

# What is a Regulation D Offering?

## General Information

This document is not legal advice, and is intended solely for information and educational purposes. If you are contemplating a private placement, or any legal transaction, you should consult someone who can provide you with the advice that you need, for your specific circumstances. Securities law, and corporate finance, is not the area for novices to play. Incorrect documentation can have serious ramifications for all involved parties.

The term "private placement" as used in this text refers to the offer and sale of any security by a brokerage firm not involving a public offering. Private offerings are not the subject of a registration statement filed with the SEC under the 1933 Act. Private placements are done in reliance upon Sections 3(b) or 4(2) of the 1933 Act as construed or under Regulation D as promulgated by the SEC, or both. Regulation D, promulgated in 1982, sets forth certain guidelines for compliance with the Private Offering Exemption. Any registered representatives who are involved in the private placement process are expected to have a working familiarity with Regulation D.

To qualify as a private placement, an offering by an issuer must meet either the requirement of Sections 3(b) or 4(2) of the 1933 Act as developed through SEC interpretation and court decisions or must follow the conditions set out under Regulation D of the 1933 Act. Persons claiming the exemption from the 1933 Act carry the burden of proving that its activities came within that exemption.

## Regulation D

### Overview

Regulation D is a series of six rules, Rules 501-506, establishing three transactional exemptions from the registration requirements of the 1933 Act.

Rules 501-503 set forth definitions, terms and conditions that apply generally throughout the Regulation. Specific exemptions are set out in Rules 504-506.

Rule 504 applies to transactions in which no more than \$1,000,000 of securities are sold in any consecutive twelve-month period. Rule 504 imposes no ceiling on the number of investors, permits the payment of commissions, and imposes no restrictions on the manner of offering or resale of securities.

Further, Rule 504 does not prescribe specific disclosure requirements. Generally, the intent of Rule 504 is to shift the obligation of regulating very small offerings to state "Blue Sky" administrators, though the offerings continue to be subject to federal anti-fraud provisions and civil liability provisions of the Exchange Act.

Rule 505 applies to transactions in which not more than \$5,000,000 of securities is sold in any consecutive twelve-month period. Sales to thirty-five "non-accredited" investors and to an unlimited number of accredited investors are permitted. An issuer under Rule 505 may not use any general solicitation or general advertising to sell its securities.

Rule 506 has no dollar limitation of the offering. Rule 506 is available to all issuers for offerings sold to not more than thirty-five non-accredited purchasers and an unlimited number of accredited investors. Rule 506, however, unlike 504 and 505, requires an issuer to make a subjective determination that at the time of acquisition of the investment each non-accredited purchaser meets a certain sophistication standard, either individually or in conjunction with a "Purchaser Representative." Like Rule 505, Rule 506 prohibits any general solicitation or general advertising.

"Accredited Investor" is defined in Rule 501(a). The principal categories of accredited investors are as follows:

1. Directors, executive officers, and general partners of the issuer, including general partners of general partners in two-tier syndicating. (The term "executive officers" is more fully defined in the Regulation.)
2. Purchasers whose net worth either individually or jointly with their spouse equals or exceeds \$1 million. It is important to note that while there is no definition of "net worth" in Regulation D, there similarly is no requirement of liquidity in the calculation of net worth for this accreditation standard. Thus, a purchaser's home, furnishings, etc. are includable in the determination of net worth.
3. Natural person purchasers who have "income" in excess of \$200,000 in each of the two most recent years and who reasonably expect an income in excess of \$200,000 in current year (or \$300,000, jointly with their spouse).
4. A business entity will be treated as a single accredited investor unless it was organized for the specific purpose of acquiring the securities offered, in which case each beneficial owner of the security is counted separately.

## **Additional Compliance Considerations under Regulation D**

The SEC has pointed out the following regarding Regulation D:

1. Regulation D does not exempt offerings from the anti-fraud and civil liability provisions of the various federal securities laws.
2. Further, Regulation D in no way relieves issuers of their obligation to furnish to investors whatever material information may be needed to make any required disclosures not misleading.
3. Similarly, notwithstanding exemption from registration at the federal level, Regulation D in no way obviates an issuer's obligation to comply with applicable state law.
4. Regulation D is interpreted as providing "transactional" exemptions to issuers only. An investor whose purchase was exempt from registration cannot resell his or her interest without establishing an independent basis of exemption.

