

## **Using Rule 506 for Raising Money**

Given that the SEC is on the verge of releasing its final regulations that will allow public advertising of Rule 506 offerings, it's a good time to review traditional Rule 506 offerings.

A Rule 506 offering is the primary type of private placement offering used across state lines because it preempts state securities laws. That's a huge help because the states cannot object to or impose conditions on the offering. All they are allowed to do is require a brief "notice" filing in each state where there are actual investors. In addition, a single set of offering documents can be used even though investors from multiple states are involved.

### **Investor Requirements**

An unlimited amount of money may be raised in a Rule 506 offering. There may be an unlimited number of accredited investors and up to 35 non-accredited but sophisticated investors.

An individual is accredited if he/she either 1) has at least \$1 million in net worth excluding the primary residence or 2) has annual income of at least \$200,000 (or \$300,000 if the spouse's income is counted too). A company is accredited if a) it has at least \$5 million in assets and is not formed for the purpose of making the investment or b) if each of its owners is accredited.

An investor is sophisticated if he/she, either personally or with the assistance of an independent professional investment adviser "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."

### **Communication of the Offering**

A traditional Rule 506 offering allows no public advertising of the offering. Instead, offers may only be made to potential investors who the offering company reasonably believes are either accredited or sophisticated. As a practical matter, generally no private placement memorandum or other specifics about the offering are provided until the potential investor has completed an investor questionnaire, the questionnaire has been reviewed and the investor appears to qualify. With a traditional Rule 506 offering, the offering company is entitled to rely on the potential investor's responses – even if they turn out later to be false – unless the offering company has some reason to believe the responses may not be accurate.

In addition, an offering company can post or transmit information or conduct seminars about itself so long as it does not refer to past, present or future offerings; does not provide a rate of return; and the communication is not primarily designed to attract potential investors. Often the last part is achieved by making the presentation educational

or informational. With care and an appropriate disclaimer, a statement can be added saying that those who want further information can obtain it if they complete and investor questionnaire and are found to be qualified. (This should not be attempted without prior review by a securities attorney, as it is very easy to cross into prohibited advertising.) No performance-base commissions can be paid to anyone (except a licensed broker-dealer) to obtain investors.

With a new potential investor, essentially at least 30 days must pass from when the potential investor returns the completed investor questionnaire until that investor is allowed to invest.

### **Information That Must Be Provided**

As with all offerings, all information that a potential investor would reasonably want to know before deciding to invest must be provided. In addition, certain specific information must be provided if the offering allows non-accredited investors. (The offering can be restricted to accredited investors only if the offering company wishes.)

For most issuers (those that are not blind-pool companies, are not offering oil or gas interests, and those that do not have past securities violations or principals with past securities violations) the information to be provided is that required in Part II of SEC Form 1-A. The table of contents for Part II provides a handy list of the non-financial information to be disclosed, which is information about:

- The Company
- Risk Factors
- Business and Properties
- Offering Price Factors
- Use of Proceeds
- Capitalization
- Description of Securities
- Plan of Distribution
- Dividends, Distributions and Redemptions
- Officers and Key Personnel of the Company
- Directors of the Company
- Principal Stockholders
- Management Relationships, Transactions and Remuneration
- Litigation
- Federal Tax Aspects
- Miscellaneous Factors
- Financial Statements
- Managements Discussion and Analysis of Certain Relevant Factors

### **Financial Information**

The financial information to be provided depends on how large the offering is.

Basically, offerings up to \$2 million the offeror must provide 1) a certified (not audited) balance sheet within 90 days of the beginning of the offering and 2) statements of income, cash flows and shareholder equity for the past two fiscal years and the current year to date (or as far back as the company goes if shorter).

With offerings up to \$7.5 million, the financial information to be provided is the same except that the balance sheet also must be for the past fiscal year (assuming the company has been in existence that long). In addition, the general rule is that the financials are to be audited unless, the issuer cannot obtain audited financials “without unreasonable effort or expense” (in the opinion of the issuer). In that case only a balance sheet dated within 120 days of the offering must be audited. Further, if the offeror is a startup (formed with minimal capitalization immediately before the offering), then no financials are required to be audited.

With offerings greater than \$7.5 million, the issuer must furnish audited income statements covering the past three years and a balance sheet for the preceding two years. The same exemptions for an offering less than \$7.5 million also apply though.

### **Filings; Advertised Rule 506 Offerings**

Within 15 days of receipt of the first check or wire transfer from an investor, Form D must be filed with the SEC. For most states, within 15 days of the receipt of the payment by the first investor in a given state, a brief “notice” filing must be made with that state.

New SEC regulations will allow public advertising of a Rule 506 offering, but only accredited investors will be allowed – no merely sophisticated investors – and the offeror will have to verify that each investor is in fact accredited. Companies with their own connections with potential investors may want to forego advertising in order to allow sophisticated investors or to avoid having to ask potential investors for verification that they are accredited.

Bruce E. Methven

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For more information on securities laws, head to Background on the Securities Laws:  
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Bruce E. Methven, 2232 Sixth Street Berkeley, CA 94710  
Phone: (510) 649-4019; Fax: (510) 649-4024  
[www.TheCaliforniaSecuritiesAttorneys.com](http://www.TheCaliforniaSecuritiesAttorneys.com)  
[CaliforniaSecuritiesAttorneys\[at\]gmail.com](mailto:CaliforniaSecuritiesAttorneys[at]gmail.com)  
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