Financing the New or Growing Enterprise: A Private Placement Primer

Prepared for Slow Money
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August 2010

Introduction

Financing a new or growing enterprise is often a difficult, time-consuming and generally fraught experience. Unless you or a partner are independently wealthy, or your venture can be "boot-strapped" (the investment requires less than your liquid cash), the time will come when you will have to look to Other Peoples' Money ("OPM"); you will have to find outside investors.

There are any number of ways that this can be accomplished, the most familiar being appeals to friends and family. But if what those who love and cherish you the most in this world can provide is insufficient for your plans (or not forthcoming), you will have to turn to outside investors.

How do you find these people? What do you do when you've found them? How do you frame the structure of the deal? How do you make it "legal?" These are the most common questions that entrepreneurs have when faced with the task of raising OPM. This primer will address these issues in a broad manner. It is not intended as the definitive discussion of these topics, but rather an introduction to the issues associated with, and the mechanisms that exist to accomplish, the task.

The information contained in this primer is not a substitute for a thorough review of the applicable state and federal laws, or the advice of professionals as reasonably necessary such as accountants, lawyers and the occasional consultant who are experienced raising capital for for-profit enterprises. In other words, this primer is *not* "legal advice" even though your author is a lawyer. There. That's the disclaimer.

Before we get started, please understand that if you can go to a bank and borrow the money you need to do what you plan – do so. Make haste. Interest rates are pretty darn low, and the process will likely be quite a bit shorter than finding and securing OPM. Of course right now banks aren't lending – to farms or farmers, start-ups or even mature and stable businesses. But if you've an "in" or believe that your plan is bank loan worthy I say go for it. If not, or if the banks' determinations confound your expectations, read on.

Also, this primer assumes you're raising money for a for-profit enterprise – a corporation, LLC or L3C. If you're starting or expanding a not-for-profit enterprise you're looking in the wrong place for advice.

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Terminology

The process described in this primer is commonly referred to as a "**private placement**." In a private placement, a company (the "**issuer**") bundles some amount of its equity (ownership) and/or its debt possibly along with some specific rights (such as board representation, enhanced voting rights, "**preferences**" such as a guaranteed dividend, etc.) in what's called an "**offering**." The offering will typically be sliced into "**units**," each of which will be priced identically. The price for one unit is the minimum investment in the offering. The offering is typically described in a "**private placement memorandum**" (sometimes called a "**red herring**" or simply a "**book**") containing a detailed description of what you plan to do, how you plan to do it, why it's a good idea, what the relevant markets look like and what the relevant returns are – financial and "**soft**" (such as strengthening a local foodshed, maintenance of a desired viewshed, enhanced soil fertility, etc. – we're talking Slow Money undertakings here, right?). It will also contain financial information in the form of the 3 most common financial reports – the profit and loss statement (or "**P&L**"), the balance sheet and the statement of cashflows. If the issuer is looking for growth capital it will have historic numbers to report. These can be either "**audited**" (the preferred modality, meaning they've been inspected by a CPA applying Generally Accepted Accounting Principles ("**GAAP**," pronounced "gap") or "**pro forma**" (not audited). Whether or not you have historic financials to report, you will have to provide projected financials which will show how the issuer's growth will be positively impacted by the investors' capital (if the investment the issuer seeks won't have a positive impact on results you'd better rethink the private placement). All financials will be for some unit of time (a month or quarter) over a period of years (for projected financials 3 years is somewhat standard though the farther out you project the less accurate you're likely to be).

The issuer's equity and debt are collectively called "**securities**," and the offer for sale, and sale, of securities in the US is a regulated undertaking. At the federal level, it's regulated by the Securities and Exchange Commission ("**SEC**"); each state, naturally, also regulates under what are known as "**Blue Sky**" laws. Under the SEC's rules, all securities offered for sale in the US must be registered with the SEC unless they are exempt – and the private placements discussed below are *all exempt*. So don't freak out – you're not going to spend the rest of your working life filing out paperwork to raise a few dollars. That's not to say that these private placements are completely unregulated because in order to be exempt from registration the issuer must (in an irony lost only on attorneys) file some papers with the SEC and each state where securities are sold. But not many and not often, and the filings are not too invasive. In fact, as we'll see below, there's an excellent reason why the filings are needed.

