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The Nuts and Bolts of Preparing Private Offerings

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INTRODUCTION

Private Placements – Overview of Topics

- What is a security? What is a private placement/private offering?
- Overview of Regulation D and S exemptions from registration
- Why the JOBS Act changed the landscape
- Finding investors/Using intermediaries and placement agents
- Qualifying prospective investors
- Preparing a private placement memorandum
- The concept of materiality
- Practical guidance for drafting disclosures
- Closing the offering and Filing Form D
- Liability for non-compliance with an exemption
- Bad Actor disqualifications

I. What is a security? What is a private offering?

A. What is a security?

- Securities Act of 1933, §2(a)(1): The term security means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit –sharing agreement....investment contract...
- Supreme Court definition of an *investment contract* in *Howey (SEC v. W. J. Howey Co., 328 U.S. 293 (1946))*:
 - A person invests money,
 - In a common enterprise,
 - Is led to expect profits and
 - Solely from the efforts of others

B. Registered and unregistered offerings

- The Securities Act of 1933 regulates the public offering/sale of securities:
 - The offering of securities for sale must generally be registered with the Securities and Exchange Commission according to the requirements at §5 of the Securities Act
 - The Securities Act exempts specific kinds securities from the registration requirements at § 5 of the Securities Act

C. Exemptions from registration requirements

- **Statutory exemption**

- §4(a)(2) of the Securities Act --- numbered as §4(a)(2) by the JOBS Act of 2012 --- exempts from registration any offering "by an issuer not involving any public offering"
- Are offerees and investors "able to fend for themselves"?
 - Is there access to information?
 - Do investors have the ability to evaluate the information?
 - *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953)

- **Safe harbor rule under Regulation D**

- Regulation D, Rule 506: Provides clear guidance for issuers and "...transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 (the Act)"

D. Overview of exemptions from registration

- Regulation A (See Rules 251-264 for "offering circular" requirements)
- New Regulation A+ (Offerings up to \$50 million)
- Regulation D
 - Rule 504 (Small offerings up to \$1 million)
 - Rule 505 (Nonpublic offerings up to \$5 million with 35 or fewer unaccredited investors)
 - Rule 506(b), 506(c) and 506(d)
- Regulation S applies where securities are offered and sold outside the United States
- A Regulation S offering may be pursued even if there are coincident offers and sales under Regulation D

E. Anti-fraud rules also apply to private offerings

- Offerings **are not** exempt from the antifraud, civil liability or other provisions of the federal securities laws
- Issuers have 10(b) and 10(b)-5 exposure:
 - "Issuers are reminded of their obligation to provide such further material information, if any, as may be necessary to make the information required under Regulation D, in light of the circumstances under which it is furnished, not misleading."
 - Look to state law as well for anti-fraud investor protections
 - Language in offering documents should be reviewed by experienced securities and litigation counsel to ensure that all material disclosures are made and to ensure that appropriate risk factors highlighted for investors.

E. Anti-fraud rules also apply to private offerings (cont.)

- State "blue sky" securities regulations also apply to protect investor
- Utah blue sky law laws define fraud at U.C.A. §61-1-1

It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly to:

- (1) Employ any device, scheme or artifice to defraud;*
- (2) Make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or*
- (3) Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.*

F. How the JOBS Act has changed the landscape

- Enacted in 2012, the *Jumpstart Our Business Startups Act*, or JOBS Act, was intended, among other things, to reduce barriers to capital formation, particularly for smaller companies.
- The JOBS Act required the SEC to adopt rules amending existing exemptions from registration under the Securities Act of 1933 and creating new exemptions that permit issuers of securities to raise capital without SEC registration.
- On July 10, 2013, the SEC adopted amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act to implement the requirements of Section 201(a) of the JOBS Act. The amendments became effective on September 23, 2013.

F. JOBS Act (cont.)

Rule 506(b) of Regulation D

- Section 4(a)(2) of the Securities Act exempts from registration “transactions by an issuer not involving any public offering.” Rule 506(b) is a rule under Regulation D that provides conditions that an issuer may rely on to meet the requirements of the Section 4(a)(2) exemption. One of these conditions is that an issuer must not use general solicitation to market the securities.
- “General solicitation” includes advertisements published in newspapers and magazines, public websites, communications broadcasted over television and radio, and seminars where attendees have been invited by general solicitation or general advertising. In addition, the use of an unrestricted, and therefore publicly available, website constitutes general solicitation. The solicitation must be an “offer” of securities, but solicitations that condition the market for an offering of securities may be considered to be offers.

F. JOBS Act (cont.)

- **Rule 506(c) of Regulation D**

- Section 201 (a) of the JOBS Act requires the SEC to eliminate the prohibition on using general solicitation under Rule 506 where all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that the purchasers are accredited investors.
- To implement Section 201 (a), the SEC adopted paragraph (c) of Rule 506. Under Rule 506(c), issuers can offer securities through means of general solicitation, provided that:
 - all purchasers in the offering are accredited investors,
 - the issuer takes reasonable steps to verify their accredited investor status, and
 - certain other conditions in Regulation D are satisfied.

