

**Reconsidering the Prohibition Against General Solicitation in Section 3(c)(7)
Offerings**

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ABSTRACT

This paper examines the seventy year history of the general solicitation prohibition during private offerings and then analyzes its continuing relevance as applied to Section 3(c)(7) offerings. The S.E.C. Staff recently issued a report questioning the continuing value of prohibiting general solicitation during private offerings made pursuant to Section 3(c)(7) of the Investment Company Act. If the S.E.C. were to follow the recommendation in the S.E.C. Staff Report, this would have tremendous implications for a growing number of hedge funds, and other investment companies utilizing the Section 3(c)(7) exemption. By allowing general solicitation, the S.E.C. would be reversing a policy with over seventy years of history in order to increase issuers' access to capital. These potential efficiency gains could come at a cost, however, since many fear that repealing the prohibition against general solicitation will eliminate one more protection for individual investors from risky investment opportunities.

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I. Introduction:

At first glance, the prohibition of general solicitation by the Securities and Exchange Commission (“S.E.C.” or “Commission”) during private offerings seems like an anomalous restriction. Since the creation of the Securities Act of 1933 (“Securities Act”), the existence of general solicitation has consistently been considered by the S.E.C. to be a central factor in determining whether or not an offering is private or public. Yet during the entire period of its existence, and especially in recent times, it constantly has been the subject of critique for its undesirable effects on the free flow of information and capital. Supporters of the prohibition cite the need for the S.E.C. to protect investors from unscrupulous issuers. Critics of the prohibition question the value of the protections, and emphasize the harm that the general solicitation prohibition causes issuers and investors who lack significant personal contacts, since it denies them opportunities to raise and invest money.

This recurring debate has resurfaced in the dialogue surrounding the regulation of hedge funds. Noting the lack of protection provided to qualified purchasers¹ by the general solicitation prohibition, the S.E.C. has recently suggested that the Commission should consider permitting general solicitation in Section 3(c)(7)² private offerings that are made exclusively to qualified purchasers.³ Removing the general solicitation prohibition for private offerings made to qualified purchasers, pursuant to Section 3(c)(7) of the Investment Company Act, likely would increase the ability of these investment companies to raise capital. It likely would also increase the investment opportunities available to qualified purchasers. These potential benefits are offset by a less significant need for the S.E.C. to protect investors, since qualified purchasers should

¹ See *infra* text accompanying note 7 (discussing Qualified Purchasers)

² See *infra* text accompanying notes 4-11 (discussing Section 3(c)(7) of the Investment Company Act of 1940)

either have the business acumen not to be duped by issuers or will hire a financial advisor who has business experience.

In examining this topic, this paper will explore the origins of the general solicitation prohibition. Next, this paper will examine the influences and decisions that have molded the general solicitation prohibition into its current form. Finally, this paper will examine whether removing the general solicitation prohibition during Section 3(c)(7) offerings could be accomplished consistently with the principles and policy behind the general solicitation prohibition.

II. What is a Section 3(c)(7) Offering?

An investment company⁴ must register with the Securities and Exchange Commission (“S.E.C.” or “Commission”) under the Investment Company Act of 1940 (“Investment Company Act”), unless it qualifies for an exception from the definition of “investment company.” One major exception from the definition of “investment company” is Section 3(c)(7), which excludes Qualified Purchaser Funds from coverage under the Investment Company Act.⁵

An investment company is a Qualified Purchaser Fund if it satisfies two conditions. Firstly, it must be “owned exclusively by persons who, at the time of the acquisition of such securities, are qualified purchasers.”⁶ A qualified purchaser is, in general terms, any natural person that has at least five million dollars of investments assets or company that has at least

³ S.E.C. Staff Report “Implications of the Growth of Hedge Funds” Sept. 2003.

⁴ Investment companies include, among other entities, any issuer which “is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading securities” The Investment Company Act, 15 U.S.C. § 80(a)(3).

⁵ 15 U.S.C. § 80(c)(7).

⁶ 15 U.S.C. § 80(a)(2)(51)(a).

twenty five million dollars of investment assets.⁷ This definition differs from a net-worth calculation, in that it excludes all non-investment assets, such as a personal residence, automobile, or any other asset not being used to earn additional money. Because Section 3(c)(7) does not include a numerical limit on the number of investors from which a Qualified Purchaser Fund may secure investments,⁸ these funds are often seen as preferable to other types of funds exempt from registration under the Investment Company Act.

Secondly, to qualify for the exception under Section 3(c)(7), a Qualified Purchaser Fund must not be “making, and does not at that time propose to make a public offering.”⁹ Section 5 of the Securities Act requires registration with the S.E.C. of all offerings of securities unless the offering fits into an exemption.¹⁰ One of the most important exemptions to registration is Section 4(2) of the Securities Act, which applies to “transactions by an issuer not involving any public offering.”¹¹ While the term “public offering” conspicuously is not defined in the Securities Act, the interpretation of what constitutes a public offering is interwoven with the Commission’s prohibition on general solicitation, and is the primary subject of this paper.

III. Origins of the Prohibition Against General Solicitation

A. 1935 General Counsel Letter

⁷ Id.

⁸ In reality, the number of investors in a 3(c)(7) fund will rarely exceed 499, because Section 12(g) of the Securities Exchange Act of 1934 (“Exchange Act”) requires periodic reporting for domestic funds with total assets exceeding \$10 million, and have issued securities held by 500 or more persons. Exchange Act § 12(g); Rule 12g-4. Regardless, a fund that can accept investments from up to 499 investors is frequently preferable to others, such as those organized under Section 3(c)(1) of the Investment Company Act, which cannot accept investments from any more than 100 beneficial owners. 15 U.S.C. § 80(a)(3)(c)(1).

⁹ 15 U.S.C. § 80(a)(3)(c)(7)(A).

¹⁰ Securities Act § 5.

¹¹ Securities Act § 4(2).

The first significant attempt by the S.E.C. to interpret the phrase in Section 4(2), “transactions by an issuer not involving any public offering” occurred in a Letter of S.E.C. General Counsel John J. Burns, published on January 24, 1935.¹² The letter stated that four primary factors were frequently indicative of whether an offering was to be considered public or private: (1) the number of offerees and their relationship to each other and the issuer; (2) the number of units being offered; (3) the size of the offering; and (4) the manner of offering.¹³ These factors reflected the General Counsel’s belief that “the purpose of the exemption of non-public offerings is largely limited to those cases wherein the issuer desires to consummate a few transactions with particular persons.”¹⁴ The first and fourth factors of this standard are the most important in explaining the creation of the prohibition on general solicitation.

By emphasizing the offerees relationship to each other, the General Counsel suggested that a small offering to randomly selected offerees could be public, whereas the same offering could be non-public if made to “persons who are all the members of a particular class, membership in which may be determined by the application of some preexisting standard.”¹⁵ Essentially, the General Counsel was suggesting that if offerees were approached on a deliberate and systematic basis, it would be an indication that an offering was private. On the other hand, an offering likely would be considered public if the offerees were approached broadly and arbitrarily, using what would later be known as “general solicitation.”

In addition to the relationship of the offerees to each other, the General Counsel’s letter stated the relationship of the issuer to the offeree could be an important factor in determining whether an offering was public or private. An offering would be considered private if made to

¹² 1935 WL 27785 (Securities Act Release No. 33-285) (Jan. 24, 1935).

