

ROBERT G HUETHINS – LEGAL ESSAYS

Private Placements - Part III – Organization and Structure

Preliminary Note

This is the third in a series of four Essays devoted to the sale of unregistered securities by the entity that issues them, a financing transaction known as a “private offering,” or “private placement.” I use those terms interchangeably and refer to the entity as the “company” or the “issuer.”

Part I of this series outlined the relationship between a typical business plan and the kind of disclosure memorandum that might be used to raise capital by a start-up or development stage company. It also touched briefly upon liquidity strategies, the use of financial forecasts and the importance of clarity in the narrative sections of offering documents.

Part II discussed the selling constraints imposed upon all private placements by the requirement that no “general solicitation” be used to promote them. It analyzed related issues associated with the use of “finders” to identify investors and summarized the important principles governing resales of unregistered securities to non-institutional buyers.

This Part discusses the legal framework that shapes the organization and structure of domestic private placements above \$1 million. Its focus is on the sale to non-employees of ordinary securities that are neither rated nor specially exempted. It also tries to unravel some of the confusion, and dispel some of the myths, associated with the term “accredited investor.” Part IV will close the series with a nuts and bolts discussion of late round, pre-IPO and post-Sarbanes-Oxley Act placements by closely held companies and will address briefly follow-on placements by companies that have already “gone public.”

Given the length and complexity of this Part, the following Table of Contents may be helpful:

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Background - The Securities Act of 1933

In 1933, the Congress of the United States found itself grappling with the worldwide economic depression that followed the 1929 stock market crash. The crash itself was blamed, in large part, on fraudulent sales of worthless stocks, bonds, notes and other securities that had been uniformly tolerated, and sometimes actively promoted, by market professionals. The Committee on Interstate and Foreign Commerce of the House of Representatives, having investigated the crash, reported that:

“During (the period from 1919 to 1929) ... some 50 billions of new securities were floated in the United States. Fully half ... have been proved to be worthless. These cold figures spell tragedy in the lives of thousands.... The floatation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor’s attention those facts essential to estimating the worth of any security.”¹

Congress’ initial reaction was to adopt the Securities Act of 1933. Section 5 of that statute makes it unlawful to sell securities in interstate commerce or through the mails unless either (a) there is “in effect” for them a “registration statement” containing those “essential” facts about which Congress was concerned, or (b) an exemption from registration is available. To be “in effect,” a registration statement must be examined and approved by the SEC.

Part I of any registration statement contains comprehensive information about the issuer and the securities that will be repeated in a “prospectus” a copy of which must be delivered to purchasers. Part II contains additional information and exhibits of interest to the SEC. The process by which a registration statement is prepared, filed, amended and approved typically begins several months before the initial filing date and ends about 90 days after that date when the SEC enters its order declaring the statement to be “effective.”

¹ H.R. Rep. No. 85, 73rd Cong., 1st Sess., at 2 (1933).

The cost of registration is very high, largely fixed and relatively impervious to economies of scale. That fact penalizes any company that needs or is able to raise only limited amounts of capital. Because private placements can be organized much more efficiently than registered offerings, and at a fraction of the cost, they are used by both closely held and publicly traded companies whenever immediate registration is not necessary to provide liquidity for investors. Debt instruments payable from internally generated cash flow, from refinancings or from planned dispositions of business units or discrete asset groups are routinely sold in private placements by companies that have no immediate plan to “go public.” Purchase options or warrants, convertible instruments and discounted equity securities coupled with some form of registration right are placed just as routinely when the company is already public or headed in that direction.

Regardless of the security involved, the threshold question for any company considering a private “placement” or “offering” (again, the terms are interchangeable) is whether, in light of the proposed structure of the financing and the audience at which it will be directed, an exemption from federal registration is available.

The exemptions have several common requirements. To minimize repetition, this discussion begins with an overview. It follows with a summary of the three most commonly invoked, an exemption for “intrastate” offerings, an exemption for limited offerings up to \$5 million, and an exemption for transactions “by an issuer not involving any public offering.”

The discussion then turns to the structural and informational requirements for the last two exemptions and concludes with a comparison of the advantages and disadvantages inherent in regulatory guidelines that have been developed for them by the SEC.

I note only in passing (without meaning to diminish the importance of the subject) that private placements must also comply with *state* laws when those laws are applicable. Often they are not. State regulation of a placement that complies with SEC Rule 506, for example, is preempted by Section 18 of the Securities Act. Rule 506 contains the most widely used regulatory safe harbor for private placements. Of remaining concern, however, are potential state registration requirements for placements that rely upon the federal exemptions for intrastate and limited offerings. Companies must also consult state laws restricting the payment of selling compensation, requiring state licensing of selling agents, providing remedies for violations that may have not have been preempted by federal law, or setting forth notice and fee requirements.

Fortunately, state laws on the subject of registration and exemption are generally compatible with their federal counterparts and thus with the principles discussed here. The states have made a concerted effort through the North American Securities

Administrators Association, Inc. to cooperate with the SEC and eliminate the redundancy and inconsistency that would normally exist in a multi-jurisdictional environment. Moreover, when both federal and state registration is necessary, most states will accept offering documents approved by the SEC without independent review.

