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EXEMPT OFFERING GUIDELINES
REGULATION D, RULE 506(b), "ACCREDITED INVESTORS" ONLY

By Philip N. Krause*

Raising investment funding for an early-stage, high-growth-potential venture can be a formidable undertaking. Not only is capital scarce and costly, but the legal ground rules also can be daunting for the uninitiated, involving a maze of overlapping federal and state statutes and regulations, and not a little "gray" area for which clear guidance is difficult to find. Undoubtedly, an exempt "private placement" only to "accredited investors," under Rule 506(b) of Regulation D promulgated by the U.S. Securities and Exchange Commission ("SEC") under the Securities Act of 1933, as amended ("Securities Act"), provides the most efficient and understandable legal framework for negotiating this maze.[1]

This pamphlet is intended to provide general guidelines to assist the non-lawyer entrepreneur in understanding the applicable federal and state securities laws while undertaking to raise investment funding. However, this pamphlet is general in nature for educational purposes only, and it is not intended to provide legal advice or establish an attorney-client relationship. Each entrepreneur is strongly advised to seek competent legal counsel having specific experience in securities law matters to assist in the investment fund-raising process.

Securities Law Terminology

The terminology used for securities law purposes can be confusing and difficult to understand, and the terms often have meanings different from their commonly understood meanings. Here are some "layman's" definitions to aid in understanding securities law terminology; however, these definitions only provide general guidance and each of these terms has a very specific meaning under the Securities Act or Regulation D.

- "Issuer" means the company (including a corporation, limited liability company or other type of legal entity) that is raising funds through the offer and sale of securities.
- "Purchaser" means the investor who is making an investment in the issuer by purchasing securities through the offering.

[1] This pamphlet describes only one alternative for structuring an offering that is exempt from the registration requirements of the Securities Act, and other exemptions are available (including different exemption approaches under Rule 506 as noted below).

- "Securities" means any shares of common or preferred stock, membership interests or units in a limited liability company, notes, debentures or other evidences of indebtedness, warrants or options, and other financial instruments received by the purchaser in connection with making an investment in the issuer.
- "Offering" means the issuer's process of raising investment funding through the offer and sale of securities. For securities law purposes, an "offer" of securities may occur far earlier in the process than expected, *i.e.* at the time the issuer is identified, the issuer's desire to raise investment funding is disclosed, and the general nature of the type of financing the issuer is seeking is disclosed (including the amount of funding sought, the issuer's pre-investment valuation and the anticipated use of proceeds). (*Note:* This is quite different from the concept of making an "offer" when negotiating for a contractual relationship.)
- "Private placement" means an offering that does not constitute a public offering of securities under the Securities Act and is, therefore, exempt from the registration requirements of the Securities Act. An exempt offering under Rule 506(b) is a private placement exempt from the Securities Act registration requirements.
- "Underwriter" means any person who purchases securities from the issuer (or from any person who controls or is controlled by the issuer) for the purpose of or with a view to the resale or distribution of the securities, and not solely for investment purposes for the person's own account to be held for an indefinite amount of time.

Exemption Requirements

A private placement will be exempt under Rule 506(b) of Regulation D from the Securities Act registration requirements if the issuer satisfies each of the following requirements:

- Accredited Investors Only. The issuer must reasonably believe[2] that all of the purchasers are "accredited investors." (As defined in Rule 501(a). See Appendix 1.)[3] The two most commonly used tests for establishing accredited investor status for individuals are:
    - Net worth test: The individual's net worth, or joint net worth with the individual's spouse, is in excess of $1.0 million (excluding the value of the person's primary residence).

[2] Amendments to Rule 506 adopted in 2013 require the issuer to "take reasonable steps to verify" a purchaser's accredited investor status if the issuer engages in general solicitation or general advertisement using an exemption under Rule 506(c) rather than Rule 506(b), as noted below.

[3] Other exemptions are available under Rule 506 and other rules under Regulation D to permit sales to non-accredited investors, but those exemptions have additional requirements and may be far more complex under both federal and state securities laws.

  - Income test: The individual's income was in excess of $200,000 in two most recent years, and the individual reasonably expects the same level in the current year (or $300,000, if spouse's income is included).

- General Solicitation Restrictions. Neither the issuer nor anyone acting on behalf of the issuer may offer or sell the securities by any form of general solicitation or general advertisement. For example, this prohibits: (1) any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio; and (2) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. (Rule 502(c).)[4]
- Resale Restrictions. The issuer must use reasonable care to assure that the purchasers are not underwriters, which includes: (1) making reasonable inquiry to determine if the purchaser is acquiring the securities for the purchaser's own account or for other persons; (2) making written disclosure to each purchaser prior to the sale that the securities have not been registered with the SEC and cannot be resold unless they are registered or unless an exemption from registration is available; and (3) placing a legend on the stock certificate or other document evidencing the securities stating that the securities have not been registered with the SEC and referring to the restrictions on transferability and sale of the securities. (Rule 502(d).)
- No "Bad Actor" Disqualification. The issuer must not be disqualified from using the Rule 506 exemption as a result of the issuer or any of its directors or executive officers (and certain other affiliated entities and individuals, including certain participants in the offering) having been the subject of a criminal conviction, or certain other legal proceedings, primarily involving securities law or related violations.[5] (Rule 506(d).)
- Form D Filing. The issuer must file with the SEC, within fifteen days after the date of the first sale of securities, a Notice of Sale on Form D. (Rule 503.)
- Integration. Every transaction within six months before and six months after the exempt offering is "integrated" with the offering and also must comply with all of the exemption requirements. (Rule 502(a).)

