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# PRIVATE PLACEMENTS UNDER UNITED STATES FEDERAL SECURITIES LAW

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## OVERVIEW

Section 5 of the Securities Act of 1933 (the "Act"), prohibits persons from using the mails or other instruments of transportation or communication in interstate commerce to offer to buy or sell, or deliver after sale, a security except in accordance with certain registration and prospectus delivery requirements.<sup>1</sup> The basis for jurisdiction under the Act is fairly broad and would, in some circumstances, include where non-U.S. issuers had meetings with investors in the United States, telephone calls with investors located in the United States or the delivery of securities to investors in the United States.<sup>2</sup> The scope of jurisdictional issues under the Act is outside of the scope of this article.

Under Section 4(1) of the Act,<sup>3</sup> the registration and prospectus delivery requirements do not apply to persons other than issuers (and their affiliates), underwriters or dealers. Accordingly, persons selling in the ordinary course securities that they have purchased from an issuer if they are not an affiliate or statutory underwriter, are generally not subject to registration requirements. This article reviews the exemptions from the registration and prospectus delivery requirements of the Act which are available for private placements by issuers.

## SECTION 4(6)

Under Section 4(6) of the Act,<sup>4</sup> offerings solely to accredited investors where there is no advertising or public solicitation are exempt from the registration and prospectus delivery requirements of the Act provided that the maximum offering amount does not exceed \$500,000 and a notice of sale is filed with the United States Securities and Exchange Commission ("SEC"). The securities sold would constitute "restricted securities" under Rule 144(a)(3) under the Act.

## SECTION 4(2)—TRANSACTIONS NOT INVOLVING A PUBLIC OFFERING

Under Section 4(2) of the Act<sup>5</sup>, the registration and prospectus delivery requirements are not applicable to transactions by an issuer "not involving any public offering". This language of the Act has been subject to judicial interpretation as well as administrative regulations issued by the SEC which provide safe harbors upon which an issuer and its counsel may rely in offering and selling securities in

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1. 15 U.S.C. § 77e.

2. "Interstate Commerce" is defined in Section 2(7) of the Act. 15 U.S.C. § 77b(7). See also *Leasco Data Processing Equipment Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972), regarding extraterritorial application of the securities laws.

3. 15 U.S.C. § 77d(1).

4. 15 U.S.C. § 77d(6).

5. 15 U.S.C. § 77d(2).

so called "private placement" transactions that are exempt from the registration and prospectus delivery requirements of the Act.

The Section 4(2) exemption was enacted to permit an issuer to make specific or isolated sales of securities to particular persons without incurring the expense of registration. Interpretations by the courts and the SEC have been somewhat restrictive.<sup>6</sup> In 1953, in an SEC enforcement action against Ralston Purina Co.,<sup>7</sup> the United States Supreme Court found that an offering to "key" employees was not a transaction exempt from registration as "not involving any public offering" even though there was no solicitation of the public or advertising. In that case, the Court focused on whether the offerees had access to the same kind of information that the Act would make available in the form of a registration statement or were in such a high degree of trust and confidence, such as executive personnel, that they would know all of this information. The Court's opinion suggests that a public offering could be an offering to a few persons or to many depending upon the quality of the offeree. The focus of later cases interpreting Section 4(2) has been not the number of offerees but whether the particular offerees or purchasers of the securities needed the protection of the Act and the disclosure thereunder.<sup>8</sup> It is the burden of the issuer to prove that it is entitled to an exemption under Section 4(2).<sup>9</sup> Because these interpretations could be seen as limiting the Section 4(2) exemption to institutions or very sophisticated investors, issuers must often rely upon other basis to assure themselves that a so-called private placement is exempt from the registration and prospectus delivery requirements of the Act.

## REGULATION D

The SEC has adopted Regulation D that provides a "safe harbor" for private placements of securities<sup>10</sup>. If an issuer complies with all the provisions of a specific rule under Regulation D then the offering will be deemed exempt from the registration and prospectus delivery requirements of the Act. Regulation D consists of Rules 501-508 under the Act.

