PRIVATE PLACEMENT OFFERINGS

Obligations of Issuers, Selling Agents and Investors

Background

A Private Placement is a security or pooled investment fund that is not offered for sale to the general public. While their issuance is governed under the Securities Act of 1933, these investments are not registered with the SEC like stocks, bonds or other publicly traded securities. In order to comply with SEC and FINRA rules and notices, private placements impose unique obligations on issuers, sellers and purchasers. This paper offers insight into those obligations.

Regulation of Public Offerings of Securities

The Securities Act of 1933 regulates the offer and sale of securities in the United States or through interstate commerce. For offerings made to the public, the SEC generally requires that the issuing company file a registration statement describing itself and the securities it intends to offer. The SEC reviews the registration to ensure that the required disclosures are made prior to declaring the registration effective.

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Securities Exempt from Registration

Because some issuers are already regulated by federal and/or state regulatory entities, the SEC deems securities issued by these entities as exempt from registration under the Act. Those issuers include:

- Federal, state and local governments and most foreign governments
- Federal and state registered banks and depository institutions
- State licensed insurance companies
- Railroads and other public carriers
- Public utility companies
- Non-profit religious, educational and benevolent organizations
- Exchange listed options and warrants
- Employee benefit plans issues sold to company employees
- Equipment lease certificates

Rules Governing Private Placements

Non- Exempt issuers may seek exemptions from registering their offerings with the SEC under several provisions of the Act:

- Rule 147 Intrastate Offerings offers an exemption if the offering is sold only to investors residing in the state the company is domiciled. Individual state requirements will apply.
- Reg. A Section 3(b) exempts offerings of less than $5 million if an offering circular is filed with the SEC and provided to all prospective investors.
- Section 4(2) exempts offerings made to sophisticated investors only and requires that information similar to what would be available in a prospectus be provided to investors.
- Reg. D Offerings, the most common exemption sought by issuers, provides three exemptions of which Rules 505 and 506 are most commonly relied upon:
    - Rule 504 applies to transactions in which less than $1 million of securities are sold in any consecutive twelve-month period. It sets no maximum on the number of investors, permits the payment of commissions, and imposes no restrictions on the resale of securities. Rule 504 does not prescribe specific disclosure requirements.
    - Rule 505 applies to transactions in which not more than $5 million of securities are sold in any consecutive twelve-month period. Sales to thirty-five non-accredited investors and to an unlimited number of accredited investors are permitted. General solicitation and advertising are not permitted. Companies must give non-accredited investors an offering circular but are not required to provide one to accredited investors.
    - Rule 506 has no dollar limitation on the offering. It is available to all issuers for offerings sold to not more than thirty-five non-accredited purchasers and an unlimited number of accredited investors. Rule 506 requires an issuer to make a subjective determination that each non-accredited purchaser, either individually or in conjunction with a Purchaser Representative, has sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of investment. Like Rule 505, Rule 506 prohibits any general solicitation or advertising.
    - Rule 502(c) applies to any Reg. D offering. It prohibits issuers from engaging in general solicitation and advertising of private placements. In order to comply, issuers or issuer representatives such as broker dealers may solicit only from clients with whom a pre-existing relationship

exists OR through finders who can demonstrate a pre-existing relationship.

Note: The JOBS ACT of 2012 and amended SEC Rule 506(c) allow general solicitation under circumstances *(see below, page 8).*

Issuers of Private Placements

Typical issuers of private placement securities include small, privately-held companies who may not yet be viable candidates for a public offering, but who do not want to give up organizational control by accepting venture capital financing. Similarly, small or relatively young companies seeking debt financing may also prefer private placements, as may larger and more established companies who simply do not wish to make their financial statements public in a registered offering. Various limited partnership investment structures (such as hedge funds and private equity funds) also prefer the privacy provided by private placements offerings. Real Estate Limited Partnerships and Tenants-In-Common also rely on private placements rather than public offerings.

