Business Transactions Solutions § 151:76

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Alan S. Gutterman*
Part VI. Finance
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SEC Regulation D,[1] which is a series of seven rules, is intended to integrate and liberalize the exemptions from registration and to achieve uniformity between federal and state exemptions in order to facilitate capital formation, particularly in small businesses.

The Section 4(a)(5) exemption[2] is available for offers or sales by an issuer solely to one or more accredited investors (§ 151:79) if the aggregate offering price does not exceed the limit of Section 3(b) and there is no advertising or public solicitation in connection with the transaction. Although there are no disclosure requirements for an offering under Section 4(5), the antifraud rules of the federal securities laws will apply. The definition of accredited investors (§ 151:79) for purposes of Section 4(a)(5) conforms to the definition for Regulation D and the reporting requirements on Form D (§ 151:82) are the same as those applicable to Regulation D exemptions.

Section 4(a)(6)[3] (§ 151:78) was added to the Securities Act as one of the most publicized, and controversial, elements of the "Jumpstart Our Business Startups Act" ("JOBS Act"), which went into effect on April 5, 2012 as Public Law 112-106. Referred to as the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012," or "CROWDFUND Act," Section 4(a)(6) allows issuers to raise up to $1,000,000 from potentially large numbers of small investors provided that extensive disclosure and reporting obligations are satisfied.

Footnotes

[*] Alan S. Gutterman is the founder and director of the Business Counselor Institute (www.businesscounselorinstitute.org) and the Growth-Oriented Entrepreneurship Project (www.growthentrepreneurship.org). He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University and a Ph.D. in Law from the University of Cambridge in the United Kingdom. For more information about Alan, see https://www.linkedin.com/in/alangutterman and/or contact him at alangutterman@gmail.com.

[1] 17 C.F.R. §§ 230.501 et seq.

[2] 15 U.S.C.A. § 77d(a)(5).

[3] 15 U.S.C.A. § 77d(a)(6).

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Rule 504 (17 C.F.R. § 230.504). The provisions of Rule 504 are available to any private companies exclusive of investment companies and blind pool companies with no specific plan of business or purpose. The maximum amount that can be raised under Rule 504 is $5 million, less the aggregate offering price for all securities sold within the 12 months before the start of and during the offering of securities under Rule 504, or in reliance on any exemption under § 3(b), or in violation of the registration requirements (§ 151:36). If a transaction under Rule 504 fails to meet the limitation on the aggregate offering price, it does not affect the availability of this Rule 504 for the other transactions considered in applying such limitation. For example, if an issuer sold $5,000,000 worth of its securities on January 1 under Rule 504 and an additional $500,000 worth on July 1 of the same year, Rule 504 would not be available for the later sale, but would still be applicable to the January 1 sale.

To qualify for the exemption under Rule 504, offers and sales must satisfy the terms and conditions of 17 C.F.R. § 230.501 (definitions) and 17 C.F.R. § 230.502(a) (integration), 17 C.F.R. § 230.502(c) (limitation on manner of offering), and 17 C.F.R. § 230.502(d) (limitations on resale), except that the provisions of § 230.502 (c) and (d) will not apply to offers and sales of securities under Rule 504 that are made:

> (i) Exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions;
>
> (ii) In one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing, and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or
>
> (iii) Exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to accredited investors. (17 C.F.R. § 230.504(b)(1))

Thus, if one of these exceptions is satisfied, the offering under Rule 504 need not be limited and may be made to the public at large with general solicitation and general advertising in the media, newspapers, over radio and television, and in seminars and meetings. (17 C.F.R. § 230.504(b)) There would also be no requirement that there be any restrictions placed on the securities as to the resale, which means that the certificates need not bear a legend stating any restriction on resale, no transfer agent instructions must be issued restricting resale of the shares, and that the shares purchased by the investors in the offering may generally be freely resold without registration. (17 C.F.R. § 230.504(b)) In effect, Rule 504 becomes, in these circumstances, a limited public offering of securities without the need to incur the expense of a formal registration. Moreover, there is no requirement under Rule 504 that any particular information such as a private placement memorandum be furnished to the investor.

In spite of its apparent flexibility, Rule 504 is rarely relied on as the exemption for a private placement transaction involving venture capitalists and other sophisticated investors. In addition, Rule 504 is only an exemption from federal law and whether such an offering will be lawful depends on the applicable securities laws of the states in which the offering occurs. In that regard, notice should be taken that in approximately 45 states a Rule 504 public offering may be combined with a Small Corporate Offering Registration ("SCOR") procedure, which uses Form U-7, a question and answer disclosure document. Information regarding SCOR requirements, including model documents, can be obtained from the website of the North American Securities Administrators Association.