Compliance with Regulation D does not exempt a transaction from the anti-fraud, civil liability or other provisions of the federal securities law. Accordingly, the anti-fraud rules under the Act and Section 10(b) and Rule 10b-5<sup>11</sup> under the Securities Exchange Act of 1934 (the "Exchange Act")<sup>12</sup> which prohibit persons from making an untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made not misleading, are still applicable. Furthermore, compliance with Regulation D does not exempt the issuer from

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6. See e.g., *SEC v. Continental Tobacco Co. of S.C.*, 463 F.2d 137 (5th Cir. 1972); *Hill York Corp. v. American Intern. Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971). 2 The SEC Speaks 341-77 (PLI 1972).

7. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

8. See *U.S. vs. Custer Channel Wing Corp. and Custer* (376 F.2d 675, 4th Cir. 1967), *G. Eugene England Foundation vs. First Federal Corp.* (663 F.2d 988, 10th Cir. 1973), *Mary S. Krech Trust vs. Lake Apartments* (642 F.2d 98, 5th Cir. 1981).

9. *SEC v. Continental Tobacco Co. of S.C.*, 463 F.2d 137 (5th Cir. 1972).

10. 17 C.F.R. §§ 230, 501-508 (hereinafter cited as Rules 501-508). The official title is "Regulation D—Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933" and is referred to as Regulation D.

11. 15 U.S.C. § 78j and 17 C.F.R. § 240.10b-5.

12. 15 U.S.C. §§ 78a-hh (hereinafter cited as the Exchange Act).

complying with any applicable state "Blue Sky" law or foreign law relating to the offer and sale of securities, although certain coordinating provisions may be applicable (see below). Attempted compliance with Regulation D does not act as an exclusive election; the issuer can also assert the availability of any other applicable exemption from registration including those under judicial interpretations of the Act, Section 4(2) or Section 4(6). Regulation D is only available to an issuer of securities and is not available to affiliates of issuers or for re-sales of the issuer's securities. Finally, Regulation D only provides an exemption for the private placement transaction in which the securities are offered and not for the securities themselves. Thus, future transactions in the securities may be subject to the registration and prospectus delivery requirements of the Act.

Regulation D consists of three categories of rules: (i) Rules 501, 502 and 503, which define common terms, provide general conditions for the exemptive rules and establish a uniform notice of sales form; (ii) Rules 504, 505 and 506, which provide the operative exemptions; and (iii) Rules 507 and 508, which address the consequence of non-compliance with certain requirements of Regulation D. They are described below.

### RULE 504 OFFERINGS

Rule 504 provides an exemption from the registration provisions of the Act for limited offers and sales of securities not exceeding an annual aggregate amount of \$1,000,000. It allows an issuer to offer and sell its securities to an unlimited number of persons without regard to their sophistication or experience. The rule does not prohibit the payment of brokerage commissions nor does it mandate specific disclosure requirements.

Rule 504 is only available to an issuer (affiliates and non affiliates of an issuer who wish to resell securities must look elsewhere for a transactional exemption). Rule 504 is not available for an investment company, blank check company or a company that is subject to reporting requirements under Section 13 or 15(d) of the Exchange Act.<sup>13</sup> Blank check companies include a development stage company that has no specific business plan or purpose or which has indicated its business plan is to engage in a merger acquisition with an unidentified company or companies or other entity or person.<sup>14</sup> It is available for foreign issuers.<sup>15</sup> The SEC has determined that "investment company" should be defined in accordance with Section 3(c)(1) of the Investment Company Act of 1940.<sup>16</sup>

Rule 504 is intended by the SEC to be used to facilitate the capital formation needs of the small start-up company seeking venture capital, and not seasoned issuers for which information is readily available by means of Exchange Act registration and reporting.<sup>17</sup> Issuers which have their securities listed on a United States National Securities Exchange, NASDAQ, the OTC Bulletin Board, or which

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13. Rule 504(a).

14. Rule 504(a)(3).

15. See Securities Act Release No. 6455, (Question 62) at 2637-13 through 2637-14.

16. Securities Act Release No. 6455, at 2637-13 N. 45.

17. See Securities Act Release No. 6339.

have engaged in a registered public offering under the Act will generally have reporting obligations under the Exchange Act and will not be eligible for Rule 504. Except as noted below, in order to be covered by Rule 504, the offerings must comply with the Manner of Offering and Transferability of Securities restrictions (see below). Except in the circumstances noted below, Rule 504 offerings may not be accompanied by general advertising or general solicitation and the securities sold in these offerings would constitute restricted securities within the meaning of Rule 144(a)(3) under the Act.

