

## ROBERT G. HUTCHINS - LEGAL ESSAYS

### Risk Capital for "Middle Market Companies" Inherent Problems - Possible Solutions

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#### Preliminary Note:

Commercial banks do not provide speculative capital, a fact that has frustrated many an entrepreneur. Banks must answer to regulators and to their own equity holders. They make loans, not bets. They lend against tangible assets and demonstrable income streams, not grand designs. The tolerance of a commercial bank for collateral, financial and business risk is usually too limited to accommodate all of the capital requirements of a growing "middle market company."<sup>1</sup>

Venture capitalists do make bets, but they hedge them. They finance a portfolio of promising but high-risk companies knowing that many will fail. They intend that the "winners" pay for the "losers" and accordingly target huge returns when pricing their capital contributions. In the typical arrangement, venture capitalists make their contributions in phases as and if the company achieves specific interim objectives. In exchange, they acquire voting preferred shares having priority claims to the company's earnings and assets. These shares are convertible to common shares at any time using a generous formula. The venture capitalists are also granted at least minority board representation (or board visitation rights) plus the power to veto or even initiate major strategic decisions. Finally, venture capitalists typically insist that, at their option, the company provide them with an exit within five or so years by being acquired or taken public if the interim objectives are achieved or by redeeming their shares if the objectives are not satisfied. Venture firms can provide sophisticated advice and valuable contacts, as well as financing, to the companies they sponsor, but they are not the first resort for entrepreneurs with an independent streak.

The public securities markets can provide capital in exchange for minority rather than controlling interests, but they are not readily accessible to middle market companies as I have defined them. A company planning an underwritten public offering will be hard pressed to attract even regional investment bankers unless it has revenue of at least \$15 million that has produced operating income of at least \$1.5

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<sup>1</sup> The term "middle market company" has become part of the financial jargon, but has not been fitted with a common definition. I use it here, somewhat arbitrarily, to describe any operating company that has left the development stage but lacks sufficient size or market allure to "go public" through a mainstream underwriter.

million. With the passing of the dot.com era of "irrational exuberance," that is probably rock bottom. The minimum dollar size required for an underwritten initial public offering or "IPO" is probably \$10 million. The entry level will be at least \$25 million for a major bank. Further, regardless of the method used to value a company, the securities sold to the public should not represent more than 25% to 35% of total equity if the offering is to avoid the taint of a "bailout." Finally, even after it is publicly held a company will be unable to make acquisitions, attract managers or raise new capital using its securities unless there is an active trading market for them. Such a market is by no means assured merely by the act of "going public."

The reality is that a middle market company will find it extraordinarily difficult to obtain backing from the establishment financial community. Obtaining pre-IPO financing is next to impossible if the owners are unwilling to relinquish their autonomy over strategic planning. While owners with glittering track records have been known to transcend the limitations of size, retain control of their companies and instill an expectation of imminent profit through sheer charisma, that phenomenon is a rare exception to the general rule. <sup>2</sup>

All of this leaves middle market entrepreneurs with a dilemma. Almost invariably they will have exhausted the resources available from family and friends when raising seed money. If they now want to obtain expansion capital *and* control their future, they must sell minority securities to a wider group of investors who may not be professional financiers, but are often sophisticated. Those investors may well demand many of the protections associated with a venture capitalist and in any case they must be discovered among the strategic partners, customers and suppliers of the company. The effort to identify such people and persuade them to invest plunges the entrepreneurs, like it or not, into the alien world of securities regulation.