Overview of the relevant federal exemptions

The exemptions from federal registration on which private placements depend, and the regulatory “safe harbors” for claiming them, are derived from Sections 3 and 4 of the Securities Act and from implementing Rules adopted under the Act by the SEC.

Sections 3(a) and (c) exempt specific “classes” of *securities* associated by the financial community and Congress with a relatively low degree of risk. They include short-term corporate notes issued as “commercial paper,” securities issued by government agencies, banks, non-profit organizations, insurance carriers and regulated investment companies, and securities the sale of which has been approved in advance (after a full hearing) by a court or an agency with fact-finding powers. Section 3 low-risk securities are regularly issued in private placements, but they represent specialized investments beyond the scope of this inquiry.

Our interest in Section 3 is directed specifically at Sections 3(a)(11) and at a Rule adopted under Section 3(b). Section 3(a)(11) exempts ordinary securities that are offered and sold exclusively within a single state. Rule 147 creates a safe harbor for claiming that exemption. Section 3(b) authorizes the SEC to exempt additional “classes” of securities where registration appears to be unnecessary and the proceeds sought do not exceed \$5 million. Rule 505 establishes the requirements for one of several Section 3(b) exemptions created by the SEC.²

Section 4 of the Securities Act exempts specified *transactions* in securities that are not already exempt *as such* under Section 3. The transactions exempted by Sections 4(1), 4(3) and 4(5) include regular trades executed on an exchange or the NASDAQ and offers and sales by underwriters, brokers or dealers that create or stabilize a market for securities for which a registration statement has been filed or is effective.

² The others include exemptions for the securities of Small Business Development Companies and securities offered and sold to employees in accordance with “Compensatory Benefit Plans” and “Compensation” contracts. Regulation A is comprised of a series of Rules authorizing small offerings to the public of up to \$5 million. The offerings are subject to SEC review of a scaled down registration statement called an “Offering Statement” that substitutes an “Offering Circular” for a “prospectus.” Among other things, Regulation A offerings require only reviewed rather than audited financial statements, a well-intentioned feature that has not been well received by the financial community. See also note 6 for an unfortunate amendment nullifying the utility of the Rule 504 exemption for offerings up to \$1 million.

Section 4(6) purports to exempt private placements of up to \$5 million made “solely to one or more accredited investors.” Though on the surface it might seem ideally suited for small placements made to the wealthy, Section 4(6) is in fact an ill-considered appendage added abruptly to the Securities Act in 1980. Standing alone, the Section is useless because it delegates to the SEC any meaningful definition of “accredited investor.” The SEC responded with Rule 501, which provides the definition in connection with the SEC’s regulatory exemptions and safe harbors. The financial community has ignored the Section and embraced the regulations.

Our interest in Section 4 is directed specifically at Section 4(2), which exempts transactions “... by an issuer not involving any public offering.” Rule 506 provides a safe harbor for claiming that exemption. Section 4(2) is the statutory predicate for private placements without limit as to amount.

The Intrastate Exemption - Securities Act 3(a)(11) and Rule 147

Section 3(a)(11) of the Securities Act creates a federal exemption from registration for:

“Any security which is part of an issue offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such state or territory.”

This is the so-called “intrastate” exemption. The statutory language is sufficiently ambiguous (“part of an issue,” “person(s) resident,” “doing business within”) that the SEC adopted Rule 147 to clarify matters. Rule 147 contains requirements for a *regulatory* safe harbor on compliance with which an “issuer” can assure itself of the *statutory* intrastate exemption. An “issuer” is an entity that proposes to sell and deliver to others (to “issue”) its own securities. Purchasers of the securities are not “issuers.” Non-issuers who wish to resell securities after taking delivery may not use the safe harbor nor, under most circumstances, may they claim an exemption under Section 3(a)(11).³

Under both the Rule and the statute, offers and sales are deemed confined to a single state only if they are made *exclusively* to persons who are “resident” within the state both at the time the offer is made and at the closing of any sale. If even a single out-of-state resident is offered or sold securities, the exemption will be lost, a fact that severely limits its availability. Difficult interpretive issues can arise over whether offerees or issuers are “resident” within a given state. For example, individuals

³ The SEC has permitted controlling persons of an issuer to re-sell in accordance with the *statutory* intrastate exemption if the issuer itself could have claimed it, but the circumstances are extraordinary and well beyond the scope of this Essay. The details are set forth in Securities Act Release 4434 (1961).

targeted by an offering often change their residence while the offering is in progress, maintain more than one residence at a time, or reside in one state but register to vote in another, etc. Identifying the state in which an issuer conducting a regional business is “resident” can be a particularly exasperating experience.