There are two circumstances where general solicitation is permitted and "freely tradable" securities may be issued under Rule 504. The issuer will not be subject to the Manner of Offering or Transferability of Securities restrictions if it registers the offering under a state law that requires the public filing and delivery of a disclosure document to investors prior to sale and makes offers and sales in accordance with those state provisions.<sup>18</sup> The disclosure document contemplated by this exemption must be publicly available at the state level. According to the SEC, the disclosure document must provide substantive disclosure to investors, including the business and financial condition of the issuer (including financial statements), the risks of the offering, description of the securities, and the plan of distribution.<sup>19</sup> For offerings in a state which does not have a provision in its law requiring public filing and delivery of a disclosure document before sale (e.g., New York and District of Columbia do not require registration of Rule 504 offerings), the transaction must be registered in another state with such a provision and the disclosure document filed in that state must be delivered to all purchasers before sale in both states.<sup>20</sup> To minimize "forum shopping" the offering must be actually made in the state with the registration procedure.<sup>21</sup>

The second circumstance where an issuer in a Rule 504 offering is not subject to the Manner of Offering and Transferability of Securities restrictions is where the transaction is effected under a state law exemption that permits general solicitation and general advertising so long as sales are made only to "accredited investors" within the meaning of Rule 501(a).<sup>22</sup> (See discussion below concerning the definition of accredited investor.) Rule 504 places an absolute ceiling of \$1,000,000 on the amount of securities that may be offered under the Rule in any twelve-month period. That amount is reduced by any sales of securities within the preceding twelve months which have been sold in reliance on an exemption under Section 3(b) of the Act<sup>23</sup> or in violation of the registration provisions under Section 5(a) of the

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18. Rule 504(b)(1)(i).

19. Securities Act Release No. 7644, at 81,774 n. 36.

20. Rule 504(b)(1)(ii) and see Securities Act Release No. 7644, at 81,744 n. 37.

21. See Securities Act Release No. 6758, at 89,015.

22. Rule 504(b)(1)(iii).

23. The Uniform Limited Offering Exemption ("ULOE") recognizes Rule 505 as the basic federal exemption to be coordinated with the state transaction exemption. Unlike Rule 505, the ULOE imposes obligations on the issuer when selling securities to any non-accredited investor that it have reasonable grounds to believe and after making reasonable inquiries shall believe that one of the following conditions have been satisfied:

(1) the investment is suitable for the purchaser upon the basis of the facts, if any, disclosed by the purchaser as to his other security holdings and as to its financial situation and needs. For purposes of this condition only, it may be presumed that if the investment does not exceed 10% of the investor's net worth, is suitable.

(2) the purchaser either alone, or with his/her purchaser representative(s) has such knowledge

Act. The concept of integration (discussed below) is also applicable to Rule 504. The offering price is the gross proceeds to be paid by investors and is calculated under Rule 501.

## RULE 505 OFFERINGS

Rule 505 provides a transactional exemption for offers and sales by an issuer to an unlimited number of accredited investors and up to 35 non-accredited investors in an aggregate amount not exceeding \$5,000,000 in any twelve month period. Commissions or other transaction-related compensation may be paid. Rule 505 was designed to achieve maximum uniformity in federal and state regulatory standards. The NASAA<sup>24</sup> Uniform Limited Offering Exemption was designed to compliment the Rule 505 exemption.<sup>25</sup>

Rule 505 is available to all types of issuers (whether corporations, foreign issuers, or non-corporate businesses, as well as those reporting under the Exchange Act) but is not available for investment companies or for issuers that are subject to any of the "bad boy" disqualification provisions contained in Rule 262 of Regulation A.<sup>26</sup> These disqualifications may attach upon the initiation or disposition of certain disciplinary, administrative, civil, or criminal proceedings involving the issuer or persons in a specified relationship with it, or upon the failure of a company reporting under the Exchange Act to file all required reports during the year preceding the offering. Under certain circumstances, exclusion resulting from one of the disqualifications may be removed by the SEC.<sup>27</sup>

Under Rule 505, all sales must comply with Regulation D's Information Delivery requirements (see below) and Manner of Offering and Transferability of Securities restrictions. The issuer is also required to file a notice of sales on Form D in accordance with Rule 503 although the failure to do so will not invalidate the exemption.

