DBA Securities Section

# Avoiding Pitfalls in Private Offerings

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# Key Takeaways

**Avoiding Pitfalls in Private Offerings**

## Understand the Market Realities

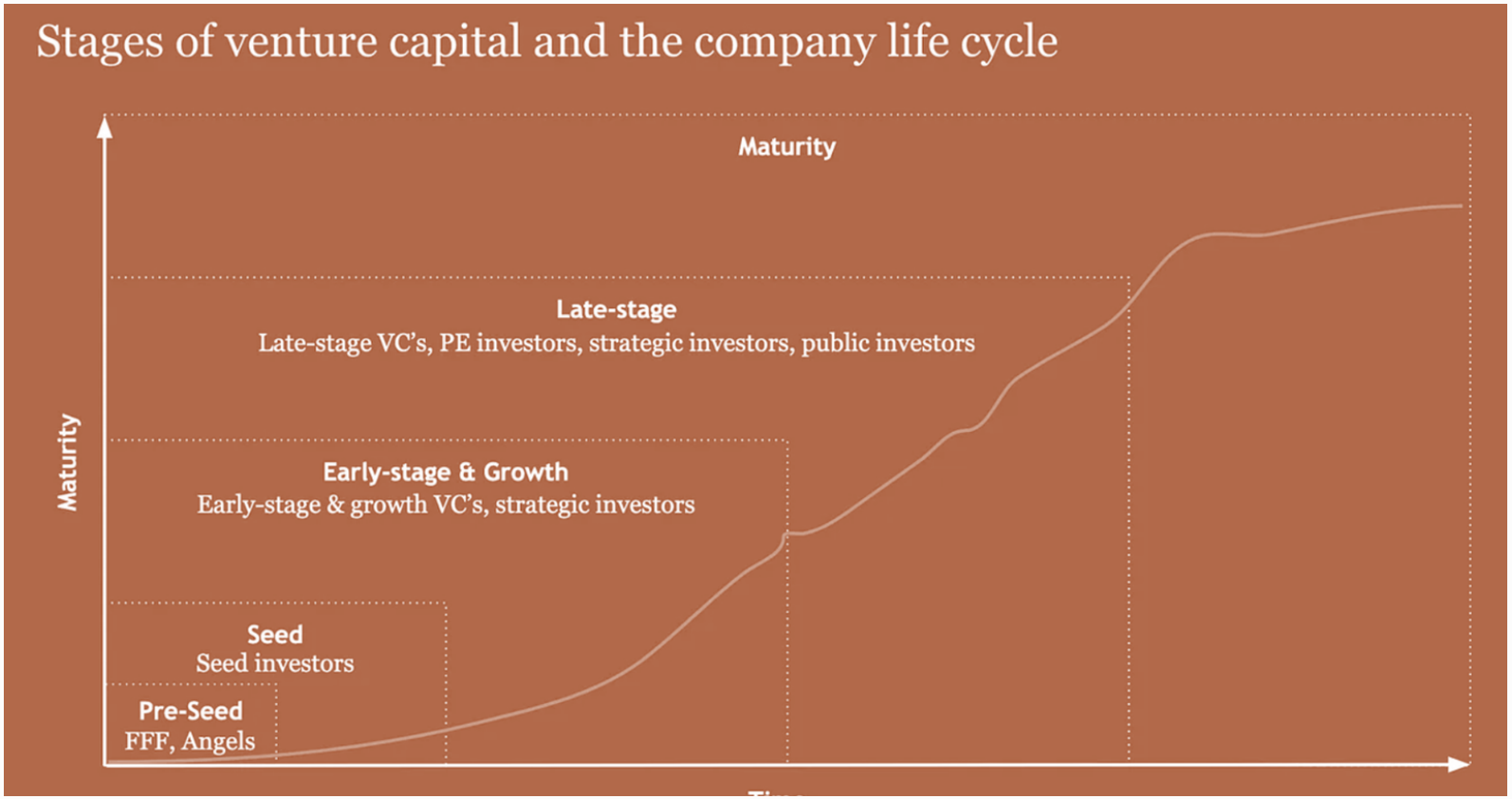
- A multitude of systems and regulations exist to protect investors; however, they are only as effective as those who take offerings to the market.
- Consequently, it is incumbent on counsel to understand the issuer, the investor and the market into which it the issuer placing its securities so that it may provide documentation and disclosure that is appropriate to all

## Choose Your Regulatory Scheme(s) Carefully

- Many failures within private offerings result from compliance issues stemming from a lack of counsel's understanding of the issuer, the type of security being offered, or the investor to whom the offering is being made

