

## ROBERT G. HUTCHINS – LEGAL ESSAYS

### Private Placements - Part II - Finding Investors - Selling Constraints Applicable to Unregistered Securities Offerings

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#### Preliminary Note

Stocks, most debt instruments and a vast array of ingenious investment contracts are called "securities." Companies that sell their own securities to raise capital are called "issuers." (In this Essay, I use the terms "company" and "issuer" interchangeably.) Persons who "distribute" securities to buyers on behalf of an issuer are called "underwriters." The process by which a company offers, sells and distributes its securities is called an "offering."

Offerings of worthless securities by issuers and their underwriters have long distressed regulators. Motivated by the desire to protect a gullible public, congress has enacted legislation requiring that, unless an exemption is available, all securities offerings be "registered" in advance through the filing of descriptive statement with the SEC. The SEC reviews the statement to determine the quality of the disclosure that will be made to investors. The states have similar registration requirements. Because of the delay and expense associated with registration, companies seeking capital are at pains to find an exemption if they can.<sup>1</sup>

The exemptions are few in number and narrowly defined. The burden of establishing an exemption falls upon the person claiming it, e.g. the issuer or the alleged underwriter. Failure to satisfy the burden can result in civil liability to investors enforced by "recision," a remedy effectively imposing a duty to repurchase the securities at the offering price even if investors have not suffered a complete loss. When the failure to register is part of a scheme to defraud, criminal as well as civil sanctions can be imposed.

For most companies, the practical risk of declining to register is not so much that some public authority will ferret out and prosecute a suspect offering on its own, but rather that counsel for a disappointed investor will claim registration was required and assert rescission rights on the investor's behalf. News of the claim can spread rapidly among the investor group. If the claim has merit, the ensuing domino effect can collapse an entire financing. What incentives are there, then, for relying upon an exemption to escape the burden of registration?

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<sup>1</sup> For a discussion of the concept of "registration" from the perspective of middle market companies see this Website, Publications, Essays, "*Private Placements Part I – Financing the Start-up or Development-stage Company*," and "*Risk Capital For 'Middle Market Companies' - Inherent problems – Possible Solutions.*"

First, there are special classes of *exempt securities*. Foremost among them are securities issued by entities that are themselves regulated. Such securities are deemed sufficiently risk free that anyone of average competence can be trusted to purchase them without help from the preliminary screening associated with registration. Bonds issued by federal and state agencies, stocks issued by banks and participating interests in pension plans sponsored by insurance companies are examples. Other securities are exempt because their unencumbered sale is thought socially desirable. Building fund notes or pledge certificates issued by qualified charitable organizations fit this category.

Second, there are *exempt transactions* in securities and these may be claimed even though the securities, as such, are *not* exempt. Some transactional exemptions exist simply because the securities markets could not function without them. Thus there is a "trading" exemption for ordinary persons who buy or sell securities for investment and are neither issuing nor underwriting them. (The New York Stock Exchange would implode immediately if everyone who traded a security on it had to register first.) Other transactional exemptions exist for licensed securities brokers and dealers. For example, brokers' transactions initiated in response to customer orders and closed on an exchange or in the over-the-counter market need not be registered. Broker-dealers acting as underwriters may engage in preliminary solicitations of prospective buyers (but may not close sales) as part of a securities offering that has entered the registration process, but has not yet completed it. These exemptions permit securities professionals to perform their functions by following established procedures in regulated capital markets.

The exemption most frequently invoked by companies raising capital, however, covers "Transactions by an issuer not involving any public offering." It is called the "4(2)" exemption because it is authorized by Section 4(2) of the federal Securities Act. The states have enacted equivalent exemptions, usually in identical language.

It is the 4(2) exemption that permits companies to use the financing technique known as a "private offering" or "private placement." A private placement, essentially, is a securities offering that is treated as "non-public," and therefore exempt from registration, because the selling effort is confined to demonstrably competent investors who are already acquainted with the issuer. There is a general consensus among legislators that mandatory registration of bona fide private placements would prevent many companies from obtaining capital and is not in the public interest.

