related to brokers as intermediaries, to the 1958 Rules on Reg D 506 offerings. That misapplication is evident again in the proposed rules on solicitation for internet based crowd funding private placements and this comment period regarding the 2012 JOBS Act would be a convenient time for the SEC to end its misapplication of the provisions of the 1934 Act to internet private offerings.

My comments address the main areas where the SEC misapplication acts as a barrier to raising capital.

1. My first point is that internet based crowd funding private placements generally fall under the jurisdiction of a self-underwriting, or direct corporate private placement, issued by the company directly to investors, without the assistance of brokers or dealers.

The misapplication of the 1934 Act rules by the SEC, however, continues to define internet private placements as if they occurred in the context of the 1934 Act, with the assistance of a broker, acting as an intermediary between buyers and sellers of capital. The earlier regulations of raising capital under Reg D 506 now contemplated by the proposed rules are based on the traditional venture capital model is that a private company goes to a venture capital firm or angel partnership and seeks capital.

[The internet has made that earlier model obsolete](#), but the proposed rules continue to misapply the earlier rules to the JOBS Act, thus negating the beneficial effects of the JOBS Act.

The effect of this misapplication in the proposed rules will make it more difficult for companies to raise capital and therefore the proposed rules on solicitation tend to undermine the intent of Congress in passing the JOBS Act aimed at making a capital raise easier, not harder, as the proposed SEC rules will do.

The SEC staff text on the proposed rules on solicitation acknowledge the prevalence and use of a self-underwriting in internet crowd funding, yet after making this acknowledgment, the SEC staff prepared rules for crowd funding as if they all occur in the context of a broker acting as intermediary:

When using general solicitation, issuers may be able to reach investors directly, without the need of an intermediary, which could result in lower transaction costs, and perhaps a lower cost of capital, for issuers.

The historical origins of the misapplication is partially related to the SEC Angel Capital Network no action letter, which stated:

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a "broker" is defined in Section 3(a)(4) of the Exchange Act as a person engaged "in the business of effecting transactions in securities for the account of others," and a "dealer" is defined in Section 3(a)(5) of the Exchange Act as a person engaged "in the business of buying and selling securities for his

own account," the Network and Network Operators neither effect the transactions in securities listed on the Network nor are in the business of buying and selling securities listed on the Network.

In its letter on ACE, the SEC made it easier to raise capital because the ACE network was deemed by the SEC not to be acting as a broker. In ACE, neither the network, nor the private company, were held to the higher standard of verification of the investors status. Rather, in ACE, the private company was allowed to rely upon the representation made by the potential investors, who were using the network to begin due diligence.

In the proposed rules on solicitation, the SEC staff reverts to an earlier, more difficult standard that requires a private company to verify the status of the investor, and implicitly suggests that a broker or other third party, acting as a broker, could make this undue and burdensome verification.

In the case of the former, we do not believe that an issuer would have taken reasonable steps to verify accredited investor status if it required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status. In the case of the latter, we believe an issuer would be entitled to rely on a third party that has verified a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on such third- party verification.

However, in the case of internet private placements, under the JOBS Act, a private company that is using a crowd funding website that is not acting as a broker is obligated to act as if it is a broker, as seen in this text from the SEC proposed rules:

We believe that the approach we are proposing appropriately addresses these concerns by obligating issuers to take reasonable steps to verify that the purchasers are accredited investors, as mandated by Section 201(a), but not requiring them to follow uniform verification methods that may be ill- suited or unnecessary to a particular offering or purchaser, given the facts and circumstances.

Contrary to the unwarranted self-congratulatory tone of the SEC text, the steps proposed by the SEC on solicitation are not reasonable, and tend to undermine the intent of Congress to make internet private placements easier.

Another part of the historical origins of the misapplication of the 1934 rules is based upon a conflict between the rules in ACE and the rules in another SEC letter, the IPONet letter.

The Divisions' interpretive letter IPONet was based on an important and well-known principle established by the 1934 Act, prior to the passage of the 1958 Reg D rules: a general solicitation is not present when there is a pre-existing, substantive relationship between an issuer, or its broker-dealer, and the offerees.

The language for "knowing your customer" is taken from the 1934 Act regarding a broker's obligations and is then applied to private placements as they may occur in the 1958 Reg D rules for a private placement.

