

**Securities Act Exemptions/
Private Placements
December 2012**

NY2 711869

Securities Act of 1933 – Registration Framework

- § 5 - Must register all transactions absent an exemption from the registration requirements
- § 4 - Transactional exemptions
- § 4(a)(2) - Private Placement Exemption
 - “Transactions by an issuer not involving any public offering.”
- Section 4(a)(1½) exemption evolved in practice
 - Not embedded in the Securities Act
- Lack of access to public capital markets increases importance of exemptions from Section 5 registration requirements

What We Will Cover

- § 4(a)(2)
- Regulation D and the JOBS Act
- Integration
- Regulation A
- Intrastate Offerings
- Rule 701
- Crowdfunding

Section 4(a)(2)

Section 4(a)(2)

- Issuer exemption
 - most utilized issuer exemption
 - application of the private placement exemption, however, has been the subject of significant debate due in large part to the brevity of its wording
 - not a “public offering” has been defined by case law and SEC interpretation and one may look to safe harbors as well
- Transactional exemption
- Restricted securities – securities sold in a private placement may not be resold absent registration or exemption from registration

Exemptions: 4(a)(2) and Ralston-Purina

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

- Supreme Court confirmed SEC position that offers and sales to a large number of employees by Ralston Purina under its stock plan were not exempt under Section 4(a)(2); provided the following “guidance:”
 - §4(a)(2) exemption focuses on “offerees” and not actual purchasers of the securities.
 - § 4(a)(2) exemption does not depend upon a numerical test; Court rejected SEC argument that extensive number of offerees was sufficient by itself to establish loss of exemption.
 - Availability of §4(a)(2) exemption “*should turn on whether the particular class of persons...need the protection of the [’33] Act*” and whether the offerees “*are shown to be able to fend for themselves.*”
 - Court stated that where offerees do not have “access to the kind of information” that a registration statement would disclose, issuer required to provide same kind of information that otherwise generally would be available in a registration statement.

Safe Harbors

Safe Harbors

- Rules and regulations that set forth conditions the satisfaction of which will ensure that there has not been a public offering
- Regulation D for offerings

Regulation D — Rules 501-508

- Includes
 - Exemption for certain offerings by issuers under \$5 million (Rules 504 and 505)
 - Private placement safe harbor (Rule 506)
- Non-exclusive safe harbor
- § 4(a)(2) still available (to the extent general advertising and general solicitation are not used)

Rule 506 Safe Harbor Requirements

- Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.
- Current requirements of a Rule 506 private placement include:
 - No dollar limit on size of transaction.
 - Unlimited number of accredited investors and no more than 35 unaccredited investors.
 - No general solicitation or advertising.
 - Resale limitations.
 - Disclosure required for non-accredited investors.
 - Form D filing within 15 days of first sale of securities.
 - Good faith effort to comply (Rule 508).
- Currently, no “bad actor” disqualification provisions

Rule 506 Purchasers

- Accredited Investors (Rule 501)
 - Institutional investors such as banks, S+Ls, broker-dealers, insurance companies, investment companies
 - Corporations or trusts with assets in excess of \$5 million
 - Not formed for purpose of making the investment (look-through rule)
 - Directors and officers of the issuer
 - Individuals with
 - Income > \$200,000 or joint income > \$300,000
 - Net worth or joint net worth > \$1 million*
 - Entity in which all equity owners are accredited investors

* Dodd-Frank Act of 2010 amended definition to eliminate ability of individuals to include the equity value of primary residences in calculation of net worth

Rule 506 Purchasers (cont'd)

- Non-accredited investors
 - Sophistication required
 - Alone or with Purchaser Representative

“Accredited Investor” Reviews

- Dodd-Frank Act provides that, upon enactment and for four years following enactment, the net worth threshold for accredited investor status will be \$1 million, excluding the equity value (if any) of the investor’s primary residence
- One year after enactment, the SEC is authorized to review the definition of the term “accredited investor” (as it is applied to natural persons) and to adopt rules that adjust the definition, except for modifying the net worth threshold
- Four years after enactment, and every four years thereafter, the SEC must review the “accredited investor” definition as applied to natural persons, including adjusting the threshold (although it may not be lowered below \$1 million)