A short note on "**notes**" is in order. The relevant federal statutory language defines a "security" as, among other things, a "note." Notes are debt instruments, i.e. they document the loan of funds from the investor to the issuer and the terms and conditions on which the loan is made (such as the date of maturity, the applicable interest rate or the lack of interest, whether periodic payments of principal, interest or both are required, whether the debt is secured by collateral or not, etc.). There are different types of notes but they all bear one defining characteristic: they all contain a promise (by the issuer, or "**debtor**") to repay the investor the amount of the loan at some future date. But the statutory language defining a "security" is prefaced with "unless the context otherwise requires." It is therefore widely understood that Congress didn't intend that every "note" be a "security." So when is a note not a security? The U.S. Supreme Court has determined that notes which bear a "family resemblance" to typical consumer notes (like checks, car loan notes, mortgages, etc.) are not securities under the federal securities law, and has provided a handy four-part test to determine if this "family resemblance" exists. The prongs of this test center on the reasonable motivations of both the issuer and investor, the plan of

distribution of the notes, the reasonable expectations of the public vis-à-vis the notes, and if there is some other regulatory framework which itself reduces the risk inherent in the notes. While a lengthy discourse on the application of each prong of the test is outside the scope of this primer, here are a few observations to help you understand if the notes you seek to issue in the units of your offering are "securities" under the relevant federal securities laws.

> Prong 1: If the issuer intends to use the proceeds of the notes for general corporate purposes, they are likely securities; if, on the other hand, you are offering notes to finance the acquisition of a particular piece of property (land, livestock, seed stock, a silo, tractor or manure spreader) they are likely not securities. If the notes are offered to raise cash to deal with specific cashflow issues and on their face require repayment (with or without interest) in less than 12 months from issue they are, again, likely not securities.
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> Prong 2: the Supreme Court, in formulating the "family resemblance" test discusses whether or not the notes are purchased for speculative trading. Since for the most part this is not the case in the types of Slow Money transactions most of us contemplate, we have to look to another factor. The most common seems to be the whether or not the offer to purchase the notes is made to a broad segment of the public or not. If they are then the notes are more likely to be deemed securities. If, on the other hand, you make your offer to a small subset of the public (local farmers, etc.) you may be able to make a cogent and convincing argument that your notes meet this prong of the test.
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> Prong 3: This is the hardest part of the test to parse. If the notes you offer contain terms and conditions typical of "securities" then the public expectation is likely to be deemed to be that they are regulated.
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> Prong 4: Bank loans are typically regulated; private loans (like those from Happy Acre Farms to its investing neighbors) are not. No alternative regulatory framework to protect investors means the notes are more likely to be deemed securities within the federal law.

Does styling a debt instrument a "bond" rather than a "note" get you anywhere in this regard? No, not really. The typical difference between these similar investment vehicles is that the former are typically secured (i.e. there is specific collateral backing the debt obligation) while the latter are typically unsecured. Bonds also typically have much longer maturity periods – 20 years not being uncommon. Notes, on the other hand, are typically for much shorter periods such as several months, or 1 to 5 years.

When a potential investor agrees to participate in the placement, s/he is said to "**subscribe**" and is called a "**subscriber**." Potential investors become subscribers by executing a contract between themselves and the issuer wherein the subscriber agrees to pay a certain amount of money to the issuer for a certain number of units of the offering, and the issuer agrees to issue the units to the subscriber in return. The form of this contract – called the "**subscription agreement**") is typically included in the issuer's private placement memorandum as described below.

So are all offerings required either to be registered or exempt? No. If what you're offering isn't a security (such as a note that meets the four-prong test discussed above) it needn't be registered or exempt. A CSA share? No – it represents a thing (a weekly basket of a particular farm's harvest for instance). An IOU for $10,000 against the proceeds when that same farm's harvest is sold? Maybe (an IOU is a note) – the IOU represents a right (in this case to future payment), not the harvest itself. If it

meets the four-prong test it needn't be registered or qualify for an exemption; but if it doesn't meet this test it is a security. We needn't spend too much time in this discussion. Suffice it to say that in most all transactions between an issuer and a number of third-parties that are trading money (or the promise of money in the future) for a right as opposed to a thing where the right is typically represented by a contract or a certificate, the thing sold is a security for the law's purposes. As in much of life, if you're in doubt as to whether your offering is of securities or not, it is often best to err on the side of caution, assume the units are comprised of securities, and behave accordingly.