Rule 147 contains imperfect but marginally helpful standards for coping with the troublesome phrases “part of an issue,” “person(s) resident” and “doing business within” that can be summarized as follows:

“(P)art of an issue.” Offers and sales of securities included in a discrete transaction will be treated as “part of an issue” if the transaction is neither preceded nor followed *within 6 months* by other offers or sales by the same issuer, in *any* state, of securities of the same or a similar class. If the transaction is confined to a single state and the offers and sales comply with all other requirements of Rule 147, an exemption from registration is assured. One of the other requirements, however, is that the securities must “come to rest” within the state in which they were purchased. Accordingly, while the offers and sales are in progress, and for 9 months after the last sale, resales of the securities are permitted only within the state or territory with respect to which the exemption is claimed. The 6-month before and after waiting period and the limitations on resale are designed to disqualify allegedly separate intrastate offerings that in reality are components of a single, integrated plan of financing being carried out in multiple states.⁴

“(P)erson(s) resident.” An entity being solicited to purchase shares will be a “person resident” in a state if its “principal” office is located there, except that if the entity has been formed specially to participate in an intrastate offering it will be a resident only if all of its beneficial owners are residents. Individuals will be “resident” if their “principal” residence, i.e. the family home, is within the state.

“(D)oing business within.” An issuer is “doing business within” a state if it is domiciled within and derives at least 80% of its gross revenue from the state, has its “principal” office and at least 80% of its gross assets there, and uses at least 80% of the offering proceeds for the purchase of real estate there or for the operation of its business.

An issuer relying upon the Rule 147 safe harbor must take certain procedural steps. It must place a legend on the certificates for the securities stating that the securities are not registered and there are restrictions on resale. It must issue stop-transfer instructions to its transfer agent (or make an appropriate stop-transfer notation in its own records) to enforce the restrictions. It must obtain a written representation from

⁴ As a guide to the circumstances under which allegedly separate offerings will be “integrated” and treated as one if the waiting periods are *not* observed, Rule 147 incorporates 5 analytical factors announced by the SEC in Release 4434. They are listed below under the caption “Dealing with the concept of Integration,” page 13. See also note 8.

each purchaser as to the purchaser's residence, and it must disclose the resale limitations in writing to all solicited investors whether or not they become purchasers.

Rule 147 does not provide the exclusive means of claiming the intrastate exemption. An issuer that fails to comply with the Rule may rely solely upon the statute and the applicable case law. On the other hand, compliance with the Rule does not obviate the need to comply with the internal law of the relevant state.

In my view, Section 3(a)(11), the implementing case decisions and Rule 147 are dangerously ambiguous and it can be expensive to rely upon them. Claiming the intrastate offering exemption requires an analysis of the geographic source of each significant component of the issuer's business. The analysis is not otherwise helpful to the issuer unless it can be used to eliminate redundant taxation at the state level. Preserving the exemption also requires an accurate identification of the "principal residence" of each offeree. Given the ambulatory propensities of 21st century Americans, accuracy is never assured. Finally, even if it is exempt from *federal* registration an intrastate offering may have to be registered with *state* securities authorities. Under the circumstances, no company should rely exclusively upon this exemption if another is available.

Introduction to SEC Exempted Securities – Securities Act 3(b) and Rule 505

Section 3(b) authorizes the SEC to "add" any "class" of exempt securities to those already named in the Section if it finds that registration of the securities "...is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering..." The "aggregate amount" at which the securities are "offered to the public" cannot exceed \$5 million.

Section 3(b) is arguably incoherent as a guiding principle and in any case its "aggregate amount" limitation is too low. By framing the SEC's authority in terms of "adding" a "class" of "securities" to those already exempted, the Section implies that the added class, like its statutory counterparts, should be comprised of inherently low risk instruments that, with relative safety, could be issued and resold without registration. Yet taken literally the language of the Section permits the SEC to exempt wildly speculative securities without regard to their risk merely by finding that the "amount" sought by the underlying offering is too small, and the offering itself too "limited" in "character," to warrant registration. This authority should probably be contained in Section 4 dealing with exempt "transactions." To add to the uncertainty, the Section provides no hint of what is meant by the oxymoronic phrase "limited character of the public offering." Finally, even assuming the SEC can identify appropriate new "classes" on its own, the "aggregate amount" it can exempt for any one such "class" is far too low. The United States now has a trillion-dollar

economy in which medium sized businesses routinely have capital requirements in excess of \$100 million.

Nevertheless, under the general authority provided by Section 3(b) the SEC has carved out a useful exemption for small private placements up to \$5 million. Rule 505 was included among the 7 Preliminary Notes and 8 Rules (501 through 508) adopted collectively in 1982 as Regulation D. Rule 505 exempts offers and sales of unregistered securities *by issuers* where, among other things, there are no more than 35 purchasers (excluding certain of their relatives and so-called “accredited” investors). The issuer must also satisfy specific disclosure requirements, must not promote the offers and sales by any form of “general solicitation” and must not price the securities to solicit “aggregate” proceeds of more than the statutory \$5 million benchmark *in any 12 month period*.

