A Five-Minute Introduction to Regulation D Private Offerings

Eric C. Perkins, Esq.
Perkins Law, PLLC

The purpose of this summary is to provide some practical guidance for conducting a private placement of securities in compliance with Rule 506 of Regulation D. This is not meant to be an exhaustive treatise on securities law or legal advice regarding a specific offering, just an informal introduction to the basics of a Reg. D private offering.

I. *An Overview of Securities Regulation*

The offer and sale of securities is regulated by both federal and state law, and the dual forms of regulation are independent from one another in many significant respects. In other words, compliance with federal securities law does not necessarily ensure compliance with state securities law. Further, the securities laws from one state to another can vary in material respects.

Generally speaking, the securities laws focus on three variables: (i) the securities being offered for sale, (ii) the parties involved in the offer and sale of securities (sellers, purchasers, and intermediaries), and (iii) the disclosure provided to investors.

All securities sold in the United States must either be registered with the Securities and Exchange Commission ("SEC") and applicable state securities authorities or qualify for an exemption from the registration requirements. Put another way, there are three types of securities offerings: (i) registered, (ii) exempt, and (iii) illegal.

Persons engaged in the offer and sale of securities generally must be registered under federal and state law as a broker-dealer or representative/agent, although a variety of exemptions from these requirements exist. For example, the so-called federal "issuer exemption" allows officers, directors, and employees of the company issuing securities (the "issuer") to sell its securities directly to investors without the assistance of a broker-dealer, subject to certain conditions. Even still, some states require issuer agents to register as broker-dealers or satisfy other substantive or procedural requirements. The "issuer exemption" is subject to very specific conditions and limitations, thus it is of limited value to a company that sponsors multiple offerings (i.e., a serial syndicator).

II. *Regulation D and Rule 506*

The SEC promulgated Regulation D in 1982 to facilitate capital raising efforts by small companies. Regulation D consists of eight rules (501 through 508), three of which (504-506) establish transactional exemptions from the federal registration requirements. Because the Rule 506 exemptions are the most flexible and widely used of the three Regulation D exemptions, the discussion below will focus exclusively on Rule 506(b) and the relatively new (adopted in 2013) Rule 506(c).

Rule 506(b) permits an issuer to raise an unlimited amount of money in a private offering from an unlimited number of accredited investors and up to thirty-five (35) non-accredited investors who meet a certain sophistication standard. Because disclosure requirements are less burdensome if a Rule 506 offering is limited to accredited investors, for this and other reasons, most Rule 506(b) offerings are specifically structured as "accredited only" offerings. Rule 501(a) defines eight categories of accredited investors, including: (i) directors, executive officers, and managers of the issuer; (ii) natural persons whose net worth, either individually or jointly with a spouse, equals or exceeds $1 million (excluding the value of a primary residence); and (iii) natural persons with annual income in excess of $200,000 in each of the two most recent years ($300,000 jointly with a spouse) and who reasonably expect the same level of income in the current year. There is increasing talk of revising the net worth and annual income tests for accredited investor status for individuals (these standards have not changed significantly since their adoption in 1982), and perhaps creating different categories of accredited investor status based on different criteria (e.g., education level, liquid investments owned).

Perhaps the most limiting restriction under Rule 506(b) is the strict prohibition against general solicitation and advertising. In other words, neither an issuer, nor anyone acting on an issuer's behalf, may utilize any form of public advertising (e.g., television, newspapers, magazines, Internet, radio, public seminars, or cold calls) in connection with the offer and sale of securities in a Rule 506(b) offering. A violation of this prohibition is incurable and jeopardizes the Regulation D exemption for the entire offering. The most common defensive measure against such an argument is to demonstrate a pre-existing, substantive relationship with each investor.

If a company does want to engage in general solicitation and public advertising, then it can utilize the Rule 506(c) exemption, which does permit such marketing and promotional activities. However, under Rule 506(c), all investors must be accredited and the company must take reasonable steps to verify the accredited status of all investors.

