Introduction to Private Placements under Regulation D

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In a day and age where venture capital investments require vast financial return potential, bank loans cannot be obtained without an unconditional personal guarantee, and high-interest credit cards have become a mainstream source of financing for bootstrapping entrepreneurs, many are turning to private placements or Regulation D Offerings in hopes of securing a much needed capital infusion for their businesses.

But is the expectation to raise funds via a private placement realistic, can anybody do it, and is there any downside to this form of financing? Well, let’s see if we can get to the bottom of this issue.

What is a Private Placement?

Private placements can take different shapes and sizes. They are commonly used to place equity, equity-linked, and debt securities with a pool of qualified investors.

If done properly, issuers are afforded an exemption from most registration and reporting requirements, either under Section 3(a)(11), the so-called intrastate offering exemption, Section 4(2), an exemption available for transactions not involving a public offering, and Regulation D of the United States Securities Act.

Since Regulation D Offerings are by far the most popular and enable the structuring of a wide cross section of equity, equity-linked, and debt placements, we will focus on this particular exemption for the remainder of this article.

This very same Regulation D, however, also closely regulates the process under which a private placement can be conducted legally.

So let’s take a closer look and find out if a Private Placement or Regulation D Offering is for you.

There are three different rules (Rule 504, 505, and 506), which further define the framework under which a private placement can be structured and which enable you to raise different maximum amounts of financing from different types of investors.

The Rules

Rule 504

Private placements structured under Regulation D, Rule 504 enable an issuer to sell up to $1,000,000 worth of securities during any 12-month period by imposing only very few restrictions on the issuer. For instance, two requirements you would have to meet in order to qualify is that the issuer can not be subject to any reporting requirements of the United States Securities Act of 1933, such as most public companies, and that the issuer cannot be an entity formed solely for investment purposes.

On the other hand, Rule 504 affords the issuer very broad discretion over the number of participating investors, the disclosure of investment related information, and the sale of restricted or even unrestricted securities.

Technically, an issuer under Rule 504 is neither required to cap the number of participating investors nor to register or provide them with a formal disclosure document before accepting investments; however, we do strongly encourage any issuer to supply a private placement memorandum or prospectus to potential investors in order to clearly establish the terms and conditions under which the securities were sold and thus limit the exposure to potential legal liabilities later on.

An issuer under Rule 504 may even engage in general solicitation, advertise and offer unrestricted securities for as long as he registers the offering in a state where such a registration and delivery of a prospectus or private placement memorandum is required and he also complies with such requirements in other states even though local laws and regulations may not require such compliance.

Rule 505

Offerings structured under Rule 505 are popular because its requirements are in keeping with most state securities laws, which are commonly referred to as “Blue Sky” Laws. Under Rule 505, an issuer can sell up to $5,000,000 worth of securities to an unlimited number of Accredited Investors and up to 35 investors that don’t have to meet any wealth or sophistication requirements.

Issuers are again afforded broad discretion over what information and disclosure documents they supply to Accredited Investors; however, they must supply any Non-Accredited Investors with a prospectus or private placement memorandum, which is similar in form and substance to those used in registered public offerings.

Rule 506 (Safe Harbor Rule)

Rule 506 is also known as the “Safe Harbor Rule” because it exempts offerings from most qualification requirements; besides, issuers that intend to offer and sell more than $5,000,000 worth of securities will have to resort to Rule 506 anyways, as this is the only rule that does not impose a maximum offering amount. Once again, issuers can sell their securities to an unlimited number of Accredited Investors and up to 35 Non-Accredited Investors with the important distinction that all Non-Accredited Investors will have to qualify as Sophisticated Investors.

If only Accredited Investors are to participate in the offering, issuers are at liberty to either supply a formal prospectus or disclosure document or forego the distribution of such offering related information altogether. Regardless of any legal requirements, we recommend that any issuer supply potential investors with a formal prospectus or private placement memorandum to clearly establish the terms and conditions under which the securities were sold.

Rules 504, 505 and 506 at a Glance

Requirements	**Rule 504**	**Rule 505**	**Rule 506**
Maximum Offering Amount	$1,000,000	$5,000,000	Unlimited
Maximum Offering Period	12 months	12 months	12 months
Investor Qualifications	Unlimited Accredited/ Sophisticated	Unlimited Accredited & up to 35 Non-Accredited	Unlimited Accredited & up to 35 Sophisticated
Prospectus Required	No	Yes (2)	Yes (2)
Advertising/Promotion Allowed	Yes (1)	No	No
Restricted Securities	Yes (1)	Yes	Yes
Form D Required	Yes	Yes	Yes

(1) Advertising and general solicitation along with the issuance of unrestricted stock under a Regulation D, Rule 504 offering is only permissible if the issuer meets at least one of the following conditions: (i) the issuer registers the offering in a state where such registration is required and also complies with mandatory disclosure requirements in other states that may not require such compliance; (ii) the issuer sells securities exclusively to Accredited Investors in a state that permits advertising and general solicitation.

(2) Issuers offering securities for sale under Regulation D, Rule 505, are not required to supply potential investors with a formal prospectus or private placement memorandum for as long as they sell exclusively to Accredited Investors.

Accredited Investors vs. Sophisticated Investors. What's the Difference?

Accredited Investors

They are often casually referred to as the Million Dollar Club because this definition is often associated with individuals having a net worth of at least $1 million or annual income of $200,000, or joint income of $300,000 with the individual's spouse[1].