The aggregate offering price cannot exceed \$5,000,000 less the aggregate offering price for all securities sold within the 12 months before the start of and

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and experience in financial and business matters that he/she is or they are capable of evaluating the merits and risks of the perspective investment. (See paragraph (1)(D) of the ULOB).

24. North American Securities Administrators Association.

25. See Note 23, supra.

26. These disqualifications include where the SEC has taken action with respect to a registration statement that it believes contains untrue statements or omissions (such as a refusal order or stop order); where certain persons (such as the issuer, directors, officers, general partners, principal securities holders, currently connected promoters or underwriters) have been convicted within five years prior to the commencement of the offering of any felony or misdemeanor with respect to the purchase or sale of any security, or involving the making of any false filing with the SEC; where such persons are subject to any order, judgment or decree of any court of competent jurisdiction temporarily and preliminarily restraining or enjoining such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with the Commission within the last five years; where such person is subject to a post office fraud order; where such person is subject to a criminal conviction during the last ten years in connection with the purchase or sale of any security, making a false filing with the Commission, or arising out of the conduct as an underwriter, broker, dealer, municipal securities dealer or investment advisor; or where such persons are subject to civil restraints, orders of judgment, and decrees within the last five years restraining person from continuing conduct or from expelling them from membership in certain securities associations.

27. Rule 505(b)(2)(iii)(C).

during the offering of securities which relied upon any exemption under Section 3(b) of the Act or were sold in violation of Section 5(a) of the Act.<sup>28</sup>

### RULE 506 OFFERINGS

Rule 506 allows any issuer to sell an unlimited amount of its securities to an unlimited number of accredited investors and up to 35 non-accredited investors. When counting investors, the Rule is concerned with purchasers only and not with offerees. It places no restrictions on the payment of commissions or similar transaction related compensation. It does not exclude any type or size of issuer, whether it is reporting under the Exchange Act or an investment company, and does not contain the "bad boy" disqualification provisions of Rule 504, although disclosure of those circumstances may be otherwise required in a disclosure document. It is available, as are the other rules under Regulation D, for business combinations including triangular mergers.<sup>29</sup>

A Rule 506 offering must be part of the same Regulation D offering and must meet the Information Delivery requirements and Manner of Offering and Transferability of Securities restrictions. The issuer must also use reasonable care to assure that the purchasers of the securities are not statutory underwriters.

The availability of Rule 506 is not dependent upon the dollar size neither of the offering nor on the filing of Form D required by Rule 503. However, failure to comply with the filing obligation of Rule 503 could jeopardize an issuer's future use of Regulation D<sup>30</sup>. In addition to an unlimited number of accredited investors, the issuer must have no more than, or reasonably believe that there are no more than 35 purchasers that are not accredited investors in the offering. Thus, technically, there could be an offering to a large number of persons provided that not more than 35 investors are not accredited. The SEC is aware of this potential and cautioned issuers that depending on actual circumstances, offerings made to large numbers of purchasers may involve a violation of the prohibitions against general solicitation and general advertising<sup>31</sup> but withdrew this admonition before adopting Regulation D.

Rule 506 requires that each purchaser who is not an accredited investor, either alone or with his purchaser representative(s), have such knowledge and experience in financial and business matters, that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser meets this requirement. Accordingly, the issuer must reasonably believe that purchasers (with their purchaser representatives) are sophisticated if they are not accredited. The issuer has the

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28. These include offerings under Rule 236 (to eliminate fractional shares or script certificates), Regulation F (assessable stock), Rule 701 (employee benefit plans), Regulation A (mini registration) and Rule 505 offerings.