Rule 506 (17 C.F.R. § 230.506). Rule 506 exempts from registration offers and sales to an unlimited number of accredited investors (§ 151:79) and no more than 35 nonaccredited investors; however, each nonaccredited investor must, either alone or with his or her purchasing representative, have the knowledge and experience in financial and business matters that he or she 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 comes within this description. There is no limit on the aggregate offering price of the securities that may be offered and sold under Rule 506 and Rule 506 may be utilized for an offering by all issuers except investment companies or issuers disqualified because of certain prior conduct of persons who are either affiliated with the issuer or with a party which is receiving commissions in connection with the offering. The disqualifications, referred to as "bad boy" provisions, are identical to those applicable to the use of Regulation A (see § 151:79) and are more specifically described in Rule 506(d) (17 C.F.R. § 230.506(d)), which is discussed in more detail below. The prohibition against "general solicitation" or "general advertising" in Rule 502(c) of Regulation D does not apply to offers and sales of securities made pursuant to Rule 506, provided that all purchasers of the securities are accredited investors. If the issuer sells securities under Rule 506 to any purchaser who is not an accredited investor, the issuer must furnish specified information to each such purchaser at a reasonable time prior to sale. The content of the required information will vary depending upon whether the issuer is subject to the reporting requirements of the Exchange Act and, if the issuer is not subject to such requirements, the aggregate offering amount of the securities involved. These requirements are discussed in detail in Offering and Disclosure Documents (§§ 152:71 et seq.). The issuer is not required to furnish any information to accredited investors; however, when an issuer provides information to nonaccredited investors in a Rule 506 offering, it should consider providing the same information to accredited investors as well in view of the antifraud provisions of the federal securities laws.

Rule 506 is often used by growing companies raising large amounts of capital from sophisticated investors, including venture capitalists. Rule 506 may also be used by public companies that are raising funds in a private placement to avoid the expense and delay of registering the securities under the Securities Act of 1933. In each case, however, it is important for the issuer to consider that offerings made solely to a group of accredited investors must nonetheless be accompanied by full, fair and complete disclosure of all "material" facts about the offering and the issuer, its management, business, operations and finances. This requirement applies even when there is no separate obligation under Regulation D to provide specific information to investors.

Rule 506, like the exemption for private offerings under § 4(a)(2) of the Securities Act of 1933 (see § 31:48), will be available only if the investor group is limited to accredited investors and a limited group of nonaccredited investors meeting somewhat subjective standards of knowledge and experience. Accordingly, it is important for the issuer to maintain clear and complete records of the scope of the solicitation, including a ledger that tracks the dissemination of offering materials. Offering materials should be numbered in order to facilitate the maintenance of adequate records and any offering memorandum should clearly restrict the ability of recipients to copy the materials or pass them on to others without the permission of the issuer.

Issuers interested in taking advantage of Rule 506 should be aware of Rule 506(c), which provides that the prohibition against general solicitation and general advertising contained in Rule 502(c) does not apply to offerings of securities made pursuant to such Rule 506(c) provided that all purchasers of securities sold in any offering thereunder are accredited investors; the issuer meets all terms and conditions of Rule 501 (the definitional part of Regulation D), Rule 502(a) (the Regulation D integration rules), and Rule 502(d) (which provides that securities sold under Regulation D are restricted securities under the Securities Act and thus cannot be resold without registration under the Securities Act or the availability of an exemption from the registration requirements); and the issuer takes reasonable steps to verify that purchasers of securities sold in such offering are indeed accredited investors. See SEC Release No. 33-9415; No. 34-69959; No. IA-3624; File No. S7-07-12.

Rule 506(c) provides that an issuer shall be deemed to take reasonable steps to verify the accredited investor status of purchaser who is a natural person if the issuer uses, at its option, one of the following nonexclusive and nonmandatory verification methods as long as the issuer does not have knowledge that such person is not an accredited investor:

(A) In regard to whether the purchaser is an accredited investor on the basis of income, reviewing any Internal Revenue Service form that reports the purchaser's income for the two most recent years (including, but not limited to, Form W-2, Form 1099, Schedule K-1 to Form 1065, and Form 1040) and obtaining a written representation from the purchaser that he or she has a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year;

(B) In regard to whether the purchaser is an accredited investor on the basis of net worth, reviewing one or more of the following types of documentation dated within the prior three months and obtaining a written representation from the purchaser that all liabilities necessary to make a determination of net worth have been disclosed: (1) with respect to assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and appraisal reports issued by independent third parties; and (2) with respect to liabilities: a consumer report from at least one of the nationwide consumer reporting agencies;

(C) Obtaining a written confirmation from one of the following persons or entities that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor: (1) a registered broker-dealer; (2) An investment adviser registered with the SEC; (3) a licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or (4) a certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office; or

(D) In regard to any person who purchased securities in an issuer's Rule 506(b) offering as an accredited investor prior to the effective date of Rule 506(c) and continues to hold such securities, for the same issuer's Rule 506(c) offering, obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor.

The instructions to Rule 506(c) provide that issuers are not required to use any of the methods described in the Rule in verifying the accredited investor status of natural persons who are purchasers and that the described methods are merely examples of the types of nonexclusive and nonmandatory methods that satisfy the verification requirement. In situations where a person qualifies as an accredited investor based on joint income with that person's spouse, the issuer would be deemed to satisfy the verification requirement by reviewing copies of Internal Revenue Service forms that report income for the two most recent years in regard to, and obtaining written representations from, both the person and the spouse. Finally, in the case of a person who qualifies as an accredited investor based on joint net worth with that person's spouse, the issuer would be deemed to satisfy the verification requirement by reviewing such documentation in regard to, and obtaining written representations from, both the person and the spouse.