In other words, beginning with the IPONet letter, the SEC commingled the 1934 language of a broker "knowing his client" with the provisions of the 1958 Reg D rules, which are related to the 1933 Securities Act. The more burdensome rules contained in the IPONet letter are inconsistent with the easier rules in the ACE letter, yet it is the IPONet rules that are now being applied to internet crowd funding private placements.

The proposed rules for a private company verifying the status of the investor in the JOBS Act continues to commingle and confuse these two acts of Congress, and the proposed rules on solicitation make it more difficult for companies to undertake a private placement because the burden of "knowing your customer" is shifted from a broker to the CEO of the private company, as if the CEO is a broker intermediary between buyers and sellers of capital.

2. The proposed rules abandon the precedents and prior history of SEC no-action letters on the use of the internet for private placements that made it easier for websites to avoid registration as a broker.

It is not exclusively the ACE letter or the IPONet letter that is causing the burden of raising capital to become more difficult for private companies in the proposed rule on solicitation. But, the ACE letter tends to be more important than the other letters for crowd funding because the ACE letter concerned internet private placements.

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In taking this position, the Division particularly notes that the Network and the Network Operators will not:

- (1) provide advice about the merits of particular opportunities or ventures;*
- (2) receive compensation from Network users other than nominal, flat fees to cover administrative costs and that such fees will not be made contingent upon the outcome or completion of any securities transaction resulting from a listing on the Network;*
- (3) participate in any negotiations between investors and listing companies;*
- (4) directly assist investors or listing companies with the completion of any transaction, for example, through the provision of closing documentation or paid referrals to attorneys or other professionals;*
- (5) handle funds or securities involved in completing a transaction; or*
- (6) hold themselves out as providing any securities-related services other than a listing or matching service.*

In ACE, the SEC laid out 6 bright line criteria for an internet website to meet to avoid registration as a broker, under the 1934 Act. Presumably, a crowd funding website that followed these 6 criteria would not be required to register as a broker.

Yet, the SEC proposed rules on solicitation ignore this set of criteria in ACE and attempts to revert to a higher more difficult standard for a private placement that was defined in by the SEC rules on internet private placements, issued in 2002.

Notwithstanding the analysis for purposes of Section 5 of the Securities Act, web site operators need to consider whether the activities that they are undertaking require them to register as broker-dealers. Section 15 of the Exchange Act essentially makes it unlawful for a broker or dealer "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills)" unless the broker or dealer is registered with the Commission. The "exempted securities" for which broker-dealer registration is not required under Section 15 are strictly limited. They do not include, for example, securities issued under Regulations A, D or S or privately placed securities that would be "restricted" securities under Securities Act Rule 144. Thus, broker-dealer registration generally is required to effect transactions in securities that are exempt from registration under the Securities Act. In other words, third-party service providers that act as brokers in connection with securities offerings are required to register as broker-dealers, even when the securities are exempt from registration under the Securities Act

The SEC's current attempt to cover all crowd funding websites as if they are brokers is inconsistent with the intent of Congress to make raising capital easier, not harder. Crowd funding websites facilitate a direct corporate private offering and the websites are not acting in the capacity of an intermediary between buyers and sellers of capital.

The 2002 text on internet websites is in direct conflict with the *Internet Capital Corporation* (December 24, 1997), which made it easier for companies to raise capital on the internet because the websites were not deemed to be a broker, under the 1934 Act.

The SEC no-action letter represented that no ICC affiliate will do business with an issuer using ICC's service or assist an issuer with an offering appearing on ICC's site. In addition, the Division of Market Regulation indicated that the operation of such a website would not trigger broker-dealer registration requirements. However, the Division of Corporate Finance noted that it was not taking a position on whether the services ICC proposed to provide issuers would render ICC an underwriter and whether the method of prospectus delivery proposed by ICC would satisfy the requirements for electronic delivery set forth in the October 1995 Release.

The Commission also granted no-action relief to StockPower, Inc. from the registration requirements of the 1934 Exchange Act when it proposed to operate a website that would enable investors to purchase company shares directly through issuers' dividend reinvestment and stock purchase plans. *StockPower, Inc.* (March 26, 1998) (1998 SEC No-Act. LEXIS 718).