So what behavior is "accordingly?" Let's turn our attention to that now.

The Regulatory Framework: Why It Exists

Many of us drawn to the ethos of Slow Money have a strong anti-regulatory bent. We are entrepreneurs and activists who tend to put people and the environment first – in our work and our personal lives. We view what we *do* as *doing good*. And we're not wrong in this in my estimation. The logical result of these trends is often a disdain for the regulatory mindset that proscribes this or requires that. Why, we ask, should we be beset with these artificial burdens when clearly what we do benefits society?

When it comes to the mechanics of seeking and securing third-party investment in our projects the rules and regulations can seem fantastically byzantine , the language daunting and plain weird. Red herrings? The Securities Act? The Securities Exchange Act? Due diligence? Pro forma financials? Blue Sky laws? Regulation D? It wouldn't be understating things, and most lawyers wouldn't disparage the question, to ask "who was doing the thinking when these rules were crafted?"

Well, the short answer is lots and lots of folks –mostly elected representatives, lobbyists and judges. Whether that explains the problem or not I leave for another day. For us, now, the important thing is that throughout all the myriad statutes, rules, regulations and court decisions concerning raising investment from others there is one over-riding concept that, once made clear, typically makes much of what comes next rather obvious:

The purpose of these laws is to provide transparency for potential investors so they have at least an even chance to avoid getting conned by unscrupulous operators.

That's it. That's what all the literally millions of words devoted to the subject come down to: those of us looking to attract outside investors are required to let the sunshine in as it relates to our proposed venture – financially, operationally, strategically, and about who we are professionally. In other words, it's all about disclosure.

"All well and good," you say, "but I'm not unscrupulous so why must I follow these rules? Since I've no intent to defraud my investors there's no danger of them getting the short end from me – so where's the upside for me?" Certainly there are a number of good reasons to follow the rules – it's what good citizens do, it gives you a warm fuzzy feeling inside, you really like paperwork, you don't want the financial police (often the FBI) knocking on your door, etc. But, among all these excellent reasons, there are a few truly outstanding ones.

1. Whatever you disclose you are immune from.

Been in business for a while and need outside capital to expand and pay off a few accumulated bills? Tell an investor you need to expand but forget to mention the aging A/P and, when you spend 10% of the money raised to bring those accounts current you've committed a fraud. Oops. Tell the investor about the A/P problem upfront and s/he can't complain – the fact that the delinquencies existed and the potential use of funds was planned are both disclosed beforehand this disclosure protects the entrepreneur. Protects from what? Why litigation of course. Lengthy, complex, spectacularly expensive litigation. As I tell my clients, the only ones who benefit from time-consuming court cases are the lawyers involved. Everyone else loses one way or the other – money certainly, peace of mind too, sometimes and most sadly relationships, always sleep. Litigation is to be avoided like a pack of rabid monkeys.

2. Investors are like family dogs – they find comfort in the familiar.

If the potential investors you are speaking with have any experience in the types of private investments we are all proposing, they will expect you – as a potential "target" of their scarce cash – to provide them the types of disclosures they've received in the past. And they'll expect it in a certain form. See? Just like your dog – they want their biscuit on the rug in the living room where the family is watching TV in the evening. Typically, investors will ask for things such as an executive summary of the deal (what the company does, how it does it, what it costs, what it makes, and what's being both sought in terms of investment and offered in return), pro forma financials (the so-called "standard" financial reports – historic and projected – a P&L statement, balance sheet and statement of cash flows), and, eventually (hopefully) your entire business plan which may (ideally) be encapsulated in a "red herring" (the "official" offering document – alternatively called a private placement memorandum or simply your "book"). If your potential investors are inexperienced they'll be fabulously impressed by your professionalism in having anticipated their questions so presciently – and in writing no less!