Commentators have noted that the easing of the general solicitation and general advertising prohibitions for Rule 506 offerings through the adoption of Rule 506(c), which became effective in 2013, was an important change. Rule 506 already had no cap on the amount of capital that could be raised and was available to both public and private companies without the need to comply with specific disclosure requirements for offers and sales solely to accredited investors (although issuers must still comply with the anti-fraud rules included in the federal securities laws). Accordingly, it is not surprising that Rule 506 was already a popular method for raising capital; however, one of the problems had been that the prohibitions on general solicitation often made issuers reluctant to try and reach out beyond accredited investors that already had a pre-existing relationship with them to generate interest in a Rule 506 offering. It is anticipated that the implementation of Rule 506(c) will increase the pool of capital available through Rule 506 by allowing issuers to expand their search efforts, using both traditional and social media outlets, without fear that they might run afoul of solicitation and advertising limitations. For example, issuers may now discuss their business activities at investment conferences without worrying about whether or not they are violating the general solicitation ban. However, it is expected that certain issuers may still be reluctant to engage in explicit advertising activities due to concerns that they may appear to be desperate and the additional recordkeeping and verification requirements. Significantly the SEC did not choose to specifically regulate the form and content of advertising that issuers may use under Rule 506(c), although general anti-fraud prohibitions would certainly apply.

Interestingly, the previously existing version of Rule 506 was preserved as a separate exemption (Rule 506(b)) when Rule 506(c) became effective, which means that there are actually two related exemptions under Rule 506: one for offerings under new Rule 506(c) that employ general solicitation and general advertising, and one for offerings under Rule 506(b) that do not use such general solicitation or general advertising. Since each of the Rule 506 exemptions depend, in different ways, on

verifying accredited investor status it is important for the issuer to maintain clear and complete records of the scope of the solicitation, including a ledger that tracks the dissemination of offering materials. Offering materials should be numbered in order to facilitate the maintenance of adequate records and any offering memorandum should clearly restrict the ability of recipients to copy the materials or pass them on to others without the permission of the issuer.

Notice should also be taken of Rules 506(d) and (e) which were adopted by the SEC with an effective date of September 23, 2013 (the "Rule 506(d) Effective Date") to implement Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 926 required the SEC to adopt rules that disqualified securities offerings involving certain "felons and other 'bad actors' " from reliance on Rule 506. (See Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, SEC Release No. 33-9414 (July 10, 2013)) The rules were drafted to be "substantially similar" to Rule 262 under the Securities Act, which contains the disqualification provisions of Regulation A under the Securities Act (see § 151:87), and also cover matters enumerated in Section 926 of the Dodd-Frank Act (including certain state regulatory orders and bars). See 17 C.F.R. § 230.506(d) and (e). In general, Rule 506(d) disqualifies an offering from relying on either Rule 506(b) or Rule 506(c) if the issuer or any other person covered by Rule 506(d) (referred to herein collectively as the "Covered Persons") has a relevant criminal conviction, regulatory or court order or other disqualifying event (referred to herein collectively as the "Disqualifying Events") that occurred on or after the Rule 506(d) Effective Date. Under Rule 506(e), for disqualifying events that occurred before the Rule 506(d) Effective Date, issuers may still rely on Rule 506, but must comply with the disclosure provisions of Rule 506(e) discussed below.

A guide to compliance with the "bad actor" rule issued by the SEC (see: http://www.sec.gov/info/smallbus/secg/bad-actor-small-entity-compliance-guide.htm) is a helpful resource and serves as the basis for the following summary of the provisions of Rule 506(d). First of all, understanding the categories of persons that falls within Covered Persons for purposes of Rule 506(d) is important because issuers are required to conduct a factual inquiry to determine whether any Covered Person has had a Disqualifying Event (see below), and the existence of such an event will either disqualify the offering from reliance on Rule 506 or will have to be disclosed to investors. In general, Covered Persons include the issuer, including its predecessors and affiliated issuers; directors, general partners, and managing members of the issuer; executive officers of the issuer, and other officers of the issuers that participate in the offering; 20% beneficial owners of the issuer, calculated on the basis of total voting power; promoters connected to the issuer; for pooled investment fund issuers, the fund's investment manager and its principals; and persons compensated for soliciting investors, including their directors, general partners and managing members.

Disqualifying Events for purposes of Rule 506(d) include certain criminal convictions; certain court injunctions and restraining orders; final orders of certain state and federal regulators; certain SEC disciplinary orders; certain SEC cease-and-desist orders; SEC stop orders and orders suspending the Regulation A exemption; suspension or expulsion from membership in a self-regulatory organization (SRO), such as FINRA, or from association with an SRO member; and U.S. Postal Service false representation orders. Many disqualifying events include a look-back period (e.g., a court injunction that was issued within the last five years or a regulatory order that was issued within the last ten years). The look-back period is measured from the date of the disqualifying event—in the example, the issuance of the injunction or regulatory order—and not the date of the underlying conduct that led to the disqualifying event.