¹³ Id. at *1

¹⁴ Id.

¹⁵ Id.; 11 Fed. Reg. 10952.

“members of a class who have special knowledge of the issuer... This factor would be particularly important in offerings to employees, where a class of high executive officers would have a special relationship to the issuer which subordinate employees would not enjoy.”¹⁶ The General Counsel determined that a “special” relationship between the issuer and the offerees could provide the offerees with intrinsic protections, such that forcing the issuer to register with the S.E.C. would not provide significant additional protections to the offeree.

The fourth factor of the General Counsel analysis, the manner in which the offering is made, stated that “transactions which are effected by direct negotiation by the issuer are much more likely to be non-public than those effected through the use of the machinery of public distribution.”¹⁷ Much like the General Counsel’s rationale regarding the preference for offerees that have relationships to each other, this factor reflects the General Counsel’s belief that the offerees should be a discrete, carefully selected group. Issuers who used the “public machinery” could not recruit investors who did not need protection, such as investors with special knowledge of the issuer, without potentially recruiting investors from the public, who might be more susceptible to manipulation.

B. Ralston Purina

In the two decades following the publication of the General Counsel’s letter, issuers and investors were still frequently uncertain and confused about what constituted a non-public offering under Section 4(2) of the Securities Act.¹⁸ In S.E.C. v. Ralston Purina Co., the United

¹⁶ 1935 WL 27785, *2 (Securities Act Release No. 33-285) (Jan. 24, 1935).

¹⁷ Id.

¹⁸ See Dougherty, Rethinking the Ban on General Solicitation, 28 Emory L.J. 67, 72 (1989).

States Supreme Court intervened, providing in its landmark decision the only words ever from the Highest Court, directly addressing the distinction between public and private offerings.¹⁹

The Ralston Purina Company had instituted a policy of allowing key employees to request, and receive, Ralston Purina stock in exchange for investing capital.²⁰ In each year that Ralston Purina sold its securities to its employees, it adopted “a corporate resolution authoriz[ing] the sale of common stock ‘to employees ... who shall, *without any solicitation by the company or its officers or employees*, inquire of any of them as to how to purchase common stock of Ralston Purina Company.’”²¹ An internal memorandum describing one of these corporate resolutions stated that “The only employees to whom this stock will be available will be those who take the initiative and are interested in buying stock at present market prices.”²²

The essential question before the Supreme Court was whether the distribution to hundreds of “key employees,” which included many blue-collar workers, constituted a non-public offering. In its factual analysis, the Supreme Court acknowledged that Ralston Purina did not use any solicitation in distributing its solicitation.²³ In its legal analysis, however, the Court did not even include solicitation as a factor to be considered in determining whether an offering was private or public. It also rejected the Commissions “superimposing [of] a quantity limit on private offerings as a matter of statutory interpretation.”²⁴ The Court essentially ignored factors 2, 3 and 4 of the General Counsel’s letter, paid nominal homage to only part of factor 1²⁵ and then created its own test for determining whether an offering was private or public.

¹⁹ S.E.C. v. Ralston Purina Co., 346 U.S. 119, 121 (1953).

²⁰ Id.

²¹ Id. (emphasis added)

²² Id.

²³ Id.

²⁴ Id. at 125

²⁵ The Court, citing the General Counsel’s letter, reiterated the statement that some offerings might be considered private if “made to executive personnel who because of their access tot he same kind of information that the act would make available in the form of a registration statement.” 346 U.S. 119, 125.; However, in dismissing the

Emphasizing the “broadly remedial purposes” of federal securities legislation, the Supreme Court switched the emphasis of a non-public offering analysis to the nature of the offerees. “[T]he exemption question turns on the knowledge of the offerees... The focus of the inquiry should be on the need of the offerees for the protections afforded by registration.”²⁶ In creating this highly ambiguous standard, the Supreme Court seemed to prefer a flexible legal principle which could be adapted to various situations, undermining earlier attempts by the S.E.C. to create bright line distinctions between “public” and “non-public” offerings.

In the two decades following Ralston Purina, the S.E.C. attempted to reconcile the principles of Ralston Purina with its own principles, as had been previously laid out in the General Counsel’s 1935 letter. For example, in a 1962 securities release concerning the “non-public offering exemption,” the S.E.C. listed as relevant to determining whether an offer is public “such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering.”²⁷ The Commission reconciled this nearly exact recitation of the General Counsel’s multi-factor analysis by noting that after Ralston Purina, “the exemption must be interpreted in the light of the statutory purpose to ‘protect investors by promoting full disclosure of information thought necessary to informed investment decisions’” and that the analysis ultimately “should turn on whether the particular class of persons affected need the protection of the Act.”²⁸

General Counsel’s suggestion that a private offering should be directed to a specific class, the Court stated that “an offering to all redheaded men, to all residents of Chicago or San Francisco.... Is no less ‘public’ in every realistic sense of the word than an unrestricted offering to the world at large.” Id. at 123.

²⁶ Id. at 127.

²⁷ 1962 WL 69540, *1 (Securities Act Release No. 33-4552) (Nov. 6, 1962).

²⁸ Id. Another example of the uncomfortable reconciliation between the views of the Commission and the Supreme Court can be found in circuit court decisions, such as the 1972 Fifth Circuit decision in S.E.C. v. Continental Tobacco Company of South Carolina, 463 F.2d 137. In this case, the court acknowledged that the “ultimate test, of course, is whether the particular class of persons affected need the protection of the Act” but then proceeded to apply the exact-same four factor test from the General Counsel’s 1935 letter, in light of this “ultimate test.” Id. at 158.

Although the Commission certainly paid lip service to Ralston Purina in this 1962 release, its analysis emphasizing the manner in which an offering was made seems irrelevant to a Ralston Purina analysis of the offerees need for protection. The Commission nonetheless persisted in applying the General Counsel's test, stating that "general solicitations of an unrestricted and unrelated group of prospective purchasers for the purpose of ascertaining who would be willing to accept an offer of securities is inconsistent with a claim that the transaction does not involve a public offering even though *ultimately there may only be a few knowledgeable purchasers.*"²⁹ The Commission later reiterated this not entirely intuitive point, stating "public advertising of the offerings would, of course, be incompatible with a claim of a private offering."³⁰

C. Rule 146(c)

The Rule 146 safe harbor was created by the S.E.C. to satisfy investor demand for greater certainty in the application of the Section 4(2) exemption.³¹ In light of the need for a "more objective standard" for satisfying the principles of Ralston Purina, the S.E.C. announced a list of five factors, all of which needed to be satisfied, in order to receive the protections of the Rule 146 safe harbor.³² These factors were: (1) the manner of offering; (2) the nature of the offerees, (3) access to or furnishing of information about the issuer; (4) limitation on the number of

²⁹ 1962 WL 69540, *1 (Securities Act Release No. 33-4552) (Nov. 6, 1962).

³⁰ Id. at *2.

³¹ 1978 WL 197118, *2 (Securities Act Release No. 33-5913) (Mar. 6, 1978).