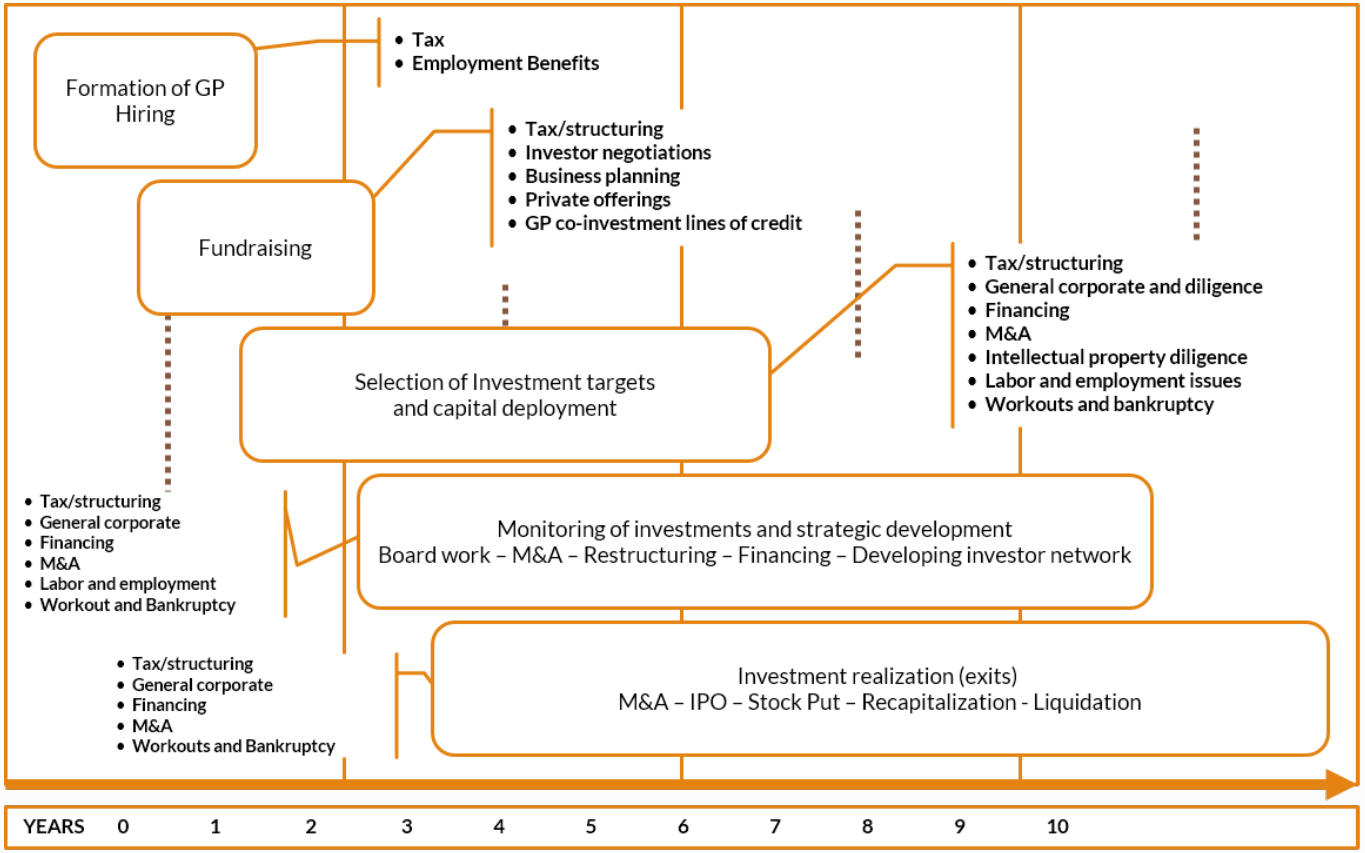
## Common Sense is a Powerful Tool

- Despite the myriad rules and policies governing private securities offerings, common sense remains a powerful tool to those lawyers who seek to ensure their clients both maximize access to capital, and maximize marketing potential