Rule 506(d) does provide an exception from disqualification when the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. The steps an issuer should take to exercise reasonable care will vary according to particular facts and circumstances and the Instruction to the Rule states that an issuer will not be able to establish that it has exercised reasonable care unless it has made, in light of the circumstances, factual inquiry into whether any disqualification exists. If all else fails, issuers may seek waivers from disqualification by the SEC based either on good cause shown or a determination by a court or regulatory authority as to whether disqualification under Rule 506 should arise as a consequence of an order, judgment or decree issued by such court or authority.

Disqualification will not arise as a result of disqualifying events that occurred before the Rule 506(d) Effective Date. Matters that existed before the Rule 506(d) Effective Date and would otherwise be disqualifying are, however, required to be disclosed in writing to investors. Issuers must furnish this written description to purchasers a reasonable time before the Rule 506 sale. Rule 506 is unavailable to an issuer that fails to provide the required disclosure, unless the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event was

required to be disclosed. The SEC expects that issuers will give reasonable prominence to the disclosure to ensure that information about pre-existing bad actor events is appropriately presented in the total mix of information available to investors. Changes were made to Form D to require that each notice on Form D claiming reliance on Rule 506 must include an explicit issuer certification that the offering is not disqualified by application of the provisions of Rule 506(d).

It is important to emphasize that the disqualification, disclosure and certification requirements in Rules 506(d) and (e) apply to all Rule 506 offerings (i.e., both Rule 506(b) and Rule 506(c) offerings) and that their provisions are broader in several respects than Rule 262 and will require that issuers review and revise their tools and techniques for ensuring compliance and make sure that any potential Disqualifying Event is discovered before a sale has occurred and steps are taken to seek a waiver or change relationships so that a party associated with a Disqualifying Event is not deemed to be a Covered Person. For example, questionnaires for directors, officers, principal shareholders and others circulated during the offering process will need to be revised to include questions that track the Covered Persons and Disqualifying Events described above and inquiries will also need to be made of persons participating in the offering who are not directors, officers or principal shareholders. See Specialty Form at § 151:156. In addition, responses to the questionnaires should be verified through third-party search services (i.e., "background checks") to compare the responses and identify/reconcile any discrepancies. Finally, further due diligence will be needed with respect to various categories of organizational Covered Persons to determine who within such organizations have the requisite power and authority in relation to the offering to be deemed Covered Persons in their own right. Additional steps may be taken and the overall goal is to be sure that even if a Disqualifying Event with respect to a Covered Person is not uncovered the issuer is appropriate situated to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a disqualifying event was required to be disclosed.

Footnotes

* Alan S. Gutterman is the founder and director of the Business Counselor Institute (www.businesscounselorinstitute.org) and the Growth-Oriented Entrepreneurship Project (www.growthentrepreneurship.org). He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University and a Ph.D. in Law from the University of Cambridge in the United Kingdom. For more information about Alan, see https://www.linkedin.com/in/alangutterman and/or contact him at alangutterman@gmail.com.

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References

Extensive changes were made in the regulatory framework for financing of emerging growth companies when the President signed the "Jumpstart Our Business Startups Act" ("JOBS Act") into law on April 5, 2012, as Public Law 112-106. One of the most publicized, and controversial, elements of the JOBS Act was the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012", or "CROWDFUND Act", which added a new § 4(a)(6) to the Securities Act (15 U.S.C.A. 77d(a)(6)) that exempts from registration under the Securities Act transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer), provided that:

- The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the § 4(a)(6) exemption during the 12-month period preceding the date of such transaction, is not more than $1million;
- The aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the § 4(a)(6) exemption during the 12-month period preceding the date of such transaction, does not exceed: (i) the greater of $2,000 or 5% of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; and (ii) 10% of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000;
- The transaction is conducted through a broker or funding portal that complies with the requirements on intermediaries set forth in § 4A of the Securities Act, which are described below; and
- The issuer complies with the requirements imposed on issuers under § 4A of the Securities Act, which are described below.

The requirements on intermediaries referred to above are set forth in § 4A(a) of the Securities Act, which provides that a person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others pursuant to § 4(a)(6) of the Securities Act shall:

- Register with the SEC as a broker or a funding portal (as defined in Exchange Act § 3(a)(80), which is discussed below);
- Register with any applicable self-regulatory organization (as defined in Exchange Act § 3(a)(26)) (i.e., FINRA);
- Provide such disclosures, including disclosures related to risks and other investor education materials, as the SEC shall, by rule, determine appropriate;
- Ensure that each investor: (A) reviews investor-education information, in accordance with standards established by the SEC; (B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and (C) answers questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers; an understanding of the risk of illiquidity; and an understanding of such other matters as the SEC determines appropriate, by rule;
- Take such measures to reduce the risk of fraud with respect to such transactions, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20% of the

outstanding equity of every issuer whose securities are offered by such person;
• Not later than 21 days prior to the first day on which securities are sold to any investor (or such other period as the SEC may establish), make available to the SEC and to potential investors any information provided by the issuer pursuant to § 4A(b) of the Securities Act, which is described below;
• Ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest, as the SEC shall, by rule, determine appropriate;
• Make such efforts as the SEC determines appropriate, by rule, to ensure that no investor in a 12-month period has purchased securities offered pursuant to § 4(a)(6) that, in the aggregate, from all issuers, exceed the investment limits set forth in § 4(a)(6)(B);
• Take such steps to protect the privacy of information collected from investors as the SEC shall, by rule, determine appropriate;
• Not compensate promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor;
• Prohibit its directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services; and
• Meet such other requirements as the SEC may, by rule, prescribe, for the protection of investors and in the public interest.