³² 17 C.F.R. § 230.146(c) (rescinded 1982).

purchasers; and (5) limitations on the subsequent disposition of securities acquired in the offering.³³

The Commission justified the first factor of its analysis, in light of Ralston Purina's apparent indifference to the manner in which an offering is made, stating "there must be limitations on the manner of offering securities, pursuant to the exemption to assure that persons to whom such securities are offered have the necessary information available concerning the issuer and can fend for themselves. To assure the non-public manner of the offering, the Rule precludes general advertising or general solicitation..."³⁴ Since all communications by issuers are subject to normal anti-fraud provisions, and factors 2 and 3 of Rule 146(c) already required that an offeree have access to relevant information and be sophisticated enough to understand that information, why did the S.E.C. impose this limitation on communications?³⁵ Regardless of whether the Commissions above stated justification for the prohibition on general solicitation is its actual rationale, Rule 146(c) was strictly enforced to prohibit advertising in private offerings.³⁶

D. Regulation D

³³ Id.

³⁴ 1974 WL 161966, *4 (Securities Act Release No. 33-5487) (Apr. 23 1974).

³⁵ In its notice of adoption of Rule 146, the S.E.C. reiterated that the rule was intended to advance the view that "Section 4(2) exemption [is] available for offerings to persons who have access to the same kind of information that registration would provide and who are able to fend for themselves. Id. at *15.

³⁶ See A. A. Ajax Co., S.E.C. No-Action Letter (issued January 15, 1979) (1979 WL 14782) (determining that an offering supported by a national advertising campaign, even if targeted at a specific class of investors interested in pension and profit sharing plans, could not be assured protection from S.E.C. enforcement action); See also, Trust Mortgage and Loan Services, Inc. No Action letter (issued December 17, 1979) (1979 WL 13222) (declining to not recommend enforcement action against a proposed interstate advertising program, designed to solicit individuals to invest in trust deeds.)

From its inception, Rule 146 was treated with great skepticism by investors. Within two years of its adoption, the S.E.C. publicly requested comment about whether the rule should be maintained, discarded or altered.³⁷ The S.E.C. responded to the investing public's concerns by making minor revisions to Rule 146 in 1978³⁸, adopting the Small Business Investment Incentive Act of 1980³⁹, and then ultimately replacing Rule 146 with Regulation D in 1982.⁴⁰

Regulation D provided investors a more objective framework from which they could make offerings with the confidence that they would safely fit in the regulatory safe harbor based on the Commission interpretation of Section 4(2). Rules 504, 505 and 506 of Regulation D provided three different types of private offerings, differentiated by the size of the offerings and the number and types of offerees. For the purposes of an analysis of private offerings made under Section 3(c)(7) of the Investment Company Act, Rule 506 is the only relevant exemption, since rules 504 and 505 are unlikely to be used due to their strict monetary investment cap.⁴¹

Rule 506 applies to offers and sales of securities, with no cap on the dollar amount of the offering.⁴² In order to satisfy the requirements of Rule 506, there must be no more than 35 purchasers of the security being offered, and each purchaser must either be an accredited investor, or have a purchaser representative with the knowledge and experience to evaluate financial matters.⁴³ Additionally, the offeror must satisfy the general conditions of Rules 501⁴⁴, 503⁴⁵ and most importantly Rule 502.

³⁷ See Request for Empirical Information Regarding Operation of Private Placement Exemptive Rule, Securities Act Release No. 33-5770 (Dec. 6, 1976).

³⁸ Private Placement Exemptive Rule, 1978 WL 197118 (Securities Act Release No. 33-5913) (Mar. 6 1978).

³⁹ Small Business Investment Incentive Act, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

⁴⁰ 17 C.F.R. §§ 230.501 - 230.506.

⁴¹ Private Placement under Rule 504 cannot exceed five hundred thousand dollars. 17 C.F.R. § 230.504. Private Placements under Rule 505 cannot exceed five million dollars. 17 C.F.R. § 230.504

⁴² 17 C.F.R. § 230.506

⁴³ An accredited investor is defined in Rule 501 as one who fits into one of 8 listed categories, most relevantly any person who purchases at least \$150,000 of the securities being offered where the total purchase price does not exceed 20 percent of the purchaser's net worth at the time of the sale. 17 C.F.R. §230.501; 1982 WL 35662 at *19, Securities Act Release No. 33-6389, (Mar. 8, 1982). Most importantly, this means that if formalities are observed, it

Rule 502 describes four primary requirements that must be met when making a Rule 506 offering: (1) all Regulation D offerings within six months of each other will be integrated, and considered as one offering; (2) any sales of securities to non-accredited investors must be accompanied by significant informational supplements; (3) no general solicitation or general advertising may be made; and (4) the issuer must exercise reasonable care in limiting the resale of its securities by investors.⁴⁶

The first, second and fourth requirements of Rule 502 are not relevant to this paper's analysis. Of relevance is the third requirement, concerning the direct prohibition of general solicitation.

IV. The Application of Rule 502(c) in the 1980's

Having analyzed the origins of the prohibition against general advertising or general solicitation, this paper next will discuss how the prohibition against general solicitation was applied by the S.E.C. during the 1980's, an era of strict enforcement. Since a vast majority of private offerings are made pursuant to Regulation D, the S.E.C.'s interpretation of rule 502(c) is extremely pertinent to all private offerings, even those made pursuant to other statutes and regulations.

Rule 502(c) prohibits "any form of general solicitation or general advertising, including but not limited to, the following: (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio;

is extremely unlikely that someone who was a qualified purchaser for the purpose of Section 3(c)(7) of the Investment Act could not also qualify as an accredited investor during a rule 506 offering.

⁴⁴ Rule 501 is the definitions section of Regulation D. It provides for, among other things, the requirements needed to be met to satisfy the accredited investor standard. 17 C.F.R. § 230.501.

and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.”⁴⁷ The S.E.C. has applied this rule by conducting a two part analysis. First, the Commission determines if advertising or solicitation to offer or sell securities occurred. Second, the Commission decides whether the advertisement or solicitation was general in nature.

A. Did Advertising or Solicitation to Offer or Sell Securities Occur?

Rule 502(c) only prohibits general solicitation or advertisement that occurs in connection with a Regulation D securities offering. Thus, if a company advertises with no intention to “offer or sell the securities of the issuer” then such advertising will not violate rule 502(c). The S.E.C. has applied its powers broadly to regulate the advertising of companies claiming their advertisements are not directly in furtherance of an offering or sale of securities.

In one representative example, Printing Enters. Management Science Inc. (“Printing Inc.”) sought to engage in promotional and marketing activities relating to the products and services that it offered.⁴⁸ Since such promotional activities were to occur simultaneously with a private securities offering, the S.E.C. was confronted with the question of whether these marketing activity were intended to facilitate the offer or sale of securities.⁴⁹ The S.E.C. declined to grant no-action relief to Printing Inc., stating that it could only evaluate whether the advertisement was in direct support of an offer or sale of securities by evaluating all the specific facts surrounding this promotion.⁵⁰

⁴⁵ Rule 503 describes the logistical formalities in filing the necessary forms. 17 C.F.R. § 203.503.

⁴⁶ 17 C.F.R. §§ 203.501 – 203.506

⁴⁷ 17 C.F.R. § 203.502(c).

⁴⁸ Printing Enters. Management Science, Inc., No Action Letter (issued Apr. 25, 1983).

⁴⁹ Id.