29. See Securities Act Release No. 6389, at 84,919. Regulation D might be seen as not applicable to Rules 504, 505 and 506 because the sales may be deemed to be from affiliates of an issuer and not the issuer). The SEC has determined that Regulation D applies in triangular mergers where the merger is structured so the issuer's securities are at no time issued and outstanding in the name of the acquisition subsidiary but are issued directly to the shareholder of the target company simultaneously as part of the merger of the target company and the acquisition subsidiary (Lithia Motors, Inc., SEC No Action Letter, 1999 WL253606 (April 28, 1999).

30. See Rule 507.

31. See Securities Act Release No. 6339, at 84,464 n. 30.

burden of proof to demonstrate compliance with Rule 506. It must keep accurate records as to its inquiry concerning sophistication, number of purchasers, their accredited status and other matters and should obtain and retain suitable documentation to demonstrate compliance.<sup>32</sup>

An added benefit of complying with the Rule 506 exemption is that under the National Securities Markets Improvement Act of 1996, private placements under Rule 506 are no longer subject to state registration requirements, although this does not prohibit states from imposing notice filing requirements that are substantially similar to those imposed by Regulation D and requiring a filing fee for such.

## DEFINITIONS

Rule 501 contains various definitions that are applicable to the interpretation of the exemptions under Regulation D. They are as follows:

*Accredited Investor*—This includes persons who are or whom the issuer reasonably believes are in the following categories at the time of the sale: (1) certain institutions, such as banks, savings and loan associations, insurance companies, broker/dealers, SBIC's, pension plans with assets in excess of \$5,000,000, business entities (such as corporations, business trusts or partnerships not formed for the purpose of acquiring the securities offered) with total assets in excess of \$5,000,000; (2) a director, executive officer or general partner of the issuer or of the issuer's general partner; (3) any natural person whose individual net worth or joint net worth with that person's spouse at the time of purchase exceeds \$1,000,000; (4) any natural person who had individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income in the current year; (5) certain trusts with total assets in excess of \$5,000,000 not formed for the purpose of acquiring the securities; and (5) any entity of which all equity owners are accredited investors.

*Affiliate*—Affiliate includes persons that directly or indirectly, through one or more intermediaries, controls or is controlled by or is under common control with the person specified. The definition is essentially the same as that contained in Rule 405 of Regulation C.<sup>33</sup>

*Aggregate Offering Price*—Includes the sum of all consideration received by an issuer for the issuance of a security. Consideration is valued at fair value if it is a non-cash consideration and the value must be reasonable at all times. It does not include a deduction for costs of the offering.

*Calculation of Number of Purchasers*—In counting purchasers under Rule 505 and 506, you can exclude purchasers who are (i) relatives and spouses or relatives of the spouse of a purchaser who have the same principal residence as the purchaser; (ii) trusts or estates where certain related family members own more than 50%; (iii) companies or organizations where certain related family members own more than 50%; and (iv) all accredited investors. Entities, such as corporations or partnerships,

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32. See *Mark vs. FSC Securities Corp.*, 870 F.2d 331 (6th Cir. 1989) and *Johnston vs. Bumba*, 764 F.Supp. 1263 (N.D. Ill. 1991), judgment aff'd, 983 F.2d 1072 (7th Cir. 1992).

33. 17 C.F.R. § 230.405.

are generally counted as one purchaser, however, if the entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor, then each beneficial owner of equity securities or ownership interest in the entity counts as a separate purchaser for purposes of Regulation D<sup>34</sup>.

*Purchaser Representative*—Includes persons who are not affiliated with the issuer or affiliates thereof (except if there is a relationship by blood) who have knowledge and experience in financial and business matters where they are capable of evaluating the risks and merits of the prospective investment, provided the investor acknowledges that such person is acting in that capacity.

## GENERAL CONDITIONS

Rule 502 contains four paragraphs setting forth the general conditions that may be applicable to offerings made pursuant to the exemptions in Rules 504, 505 and 506 and covers the following topics: (1) Integration; (2) Information Delivery requirements; (3) Manner of Offering restrictions; and (4) Transferability of Securities restrictions. They are discussed below.