The term "funding portal" is defined as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to § 4(a)(6), that does not:
• Offer investment advice or recommendations;
• Solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
• Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
• Hold, manage, possess, or otherwise handle investor funds or securities; or
• Engage in such other activities as the SEC, by rule, determines appropriate. (15 U.S.C.A. § 78c(a)(80)).

The requirements on issuers referred to above are set forth in § 4A(b) of the Securities Act, which provides that for purposes of § 4(a)(6) of the Securities Act, an issuer who offers or sells securities shall:
(1) File with the SEC and provide to investors and the relevant broker or funding portal, and make available to potential investors:
• The name, legal status, physical address, and website address of the issuer;
• The names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20% of the shares of the issuer;
• A description of the business of the issuer and the anticipated business plan of the issuer;
• A description of the financial condition of the issuer, including, for offerings that, together with all other offerings of the issuer under § 4(6) within the preceding 12-month period, have, in the aggregate, target offering amounts of: (i) $100,000 or less: (I) the income tax returns filed by the issuer for the most recently completed year (if any); and (II) financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects; (ii) more than $100,000, but not more than $500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the SEC, by rule, for such purpose; and (iii) more than $500,000 (or such other amount as the SEC may establish, by rule), audited financial statements;
• A description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
• The target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount;
• The price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor shall be provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;
• A description of the ownership and capital structure of the issuer, including: (i) terms of the securities of the issuer being offered and each other class of security of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including how the rights of the securities being offered may be materially

limited, diluted, or qualified by the rights of any other class of security of the issuer; (ii) a description of how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered; (iii) the name and ownership level of each existing shareholder who owns more than 20% of any class of the securities of the issuer; (iv) how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions; and (v) the risks to purchasers of the securities relating to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties; and

• Such other information as the SEC may, by rule, prescribe, for the protection of investors and in the public interest;

(2) Not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker;

(3) Not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking such steps as the SEC shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospective, of such compensation, upon each instance of such promotional communication;

(4) Not less than annually, file with the SEC and provide to investors reports of the results of operations and financial statements of the issuer, as the Commission shall, by rule, determine appropriate, subject to such exceptions and termination dates as the Commission may establish, by rule; and

(5) Comply with such other requirements as the SEC may, by rule, prescribe, for the protection of investors and in the public interest.

Section 4A(c) of the Securities Act provides for liability for material misstatements and omissions made during the course of an offering under § 4(a)(6). Section 4A(e) provides that securities issued pursuant to § 4(a)(6) will be "restricted securities" and thus may not be transferred by the purchaser of such securities during the one-year period beginning on the date of purchase, unless such securities are transferred to the issuer of the securities; to an accredited investor; as part of an offering registered with the SEC; or to a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the SEC. According to § 4A(f) of the Securities Act, § 4(a)(6) shall not apply to transactions involving the offer or sale of securities by certain types of issuers including issuers that are subject to the reporting requirements of the Exchange Act.

The SEC rules for the "crowdfunding" initiative are set out in 17 C.F.R. Part 227, titled "Regulation Crowdfunding, General Rules and Regulations" and include the crowdfunding exemption and requirements (17 C.F.R. 227.100), requirements for issuers (17 C.F.R. 227.201 et seq.), requirements for intermediaries (17 C.F.R. 227.300 et seq.), funding portal regulations (17 C.F.R. 227.400 et seq.) and miscellaneous provisions relating to topics such as restrictions on resales and disqualification provisions (17 C.F.R. 227.501 et seq.). With respect to the requirements for issuers, 17 C.F.R. 227.201 et seq. addresses disclosure requirements, ongoing reporting requirements, filing requirements and form, advertising and promoter compensation. The rules:

• Permit a company to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period; and

• Permit individual investors, over a 12-month period, to invest in the aggregate across all crowdfunding offerings up to:

○ If either their annual income or net worth is less than $100,000, than the greater of $2,000 or five percent of the lesser of their annual income or net worth.

○ If both their annual income and net worth are equal to or more than $100,000, 10 percent of the lesser of their annual income or net worth; and

• During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed $100,000.

All transactions relying on the rules must take place through an SEC-registered intermediary, either a broker-dealer or a funding portal. The rules include detailed requirements for funding portals, which must be prepared to register with the SEC on "Form Funding Portal" and become a member of a national securities association (i.e., FINRA).