# Company Fundraising Cycles

Know the Market and the Stakeholders Involved

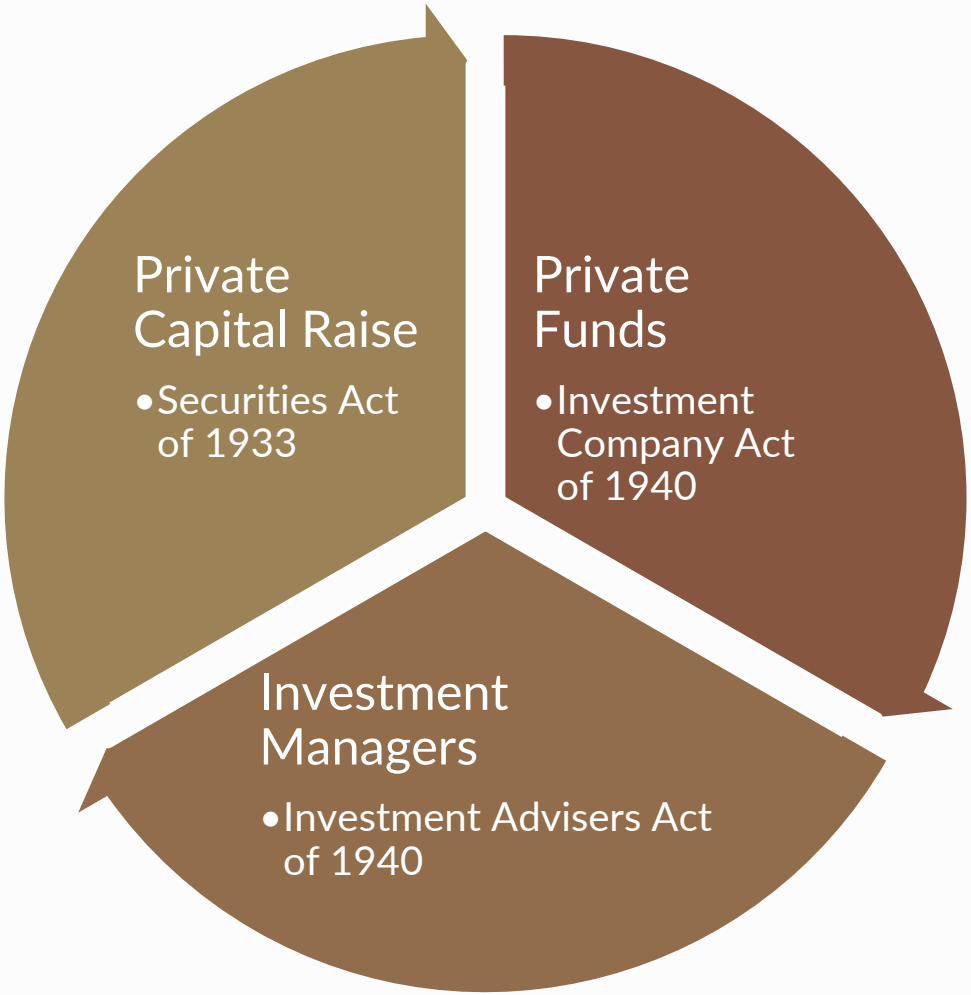



# Do I Need Expertise?

Different Issuers, Different Investors, Different Specializations

# Different Issuers – Different Rules

**Who is my Issuer?**



# Regulatory Basics

**Is a Security Being Issued?**

## Section 5, Securities Act of 1933

- Section 5 of the Securities Act of 1933, as amended (Securities Act), requires **all offers and sales of securities** to be registered with the Securities and Exchange Commission (SEC) **unless there is an available registration exemption**

## What is a "Security"? - Section 2(1)

- Howey Test
- "any note, stock, treasury stock, security future, security-based swap, bond, . . . or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing

# Regulatory Basics

**Common Code Provisions and Exemptions**

## Most common exemptions

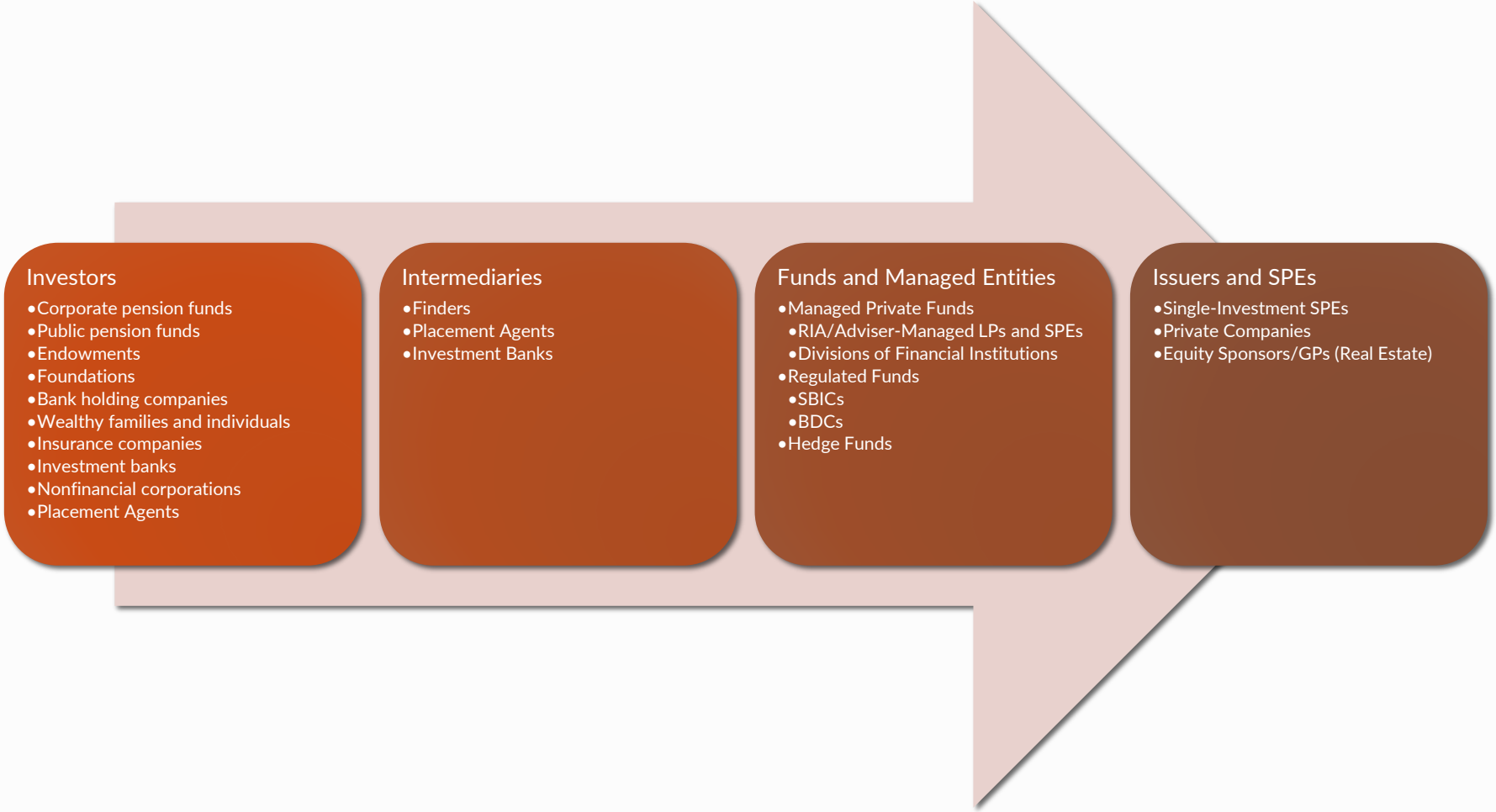
- Section 4(a)(2) of the Securities Act, which exempts from registration transactions by an issuer **not involving a public offering**
- Rule 506 of Regulation D, which provides **safe harbor** exemptions under Section 4(a)(2) for private placements that meet specified objective standards

## Section 4(a)(2) Issuer Private Placements & Safe Harbors

- Rule 504 (under Section 3(b)(1))
- **Rule 506(b) (supplement to Section 4(a)(2))**
- Rule 506(c) (supplement to Section 4(a)(2))
- **Offering Features**: Investor suitability, Limited number of investors, Prohibition on general solicitation and general advertising, Information requirement, Transfer restrictions on "Restricted Securities", Investment intent, Integration with other offerings