3. The exercise of complying with the rules can clarify both your strategic thinking and your pitch to potential investors as it identifies problems with your plan – so you find them before potential investors do (so embarrassing and often the end of that conversation).

It's your business – who knows it better than you? Hopefully no one. Going through the routine of putting your plan to paper, the verbiage and numbers, will help you clarify your thinking, identify problems and craft solutions to them. It will help you perfect how you describe what you're doing and planning to do, and so make you (at least sound) more organized, coherent and articulate about your plans and how you will use the investors' capital. It's ok to respond "I don't know, let me get back to you" when posed a question you don't know the answer to (corollary: it is NEVER ok to lie to a potential investor – the relationship is intrinsically one of trust); it's much more impressive (and thus better) to have a ready answer based on your historic and projected operations. When you can demonstrate a thorough understanding of your business and can adequately explain it to others potential investors will be impressed. And you want to impress them: you're selling them your vision, offering them participation in the upside (financial, "green," soil-fertility-promoting, good land and animal stewardship, etc.).

One final note: no matter whether your offering is of securities or not, whether it is exempt from registration or requires the full-court press of complete Securities Act and Blue Sky compliance, all business dealings – raising outside capital included – are subject to the various federal and state anti-fraud laws. You may not lie, you may not cheat. Those behaviors are reserved for large multi-national corporations (or so it seems).

So, now that we understand the “why” of financial regulation compliance in the context of raising outside investment, let’s turn to the “what” –the mechanism for raising these funds.

Working with Investors

Investing is the practice of placing funds with a certain entity in the expectation of a return. A return may take many forms. Dividends and yield (interest) on a note are typical examples. Other types of returns are also realizable and sometimes sought by investors. Losses – a reduction in the value of the investment – are sometimes sought for their tax benefits (nuts, right?). Sometimes it’s the introduction of a particular product in a given geography, for example when a rural county pays for a large animal vet’s education in return for that doctor practicing in the county after graduation for a set number of years. And sometimes, investors look for asset preservation as, for instance, when a group of homeowners in an area invest in a local farm to ensure that open areas remain open, the soil fertile, the land well-tended and cared for.

While all of these things are returns, certainly the most often sought-for return is financial: investors typically seek the return of their capital plus some level of profit in the form of lucre (filthy or otherwise). The discussion in this primer assumes the investors you pitch your deal to are seeking at least some level of financial returns -- even those drawn to Slow Money and its ethos. Those returns may be miniscule or mighty but they include some financial aspect. They likely also, of course, seek some of the “softer” or “green” returns such as sustainable land stewardship, a nice view shed, a protected food shed, locally and humanely raised livestock, etc. Each is valuable.

But regardless of whether your offering holds out the promise for financial or soft returns (or both) you will have to deal with the psychology of your potential investor pool. You will also likely have to deal with the reality of the various federal and state securities laws. So, no matter what the offering, you’ll have to craft a deal that works within this context of investor desire and governmental requirements. Your private placement memorandum -- the issuer’s book – must reflect this.

In a typical deal, the issuer’s management (i.e. you, the entrepreneur) meets with potential investors to introduce them to the company and the offering. While the logic of investing is no doubt obvious to you and your team, investors may require more than one meeting or phone call before they subscribe. Once they agree to participate, you’ll want to get them to sign on the dotted line and complete any necessary paperwork – all of which is part of the private placement memorandum.

More on Units

Every deal starts with the offering – the “thing” you are offering to your potential investors in return for their cash, and it’s in the form of units. A familiar offering is stock. Stock, of course, is a measure of ownership in the issuer. There are a number of types of stock – common (voting), preferred, senior preferred, subordinate or junior preferred, to name a few. Besides equity an issuer can issue debt (its IOUs). Whether styled bonds or notes, these types of securities are evidence of indebtedness. Debt of course must be paid back; equity typically is not – it either earns a return (a portion of the issuer’s profits) or it doesn’t (because the issuer is failing and the investment or some portion of it is a loss). And, in between equity and debt there are the so-called “convertible vehicles” which has a nice ring to it. Convertibles have aspects of both debt and equity such that the initial investment is repaid (with interest or without) and, generally once repaid, the debt coverts to equity based on some previously agreed to formula.