Even though securities issued under Rule 505 need not be registered with the SEC, they are “restricted” in contrast to the low-risk securities exempted by name in Sections 3(a) and (c) of the Securities Act. Accordingly, after they have been purchased from the issuer, Rule 505 securities may not be re-sold without registration unless a new exemption is available to the reselling holder at the time the resale occurs. Furthermore, state law is not preempted by the Securities Act in the case of Rule 505 securities. The issuer must determine separately whether a state exemption is available for them.⁵

Introduction to the Private Offering Exemption - Section 4(2) and Rule 506

As stated, Section 4(2) of the Securities Act exempts transactions “... by an issuer not involving any public offering.” Recall that an “issuer” is a company that initially creates then sells and delivers a security to its original purchaser. Immediately after that “transaction,” the security is outstanding and neither its purchaser nor any subsequent holder is an “issuer.” The distinction between an issuer and a subsequent holder is critical to an understanding of Section 4(2). The Section does not apply to resales by holders of securities that are already outstanding. Those securities are “restricted” and reselling holders must first register them unless a separate exemption is available at the time of resale.

The sole structural requirement for a statutory Section 4(2) exemption is deceptively simple on the surface; the issuer must not “involve” itself with a “public offering.”

⁵ Rule 504, also adopted under Section 3(b), provides a federal exemption for offerings up to \$1 million. In its original form, this Rule permitted basic information about the securities to be disseminated publicly and it omitted any restriction on resales. Because of those lenient provisions, Rule 504 was widely used for very small financings that were promoted using mass media. In an effort to stop perceived abuses, however, the SEC has recently subjected the provisions to a requirement that the offering be registered in at least one state, unless all sales are made to “accredited purchasers” *and* the relevant state permits both an exemption and general solicitation. That condition nullifies the practical utility of Rule 504.

Unfortunately, the term “public offering” is not defined in any statute or regulation, and the courts have done little to clear the air. In 1953, the Supreme Court of the United States non-plussed the legal and financial communities by ruling that the question whether an offering must be registered because it is *public* does not turn on the *number* of investors solicited, as might be expected. Instead, it turns on whether the solicited investors (called “offerees”) can *protect* themselves without the help of the prospectus required for registered offerings by the Securities Act.⁶

The lower courts, though giving lip service to other factors, agree generally that for the statutory exemption to be available the offerees must be “sophisticated” enough to evaluate the securities on their own. It is assumed that sophisticated offerees will not purchase securities unless they are furnished or given access to all relevant information. As a result, they do not need the comprehensive forced disclosure that registration would impose on the issuer.

Under the case law, then, if the offerees are “sophisticated” the offering does not “involve” the public and it is exempt under Section 4(2). The challenge is to apply that principle to specific situations. A physician, for example, might be highly “sophisticated” when evaluating the products of a manufacturer of surgical instruments, but woefully naïve when evaluating the financial statements of the same manufacturer or any information at all about an entertainment company. Moreover, if even a single offeree is not “sophisticated” the offering must be registered under the more conservative court rulings regardless of its size, the number of persons solicited or the number who actually purchase securities. While I think that offerings limited to a handful of people are simply not “public” whatever may be their other shortcomings, no court or agency has been willing to devise a numerical standard and the Congress has steadfastly refused to provide one.

The necessity of gauging the sophistication of all “offerees” created a climate of uncertainty for Section 4(2) private placements that continued unabated until 1982. In that year, however, the SEC adopted Rule 506 of Regulation D. The Rule sets forth guidelines for a safe harbor on which a company can rely when claiming a statutory Section 4(2) exemption. Rule 506 placements are *not* limited as to the amount of proceeds sought or the number of “offerees” solicited. They *are* limited to 35 purchasers (plus “accredited” investors and relatives living in the home) and they may not be promoted by “general solicitation.”

Rule 506 finesses the statutory “sophistication” requirement four ways: First the Rule pegs its safe harbor on the number of purchasers, which will be known, rather than on the number of “offerees,” which will remain indefinite. That alone is a vast improvement over the case law. Second, the Rule incorporates a helpful definition of “accredited investor” (found in Rule 501) and provides that such an investor need not

⁶ The case is cited as *SEC v. Ralston Purina Co.* 346 US 119 (1953).

be counted when calculating the 35-purchaser limitation. Third, the Rule provides that the 35 purchasers who are not “accredited” may lawfully participate if the issuer believes reasonably that at the time of their purchase they have “...such knowledge and experience in financial and business matters that (they are) capable of evaluating the merits and risks of the prospective investment....” By contrast, many of the cases interpreting the statute impose an unyielding requirement that all offerees must, *in fact*, be sophisticated *regardless* of the issuer’s belief. Fourth, the Rule permits the use of a “purchaser representative” who may consult with investors and provide them vicariously with the relevant “knowledge and experience.”

A “purchaser representative” must not be affiliated with the issuer (as an officer, director, 10% shareholder etc.), must have the requisite knowledge and experience in financial and business matters (either alone or with other purchaser representatives or with the purchaser), must be acknowledged in writing by the purchaser as the purchaser’s representative and must disclose to the purchaser, also in writing, any material relationship with the issuer and any compensation. The issuer itself, however, can pay the compensation and often agrees to do so as part of the transaction. There are various refinements.