To claim the 4(2) exemption, a company offering securities must not seek buyers by means of a "general solicitation," one calculated to reach the public at large. I examine that prohibition below.<sup>2</sup>

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<sup>2</sup> The SEC, acting under authority granted by Section 3(b) of the Securities Act, has published Rule 505 of Regulation D creating a separate, purely regulatory exemption

## Private Placements - Complying With The Prohibition Against "General Solicitation"

Let us repeat, with emphasis, the operative text of Section 4(2). It provides an exemption from registration for "*Transactions by an issuer not involving any public offering.*" The Section is devoid of explanatory language. There is no statutory guideline or numerical benchmark for determining when an issuer engaged in a securities transaction has managed to "involve" itself with a "public offering." We are left with a sweeping but unadorned command: "public" offerings must be registered. We are told elsewhere in the statute that "involvement" in a public offering that is not registered will bring dire consequences.

Though the underlying congressional goal may be salutary, Section 4(2) must be understood to be effective. Congress may have assumed that the distinction made by the Section between public and non-public offerings would either be self evident to those in the field, or soon clarified by the courts. In fact, the distinction had always been murky to the financial community and subsequent judicial decisions have not been models of clarity. The Supreme Court has ruled that the question whether an offering is public does not turn upon the number of people contacted, as one would expect, but upon the ability of the targeted investors (the "offerees") to assess the merits and bear the financial risks of the offering. That lofty pronouncement, however, is not helpful in practice. The reality is that securities are sold, not bought. The threshold question for any company considering a private placement concerns the extent to which Section 4(2) actually limits selling methods. The answer is not found in judicial musings about investor sophistication or risk tolerance.

The prohibition against "general solicitation" evolved over time and is traceable to a number of sources. As applied by securities administrators and courts, its effect is to negate a claimed 4(2) exemption (regardless of other circumstances) whenever the means used to communicate an offering are indiscriminate and appear designed to reach persons who are not known to the issuer (i.e., members of the "public"). The prohibition appears uniformly in the federal and state regulations defining private placements (e.g. "...no general solicitation shall be used"). It is cited by courts as a cornerstone of securities law enforcement policy. It is as easy to articulate as Section 4(2) itself. Unfortunately, its meaning is just as obscure. To think and act within its limits, we must rely upon principles derived from a long list of interpretative lower court decisions, administrative releases and SEC "no-action" letters. The principles are as follows:

- **Avoid Indiscriminate Communications:** The manner in which an offering is communicated is the most important key to determining whether it is

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for non-public offerings of up to \$5,000,000. The restrictions on the selling effort are virtually identical to those that have evolved for statutory private placements under Section 4(2). For a discussion of Rule 505, see this Website, Publications, Essays, "*Private Placements – Part III – Organization and Structure.*"

"public." It does not matter how many people actually buy the securities. The less selective the method of communication proves to be, the more the selling effort takes on the appearance of a "general solicitation." Newspaper advertisements, mass mailings and the use of broadcast media are obvious attempts at general solicitation and are expressly prohibited in private placements by all regulations on the subject. Not surprisingly, offerings directed at persons only superficially limited by class, such as all Rolls Royce owners, or all stockholders of Microsoft, will also be found illegal unless registered. Such offerings, though not in terms open to everyone, are nevertheless "public" in character, because the method used to select investors bears no relationship to the avowed purpose of the selection; i.e., to reach qualified investors known to the issuer. Perhaps less obviously, the use of "friends," initial investors, business associates, or other intermediaries who tout the investment to persons with whom neither they nor the issuer are well acquainted also creates the impression of a general or "public" selling effort. As observed below, any use of third parties to place securities "privately" carries considerable risk. By contrast, personalized written communications, telephone calls or meetings confined to selected persons whose background, financial position and business sophistication are already known to the issuer are clearly lawful and constitute the heart of a "private placement."