There are three capital raising strategies that, in an appropriate case, could be utilized successfully by a middle market company to raise capital, at a fraction of the cost of an underwritten offering, without resorting to venture capitalists or using an underwriter. The first involves a public offering that can be registered with the SEC on a simplified form by a "small business issuer." The second involves a small

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<sup>2</sup> An investment banker normally would dismiss out-of-hand an owner who said: "My company writes imaging software for the motion picture industry. It had gross revenue for the nine months just ended of \$10.6 million from which it derived operating income of \$3.1 million. I want to take it public for *\$132 million*." Of course if the owner's name is Steve Jobs, he can have his choice of investment bankers, but the offering sells on hype and the stock can be volatile. Pixar common shares were launched on November 29, 1995 at \$22. They rocketed to \$49 1/2 within days, then fell to \$12 1/4 and were trading at \$15 5/8 on September 30, 1996 with about 38 million shares outstanding. On January 17, 2002 the share price stood at \$32.50 having ranged over the previous year from a high of \$48.49 to a low of \$28.94 with from 45 to 49 million shares outstanding. The shares are listed on the NASDAQ under the symbol PIXR.

offering by non-reporting issuers limited to a maximum \$5 million that is not registered but can nevertheless be made to the general public under SEC Regulation A. The third involves sophisticated use of non-public offerings that are exempt from registration and available to all issuers under both federal and state securities laws.

Before discussing these strategies, however, I must observe that they have two fundamental limitations. First, as a *practical* matter small registered or Regulation A offerings, even if publicly promoted, will not be successful without an underwriter unless the company can attract buyers on its own by directing its solicitation to a large group of empathetic investors drawn from its customers and other business contacts. Second, as a *legal* matter the private offering exemptions *prohibit* general solicitation and require that representatives of the company be acquainted *personally* with investors *prior* to the time the offering begins. With those qualifications, the following strategies may be helpful to middle market companies.

### **Introductory Principles**

Shares of stock, bonds, most promissory notes and other investment instruments are "securities." The law prohibits the offer or sale of any security (an "offering") without "registration" (and the delivery to investors of a formal document explaining the offering called a "prospectus") unless an *exemption* is available. Offerings that are neither registered nor exempt expose the issuing company (the "issuer"), its officers, directors, underwriters and other selling agents to civil and administrative liability. Willful violations of securities laws can result in criminal sanctions.<sup>3</sup>

The danger associated with securities offerings is their propensity to reach people who are not equipped to evaluate them, who do not have access to meaningful information about them and who cannot afford to lose their investment in them. The legislative response has been to require registration to ensure full disclosure of all significant facts and risks associated with an offering. Some states will *prohibit* offerings involving suspect businesses or capital structures deemed unfair to investors (the underlying regulatory scheme is called "merit review"). Federal securities laws and the remaining states permit even wildly speculative offerings to go forward so long as appropriate disclosure is made.

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<sup>3</sup> There are exemptions both for *securities* and for *transactions* in securities. Exempt *securities* are those deemed relatively risk free (e.g., securities issued by the federal government) and those otherwise exempted by the SEC under special Rules. The primary *transactional* exemption available to an *issuer* covers securities that are neither offered nor sold to the *public*. It is provided by Section 4(2) of the Securities Act and its state counterparts. For an extended discussion of these exemptions see this Website, Publications, Essays - *Private Placements Parts I, II and III*.

Registration involves the filing of a "registration statement" (that includes the prospectus) with the SEC and, subject to exceptions that are irrelevant for us, with all states in which the securities will be sold. The primary filing document is Form S-1. Other forms are available for specific classes of issuers. The filing describes in detail the issuer, its business, its financial condition, the securities, the uses to be made of the offering proceeds and the risks of the investment. It is subject to approval by SEC staff members who critique it in formal comments. The issuer and its counsel respond with amendments until the SEC is satisfied, a process that can consume from three to four months after the original filing date.

When the SEC has approved it, the registration statement is declared "effective" and the issuer can sell its securities to the *public* using advertising that complies with various regulations. When the offering is underwritten on a "firm commitment" basis, the sales are arranged through investment bankers registered as broker-dealers who act as the underwriters. Underwriters purchase the securities directly from the issuer at a negotiated discount from the public offering price then re-sell them to their customers at that price realizing profit equal to the difference or "spread. That process is called a "distribution." An underwriter participating in a distribution assumes with the issuer itself responsibility (and liability) for the adequacy and accuracy of the disclosure in the registration statement. In addition to their initial valuation analysis, underwriters complete a detailed "due diligence" investigation of the issuer, including a thorough editing of the registration statement, before committing to the financing. Because stock market prices fluctuate continuously, pricing for the offering is not fixed until immediately prior to the effective date of the registration statement, a fact that is disconcerting for a first time issuer.<sup>4</sup>