Who decides what the offering will be, what the units will consist of? Well, initially, the issuer. The issuer determines whether it will offer debt, equity or some convertible vehicle or even a combination of these along with any preferences. At what price? Again, initially, the issuer determines this. You'll want to consult with an accountant in this regard to determine what the issuer can afford to offer and at what price.

There are a number of commonly used valuation methodologies. Mutliples of annual sales or earnings are commonly used. Som industries have standard measures of what a company may be worth, it's so-called "**enterprise value**." Of course, if the issuer is a start-up or has limited historical financials to work with it's more of a crap shoot. Here's a conservative approach to pricing: first, you'll have to assign the issuer a "**pre-money valuation**" by applying some defensible methodology. An accountant can help you determine this. Let's assume the pre-money valuation is $1 million, and you're raising $125,000 through your offering. Now that you have an enterprise value we can price the equity. Assume the issuer has authorized 200 shares of common stock. The per-share price then is $5,000 ($1m divided by 200). Thus, in order to raise $125,000 you'd have to sell 25 shares. Again, this is a very conservative approach to pricing, and depending on a variety of factors you may be able to successfully argue for a higher pre-money valuation.

But, in the end, every deal is negotiable until you land the big fish – the "lead investor." A lead investor is typically some one or thing with deep pockets (so they can take a good chunk if not the majority of the offering) and a reputation as a savvy investor. If you find a lead investor but they want a change to the offering , unless that change is financially or ethically a problem or otherwise unreasonable, you're likely well advised to accept the change and amend your offering to the other investors accordingly. Why? Because investors tend to behave like lemmings: once the lead takes the leap the rest will likely follow. Must you have a lead investor? No, but it's often easier to complete – or "close" – your offering if you do as result of the whole "investors like lemmings" thing.

What else is in an offering? Well, depending on the size of the investment sought and its nature, you may offer board representation or other preferences. If your investors are a smart lot, with something valuable and real to contribute to your undertaking – like past growth-stage company experience, the ability to raise additional funds (should that become necessary), strong networks among distributors, etc. – you may find that having these folks working with you beyond financing your enterprise is a good thing.

The Offering: What Form Does it Take?

Must an offering be in writing? Yeah, pretty much always. Must you have an attorney prepare the documents? Not necessarily. Depending on the complexity of the offering, its size, the number of investors, your comfort with the relevant legal issues and your ability to learn what's necessary, etc., It's not rocket science but it is certainly rather complex, the documentation potentially voluminous. As a result, it may be simply more constructive to engage a professional to lead the issuer's documentation team. Only the entrepreneur can adequately describe, with the necessary ardor and conviction, what, how, why, etc., and you must be prepared to cogently, concisely and in an articulate manner do so – in writing; but an experienced professional can put together the entire offering document, complete any regulatory requirements, and manage the closing and transfer of funds relatively quickly. Is an accountant necessary? Again, the same considerations apply: how complex is the deal and the bookkeeping involved? What is your familiarity preparing and reviewing GAAP financials? It's a

balancing act – some people on your team may have the requisite skills and knowledge and you should fill in the gaps with professionals as needed.

So what writing is sufficient? Typically the private placement memorandum may be thought of as a sandwich. The bread in this sandwich is legal, the meat the business plan.

The top layer of bread is boilerplate that accomplishes a number of things. First and foremost, it identifies the issuer and describes the offering. It then proceeds to provide the issuer, its owners (you), directors (you) and managers (you) the fullest extent of liability protection that it can under the law. This is to protect things like your children's home from being the subject of any legal grief due to a business problem that may spring up later if an investor becomes aggrieved due to perceived underperformance of the issuer after the investor agrees to participate. To do this, it expounds at length, in all capital letters, often in bold type, to the effect that only a full-on idiot would consider investing in the units, that the whole damn thing is likely to end up in the toilet and, if it does tank as any rational being would expect, the investor has no recourse beyond what's described in the boilerplate and should expect to lose the entire amount of their investment in the units. As if that weren't enough, it then goes on to inform any fool still reading that even in the unlikely event the units appreciate in value that no liquid market for the securities in the units exists and, what's more, there's no likelihood that such a market will develop in the future. Furthermore, the securities in the units are unregistered and, as such, are not freely tradable anyway and there's no guarantee that the securities will be registered in the future. Nice, right? Why would anyone say such terrible things about your baby, your company, your %^&*() offering?!?