- **Eliminate Unsuitable Investors In Advance:** Regardless of the content of the message, any organized communication requires a preliminary assessment of the *composition* of its audience. In the context of a private placement, it is not enough to limit the audience to known persons. The evil associated with unregistered securities offerings lies in their propensity to reach people who are not equipped to evaluate them or who cannot afford to lose their investment in them. Companies selling securities without registration, accordingly, should screen potential investors before contacting them. They should not contact persons they believe to be inexperienced in business, ignorant of financial matters or without discretionary funds. They should also avoid persons whose competence they cannot assess at all for lack of information.

- **Document The Relationship With Investors:** The issuer, on the basis of existing information, must have a reasonable basis for believing (and must actually believe) that the offering is suitable for all investors to be contacted. The belief must be formed before contact is made. Possession of the necessary information requires something of a pre-existing relationship. The relationship may be business, personal, or professional but, whatever its source, it must be "substantive." It must have produced information permitting a reasonable inference that the investor has experience in business and financial matters and can afford to invest. Documenting that relationship is essential. To protect their company, executives in charge of a private placement should compile a record of the date upon which, and the manner in which, each potential investor has first been contacted *about the offering*. The record should include a short history of the previous relationship between the investor and the company. It should stress those facts produced by the relationship which prompt a *reasonable inference* (certainty is not required) that the investor will understand the investment and can afford to invest.

- **Never Establish Relationships in Anticipation of an Offering:** Buying information to identify possible investors (e.g., a mailing list) is fatal. The relationship with prospective investors must exist independently of and *prior to* the commencement of the offering. Otherwise the registration requirement would quickly become a dead letter and securities would be sold through the preliminary acquisition of a mailing list or other convenient data base, followed by solicitation labeled as private but in fact directed at anyone in the data base who can be found.

On the other hand, any company can and should document an investor database, systematically and aggressively, from existing relationships and new ones that arise during the normal course of its business. The dynamics of business place most companies in a position not only to establish relationships, but also to obtain information about investor suitability, turning the relationship from a casual one into a "substantive" one for legal purposes.

- **Be Careful about Concurrent Product Advertising:** The prohibition is limited to the general solicitation of buyers of unregistered securities. It does not apply to business patrons or customers. Nothing in the securities laws prevents a company from advertising its *products* to the general public by any means otherwise lawful. Such "generic" advertising, however, obviously cannot be used as a pretext to promote an offering of securities. References to capital raising or to investment returns associated with the sale of the company's products, for example, should never be made. They would condition the market for the allegedly private securities offering. Securities counsel should be asked to review in advance of publication any product advertising that will coincide with a securities offering.

- **Be Careful when using "Finders" Or Paying Commissions:** Companies necessarily sell securities through representatives. Typically the representatives are already associated with the company as directors or executive officers. The actions they take in their official capacities are those of the company itself. Occasionally, however, companies also use third party intermediaries, or "finders," to locate investors in unregistered offerings. When no compensation is paid for the selling effort, the use of these representatives will not jeopardize a 4(2) exemption *if the other principles outlined here are observed*. It will be important to acquaint each third party representative, preferably in writing, with all of the selling restrictions. Representatives of the company must have the required "substantive" relationship with all of the persons they contact. A single careless letter or phone call by a well meaning but uninformed representative can ruin an otherwise solid exemption.