Accredited Investor – Guidance

- The SEC provided additional guidance regarding the net worth standard:
 - **C&DI Question 179.01:** Under Section 413(a) of the Dodd-Frank Act, the net worth standard for an accredited investor, as set forth in Securities Act Rules 215 and 501(a)(5), is adjusted to delete from the calculation of net worth the “value of the primary residence” of the investor. How should the “value of the primary residence” be determined for purposes of calculating an investor’s net worth?
 - **Answer:** Section 413(a) of the Dodd-Frank Act does not define the term “value,” nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of the net worth calculation. As required by Section 413(a) of the Dodd-Frank Act, the Commission will issue amendments to its rules to conform them to the adjustment to the accredited investor net worth standard made by the Act. However, Section 413(a) provides that the adjustment is effective upon enactment of the Act. When determining net worth for purposes of Securities Act Rules 215 and 501(a)(5), the value of the person’s primary residence must be excluded. Pending implementation of the changes to the Commission’s rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor’s net worth. [July 23, 2010]

New Accredited Investor Definition

- On December 21, 2011, the SEC adopted final rules, amending the accredited investor standard to reflect the requirements of the Dodd-Frank Act.
- As amended, the new individual net worth standard in the accredited investor definition under rule 215 and rule 501 of Regulation D is:
 - Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds \$1,000,000.
 - The person's primary residence shall not be included as an asset;
 - Indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of the sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and
 - Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability.

No General Solicitation or Advertising

- Prohibition applies to issuer and its agents
- Rule 502(c)
 - No general solicitation or advertising
 - No seminar with attendees invited by general solicitation or advertising
- Importance of preexisting substantive relationship with offerees
- Importance of process safeguards
- The significance of being “in registration”
 - Black Box and Squadron, Elenoff No-Action letters (QIBs and a limited number of institutional accredited investors) and C&DI guidance
- Rule 135c
 - Safe harbor for limited issuer announcement of exempt offering

The JOBS Act: Rule 506 Changes

- The JOBS Act contains various provisions that affect exempt offerings.
- Title II of the JOBS Act directs the SEC to eliminate the ban on general solicitation and general advertising for certain offerings under Rule 506 of Regulation D, provided that the securities are sold only to accredited investors, and under Rule 144A offerings, provided that the securities are sold only to persons who the seller (and any person acting on behalf of the seller) reasonably believes is a QIB.

Title II: SEC Proposal

- On August 29, 2012, the SEC proposed amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act to implement Section 201(a) of the JOBS Act.
- Public comment period closed on October 5, 2012.
- The SEC's proposed rules implement a bifurcated approach to Rule 506 offerings.
 - As proposed, an issuer may still choose to conduct a private offering in reliance on Rule 506 without using general solicitation, thereby avoiding the enhanced verification requirement

Title II: SEC Proposal (cont'd)

- In order to implement this approach, the SEC proposed new paragraph (c) in Rule 506, which would permit the use of general solicitation, subject to the following conditions:
 - The issuer must take reasonable steps to verify that the purchasers of the securities are accredited investors;
 - All purchasers of securities must be accredited investors, either because they come within one of the enumerated categories of persons that qualify as accredited investors or the issuer reasonably believes that they qualify as accredited investors, at the time of the sale of the securities; and
 - The conditions of Rule 501 and Rules 502(a) and 502(d) are satisfied.

