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CAPITAL FORMATION VIA PRIVATE PLACEMENTS

Solicitation for Capital

Rule 502(c) of Regulation D ("Rule 502(c)") prohibits issuers from general solicitation and general advertising in private placements. Given those limitations, many issuers find it difficult to attract investors.

One method of demonstrating that the sale of a security through a private placement is not the result of general advertising or general solicitation is for there to be a documented substantial and pre-existing relationship between the issuer and the prospective investor.[1] To be "substantial" the relationship should involve a discussion of the prospective investor's financial goals and objectives, and one should examine the nature and quality of the relationship. To be pre-existing, a relationship should be in place before the terms of the offering are developed and before the offering commences.[2]

It is not necessary that the issuer have the substantial and pre-existing relationship between itself and the prospective investor. In lieu of such a relationship, the issuer can also demonstrate a substantial and pre-existing relationship with a prospective investor through a "finder" that is acting on behalf of the issuer. A finder may be a company, service or individual such as a broker-dealer who may receive a fee in connection with the solicitation of potential investors. Finding such finders may prove difficult in itself. As in the case with the prohibition against general solicitation to attract investors in the course of a private placement offering, it appears that a firm cannot engage in a general solicitation to find finders. It is quite likely that the SEC would find that a cold mass mailing of a brochure or executive summary summarizing a private placement memorandum, which was made to finders would be a general solicitation, regardless of whether the recipients were viewed as investors or merely conduits to investors.[3]

An issuer may take advantage of a substantial and pre-existing relationship between a finder and a prospective investor depending on the nature and quality of that relationship. According to the Commission: the types of relationships with offerees that may be important in establishing that 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 persons with whom the relationship exists or that otherwise are of some substance and duration. [4]

Even though an issuer may rely on an agent or affiliate's substantial and pre-existing relationship with a prospective offeree, the issuer should make its own assessment of the offeree's accreditation and suitability rather than relying on that of the agent or affiliate. Because the issue is, whether the issuer "reasonably believes" that the potential investor has enough knowledge and sophistication to properly evaluate the investment opportunity, the issuer should have some basis beyond the finder's certification for assessing the investor.

Having a substantial and pre-existing relationship is not the exclusive means of demonstrating the absence of general advertising or solicitation. Where an investor, unsolicited, expresses interest in the sale of a certain security by an issuer, and the issuer has not engaged in general advertising or general solicitation that is

related to the security in question, the issuer may sell the security to the prospective investor without violating Rule 502(c).

The realities, however, suggest caution in the absence of a substantial and pre-existing relationship. Depending on the circumstances under which an offer is made, there may well be varying levels of risk. For instance, if a friend of an issuer's existing investor asks the issuer about the purchase of a security, there should be no reason that the issuer could not sell the security to the friend, especially if the issuer has not encouraged the existing investor to make referrals; however, doing so may raise questions regarding the absence of a general solicitation.

The use of electronic media to offer securities, however, has already loosened the reigns placed on general solicitation. In response to the growing interest on the part of issuers to offer and sell securities via the internet, the SEC and many states have sought ways to permit solicitations over the internet without deeming such actions to be general solicitations. For example, in IPONET (July 23, 1996), the SEC permitted electronic solicitation of investors where the prospective investors were pre-qualified through the use of questionnaires and then permitted to participate in current offerings. In effect, the electronic solicitation process in IPONET collapses the previously required two-step process of establishing a prospective investor's qualifications, and then offering securities to that investor only in offerings not existent at the time of the original solicitation.

The limitation on advertising underscores the importance of careful attention to, and review of, all of an issuer's promotional materials and reports. An issuer and its affiliates and agents may not engage in advertising designed to attract investors to a private placement offering. However, the issuer may continue generic advertisements and reports wholly unrelated to the offering. [5]

A question is raised as to whether or not a finder has to be registered as a broker-dealer. Generally speaking, a finder does not have to be registered as a broker-dealer if a finder's activities are limited. A "broker" under the Securities Exchange Act is "any person engaged in the business of effecting transactions in securities for the account of others." The Commission has found activities such as (a) participating in presentations or negotiations, (b) making any recommendations concerning securities, (c) receiving transaction-based compensation, (d) structuring a transaction or making recommendations regarding the nature of the securities, whether to issue securities or the assessed value of securities sold, and (e) continuing involvement in sales of securities to trigger broker-dealer registration obligations.[6]

Finders and consultants may avoid registration by limiting their activities to introducing prospective investors to an issuer and basing their compensation on either a flat fee or a percentage commission rather than on the outcome of the issuance or the amount of money raised by the offering.[7] While a commission is not a definite indication that the finder should be registered, it serves as a red flag, especially if the finder in question has been engaged in other private placements wherein he received commissions as a finder or broker.[8]

Rule 3a4-1 provides a non-exclusive safe harbor from the definition of a broker for persons associated with an issuer who are engaged in securities related activities incident to their duties on behalf of the issuer. [9] Employees and possibly individual affiliates of an issuer who are not registered representatives of broker-dealers may be considered "associated persons" for purposes of Rule 3a4-1, in which case they may be exempt from registration and will be permitted to engage in limited sales activities pursuant to the Rule's safe harbor.