Advantages and Disadvantages for Issuers of Private Placements

By avoiding a public offering, issuers are able to spare themselves the time and expense involved in registration, meaning they can bring securities to market more quickly. Issuers also avoid disclosing their financial statements to the general public and to competitors, a highly valued aspect of private placements to some of the parties noted previously. Because the issuer controls the dissemination of offering material, they can tightly control who sees that information, when they see that information, and what information they see. The principal disadvantage faced by issuers is the limited number of prospective buyers. Issuers must offer more attractive interest on debt and greater discounts to market value on equity shares in order to compete for prospective buyers.

Advantages and Disadvantages for Investors in Private Placements

The principal attraction to investors in private placements is the prospect of higher returns. Private equity and debt securities are priced cheaper than issues of public companies, meaning investors have an opportunity to earn above market returns. Investors demand, and get, a return premium to compensate them for the reduced disclosure from the issuer, reduced liquidity of the issued securities and often the limited performance history of the issuer itself.

Hedge funds and private equity funds structured as limited partnerships are also sold as private placements. Hedge funds can be attractive to investors seeking higher investment returns or returns with reduced correlation to traditional asset classes. Private equity funds provide investors an opportunity to invest through a managed partnership in companies they would otherwise not have access to. Again, investors are seeking returns higher than the market rate. Hedge funds and private equity funds rely heavily on the ability of the manager and have higher fees, reduced transparency and restricted liquidity.

Hedge funds and private equity funds, because they engage primarily in the business of investing, can be subject to regulation under the Investment Company Act of 1940 and the Investment Advisers Act. A detailed examination of hedge funds and private equity funds is outside the scope of this paper.

Who May Purchase Private Placements

Because private placement offerings have different features than conventional investment vehicles, regulators have restricted their sale to a limited group of investors. Issuers, selling agents and investors all have responsibilities to ensure that the securities being offered are appropriate for the purchaser. Section (4)(2) of the Securities Act requires that investors have sufficient knowledge and experience in business to be able to evaluate the risks and merits of investing and have the financial means to bear the potential loss of that investment. To that end, issuers and selling agents are required to qualify prospective investors, and investors are required to attest to their qualifications as purchasers prior to investing. The SEC lists standards relating to those who are eligible to invest:

- <u>Accredited Investors</u> as defined in Rule 501 of the Act include:
  - Individuals with a net worth individually or jointly with their spouse greater than $1 million *excluding* their home (post-July 2010) OR with individual income greater than $200,000 or $300,000 jointly in the past two years and who can reasonably expect the same in the current year.
  - Corporations, partnerships or Limited Liability Companies with assets greater than $5 million and not formed for the specific purpose of purchasing the issue.
  - Revocable Trusts of accredited investors, bank trusts as defined in Section 3(a)(2) of the Securities Act or trusts whose assets are greater than$5 million, all of whom were not formed specifically to purchase the issue.
  - Banks and savings institutions defined in Section 3(a)(2) and 3(a)(5)A of the Securities Act.
  - Insurance companies as defined in Section 2(13) of the Securities Act.
- <u>Qualified Purchasers</u>, *i.e.* super-accredited investors as defined in the Investment Company Act of 1940, including:
  - Individuals or an individual and spouse with not less than $5 million in investments, not including their principal residence.
  - Family corporations, Limited Partnerships (FLP's), foundations, charitable organizations or trusts established by two or more related persons with not less than $5 million in investment and not formed for the purpose of purchasing the offering.
  - Trusts, other than family trusts above, not formed for the specific purpose of investing in the offering.
  - Other entities with not less than $25 million in investments not formed specifically for the purpose of investing in the offering.
- <u>Qualified Institutional Buyers (QIBs)</u>: As defined by Rule 144A of The Act, a QIB is any entity acting for its own account or on behalf of other QIBs who "owns and invests on a discretionary basis" at least $100 million in securities not affiliated with that entity. Entities considered QIBs include:
  - Insurance companies.
  - Investment companies registered under the Investment Company Act.
  - Small Business Investment Company licensed by the SBA.

