

Private Placement Memorandum And Regulation D

Private Placement Memorandum And [Regulation D](#): The [§4\(2\), or private-offering](#), exemption is the basis on which most emerging business enterprises are able to sell securities in the United States. (The term refers to that section in the '33 Act that contains the exemption.) Because of a series of fundamental miscues when the legislation was first drafted, the '33 Act reads backwards. Instead of postulating a definition of exempt private offerings, or defining the offerings which must be registered, the Act suggests that all sales of securities are to be registered and then exempts various transactions, including ones "not including any public offering" of securities. Since by far the great bulk of transactions are of the exempt variety, the tail is wagging the dog. Were the language to be interpreted literally, a crime wave could break out in this country as unsuspecting small businessmen, raising a few dollars from friends and relatives for the classic corner fruit stand, wind up invoking the civil (and, theoretically at least), criminal sanctions for violations of [§5 of the '33 Act](#).

For many years, the corporate bar urged the SEC to define the entire process by which securities move from the [issuer](#) to the investors so that private transactions could go forward with certainty. Until relatively recently, the Commission stoutly resisted these pleas. The SEC repeatedly denied, for example, the persistent notion that sales to twenty-five or fewer persons constituted a private offering and clung to the conceptually immaculate-but practically untidy-view that "offerees" were the key indicator, a slippery criterion since the federal definition of "offer" was and is much broader than the common sense construction of that term would indicate. Faced with a variety of devices cleverly calculated to mask disguised offers, the SEC's announcements are replete with language suggesting that the mere hint could constitute "indirect solicitation."

During the period of uncertainty, practitioners worked out their own guidelines, with little help from the SEC, to determine when a placement was exempt. This body of learning continues to be marginally pertinent, since the new rules, while providing a "safe harbor" for certain issues, do not replace the less certain parameters of [§4\(2\)](#) for offerings that cannot fit under the black-letter rules of Regulation D, described hereafter.

Thus, in 1982, after almost forty years of tugging and hauling, the law finally came to a sensible resting place; the Commission-promulgated Regulation D, or "Reg. D" as it is called, which provides a practical "safe harbor" without a host of difficult traps for issuers and their counsel.

Reg. D is not exclusive. For placements unable to fit within the black-letter rules of Reg. D, [§4\(2\)](#) continues to be available. However, the thrill has largely gone out of this area of practice. We are dealing now with private offerings with thousands of offerees and hundreds of purchasers; some such private offerings result in instant public companies, required to register (because they have more than 500 shareholders) under [§12\(g\) of the Securities Exchange Act of 1934](#). The SEC has at last come to the point one expected it would never occupy-administering a rule offering relative certainty, a rule which authorizes the issuance of billions of dollars of securities annually in major transactions without the benefit of public [registration](#).

Reg. D, which covers solely primary, or issuer, transactions, breaks down into six sections. [Rule 501](#) is a definitional rule; most important is the definition of "accredited investor," which is any person within one of following categories:

1. **Institutional investors:** banks, insurance companies, investment companies, broker/dealers, thrift institutions, business development companies, SBICs, certain employee benefit plans, and certain 501(c)(3) charitable corporations.
2. **Insiders:** directors, executive officers, and general partners of the issuer.
3. **"Rich individuals":** natural persons whose joint net worth at the time of purchase exceeds \$1 million or whose individual **net income** was over \$200,000 (\$300,000 if joint) for each of the preceding two years, coupled with a reasonable expectation of that income level for the current year.
4. **"Rich" entities:** any corporation, business trust, or **partnership** with total assets in excess of \$5 million if not organized for the purpose of making the investment, plus any private trust with assets in excess of \$5 million, not organized for the purpose and directed by a sophisticated person.
5. **Aggregates of the above:** any entity whose equity owners are entirely accredited investors under any category.

[Rule 501's](#) other key provision relates to the calculation of the number of allowable purchasers in an exempt transaction. Accredited investors are excluded from the count, meaning that there may be, with limitations explored in this chapter, an unlimited number of accredited investors.

[Rule 502](#) sets forth the general terms and conditions to be met if Reg. D is to apply. It specifically addresses integration of contemporaneous offerings, the information to be provided investors, and limitations on the "manner" of the offering and/or resale. [Rule 503](#) adds the notice requirements on [Form D](#), to be filed by the issuer with the SEC no later than fifteen days after the "first sale" of securities.