F. JOBS Act (cont.)

- An “accredited investor” includes a natural person who:
 - earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or
 - has a net worth over \$1 million, either alone or together with a spouse (excluding the value of the person’s primary residence).
- In a private placement relying on the exemption under Rule 506(b) and not the JOBS Act, 35 unaccredited investors may come into the offering
- If you rely on the JOBS Act, how do you comply with the requirement to take a reasonable step to ensure an investor is accredited?

F. JOBS Act (cont.)

- SEC's non-exclusive list of verification methods:
 - verification based on income, by reviewing copies of any Internal Revenue Service form that reports income, such as Form W-2, Form 1099, Schedule K-1 of Form 1065, and a filed Form 1040;
 - verification on net worth, by reviewing specific types of documentation dated within the prior three months, such as bank statements, brokerage statements, certificates of deposit, tax assessments and a credit report from at least one of the nationwide consumer reporting agencies, and obtaining a written representation from the investor;
 - a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant stating that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the last three months and has determined that such purchaser is an accredited investor.

G. Finding Investors

- Use registered intermediaries and placement agents
- Check background of placement agents:
 - FINRA (Financial Industry Regulatory Authority)
 - FINRA is dedicated to investor protection and market integrity through effective and efficient regulation of the securities industry.
 - Not the government– private regulatory authority
 - <http://brokercheck.finra.org/Search/Search>
 - Broker-dealers should be FINRA members
 - SEC/state regulators
 - <http://www.sec.gov/investor/brokers.htm>
 - States play an expanded role – look to state investment adviser rules

G. Finding Investors (cont.)

- Consequences of unregistered broker-dealers or placement agents being engaged to sell a deal:
 - Rescission of investment --- Issuer Liability
 - Potential adverse action by the SEC and state regulators
 - Issuer could be deemed a "bad actor" disqualified from future Rule 506 offerings
 - SEC enforcement actions apply to **US persons** who sell or place investors in deals outside the United States
 - Negotiating on behalf of investors, engaging in any regular business activities that focus on matching investors and deals, evaluating merits of a deal and making recommendations to buy or sell are activities that the SEC and states regulate

H. Qualifying Prospective Investors

- Under Rule 505 and Rule 506(b), an unlimited number of accredited investors may participate in offerings and up to 35 non-accredited investors may participate
- Under Rule 506(c) --- JOBS Act --- only accredited investors may participate
- Under Rule 506(b), an unaccredited investor must be sophisticated meaning that alone or with a purchaser representative, the investor "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment"
- Rule 506(b) requires issuer to have reasonable belief that an investor is accredited based on investor's self-certification in a questionnaire
- Rule 506(c) --- JOBS Act --- requires reasonable steps to verify that all purchasers are accredited investors

H. Qualifying Prospective Investors (cont.)

- Burden to demonstrate compliance and eligibility for exemption is on issuer
- Recordkeeping – issuers should maintain questionnaires and correspondence with investors as well as any back-up documentation
- Regulation S does not require investors to be accredited
- Regulation S sale must take place outside the US and purchaser may not be a US person
- In a concurrent Regulation S and D offering, maintain list of Regulation S investors with appropriate questionnaires and evidence that sale was transacted outside the United States

II. Guidance for Preparing Offering Materials

A. Preparing a Private Placement Memorandum (PPM)

- Antifraud provisions of federal and state law require issuers to provide investors with full, fair and complete disclosures of all material facts about the issuer, its management, business, operations and finances
- If offering will be sold to non-accredited investors under Rule 505 or 506(b), financial disclosures are required pursuant to Rule 502(b)(2)
- A PPM is designed to comply with disclosure requirements under Rule 502(b)(2)
- A PPM should contain fair and balanced statements regarding the issuer and the offering
- A PPM is also an issuer's defense against future allegations of fraud
- Oral statements by the issuer, a broker-dealer or placement agent must be consistent with the PPM
- FINRA Rule 5123: File PPM and offering docs. 15 days before first sale

B. What is material in terms of a disclosure?

- Look at existing case law and doctrine on materiality
- **Buried Facts doctrine**
 - Don't bury the facts in too much information [e.g., *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331 (E.D. PA 1970), finding proxy statement to be materially misleading for prominently disclosing an investment advisor's favorable opinion but burying in an appendix that the adviser had failed to evaluate the firm's assets)
- **Total Mix test**
 - There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available (*TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976))