Registered securities offerings are almost invariably underwritten. A few corporate acquisitions have been structured as "directed offerings" in which the securities of the corporation are registered to enhance the remedies and post closing flexibility of a single purchaser with extraordinary bargaining power. Obviously, no underwriter is required in that situation. Small registered offerings have occasionally been sold on a "best efforts" commission basis, with varying results, by broker-dealers acting as placement agents for the issuer. Because placement agents are statutory underwriters, with all of the risk that status entails, best efforts distributions are rarely attempted. When they are, the commissions are apt to be

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<sup>4</sup> Offerings made pursuant to an exemption do not require a statutory registration statement or prospectus and are relatively inexpensive to prepare. The exemptions for limited "public" offerings discussed below all require the prior approval of selling literature and offering documents, however, and thus are subject to regulatory oversight. Further, there are no exemptions from the anti-fraud and civil liability provisions of the securities laws for any security or any transaction. Accordingly, a company is bound to make full and accurate disclosure to investors regardless of the size, structural format, or exempt status of its offering.

quite high. Under the circumstances, companies have traditionally distributed their securities to the public through a syndicate of investment banking firms.

Moreover, a firmly underwritten and registered securities offering is extraordinarily expensive. The expense is easily justified if the offering succeeds, but can be devastating if all of the targeted capital is not raised. Legal fees will range from \$150,000 to \$225,000 and can be much higher depending upon the complexity of the offering, the business, financial and legal history of the issuer, the size of the underwriting group, the number of states in which the securities will be sold and other factors. To that must be added accounting fees and printing costs. The underwriting discount can equal 7% or so of the public offering price, by far the largest component of expense. Most of the fees (as opposed to underwriting discounts) are incurred prior to closing, before the issuer can be certain the offering will be successful. The total expense, which is largely fixed, will be as high as 10% of the proceeds in small offerings.

### **Simplified Registered Offerings by “Small Business Issuers”**

Nevertheless, there may be some room to maneuver. Companies graduating from middle market status that intend to "go public" have often acquired considerable sophistication and in the normal course of their business have engaged reputable accounting firms to audit their financial statements. If they can qualify as a "small business issuer," they can register seamlessly at the federal level as a result of commendable efforts by the SEC to simplify the disclosure process for companies with limited resources.

- "Small business issuers" are companies having revenues and a "public float" each less than \$25 million.<sup>5</sup> Such issuers can file a simplified registration statement on Form SB-1 for offerings up to \$10 million and on Form SB-2 for offerings above that level. (The staff of the SEC favors Form SB-2 for all small business offerings, primarily because of the higher level of financial disclosure required by that Form.) Post-offering quarterly and annual reports have also been simplified for small business issuers through Forms 10Q-SB and 10K-SB respectively. Full reporting is still required from these issuers on form 8K for significant events that occur between scheduled filings, e.g. changes in control, transactions in significant assets outside of the normal course of business, insolvency proceedings and changes in (or disagreements with) independent accountants. All securities registered on Forms SB-1 or SB-2 are freely tradable after they have been issued.

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<sup>5</sup> A "public float" is the aggregate reported market value of publicly traded securities held by "non-affiliates," persons not having a control relationship with the issuer. By definition, a company has no public float prior to its IPO.

- A small business issuer that has completed a public offering without underwriters will lack "market makers" for its securities (brokerage firms that stand ready to buy or sell the securities during all trading hours). There will be no active trading in these securities unless, at the least, the issuer can provide holders with an alternative means of accessing prevailing prices. The SEC now permits an issuer to do that by publishing on a bulletin board or the Internet prices quoted or negotiated in transactions concluded directly between holders. The issuer acts as a reporting entity only, must disclose the absence of a formal trading market for the securities (and the concomitant risk that the securities may be "very illiquid"), must include "the price and number of shares for recent transactions," must insure that holders have access to current material information and may neither facilitate transactions nor hold funds.