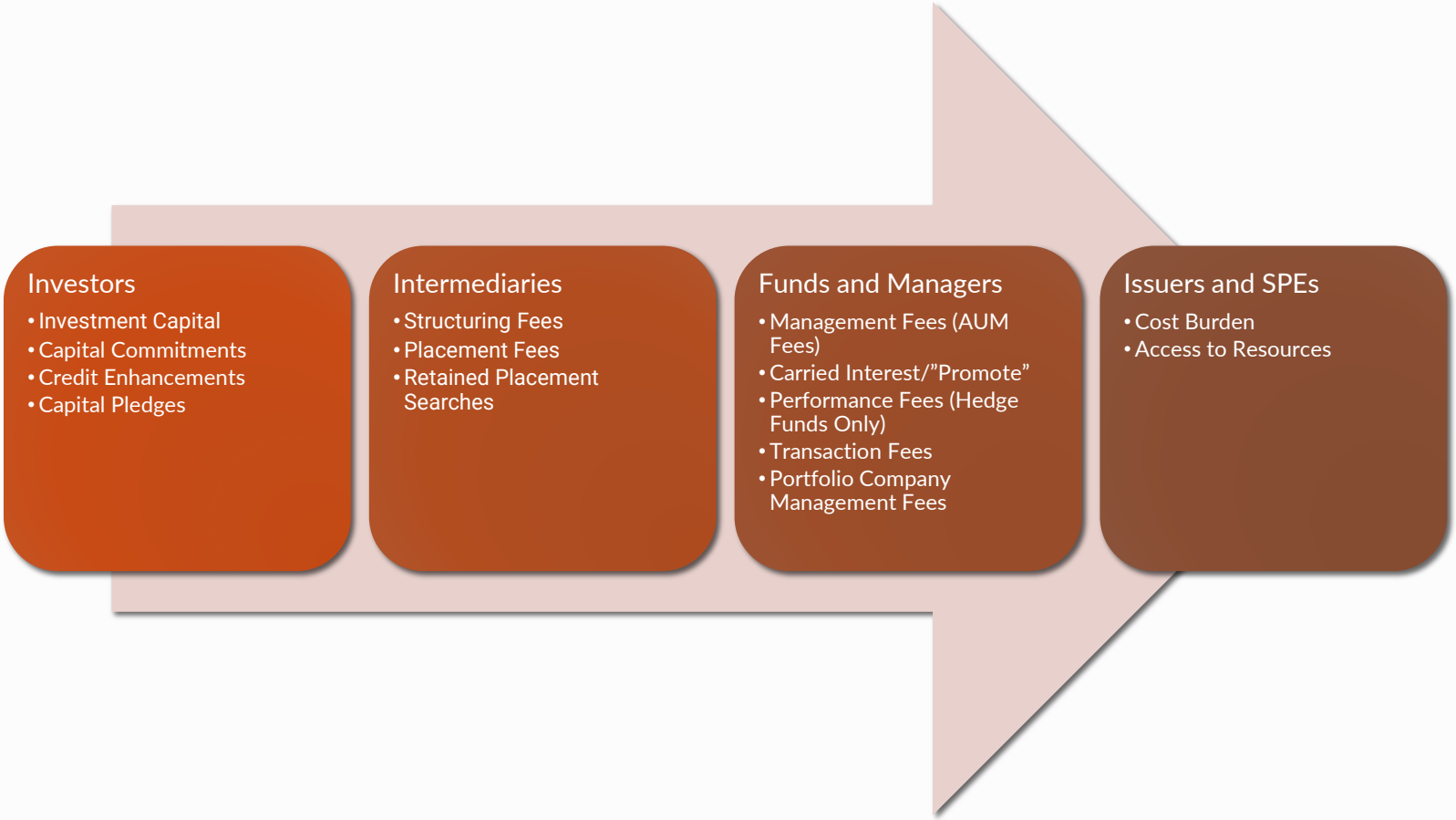
## Rule 10b-5 Anti-Fraud Rules

- Private civil cause of action & SEC criminal enforcement
  - "it shall be unlawful for any person . . . (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact . . . or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."