The innovative use of purchaser representatives can be invaluable in Rule 506 private placements. For example, assume my hypothetical physician considering a placement by a manufacturer of surgical instruments knows all about the instruments and the market for them, but next to nothing about financial statements or the markets for securities. Neither his accountant nor his stockbroker knows anything about surgical instruments. Between the three of them, however, they possess all of the knowledge and experience required for the Rule 506 safe harbor.

Structural and Disclosure Requirements

Regulation D imposes several “conditions” all of which must be satisfied by a company that relies upon the exemption provided by Rule 505 or the safe harbor provided by Rule 506. First, as stated these Rules apply only to “issuers” and are not available for affiliates or re-selling shareholders. Second, even though transactions conforming to the Rules are exempt from federal *registration* they are *not* exempt from the antifraud and civil liability provisions of the federal securities laws. Third, Rule 505 transactions must still comply with applicable state law. The other conditions are summarized as follows:

Counting Purchasers

Rules 505 and 506 both limit the number of purchasers to 35, but in each case there are helpful exclusions. Any “accredited investor” and any relative, spouse or spousal relative who has the same principal residence as a targeted purchaser may be excluded together with any trust, estate, corporation or other organization in which the purchaser and/or the excluded relatives collectively have more than a 50%

interest. The excluded persons may purchase the offered securities directly and for their own account.

Corporations, partnerships and other organizations will be treated as single purchasers unless they were formed specifically to participate in the transaction in which case each beneficial owner will be counted separately. Qualified employee retirement or benefit plans, fruitful sources of capital in any placement, will be treated as single purchasers if the trustee makes all investment decisions.

Calculating the \$5 million “aggregate amount” – Rule 505 Offerings

Rule 505 requires that the “aggregate offering price” not exceed \$5 million “...less the aggregate offering price for all (other) securities sold within the 12 months before the start of and during the (Rule 505 transaction).” That limit applies, however, only if the other securities were also sold in reliance upon an exemption under Securities Act Section 3(b), e.g. the exemption provided by Rule 505 itself, or were sold in violation of the registration requirement of the Securities Act. Thus neither the offering price of *registered* securities nor the offering price of unregistered securities exempt under Sections 3(a) or (c), Rule 147, Section 4(2) or Rule 506 need be subtracted from the \$5 million even if sold within the previous 12 months.

Providing Disclosure

The securities laws impose upon all companies acting as issuers a duty to disclose accurately all “material” facts surrounding an offering whether or not registered. To conduct a safe offering, the company must comply with the duty. To sell its securities, however, the company must describe itself, its business and the investment persuasively. The art of raising capital consists of the successful balancing of those conflicting imperatives.

To defend misrepresentation claims, the company and its directors, officers and outside promoters must show that, after reasonable investigation, they did not know, and with the exercise of reasonable care could not have known, of the alleged misstatement or omission. They must act affirmatively to verify the accuracy and completeness of the company’s disclosure. The verification process has become known as “due diligence.”

Not surprisingly, the SEC has been unwilling to leave the question of what facts must be disclosed in unregistered offerings to the unfettered discretion of companies and their advisers. Companies relying upon Rules 505 or 506 must furnish to all investors who are not “accredited” detailed information to the extent required by Rule 502, plus access to any additional information requested by and provided to an accredited investor.

Rule 502 requires that the detailed information be furnished to purchasers only “to the extent material to an understanding of the issuer, its business, and the securities being offered...” The quoted language provides relief from the burden of disclosure whenever the information specified by the Rule is not “material” (would not be significant to a reasonable investor), e.g. because of the special characteristics or limited operating history of the company. The extent to which the exclusionary language may safely be relied upon varies with each company and each transaction.

In general, a publicly traded company must furnish to non-accredited purchasers narrative information of the type that would be included in any registration statement for which the company is eligible. Closely held companies may use Part II of simplified Form 1-A if they are eligible to use it. If not, they must use a form of registration statement for which they *are* eligible. The *narrative* disclosure requirements thus parallel those for registered or Regulation A offerings although the offering documents need not be subjected to SEC review.

Significant relief is provided in the area of *financial* disclosure. For placements up to \$2 million, a company need provide only an audited balance sheet dated within 120 days of the start of the selling period, plus annual statements, which need not be audited, of income, cash flows and changes in stockholder’s equity for each of the two fiscal years preceding the balance sheet date (or for any shorter period that the company has been in business). The company must also provide an interim balance sheet as of the end of its most recent fiscal quarter, plus interim statements of income and cash flows for the stub period to the balance sheet date and for the comparable stub period for the prior fiscal year, again without audit.

For placements up to \$7.5 million, a company must provide the same financial information except that the annual statements of income, cash flows and changes in stockholder’s equity must be audited unless the cost of the audit would be unreasonable given the circumstances faced by the company. In that case only the balance sheet need be audited. I should note, however, that in my experience a company that withholds full audited financial statements on the ground that the expense of obtaining them is unreasonable would find it difficult to sell its securities.