- The SEC has also published comprehensive guidelines on the use by issuers of electronic media. These guidelines include basic principles that apply to companies conducting online offerings of registered securities. If followed carefully, the guidelines can enable a small business issuer with an Internet presence to self-sell its securities to a wide audience without being dependent upon the traditional customer network used by underwriters. Self-sold Internet offerings are still in their infancy, but they may well be the wave of the future for smaller companies.

### **Unregistered but Exempt "Public" Offerings**

Special initiatives by the SEC and most states have made it possible for middle market companies to solicit capital from the public through special small offerings that are exempt from registration. The initiatives involve relaxed disclosure requirements and allow solicitations of investment interest through media advertising.

- Preliminary advertisements that "test the waters" for investment interest have been approved for unregistered public offerings seeking up to \$5 million under SEC Regulation A. The text of each advertisement, limited to a summary description of the company and the proposed offering, must be approved in advance by regulators. The advertisements can be made via print or broadcast media, but they cannot solicit money or subscriptions. Instead, they ask interested investors to request formal offering documents by mail or telephone. Regulation A securities, though exempt from registration, are freely tradable after they have been issued. The issuer files an "offering statement" on Form 1A. The statement includes an "offering circular" for investors in lieu of a prospectus. The filing is approved by the SEC staff then accepted by state authorities without independent review in a process called registration "by coordination." The SEC examination is conducted by its Office of Small Business Review in Washington, D.C. Regulation A offerings, particularly when coupled with a "test-the-waters" preliminary advertisement, are an attractive financial tool for many expanding companies. Regulation A securities are

often illiquid, but issuers may post re-sale prices to improve trading subject to the limitations noted above.<sup>6</sup>

- A number of states have adopted a "fill-in-the-blanks" Small Corporate Offering Registration or "SCOR" disclosure form. The completed SCOR form must be approved by the state Securities Administrator. It can be used by companies with a simple stock structure and a straightforward business plan to solicit capital from the general public in an amount not to exceed \$1 million. SCOR securities are exempt from federal registration and are freely tradable. SCOR issuers may post re-sale prices by following the federal guidelines.

For qualified companies Regulation A or SCOR offerings can bring about a substantial reduction in the regulatory compliance burden, and in the resulting cost of capital, when compared with traditional full registration. These offerings have the added advantage of permitting *some* solicitation of the general public, although the content of media advertising is circumscribed. Nevertheless, they have practical limitations. Speculative securities in small, unknown companies are not sought-after investments. Persons who are not already impressed with a company may be unwilling to invest in it on the basis of a cursory public announcement followed by a formal disclosure document, even one that is well-prepared.

The SCOR Form, in particular, achieves its simplicity by imposing on issuers an amateurish question and answer format that simply is not persuasive to anyone who does not already have a compelling reason to invest. Even when the issuer can count on a broad and loyal customer base, its SCOR securities tend to be purchased in small amounts as souvenirs rather than investments and the proceeds trickle in too slowly to be of much help.

Finally, both Regulation A and SCOR offerings involve regulatory scrutiny of the public selling effort and also of the disclosure to investors, even though disclosure is simplified. Thus a government approval process of indeterminate length must still be added to the time required to organize and prepare any offering made to the public and the effort to obtain approval carries its own cost.

### **Intrastate Offerings and Private Placements**

For many companies seeking to self-sell their securities, particularly those without a built-in public following, an exempt "intrastate" offering or a "private

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<sup>6</sup> Regulation A permits issuers to use unaudited financial statements for disclosure purposes if they do not already prepare audited statements for other purposes. That reduces costs, but investors are often wary of Regulation A offerings because the financial disclosure lacks the independent accountant's assurance of "fair presentation" provided by an audit report.

placement" may be preferable to a Regulation A or SCOR offering because it can be organized quickly, free of regulatory scrutiny.