- An employee benefit plan for employees of a state, a state agency or political subdivision.
- Any employee benefit plan under title I of the Employee Retirement Income Security Act of 1974.
- Any trust fund whose trustee is a bank or trust company.
- A business development company defined in section 202 of the 1940 Act.
- A 501(c) (3) organization.
- Any Registered Investment Advisor.
- A registered dealer under section 15 of the Exchange Act that, acting for its own account or the accounts of other QIB's owns and invests on a discretionary basis at least $10 million in securities.
- A registered dealer under section 15 of the Exchange Act acting as riskless principal for a QIB.
- An investment company registered under the Investment Company Act that is part of a family of investment companies which in the aggregate owns at least $100 million in securities other than those of the issuer.
- Any entity of which all equity owners are QIBs.
- Any bank or savings association that acting for itself or the accounts of other QIBs in the aggregate owns and invests on a discretionary basis at least $100 million in securities not affiliated with the issuer AND has an audited net worth of at least $25 million.

Obligations of Broker Dealers When Selling Private Placements

FINRA's Suitability Rule 2310 imposes an obligation on members and associated persons to have a reasonable basis for recommending any investment, meaning the recommendation must be considered suitable for at least some investors, and that the recommendation is suitable for the particular investor to whom it is recommended.

- Suitability of the investment: Applying the standard of *reasonable due diligence,* the member and its associated person must believe the recommendation is suitable for at least some investors. Reasonable due diligence would include an effort to understand the issuer and its management, issuer assets and the business prospects or business strategy of the issuer.
- Investor suitability: Meeting the accredited investor or qualified purchaser standard by itself does not determine suitability. The customer's investment profile, investment experience, investment holdings, tax status, risk tolerance, liquidity needs and investment time horizon all need to be considered when determining suitability.
- A pre-existing relationship is required between a prospective investor and the issuer or the issuer's representative. General solicitation via advertisements, articles or notices published or broadcast through any media is not permitted. Seminars or meetings regarding the offering may be held only if attendees are known and pre-qualified in advance of the meeting. (Amended for Reg. D offerings post-September 2013)
- Oral representations by issuer and selling agents must be consistent with information contained in the offering circular or private placement memorandum.

Private Placement Offering Documentation

- Private Placement Memorandum (PPM): While Rules 505 and 506 require that issuers provide an offering circular only to non-accredited investors, as a practical matter most issuers elect to provide one to all prospective investors, even those whose accreditation status would not entitle them to one. To ensure that prospective investors have adequate information about the issuer and the offering, almost every issuer will prepare a disclosure document typically referred to as a PPM or Confidential Offering Memorandum (COM). This document, which is customarily prepared by the issuer in consultation with counsel, will provide extensive information detailing the offering, the issuer and its management and the use of proceeds from the offering. The PPM or COM will also discuss and detail the risks of investing, the limitations to selling or transferring ownership in the investment, tax considerations to the investor and the standards and suitability requirements that apply to prospective investors.

- <u>Subscription Agreement</u>: To invest, the investor or subscriber must sign the Subscription Agreement, which documents the terms of the offering and representations and warranties made by both the issuer and the subscriber. A subscriber cannot be accepted into the partnership without affirming in writing that he is an accredited investor or qualified purchaser, has sufficient knowledge and experience to evaluate the risks and merits of investing, that he is prepared to bear the economic risks of investing and that he is not acquiring the shares for re-sale. The signature page of the Subscription Document contains both a Subscriber Certification and an Issuer Certification which, when signed, certify that the representations made in the documentation are true and accurate.
- <u>Form D</u>, sometimes called the Notice of Sale, is required to be filed with the SEC by the issuer within 15 days of the first sale of securities under a Reg. D offering. The date of sale is the date upon which the first purchaser signs the subscription document. This form, available online, provides a brief description of the company, its officers and directors and information about the investments or securities offered.