If commissions or other forms of compensation are demanded or contemplated, counsel should be consulted immediately. All states impose restrictions upon the selling compensation that may be paid by issuers in private placements and most also require that persons who sell securities for compensation as a significant part of their business be registered as an investment adviser or broker dealer. For larger private placements compensation may be paid, but only (a) to persons registered as brokers or sales persons, (b) to unregistered persons who sell only to "accredited" investors or (c) to unregistered persons who do not make it a

regular practice to promote investments or render investment advice, take no part in the negotiation of the transaction and neither evaluate nor recommend the securities.<sup>3</sup>

All finders should be acquainted with the issuer before the offering begins. Issuers in a private placement cannot solicit either investors *or* finders by general means. Finders should recommend the company, *not* the offering. Ideally the company would accept from a finder only the name, address and telephone number of a prospective investor and would conduct all of the ensuing negotiations directly.

- **Special problems:**

⇒ **The unsolicited inquiry.** When a third party not already involved in the selling effort approaches the company with the name of a prospective investor, or when a stranger makes an unsolicited inquiry about an offering, the company may respond. If appropriate otherwise, the company may complete a sale to the prospect if it did not, with the goal of reaching the public, set in motion the chain of events by which the prospect learned of the offering. These inquiries are inevitable. The mere fact that a company is making a securities offering will not, by itself, be treated as the general solicitation of all those who will find out about it. Two simple rules should be followed here: First, when referrals are made, the referring person should be told that the prospect must contact the company directly. The company should not make cold calls to referred prospects and should not negotiate with a prospect through the referring person. Second, the company should document the manner in which an apparent stranger learned of the offering. Where possible, it should verify the source of the information. The purpose, of course, is to emerge with a record supporting the company's position that no general solicitation was used.

⇒ **Investment Clubs and Matching Services.** Investment clubs, entrepreneurial networks and any number of matching or "dating" services are regularly touted as sources of private investment capital. These organizations vary widely in their methods and purposes and in the sophistication and financial resources of their members. Some have a checkered legal history. Others, such as those sponsored by educational institutions, constitute a valuable resource for investors and companies alike. When considering these sources in the context of a private placement, a company should remember that the general rules apply. Thus a company may not contact investment clubs by general solicitation. A company can contact a recognized club privately to discuss a proposed offering so long as it is clear that (a) the club itself will not be an investor and (b) the club is

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<sup>3</sup> In general, "accredited" investors are persons whose financial position allows them to absorb a total loss of the investment, or persons whose relationship with the issuer gives them access to inside information e.g. directors, officers, partners, etc. They must meet elaborate definitions.

acting on behalf of its members, not issuers. The company should avoid organizations that charge a fee for introducing an issuer to members (although a reasonable charge to cover expenses is appropriate). Companies should ask to see, and should review carefully, the criteria for membership in the organization. The members should be selected because of their business and financial sophistication, financial resources and active interest in private placements. The company should not make a presentation to any group that will include new members who are attending specifically to learn about the company's offering. The information about the company that is distributed by the organization should be summary in nature, as should any presentation made to members by the company itself. Individual members considering an investment in the company's securities should be instructed to contact the company directly after the presentation is made.

- **Summary of Things to Avoid:**

- ⇒ Media advertising and cold calls;
- ⇒ Purchased mailing lists, reference sources, or third party networks;
- ⇒ Unrestricted mass mailings;
- ⇒ Formal seminars promoted by general announcements, RSVP cards, etc.;
- ⇒ The use of finders or intermediaries who do not understand, or will not observe, the selling restrictions applicable to the company (all intermediaries are representatives of the company subject to the rules listed here);
- ⇒ Compensation paid for selling securities (no matter how devised) unless the arrangement is reviewed by counsel;
- ⇒ The advertising of securities masquerading as the advertising of products or services.

- **Summary of Things to Stress:**

- ⇒ A written record of the persons contacted in connection with an offering and the reasons for contacting them;
- ⇒ Small, face-to-face and documented meetings or one-on-one negotiations;
- ⇒ The prescreening of investors with documentation of the reasons motivating the selection, before selling efforts begin;

⇒ Full and written disclosure of all merits and risks associated with the offering in the form of a confidential memorandum delivered to all investors, against a written, dated and signed receipt;

⇒ The avoidance of supplementary selling materials that change the facts, minimize the risks, or expand the returns or other benefits described in the memorandum.