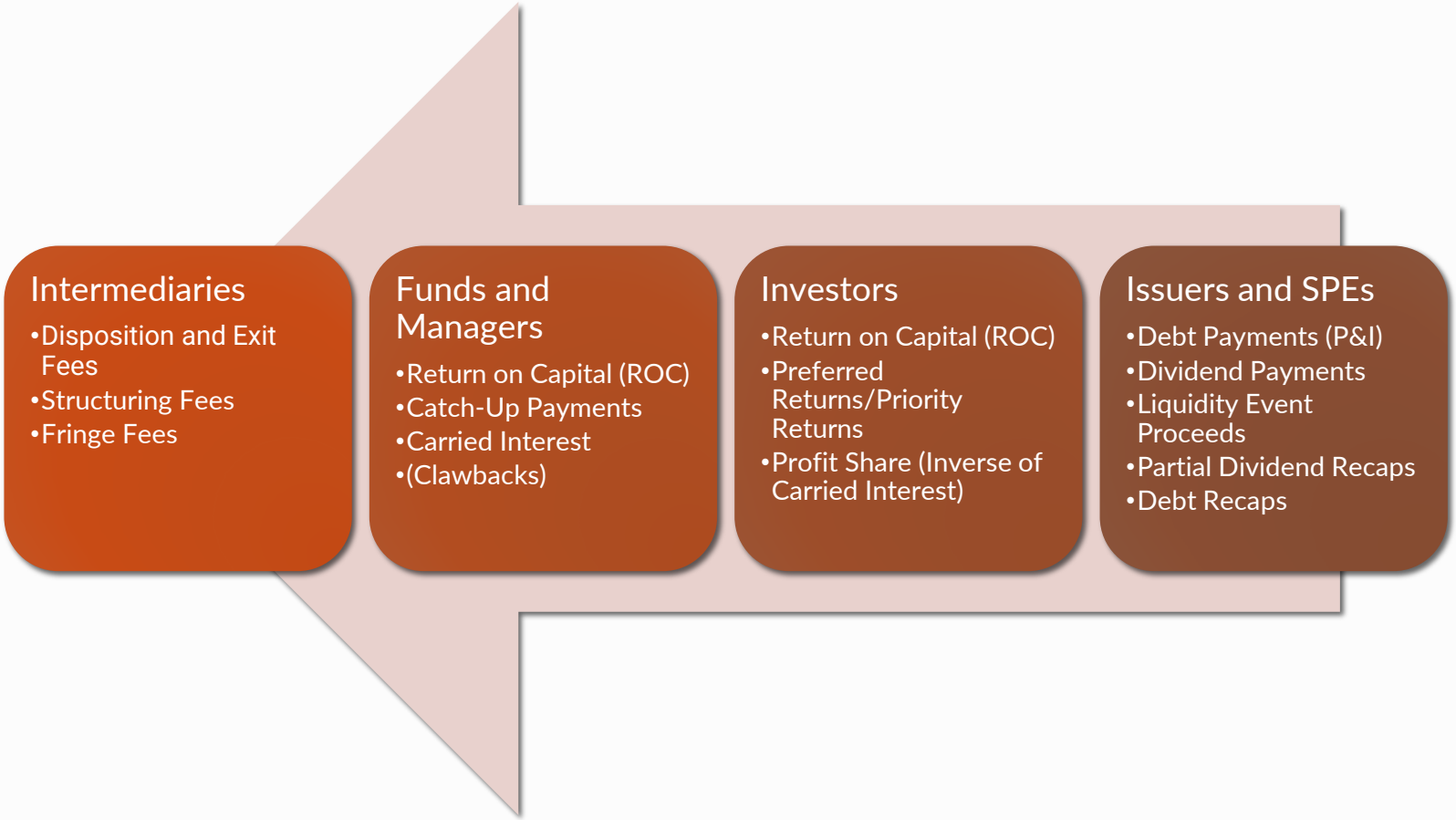

# Private Offering Ecosystem

Investors and Investments




# Private Offering Ecosystem

Capital Flows and Fees

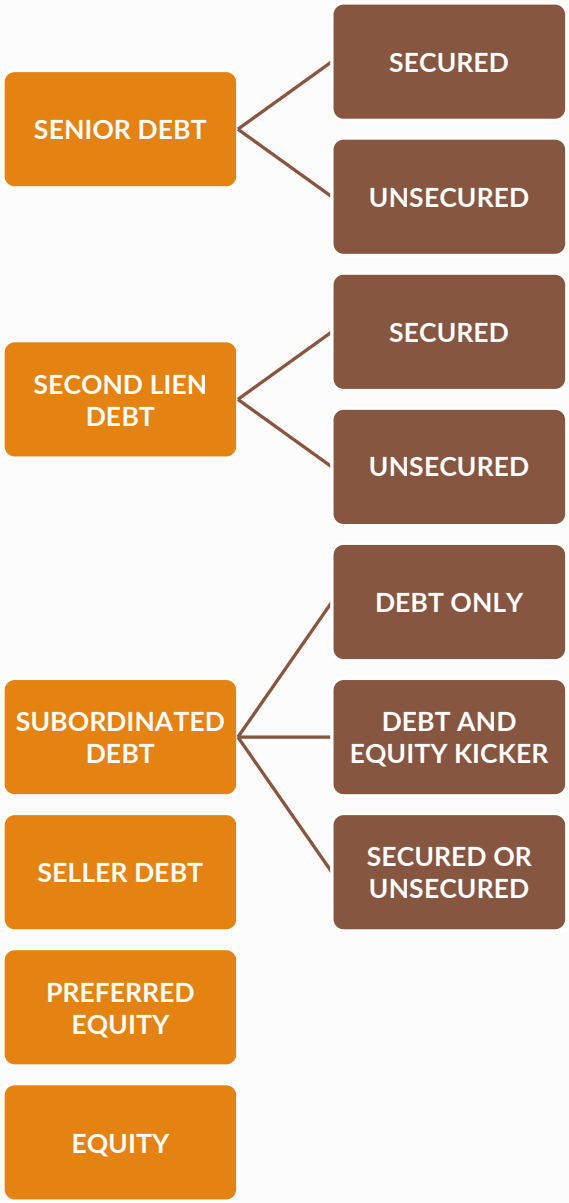



# Private Offering Ecosystem

Returns and Income

# Regulatory Basics

## Capital Types



# Regulatory Basics

**Most Common Exemptions**

## Rule 506(b) Private Placements

- Allow companies to raise unlimited capital from investors with whom the company has a relationship and who meet certain wealth thresholds or have certain professional credentials. A company cannot use general solicitation in a 506(b) private placement