## INTEGRATION

In determining what constitutes a Regulation D offering and whether the offering meets all of the terms and conditions of a specific rule, one must evaluate what constitutes the "offering". Rule 502(a) excludes from an offering offers and sales that are made six months before the start of a Regulation D offering or which are made more than six months after a Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer which are of the same class (except certain sales to employee benefit plans). Thus, in determining whether the Manner of Offering, Information Delivery, the number of purchasers and the aggregate offering amount or other requirements of Regulation D have been met, the integration analysis is critical. Rule 502(a) provides a safe harbor for integration. However, some offerings which fall within those six-month windows may not, in some circumstances, be integrated.

The term offering is not defined in the Act or in Regulation D. If the issuer offers or sells securities for which the six month safe harbor in Rule 502(a) is not available, a determination as to whether separate sales of securities are part of the same offering (i.e., are integrated) depends on the facts and the circumstances. In Rule 502(a) the SEC notes that the following factors would be considered in determining whether offers or sales should be integrated for purposes of the exemption under Regulation D if the safe harbor does not apply: (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 received; and (e) whether the sales are made for the same general purpose.<sup>35</sup> At least one court has held that the issuer has

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34. Rule 501(e)(a)(2).

35. See Note to Rule 502(a).

the burden of proving that multiple offerings of securities should not be integrated.<sup>36</sup>

A subsequent public offering which is registered with the SEC will not generally disqualify a previous private placement within the safe harbor period if the private placement is under Section 4(2) of the Act or Rule 506 and has been completed prior to commencement of the public offering.<sup>37</sup>

In the event that there is a foreign offering at the same time as a Regulation D offering, the SEC's policy is that transactions otherwise meeting the requirements of an exemption will not be integrated with simultaneous offerings made outside the United States in compliance with Regulation S.<sup>38</sup>

## INFORMATION DELIVERY REQUIREMENTS

The Information Delivery requirements are set forth in Rule 502(b) and are applicable to offerings under Rules 505 and 506, but not to offerings under Rule 504. In the SEC's view, an issuer is required as a condition of the exemption to furnish specific information to investors and should furnish the same kind of information to the extent material to an understanding of the issuer, its business and the securities being offered, as would be required if the securities were registered.<sup>39</sup> In offerings to accredited investors only, the issuer is not required to furnish specific information. This is on the theory that such persons do not need this information because all of the purchasers are in a position to acquire the information on their own and to adequately protect themselves. In an offering to non-accredited investors only, the issuer must furnish specified written information to each non-accredited investor a reasonable time prior to sale.<sup>40</sup> Where the sale is to both accredited and non-accredited investors, disclosure is only required to be made to non-accredited investors. However, issuers would be wise to provide all purchasers in these circumstances the same information. In the event that the issuer makes selected disclosure to accredited investors (that has also not been made to non-accredited investors), it is required to notify the non-accredited investors of such and, upon request, furnish such information to the non-accredited investor.<sup>41</sup> The information which is required to be delivered is set forth below.

### *a. Non-Financial Statement Information*

Where an issuer is not subject to reporting requirements under Section 13 or Section 15(d) of the Exchange Act and is eligible to use Regulation A, it can provide the same kind of information required in Part II of Form 1-A. If the issuer is not eligible to use Regulation A, it must provide the same kind of information as required in Part I of a registration statement filed under the Act on the form the issuer would be entitled to use. There is some flexibility in this disclosure requirement as the introductory language in Rule 502(b)(2)(i) requires the issuer to

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36. *Western-Realco Ltd. Partnership 983-A vs. Harrison*, 791 P.2d 1139, Colo. CT. App. 1989.

37. See Rule 152 and *Verticom, Inc.*, SEC No-Action Letter, 1986 WL 65214 (February 12, 1986). This issue is also addressed in the SEC's "Aircraft Carrier Release", Securities Release No. 7606A.

38. See Securities Act Release No. 6863 and Note to Rule 502(a).

39. See Hopper, Konouff, Smith & Peryam, SEC no-action letter, 1982 WL 29792 (September 10, 1982).

40. Rule 502(b)(2)(v).

41. Rule 502(b)(2)(iv).

furnish the specified information "to the extent material to an understanding of the issuer, its business, and the securities being offered".