### **Resales by Investors - Dealing With "Restricted Securities"**

Section 4(2) provides an *issuer's* exemption, one that may be claimed only by companies raising capital for themselves. The 4(2) exemption does *not* cover holders who bought their securities from those companies and want to *resell* them. Such holders are not "issuers" and their securities are "restricted." Restricted securities must be registered before they can be resold unless *another* transactional exemption is available for them *at the time of resale*. That principle requires that we turn our attention to the trading exemption mentioned earlier, the one that permits the New York Stock Exchange to function. The trading exemption is found in Section 4(1) of the Securities Act.

Section 4(1) exempts transactions "...by any person other than an issuer, underwriter, or dealer." As stated, investors who purchase securities in a private placement are not "issuers" of those securities. We can assume they will not generally be "dealers" in them. Accordingly, they may resell their securities without registration unless they are "underwriters." They will be underwriters if they acquired their securities as part of a "distribution." A "distribution" occurs, for our purposes, when insiders acquire securities from an issuer in an allegedly exempt "private" placement then, by pre-arrangement, resell them to a wider group of people. Such insiders are treated as "underwriters" because they perform for the issuer the function of a Merrill Lynch, acting as a conduit through which the securities flow from the issuer to the general public. That is why companies require that purchasers in a private placement certify they are purchasing only for "investment," and not for "resale."<sup>4</sup>

Issuers protect themselves against an inadvertent "distribution" by precautions taken when the private placement is made. Investors intending later to resell their securities under Section 4(1) must demonstrate on their own that they are

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<sup>4</sup> The distinction between purchasing for "investment" and purchasing for "resale" is contradictory on its face, but has become serviceable over time. Of course the purchaser intends to resell the securities at some point. That is how capital appreciation is realized. The purpose of a certification of investment intent is merely to show that the purchaser does not anticipate a specific resale at the time of purchase and is prepared to absorb the economic risk of the investment. When that state of mind exists, the securities are said to have "come to rest" in the hands of the purchaser. They will not, by virtue of the "private" placement, reach the general public.

not "underwriters." The demonstration can be made by either of two methods: first, by complying with regulatory safe harbors found in SEC Rules 144 or 144A; second, by complying with less formal requirements evidenced by SEC interpretive releases and "no action" letters. The following summary of these methods reflects a ruthless suppression of detail. Resales of unregistered and "restricted" securities should not be attempted without the advice of counsel.

- **Reselling Securities under Section 4(1) - Method One - The Regulatory Safe Harbors – Rules 144 and 144A**

⇒ **Resales while the Issuer is privately held:**

√ **Rule 144:** Rule 144(k) provides that investors who acquire unregistered securities from an issuer or its "affiliate," and who are not themselves an affiliate, may resell the securities in any market without restriction, but only after they have held the securities for at least two years. By that time, the securities are deemed to have "come to rest." The holding period begins when the investor has fully paid for the securities. (There are elaborate provisions for calculating the holding period of securities acquired under special circumstances. Examples include securities issued as the result of a stock dividend, split, recapitalization or conversion, securities delivered out of pledge and securities acquired by gift or from a trust or estate.) An "affiliate" is a person that controls, is controlled by, or is under common control with the issuer. Affiliates include statutory entities that are members of an issuer's corporate group, natural persons who are the issuer's directors or officers and others who control the issuer through share ownership or by contract. Rule 144(k) is not available for affiliates. Further, affiliates may not resell securities under any other provision of Rule 144 while the issuer is a private company. However, they can, in an appropriate case, claim the "4(1½)" exemption discussed below.