Title II: SEC Proposal (cont'd)

- “Reasonable efforts” to verify investor status may differ depending on the facts and circumstances, and the SEC provides the following non-exhaustive list of factors that may be appropriate to consider:
 - *The nature of the purchaser.* The SEC describes the different types of accredited investors, including broker-dealers, investment companies or business development companies, employee benefit plans, and wealthy individuals and charities.
 - *The nature and amount of information about the purchaser.* Simply put, the SEC states that “the more information an issuer has indicating that a prospective purchaser is an accredited investor, the fewer steps it would have to take, and vice versa.”
 - *The nature of the offering.* The nature of the offering may be relevant in determining the reasonableness of steps taken to verify status, *i.e.*, issuers may be required to take additional verification steps to the extent that solicitations are made broadly, such as through a website accessible to the general public, or through the use of social media or email. By contrast, less intrusive verification steps may be required to the extent that solicitations are directed at investors that are pre-screened by a reliable third party.

-

Title II: SEC Proposal (cont'd)

- The SEC confirmed the view that Congress did not intend to eliminate the existing “reasonable belief” standard in Rule 501(a) of the Securities Act or for Rule 506 offerings.
 - It confirmed that if a person were to supply false information to an issuer claiming status as an accredited investor, the issuer would not lose the ability to rely on the proposed Rule 506(c) exemption for that offering, provided the issuer “took reasonable steps to verify that the purchaser was an accredited investor and had a reasonable belief that such purchaser was an accredited investor.”
- The SEC also proposed to add a separate check box on Form D for issuers to indicate whether they are claiming an exemption under Rule 506(c).
- The SEC confirmed that privately offered funds can make a general solicitation under amended Rule 506 without losing the ability to rely on the exclusions from the definition of an “investment company” available under Section 3(c)(1) and 3(c)(7) of the Investment Company Act.

Title II: SEC Proposal (cont'd)

- In addition to the proposed changes to Rule 506, the SEC proposed to amend Rule 144A to eliminate references to “offer” and “offeree,” and thus require only that the securities are sold to a QIB or to a purchaser that the seller and any person acting on behalf of the seller reasonably believe is a QIB.
- Under this proposed amendment, resales of securities pursuant to Rule 144A could be conducted using general solicitation, so long as the purchasers are limited in this manner.

Resale Limitations

- Rule 502(d)
 - “The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters.”
- Reasonable care =
 - Reasonable inquiry of purchasers
 - Written disclosure to purchasers that resale is restricted
 - Legends

Disclosure Requirement

- None mandated for accredited investors or for Rule 504 transactions (< \$1 million)
 - Anti-fraud rules apply
- Mandated for non-accredited investors (Rule 502(b))
 - Generally, registration statement-like disclosure
 - Financial statement requirement varies based on size of transaction

New “Bad Actor” Disqualification

- On May 25, 2011, the SEC proposed amendments to rules promulgated under Regulation D to implement the Dodd-Frank Act Section 926’s provision regarding ‘bad actors’ for Regulation D.
- Unlike Rule 505 of Regulation D, Regulation E and Regulation A, Rule 506 of Regulation D does not currently have any “bad actor” disqualification provisions.
 - “Bad actor” disqualification requirements prohibit issuers and others, such as underwriters, placement agents, directors, officers, and shareholders of the issuer, from participating in exempt securities offerings, if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.
- Bad actor provisions expected to be finalized at or about the same time as the SEC finalizes rules relating to Rule 506 and Rule 144A.

Blue Sky Considerations

- Securities that are sold pursuant to Rule 506 are considered “covered securities” for purposes of Section 18(b)(4)(D) of the Securities Act
 - This means that securities sold in reliance on Rule 506 are exempt from state securities review
- An issuer that relies on Section 4(a)(2) will need to consider state securities requirements