## Rule 506(c) General Solicitation Offerings

- Allow companies to raise unlimited capital by broadly soliciting investors who meet certain wealth thresholds or have certain professional credentials

## Rule 504 Limited Offerings

- Allow companies to raise up to $10 million in a 12-month period, in many cases from investors with whom the company has a relationship.

# Regulatory Basics

Additional Exemptions

## Regulation Crowdfunding Offerings

- Allow eligible companies to raise up to $5 million in investment capital in a 12-month period from investors online via a registered funding portal

## Intrastate Offerings

- Allow companies to raise capital within a single state according to state law. Many states limit the offering to between $1 million to $5 million in a 12-month period

## Regulation A Offerings

- Often referred to as a “mini-IPO”, allow eligible companies to raise up to $20 million in a 12-month period in a Tier 1 offering and up to $75 million in a 12-month period in a Tier 2 offering through a process similar to, but less extensive than, a registered offering

# Regulatory Basics

**Avoiding General Solicitations**

## Avoiding General Solicitation

- Conduct an offering that is limited to investors with whom the company (or its broker dealer or investment adviser) has a pre-existing, substantive relationship

## Pre-Existing

- Generally means the relationship was formed **before** the start of the offering.
- Also can be established through a broker-dealer or investment adviser prior to that investment professional's participation in the offering

## Substantive

- Formed when the entity offering securities (i.e., the company or its broker- dealer or investment adviser) has **sufficient information to evaluate** and evaluates a potential investor's status as an accredited investor

# Regulatory Basics

**Retail Communications and FINRA**

## Private Placement Retail Communications

- Many private placement offerings to retail investors include marketing or sales communications that meet the definition of retail communication in Rule 2210(a)(5)
- The adoption of Rule 506(c)under Reg D eliminated the prohibition against general solicitation and advertising for private placement offerings where all purchasers of the securities are verified accredited investors
- Consequently, member firms have become increasingly involved in the distribution of private placement securities through online platforms and other widely disseminated communications such as digital advertisements
- FINRA Rule 2210(d)(1) requires that all member firm communications be fair, balanced and not misleading

# Regulatory Basics

**Demo Days**

## Demo Days?

- Recent rule changes clarify how companies can pitch to potential investors at qualifying demo day events without being considered a general solicitation

## Key Criteria

- Sponsor of the event is a college, university, state or local government, nonprofit organization, angel investor group, incubator, or accelerator
- Sponsor is limited in its role outside of serving as the event host
- Advertising for the event does not reference any particular securities offering
- Information about the offering shared during the event is limited to notification of planned or ongoing offering, type and amount of securities being offered, intended use of the proceeds, and unsubscribed amount

| | Rule 504 | Rule 506(b) | Rule 506(c) |
|---|---|---|---|
| **Maximum size of offering** | $5 million (in aggregate with all securities sold under Section 3(b)(1) or in violation of Section 5(a) of the Securities Act) per year | No limit on size of offering | No limit on size of offering |
| **Issuers permitted to rely on this exemption** | Non-reporting companies; non-investment companies (as defined in the Investment Company Act of 1940, as amended (ICA)), nor blank check companies | Any issuer. It can be used by both reporting companies and non-reporting companies | Any issuer. It can be used by both reporting companies and non-reporting companies |
| **"Bad actor" disqualification** | Bad actor disqualification by reference to Rule 506 bad actor disqualification | Certain Criminal Convictions (5-10 years old)<br>Court Injunctions (5 years old)<br>SEC Administrative Orders (5 years old)<br>State Securities Regulator Orders<br>Security Industry Bars, Suspensions, Expulsions | Same |
| **Types of investors that can buy the securities** | Any investor. No limits on number or sophistication of investors | Unlimited accredited investors and up to 35 non-accredited investors (must be sophisticated investors) | Unlimited accredited investors |
| **Limitations on resale of securities?** | Yes, subject to the exceptions provided by Rule 504(b)(1) | Yes | Yes |
| **Form D filing?** | Yes | Yes | Yes |
| **Blue Sky Preemption?** | No | Yes | Yes |