Companies relying on the rules are required to conduct their offerings exclusively through one intermediary platform at a time and must be "eligible" to use the exemption. Under the rules, ineligible companies include non-U.S. companies, Exchange Act reporting companies, certain investment companies, companies that are subject to disqualification under

Regulation Crowdfunding, companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement, and companies that have no specific business plan or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Importantly for companies eligible to seek crowdfunding under the exemption, they must be prepared to file certain information with the SEC on Form C and provide this information to investors and the intermediary facilitating the offering, including among other things, information that discloses:

- The price to the public of the securities or the method for determining the price, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount;
- A discussion of the company's financial condition;
- Financial statements of the company that, depending on the amount offered and sold during a 12-month period, are accompanied by information from the company's tax returns, reviewed by an independent public accountant, or audited by an independent auditor. A company offering more than $500,000 but not more than $1 million of securities relying on these rules for the first time would be permitted to provide reviewed rather than audited financial statements, unless financial statements of the company are available that have been audited by an independent auditor;
- A description of the business and the use of proceeds from the offering;
- Information about officers and directors as well as owners of 20 percent or more of the company; and
- Certain related-party transactions.

In addition, companies relying on the crowdfunding exemption would be required to file an annual report with the SEC and provide it to investors.

Securities purchased in a crowdfunding transaction generally cannot be resold for one year. Holders of these securities would not count toward the threshold that requires a company to register its securities under Exchange Act Section 12(g) Act (§ 151:37) if the company is current in its annual reporting obligations, retains the services of a registered transfer agent and has less than $25 million in total assets as of the end of its most recently completed fiscal year. In addition, securities issued under § 4(a)(6) will be considered to be "covered securities" for purposes of the National Securities Markets Improvements Act (§ 151:91), thus exempting such securities from state securities law registration requirements.

While "crowdfunding" has received a large amount of media attention, it remains to be seen whether or not it becomes a practical alternative for issuers given that they are limited to $1 million in 12 months; investors are limited to small amounts; transactions must be conducted through a regulated intermediary—either a registered broker or a registered funding portal; and they are subject to significant disclosure, financial information and reporting requirements and restrictions on outside advertising. Rule 504 (§ 151:78) already allows issuers to raise up to $5 million from an unlimited number of investors; however, it is rarely used because Rule 504 offerings are still subject to regulation under state securities laws. Information regarding Regulation Crowdfunding, including the new forms, is available on the SEC website.

Footnotes

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§ 151:79. Investor qualifications

References

Sales may be made under Rule 506 (17 C.F.R. § 230.506) (§ 151:77) to unaccredited investors acting with the assistance of a purchaser representative as defined by Rule 501(h). A "purchaser representative"[1] is defined as any person who satisfies all of the following conditions or who the issuer reasonably believes satisfies all of the following conditions:

(i) Is not an affiliate, director, officer, or other employee of the issuer, or beneficial owner of 10% or more of any class of the equity securities or 10% or more of the equity interest in the issuer, except where the purchaser is:

• A relative of the purchaser representative by blood, marriage, or adoption and not more remote than a first cousin;

• A trust or estate in which the purchaser representative and any persons related to him or her or collectively have more than 50% of the beneficial interest (excluding contingent interest) or of which the purchaser representative serves as a trustee, executor, or in any similar capacity;

• A corporation or other organization of which the purchaser representative and any persons related to him or her collectively are the beneficial owners of more than 50% of the equity securities (excluding directors' qualifying shares) or equity interest;

(ii) Has such knowledge and experience in financial and business matters that he or she is capable of evaluating, alone, or together with other purchaser representatives of the purchaser or together with the purchasers, the merits and risks of the prospective investment;

(iii) Is acknowledged by the purchaser, in writing, during the course of the transaction, to be his or her purchaser representative in connection with evaluating the merits and risks of the prospective investment; and

(iv) Discloses to the purchaser in writing a reasonable time prior to the sale of securities to that purchaser any material relationship between himself or herself or his or her affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

The concept of an accredited investor plays an important role in the following contexts with regard to the exemptions under Regulation D and Section 4(a)(5):

(i) Purchasers who are accredited investors are not counted for determining the thirty-five purchaser limitations of Rule 506 (17 C.F.R. § 230.506) (§ 151:77).

(ii) A disclosure document does not have to be delivered to an accredited investor. Accordingly, in an offering made entirely to accredited investors, no disclosure document has to be used.

(iii) If written information is furnished to accredited investors which are not also furnished to nonaccredited investors, the nonaccredited investors must be advised of this fact and upon request must be furnished the same information.

(iv) Section 4(5) offerings can only be made to accredited investors.

Rule 501(a) defines an "accredited investor" as any person falling within specified categories, or who the issuer reasonably believes comes within one of the specified categories, at the time of the sale.[2] Accredited investors are presumed to meet purchaser sophistication and experience requirements that may have existed under prior law without the need for the issuer to

make subjective judgments regarding their suitability. Among the categories included are the following:

- Institutional investors of various types;
- Certain persons in a management capacity with respect to the issuer;
- Any natural persons meeting specified income and net worth standards; and
- Entities in which all of the equity owners are accredited.

Rule 501(e)(1) provides[3] that a relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser, and trusts, estates, corporations and other organizations in which the purchaser and such related persons own collectively more than 50% of the beneficial (equity) interest are deemed one person in determining the thirty-five person limitation for purposes of Rule 506 (17 C.F.R. § 230.506) (§ 151:77).