- Offerings made entirely to residents of a single state (an "intrastate offering") are exempt from *federal* regulation under Section 3(a)(11) of the Securities Act and SEC Rule 147. Registration may be required with the relevant state, but most state securities authorities are cooperative and helpful when reviewing their own registration forms. Securities issued in an intrastate offering may be resold free of *federal* regulation after nine months. The resales remain subject to state law. I note, however, that a federal exemption will not be available if even one offer or sale is made out-of-state. Intrastate offerings should therefore be reserved for transactions in which the issuer is *assured* of an adequate purchaser base within its home state.<sup>7</sup>

- Section 4(2) of the Securities Act exempts issuer transactions "...not involving any public offering." Statutory equivalents have been enacted in virtually all states. Securities issued in a non-public or "private" offering, however, are "restricted." They may not be *resold* without registration or an exemption. Since all investors require some assurance of liquidity, private offerings are best suited for companies that fit either of two categories: The first consists of companies engaged in businesses that can provide holders with attractive cash distributions, thus making an investment in their securities self-liquidating. The second is comprised of companies that plan to complete an IPO or to be acquired in the foreseeable future.

SEC Regulation D contains Rules for the *structural* requisites of certain exempt offerings. The Regulation confines public filings to a notice summarizing the offering and identifying the exemption(s) claimed for it. It defines the *time periods* within which discrete exempt offerings must be completed to avoid being "integrated" (combined for regulatory purposes) with other offerings that may *not* be exempt. It also provides detailed guidance for the *disclosure* that must be provided to investors and it specifies the maximum number of ultimate *purchasers* to whom securities may be sold.<sup>8</sup>

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<sup>7</sup> For a detailed discussion of the federal Intrastate and Private Offering Exemptions, see this Website, Publications, Essays, *Private Placements Part III – Organization and Structure*.

<sup>8</sup> Under Regulation D, allegedly discrete offerings must be separated by six months. If they are not, a series of them can be treated as a single continuous offering made to all investors contacted in each component of the series. Among other things, that increases substantially the risk that the issuer may be found to have engaged in an unlawful "public" solicitation. Regulation D offerings may be sold to 35 purchasers *plus* adult family members living in the home, controlled entities and an unlimited number of "accredited" investors. See note 11.

Regulation D, however, does not limit expressly the number of *potential investors* to whom the securities may be *offered for sale* in the first instance and it does not clarify the *means* by which a private offering may be *promoted*. It merely forbids "any form of general solicitation or general advertising" without defining those concepts beyond painfully obvious references to solicitations by mass media. Thus the Regulation does not reach the most important threshold question relating to an offering: *What can be done to find investors?* Fortunately, SEC "no-action" letters and interpretative releases clarify the solicitation principles so that Regulation D securities can be sold by careful issuers without creating an unacceptable risk of an inadvertent and non-exempt "public" offering.<sup>9</sup>

### Conclusions and Recommendations

There has occurred a welcome and valuable relaxation of many burdensome requirements that historically confronted middle market companies offering securities. Nevertheless, the practical reality is that securities are sold, not bought, and an offering is an exercise in futility if purchasers cannot be found. I recommend that middle market companies conduct a preliminary evaluation, or feasibility study, before attempting the corporate cleanup, due diligence investigation and detailed regulatory review necessary for an offering.

- **Feasibility Study - All Offerings:** The consent of existing security holders should be obtained before any significant work is done on a prospective new offering unless consent is not required under the company's charter. Specific approval should be sought for the percentage of company equity to be sold to new investors and for the resulting dilution of existing equity interests. Because of the capital that a successful new offering will produce consent is usually given, but there might be initial resistance until the benefits of the offering are fully explained. Restrictive shareholder agreements and charter provisions must be amended or eliminated to the extent they are inconsistent with the offering. The company should be valued carefully and the tentative offering price per share should be tied to realistic projections of the company's future earnings. Pie-in-the-sky valuations requiring relatively high contributions to tangible net worth by new investors are fatal to an offering.

