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In this issue...

PRIVATE PLACEMENTS-THE SALE OF UNREGISTERED SECURITIES

I. Introduction	Pg 1
II. Private Placements	Pg 1
A. Rules 504 and 505	Pg 2
B. Rule 506	
III. Transaction Exemptions from Registration	Pg 3
IV. Intrastate Offering Exemption	Pg 4

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Private Placements-The Sale of Unregistered Securities

I. INTRODUCTION

Start up companies and companies expanding in growth are on a continuous search for additional capital, whether equity or debt. In their endeavor to raise this capital, the companies inevitably are confronted with the issue of how to raise the capital without violating the provisions of both state and federal securities laws. Most states have laws requiring the registration of the offer or sale of securities either from or in their jurisdictions. These laws are generally known as "blue sky laws." As with the federal laws, most states also have limited exemptions for the offer or sale of securities which require technical application. In this release we will be discussing the sale of unregistered securities under federal law, primarily the Securities Act of 1933 (the "Act").

The Act is based on the premise that investors unable to fend for themselves can best be protected by requiring 'full and fair disclosure,' upon which they can make intelligent investment decisions. To better ensure full and fair disclosure, section 5 of the Act requires that all non-exempt offerings of securities be registered. It is this registration process that provides the Securities and Exchange Commission an opportunity to review offering materials prior to a securities offering, thus insuring some protection to the unwary public.

It is critical in the capital raising function to determine whether or not there are applicable exemptions available for the capital raise, thus avoiding the costly registration process, and what must be done by the company to comply with the exemptions. As enacted, the Act did not envision any disclosure requirements for exempt offerings. The statutory design, how-

ever, has been substantially altered in recent years, with embellishment of many exemptions through Commission rules and court decisions, to require in exempt offerings a distribution of information comparable to that called for in the typical prospectus.

The Act has five transaction exemptions available to companies issuing their own securities: the single issuer exchange exemption found in section 3(a)(9) of the Act; the regulated exchange exemption found in section 3(a)(10) of the Act; the intrastate offering exemptions found in section 3(a)(11) of the Act and in SEC rule 147 thereunder; the private offering exemptions found in section 4(2) of the Act and in SEC rule 506 thereunder, and 4(6) of the Act and in SEC rules 504 and 505 and regulation A thereunder.

II. PRIVATE PLACEMENTS

Section 4(2) of the Act exempts from registration 'transactions by an issuer not involving any public offering.' The legislative history of section 4(2) indicates an intent to exempt those transactions 'where there is no practical need for the Act's application...or where the public benefits are too remote.' The courts have interpreted this exemption as contemplating situations in which the financial sophistication of the offerees, the limited manner of offering, or both render unnecessary the protective function of the Act's registration provisions.

Regulation D, which was adopted on March 8, 1982, and became effective on April 15, 1982, among other things contains rules 504, 505, and 506, which replaced rules 240, 242, and 146 respectively. The statutory source of the exemptions provided by rules 504 and 505, which limit the size of offerings to \$1,000,000 and \$5 million respectively, is

(Continued on page 2)

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section 3(b) of the Act. The statutory source of the rule 506 exemption is section 4(2) of the Act, which contains no limit on the size of an offering. Rule 501 contains definitions relevant to each of the exemptions under regulation D, including a definition of 'accredited investor,' a pivotal term in both rules 505 and 506. Rule 502 sets forth general standards applicable to all three of the regulation D exemptive rules, including the following integration standard: All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act.

It is important to note that to preserve the safe harbor, offers may not begin within six months of the most recent sale, even though sales in the purported new offering will not be consummated until a later date. Rule 502(a) also provides that the five integration criteria referred to in SEC Release No. 4552 are to be applied in analyzing whether activity outside the safe harbor merits integration. Rule 502 also contains provisions relating to the manner of the offering, including a prohibition against general solicitation or advertising, restrictions on resales, and information requirements.

A. Rules 504 and 505

The rule 504 exemption is available to all issuer offerings other than an offering by a reporting company or an in-

vestment company. Accordingly, it can be used by limited partnerships and foreign issuers. Rule 504 limits the amount of the offering during a twelve-month period to \$1,000,000. Included in that amount are all sales made within the preceding twelve months pursuant to regulation A or rule 505 and any sales made in violation of section 5 of the Act. There is no limitation on the number of shareholders of the issuer upon completion of the offering or restrictions on the payment of commissions. Rule 504 does not require the use of a specific disclosure document; however, there may be a disclosure requirement under the applicable state laws. If the securities are registered (under state law) and sold exclusively in states that require the delivery of a disclosure document, the regulation D restrictions against general solicitation and advertising are inapplicable and the securities, which are unrestricted, may be acquired for resale. The important emphasis on rule 504 is that, assuming registration in a particular state, the securities are issued without a restrictive legend, and may be resold immediately. This provides liquidity to an investor, without waiting the typical 1 – 2 years under rule 144 prior to resale. However; this obviously presupposes that the issuer has commenced trading.