The three exemptions are not intended to be mutually exclusive, that a reliance on one exemption is not deemed to be an election to the exclusion of any other applicable exemption.

Finally, the exemptions of Regulation D may not be claimed with respect to any plan or scheme to evade the registration provisions of the act.

Existing state securities regulations at times impose substantially more onerous limitations on issuers than Regulation D. Issuer's counsel must be consulted regarding the requirements of the securities law of each state in which an offering is going to be sold.

## **Form D**

Notices, on Form D, are due within fifteen days after the first sale of securities in an offering under Regulation D. It will be prepared by Issuer's counsel.

## **Private Placement of Restricted Securities outside Regulation D**

The specific requirements to be satisfied in establishing an exemption under Section 4(2) for a private placement are not stated in that section of the Securities Act of 1933. By studying SEC interpretations and court decisions dealing with Section 4(2), the basic requirements which a private placement must meet can be determined. They are summarized below:

All the offerees and purchasers must have access to the same kind of information concerning the issuer which would appear in an SEC registration statement, and these persons must be able to comprehend and evaluate such information. It must be kept in mind that any offer to an offeree who would not qualify, as well as a sale to a purchaser who would not qualify, may destroy the private placement exemption and result in a violation of Section 5 of the 1933 Act.

The issuer and any parties acting for the issuer, including the broker-dealer, must take all reasonable steps to insure that the information given to the offerees and purchasers is complete and accurate. This is "due diligence." All information passed on in the course of the private placement, either orally or by memorandum (or offering circular), is subject to the anti-fraud provisions of the federal securities laws. The fact that the offering memorandum is not reviewed by the SEC does not lower the standards for accuracy which would be applicable to any registered offering.

All of the offerees must have access to meaningful current information concerning the issuer. The fact that an offeree has considerable financial resources or is a lawyer, accountant or businessperson, and thus may be considered sophisticated, does not eliminate the need for appropriate information to be made available.

While there is no specific limitation on the number of offerees, the greater the number of offerees, the greater the likelihood that the offering will not qualify for the exemption. In this connection, a private placement cannot be the subject of advertising, general promotional seminars or public meetings in connection with the offering. This limitation does not preclude meeting with offerees to discuss the terms of the offer or to present information concerning the issuer or the offer. After the private placement has been completed, a general announcement (such as a tombstone ad) concerning it may be made if this is desired.

Purchasers in a private placement must acquire the securities for investment and not for the purpose of further distribution. If the purchaser acts in such a manner so as to participate in distribution of the securities to the public, either directly or indirectly as a link between the issuer and the public, he or she will be deemed to be an underwriter and the selling broker-dealer and other participants in the distribution, including the issuer, will be in violation of Section 5 of the 1933 Act. Each of the purchasers must intend to acquire for investment at the time the securities are purchased. Whether or not investment intent was present will be determined from all the circumstances surrounding the acquisition. Such circumstances would include the financial capability of the purchaser to hold the securities for the long term and whether the purchaser signed a letter of investment intent. The amount of time the securities have been held (the holding period) is one of the factors in a hindsight determination that an investment intent existed at the time of purchase. A two-year holding period is deemed to be the bare minimum.

What is readily apparent from the foregoing is that current and accurate information about the offerees in a private placement transaction is absolutely essential for the making of judgments as to suitability, ability to evaluate an offering, and investment intent.

## **Private Placement Offering Memorandum**

To meet the requirement of Regulation D or the requirements of Section 4(2) of the 1933 Act (the private placement exemption), the issuer is almost always required to make extensive disclosures regarding the nature, character and risk factors relating to an offering. The disclosure document often is labeled "Offering Memorandum" or given a similar title, which, in the normal course, is based upon information provided to counsel to the issuer. While a properly executed private placement is exempt from the registration provisions (i.e. Section 5 of the 1933 Act) of the federal securities laws, the transaction (and the disclosures made or a lack thereof) is subject to the anti-fraud provisions. If the offering memorandum is a particular private placement turns out to be materially misleading in terms of disclosures which have been made (or which should have been made), the broker-dealer and its principals may be deemed to have violated or aided or abetted violations of the anti-fraud provisions of the federal securities laws.

Unfortunately, because of the nature of a private offering, those looking to review an offering memorandum for educational purposes will have a very difficult time finding one.