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<sup>9</sup> The distinction between public and private offerings will not be found in any statute or regulation. Legislators and agencies alike fear that a bright-line definition would fail to cover all of the schemes for disguising an unregistered and illegal public offering as an exempt private one. No common law numerical test has emerged either and judicial opinions on the subject are of dubious practical utility. The leading case, for example, contains a solemn pronouncement by the United States Supreme Court that a private offering is one made only to persons who do not need the protection of the securities laws because they can "fend for themselves." [United States v. Ralston Purina Co. \(1953\)](#).

Aggressive business expansions may best be financed in stages. Private offerings should be reserved for the early rounds. Once media advertising is used to "test the waters" the company is committed to a Regulation A or SCOR offering unless it is willing to terminate the advertising and wait six months to comply with Regulation D. The company should not expect that approved advertising, as such, will sell its securities to strangers. Exempt "public" offerings, like private ones, will usually be sold through direct negotiations with known prospects. *The primary advantage of obtaining the right to solicit the public lies in the ability to contact all such prospects without unacceptable legal risk.*

Review the probable form or subject matter checklist the company will use to disclose its offering without attempting to draft a responsive document. Securities counsel can usually identify the applicable requirements without extensive consultation. They will be derived from SEC regulations. The review will provide valuable insight and a "feel" for the disclosure process.

Where possible, insure the stability of senior management with written executive employment contracts through which clear lines of responsibility and authority are established. The quality and commitment of the company's management team are the most important factors in selling an offering.

- **Registered Offerings by "Small Business Issuers":** Two years' audited financial statements will be required if Form SB-2 is used. It is desirable that the audit be conducted by a recognized accounting firm. The strategic and operating plans for the company, including realistic financial forecasts and related projections, should be added to the financial statements. The resulting package should contain sufficient information to provide a meaningful, if not comprehensive, assessment of the company. The package should be reviewed by securities counsel who can provide advice respecting the appropriate structure for the offering.

If the company determines to explore the possibility of an underwritten offering despite its middle market status, the package should be delivered to at least three investment banking firms for their review. Some underwriters disdain small offerings, others specialize in them. Underwriters vary widely in the quality of their research and in their approach to specific industries. Pricing estimates should not dominate the selection process. The market will price the offering, not the underwriter. In any case, the securities will be offered below their optimum price to provide a hedge against post offering volatility.

Some underwriters use a "wholesale" distribution network and others distribute at "retail." The major underwriters have the capacity to reach a nationwide market. Institutional investors are avoided in many IPOs in the belief that they will abandon a stock quickly if it does not perform well. By contrast, it is usually assumed that individual investors will be more inclined to stick with a company through the inevitable ups and downs. Often a compelling case can be made for a mixed distribution.

Ask for and check references from each potential underwriter. When possible speak with executives of other companies that the underwriter has taken public. Was the research satisfactory? Was the scheduling realistic? Did the underwriter support the securities after the offering was complete? Above all, try to identify an underwriter with a genuine interest in a long-term relationship with the company.

If the company is unable to attract an underwriter, or is unwilling to compensate one, consider registering the securities as a “small business issuer” then self-selling selling them online or through mass media. Remember, however, that self-sold registered offerings should not be attempted unless the company is able to incur the substantial administrative expense necessary to comply with ongoing reporting requirements under the Securities and Exchange Act and to provide a limited market for the securities through a self-maintained “bulletin board” that posts transactions between holders.

- **Unregistered “Public” Offerings and Private Placements:** Arrive at a *preliminary* estimate of the desired capital to be raised now and in the foreseeable future and the percentage of company equity to be exchanged for it. Decide upon a preferred liquidity strategy, an indispensable requisite for a successful offering. The remaining components of the proposal to investors, including final pricing, preferences and conversion rights, can be deferred until the feasibility of the proposed offering can be determined.