Regulation D — Summary

| | Rule 504 | Rule 505 | Rule 506 |
|-------------------------------------|---|--|---|
| Aggregate Offering Price Limitation | \$1,000,000 (12 mos.) | \$5,000,000 (12 mos.) | Unlimited |
| Number of Investors | Unlimited | 35 plus unlimited accredited | 35 plus unlimited accredited |
| Investor Qualifications | None required | None required | Purchaser must be sophisticated (alone or with representative); accredited presumed to be qualified |
| Sales Commissions | Permitted | Permitted | Permitted |
| Limitations on Manner of Offering | Usually no general solicitation permitted | No general solicitation permitted | No general solicitation permitted currently, pending JOBS Act changes |
| Limitations on Resale | Usually restricted | Restricted | Restricted |
| Issuer Qualifications | No Exchange Act reporting "blank-check" or investment companies | No investment companies or issuers disqualified under Regulation A (except upon SEC determination) | None |
| Notice of Sales | 5 copies of form D to be filed with SEC within 15 days after first sale (called for by Regulation D, but not required for exemption). | | |
| Information Requirements | None | 1. If purchased solely by accredited investors, no information specified. | |

Regulation D — Summary (cont'd)

| | Rule 504 | Rule 505 | Rule 506 |
|--------------------------|----------|----------|--|
| Information Requirements | | | <p>2. If purchased by nonaccredited investors,</p> <ul style="list-style-type: none">a. nonreporting companies under the Exchange Act must furnish the same kind of information as in a registered offering, or in a Regulation A offering if eligible, but with somewhat modified financial statement requirements;b. reporting companies must furnish (i) specified Exchange Act documents or (ii) information contained in the most recent specified Exchange Act report or Securities Act registration statement on specific forms, plus, in any case, (iii) updating information and limited additional information about the offering.c. Issuers must make available prior to sale:<ul style="list-style-type: none">i. Exhibitsii. Written information given to accredited investors;iii. Opportunity to ask questions and receive answers;d. Issuers must advise purchasers of the limitations on resale. |

§ 4(a)(2) Remains Available

- The JOBS Act does not amend Section 4(a)(2); it only requires the SEC to amend Rule 506
- SEC Rel. No. 33-4552 (Nov. 6, 1962)
 - Relationship between offerees and issuer
 - Nature, scope, size and manner of offering
- ABA Federal Regulation of Securities Committee, Section 4(2) and Statutory Law, 31 Bus. Law. 485 (1975)
 - Offeree qualification
 - Availability of information
 - Manner of offering
 - Absence of redistribution

Integration

Integration

- Prevents circumvention of registration requirements by separating single non-exempt offering into several exempt offerings
- Six-month safe harbor – Rule 502(a)
- Proposed to be reduced to 90 days
- SEC's integration doctrine may apply to an offering that otherwise qualifies for an exemption under Regulation D

Integration – Five Factors Test

- Under SEC’s integration doctrine, the following factors (“five factors”) are considered in determining whether one sale of securities by an issuer will be integrated with (*i.e.*, treated as part of the same offering as) a prior or subsequent offer or sale of securities by the issuer:
 - Part of a single financing plan;
 - Issuances of the same class of securities;
 - Sales occur at or about the same time;
 - Same type of consideration is received; and
 - Proceeds will be used for same general purpose.

Integration – Safe Harbors

- Safe harbor for offshore offerings
 - Regulation S (“Reg S”) provides that offshore sales under Reg S generally are not integrated with offerings in the United States.
- Rule 152
 - Provides that the phrase “transactions by an issuer not involving any public offering” contained in Section 4(a)(2) of the Securities Act will be deemed to apply to transactions not involving any public offering at the time of the transactions although the issuer subsequently decides to make a public offering and/or files a registration statement.
 - **Practical application:** If a good private placement is either completed (or abandoned), the transaction will not be integrated with a later public offering of additional securities (or of the abandoned unsold securities), and the five-factor integration test need not be applied.

Integration — Safe Harbors (cont'd)

- Rule 155(b) – Private → Registered
 - Safe harbor for changing a private offering into a registered offering so long as
 - No securities are sold in the private offering,
 - All offering activity is terminated prior to filing the registration statement,
 - The prospectus for the public offering discloses certain information about the private offering. and
 - The registration statement is not filed until at least 30 days after the termination of all offering activity, unless the private offering was made only to accredited or sophisticated investors, in which case the issuer may file immediately after terminating the private offering.