For placements above \$7.5 million a company must provide extensive financial information of the type that would be required by a registration statement on the relevant Form. However, if the Company is a “Small Business Issuer,” e.g. if both its gross revenue and the aggregate market value of its outstanding equity securities held by non-affiliates is less than \$25,000,000, it may use Form SB-2. The financial disclosure required by this Form is less burdensome than the disclosure required by Form S-1; the general Form for registered offerings. Under Form SB-2, the company need provide an audited balance sheet for only its last fiscal year instead of its last 2 fiscal years. It need provide audited statements of income, cash flows and changes in stockholder’s equity for only its last 2 rather than its last 3 fiscal years. It may eliminate the 5 years of “Selected Financial Data” and many of the supporting

schedules required by Form S-1. It need not discuss the ratio of its earnings to its fixed charges and it need not provide quantitative and qualitative disclosure about the market risk attaching to its portfolio and non-portfolio investments or its financial instruments.

Dealing with the concept of “Integration”

A private placement that is in technical compliance with Rules 505 or 506 will not be exempt if it is actually part of a plan to evade the registration requirement of the Securities Act. A common means of evading registration is to break a single plan of financing into several parts then assert that each part is a separate transaction entitled to its own exemption. We have already seen that Rule 147 counters this in the context of the intrastate exemption by imposing a six month waiting period between placements and restricting the resale of Rule 147 securities for 9 months following the closing of the original transaction.

Rule 502 conditions the Rule 505 exemption and the Rule 506 safe harbor upon a similar six-month waiting period between transactions. The purpose is to deny an exemption to phased offerings that otherwise would evade the 35-purchaser limit common to both Rules, the \$5 million limit imposed by Rule 505 or the sophistication requirement imposed by Rule 506. When the waiting period is not observed, the question becomes whether allegedly separate transactions will be “integrated,” and treated as a single transaction for regulatory purposes, in light of the following factors:

- (a) Whether the sales are part of a single plan of financing;
- (b) Whether the sales involve issuance of the same class of securities;
- (c) Whether the sales have been made at or about the same time;
- (d) Whether the same type of consideration is being received; and
- (e) Whether the sales are made for the same general purpose.⁷

No one of these factors is determinative, but all are important. The relative weight to be assigned to each of them will vary with each transaction. Any company planning more than a single round of exempt financing should review them carefully.

Resale Restrictions

As I have noted, unregistered securities issued in reliance upon Rule 505, Section 4(2) or Rule 506 are “restricted” and may not be *resold* without registration unless a separate exemption is available. Rule 144 creates an exemption for resales through “brokers’ transactions” where the issuer is a public company, the securities have been

⁷ The factors were announced in Securities Act Release 33-4434 (1961) cited by Rule 147. See note 5. They were repeated in Release 33-4554 (1962) cited by Rule 501.

held for 1 year and certain volume limitations are satisfied. After a holding period of 2 years, unregistered securities held by non-affiliates are no longer restricted at all, and may be resold freely whether or not the issuer is public. An “affiliate” is a person or entity closely connected with the issuer through a control relationship, e.g. as a director, officer or major shareholder of the issuer or a member of a corporate group that includes the issuer.⁸

Securities Act Rule 144A creates a separate resale exemption where the purchaser is a “qualified institutional buyer,” in general an insurance or investment company, benefit plan, registered investment adviser, registered securities dealer or bank that already owns and invests on a discretionary basis \$100 million or more in other securities. Rule 144A has created an enormous secondary market for privately placed securities that are issued by seasoned companies and rated as investment grade.

Finally, in a series of “no-action” letters the SEC has permitted certain resales to occur without registration even though the transaction does not qualify for a safe harbor under either Rule 144 or Rule 144A. The securities must have been held long enough to have “come to rest,” thus permitting the conclusion that they were not originally purchased with a view to their “distribution.” The reselling security holder must take the precautions an issuer would take if engaged in a direct private placement of the same securities at the same time. The SEC has refused to elaborate upon the holding period or the precautions.

The general view among corporate finance lawyers is that the securities should be held for at least 1 year, the minimum holding period under Rule 144. The purchaser should be provided with current financial and narrative disclosure about the issuer that conforms to Rule 502. The certificates should bear a legend to the effect that they remain restricted in the hands of the purchaser who may not resell them again without registration or an exemption. The purchaser should sign an acknowledgement that the purchase was made for investment and agree in writing to comply with the resale restrictions.

If all of this is done, the result is the “4(1½) exemption,” so-called because the resales have attributes both of the ordinary trading exemption under Section 4(1) of the Securities Act and the issuer’s private offering exemption under Section 4(2). In a proper case, the “4(1½)” exemption can be used by affiliates as well as non-affiliates. I must add, however, with the infuriating equivocation of lawyers, that each situation is unique and must be analyzed separately on its own facts.