⁵⁰ Id.; In another no-action letter, an oil company, Remco, sought to publicize significant achievements and events, such as the successful completion of oil wells. Remco, No-Action Letter (Aug. 20, 1985). The Commission refused

The Commission expanded the coverage of Rule 502(c) in its Gerstenfeld No-Action letter, explicitly prohibiting advertisements that occurred even when a private placement was not simultaneously occurring.⁵¹ In Gerstenfeld, a syndicator wished to place an advertisement generally stating that it sells securities, and inviting parties to contact the syndicator for further information.⁵² The Commission declined to recommend no-action, explaining that if an advertisement is made while the issuer is in the process of offering and selling securities, as in Printing Enters., then the advertisement would clearly be in furtherance of an offer or sale of securities and violate rule 502(c).⁵³ Even if a security is not currently being offered, however, if the primary purpose of the advertisement is either to sell securities or to condition the market for the future sale of securities, then the advertising would be in furtherance of an offer or sale of securities and thus, would violate Rule 502(c).⁵⁴

The Commission has also created a body of law describing the instances in which an advertisement by a third party can be treated as if it was promulgated by the issuer. In the Oil and Gas Investor No Action Letter, for example, the Commission declined to provide no-action relief regarding whether an advertisement would violate Rule 502(c) if the issuer did not sponsor the advertisement, and it was published in an independent source.⁵⁵ In a similar case, the Commission again declined to provide no-action relief to a question regarding whether an independent source could distribute reviews and analyses of various private offerings to a limited

to evaluate whether Remco's claimed attempts to develop name-recognition, during an ongoing private placement, would violate Rule 502(c). Although it appeared to the Commission that "such material would be intended to offer or sell securities," whether or not the press release would violate Rule 502(c) would depend on the exact words of the advertisement, as well as the specific circumstances surrounding the advertisement. Id.

⁵¹ Gerstenfeld, No-Action Letter, 1985 WL 55681 (Dec. 3, 1985)

⁵² Id.

⁵³ Id.

⁵⁴ Id.

⁵⁵ Oil and Gas Investor, No-Action Letter (Jan. 23, 1984).

group of paid subscribers.⁵⁶ The Commission, during the 1980's, seemed content to discourage third party advertisements by adjudicating whether such advertisements violated Rule 502(c) on a case by case basis.

B. Was the Advertising or Solicitation General in Nature?

If an advertisement is not in furtherance of a private offering, there will be no need to continue with a 502(c) analysis. If the advertisement is in furtherance of an offer or sale of securities, the Commission next analyzes whether the advertisement is general in nature. The S.E.C. has interpreted Rule 502(c) to allow for non-general advertising, meaning advertising in which the issuer and offeree have a “pre-existing, substantive relationship.”

i. Pre-Existing, Substantive Relationship Requirement of Rule 502(c)

In 1982, in the Woodtrails-Seattle No-Action letter, a partnership proposed to mail a written offer to three hundred and thirty persons who had previously invested in other limited partnerships sponsored by the general partner of the new partnership.⁵⁷ These investors had a pre-established relationship with the general partner, who was described to have had a reasonable belief that the offerees were knowledgeable and experienced in financial matters.⁵⁸ The Commission gave the partnership no-action relief, clearing the way for it to contact the offerees.⁵⁹

⁵⁶ Tax Inv. Information Corp., No Action Letter, 1983 WL 29834 (Feb. 7, 1983).

⁵⁷ Woodtrails -Seattle, No Action Letter, 1982 WL 29366, (Aug. 9, 1982).

⁵⁸ Id.

⁵⁹ Id.

That same year, a partnership dedicated to boarding, breeding, and training race horses sought to solicit investments by conducting a targeted mailing to “Thoroughbred Owners and Breeders Association” members in three states, distributing brochures to customers at a horse sale, and by advertising in a trade journal for people with specific interests in race horses.⁶⁰ The Commission simply stated that such advertisements would not comply with Rule 502(c), presumably because the partnership lacked a pre-existing relationship with the potential investors it was soliciting.⁶¹

The most definitive example of the seriousness with which the S.E.C. has applied this pre-existing substantive relationship requirement was the administrative action taken against Kenman Corporation (“Kenman”), in which the Commission found that Kenman violated Section 5 of the Securities Act by engaging in a public offering without registration.⁶² Kenman’s offering did not qualify for exemption under Regulation D or Section 4(2) because the S.E.C. determined that Kenman had engaged in general solicitation while offering to sell securities.⁶³ The Commission stated “[i]n determining what constitutes a general solicitation, [The Commission] has underscored the existence and substance of a pre-existing relationship between the issuer and those being solicited. See No Action Letter re: Woodtrails-Seattle, Ltd., dated July 8, 1982. ... “[A]lthough the make-up of the lists may indicate that the persons themselves have some degree of investment sophistication or financial well-being, utilization of lists of thousands of persons with no pre-existing relationship to the offeror clearly does not comply

⁶⁰ Aspen Grove, No-Action Letter, 1982 WL 29706 (Dec. 8, 1982).

⁶¹ Id.

⁶² Kenman Corp. Administrative Proceeding File No. 3-6505 (Apr. 19, 1985)

⁶³ Id.

with the limitation of Rule 502(c) on the manner of solicitation. Se e.g., No Action Letter re: Aspen Grove, dated October 6, 1982.”⁶⁴

ii. How to Establish a Substantive Relationship with an Investor.

As the risks of failing to comply with the general solicitation requirement became apparent, issuers increasingly sought guidance on how they could establish a pre-existing substantive relationship. In Mineral Lands Research & Marketing Corporation, Mineral Lands Corp. sought to utilize a director to offer its securities to six hundred investors who had bought insurance and financial products from him in his capacity as a director of a second business.⁶⁵ The S.E.C. responded to the interpretive issue raised by Mineral Lands Corp. by clarifying the types of relationships that could be considered substantive. “The types of relationships with offerees that may be important in establishing a general solicitation has not taken place are those that would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the person with whom the relationship exists or that otherwise are of some substance and duration.”⁶⁶

A broker-dealer may establish a relationship through general advertising or general solicitation, so long as such solicitation does not promote the offer or sale of securities.⁶⁷ In order to create a substantive relationship, a broker-dealer may furnish questionnaires to potential

⁶⁴ Id.; For additional material supporting the S.E.C. proposition that the pre-existing relationship requirement applies to sophisticated and unsophisticated investors alike, See The Texas Investor Newsletter, SEC Interpretive Letter, (issued Dec. 23, 1983) (stating that solicitation aimed at accredited investors does not satisfy 502(c) and is still an impermissible solicitation (FN220)). See also Webster Management Assured Return Equity Management Group Trust, S.E.C. No-Action Letter, 1987 WL 107526 (Jan. 6, 1987) (stating that high sophistication of investors is not a substitute for the pre-existing relationship requirement).

⁶⁵ Mineral Lands Research & Marketing Corp., S.E.C. No-Action Letter, 1985 WL 55694 (Dec. 4 1985)..

⁶⁶ Id. at *2.