Rule 501(e)(2) provides[4] that a corporation, partnership or other entity is counted as one purchaser for purposes of Rule 506 (17 C.F.R. § 230.506) (§ 151:77) unless it is organized for the specific purpose of acquiring the securities being offered in which event each beneficial owner of securities of the entity is counted. The SEC has indicated that no one factor will determine whether an entity should be regarded as organized for the specific purpose of making an investment.[5] Significant factors include:

- The existence and nature of prior activities by the entity;
- The structure of the entity (i.e., whether the entity has centralized management and decision making);
- The proposed activities of the entity;
- The relationship between the entity's investment in the Regulation D offering;
- The entity's capitalization; and
- The extent to which all equity owners of the entity participate in all investments by the entity.

If a corporation or other entity is not considered a single purchaser because it was formed for the purpose of buying the securities, the provisions of Rule 501(e)(1) excluding certain purchasers, such as a spouse of a purchaser, are applicable in determining the number of purchasers represented by the shareholders (or other interest owners) in the entity.[6]

Rule 501(e)(3) provides that a noncontributory employee benefit plan that is subject to ERISA shall be counted as a single purchaser if the trustee makes all of the investment decisions for the plan.[7]

Footnotes

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1 17 C.F.R. § 230.501(h).

2 17 C.F.R. § 230.501(a).

3 17 C.F.R. § 230.501(e)(1).

4 17 C.F.R. § 230.501(e)(2).

5 Hall Moneytree Associates Limited Partnership, SEC No-Action Letter, 1983 WL 29899 (Nov. 3, 1983).

6 17 C.F.R. § 230.501(e)(2).

7 17 C.F.R. § 230.501(e)(3).

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§ 151:80. Disclosure requirements

References

Pursuant to Rule 502(b)(1), no specific information is required to be furnished for offers and sales effected pursuant to Rule 504 (§ 151:77), or for offers and sales effected in reliance on Rule 506 (17 C.F.R. § 230.506) (§ 151:77) which are made only to accredited investors (§ 151:79). However, if a Rule 504 offering amounts to a public offering consideration must be given to the applicable securities laws of the states in which the offering occurs and it may be necessary and appropriate to rely on a Small Corporate Offering Registration ("SCOR") procedure, which is recognized in approximately 45 states and uses Form U-7, a question and answer disclosure document. Information regarding SCOR requirements, including model documents, can be obtained from the website of the North American Securities Administrators Association at http://www.nasaa.org/.

If a Rule 506 (17 C.F.R. § 230.506) (§ 151:77) offering involves any nonaccredited investors, the issuer is required to furnish them with specified information, although an issuer should consider providing the prescribed information to accredited investors (§ 151:79) as well, in view of the antifraud provisions of the federal securities law.

The prescribed information that must be furnished to nonaccredited investors in a Rule 506 (17 C.F.R. § 230.506) (§ 151:77) offering depends upon whether or not the issuer is a reporting company and, if the issuer is not a reporting company, the aggregate offering amount of the securities involved. These requirements are discussed in detail in Offering Documents and Business Plans (§§ 152:71 et seq.).

For offerings under Section 4(6) of the Securities Act issuers must file with the SEC, and provide to potential investors and the relevant broker or funding portal, certain specified information regarding the issuer, its directors and officers, its ownership structure, its business and financial condition and the stated purpose and intended use of the proceeds of the offering. For further discussion of specific disclosure requirements for Section 4(6) offerings, see § 151:78.

Footnotes

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§ 151:81. Resale restrictions

References

Securities issued pursuant to Rule 504 (§ 151:77) are not subject to any restrictions on resale. Shares sold under Rule 506 (17 C.F.R. § 230.506) (§ 151:77) are restricted securities.[1] As restricted securities, such shares can be resold only if registered or pursuant to an applicable exception. Rule 502(d) calls for the issuer to exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of Section 2(11) of the Securities Act.[2] Reasonable care may be demonstrated by the following:

(i) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;

(ii) Written disclosure to each purchaser prior to sale that the securities have not been registered under the Securities Act and, therefore, cannot be resold unless they are registered under the Securities Act or unless an exemption from registration is available; and

(iii) Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Securities Act and setting forth or referring to the restrictions on transferability and sale of the securities.

While taking these actions will establish the requisite reasonable care, it is not the exclusive method to demonstrate such care and other actions by the issuer may satisfy the requirements of the Rule. In addition, Rule 502(b)(2)(vii) requires the delivery of written disclosure of the limitations on resale to nonaccredited investors in Rule 506 (17 C.F.R. § 230.506) (§ 151:77) offerings.[3]

Securities issued pursuant to Section 4(6) will be "restricted securities" and thus may not be transferred by the purchaser of such securities during the one-year period beginning on the date of purchase, unless such securities are transferred to the issuer of the securities; to an accredited investor; as part of an offering registered with the SEC; or to a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance, in the discretion of the SEC. (15 U.S.C.A. § 77A(e))

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[1] 17 C.F.R. § 230.502(d).