Integration — Safe Harbors (cont'd)

- Rule 155(c) – Registered → Private
 - Safe harbor for abandoning a registered offering and conducting a private offering so long as
 - No securities are sold in the registered offering,
 - The issuer withdraws the registration statement,
 - The private offering does not commence until 30 days after withdrawal of the registration statement,
 - The issuer notifies the private offerees that (1) the offering is not registered, (2) the securities will be restricted, (3) protection under Section 11 of the Securities Act will not be afforded and (4) a registration statement was filed and withdrawn, and
 - The private offering materials disclose any material changes to the issuer's affairs that are material to the investment decision in the private offering.

Integration — No-Action Letters

- **Black Box and Squadron, Ellenoff SEC No-Action Letters**
 - **Facts:** Restructuring involving the following transactions to occur simultaneously:
 - Existing security holders to receive new securities in a private placement in exchange for existing securities,
 - New capital to be raised in a private placement of convertible debentures and
 - New capital to be raised in an initial public offering.
 - **Outcome:** The private placement with existing security holders and the private placement of the convertible debentures need not be integrated with the later public offering because
 - The existing security holders and investors would have entered into their respective agreements prior to the filing of the registration statement and
 - The private placements would be completed prior to the filing given that the obligations to acquire the securities would be subject only to the satisfaction of specified conditions outside of the control of the security holders and investors.

Integration — No-Action Letters (cont'd)

- **Policy**

- If the private placement of the convertible debentures was made only to qualified institutional buyers (“QIBs”) and three or four accredited investors, the private placement need not be integrated with the public offering even if it would not be completed at the time the registration statement was filed.
- If the private placement of the convertible debentures was terminated prior to completion and later there is a registered offering of the debentures based on Rule 152, the abandoned private placement would not be integrated with the public offering.
- The filing of a registration statement is deemed to be the commencement of the public offering.

- **Subsequent Clarifications**

- The SEC later clarified that the number of offerees and purchasers is a factor in evaluating the applicability of the policy and the policy is limited to situations involving QIBs and no more than two or three large institutional accredited investors.

Integration – SEC Interpretive Guidance

- See principally C&DI 139.25, which addresses a side-by-side private offering (under Section 4(a)(2) or Rule 506) with a registered public offering without having to limit the private offering to QIBs and a small number of large institutional accredited investors
- The focus is on how the investors in the private offering are solicited
 - Investors were not identified or contacted in connection with the public offering
 - Investors did not contact the issuer as a result of the general solicitation by means of the registration statement

Documentation

Private Placement Documentation

- Prospective Investor Questionnaire
- Subscription or Purchase Agreement
 - Purchaser Representations
 - Resale Restrictions
 - Legends
- May also include:
 - Registration Rights Agreement
 - Investor Rights Agreement
 - Stockholders' Agreement
 - Voting Agreement
 - Legal Opinion

Private Placement Documentation (cont'd)

- Disclosure Documents
 - Rule 144A style offering memorandum – quasi-prospectus
 - Private placement memorandum
 - Wrap around public disclosures
 - More detailed disclosure style

Practical Tips

- Just Say No to Non-accredited Investors
 - Disclosure
 - Litigation Risk
 - Shareholder Relations
- Disclosure Documents
 - No material omissions
 - Not marketing documents
 - 20/20 hindsight
 - Don't assume that the representations in the final documents will save you from exposure if you use aggressive marketing documents

Practical Tips (cont'd)

- Control of the Shareholder Base
 - Keep the number down and keep current contact information
 - Voting agreements
 - Protective provisions
 - Tripping threshold for Exchange Act reporting, as amended by the JOBS Act:
 - Total assets exceeding \$10m as of the last day of the company's fiscal year, and
 - A class of equity securities held of record by either (i) 2,000 persons, or (ii) 500 persons who are not accredited investors (for banks and bank holding companies, a class of equity securities held of record by 2,000 or more persons)
 - Holders of record excludes certain persons, including, for example, employees who received options in exempt transactions