## **Supplementary or Corrective Material**

During the course of private placement activities on a particular issue, or prior to the closing, it may become necessary to update or correct information supplied in the private placement memorandum as originally prepared. The corrected information must be brought to the attention of the offerees by means of a cover or transmittal letter which describes the changes or additions. Depending upon the information transmitted, reconfirmation of an investors desire to invest may be required. The files maintained with respect to a particular offering must contain a record of what has been done. Prior to closing an offering, meaning the acceptance of investors in a transaction, a brokerage firm Principal must verify that all such amendments have been sent to all subscribing offerees and that the files are accurate and complete.

## **Offeree Access to Information**

In most private placement offering memoranda, it is stated that the memorandum has been prepared by counsel to the issuer (i.e., the corporation) from documents which have been provided by representatives of the issuer. Offerees are invited to meet with representatives of the issuer to make an independent investigation and verification of the matters disclosed in the offering memorandum. Courts, reviewing private placements when challenged, weigh investor access to underlying information about the transaction very heavily in the determination of whether there has been compliance with the private placement exemption. The brokerage firm's designated Principal should obtain a commitment from the Issuer that potential purchasers and their representatives shall be given access to underlying information about the transaction if they desire to pursue such information. The fact that information is available to offerees should be specifically disclosed to the offerees at a conspicuous point in the offering documents.

## **PRIVATE PLACEMENT OFFERING PROCESS**

### **Offering Commencement and Termination**

The commencement date of private offerings is fixed generally at the date of the availability of the approved offering documents, for distribution to sales personnel.

The termination date for a private offering is dependent on the type of offering being made. An "all or nothing" offering contains, by its terms, a fixed or defined date for the termination of the offering. A "best efforts" offering may have an indeterminate termination period meaning that the offering continues until the full number of Securities is placed and the subscribers are formally accepted by both the issuer (or a duly authorized representative) and by a Principal of the brokerage firm.

The sales objectives in a best efforts offering, of course, is that all securities will be placed with suitable investors. However, short of all securities being placed, it is required that a minimum amount of money need be raised which shall be sufficient, after the funding of all of the organizational and offering expenses, and giving consideration to the fixed contractual obligations of the issuer, without changing the nature of the investment called for by the general terms of the offering. The issuer may be given the option of funding required issuer obligations by the making of loans or deferral of fees. In such a case where the issuer funds financial requirements prior to the placement of all of the securities, it is the obligation of the brokerage firm to assure itself that appropriate disclosure to all offerees (and subscribers) be made and to assure itself that the basic nature and character of the transaction called for by the terms of the offering are maintained. If it appears that they cannot be maintained, then the transaction must be rescinded and monies paid by subscribers must be refunded.

## **Possible Need for a Purchaser Representative**

A judgment must be made as to the business sophistication of a purchaser. If it is determined that a particular purchaser is not sufficiently sophisticated in business matters to effectively evaluate the investment opportunity, then he or she must be assisted by a "purchaser representative," i.e., a person possessing the requisite sophistication (chosen by the purchaser) who is able to and does assist in evaluating the investment opportunity and who is not an affiliate of the issuer, not the brokerage firm. Also, State Blue Sky laws impose additional requirements for their investors. Only customers known to registered representative personally should be sent only brokerage firm approved offering materials. If there is doubt about the individual's need for a purchaser representative, the subscriber should be required to obtain one.

## **No General Solicitation**

1. Cold Calling is not permitted.
2. Advertisements, articles, notices or any other communication cannot be published in any newspaper, magazine, newsletter or similar media or broadcast on TV, radio or cable.
3. No seminars or meetings may be held with regard to any current offering unless each invitee is known and qualified in advance.
4. No mention of any specific offering or past performance may be made at generic seminars (i.e. seminars to discuss the general concept of such investments).

## **No Fee Sharing**

Fees may not be split with non-registered persons such as lawyers, accountants or investment advisers.

## **Investment Intent**

Purchasers of private placement securities must purchase for investment purposes and not for the purpose of resale. The typical subscription documents used in private placements contains what is called "investment letter language." This representation should be personally verified. Consideration should be given as to whether the investment representation makes sense in view of the surrounding circumstances of the proposed purchaser.

## **Oral Representations**

Offerees, having received private placement offering documents, frequently request oral explanations or supplements to the information presented. Great care should be taken in making oral disclosures regarding a private placement. Deviation from the printed material is prohibited. Written notes of conversations with offerees (and their representatives) should be made, dated and placed in the client's file.

