Business Transactions Solutions § 152:169

Business Transactions Solutions | September 2018 Update
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Part VI. Finance
Chapter 152. Offering and Disclosure Documents
V. Additional Practice Tools
A. Client Communications

§ 152:169. Client letter relating to proposed limited offering

Dear *[name of authorized representative of client]*:

I understand that you are interested in raising additional capital for your corporation by selling stock to persons who are not currently stockholders. This letter is intended to introduce you to the state and federal laws applicable to such sales in order to provide you with an idea of what you can and cannot do in connection with your proposed offering and what the cost and complexity of the offering might be. We will need to meet to discuss the securities laws in much greater detail and to understand the terms of your proposed offering and the number and types of investors you would like to approach. However, I hope our discussions can move more quickly if you have the background information set forth in this letter.

1. Registration Requirements

Both the state and federal governments regulate offers and sales of securities. The definition of a "security" is broad and includes common stock and preferred stock, investment contracts, and in some cases, promissory notes or other debt obligations.

The state securities laws are called "blue sky" laws and require all offers and sales of securities to be registered in each state in which sales are solicited or a purchaser resides. In some states, the nature of the securities being offered is reviewed by the state, and the offer or sale must meet certain standards and be qualified. As a general rule, all offers and sales of securities in the United States must also be registered with the Securities and Exchange Commission ("SEC"), but there are exemptions to the federal registration requirements upon which you may be able to rely and which are discussed in more detail below.

Both state and federal securities laws impose penalties for noncompliance. For example, investors have the right to rescind

purchases of securities sold in violation of law and to obtain a refund of the purchase price paid. If the noncompliance involves the failure to qualify for an exemption from registration requirements, it can cause the entire offering to lose its exempt status even if the failure involves only a single requirement or a single investor. Loss of exemption for the entire offering means that all investors may have a rescission right. Penalties for noncompliance with the securities law can be imposed not only on the corporation issuing the securities but also on those who control the corporation. Criminal penalties can be imposed for willful noncompliance with the securities laws. In addition, even an assertion of noncompliance with securities laws can cause significant damage to the reputation of the corporation and its senior managers.

2. Exemptions

Most securities offerings are made pursuant to exemptions from registration requirements. The cost of an SEC registration is prohibitive unless a corporation is seeking large amounts of capital. Even the cost of registering or qualifying an offering with a state can be significant.

The most frequently used federal exemption is that for offerings "not involving any public offering." This exemption is created by § 4(a)(2) of the Securities Act of 1933, and while a public offering might seem like a relatively simple concept, determining whether a particular offering is public involves issues such as the number of investors to whom offers are made, their level of financial sophistication, and the information they have been furnished. Also relevant is the manner in which the offering has been conducted since general solicitation or advertising is prohibited. The law relating to these issues has been developed by the courts and the SEC on a case-by-case basis and is sometimes inconsistent.

Fortunately, the SEC has created a "safe harbor" exemption under § 4(a)(2), referred to as "Regulation D", which provides that if certain requirements are met, an offering not be considered a public offering. Regulation D includes rules on the manner in which investors may be solicited, the number of investors, and the dollar amount of securities that investors may purchase. Regulation D also sets standards for the financial sophistication of investors and the information they must be furnished and the eligibility of corporations to rely on its exemptions.

Most states have exemptions from their registration and qualification requirements similar to Regulation D. In some cases, states require only the filing of a notice of sale and payment of filing fee for offerings meeting the Regulation D requirements. For example, the law of the state of *[name of state]* provides *[summary of private offering exemption]*. However, states' blue sky laws differ, and the availability of exemptions needs to be determined in advance of the offering for each state in which securities are offered or investors reside.

The burden of showing entitlement to an exemption from securities law registration falls of the corporation that issues securities. Extreme care is required to insure that all the requirements for the exemption are met. Strict controls on the procedures used to offer and sell securities must be adopted and followed.

3. Numbers of Investors and Their Qualifications

Regulation D contains rules relating to the number and type of persons who may invest in a private securities offering. Rule 504 allows offers and sales to an unlimited number of investors and there are generally no investor qualification requirements as long as the corporation does not engage in general solicitation or advertising, but that rule applies only to offerings of $5 million or less within a 12-month period. Rule 506(b) permits the offer and sale of an unlimited dollar amount of securities to an unlimited number of "accredited investors" and not more than 35 investors who are unaccredited but sophisticated. Accredited investors include institutional investors, business entities with more than $5 million in assets, and high-income and high-net worth individuals. In order for an unaccredited investor to be considered "sophisticated," the offeror must reasonably believe that the investor has enough knowledge and experience in financial and business matters to evaluate the merits and risks of the investment. In some cases, the necessary sophistication can be provided by a "purchaser representative," such as an attorney or accountant.