⁶⁷ Hutton, S.E.C. No Action Letter, 1985 WL 55680 (Dec. 3, 1985).

investors.⁶⁸ In the H.B. Shaine Co. No-Action Letter, H.B. Shaine proposed to give a questionnaire to potential investors with whom it had no prior relationship.⁶⁹ The questionnaire included questions pertaining to, among other things, the respondent's employment history, business experience, business and professional education, investment experience, income and net worth.⁷⁰ The Commission responded to this proposal by stating that "a satisfactory response by a prospective offeree to a questionnaire that provides a broker-dealer with sufficient information to evaluate the respondent's sophistication and financial situation will establish a substantive relationship."⁷¹ Questionnaires to potential investors must be "generic in nature" and can "not make reference to any specific investment currently offered or contemplated for offering."⁷²

V. The SEC Has Considered Easing the General Solicitation Requirements (1990's to Present)

In the 1990's, the S.E.C. began to reconsider the rigidity with which it applied the general solicitation prohibition in the 1980's. The cracks in the Commission's application of the general solicitation prohibition began with offerings not made under Regulation D, such as those under Regulation A and Rule 1001. These smaller, unregistered offerings were allowed to proceed while utilizing general solicitation, thus providing examples of how in certain situations, the benefits of increased capital liquidity caused by allowing general solicitation outweighed the risks of increased abuse by anonymous issuers of investors. This perceived devaluation of the

⁶⁸ It appears that, currently, such questionnaires distributed through general advertising or general solicitation are not considered to be an acceptable way for persons who are not broker-dealers to establish a substantive relationship with investors. See Agristar, No Action Letter, 2004 WL 299067 (Feb. 9, 2004) (declining to provide no-action relief to agricultural company seeking to create a database of accredited investors for future potential use).

⁶⁹ H.B. Shaine Co., S.E.C. No-Action Letter, 1987 WL 108648 (May 1, 1987).

⁷⁰ Id.

⁷¹ Id.

⁷² Bateman, S.E.C. No Action Letter, 1985 WL 55679 (Dec. 3, 1985).

general solicitation prohibition fueled the movement to relax, and possibly abandon, the application of the general solicitation prohibition to offerings under Regulation D.

A. Safe Harbors for Small Offerings

The S.E.C. has the authority, pursuant to Section 3(b) of the Securities Act, to exempt from registration offerings to the public that do not exceed a specified amount, currently at \$5 million.⁷³ Pursuant to this authority, the S.E.C. has created Regulation A and California Code 1001, two statutory schemes for conducting offerings less than \$5 million. Significantly, the S.E.C. chose to allow general solicitation in both of these offerings

i. Regulation A

Regulation A was adopted in 1992 to exempt from registration companies engaging in limited offerings. To qualify, a company has to participate in a regime of miniregistrations for offerings made during any twelve month period which have an aggregate price not greater than \$5 million.⁷⁴ Although disclosures still need to be made, Regulation A provides companies pursuing relatively small financing arrangements to do so using a simplified and less expensive procedure.

One of the most significant features of Regulation A is Rule 254, which specifically allows issuers to “test the waters” and solicit investors to evaluate their interest, prior to the filing

⁷³ The Securities Act § 3(b).

⁷⁴ 17 C.F.R. §§ 230.251 – 230.263.

an offering statement.⁷⁵ This testing the waters approach still prohibits solicitations for money and acceptance of compensation prior to when the offeror has complied with the requirements of the miniregistration.⁷⁶ If there is not sufficient investor interest for the issuer to go forward with the Regulation A offering, the issuer may terminate the planned offerings without having incurred the significant compliance costs of registration. If the issuer determines that there is sufficient interest from investors, it may proceed in compiling and filing the appropriate S.E.C. documents with the security of knowing that the benefits of future investments will justify these compliance costs.

This “testing the waters” feature of Regulation A has been most effectively utilized by offerors who have used the Internet to solicit investment interest. The S.E.C. has allowed offerings under Regulation A to include solicitation through an independent website without an underwriter intermediary.⁷⁷ Issuers using the Internet to solicit interest in their securities have benefited from this efficiency creating feature of Regulation A. Thus, because of the lack of the ban on general solicitation, Regulation A has been used as an alternative to Rule 505 of Regulation D.

ii. Rule 1001 and Rule 135(d)

Rule 1001 was created in 1996 as a federal exemption to piggyback onto the California State exemption for offerings not greater than \$5 million, made under California Corporations

⁷⁵ 17 C.F.R. §230.254.

⁷⁶ *Id.*

⁷⁷ Spring Street Brewing Co., S.E.C. No Action Letter, 1996 WL 899364 (April 17, 1996) (stating that as a non-broker dealer, the website should eliminate its control over invested funds, but nonetheless should qualify for exemption from registration under Regulation A).

Code § 25102.⁷⁸ The California State exemption was created in 1994 to facilitate the raising of capital by small businesses.⁷⁹ Sales of securities under the California exemption could only be made to qualified purchasers, as defined by California law.⁸⁰ Additionally, issuances could not exceed ten percent of the net worth of the investor, could consist of only one-class of stock, and could be made only to a purchaser able to protect his or her own interests.⁸¹ Securities offered through Rule 1001, are considered by the S.E.C. to be “restricted securities” which limits their re-sale rights, and decreases the value of the security relative to a comparable non-restricted securities.⁸²

Of particular importance to this paper, the Commission agreed to allow general solicitation and advertising in any offering made pursuant to Rule 1001 and California Corporations Code § 25102.⁸³ Furthermore, the Commission went a step further and, when proposing Rule 1001, simultaneously requested comment on whether the Commission should allow general solicitation in all private offerings made under Rules 505 and 506 of Regulation D.⁸⁴ The Commission suggested that it was considering this major policy reversal because “the inability to reach out broadly to find possible qualified investors for Regulation D exempt offerings hampers the utility of the exemption and may raise the costs to companies of trying to

⁷⁸1996 WL 225966, Securities Release No. 33-7285 (May 1, 1996).

⁷⁹Id., citing Section 3, California Senate Bill 1951.

⁸⁰The definition of qualified investor includes many classes of people, including: any person purchasing more than \$150,000 of securities in the offering; and a natural person who’s net worth exceeds \$500,000 or whose net worth exceeds \$250,000 if such person’s annual income exceeds \$100,000. 1995 WL 385854, *2 (Securities Act Release No. 33-7185) (June 27, 1995).

⁸¹ 1995 WL 38584, Securities Act Release No. 33-7185, *2.

⁸² Rule 1001, 17 C.F.R. 230.1001.

⁸³ Id.

⁸⁴ See 1995 WL 285854, *1 (Securities Act Release No 33-7185) (June 27, 1995) (“Against the backdrop of this new approach in California, the Commission is considering whether amendment to Regulation D should be proposed that would similarly facilitate better use of the exemptions and lower the costs for companies by revising or eliminating the prohibition against general solicitation for Rule 505 and 506 offerings.”).

do these exempt offerings; California’s new exemption demonstrates the potential benefits of re-examining the costs and benefits of such prohibition.”⁸⁵

In a release issued the same day as the proposed California Exemption under Rule 1001, the S.E.C. proposed Rule 135(d). Proposed Rule 135(d) would allow issuers contemplating initial public offerings to solicit indications of investor interest prior to the filing of a registration statement.⁸⁶ Emphasizing its increased interest in enhancing “the efficiency of the capital markets” while drawing from its experiences that “[with Regulation A offerings], solicitations do not appear to have raised significant investor protection concerns,”⁸⁷ the Commission questioned whether, following an unsuccessful “testing the waters” under the proposed rule 135(d), an issuer should be allowed to proceed with a private offering under Regulation D. Since immediately allowing a subsequent private offering would effectively destroy the prohibition on general solicitation, the Commission was reluctant to allow such actions to proceed. It did suggest, however, that it might be amenable to revising the rules governing the integration of the two offerings, requiring only 20 days of separation between the “testing the waters” for an IPO and the subsequent Regulation D offering, thereby greatly diminishing the efficacy and strength of the prohibition on general solicitation.⁸⁸

While Rule 1001 and Rule 135(d) were being passed, the Commission continued to propose options that would allow small issuers to raise money with greater ease. The S.E.C.