StockPower's website would provide software that facilitates the transmission of order information and payment between investors and the bank transfer agents for issuers' dividend reinvestment and stock purchase plans. The no-action relief was premised on StockPower's representations that it (1) would not select the bank transfer agents to which orders would be sent; (2) would not provide trade execution and would not handle customer funds or securities; (3) would not recommend or endorse specific securities; and (4) would not receive any compensation related to investor orders or securities transactions effected using the software, other than reimbursement for particular expenses from bank transfer agents.

The proposed rules on solicitation are also inconsistent with the previously cited IPONET letter. In the IPONET no-action letter, the Commission stated that IPONET's activities will not amount to general solicitation or general advertising as long as:

- (1) both the invitation to complete the questionnaire and the questionnaire itself must be generic in nature and may not refer to any specific transaction or offering;*
- (2) the password-protected page containing offerings may become available to a particular investor only after the IPONET-affiliated broker-dealer determines that the particular investor is accredited or sophisticated; and (3) the potential investor may purchase securities only in offerings that are posted on IPONET after the point in time at which that investor has qualified as an accredited or sophisticated investor.*

Presumably, if a private company uses a crowd funding website to raise capital and the website satisfies the conditions of the IPONET Letter, the issuer also should be able to establish a relationship with potential investors through the Internet. The issuer then should be able to post offering materials to an Internet website that is accessible only to those persons with which the issuer had established the required relationship prior to the time the offering commenced.

This same logic was applied by the SEC in *Shaine* (1987). A preexisting substantive relationship for purposes of general solicitation under Rule 502(c) may be established through the proper use of a satisfactory questionnaire (as submitted). See letter re H. B. Shaine & Co., Inc. dated March 31, 1987.

Shaine determined accredited status by having potential investors complete questionnaires designed to evaluate each potential investor's sophistication and financial resources. The SEC proposed rules on solicitation ignore the precedent in *Shaine* in favor of a much more difficult standard, which subverts the intent of Congress to make raising capital easier.

In a direct corporate private offering, there is no broker intermediary, yet the proposed rules on solicitation are written as if there is an imaginary broker. The proposed SEC rules on solicitation ignore the provisions of ICC and StockPower, and create an undue regulatory burden on both private companies and crowd funding website operators by reverting to the more difficult standards contained in the 2002 SEC rules.

3. The proposed rules on solicitation are inconsistent and in contradiction with the U. S. Supreme Court ruling in *Ralston Purina* related to providing enough data so that investors could "fend for themselves."

The SEC proposed rules state:

*We are proposing a requirement in Rule 506(c) that issuers using general solicitation “take reasonable steps to verify” that the purchasers of the offered securities are accredited investors. Whether the steps taken are “reasonable” would be an objective determination, based on the **particular facts and circumstances of each transaction.** (bold is added for emphasis)*

The Supreme Court ruling in *Purina* however, clearly states that information provided to a potential investor in a private placement must not be based upon specific facts and circumstances, but must be subject to a general principle of full disclosure and fair dealing so that the investor can fend for themselves.

The burden upon the private company CEO is not to “know his customer” or establish a pre-existing relationship, as required of brokers under the 1934 Act. The burden for the CEO established in *Purina* is to treat all potential investors uniformly and fairly in making full disclosure.

A "facts and circumstances" rule application in the proposed rules on solicitation, is therefore inconsistent with the Supreme Court precedent in *re Purina*.

4. The proposed rules on solicitation fail to logically connect the Reg D Rule 506 rules on "pre-existing" relationship to the JOBS Act. The misapplication occurs because "pre-existing relationships" criteria in the proposed rules has been commingled by the SEC staff with the credentials and financial qualifications of an accredited investor.

There is no legal nexus between an investor's prior relationship with a company and the credentials of the potential investor under Section 501 of the 1958 Act.

In other words, the existence of a prior relationship is not dependent or connected logically to the financial qualifications of a potential investor. Yet, the SEC proposed rules on solicitation commingle these two different criteria, as if they are one and the same.

