GROWTH CAPITAL SERVICES
MEMBER FINRA, SIPC

COMPLIANCE BULLETIN

The Perils of Pre-Marketing

2017

Growth Capital Services
Member FINRA, SIPC

582 Market Street, Suite 300
San Francisco, CA 94104

Tel : 415-692-0050
www.growthcapitalservices.com

The Perils of Pre-Marketing

We received an email recently from one of our reps that nicely encapsulates a question that we have heard from many of you.

> "Increasingly, both for your sake and ours, we are trying to test the market with some of these enterprise ideas before going to the trouble/time of signing them up. Once we take their money in retainer we create a bond and also an obligation, and if they are hard to finance, then they can consume a LOT of cycles. This burns our time (and indirectly, yours)…. For these reasons, I am going a little farther down the road of exploring with potential investors whether they might be interested in Concept A or B before making it an official engagement. This does not gibe perfectly with the GCS paperwork process I realize, but I really think it is smart for everyone."

This is the process of "pre-marketing," which refers to testing an idea out with potential investors before going through the process of a deal review. Surely, one might think, if an investor is only given a snapshot of a deal on a no-name basis, without enough information to be able to invest, then how could this be considered solicitation?

We thought this a fair question and worthy of some research. Unfortunately, the answer from our legal and compliance team was unanimous: any discussion of deals, no matter how cursory or anonymous, can be considered solicitation.

The relevant conduct that requires registration at the federal and state levels, and triggers our internal paperwork processes, is "effecting transactions in securities." This is the language used by the state statutes as well as the federal rules. While not addressed or defined specifically in any FINRA rule, solicitation is understood to be an element of broker-dealer activity that qualifies as engaging in effecting transactions in securities.

Solicitation is used to describe any direct or indirect communication with an issuer, customer or counterparty that is intended, or reasonably likely, to have

the result of obtaining or retaining any securities business. As with most SEC and FINRA issues, this would be assessed on a "totality of the circumstances" basis, meaning that you can't just look at a specific communication in a vacuum, but need to factor in all relevant circumstances and other communications, before and after. Since the rep described “exploring with potential investors whether they might be interested in Concept A or B,” this activity is very likely to be considered solicitation in connection with one or more potential offerings. Our team notes that in our collective experience, regulators have taken a broad view of what they consider to be solicitation; while those are engaged in the business end see this as a grey area, the regulators prefer to think in black and white.

Note that being engaged on a retainer basis does not necessarily trigger the need for deal review. This is what we consider the “engagement letter” stage, and it is very common for our reps to work with a client for weeks or even months to hone the details of the investment proposal before going live with it. However, before any discussion with investors, even on a preliminary basis, the deal and its presentation materials must be reviewed by our compliance team in what we refer to as the “deal memo” stage. As one of our supervisors noted, “you have to touch first base before going to second.”

Our firm has had direct experience with this issue. A rep (who is no longer with the firm) reached out to some of his venture capital buddies as a favor to a friend with an interesting if early-stage business. He did not even think to alert our deal team because the business in question was far removed from his normal activity, and he was not planning to take a commission on it. However, when FINRA discovered the communications in their routine review of the firm, they took this as “selling away” by the rep and as improper supervision by the firm. This led to months of investigation and legal expense, culminating in on-the-record testimony and deposition by both the rep and the firm’s principals. Not fun for anyone.

A similar understanding of solicitation applies to state registration. It would be more convenient to find out whether there is any interest from investors in a particular state before registering there. However, most states do not

permit a “testing of the waters.” Fortunately, now that GCS is registered as a broker dealer in all 50 states, it is a matter of a day or two and several hundred dollars for each rep to become registered in any particular state.

Bottom Line

Before reaching out to any investors, get your deal cleared by our compliance team. You’ll be glad you did.