⁸⁵ Id. at*5; The California exemption was adopted within a year of its proposal. In the Securities Release in which its adoption was announced, the Commission stated that it received a number of comments supporting the relaxing of the general solicitation requirement for Rule 505 and 506, but that a decision on how to reform Rules 505 and 506 will be postponed pending the reports of various studies by the Commission. 1996 WL 225966, *4 (Securities Act Release No. 33-7285) (May 1, 1996).

⁸⁶ 1995 WL 385857, Securities Act Release No 33-7188 (June 27, 1995).

⁸⁷ Id.

⁸⁸ Id. (“Would another approach be to provide a special integration safe harbor for private placements following a Rule 135(d) “test the waters” solicitation?”).

announced, for example, their consideration of a “pink herring” registration statement.⁸⁹ Under this approach, all private and public issuers would be required to file a “pink herring” registration statement with the S.E.C. consisting of “limited financial information regarding the price, the type of security, the method of distribution and financial results.”⁹⁰ Although this would require all issuers to register, the costs of such registrations would be limited. Additionally, all issuers filing a “pink herring” registration would be allowed to make general solicitations about this offering, and then later choose to make their offering a private one, using Regulation D for example.⁹¹ During this same release, the S.E.C. once again overtly questioned the efficacy of the general solicitation prohibition in Regulation D, and requested comment on whether the Commission should relax this prohibition.⁹²

B. Steps Taken by the S.E.C. to Relax the General Solicitation Prohibition

The S.E.C responded to this growing internal and external pressure to ease the general solicitation requirements in Regulation D offerings through two series of no-action letters. The first series of no-action letters described the ability of independent third-party websites to create prior substantive relationship with potential investors, as well as the types of investment services that such websites could provide those investors. The second series of no-action letters addressed the ability of issuers to solicit investors with whom they have an indirect prior substantive relationship.

⁸⁹ Securities Act Release No. 33-7314 (July 25, 1996).

⁹⁰ Id.

⁹¹ Id. at *13.

⁹² Id. at *14.

i. General Solicitation and the Use of Internet Websites as Intermediaries

The IPONET no-action letter involved a sole proprietorship that sought to create a website to facilitate the matching of investors and issuers.⁹³ One section of the website, entitled the “accredited investors” section, would contain a customer database of accredited investors who had registered with the IPONET website.⁹⁴ In order to gain access to the database, the website member had to complete a questionnaire with specific questions that would lead IPONET to possess a “reasonable belief” that the member is an accredited investor, within the meaning of Rule 501(a).⁹⁵

The website contained various security features, including password protection, to prohibit non-registered accredited investors from accessing the parts of the website intended only for accredited investors.⁹⁶ The names of the accredited investors would be kept confidential, unless the accredited investors requested that IPONET release their names and contact information to a particular issuer.⁹⁷ Accredited investors would only be allowed to invest in private offerings that were posted on IPONET subsequent to the time of the member’s registration, and only after “sufficient time” had elapsed between the time of a member’s registration and the inception of the private offering.⁹⁸

The question before the Commission was whether IPONET’s solicitation of members, though the recruitment of accredited investors and the posting of questionnaires on their website, would violate Rule 502(c), if such members subsequently participated in a private offering made

⁹³ IPONET, S.E.C. No-Action Letter, 1996 WL 431821 *1, (July 26, 1996).

⁹⁴ *Id.* at *2.

⁹⁵ *Id.* at *3.

⁹⁶ *Id.* at *3.

⁹⁷ *Id.* at *3.

⁹⁸ *Id.* at *4.

under Regulation D through the website.⁹⁹ The Commission announced that they would not pursue action an administrative action against IPONET, conditioned on three factors: (1) both the invitation to complete the questionnaire, as well as the questionnaire itself, would be generic in nature and make no references to any specific transactions; (2) the password-protected page for accredited investors would only be available to members after W. J. Gallagher & Co. has made the determination that the potential investor is accredited or sophisticated¹⁰⁰; (3) a potential investor could only purchase securities posted on IPONET after that investor had become an official member of IPONET's accredited investor page.¹⁰¹

The IPONET no-action letter allowed an intermediary website, meeting certain specified qualifications, to create a forum for investors completely unrelated to issuers to learn about the investment opportunities provided by those issuers, and then possibly invest. Although this was done within the confines of Kenman's pre-existing substantive relationship requirement, it nonetheless drastically expanded the role that third-parties could play in soliciting investors, by deviating from no-action letters such as Oil & Gas Investor.¹⁰² After IPONET, the use of websites re-defined the functional application of the "pre-existing substantive relationship" requirement.

Following IPONET, the S.E.C. issued several no-action letters expanding the permissible role of websites, such as IPONET. In the Angel Capital Networks No-Action letter, the Commission allowed an IPONET style website to provide a matching service, in which it would suggest to accredited investors specific investment opportunities believed to be a good "match"

⁹⁹ Id.

¹⁰⁰ Gallagher Co. was hired by IPONET to maintain a system for supervising the IPONET's actions. Gallagher in some instances would act as an underwriter, and in other instances would act as a "selected dealer." Id. at *2.

¹⁰¹ Id. at *6.

¹⁰² See discussion of Oil and Gas Investor, supra.

for that investor.¹⁰³ An accredited investor could enter factors, such as the sector/industry of the business, the state in which the company was located, the existence of minority ownership, and the “matching service” provided by Angel Networks would suggest issuers who fit the selected characteristics.¹⁰⁴ Significantly, Angel Networks would be run and operated by a non-profit organization, such as a university, whose sole purpose was to facilitate the efficient distribution of capital, not to make a profit. The S.E.C. did not require Angel Networks, when performing these functions, to register as a broker-dealer under Section 15(b) of the Exchange Act, nor as an investment adviser, under the Investment Adviser’s Act of 1940.

In another no-action letter, Lamp Technologies, the Commission further expanded the range of activities that an IPONET style website could perform in connection with a private offering.¹⁰⁵ The Commission advised Lamp Technologies that it would not commence enforcement action against a password-protected website that allowed accredited investor subscribers to access information about issuers.¹⁰⁶ Members of Lamp Technologies’ website would be charged a subscription fee for the rights to access the website’s database of investment opportunities.¹⁰⁷ This for-profit website would allow subscribers to conduct searches of hedge fund data using user-selected criteria. Although the website would not provide “matching” in the same sense as would the non-profit organization operator in Angel Networks, it would allow investors to use interactive features to help them locate hedge funds with preferred characteristics.

The Lamp Technologies no-action letter also provided investors greater clarity and flexibility in making investments, once they had completed the website’s questionnaire. The

¹⁰³ Angel Capital Electronic Network, S.E.C. No-Action Letter, 1996 WL 636094 (Oct. 25, 1996).

¹⁰⁴ Id. at *4.

¹⁰⁵ Lamp Technologies, Inc., S.E.C. No-Action Letter, 1997 WL 282988 (May 29, 1997).

¹⁰⁶ Id. at *8.