Additional Broker Dealer Obligations Under FINRA Related to Selling Private Placements

FINRA periodically publishes updates and amendments to its rules through its Notice-To - Members (NTM) program. Pertinent NTMs on the topic of private placements and their interpretation include:

- <u>NTM 03-07 Obligations When Selling Hedge Funds</u>: FINRA focuses attention specifically on selling hedge funds to retail investors and emphasizes that sales material and oral representations provided to prospective investors must be balanced in their representation of the risks and potential disadvantages of hedge funds including the use of leverage, limited liquidity, complex tax structures, higher fees and reduced regulation compared to mutual funds.
- <u>NTM 03-71 Non-Conventional Investments</u>: Because they often have more complex features than traditional investments, private placements are considered to fall within the guidelines of this notice which emphasizes “due diligence/reasonable basis suitability.” Broker dealers and associated persons must take reasonable steps to understand the offered investment, including its liquidity, transparency of pricing, creditworthiness of the issuer, the value of underlying collateral, if applicable, the factors determining return, risks to principal, tax consequences and costs and fees associated with purchasing the investment.
- <u>NTM 05-18 Private Placements of Tenants-In-Common (TIC) Interests</u>: In addition to the issues highlighted in NTM 03-71, FINRA provides guidance in regard to some of the unique features of this product which include:
    - Referral Fees: The prohibition of payment of referral fees to unregistered real estate agents by broker dealers.

- Suitability: Because TIC buyers are motivated by potential tax savings, members must make a suitability determination as to whether the tax benefit outweighs the fees and expenses incurred by purchasing the TIC.
- Due Diligence: Before recommending, the member should have an understanding as to whether the offering will qualify as a like-kind exchange under Section 1031.
- Secondary Markets: No secondary market can exist due to TIC unanimous consent rules.
- Solicitation: Registered representatives who also hold a real estate license may not solicit potential TIC investors via real estate seminars. However, a broker dealer will not be considered to be advertising a TIC if the advertisement is generic, it is not made in contemplation of an offering and the broker dealer has procedures to ensure investors solicited via the advertisement will not be solicited to purchase a current offer or one contemplated at the time of the advertisement.

- NTM 10-22 Obligation of Broker Dealers to Conduct Reasonable Investigations in Reg. D Offerings: This notice reiterates the due diligence requirements placed upon broker dealers who market private placements while focusing attention on offerings in which the broker has an affiliate relationship with the issuer. NTM 10-22 places responsibility on the broker dealer to resolve any conflict of interest that could hinder an unbiased investigation into the issuer to ensure that representation by the issuer are fair and balanced if the broker dealers assists in preparation of the PPM and to note any red flags identified via its due diligence.

Obligations of Investors in Private Placements

As with any investment, investors bear certain responsibilities when committing their financial assets. Investors should thoroughly educate themselves before investing by reading the available sales literature and offering material, asking questions of their financial representative, making sure their investment representative has a clear understanding of their financial situation and investment goals, and seeking guidance from other trusted advisors such as their CPA or attorney.

Securities of publicly traded companies are typically broadly traded, researched and reported in news reports and publications, offering investors multiple sources of information and opinions. Available information about private offerings is typically limited to what the issuer makes available in their Private Placement Memorandum. Therefore, it is important that prospective investors read and make a bona fide effort to understand the information contained in the offering materials. Unlike marketable securities or mutual funds, investors in private placements are required to attest that they have read the PPM. Investors should not take lightly their obligation to do so.

Unlike investing in marketable securities, investors in private placements are required to attest to their qualification to invest. SEC regulations make clear distinctions among investors so as to assure that those investing in private placements have the financial means to bear the risks of investing and the capability to evaluate the merits and risks of investing. . Investors should understand that they bear a responsibility to truthfully represent their qualification as an investor as it relates to their financial means, and ability to understand the merits and risks of investing.

Recent changes to SEC Rule 506 of Reg. D

Section 201(a) of the JOBS Act of 2012 required the SEC to eliminate the prohibition on general solicitation and advertising. In response, the SEC amended paragraph (c) of Rule 506. Under the new rule, which became effective in September 2013, issuers can offer securities by general solicitation if they offer securities exclusively to accredited investors and the issuer takes reasonable steps to verify the investors' accreditation status. To that end, FINRA recommends reviewing IRS forms, bank or brokerage reports and obtaining written verification from a broker dealer, attorney or CPA.

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