Compile a formal list of all prospects known personally to company representatives who might be in a position to invest. In addition to names and addresses include occupations, references to business experience and financial status if known and a one or two sentence summary of the duration and source of the relationship (e.g. "two years, marketing consultant, upper-end home and lifestyle, works with Julie Smith our rep on the east side"). Then compile a second, more extensive list of business customers and suppliers, professional advisers and persons identified through social clubs, community organizations or networks who might be familiar with the company, its existing representatives or its business. Again, add as much supplementary information as possible. *Before* soliciting anyone about a possible investment, take the resulting database to securities counsel for review. The first list might be a promising source for a private offering. The second might lend itself to a public offering using approved general solicitation. There will obviously be some overlap.

- **Selling a Private Offering:** Concentrate on existing relationships. Advertisements, cold calls, mass mailings and public meetings are prohibited. On the other hand, one-on-one discussions and small, private meetings with persons who are already known to directors, officers, or other representatives of the company are permitted. Each person solicited should have a pre-existing, "substantive" relationship with a representative supporting a reasonable conclusion that the person can assess the merits and risks of the offering, can afford to invest, has access to

relevant information about the issuer or will review such information if it is provided.

Consider the use of finders. Companies may always sell securities through their authorized executives if no compensation is paid for the selling effort. Without such authority, the private offering exemption would be meaningless for any corporation or other statutory entity. Companies may also use independent "finders" to locate investors if both the company and the finder deal adequately with two separate questions: The first is whether the finder must register as an investment adviser or broker-dealer. The second is whether use of a compensated finder will violate specific prohibitions applicable to the exempt offerings under state law. Here are some answers:

⇒ *Must finders be registered?* Investment advisors, broker-dealers and sales persons must register with the SEC and the states in which they conduct business, but there are exceptions. Unregistered finders are permitted to locate investors in a private offering, and may even be compensated, if they 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>10</sup>

⇒ *Will a compensated finder threaten the exemption?* The states often condition their exemptions for private offerings upon the absence of selling compensation. On the other hand, in many states private offerings can be promoted by compensated finders who are registered as a broker-dealer or salesperson or who limit their solicitation to affluent investors who can qualify as "accredited."<sup>11</sup>

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<sup>10</sup> The finder should be acquainted with a representative of the company. Companies engaged in a private offering cannot solicit either investors or finders by general means. Unregistered finders should recommend the company, not the offering. Ideally the company would accept from such a finder only the name, address and telephone number of a prospective investor and would conduct all of the ensuing negotiations directly.

<sup>11</sup> "Accredited" investors include large financial institutions, directors and officers of the company (who have access to inside information) and individuals deemed sufficiently well heeled as to be cushioned from the financial risk associated with an offering. In brief, individuals currently earning more than \$200,000 per year (\$300,00 with their spouses) or having a net worth of \$1 million or more are accredited. Business entities with assets of \$5 million or more are often accredited, as are retirement plans which have \$5 million in assets, are trustee by a bank, or are self-trustee by individuals who are themselves accredited. There are numerous refinements. "Accreditation" should not be confused with "suitability," a relatively lenient state financial standard used in very small offerings, or with "sophistication," a separate requirement that purchasers of securities in a private offering have the ability to assess the merits and risks of the investment.

Verify the source of an unsolicited inquiry. Companies engaged in a private offering commonly receive unsolicited inquiries from new prospects that learn of the offering while it is in progress. The company can respond so long as its representatives did not, with the goal of reaching the public, set in motion the chain of events by which the prospect learned of the offering. The company should negotiate directly and confirm the absence of a general solicitation (e.g. the prospect did not receive a "cold call" from a misguided representative or finder).

Verify the number and status of purchasers. The company must satisfy all requirements for the number, financial position and business sophistication of purchasers in a private offering and that is not a simple task. Recall that Regulation D limits the number of purchasers to 35 *plus* certain additional investors (notes 9 and 11). The calculation requires an accurate assessment of the financial position of all investors and of their relationship to each other. The practice is to obtain documented assurance from investors that they are experienced in business or financial matters and are accredited, or that the investment is otherwise suitable for them.

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