Commission consented in Lamp Technologies that a thirty day waiting period following the completion of a generic accredited investor questionnaire was all that was necessary until a subscriber could begin investing using that website.¹⁰⁸ Additionally, once a member was allowed to begin investing in securities listed on the website, they could invest in any security that had been previously posted, not just those posted after their membership had become effective, as in IPONET.¹⁰⁹ Finally, the Commission broadened the applicability of the IPONET line of no-action letters to entities other than websites, stating in footnote “we also would not object if similar screening procedures were used by the publisher of a private fund directory, distributed in paper, rather than in electronic, format.”¹¹⁰

ii. Relaxing the General Solicitation Prohibition in Instances Involving an Indirect Pre-existing Substantive Relationship

The first major decision by the S.E.C. in which it began to ease the prior substantive relationship requirement of the general solicitation ban was the Paul Anka No-Action letter.¹¹¹ In this no-action letter, the S.E.C. allowed a non-broker dealer to refer investors with whom he had a prior relationship to an offeror.¹¹² Paul Anka entered into an agreement with The Ottawa Senators Hockey Club Limited Partnership (“Ottawa Senators”), in which Mr. Anka would refer accredited investors to the Ottawa Senators in exchange for being paid a finder’s fee.¹¹³ Since Mr. Anka gained his connections to accredited investors as an entertainer, and was not a broker-

¹⁰⁷ Id. at *2.

¹⁰⁸ Id. at *6.

¹⁰⁹ Id. at *3.

¹¹⁰ Id. at *9, FN13.

¹¹¹ Paul Anka, S.E.C. No-Action Letter, 1991 WL 176891 (July 24, 1991).

¹¹² Id.

¹¹³ Id. at *1.

dealer, he agreed to provide no analysis, advice nor to share or distribute any sales information.¹¹⁴ Under the condition that Mr. Anka would not participate in any advertisement, endorsement or general solicitation, the Commission decided not to recommend enforcement action against Mr. Anka even though he had not registered as a broker-dealer.¹¹⁵

Perhaps the most significant decision by the S.E.C. was the Quest Network no-action letter, which involved the attempts of an investment fund making private offerings using Rule 506 to “identify prospects only from a limited and defined group of persons through a chain of prior relationships.”¹¹⁶ The Commission gave Quest permission to ask all current directors, former directors, security-holders and the family members of these three groups to solicit anyone with whom they had a pre-existing substantive relationship.¹¹⁷ Additionally, any registered investment advisor with whom Quest had sufficient business relationship could solicit any of their pre-existing substantial relationships to invest directly in Quest.¹¹⁸ Finally, a placement agent, or any subplacement agents working with the placement agent, could directly solicit any investor with whom they had a pre-existing substantive relationship.¹¹⁹

This decision in Quest was consistent with the Commission’s trend from the Bateman¹²⁰ and Paul Anka no-action letters, not to apply the general solicitation prohibition against communications between issuers and investors with indirect pre-existing substantive relationships. Although consistent, it nonetheless gutted the pre-existing substantive relationship

¹¹⁴ Id. at *2.

¹¹⁵ Id. at *6.

¹¹⁶ Royce Exchange Fund Quest Advisory Corp., S.E.C. No Action Letter, 1996 WL 490692 at *7 (August 28, 1996).

¹¹⁷ Id. at *7.

¹¹⁸ Id. at *7.

¹¹⁹ Id. at *3.

¹²⁰ The Commission held in the Bateman No-Action letter that there is no requirement that there have been an actual business relationship between the issuer and the prospective investor, only that the issuer have “sufficient information” to evaluate the prospective investors sophistication and financial situation. Bateman Eichler, Hill Richards, Inc. S.E.C. No-Action Letter, 1985 WL 55679, *2 (Dec. 3, 1985).

requirement as applied to most investment companies. Although the basic tenants of the pre-existing relationship requirement are still in effect,¹²¹ after Quest it seems that any investment company dutiful in following the procedures created by the Commission could use indirect means to solicit a wide-range of investors with whom it lacked a direct pre-existing substantive relationship.

A major exception to the Commission's trend of applying a weakened version of the general solicitation prohibition regards solicitation by companies without investment experience. In Agristar, a recent case involving a communications company with significant relationships with farm principals primarily through their collection of industry data, the Commission was far less flexible in allowing general solicitation than it was with Quest.¹²² Although the Commission did not elaborate on why it declined to grant no-action relief,¹²³ it seems to have doubted the ability of this non-financial company to be aware of the financial sophistication of the persons with whom it had relationships.¹²⁴ After Agristar, it appears that for a non-financial company to solicit accredited investors using a generic questionnaire, it cannot do so independently, but rather must use a registered investment advisor or placement agent.¹²⁵

iii. Remnants of the General Solicitation Prohibition

¹²¹ See e.g., In the Matter of CGI Capital, Inc., Admin. Proceeding File No. 3-10331 (Sept. 29, 2000) (CGI was determined by the SEC to have violated Section 5 of the Securities Act because it disseminated preliminary information about the securities being offered privately, using e-mail to contact potential investors with whom CGI lacked a pre-existing substantive relationship.)

¹²² Agristar Global Networks, S.E.C. No-Action Letter, 2004 WL 299067 at *4, *6.

¹²³ Id. at *8.

¹²⁴ Id. at *6 (explaining Agristar's lack of "experience with Farm Principals in the context of prior investments in the nature of a broker dealer, fund manager or the like").

¹²⁵ Id. at *7.

As demonstrated by Agristar, although the S.E.C. has taken steps to relax the rigidity of the general solicitation prohibition, it continues to consider the prohibition on general solicitation a bedrock protection provided to investors in private offerings. The dichotomy between the Commission's treatment of Quest and Agristar demonstrates the importance placed by the Commission on the ability of solicitors to evaluate the sophistication of the investor, based on the nature and extent of their pre-existing relationship.

Another instance exemplifying the Commission's reluctance to abandon the general solicitation prohibition is in its amendments to Rule 155, affecting the integration of private offerings following abandoned registered offerings. Rule 155 allowed issuers increased flexibility by creating a thirty day safe harbor in which issuers who initially were attempting to pursue a registered offering could abandon their attempts and, after thirty days, begin to pursue a private offering.¹²⁶ The Commission declined to extend this safe harbor from traditional integration analysis to issuers who could not demonstrate that the private offering did not involve general solicitation or advertisement.¹²⁷ The Commission declared that the "[u]se of the registered offering to generate publicity for the purpose of soliciting purchasers for the private offering would be considered a plan or scheme to avoid the registration requirements of the Securities Act."¹²⁸ The Commission effectively prohibited small issuers from engaging in general solicitation during public offerings if they wished to preserve their ability to fall back upon Rule 155's safe harbor.

C. SEC Staff Report "Implications of the Growth of Hedge Funds"

¹²⁶ Rule 155(a), 17 C.F.R. 230.155(a).

¹²⁷ Id.

In September 2003, a S.E.C. Staff Report examined the rising importance of hedge funds in the U.S. economy, described the current regulatory framework in which hedge funds operate, and recommended to the Commission that it consider nine policy recommendations.¹²⁹ The most important of these nine recommendations, for the purposes of this paper, is the recommendation that “[t]he Commission should consider permitting general solicitation in Section 3(c)(7) Hedge Fund offerings.” The report stated “[u]nlike a Section 3(c)(1) fund, a Section 3(c)(7) fund can be sold to an unlimited number of investors, so long as they are “qualified purchasers.... There seems to be little compelling justification for prohibiting general solicitation or general advertising in private placement offerings of Section 3(c)(7) funds that are sold only to qualified purchasers.... [P]ermitting funds, including hedge funds, that limit their investors to a higher standard (e.g., qualified purchasers) to engage in general solicitation could facilitate capital formation without raising significant investor protection concerns.”¹³⁰

VI. Would Permitting General Solicitation of Qualified Investors During Section 3(c)(7) Offerings Comport with the Fundamental Principles of the General Solicitation Prohibition?