The exemptions themselves are contained in [§504](#) (issues of \$1 million or less), [§505](#) (issues of \$5 million or less), and [§506](#) (all other issues).

The antifraud provisions still apply to all transactions, and therefore Reg. D does not do away with the necessity for disclosure (although disclosure requirements are relaxed in some instances). It is also important to note that the burden of qualifying for the exemption has not been shifted; it is still up to the issuer and its advisers to make certain that each of the requirements of Reg. D has been complied with. However, the SEC has caved in to the argument that substantial compliance should be enough to maintain the exemption's applicability. In sum, not only is Reg. D an enormous help to issuers and their counsel, but the SEC has also been forthcoming in explaining the rule. In a release published on March 3, 1983, the staff issued an extensive interpretation in question-and-answer format. A number of no-action letters have further fleshed out the bar's insights into the staff's views. Reg. D itself is, as rules go, quite specific; it's possible, indeed, for a layman to understand the major provisions of the rule simply by reading it. Since its original promulgation in 1982, there have been a number of relaxing improvements. Thus, in 1988 the definition of "accredited investor" was enlarged, and the [Rule 504 exemption](#) ostensibly increased from \$500,000 to \$1 million. In 1989, the SEC de-emphasized the filing of [Form D](#) (no longer a condition to the exemption, although still required to be filed); adopted a change to the effect that, in [Rule 505](#) and [506](#) offerings with both accredited and non-accredited investors, the specified information need only be

supplied to the non-accredited investors (one wonders what lawyer would be brave enough to furnish material to some but not all investors in a placement); and finalized [Rule 508](#), the "excuse me" or "innocent and immaterial" (I & I) rule, which allows issuers to be forgiven for committing violations of Reg. D which are "insignificant" and occur despite a "good-faith attempt" to comply. And, in 1992, as part of the Small Business Initiative, the limit on the [Rule 504 exemption](#) was effectively raised to \$1 million, and securities issued in Rule 504 transactions are no longer "restricted" securities.

The rules ostensibly allow for the issuance and sale of securities to an unlimited number of purchasers (culled from an unlimited list of offerees) if they qualify as accredited investors, meaning people who are rich or otherwise qualified in the eyes of the SEC. Contrary to all prior learning, Reg. D (with exceptions having to do with the way prospects are identified) is not technically offended if the placement is made available to an unlimited number of offerees, a dramatic departure from the SEC's former view. Given a pool of "rich" people and a pre-sanitized prospect list, an issuer can make what amounts to a public offering-with perhaps as many as a thousand or more purchasers of the security and some multiple of that number as offerees-without technically running afoul of Reg. D.

A critical caution is in order at this point, however. Regardless of the number of purchasers (maybe even none) or offerees, if the placement is made on the basis of either "general solicitation" or "general advertising," then an unregistered public offering may have occurred. Obviously, it's hard to get a deal in front of even a limited number of potential purchasers without participating in some kind of activity reasonably viewed as "solicitation." The problem facing a founder approaching Reg. D is how to keep from running afoul of the ban on "general" solicitation and yet get his [business plan](#) out widely enough so that he has a chance of raising the money.

The first rule of thumb in this area is almost a banality, but it is one that bears constant repetition: keep careful records. An analysis of the cases in which issuers were held to have gone beyond the bounds of [§4\(2\)](#) will show varying fact patterns, as one might expect, but, in the author's view, one consistent theme pops up: the issuer and its agents did not keep careful records and, therefore, were unable to state with certainty when challenged in court how many people had been offered the opportunity. Continuing that tradition, in a 1985 SEC enforcement proceeding under Reg. D involving an illegal general solicitation, the order prominently reflected the fact that the number of persons solicited was not known because the issuer's records were so inadequate.