The reality, of course, is it isn't quite that bad, but the gist is the same: the opening boilerplate reflects some of the unfortunate realities of entrepreneurship: many ventures fail, and we live in litigious times. So, in its own spectacularly obnoxious way, this part of the private placement memorandum merely ensures that all potential investors are informed of some of the macro truths of the marketplace. This, then, is part of the disclosure discussed above and it serves that purpose. Generally, most potential investors are familiar with these facts so, despite all its upper-case boldness, the boilerplate is not usually the reason someone declines to subscribe to the offering.

The meat of the private placement memorandum is a business plan in one form or another. Must it be a full-blown, b-school class project kind of thing? No. In fact, it shouldn't be – that would be way too long. But it must contain certain things to adequately describe the issuer and its plan, make the case for the investment itself and its price (so you'll need to include adequate financial statements as described in the next paragraph), describe the risk factors that the issuer faces and how they will be overcome, and depending on which exemption from the SEC's securities registration rules the issuer is relying on, meet any regulatory disclosure obligations (more on this below). So in this section of the private placement memorandum, the issuer gets to trumpet its merits and provide a counterweight to the opening boilerplate's warnings. Note, however, that this section is also primarily about disclosure – we are describing the deal and why it makes sense in the context of potential stumbling blocks.

The bottom slice of bread is the subscription agreement. Also included in this section are any subscriber questionnaires that may be desired (identifying subscribers with a high degree of precision is a good idea so you know who you're now doing business with) or required (see the section on Reg D, below).

That’s it. That’s the private placement memorandum. It’s what you give to potential investors interested in becoming subscribers, and it’s what you or your attorney will possibly file to comply with the applicable state Blue Sky laws if required.

A note on business plans: there’s been a bit written lately in the popular press about the value of business plans. The received wisdom is that a business plan is an indispensible tool to assist the entrepreneur in planning a business. After all, a properly constructed business plan will require that you think about your business (whether proposed or existing) in an holistic fashion. You will have to come to terms with the competitive environment, the risks associated with the undertaking, to whom you will market and how, how much money is required, where it will come from, what form the units will take and at what price, etc. A well thought out business plan, therefore, can be expected to be a lengthy, detailed and often technical document. It is not unusual for it to run up to 100 pages or more. And thus the rub: who is going to read such a thing? Certainly the entrepreneur and key team members should – they should author and study it. But, unless your grandparents are still with us, it’s unlikely that anyone else will have the desire to read your stellar prose and work through the complicated financials. Indeed many investment bankers and other professional investors state outright that they won’t read it. So why bother? Two reasons: first, it forces you to take an holistic view of your business and deal with the myriad issues confronting it and working against its success. Second, writing the detailed treatise permits you to write what the investors will read – the executive summary. The executive summary provides a brief description of what is in the business plan, hitting its high points; it is typically this summary treatment of your business plan that will make its way into your private placement memorandum. The executive summary usually serves as an introduction to the full business plan and, for this reason, many entrepreneurs attempt to write it first. This is a mistake. Take the time, do the work, write the business plan. Then write the executive summary. Thus the business plan is indispensible.

Making the Unregistered Offering: Regulation D

Once you’ve determined to make an offering of securities, you will want to ensure that it is exempt from the full registration requirements of the federal securities laws. There are a number of ways to do this but, by far, the most common is to make what is known as a “Reg D” offering. Reg D refers to Regulation D of the federal Securities Act of 1933. Reg D provides 3 exempt offering modalities designed to permit an issuer to raise varying amounts of money from outside investors by selling exempt securities in the issuer. Each of the 3 modalities is covered by its own section of Reg D – Section 504, 505 and 506. Besides capping the amount of money that may be raised by a particular offering, the various Sections (sometimes called “Rules”) proscribe the number of “accredited” and “unaccredited” investors the offering may accept, requiring greater disclosures for larger offerings and those involving more unaccredited investors.