Rule 505 can be used for offerings by issuers such as oil and gas companies, limited partnerships, and foreign issuers. It cannot be used by an issuer that is an investment company or issuers disqualified because of certain prior conduct on the part of persons affiliated with the issuer or a party receiving commissions in connection with the offering.

An issuer cannot raise more than \$5 million pursuant to rule 505 during a twelve-month period. The manner of calculating the limitation is similar to that in applying the \$1,000,000 limitation under rule 504; that is, there must be added to the aggregate offering price of the securities being offered pursuant to the rule, the aggregate offering price of securities sold during the preceding twelve months in reliance upon a section 3(b) exemption and securities sold during the same period in violation of the registration provisions. Securities of predecessors and affiliates are, accordingly, included only to the extent the general integration concepts contained in SEC Release No. 4552 are applicable. Securities sold in reliance on the rule 506 exemption are not included, provided integration of the rule 505 and 506 offerings is not called for by SEC Release No. 4552.

A rule 505 offering can be made

to an unlimited number of offerees, provided there are no more than thirty-five nonaccredited investors. Nonaccredited investors in a rule 505 offering do not have to meet any sophistication or suitability requirements. An issuer can make a series of rule 505 offerings, each of which may involve up to thirty-five nonaccredited purchasers, provided that the offerings are not deemed integrated and collectively do not exceed the \$5 million limitation. In calculating the number of nonaccredited investors, a corporation, partnership, or other entity is counted as one purchaser unless it is organized for the specific purpose of acquiring the securities being offered. In this event, each beneficial owner of an equity interest in the entity is counted. A relative, spouse, or relative of a purchaser who has the same principal residence as the purchaser, and trusts, estates, and entities in which the purchaser and such related persons own collectively more than fifty percent of the beneficial (equity) interest are deemed one person in determining the thirty-five person limitation. The latter provision relating to trusts, estates, and entities is a relaxation of rule 242, which required 100% ownership by such persons.

B. Rule 506

Rule 506, although substantially identical to rule 505, differs in the following respects:

- Whereas a rule 505 offering cannot exceed \$5 million in a twelve-month period, rule 506 offerings can be unlimited in amount.
- Any issuer (including an investment company) can use the rule 506 exemption.
- There is no disqualification because of prior conduct of persons affiliated with the issuer or a party receiving commissions in connection with the offering.
- The nonaccredited purchasers in a rule 506 offering (but not a rule 505 offering), either alone or with the assistance of a purchaser representative, must have sufficient financial and business knowledge and experience to be capable of evaluating the merits and risks of their prospective investments. This is the principal difference between the two rules and the main incentive for using rule 505 for offerings of under \$5 million.
- The disclosure requirements are the same under rules 505 and 506 if the issuer is a reporting company under the Exchange Act. If the issuer is not a reporting company, the financial statement disclosure requirements in a rule 506 offering are

(Continued on page 3)

somewhat more stringent if the offering exceeds \$5 million, assuming the sale to nonaccredited purchasers.

Additionally, as the result of the passage of the National Securities Markets Improvement Act (NSMIA) into law on October 11, 1996, state registration requirements generally do not apply in the case of an offering pursuant to Rule 506 of Regulation D. NSMIA does not prohibit a state from imposing in connection with a Rule 506 offering notice filing requirements substantially similar to Form D.

Section 4(6)

Section 4(6) of the Act was enacted in 1980 as a means of easing the restrictions on private placements of securities. This was prior to the adoption of rule 242 and regulation D and after a substantial period in which small companies had been largely denied access to the capital markets.

Specifically, section 4(6) provides an exemption from registration for transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under Section 3(b) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commissions as the Commissions shall prescribe.

This exemption has largely become a dead letter in the Act because shortly after its adoption the Commission proposed and adopted regulation D, which under rule 505 provides for sales of securities under substantially the same (but less onerous) conditions as those provided in this provision. These two exemptive provisions differ only in the following respects:

- Sales under section 4(6) may only be made to accredited investors, a term defined in section 2(15) of the Act and now extended in rule 501(a).
- Section 4(6) contains no limitations on the kinds of issuers who may rely on the exemption, whereas rule 505 may not be relied upon investment companies or issuers disqualified under the 'bad boy' provisions of rule 252(c).
- Because section 4(6) does not contemplate sales to nonaccredited investors, it has no disclosure requirements.
- The section 4(6) exemption rests upon the purchasers that are 'accredited investors,' whereas the rule 505 exemption

is available if the issuer reasonably believed that all but thirty-five of the purchasers were 'accredited investors.'