√ **Rule 144A:** Rule 144A provides a non-exclusive, transactional exemption for unregistered securities offered and resold by either affiliates or non-affiliates solely to entities that are, or that the seller believes reasonably are, "qualified institutional buyers." A qualified institutional buyer is an insurance, investment or business development company, a government or private employee retirement or benefit plan, an investment adviser, a securities dealer or a bank that, in each case, owns and invests on a discretionary basis at least \$100 million in the securities of non-affiliates of the issuer. The seller may rely upon the buyer's recently published financial information to determine whether the

buyer is qualified. The seller must inform the buyer that the seller is relying upon Rule 144A and must provide the buyer with a brief statement of the issuer's business plus the issuer's most recent financial information. There are a number of refinements and qualifications. As a practical matter, Rule 144A is useful only for resales of rated securities issued by large, seasoned companies.

⇒ **Resales under Rule 144 after the Issuer "goes public:"**

If the issuer files a registration statement and complies with its reporting obligations under the federal Securities Exchange Act, the Rule 144 holding period for its remaining unregistered securities is shortened to one year for resales that (a) are made on an exchange through registered broker-dealers, (b) are described in a notice on Form 144 filed with the SEC and the relevant exchange and (c) do not exceed specified volume limitations. The limitations are equal to the greater of (i) 1% of the outstanding securities of the relevant class, or (ii) the average weekly reported volume of trading in such securities during the 4 weeks preceding the filing of Form 144. Both affiliates and non-affiliates may resell in the public markets by meeting the forgoing requirements. Non-affiliates may rely upon Rule 144(k) for the securities of public as well as private companies. After a two-year holding period, the unregistered securities of a public company held by non-affiliates are no longer "restricted" and may be resold freely in any market.

• **Selling Under Section 4(1) - Method Two - The "Section 4(1½)" Exemption**

The SEC has allowed private resales of restricted securities to occur under Section 4(1) without compliance with Rules 144 or 144A if (a) the securities were purchased without an intent to distribute them to the public and (b) their resale is accompanied by the precautions that would be taken by an *issuer* to claim the exemption for non-public offerings under Section 4(2). If those requirements are satisfied, the SEC has indicated registration is not required because "some of the established criteria for sales under both Section 4(1) and 4(2) of the (Securities) Act are satisfied." The result is the so-called "4(1½)" exemption, one characterized by the SEC as a "...hybrid exemption not specifically provided for in the Act but clearly within its intended purpose."

Investors reselling unregistered securities under the 4(1½) exemption should observe the following guidelines:

⇒ **Holding Period - Change of Circumstances - Avoiding the Prohibited "Distribution:"** The securities should have been held for a long enough period that a plausible argument can be made they have come to rest and the original purchaser has absorbed the risk of the investment or that the resale was prompted by an unanticipated change of circumstances. I believe that one-year, or one full

business cycle, would be an adequate holding period in many instances. Any claimed change in circumstances should be thoroughly documented to support the contention that the original purchase was not tainted by an intent to participate in a public distribution.

⇒ **Procedural Limitations - Taking the Precautions of an Issuer:**

The resale effort must be directed only to known persons who would have been qualified for participation in a non-public offering had they been solicited by the *issuer*. When inducing the purchaser to buy, and when closing the transaction itself, the reselling investors should make the same disclosures that the issuer would make. Prior to the sale, the prospective purchaser should be handed the latest financial information for the issuer. The narrative disclosure about the issuer should be updated as necessary. New purchasers should bind themselves to acquire their securities for investment only and not with the present intent to resell them.

⇒ **The Issuer as Purchaser:**

Occasionally circumstances arise in which the issuer is asked to reacquire (redeem) outstanding securities. If the issuer is to be the purchaser, the transaction documents should make it clear that what is occurring is a true redemption, that the issuer is purchasing for its own account and that it is not a mere nominee for another person for whose benefit the transaction is actually occurring. No profit should be paid to the investor whose securities are being redeemed, a minimum holding period of one year should be satisfied and any claimed change in circumstances should be documented.

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