Secondly, it goes without saying that the ban on advertising, even though stated in terms of "general advertising," really means no advertising at all; since it is difficult to conjure up a practical scenario involving "nongeneral" advertising-it is an oxymoron. Thus, announcements of the offered opportunity in the newspapers, on the radio, on television, and so forth, are not in order. One would think that this constraint was clear enough; either you trumpet the investment opportunity in the media or you don't-but nothing in life is simple when the securities laws are involved. An ambiguity is likely to arise if, for example, the technology being exploited is interesting and the press wants to do an interview with a founder naturally proud to have come up with a scientific breakthrough. In theory, if the founder limits his conversation with reporters to the technology and makes no mention of the fact that he's out hustling to find funding, the media have not been used "in connection with"

the sale of a security. The problem is that one hasn't control of what a reporter will actually publish; a single mention in the press of the pending offering could inadvertently blow Reg. D's safe harbor. In a 1985 no-action letter commenting on so-called tombstone advertising (an ad which does no more than give the barest of information), the staff restated its view that materials designed to "condition the market" for the securities constituted an offer even though the tombstone did not specifically mention the transaction in question. (The *risk*, I hasten to add, is not likely to be SEC enforcement, as the discussion below indicates; the danger is that a disgruntled investor will initiate a civil action based on an allegation that the "safe harbor" is unsafe.)

Even with the most careful records, a forbidden solicitation may still be alleged because the word "general" is not susceptible of a precise, objective test. For example, a founder may want to mail to a list of, say, all venture-capital funds named in [Pratt's Guide to Venture Capital Sources](#), the most common reference book in the field. If a mailing does go out to a thousand names, is that a general solicitation? The SEC has helped illuminate the issue in a series of no-action letters. Taken together, the letters indicate a staff view that general solicitation does not occur when the solicitor and his targets have a nexus: as the SEC puts it, a "substantial preexisting" relationship.

The learning comes largely from the tax-shelter syndication area, where placement agents with long lists of previously screened prospects are the norm, because, at least prior to 1987, tax-shelter "junkies" (as they were called) tended to be repeat buyers. Thus, in a factual pattern that runs through the no-action responses most often cited as influential, it is typically brokers, not the founder, who are soliciting individuals to invest in limited-partnership products. In order to establish a meaningful "preexisting business relationship" between the broker and the prospect, the brokers send out "cold" mailings well in advance of the deals-questionnaires asking individuals to fill in certain financial information and to establish a record of their "sophistication" in such transactions. Reading the requests together, the staff's view is that an offering not in existence at the time the questionnaire was mailed can be sent out widely without running afoul of the general-solicitation constraint.

However, a founder doing his first, and perhaps the only deal of his lifetime has no access to a list of prior prospects. Absent such a list, the founder is left to soliciting his friends, business acquaintances, and parties with whom he can conjure up a prior relationship of some kind. Presumably, that list can be expanded vicariously, by asking his lawyer, accountant, and/or banker to make the material available to potential purchasers with whom they are acquainted. How much further he can go is still unclear. Parenthetically, as was earlier indicated, it is critical to keep careful records identifying all offerees, even though the names do not appear on a master mailing list. If an intermediary is asked to help, it is important to memorialize the intermediary's activities.

Finally, while the foregoing discussion exemplifies the law, at least according to the face of the statute, the rules, and the reported precedents, there has appeared in recent years a phenomenon, which this writer on occasion has jokingly labeled a "crime wave," which needs to be taken into account. That is to say, for years the classic view among practitioners was that there could be no mention in the public press or in public forums of a pending private offering. The term "gun jumping" is sometimes applied in this context, although it appears in other legal contexts as well.

When confronted with an inadvertent leak to the press about a private offering, the more cautious law firms would insist that the placement come to halt, a cooling off period ensue, and the solicitation efforts be not restarted until the effect of the unauthorized and unfortunate public announcement had been vitiated by the passage of time. There has been no explicit from that notion. That is to say, there appear routinely in the trade press (such as [The PE Analyst](#)) issuer-generated reports of private placements in process, sometimes specifying the amount of the capital being solicited. Moreover, at the venture-capital clubs and other public forums in which companies seeking private equity present themselves, obviously the potential investors are attracted by public media announcements, mass mailings, ads in newspapers, bulletin-board presentations, and the like. The SEC appears to be looking the other way, except perhaps in the event of blatant fraud; therefore, since no law firm can appear to be "holier than the Pope," experienced counsel are themselves overlooking public announcements and presentations which otherwise would qualify as general solicitation and advertising and disqualify the placement.