*b. Financial Statement Information*

For financial statements, the level of disclosure is based on the size of the offering. With respect to offerings that are up to \$2,000,000, Rule 502(b)(2)(i)(B)(1) authorizes a reduced level of disclosure for non-reporting companies and requires the information required by Item 310 of Regulation S-B<sup>42</sup> but only requires the issuer's balance sheet to be audited to a date within 120 days of the start of the offering.

In offerings up to \$7,500,000, Rule 502(b)(2)(i)(B)(2) requires the issuer to deliver the financial statement information required in a Form SB-2. This incorporates Item 310 of Regulation S-B discussed above and requires essentially an audited balance sheet for the latest fiscal year, and audited statements of income, cash flows and changes in stockholders' equity for each of the preceding two fiscal years.

For offerings over \$7,500,000, the financial statements must be as required in a registration statement filed under the Act on the form that the issuer is entitled to use. This would generally require three years statements of income, cash flows and changes in stockholders' equity and balance sheets for the preceding two years on an audited basis.<sup>43</sup>

For all three classes of offerings, for issuers that are not limited partnerships, only the balance sheet dated within 120 days of the offering must be audited if the issuer cannot obtain audited financial statements without unreasonable effort or expense. Limited partnerships may use audited financial statements prepared on the basis of federal income tax requirements if other audited financial statements are not available without unreasonable effort or expense.

Where the issuer is subject to reporting under the Exchange Act, it can deliver (1) its annual report for the most recent fiscal year; (2) its proxy statement filed in connection with such annual report; and (3) if requested in writing by a purchaser, a copy of the issuer's most recent Form 10-K and/or 10KSB. Alternatively, the issuer can furnish the information contained in its Form 10-K or 10KSB, or in a registration statement on Form S-1, Form SB-1, Form SB-2 or Form S-11 under the Act, or on a Form 10 or Form 10-SB registration statement under the Exchange Act. The issuer is not required to provide the exhibits to a registration statement required by Item 601 of Regulation S-K, if it identifies the documents and they are made available to a purchaser, upon his written request, a reasonable time prior to his purchase.<sup>44</sup>

Special disclosure obligations apply to foreign private issuers eligible to use Form 20-F under the Exchange Act.<sup>45</sup> There are also special rules for business combinations.

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42. 17 C.F.R. § 228.310.

43. See Regulation S-X and Items 10 and 11 of Regulation S-K.

44. Rule 502(b)(F)(2)(iii).

45. Rule 502(b)(2)(i)(C).

*c. Opportunity to Ask Questions*

Rule 502(b)(2)(v) requires the issuer to make available to each purchaser at a reasonable time prior to the purchase, the opportunity to ask questions and receive answers concerning the terms and conditions of the offering from the issuer, and obtain any additional information, to the extent the issuer possesses it or can acquire it without unreasonable effort or expense, that is necessary to verify the accuracy of the information provided.

*d. Disclosure of Resale Limitations*

Rule 502(b) requires that unaccredited investors be clearly advised of the "restricted" character of the securities being offered for sale.

### MANNER OF OFFERING RESTRICTIONS

Rule 502(c) contains a prohibition on general solicitation or general advertising. This includes the prohibition of offering or selling the securities by any form of general solicitation or general advertising including advertisements, articles or notices published in newspapers, magazines or similar media or broadcast over television or radio or in any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. An issuer must be careful concerning the manner in which it solicits its investors and the manner in which it and its affiliates conduct themselves. The Rule does not prohibit institutional advertising or other general communication on behalf of an issuer regarding its normal business activity, but does prohibit anything that is related to sensitizing the market for its securities, although tombstone advertisements, after an offering and well before any subsequent offering, may be acceptable.<sup>46</sup> Whether or not an issuer's product promotion or institutional advertising can also be deemed general solicitation or general advertising for the offer or sale of its securities under Regulation D is a question of fact and requires an evaluation not only of the content of the specific advertisements but also of the actual use of each advertisement in relation to the offering of securities.<sup>47</sup>

### TRANSFERABILITY OF SECURITIES RESTRICTIONS

Securities acquired in any Regulation D transaction, other than those in certain offerings made in reliance upon Rule 504 (discussed above), must be taken for investment and not with a view towards distribution. The securities have the status of securities acquired not in a public offering and cannot be resold without registration under the Act or an exemption therefrom.<sup>48</sup> As a result, the securities are "restricted" within the meaning of Rule 144(a)(3) under the Act and may be resold in reliance on Rule 144. Rule 502(d) places the duty on the issuer to exercise reasonable care to assure that the purchasers are not underwriters of the securities

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46. See *Alma Sec. Corp.*, SEC No-Action Letter, 1982 WL 29423 (July 2, 1982).