However, the term Accredited Investor also applies to a much broader range of professionals and organizations. For instance, banks, insurance companies, registered investment companies, including small business investment companies (SBIC's) all qualify as Accredited Investors. The term also covers charities, corporations, partnerships, and trusts with assets in excess of $5 million. Directors, officers and partners of businesses either selling securities or where all equity holders are considered to be Accredited Investors, also qualify.

Sophisticated Investors

This term is much more loosely defined and applies to individuals and organizations that have sufficient experience in dealing with investment related matters including doing their own research, due diligence, and evaluation of the merits of a potential investment.

Since doing the required due diligence on investors' wealth and sophistication standards rests with you, the issuer, most issuers are employing an investor suitability questionnaire, which is often supplied as part of the required disclosure documents, prospectus or private placement memorandum. Asking potential investors to answer a few questions concerning their financial background and experience in dealing with investment related matters is probably the least

[1] Pursuant to the "Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC issued a new Compliance and Disclosure Interpretation (CDI 179.01) on July 23, 2010 based on which individuals desiring to qualify as Accredited Investor can no longer include their principal residence in their calculation of their net worth to satisfy the minimum wealth requirement of $1,000,000. Pending the implementation of this new definition in SEC rules and regulations, candidates may also exclude indebtedness that is secured by their principal residence up to its fair market value. Amounts exceeding the residence's fair market value still need to be reflected as liability in their calculation of their net worth.

invasive way to gather required background information and ensure your compliance with state and federal securities laws.

Speaking of disclosure documents, prospectuses and private placement memoranda, let's explore this document in greater detail next.

What is a Prospectus, Private Placement Memorandum, or Substantive Disclosure Document? Do I need one for my offering and are there any formal requirements in terms of content and format?

The prospectus, private placement memorandum, or substantive disclosure document is a key element of any securities offering. Although issuers are generally held to the same disclosure requirements as if their offering were a public offering, information supplied in a prospectus under Regulation D typically includes detailed and balanced information on issues such as the business of the issuer, competition, and market conditions, senior management, risk factors, financial statements, and in depth information on the securities that are offered for sale. A private placement memorandum usually consists of a descriptive part, a subscription or promissory note agreement, and an investor suitability questionnaire.

The task of drafting a private placement memorandum should be approached with the required thoughtfulness and probably entail a close working relationship with a seasoned securities attorney, certified public accountant, or investment banking professional to ensure that your offering is viable and in compliance with state and federal securities laws.

Advantages & Disadvantages of Private Placements

Advantages

On the upside, a private placement or Regulation D offering will probably enable an issuer to penetrate the capital markets faster, more efficiently and cost-effectively than with any registered offering or other form of formal outside financing.

If done properly, it is also likely that the issuer can raise more capital in return for a lesser equity stake in the company, if compared to traditional venture capital deals. Unlike financing that is sought from venture capitalists or angel investors, the purchase of shares under a private placement is non-negotiable and subject to a fixed price per share or membership interest.

It is also likely that investors who are interested in participating in a private placement are less inclined to require a board seat or otherwise play an active role in your company.

Disadvantages

Well, jumping through all these hoops won't guarantee you any proceeds from an offering unless you are able to tap into a pool of qualified investors, team up with a licensed broker dealer, or work with a prospecting service that supplies you with a constant flow of qualified leads. Also, keep in mind that under most rules you are strictly prohibited from advertising or promoting your offering, even on your website or blog, which can make it difficult to generate the required interest in your offering.

Private placements are no playing ground for the inexperienced and financial novices. Composing a viable offering and corresponding prospectus or private placement memorandum can become a daunting task. It requires skill and experience in such delicate legal and financial matters to create an offering that will appeal to potential investors and be in compliance with all relevant securities laws and regulations. A slight misstep can subject you to substantial civil and even criminal sanctions; result in lawsuits filed by disgruntled investors, or render the entire offering useless. Please make sure you have the required insight into capital market conditions along with the expertise and experience in dealing with rather complex financial and securities related matters before attempting to raise funds with a private placement on your own. In most cases it is advisable that you retain the services of a seasoned securities attorney, certified public accountant or investment banking professional.

Compliance

Filing of Form D with Securities & Exchange Commission

While offerings relying on an exemption from registration under Regulation D, Rule 504, 505, or 506 are exempt from most registration and reporting requirements under the United States Securities Act of 1933, the Securities & Exchange Commission (SEC) requires that you file Form D within 15 days of the first sale of any securities offered thereunder. Form D requires the issuer to disclose a nominal amount of background information on the issuer, management, promoters of the offering and the offering itself. It is not a merit based review and the filing of Form D should not be confused with filing a registration statement with the SEC.

State Securities Laws (Blue Sky Laws)

You should also carefully review state securities laws in states where you intend to make your offering available to potential investors. The fact that you rely on a federal exemption does not necessarily mean that you won't face additional regulatory requirements under state securities laws. Some states require that you file a simple notice, whereas others require more substantial disclosure concerning the issuer and offering.

Conclusion

Raising equity or debt financing through a private placement can yield substantial benefits for a more mature issuer. If you are prepared to commit to the required legwork and dedicate the required time and resources to compose an equitable offering, this process is likely to be a viable alternative to knocking doors of venture capitalist, so-called angel investors, and other investor circles.

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