Other Offering Exemptions

Small Offerings

- **§ 3(b) authorizes SEC to exempt offerings of < \$5 million during a 12-month period**
- **Implementing Rules**
 - Rule 504 of Reg. D (up to \$1 million)
 - Rule 505 of Reg. D (up to \$5 million)
 - Regulation A

Reg A Basics

- Eligible issuers - principal place of business in the United States or Canada, and not subject to Section 13 or Section 15 reporting before the offering and not disqualified
- Primary offerings or secondary offerings (subject to certain limitations)
- Bad actor disqualification
- Offering threshold – currently \$5m per 12-month period, or \$1.5m for selling stockholder (not aggregated with other exempt offerings)
- Requires filing of a Form 1-A Offering Statement and delivery of Offering Statement to investors
- Integration safe harbors – not integrated with subsequent Reg S offerings or 701 offerings or completed exempt offerings (Section 4(a)(2) or Reg D). Other than the safe harbor, one would consider the same five-factor test.

Reg A Basics (cont'd)

- Currently, Regulation A allows for an offering of up to \$5 million of securities of an issuer including up to \$1.5 million of securities offered by selling security holders in any 12-month period.
- Requires filing of a Form 1-A Offering Statement and delivery of Offering Circular to investors.
- Offering communications - under Reg A, an issuer may “test the waters”
- Nature of the securities - the securities sold in reliance on Reg A are not “restricted securities”
- Blue sky
- Liability

Title IV: Offering Exemption

- Title IV of the JOBS Act establishes a new offering exemption similar to Regulation A, the Section 3(b)(2) exemption.
- Under the exemption, an issuer will be able to offer and sell up to \$50 million in securities within a 12-month period without Securities Act registration. The issuer may offer equity securities, debt securities, and debt securities convertible or exchangeable for equity interests, including any guarantees of such securities.
- The SEC Staff is working on proposed rules, although there is no deadline in the JOBS Act for these rules.

Intrastate Offerings

- § 3(a)(11) exempts securities offered and sold only to persons resident in a single state by an issuer incorporated in and doing business in that state
- Rule 147 Safe Harbor
- Practical limitations
 - Strict compliance required
 - Resales limited to state residents until securities come to rest (Rule 147 = 9 mos.)

Rule 701

- Exemption for compensatory issuances by private companies to directors, employees, consultants and advisors
- In any 12-month period, not more than greatest of:
 - \$1 million
 - 15% of total assets
 - 15% of class
- Disclosure required:
 - Written plan or contract
 - Additional disclosure if > \$5 million sold in any 12-month period
- No integration
- Restricted securities but may be resold 90 days after IPO by non-affiliates

Other Registration Exemptions

- Rule 144A
 - Exempts resales of privately placed securities to QIBs
- Regulation S (Rules 901-905)
 - Safe harbor exemption for offshore transactions
- § 3(a)(10)
 - Exemption for securities issued in complete or partial exchange for outstanding securities where the terms of the issuance and exchange are approved in a state fairness hearing
 - Practical alternative to private placement exemption in M&A context

Crowdfunding

- Crowdfunding permits entrepreneur to pool money from individuals who have a common interest and are willing to contribute to a venture
- Crowdfunding may or may not involve the sale of securities
- To the extent the effort involves the sale of securities then the offering must be registered or must rely on an exemption
- A recent enforcement action highlighted this issue

Title III: Crowdfunding

- Title III of the JOBS Act addresses “crowdfunding,” which involves seeking funding over the Internet from a potentially large group of investors putting up relatively small amounts.
- Given the difficulty in relying on existing exemptions from registration for crowdfunding efforts involving the offer and sale of securities, the JOBS Act amended Section 4(a) of the 1933 Act to add a new paragraph (6), which provides a new crowdfunding exemption from SEC registration, as well as preemption from state Blue Sky laws.
- The SEC is required to adopt rules implementing the crowdfunding exemption by December 31, 2012, and the SEC Staff has indicated that they are currently working on rule proposals.