# Three Primary Paths

## Confirm Exemption and Related Requirements

# Regulatory Basics

**Integration**

## 6-Month Rule

- Taking advantage of any registration exemptions through a Regulation D offering requires that all sales of securities of the same class or for the same purpose within the six months preceding and following a reported offering must be integrated

## Exceptions

- Offers and sales will not be integrated if, based on the particular facts and circumstances, the Issuer can establish that each offering either complies with the registration requirements of the Securities Act or that an exemption from registration is available for the particular offering (including four specific safe harbors for non-integration)
- The concept of integration seeks to prevent issuers from improperly evading registration with the SEC by artificially dividing a single offering into multiple offerings

# Regulatory Basics

**Accredited Investor Overview**

## Criteria: Individuals

- Net worth over $1 million, excluding primary residence (individually or with spouse or partner)
- Income over $200,000 (individually) or $300,000 (with spouse or partner) in each of the prior two years, and reasonably expects the same for the current year

## Criteria: Professionals

- Investment professionals in good standing holding the general securities representative license (Series 7), the investment adviser representative license (Series 65), or the private securities offerings representative license (Series 82)
- Directors, executive officers, or general partners (GP) of the company selling the securities (or of a GP of that company)
  - Different from the “Issuer Exemption”
- Any “family client” of a “family office” that qualifies as an accredited investor
- For investments in a private fund, “knowledgeable employees” of the fund

# Regulatory Basics

**Accredited Investor Overview**

## Criteria: Corporates

- Entities owning **investments** in excess of $5 million
- The following entities with **assets** in excess of $5 million: corporations, partnerships, LLCs, trusts, 501(c)(3) organizations, employee benefit plans, “family office” and any “family client” of that office
- Entities where **all equity owners** are accredited investors
- Investment advisers (SEC- or state-registered or exempt reporting advisers) and SEC-registered broker-dealers
- A bank, savings and loan association, insurance company, registered investment company (RIC), business development company (BDC), or SBIC or rural SBIC

| Scenario | PPM Required by Law? | Market/Practical Expectation | Notes |
|---|---|---|---|
| Rule 506(b) – Only Accredited Investors | No | Strongly advised | Broker-dealers and institutions usually require a PPM; protects against liability |
| Rule 506(b) – Any Non-Accredited Investors | Yes | Mandatory | Extensive disclosures required, typically via a PPM |
| Rule 506(c) – General Solicitation Allowed | No | Strongly advised | Only accredited investors allowed; PPM is best practice for compliance and risk |

# Do We Need a PPM?

A Common and Loaded Question

# Regulatory Basics

**Content of Disclosures**

## Non-Accredited Investor Standards

- Issuers must provide detailed disclosures **equivalent to those in a registered public offering**, including:
  - Business operations, risks, and use of proceeds
  - Audited financial statements for offerings over $20 million
  - Management background and conflicts of interest

## Accredited Investors?

- While Regulation D **minimizes** federal disclosure mandates for accredited-only offerings, issuers must rigorously document material information to comply with anti-fraud rules and state requirements
- A well-drafted PPM remains critical for risk management, even when not legally required

# Regulatory Basics

**Best Tips for Counsel**

## Issuer Due Diligence

- Verify material facts (financials, contracts, litigation) to prevent misrepresentation claims
- Conduct background checks on management and key stakeholders

## Offering Due Diligence

- Evaluate veracity of claims made and related disclosure
- Consider and evaluate risk with information gaps, potentially misleading statements and other common issues

## Investor Due Diligence

- Does the Issuer “know” the investor?
- Ensure compliance with AML requirements

# Regulatory Basics

**Best Tips for Counsel**

## Scope of Disclosure

- All documents and communications can become part of the “disclosure” documents in a private offering depending on facts and circumstances
- What is presented formally versus informally?
- What off-channel/electronic communications are occurring?

## Required Filings

- Disclosure Documents
- Subscription Agreements
- Form D (15 days)

## Recordkeeping

- All disclosure, subscription and verification documents must be kept for **5 years**

# Regulatory Basics

**Best Tips for Counsel**

## Monitor for Changes

- A regulatory requirement to update private offering materials exists only in rare circumstances; however, they can be implied by statements made in disclosure materials and/or by the Issuer itself
- If material changes occur, consider the need to update investors and the form/medium of communication

## Remember Rescission and State Claims!

- State securities laws and related claims can offer far lower thresholds for plaintiffs

AVOIDING PITFALLS IN PRIVATE OFFERINGS

# QUESTIONS AND PARTING THOUGHTS