B. What is material in terms of a disclosure? (cont.)

- Historical facts: Is information relevant to current financial position of company? See *TSC v. Northway* (U.S. 1976)
- Speculative information: "Probability vs. magnitude" test, See *Basic v. Levinson* (U.S. 1988)
- Soft information regarding forward-looking projections: Is there a basis for an opinion/prediction? See *Virginia Bankshares v. Sandberg* (U.S. 1991)
- Information on management: Is there a conflict of interest? Is compliance with laws unclear? See *In re Franchard* (SEC 1964)
- Social/environmental information: Are environmental proceedings pending or potential? Is business impacted by climate change? See *Guidance on Climate Change* (SEC 2010)
- Cyber-security threats and data security: New territory for disclosures, See <http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm>

C. Ten Tips for Drafting Risk Factors and Disclosures

1. Disclose any material permits that will be needed but that have not been issued (e.g., building permits in projects involving real property, environmental permits where required)
2. Disclose pending or aspirational financing such as a senior loan or bond financing, and articulate consequences to investors if funding is not secured
3. Disclose litigation that may impact the overall financial position of the issuer, or that could impact a reasonable investor's decision to invest, such as related parties in a deal and non-arm's length transactions
4. Consult specialized legal counsel for areas outside your expertise that play a role in your client's deal (e.g., health care lawyers if you are dealing with FDA regulatory disclosures)
5. Stay current on new areas such as cyber-security so that you know how the SEC is advising issuers on risk disclosure

C. Ten Tips for Drafting Risk Factors and Disclosures (cont.)

6. Don't bury relevant facts in irrelevant information
7. Understand the issuer's operational and financial risks so you can identify facts that should be included with disclosures
8. Consider contemporary issues such as climate change, labor shortages, terrorist threats and related risks as they relate to the issuer and the investment opportunity
9. Meet with a client several times to draft a PPM and to ensure that risk factors are correct and sufficient
10. Keep in mind that you have ethical obligations as a lawyer (e.g., duty of candor to a tribunal, duty of competence)

D. Closing an Offering and Form D

- Develop a pre-launch checklist to review with a client
- Ensure that PPM and all offering materials are current
- Check state registration requirements
- File Form D with the SEC (Notice of Exempt Offering of Securities)
 - File within 15 days of first sale--- with SEC and possibly with State
 - You must indicate the exemptions you are seeking, e.g., JOBS Act under Rule 506(c)
 - If offering is on market for more than one year, an annual Form D must be filed
 - See <http://www.sec.gov/info/smallbus/secg/formdguide.htm> for guidance on important issues such as when an amended Form D is or is not required
 - Consequences of failure to file Form D

E. Liability for Noncompliance with an Exemption

- Rule 508 under Regulation D
 - Insignificant deviations
 - Failure to comply with technicality does not result in loss of exemption
 - Good faith important factor
 - Failure is insignificant with respect to offering as a whole

F. Bad Actor Disqualification in Rule 506 Offerings

- Understanding the categories of persons that are covered by Rule 506(d) (which we refer to as “covered persons”) is important because issuers are required to conduct a factual inquiry to determine whether any covered person has had a disqualifying event, and the existence of such an event will either disqualify the offering from reliance on Rule 506 or will have to be disclosed to investors.
- *“Covered persons” include:*
 - the issuer, including its predecessors and affiliated issuers
 - directors, general partners, and managing members of the issuer
 - executive officers of the issuer, and other officers of the issuers that participate in the offering
 - 20 percent beneficial owners of the issuer, calculated on the basis of total voting power

F. Bad Actor Disqualification in Rule 506 Offerings (cont.)

- promoters connected to the issuer
- for pooled investment fund issuers, the fund's investment manager and its principals
- persons compensated for soliciting investors, including their directors, general partners and managing members
- Under the final rule, disqualifying events include:
 - Certain criminal convictions
 - Certain court injunctions and restraining orders
 - Final orders of certain state and federal regulators
 - Certain SEC disciplinary orders
 - Certain SEC cease-and-desist orders

F. Bad Actor Disqualification in Rule 506 Offerings (cont.)

- SEC stop orders and orders suspending the Regulation A exemption
- Suspension or expulsion from membership in a self-regulatory organization (SRO), such as FINRA, or from association with an SRO member
- U.S. Postal Service false representation orders
- Many disqualifying events include a look-back period (for example, a court injunction that was issued within the last five years or a regulatory order that was issued within the last ten years). The look-back period is measured from the date of the disqualifying event—in the example, the issuance of the injunction or regulatory order—and not the date of the underlying conduct that led to the disqualifying event

Conclusions

- An update on Crowd Funding – How useful is this going to be?
- What about EB-5 foreign financing? Does this program have a future?
- Can an issuer use the Internet to solicit investors? (JOBS Act)
- Pointers for insulating your deal from litigation- Investors file claims when they lose money
- Keep CLE current and also take a course at least every other year that addresses professional responsibility
- Consider looking at developments on the public company side (e.g., case law on materiality of disclosures) to prepare better PPMs
- Resources to consider:
 - <http://www.sec.gov/spotlight/disclosure-effectiveness.shtml>
 - <http://www.sec.gov/spotlight/enf-actions-ponzi.shtml>