⁸ For a summary of Rule 144 see, Essays, *“Private Placements - Part II - Finding Investors. Selling Constraints Applicable to Unregistered Securities Offerings.”*

Notice Requirement – Form D

Rule 503 requires that companies relying on Rules 505 or 506 file a “Notice of Sale of Securities” with the SEC on Form D. The filing must be made “no later than 15 days” after the first sale of the securities. Normally, a failure to file with respect to a given offering will not cause the loss of the exemption for that offering under either Rule. However, the safe harbors are not available to any company that is subject to an injunction based on a previous failure to file. To avoid an inadvertent delinquency, I recommend that the company file Form D as soon as it has approved the offering documents and entered the selling period.

The Form provides for disclosure of basic information about the company, its promoters, directors, officers and beneficial owners. It also requires disclosure of the exemption(s) relied upon, the proceeds sought, the sales (if any) actually completed, the number of investors targeted and the states in which they reside. As a general matter the SEC staff uses the Form primarily as a means of assessing the frequency and manner in which Regulation D is actually being used. Nevertheless, companies relying on Rule 505 must include an undertaking to provide the SEC staff on request with the information provided by the company to non-accredited investors.⁹

Most state regulatory schemes require that companies file a copy of Form D with the local Securities Administrator when conducting a Rule 505 or 506 offering within the state. Recall that state laws requiring mere notice and a filing fee are not preempted by the Securities Act even for Rule 506 offerings. The fees are quite modest, e.g. \$300 in Washington. On the other hand, if the issuer relies upon Rule 505, and the offering is not separately exempt under state law, the offering documents are subject to full state review. By way of some consolation, however, I have found the states to be generally cooperative during the review process.

The “Accredited Investor” – Facts and Myths

Securities offerings have a tendency to reach people who do not understand them and cannot afford to lose their investment in them. That is why such offerings must generally be registered unless they are limited to persons or organizations that do not need the protection of the registration process. In an effort to help companies identify these self-reliant sources of capital, the SEC has incorporated within Rules 505 and 506 the concept of an “accredited investor.”

⁹ I have never seen such a request and suspect that one would be made only if the SEC were considering enforcement proceedings based on the information in the Form itself. I note from the reported enforcement cases that a poorly prepared SEC filing can inadvertently reveal a failure to comply with the securities laws, to the chagrin of those responsible. An obvious example of this in the context of Rule 505 would be the filing of a Form D disclosing aggregate offering proceeds of \$6 million.

It should be apparent by now that there are decided advantages to dealing with “accredited investors.” Such investors need not be provided with the line-item disclosure required for others by Rule 502. They need not be counted when calculating the 35-purchaser limitation imposed by Rules 505 and 506. They need not be included among the “sophisticated” purchasers required by the latter Rule. The issuer can count investors as “accredited” if it has a reasonable basis for believing they are, even though, in fact, they do not understand the investment and would be ruined financially by its loss. As a result, confining an offering to accredited investors can reduce substantially the cost of preparing offering documents, particularly where the investors are actively investigating the transaction on their own. The use of accredited investors can also expand significantly the size of the audience at which an offering is directed.

There are, however, some dangerous myths about accredited investors that have gained widespread acceptance. To dispel the myths, I must begin with the definition of the term.

Section 2(a)(15) of the Securities Act defines “accredited investor” to mean entities that are obviously affluent and sophisticated such as financial institutions, insurance companies and the like plus persons defined as accredited by the SEC “on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management...”

The SEC responded with Rule 501(a) under which accredited investors fall into one of two basic categories. The first consists of persons that, because of their relationship to the issuer, are deemed to have access on their own to the kind of information registration would provide. Examples include the issuer’s officers, directors, partners and corporate affiliates. The second category consists of persons or organizations that, because of their net worth, income or gross assets are deemed able to absorb the loss of their entire investment without jeopardizing their financial security. Examples include individuals with a net worth of at least \$1 million or income of at least \$200,000 (\$300,000 with spouse), and certain retirement plans, business entities or trusts with \$5 million or more in assets.

The problem is this: Because accredited investors need not be counted against the 35-purchaser limitation and no specific form of disclosure need be provided to them, it is widely assumed that companies can deal with them freely without violating the securities laws. Specifically, many companies and their advisers believe that sales of unregistered securities can always be made to accredited investors without unacceptable risk by using a bare bones information memorandum (often little more than a term sheet). They also believe that accredited investors may be found by any means available including a general solicitation of the public. Neither assumption is accurate and acting upon either of them can ruin an otherwise meritorious capital raising effort.

First, the company may not be dealing with accredited investors at all. Unless its offering is confined to Fortune 500 firms, a company can rarely be confident either that all its purchasers are in fact “accredited” or that its belief that they are is reasonable. The accepted practice is to rely upon self-certification provisions contained in “suitability questionnaires” submitted by all investors. The questionnaires are backed by warranties of accuracy contained in the subscription agreements signed by those investors who actually purchase the securities. The questionnaires are reviewed if the company is prudent, but are almost never substantiated for fear of offending investors. The SEC staff has refused to endorse this practice as a matter of policy taking the position that the reasonableness of the requisite “belief” depends upon all the facts and circumstances. In my view, no issuer should risk litigation on this point merely to reduce its disclosure burden.