Before choosing whether to adopt the S.E.C. staff report recommendation of repealing the prohibition against general solicitation during Section 3(c)(7) offerings, it should be considered whether doing so would comport with the fundamental principles behind the general

¹²⁸ Securities Act Release No. 33-7943, *7 (Jan. 26, 2001).

¹²⁹ These nine policy recommendations were: (1) Requiring hedge fund advisers to register as investment advisers; (2) Requiring hedge fund advisers to provide a brochure specifically designed from hedge funds; (3) Requiring certain registered investment companies to follow board adopted valuation procedures; (4) Requiring additional disclosure to be provided about layered fees of “Fund of Funds”; (5) Regulators should continue to monitor whether suitability obligations are being met; (6) Permitting General Solicitation in Section 3(c)(7) hedge fund offerings; (7) Monitoring capital introduction services provided by prime brokers; (8) Encouraging the hedge fund industry to embrace and further develop best practices; and (9) Investor Education. S.E.C. Staff Report “Implications of the Growth of Hedge Funds” (Sept. 2003).

solicitation prohibition. As discussed earlier in this paper, the current interpretation of the general solicitation prohibition is a product of three major influences: (1) the 1935 Letter of S.E.C. General Counsel John Burns; (2) the United States Supreme Court decision in *Ralston-Purina v. United States*; and (3) the S.E.C.'s Rules 146 and 502(c). Although at times these documents contained seemingly irreconcilable principles and justifications, understanding the principles behind these three influences will help illuminate the feasibility of the S.E.C. staff report recommendation.

The 1935 Letter from General Counsel John Burns emphasized what he perceived to be the five major factors helpful in making a literal differentiation between an offering made to the public and to the private. While General Counsel Burns did not specifically prohibit general solicitation, his letter stated that offerings that are not made through direct negotiation, particularly if made to a group lacking connections within itself or to the issuer, would most likely be considered public. This multi-factored non-public offering analysis provided a loose formula for distinguishing public and non-public offerings, but ultimately little guidance in what were the principles behind this interpretation.

The Supreme Court in *Ralston Purina*., on the other hand, seemingly was not concerned with Burns's literalistic interpretation of the private placement exemption. Rather, the Supreme Court seemed to deduce that since registration was designed to provide investor protections, only those offerings made to investors requiring protection were public. Thus, general solicitation would only be relevant to a *Ralston Purina* analysis to the extent that investors contacted through general solicitation might intrinsically require greater protections, for example due to the lack of accountability caused by the anonymity between issuer and investor.

¹³⁰ *Id.* at 100.

The S.E.C. has since created Rule 146 and subsequently Rule 502(c), both of which prohibited “general solicitations and general advertising” in support of a private offering. In various no-action letters and administrative actions discussed in this paper, the S.E.C. has attempted to apply the general solicitation prohibition in a way consistent with the General Counsel’s and Supreme Court’s principles. Although in the 1980’s the S.E.C. seemed intent on using the General Counsel’s letter as a baseline for interpreting the term non-public, throughout the 1990’s the importance of the investor-centric logic of Ralston Purina became increasingly important. Thus, the S.E.C. has carved out exceptions to their literalistic interpretation of non-public offerings in instances such as in the IPONET line of no-action letters, the Quest indirect substantive relationship cases, as well as, arguably, Rule 1001 and Regulation A.

A repeal of the general solicitation prohibition during Section 3(c)(7) offerings to qualified purchasers would probably not survive a strict application of the principles of General’s Counsel Burn’s letter. Such solicitations, absent unusual circumstances, would not comply with most of the five factors considered by General Counsel Burn’s to be determinative of whether an offering is non-public. On the other hand, strictly applying the U.S. Supreme Court’s analysis in Ralston Purina would likely produce the opposite result. Qualified Purchasers will either have the financial acumen, or be able to afford advisors with such expertise, that they should survive a Ralston Purina analysis in which “the focus of the [non-public offering] inquiry should be on the need of the offerees for the protections afforded by registration.”¹³¹

The S.E.C. in interpreting the former rule 146 and rule 502(c), has attempted to reconcile the literalistic interpretation of non-public offerings with the principle that the S.E.C. should not regulate issuances in which investors do not need protection. Thus, whether the S.E.C. will allow general solicitation in Section 3(c)(7) offerings to qualified purchasers will depend greatly

on whether the efficiency gains of allowing general solicitation outweigh the increased risk to investors.

The efficiency gains generally described by advocates for allowing general solicitation in private offerings to sophisticated investors generally fit into three categories: gains to investors, to issuers, and to the market. It is argued that the general solicitation ban hurts wealthy investors who lack personal connections to managers of private investment vehicles, and thus are deprived of money-making opportunities. Similarly, private issuers who lack extensive personal relationships will be denied access to capital. Finally, critics argue that the general solicitation ban is an impediment to the flow of information, which creates unnecessary inefficiencies in the market, distorting the cost of capital for private issuers depending not on the value of the underlying security but rather on the personal relationships of the issuer.

These efficiency gains possible by repealing the general solicitation prohibition are not undisputed. Arguably allowing general solicitation would allow large funds to advertise more than smaller funds, effectively increasing the smaller fund's cost of capital. Additionally, any inefficiency caused by the current lack of information flow would be more than offset by the inefficiencies created by the ability of advertiser's to manipulate the market. Finally, hedge funds increasingly are turning away from wealthy individuals to institutions for the bulk of their funding. It is unlikely that these financial institutions will have their investment decisions influenced by advertisements.

The risks of repealing the general solicitation prohibition in Section 3(c)(7) offerings is also a contested issue. For example, it is possible that increased media use would also increase the manipulation of investors. This contention is disputed, firstly, because it discounts the sophistication of qualified purchasers to obtain and process information efficiently. Secondly, if

ee Note 26.

the S.E.C. determined that even the most sophisticated investors were subject to manipulation by the coercive forces of the media, it could protect investors by regulating the content of advertisements (i.e. by applying strict informational requirements, for example).

Another risk of repealing the general solicitation prohibition in Section 3(c)(7) offerings is that doing so would distort the market. It could induce qualified purchasers to disproportionately invest in Qualified Purchaser Funds, discouraging them from investing in other arguably preferable sources. This argument, once again, discounts the ability of sophisticated qualified purchasers to make wise investment decisions. Assuming that investors act rationally and base their decision on a free flow of information, qualified purchasers should be trusted to efficiently allocate their capital.

VII. Conclusion

In conclusion, repealing the general solicitation prohibition in Section 3(c)(7) offerings could be accomplished by applying the principles behind the general solicitation prohibition. Although allowing general solicitation might expose investors to greater risks, the examples of Regulation A and Rule 1001 show that this is not necessarily the case. Additionally, while there are some doubts concerning the extent that allowing advertising would increase market efficiency, it seems likely that increased information flows will lead to a more efficiently functioning market. Thus, there exist strong precedential and policy reasons to support the S.E.C. staff's recommendation that the general solicitation prohibition should be repealed during Section 3(c)(7) offerings to qualified purchasers.