[2] 17 C.F.R. § 230.502(d).

[3] 17 C.F.R. § 230.502(b)(2)(vii).

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§ 151:82. Filing requirements

References

An issuer offering or selling securities in reliance on Rules 504 or 506 must file with the SEC a notice of sales containing the information required by Form D (17 C.F.R. 239.500) for each new offering of securities no later than 15 calendar days after the first sale of securities in the offering, unless the end of that period falls on a Saturday, Sunday or holiday, in which case the due date would be the first business day following.[1] Every notice of sales on Form D must be signed by a person duly authorized by the issuer.[2]

The information required by Form D must be filed with the SEC electronically by means of the SEC's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) in accordance with EDGAR rules set forth in Regulation S-T (17 C.F.R. Part 232). The online filing system is accessible from any computer with Internet access. The data filed is available on the SEC Web site and is intended to be interactive and easily searchable by regulators and members of the public who choose to access it.

An issuer may file an amendment to a previously filed notice of sales on Form D at any time.[3] An issuer must file an amendment to a previously filed notice of sales on Form D for an offering to correct a material mistake of fact or error in the previously filed notice of sales on Form D, as soon as practicable after discovery of the mistake or error.[4]

In addition, an amendment must be filed to reflect a change in the information provided in the previously filed notice of sales on Form D, as soon as practicable after the change, except that no amendment is required to reflect a change that occurs after the offering terminates or a change that occurs solely in the following information:[5]

- The address or relationship to the issuer of a related person identified in response to Item 3 of the notice of sales on Form D;
- An issuer's revenues or aggregate net asset value;
- The minimum investment amount, if the change is an increase, or if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in a decrease of more than 10%;
- Any address or state(s) of solicitation shown in response to Item 12 of the notice of sales on Form D;
- The total offering amount, if the change is a decrease, or if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in an increase of more than 10%;
- The amount of securities sold in the offering or the amount remaining to be sold;
- The number of nonaccredited investors who have invested in the offering, as long as the change does not increase the number to more than 35;
- The total number of investors who have invested in the offering; or
- The amount of sales commissions, finders' fees or use of proceeds for payments to executive officers, directors or promoters, if the change is a decrease, or if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in an increase of more than 10%.

Finally, an issuer must file an amendment to a previously filed notice of sales on Form D for an offering annually, on or before the first anniversary of the filing of the notice of sales on Form D or the filing of the most recent amendment to the notice of sales on Form D, if the offering is continuing at that time.[6]

An issuer that files an amendment to a previously filed notice of sales on Form D must provide current information in response to all requirements of the notice of sales on Form D regardless of why the amendment is filed.[7]

Although issuers relying on Regulation D routinely file a Form D, the filing is not a condition to the availability of the exemption. Under Rule 507,[8] if the issuer fails to timely file a Form D, the SEC can obtain an order from a court of competent jurisdiction directing a filing. Once such an order is issued, the issuer is disqualified from relying on Regulation D for future transactions. However, the disqualification can be waived upon a showing of good cause by the issuer that the exemption should not be denied.

Footnotes

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1 17 C.F.R. § 230.503(a)(1).

2 17 C.F.R. § 230.503(b)(2).

3 17 C.F.R. § 230.503(a)(2).

4 17 C.F.R. § 230.503(a)(3)(i).

5 17 C.F.R. § 230.503(a)(3)(ii).

6 17 C.F.R. § 230.503(a)(3)(iii).

7 17 C.F.R. § 230.503(a)(4).

8 17 C.F.R. § 230.507.

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§ 151:83. Compliance deviations

References

The Regulation D exemption originally required compliance with all the terms and conditions of Rules 501 through 503 and of the specific Rule (Rule 504 (§ 151:77), or Rule 506 (§ 151:77)) upon which reliance was being placed in order for the exemption to be available. Regulation D was amended to add Rule 508 as an attempt to provide some comfort to issuers that certain insignificant deviations from a term, condition or requirement of Regulation D would not cause the exemption to be lost, provided that the party complaining was not directly injured by the deviation and that the issuer made a good faith and reasonable attempt to comply.[1]

Rule 508[2] provides that failure to comply with a condition or requirement of the rule will not result in a loss of the exemption as to any specific offer or sale if the person relying on the exemption demonstrates that:

(i) Such condition or requirement was not directly intended to protect the complaining party;
(ii) The failure to comply was "insignificant to the offering as a whole"; and
(iii) A good faith and reasonable attempt was made to comply.

Rule 508[3] specifically declares that failure to comply with the following limitations shall be deemed to be significant to the offering as a whole:

(i) The dollar limitations of Rules Rule 504 (§ 151:77);
(ii) The number of purchasers limitations of Rule 506 (§ 151:77); and
(iii) The limitations, to the extent applicable, on general solicitations or general advertising.

Rule 508 also provides that nothing in the rule excuses the failure to comply in an action brought by the SEC.[4]

Footnotes

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1 17 C.F.R. § 230.508.

2 17 C.F.R. § 230.508(a).

[3] 17 C.F.R. § 230.508(a)(2).

[4] 17 C.F.R. § 230.508(b).

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