Pre-Existing Substantive Relationship Requirement With Investors

If an offeror is making an offering that does not allow public advertising, such as a traditional Rule 506 offering, then according to the SEC a pre-existing substantive relationship is required before a potential investor can invest. Specifically, the SEC has said that the existence of a relationship between potential purchasers and an issuer prior to an offer is an important factor in determining whether there is public advertising in violation of the securities laws. As one might expect, the SEC has been criticized for conflating a pre-existing relationship with the lack of public advertising.

In fact, the SEC has also stated that an actual prior business relationship with each investor is not the only way to show the absence of a general solicitation. Instead, the SEC has stated that a “relationship” may be established by 1) using an investor questionnaire before making any offering to a qualified potential investor and 2) letting enough time pass between the return of the questionnaire and any investment.

Unfortunately, it is not clear how much time is sufficient. At least one SEC no-action letter indicates that certainly 30 days is enough. Some believe that at least one purpose of letting time lapse is to provide a cooling-off period so that the potential investor has adequate time to reflect and make a considered decision without being “railroaded” into quickly investing by an overzealous offeror.

Some offering types require a specific waiting period before an investor can invest. For example, in a California qualification by permit offering that seeks to avoid a merit review by the State, the offeror must deliver a copy of “A Consumer’s Guide to Small Business Investments” to each potential investor at least five days before the investor can invest. Unfortunately, most offering types do not have any specific requirements.

In an ideal world, where an offeror did not already have a relationship with a potential investor, the offeror would let at least 30 days pass from when the offeror received the completed investor questionnaire back to when the investor signed the subscription agreement. Where that is not practicable, the offeror should try to develop as much of a relationship as it can with each potential investor of this type before that investor invests. In addition, it is recommended that a minimum of five calendar days pass from the time that the investor receives the private placement memorandum (or other disclosure document) to when the investor signs the subscription agreement.

It is also good practice, after an investor has received the PPM and had a bit of time to consider it, for the offeror to send the investor an email asking if the investor has any questions before allowing that investor to invest. Such emails should, of course, be retained, along with any other emails in that string.

Bruce E. Methven

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Bruce E. Methven, 2232 Sixth Street Berkeley, CA 94710
Phone: (510) 649-4019; Fax: (510) 649-4024
www.TheCaliforniaSecuritiesAttorneys.com
CaliforniaSecuritiesAttorneys[at]gmail.com