47. *Printing Enters. Management Science, Inc.*, SEC No-Action Letter 1983 WL 28165, (March 23, 1983).

48. See preliminary Note 4 to Regulation D.

within the meaning of Section 2(a)(11) of the Act.<sup>49</sup> Generally, this requires reasonable inquiry to make sure the purchaser is acquiring the securities for himself and not for other persons, written disclosure prior to sale of the securities that they have not been registered under the Act and cannot be resold without registration unless there is an applicable exemption, and the placement of a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on the transferability and sale of securities (Rule 502(d)).

### FILING NOTICE OF SALES

Rule 503 requires an issuer making sales under Regulation D to file with the SEC five copies of a notice of sale on Form D, provided that the failure to so file will not invalidate an offering which is otherwise entitled to a valid Regulation D exemption.

### RELIEF FOR INSIGNIFICANT DEVIATIONS

Rule 508 provides, in some circumstances, a defense against private actions or rescission for issuers relying upon Rules 504, 505 or 506 if the issuer has failed to comply with certain terms, conditions or requirements of Regulation D. In order to benefit from the Rule, the person relying on the exemption must demonstrate that the term, condition or requirement violated was not directly intended to protect the complaining party, the failure to comply was insignificant to the offering as a whole and a good faith and reasonable attempt was made to comply with all of the terms and conditions of the Rule.

### COORDINATION WITH STATE BLUE SKY LAWS

Regulation D provides an eligible issuer with potential exemptions from federal registration requirements. It does not relieve the issuer from satisfying the registration obligations of each state or jurisdiction where it plans to offer or sell its securities, whether inside or outside the United States. Securities laws in most states contain a provision which makes it unlawful for any person to offer or to sell any security in that jurisdiction unless the securities are registered under the statute or the security or transaction is exempt.<sup>50</sup> In many circumstances, securities that are exempted under Regulation D will be exempted from registration at the state level by comparable exemptions, but that is not always the case. Counsel must carefully review the laws of each jurisdiction where offers or sales may be made to make sure what requirements may be applicable.

As of May 1, 2000, 39 states have coordinated their limited offering exemptions directly with Rule 505. To meet the state rule requirement they require compliance with all of the conditions of Rule 505. In addition, other requirements may be applicable. Under the National Securities Markets Improvement Act of 1996

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49. Section 2(a)(11) of the Act defines underwriter as "persons who purchase from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security."

50. See Section 301 of the Uniform Securities Act. It has been adopted or substantially adopted with modifications in 38 states and the District of Columbia.

("NSMIA"), any security that is a covered security is protected by Section 18(a)(1)(A) of the Act from state registration requirements. "Covered securities" includes private placements that are exempted under Rule 506. However, private placements made in reliance on Section 4(2) without reliance on Rule 506 under the Act, or in reliance on Rules 504 or 505, or Section 4(6) are not covered securities and may be subject to regulation by the states. Although state regulation of Rule 506 offerings is now pre-empted by Section 18, a state is not prohibited from imposing notice filing requirements that are substantially similar to those required by Regulation D. Therefore, an issuer making a Rule 506 offering must determine whether state law where the offering occurs imposes a filing requirement. Section 18 also preserves state jurisdiction to impose filing fee requirements. As of March 1, 2000, 45 states have adopted new notice filing procedures as a result of Section 18 of the Act for offerings made in reliance on Rule 506.

### CONCLUSION

United States federal securities laws provide a comprehensive set of procedures and rules upon which counsel designing private placements can rely. These are flexible and apply to mergers, reorganizations and other activities, as well as direct sales of securities by issuers for cash, property or other consideration. Private placements also need to comply with any applicable state law, to the extent not exempt under NMSIA, and the law of any foreign jurisdiction in which the securities are offered or sold.