There are no express aggregation provisions for section 4(6) offerings, whereas rule 505 offerings must include all sales made in reliance upon section 3(b) exemptions as well as sales in violation of section 5 of the Act.

Section 4(6) does not have the benefit of the six-month safe harbor set forth in rule 502(a).

III. TRANSACTION EXEMPTIONS FROM REGISTRATION

SECTION 3(a)9

Section 3(a)(9) of the Act provides an exemption for any securities exchanged by the issuer solely with its existing securityholders in which no commission or other remuneration is given directly or indirectly for soliciting exchange. Offerings pursuant to section 3(a)(9) must be bona fide in the sense that the recipients of the newly issued securities may not be conduits in a broader public offering.

The section 3(a)(9) exemption has received little judicial or administrative interpretation. The threshold question of 3(a)(9) analysis is whether the offered securities and the securities to be surrendered are issued by the same entity. If they are not, then even if the new issuer represents essentially a reconstruction of the original issuer, the exemption will be unavailable even though no new investment decision is required. The distribution must be accomplished largely by the issuer's personnel without extra compensation, except for reimbursement of incidental expenses.

Section 3(a)(9) does not require the use of a disclosure document, although, as a practical matter, most such offerings are accompanied by a document setting forth the terms of the exchange and describing the new securities being offered. The exemption, in large measure, is premised on the belief that existing security holders of the issuer will normally be familiar already with the operations, management, and finances of the issuer, and that therefore the registration process will provide little additional investor protection. Further investor protection is also obtained through prohibition against the payment of commissions or special solicitation fees.

SECTION 3(a)10

Section 3(a)(10) of the Act provides a transaction exemption for the issuance of securities in exchange for

securities, claims, or properties in which the fairness of the exchange has been approved after a hearing by a court, official, or agency of the United States, or any state or territorial banking or insurance commission or other governmental agency expressly authorized by law to grant such approval. For example, the exemption applies to the issuance of securities under the Public Utility Holding Company Act. Specifically, section 3(a)(10) provides any security which is issued in exchange for one or more bona fide outstanding securities, claims, or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

Although this provision originally was adopted to cover the reorganizations of financially troubled companies, today it is not available for use in bankruptcy proceedings as a result of a statutory amendment adopted in 1978. Nevertheless, it is commonly used in acquisitions transactions in which the applicable state law provides for a hearing on the merits to determine the fairness to the transaction.

Section 3(a)(10) offerings do not necessarily involve the preparation and dissemination of a disclosure document. Instead, they rely upon substantive review by an impartial tribunal to ensure investor protection. Many regulators would consider this form of protection superior to the Act's registration process, as there is always a strong likelihood that many, if not most, offerees would not read a prospectus if it were disseminated to them, assuming they even received it prior to their purchase.

IV. INTRASTATE OFFERING EXEMPTION

Section 3(a)(11) of the Act exempts from registration any security that is a part of an issue offered and sold only to persons residing within a single state or territory. The intrastate offering exemption provided for by section 3(a)(11) is premised on the notion that wholly intrastate transactions are adequately policed by state regulation. Specifically, section 3(a)(11) exempts from registration: any security which is a part of
(Continued on page 4)

an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

To be eligible for the intrastate exemption under section 3(a)(11), noncorporate issuers must be residents of, and corporate issuers must be incorporated within, the state in which all prospective offerees reside. An offer to even one out-of-state resident is sufficient to deny the availability of the exemption. In addition, the issuer must be 'doing business,' and under rule 147, at least eighty percent of the financing proceeds must be used, in the state. Although the entire offering must be sold exclusively to residents of the subject state, section 3(a)(11) offerings are not limited in size, nor are there any specific disclosure requirements.

The exemption afforded by section 3(a)(11) applies to 'any security which is part of an issue' offered and sold exclusively to residents of one state. Therefore, if an entire issue is not sold intrastate, the

exemption is unavailable. The courts and the Commission have applied traditional integration criteria to the definition of 'part of an issue,' which may result in combining two purportedly separate offerings by an issuer for purposes of determining the exemption's availability.

Moreover, rule 147, which represents the Commission's attempt to establish objective standards for the application of section 3(a)(11), provides that all sales must be to residents of the subject state by not permitting resales to nonresidents until nine months after the issuer's last sale.

Rule 147, paragraph (b)(2), attempts to eliminate some of the uncertainty in factually determining whether integration is required by providing:

For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sales or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4 (2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, for

sale or sales pursuant to this rule, provided that, there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

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