An **accredited investor** is defined by the federal securities laws as an entity (human or otherwise) that meets certain criteria which are proxies for investing acumen or at least the ability to absorb a financial loss; unaccredited investors are any entity that isn’t accredited. So what is an accredited investor? An accredited investor, generally, is an entity – human or not – that is presumed to have a degree of financial sophistication and wherewithal which, together, enables such an investor to adequately review an offering to determine if it is suitable for that investor and the ability to withstand the total loss of their investment in the offering if the deal goes bad. The regulations define the following as *de facto* accredited investors:

1. Banks, savings and loans, registered broker/dealers of securities, insurance companies, and registered investment and business development companies. Also employee benefit plans with assets in excess of $5 million established by a state or any of its political subdivisions (such as a county or municipality), and employee benefit plans as defined by the federal Employee Retirement Income Security Act of 1974 (commonly known as "ERISA") but only if the decision to invest is made by a plan fiduciary that is either a bank, savings and loan, insurance company or registed investment advisor unless the plan has assets in excess of $5 million (in which case the fiduciary need not be any of the listed types). Self-directed retirement plans are also accredited so long as the decision-maker him/herself is also accredited.

2. A private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940.

3. A 501(c)(3) corporation (as defined by the Internal Revenue Code) or a "Massachusetts" or similar business trust or partnership provided, however, that such entity not be formed specifically to acquire the securities being offered and that it have total assets in excess of $5 million.

4. Any director, officer or general partner of the issuer or the director, officer or general partner of a general partner of the issuer.

5. A person whose individual net worth, or joint net worth with such person's spouse, at the time of the purchase exceeds $1 million.

6. A person with an individual income in excess of $200,000 in each of the 2 most recent years or joint income with his or her spouse in excess of $300,000 in each of those years, and a reasonable expectation that such income levels will be achieved or surpassed in the current year.

7. A trust with total assets exceeding $5 million so long as it is not formed for the specific purpose of purchasing the securities and the decision to purchase is "directed" by a sophisticated investor.

8. Finally, any non-human entity all the equity owners of which are, themselves, accredited investors.

Clearly, most of us are interested in definitions 5 and 6 – natural persons (i.e. humans and not corporations or trusts). Note that these definitions have not changed much in the time since Reg D was first promulgated (1982), so inflation has effectively increased the pool of accredited investors well beyond what the SEC had in mind when it crafted the Rules. This clearly works in issuers' favor.

Any investor not within the 8 categories listed above is **unaccredited**. An unaccredited investor may, however, still be considered sophisticated within the meaning of the Rules if they, either on their own or with their "purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." Thus, if an unaccredited investor is represented by a professional -- a registered investment advisor, an attorney, etc. – they are clearly "**sophisticated**." If they are not, the issuer

should take steps rationally calculated to determine the unrepresented, unaccredited investor's level of comfort with such private placements and their ability to withstand the potential loss of their entire investment in the offering. This is most commonly accomplished through the investor questionnaire discussed above.

What Reg D is, then, is a framework that requires that as the amount of money increases or the number of unaccredited investors exceeds certain thresholds a would-be issuer must make greater disclosures to would-be investors. There is, I think, symmetry here: more at stake either in financial terms (the size of the offering) or human (unaccredited investors) the more the issuer most disclose in hopes that such disclosure will prevent investor fraud. Remember, no matter whether you are raising $10 or $10 million, from accredited, sophisticated or unaccredited investors, the anti-fraud laws always apply.

Let's now turn to the actual Reg D rules; what they permit, what they prohibit, how they work.

Reg. D, Rule 504

Rule 504 permits an issuer to offer up to $1 million in its securities in a 12-month period. (Note – that's "offered," not "sold.") The securities may be sold to an unlimited number of investors, and they need not be accredited or sophisticated. Rule 504, however, prohibits "general solicitation" and advertising of the offering. In practice this means that you can only pitch your offering to folks or funds (such as a private equity fund or a family office) you know or are introduced to and not by any advertising (in any medium) or notices or even at a "seminar or meeting whose attendees have been invited by any general solicitation or general advertising." This rule against advertising/soliciting will be waived if the offering is registered under at least one state's Blue Sky laws that require the issuer to make substantive disclosures to investors as part of the offering. Issuers under Rule 504 must file a form with the SEC no later than 15 days after their first sale of an offered security but this is for identification purposes mainly. This form is called Form D and may be found on the SEC's website (www.sec.gov).