Second, there is *no* statutory, regulatory or judicially created exemption from liability for material misstatements or omissions in the information used to promote private placements. Regulation D states expressly that securities offerings relying upon it:

“... are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers are reminded of their obligation to provide such further material information, if any, as may be necessary to make the information required under this regulation, in light of the circumstances under which it is furnished, not misleading.”

Investors who are accredited by virtue of their close relationship with the company feel deeply betrayed when it appears they have been misled. Investors who are accredited financially, precisely because they *are* so accredited, have the means, and often a marked tendency, to engage counsel promptly when an investment is not successful. The only effective way to minimize the risk of misrepresentation claims is to provide full disclosure. There are no better standards for disclosure than the applicable SEC rules and regulations.

Third, the prohibition against general solicitation in exempt offerings applies to accredited investors as thoroughly as it applies to others. Nevertheless careless issuers regularly insist on probing for investors using cold calls, public seminars, or other general means that purport to be limited to “accredited investors.” They take the position that they are relying upon the Section 4(2) statutory exemption, not the safe harbor provided by Rule 506 of Regulation D. However, Section 4(2) requires that all persons solicited be “sophisticated” not “accredited.” Many investors who prove to be financially accredited are not sophisticated at all, e.g. persons who inherit wealth but have no experience in business or financial matters.

Finally, although companies can compile a general database about prospects beforehand, the formal solicitation of investors takes place prior to the time their

questionnaires are returned and is thus complete *before* the sophistication of these investors, to say nothing of their accredited status, can be warranted by them.¹⁰

Choosing between Rules 505 and 506

It must be emphasized that Regulation D, which contains Rules 501 through 508, does not provide the exclusive means for claiming an exemption from registration. There is no such thing as “violating” Regulation D in any culpable sense. Accordingly, a company that fails to satisfy a condition for the Rule 505 exemption or the Rule 506 safe harbor *can still claim any other applicable exemption*. Thus a company that fails to furnish all of the line-item information required by Rule 502 may not claim the statutory Section 3(b) exemption provided by Rule 505 or the safe harbor for the statutory Section 4(2) exemption provided by Rule 506. However, the company may still claim an exemption under Section 4(2) itself. It could argue, if challenged, that the information it did provide was sufficient under the circumstances and the applicable case law. If the company confined its offers and sales to a single state, it could also claim the intrastate exemption provided by Section 3(a)(11) or Rule 147 neither of which has a specific information requirement. If at the same time the company was selling unregistered securities abroad in a qualified “offshore transaction,” it could claim the safe harbor provided by Securities Act Regulation S, adopted by the SEC for foreign sales, while simultaneously claiming the Section 4(2) exemption for its offers and sales within the United States.

As a result, companies have some freedom of choice respecting the available exemptions. When choosing between Rules 505 and 506 they will begin by noting certain common elements. As we have seen, both of these Rules prohibit “general solicitation” and both limit the number of purchasers to 35 (plus accredited investors and certain relatives living with identified purchasers). The informational requirements imposed by these Rules are identical except for the added financial disclosure for Rule 506 offerings above \$7.5 million. On the other hand, there are important structural differences between them that must also be taken into account:

Limited Offering Proceeds: Rule 505 may not be used to raise more than \$5 million in “aggregate” proceeds within any 12-month period. There is no limitation on the proceeds that can be raised under Rule 506.

State review: Section 18(b)(4)(D) of the Securities Act preempts state law (except for notice and filing fee requirements) for private placements that comply with Rule 506. That means that Rule 506 placements need not be subjected to state review. There is no preemption, however, of state review of placements that rely upon Rule 505. If

¹⁰ Companies can, however, solicit a surprisingly large audience if it is comprised of prospects with whom representative of the company have a “prior substantive relationship.” See Essays, “*Private Placements – Part II – Finding Investors - Selling Constraints Applicable to Unregistered Securities Offerings.*”

review by a state is required, the cost of a Rule 505 transaction will increase to the extent the issuer must respond to the questions or comments of the staff of the reviewing authority.

Sophistication Requirement: Under Rule 506 a company must have a reasonable “belief” that all purchasers who are not “accredited investors” are nevertheless “sophisticated.” There is no sophistication requirement imposed by Rule 505. The process of screening purchasers or providing representatives for them to establish the requisite “belief” can increase the cost of a Rule 506 transaction. On more than a few occasions in my experience, particularly in smaller markets, companies and investors alike have simply refused to engage or pay a qualified purchaser representative. Under those circumstances, the companies have three options: they can deal exclusively with accredited investors; they can conform their placements to Rule 505 after all; or they can try to establish their “belief” solely on the basis of personal interviews and self-certification provisions contained in investor questionnaires. While certainly helpful, neither interviews nor questionnaires are foolproof.

“Bad boy” disqualification: Rule 505 cannot be relied upon if, among other things, the company, its underwriter, or any of its affiliates, directors, officers or 10% or greater shareholders is subject to pending SEC enforcement proceedings, has been convicted within the past 5 years of any criminal violation of the securities laws or within the past 10 years has been convicted of a criminal violation involving the making of false statements to the SEC. Rule 506 contains no such disqualification.

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