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 prohibition against “general solicitation or general advertising” in Rule 502(c) of Regulation D applies to offerings made in reliance on Rule 505 or Rule 506 of Regulation D and presents a significant obstacle for issuers attempting to rely on these commonly used exemptions from the registration requirements of the federal securities laws in connection with an Internet offering. However, an issuer can generally get around this limitation by establishing a preexisting, substantive relationship with potential investors. But, even if an issuer or broker-dealer limits access to offering materials posted on its Internet website or otherwise available through the Internet to those potential offerees that first provide information establishing their status as “accredited” or “sophisticated” investors prior to viewing the materials, a preexisting substantive relationship would not exist and the issuer or broker-

dealer would violate the prohibition regarding general solicitation or advertising. Simply gathering information on prospective investors as part of an offering is not sufficient to establish a preexisting substantive relationship. If, however, an issuer (or broker-dealer) locates prospective investors otherwise than through a general solicitation, it may deliver offering materials to them through the Internet. The delivery may be made either through proprietary computer services or to the recipient's previously furnished e-mail address.

In the easier standards of the IPOnet No-Action Letter, the SEC responded that “the qualifications of accredited investors in the manner described and the posting of a notice concerning a private fund on a Web site that is password-protected and accessible only to subscribers who are pre-determined by Lamp Technologies to be Accredited Investors would not involve a ‘general solicitation’ or ‘general advertising’ within the meaning of rule 502(c) of Securities Act Regulation D.” *Id.* at 77,809.

Yet, in the proposed rules on solicitation, the SEC staff reverts to a much more difficult standard.

For a relationship with an offeree to be “substantive,” the issuer or the broker-dealer either must be able to determine the financial circumstances or sophistication of the person with whom the relationship exists or the relationship must be of some substance or duration.

While the Commission endorses the “preexisting, substantive relationship” test, it cautions that the “presence or absence of a general solicitation is always dependent on the facts and circumstances of each particular case.”

Conclusion and summary:

The SEC staff proposed rules on solicitation confuse and commingle the elements of different rules and laws, among them: important terms are in bold for emphasis

1. issuer takes reasonable steps to verify that the purchasers are **accredited investors**.
2. Although the terms “**general solicitation**” and “**general advertising**” are not defined in Regulation D, Rule 502(c) does provide examples of general solicitation and general advertising, including advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising.¹⁹ By interpretation, the Commission has confirmed that other uses of publicly available media, such as unrestricted Web sites, also constitute general solicitation and general advertising.²⁰
3. We are proposing a requirement in Rule 506(c) that issuers using general solicitation “take reasonable steps to verify” that the purchasers of the offered securities are accredited investors. Whether the steps taken are “reasonable” would be an objective determination, based on the **particular facts and circumstances of each transaction**.
4. An issuer that solicits new investors through a Web site accessible to the general public or through a widely disseminated email or social media solicitation would likely be obligated to take greater measures to verify accredited investor status than an issuer that solicits new investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party, **such as a registered broker-dealer**. In the case of the former, we do not believe that an issuer would have taken reasonable steps to verify accredited investor status if it required only that a person check a box in a questionnaire or sign a form, absent other information about the purchaser indicating accredited investor status. In the case of the latter, we believe an issuer would be entitled to rely on a third party that has verified a person's status as an accredited investor, provided that the issuer has a reasonable basis to rely on such third- party verification.

The irrationality of the SEC's confusing and commingling of these terms in the proposed rules on solicitation are revealed in the text, where the SEC staff states that all the terms are connected, at least in the imaginary model of private placements in the proposed rules:

5. **These factors are interconnected**, and the information gained by looking at these factors would *help an issuer assess the reasonable likelihood* that a potential purchaser is an accredited investor, which would, in turn, affect the types of steps that would be reasonable to take to verify a purchaser's accredited investor status

The JOBS Act was not passed by Congress in order to help an issuer assess the credentials of an investor. The SEC logic contained in the proposed rules has the intent of Congress exactly ass-backwards.

The rules are intended to help investors conduct due diligence so that they can fend for themselves.

The factors cited by the SEC are not connected, and the SEC attempt to connect them to crowd funding and the 2012 JOBS Act undermines and subverts the intent of Congress to make raising capital easier.

The proposed rules are late in arrival and defective in content, and should be scrapped in their entirety in favor of the prior guidelines for internet private placements contained in ACE, IPONet, ICC and Shaine.