Under this exemption, if all of the requirements are met, the offering is not limited by the amount of funds to be raised, or by the number of investors. However, each of the requirements

[4] Amendments to Rule 506 adopted in 2013 would permit the issuer to engage in general solicitation and general advertisement in connection with a private placement offering. The higher standard requiring the issuer to "take reasonable steps to verify" a purchaser's accredited investor status, as noted above, would apply to such an offering, and the higher standards may be difficult for the issuer to satisfy. (Rule 506(c).)

[5] The disqualification provisions are very detailed and must be reviewed carefully by the issuer at or before the time of the offering, and certain disclosures to investors may be required.

must be met or the exemption may be lost for the entire offering. In particular, the entire exemption changes very significantly if only one investor is not an accredited investor.

State law compliance: Under a Regulation D, Rule 506 exemption, federal law pre-empts state securities laws, so that compliance with federal securities law is sufficient for compliance with state securities laws. However, most states will require the issuer to file a Form D (Notice of Sales) with and to pay a filing fee to the applicable state securities law regulatory authority, typically at or about the same time as the Form D is filed with the SEC. The following states should be considered for this purpose: where the issuer's primary business office is located, where any investor resides, where any part of the investment transaction was discussed with any investor, and where any part of the investment transaction was closed with any investor.

Disclosure Requirements

The "anti-fraud" requirements of federal and state securities laws apply to exempt offerings. If all of the above exemption requirements are met, then the offering is not subject to any "mandated" disclosure requirements, *i.e.* disclosure requirements (such as audited financial statements) as may be specifically mandated by SEC regulations. However, the general anti-fraud requirements must be satisfied by disclosing to each investor, at or before the time the investment transaction is closed, all material facts, which means all information a reasonably prudent investor would believe is important to know in order to make an informed investment decision. The issuer has the legal responsibility for assuring that all material facts are disclosed to the investor, and in the absence of any mandated disclosures the issuer must determine for itself the information and documents that constitute material facts to be disclosed. The "best practice" for satisfying this responsibility is that all disclosures should be made or confirmed in writing.

The facts that may be material to any particular issuer or investment transaction depend on the applicable facts and circumstances. However, as a general guideline, the following information and documents should be considered for disclosure:

- Risk factors
- Business plan (including the full range of information typically included in a good business plan)
- Management resumes
- Organizational documents
- Ownership structure
- Historic financial statements and pro forma financial projections
- Any significant regulatory aspects of the company's business or products.

- Any significant income tax considerations based on the type of securities being offered (*e.g.* if the company is structured for "flow-through" taxation)
- The legal documents for closing the investment transaction

Persons Involved in Fund-Raising Process

Persons who participate in an issuer's fund-raising process also may be regulated under federal and state securities laws. Depending on the roles they play and the functions they perform, these persons may be regulated as "broker-dealers," "agents," "salesmen" or "investment advisors" (or other similar terminology). Using a broker-dealer, agent or investment advisor in connection with an exempt private placement can significantly increase the complexity of the legal compliance issues. In particular, "finders" who are compensated for identifying and introducing prospective investors to an issuer raise very challenging legal issues for an offering.

As a general guideline, the issuer should assure that the following requirement is satisfied, in order to avoid regulation of the persons participating in the fund-raising process:

- No commissions, finders' fees or other remuneration may be paid or given, directly or indirectly, for soliciting any prospective purchaser or in connection with the sale of securities, to any person who is not registered as a broker-dealer, agent or investment advisor under federal and all applicable state securities laws.

Additional Resources

- For the SEC's layman's summary of the definition of "accredited investor," as formally defined in Rule 501(a), go to: http://www.sec.gov/answers/accred.htm
- For the full text of Regulation D, 17 C.F.R §§ 230.500 *et seq*., go to: http://www.ecfr.gov/cgi-bin/text-idx?node=17:3.0.1.1.12&rgn=div5
- For Form D, go to: http://www.sec.gov/about/forms/formd.pdf
- For additional resources, see the resources links on the web site for the Institute for Entrepreneurship and innovation, at: http://www.entrepreneurship.bloch.umkc.edu/resources/legal_advice_entrepreneurs.asp

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APPENDIX 1
Definition of "Accredited Investor"

Regulation D, Rule 501(a)

(a) *Accredited investor*. *Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000.

(i) Except as provided in paragraph (a)(5)(ii) of this section, for purposes of calculating net worth under this paragraph (a)(5):

(A) The person's primary residence shall not be included as an asset;

(B) Indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and

(C) Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability;

(ii) Paragraph (a)(5)(i) of this section will not apply to any calculation of a person's net worth made in connection with a purchase of securities in accordance with a right to purchase such securities, provided that:

(A) Such right was held by the person on July 20, 2010;

(B) The person qualified as an accredited investor on the basis of net worth at the time the person acquired such right; and

(C) The person held securities of the same issuer, other than such right, on July 20, 2010.

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in §230.506(b)(2)(ii); and

(8) Any entity in which all of the equity owners are accredited investors.