A finder may provide market and financial analyses, prepare feasibility

studies, hold meetings with registered broker-dealers, prepare or supervise preparation of private placement memoranda, and otherwise assist the issuer in structuring the offering. However, participation in detailed discussions or recommendations regarding the nature of the securities, whether to issue securities or the assessed value of securities sold is inappropriate. [10]

Payment of Finders Fees

If the finder hopes to avoid broker-dealer registration, a flat fee is more appropriate than a commission that is based on the outcome of the issuance.[11] Commission compensation demonstrates success in effecting transactions for the account of others and is a factor of paramount importance; a hallmark of brokerage activity is the collection of a commission for one's services. While a commission is not a definite indication that the finder should be registered, it serves as a red flag, especially if the finder in question had been engaged in other private placements wherein he received commissions as a finder or broker.[12] Regardless of the method of compensation, any financial relationship with a finder must be disclosed to the investor.

However, the less involved a business consultant is in the negotiation and structuring of a transaction, the less likely it will be that the SEC staff will require the business consultant to register as a broker-dealer despite the fact that it receives transaction based commission. The SEC staff has recognized that "individuals who do nothing more than bring merger or acquisition-minded persons or entities together and do not participate in negotiations or settlements probably do not fit the definition of a "broker" or a "dealer" and would not be required to register. On the other hand, individuals who play an integral role in negotiating and effecting mergers and acquisitions, particularly those persons who receive a commission for their efforts based on the cost of the exchange of securities, …are required to register with the Commission." [13]

For example, in Corporate Forum, Inc., SEC No-Action Letter dated December 10, 1972, a financial consultant represented that it would locate merger and acquisition candidates for its clients and make a financial analysis of such candidates, but would allow the clients to negotiate and consummate the transaction found for it by the financial consultant. The SEC staff predicated its no-action relief on the premise that the financial consultant would not participate in the negotiation of any transaction involving its client.[14] And in at least one instance, the SEC staff was willing to take a no-action position in regard to the non-registration of a finder who proposed to "upon occasion, as part of the consultative, advisory and negotiating process articulate, explain or defend negotiating proposals or positions that have been adopted by its client or that the finder had recommended for its clients."

However, the SEC recently found a person to be a broker while engaging in activities similar to those a finder may engage in.[15] In 1991, Michael Milken was barred from associating with a securities broker pursuant to an SEC order.[16] Milken was found to have violated the 1991 order in connection with two transactions where he was acting as a business consultant: (1) a transaction between MCI Communications Corporation ("MCI") and The News Corporation ("News Corp.") and (2) a transaction between New World Communications Group, Inc. ("New World") and News Corp. in which New World agreed to transfer network affiliation of nine of its television stations in exchange for a $500 million investment by News Corp. in New World. In finding that Milken acted as a broker in the transactions and ordering Milken to disgorge the $42 million fee he earned, the SEC found Milken's contact with the opposing party a critical factor. The SEC cited that he "introduced companies, proposed business arrangements that involved the purchase, sale or exchange of securities, and participated in negotiations regarding the structure of the transactions and securities to be issued in connection with those

transactions." The SEC also noted that Milken received transaction based compensation.

The SEC failed to take action in another transaction between Turner Broadcasting System ("Turner") and Time Warner Inc. ("Time Warner") for which Milken acted as a business consultant. In this instance, the SEC did not find a violation where an agreement in principle to merge the two organizations was reached without his involvement and Milken's role was to articulate the strategic benefits of the transaction to both parties and to keep the parties focused on those benefits.

To request further information on the subject matter of this release call Securities Law Institute at: Toll Free (888)546-6454 or (702) 866-5800 or

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[1] Woodtrails-Seattle, Ltd., SEC No-Action Letter dated August 9, 1982.

[2] Ovation Cosmetics, Inc., SEC No-Action Letter dated February 6, 1976.

[3] Pennsylvania Securities Commission , SEC No-Action Letter dated January 16, 1990.

[4] Mineral Lands Research & Marketing Corp. SEC No-Action Letter dated December 4, 1985.

[5] Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 688 (5th Cir. 1971;ENI Corporation dated December 3, 1975; Oil and Gas Investor (September 9, 1983; and Econative Corp./Geller, Barry (February 27, 1978.

[6] John R. Wirthlin, SEC No-Action Letter dated January 19, 1999; Paul Anka, SEC No-Action Letter dated July 24, 1991; Caplin & Drysdale, Chartered, SEC No-Action Letter dated April 8, 1982; John DiMeno, SEC No-Action Letter dated October 11, 1978; and David A. Lipton, Broker-Dealer Regulation, §1.03, at 1-10 (15 Securities Law Series 1988).

[7] Richard S. Appel, SEC No-Action Letter dated February 14, 1983.

[8] Carl L. Feinstock, SEC No-Action Letter dated April 1, 1978.

[9] Securities Exchange Act Re.No. 22172 dated June 27,1985.

[10] Victoria Bancroft, SEC No-Action Letter dated August 9, 1987; Miller & Co., Inc., SEC No-Action Letter dated August 15, 1977.

[11] John R. Wirthlin, SEC No-Action Letter dated January 19, 1999; Richard S. Appel, supra.

[12] Carl L. Feinstock, supra.

[13] Gary L. Pleger, Esq., SEC No-Action Letter dated October 11, 1977; IMF Corp., SEC No-Action Letter dated May 15, 1978

[14] Miller & Co., Inc., SEC No-Action Letter dated August 15, 1977.

[15] SEC v. Michael R. Milken, Litigation Release No. 15654 dated February 26, 1998.

[16] In the Matter of Michael R. Milken, Exchange Act Release No. 28951 dated March 11, 1991.