## Acceptance of Offerees as Purchasers

In all private placement offerings, the subscribers must be formally accepted by the issuer. The acceptance of subscribers is based upon a subscriber questionnaire and, possibly, the customer's account information (a document signed by the client). A review of the contents of this form by a representative of the firm who is qualified to make such determinations is imperative.

Following the acceptance of the subscribers in an offering by both the issuer and the principal, the offering shall be terminated by notification to all involved sales persons or entities.

## Mechanics of Offering Process

The offering documents should be numbered. Unnumbered copies should be marked "For Information Only", "File Copy" and other appropriate notation.

1. A distribution control sheet will be created, and monitored. As offering documents are assigned to particular registered representatives, the number of the offering documents, together with the registered representative's name, should be placed on the control sheet.
2. A sales control sheet will be maintained reflecting current sales.
3. Incoming checks, subscription agreements, and executed suitability documents will be logged on the Sales Blotter on a daily basis.
4. Checks should be reviewed for acceptability by the firm, recorded on the brokerage firm's receipts blotter, and forwarded to the individual bank escrow agent, and where appropriate to the Issuer, together with the purchaser's name, address, social security number, and number of shares/units.
5. Incoming subscription agreements should be approved by the firm, recorded on the sales blotter and forwarded to the Issuer for acceptance. A copy must be maintained for the brokerage firm files.
6. Confirmations should be sent immediately to the subscriber upon acceptance, to the registered representatives, and a file copy should be retained (e.g. a copy of the Subscription Documents.)
7. Form D will be filed, on a timely basis, by counsel to the Issuer, with the SEC and with those states that require it.
8. Care should be taken that any other forms necessary to comply with the state Blue Sky authorities will be timely filed. Counsel to the issuer or brokerage firm counsel should generally be consulted as to the required forms in the states where the securities have been sold. Generally, this is accomplished by counsel to the issuer. (Some states require no forms.)
9. A complete file containing the above-described documents for each private placement should be maintained as part of the brokerage firm's records.

## **Escrow Account - Private Placements Only**

The federal securities law (the Exchange Act) is very specific with respect to the required treatment of an escrow account maintained in an "all or none" or "part or none" offering.

The rules applicable to "all or none" or "part or none" offerings relating to the maintenance of an escrow account for a given offering are Rules 10b-9 and 15c2-4 of the Securities Exchange Act of 1934. Rule 10b-9 requires, in general, that in an "all or none" or "part or none" offering (as opposed to a "best efforts" offering) monies paid for the purchase of securities must be returned to the investors if the specified number/dollar amount of securities is not sold within a specified time. In other words, the "all or none" or "part or none" offering requires specification of the number of securities and the time of the selling period. Both terms must be adhered to.

Rule 15c2-4 requires, in general, that the monies received from investors be deposited into a separate segregated bank account (Independent Bank as Escrow Agent) and held for the investors' benefit until the "all or none" or "part or none" terms have been complied with. If the terms of the offering are met, the money is to be transmitted to the issuer. If not, the monies are to be returned to subscribers.

The specific procedures to be followed in the handling of escrow accounts for "all or none" or "part or none" transactions are as follows:

1. When an "all or none" or "part or none" offering is commenced, an escrow agreement shall be created. This document should be executed by the brokerage firm and the bank. The brokerage firm is required to keep a copy of all escrow agreements on file to demonstrate compliance with Rule 15c2-4.
2. An escrow account should be opened by the bank. The escrow account is governed by the escrow agreement. The account typically requires signatures of representatives of both the brokerage firm and the Issuer before any checks can be issued from the account.
3. Incoming monies should be deposited immediately into the escrow account, along with the purchaser's name, address, social security number and number of shares/units.
4. Upon the completion of the "all or none" or "part or none" terms of the agreement or upon the expiration of the specified time period, the escrow agent verifies that the terms of the escrow agreement have been or have not been met by the designated date and that the funds should be released from escrow.
5. The issuer then transmits written confirmation stating that a determination has been made that the conditions of the escrow have or have not been complied with and request a release of the funds.
6. Upon receipt of the written confirmation described above, the funds are transmitted to the proper entity or persons.
7. The documentation created by these procedures is then retained in a segregated file for audit or regulatory review.

8. In a "best efforts" offering, the brokerage firm is contractually bound to use its "best efforts" to place the securities with suitable investors. The brokerage firm will follow the procedures as outlined above regarding placement of subscriber's funds in an independent bank escrow account.