A notice filing on Form D must be filed electronically with the SEC no later than fifteen (15) days from the first sale in any Rule 506 offering. There is no federal filing fee.

III. State Blue Sky Compliance

An issuer must also qualify for an exemption from the registration requirements in each state where its securities are offered for sale. Securities sold in compliance with Rule 506 are considered "covered securities," as defined by the National Securities Markets Improvement Act of 1996 ("NSMIA"). Under NSMIA, states are preempted from regulating covered securities in many material respects, although states may continue to impose notice filing and fee requirements and also enforce state antifraud rules and broker-dealer licensing requirements.

Accordingly, state blue sky compliance in a Rule 506 offering consists primarily of filing a Form D with the state no later than fifteen (15) days after an initial sale in that state and paying a filing fee. Some states also require that a Form U-2 (Consent to Service of Process) be filed, but many states are eliminating that requirement following the 2008 release and adoption of a new Form D that incorporated the same consent to service of process language directly into the Form D itself.

IV. The Offering Process

As Private Placement Memoranda ("PPMs") are distributed during the course of an offering, an issuer should number each copy and maintain a distribution log that keeps track of each PPM and the name and address or each recipient. This is one safety measure against a future claim of general solicitation in a Rule 506(b) offering, and as a general matter it is considered a best practice in the private placement industry.

Interested investors will complete a subscription agreement and questionnaire in which they disclose certain information and contractually agree to purchase the offered securities. All subscription documents must be carefully reviewed and approved not only by the registered representative making the sale and his broker-dealer firm, but also by the issuer, who ultimately has the final right to approve or reject each investor. If the subscription documents are incomplete, they should be returned immediately to the investor for completion. In a Rule 506(b) offering open only to accredited investors, all investors must either be accredited at the time of investment or the issuer must have had a reasonable basis for believing they were accredited at the time of investment. Issuers generally rely on the subscription documents to satisfy the "reasonable basis" test, thus it is very important to have complete subscription documents on file for each investor. As discussed above, a higher standard applies in Rule 506(c) offerings, so issuers must take additional steps to verify the accredited investor status of investors.

Incoming checks and subscription documents should be logged onto a sales blotter on a regular basis. Checks should be reviewed for acceptability and immediately processed in accordance with the terms and conditions described in the PPM. When an investor's subscription documents have been formally approved and accepted by the issuer, written confirmation should be promptly delivered to the investor and his registered representative. The issuer must provide regular sales blotter updates to legal counsel so that blue sky notice filings can be made on a timely basis.

In a typical contingency offering (e.g., a minimum-maximum offering), all offering proceeds must be returned to investors if the stated contingency is not met within the time specified in the PPM. The escrow account in which the initial offering proceeds are deposited must be a segregated bank account maintained for the benefit of the investors. During the escrow period, all investor checks must be made payable to the escrow agent. There are restrictions as to how the escrow account must be set up and how escrowed funds may be invested. These restrictions come from SEC Rules 10b-9 and 15c2-4. These and other terms of the escrow arrangement are memorialized in a written escrow agreement between the issuer and the escrow agent (sometimes a managing broker-dealer is a party to the escrow agreement).

Upon timely satisfaction of the escrow conditions, the issuer gives notice to the escrow agent to break escrow, and the escrow agent transmits funds to the issuer. From that point forward, offering proceeds may be received by the issuer and deposited directly into the issuer's operating account. Upon completion or termination of the offering, the issuer should make a concerted effort to organize and retain its offering and investor documentation in a master file in the event of an audit or regulatory review.

Please do not hesitate to contact Perkins Law, PLLC at 804-205-4152 or eric@ericperkinslaw.com with additional questions or information about our flat fee packages for assistance with Regulation D private offering transactions and compliance.

* This material is provided for informational purposes only and should not be construed as legal or tax advice, nor should it be acted upon without prior consultation with your own professional advisors. Receipt of this information does not create an attorney-client relationship between the recipient and the author.