Prospective investors must be asked to complete a confidential investor questionnaire in connection with a Regulation D

offering. The questionnaire provides detailed information about the investor, including the investor's education, previous investment experience, income, and net worth that is relevant to determining whether the investor is accredited or sophisticated.

Rule 506(b) represents the traditional approach to Rule 506 offerings, which assumed and required that issuers not engage in general solicitation or advertising; however, Rule 506(c) is available for situations in which general solicitation is intended provided that all purchasers are accredited investors. This means that even though the offering includes general solicitation, actual sales must be limited to accredited investors and the offeror needs to be prepared to demonstrate that it has taken "reasonable steps" to verify the accredited investor status of each purchaser. The verification process can be complex and we'll need to discuss it further if it relevant to your proposed offering; however, suffice to say that you will not be able to simply rely on the investor's self-certification of accredited investor status.

4. Disclosure

There must be full and fair disclosure of the nature of the securities being offered and the corporation offering them. All disclosures must be true, and there may not be any omissions that would make the disclosures misleading. These disclosure and antifraud requirements apply whether or not the offering qualifies for an exemption from registration.

Disclosures pertaining to a securities offering are typically contained in a "private placement memorandum" that is delivered to prospective investors. At a minimum, this document must disclose all "material" information concerning the investment. This encompasses any information that a reasonable investor would consider important in making a decision to invest in the offered securities. The length and content of a private placement memorandum depends on the business and ownership of the corporation issuing the securities being offered and the nature of those securities. It also depends on the sophistication of potential investors and their access to information. It is not uncommon for a private placement memorandum to be quite long and detailed. Even if you opt for a shorter document, we highly recommend that it include customary risk factors relating to the operation of the business, the terms of the offering and the liquidity and value of the securities purchased in the offering.

5. Form of Offering

Securities offerings under Rules 504 (other than offerings registered in a state requiring use of a substantive disclosure document or conducted under a state exemption for sales to accredited investors with general solicitation) and 506(b) cannot involve a "general solicitation." This means that the securities cannot be advertised as being for sale in newspapers or on radio, TV, or on the Internet, and there can be no notice of the existence of the offering through such media. It also means that the offering may not be announced at any conference or meeting if the attendees have been invited by a general solicitation.

A general solicitation is avoided if solicitations are limited to persons with whom the issuer has had a prior relationship. If the corporation engages a broker-dealer registered with the SEC to sell its securities, there is no general solicitation if the broker-dealer solicits persons with which it has had a preexisting relationship. Approaches to individual institutional investors also may not involve a general solicitation.

As mentioned above, securities offerings Rule 506(c) are not subject to the prohibition against general solicitations; however, all purchasers must be accredited investors.

The persons selling offered securities must be registered with the state and federal government as "broker-dealers" or agents unless an applicable exemption from registration is available. In most cases, executive officers, directors, and full-time employees who perform substantial duties for a corporation other than selling securities are permitted to sell its securities without registering as long as they do not receive separate compensation for sales activities. Exemptions from securities law registration requirements can be lost if sales are made by unauthorized persons, so all aspects of the sales process must be monitored and controlled. In particular, you should be careful about engaging consultants as "finders" in the capital raising process and ensure that they have complied with applicable registration requirements.

6. Conclusion

The discussion above has focused on the exemptions from registration offered by Section 4(a)(2) of the Securities Act and Regulation D. While these are the most frequently used exemptions, we are happy to discuss other options with you. For example, an unlimited amount of securities may be sold in offerings that satisfy the rigorous requirements for an "intrastate offering" and as much as $50 million may be raised in any 12-month period under Regulation A, although a Regulation A offering can be quite complex and expensive and requires preparing of a comprehensive disclosure document on Form 1-A that is akin to a registration statement filed with the SEC for a public offering. You may also have heard about offerings under Regulation Crowdfunding, which can be used to raise up to $1 million in a 12-month period; however, these offerings need to be made solely through an appropriate regulated platform and require the preparation of a Form C, which resembles a Form 1-A.

Although the securities laws can be complicated and the penalties for noncompliance severe, many corporations have raised the capital they need with private offerings. The chances of a successful offering are enhanced if the corporation is fully aware of the restrictions and requirements imposed by the securities laws at the outset. I look forward to talking with you about the securities laws and working with you to structure an offering that not only meets your requirements for new capital but also complies with applicable securities laws.

Sincerely,

_____
[Name of attorney]

Notes

Use of form: This is a form of letter to be sent to a client contemplating making a private placement or limited offering of its securities. The letter provides the client with basic information about the securities laws in order to expedite the discussion of the securities law aspects of the proposed offering. The form mentions the key requirements for an offering under Regulation D and also notes various alternatives including intrastate offerings, Regulation A offerings and capital raising through crowdfunding (i.e., Regulation Crowdfunding).