Because Rule 504 only permits a raise of up to $1 million in a year (the offering has a low dollar cap) it requires almost nothing of would-be issuers unless they want to solicit or advertise. As we'll see, many states' Blue Sky laws require that issuers file with a state agency (often the attorney general's office) an offering document that meets the substantive disclosure requirements of Rule 504 – but they don't entail a review or acceptance of those documents on file; they are there in case a claim of fraud or other illegality is made later and subsequent investigation required.

Not to suggest that raising a million bucks is easy – it typically isn't, indeed raising $5 million tends to be easier for a variety of reasons – but in some cases it happens just from those we know. Friends, family, business counterparts, etc. In this case, would an issuer looking to raise no more than $1 million within 12 months who has no need of soliciting or advertising generally or even at all still choose to file a substantive disclosure under a relevant Blue Sky law? Perhaps not – it depends on the various relationships and sums involved. But there might be good cause to do so because, remember, disclosure leads to immunity and properly crafting a private placement memo will help ensure that the disclosures are sufficient.

Reg. D, Rule 505

For issuers seeking to raise up to $5 million during a 12-month period, Rule 505 is for you. As with Rule 504, the limitation is to the value of the securities offered, not sold. No more than 35 unaccredited investors may participate in a Rule 505 offering though there is no cap to the number of accredited

investors. Because the amount of money involved is potentially large, issuers are required to provide would-be investors with full anti-fraud disclosures. And, while Rule 505 doesn't require unaccredited investors be "sophisticated," it does require that issuers provide unaccredited investors additional disclosures; accredited investors need not be given these additional disclosures. As in a Rule 504 offering, issuers are required to file a Form D with the SEC within 15 days of the first sale of securities through the offering, and are barred from conducting general solicitations and advertising of the availability of the offering. Also like Rule 504 offerings, Rule 505 offerings are subject to state Blue Sky regulations.

Reg. D, Rule 506

Rule 506 is the preferred rule for most private placement issuers for a number of reasons. To begin with, Rule 506 does not cap the amount that may be raised in any period of time, nor the number of offerees though no more than 35 unaccredited investors may participate. Unlike Rules 504 and 505, however, Rule 506 does require that unaccredited investors be sophisticated, and the full anti-fraud disclosures must be made along with additional issuer information being provided to unaccredited offerees. As in the other Reg. D offerings, issuers are required to file a Form D within 15 days of their first sale of securities under this Rule. A significant benefit to offerings under Rule 506 versus either Rules 504 and 505 is that Rule 506 offerings are what are known as "covered" securities. This is a technical issue too complex for this simple analysis. For our purposes, however, it is sufficient to say that as covered securities the offering is exempt from state Blue Sky laws. Note that this doesn't mean that there are no Blue Sky filing requirements – there are. But, significantly, this does mean that a Rule 506 issuer need only file a copy of its Form D with the state(s) where the offering is made. This, of course, simplifies the Blue Sky filings a great deal (and, thus, reduces the cost of preparing the Blue Sky filings themselves).

Conclusion

Raising money from outside investors is clearly an often complicated and difficult undertaking. But it's not impossible, nor need it be onerous in terms of paperwork and governmental filings. With some planning and forethought, an issuer can raise the capital it requires to execute its business plan while not exposing itself (or its owners, directors, officers, employees, etc.) to undue liability.

Reg D is not the only way for an issuer to proceed but, as mentioned, it is the most common. Reg D has been around for over 20 years now and, as such, is relatively mature – meaning it's well understood. Unless you or a member of your team are an attorney, however, you are well advised to seek the counsel of such a professional to assist you in preparing your private placement memorandum and ensuring any required filings (Form D and any applicable state Blue Sky requirements) are met.

Good luck!