

# CLIENT NEWSLETTER

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**Robert A. Youngberg  
Attorney & Counselor  
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## The Regulation D, Rule 506 private offering exemption Raising Capital Through Private Placements

By **Robert A. Youngberg**

Securities laws protect investors and the general public by prohibiting fraud and misrepresentation in the sale of securities and by requiring companies to make full disclosure of all important information about their securities.

Generally, those who offer securities must register them with the Securities & Exchange Commission (SEC).

However, registration can be costly and burdensome for small businesses. Before selling securities, a company must file with the SEC a detailed *Registration Statement*, which is expensive and time-consuming to prepare. After the securities are sold, the company, its officers, directors and major shareholders, have continuing obligations to file quarterly, annual and other regular reports with the SEC.

All companies, whether large or small, must register their securities – unless they meet the conditions for an exemption.

One important exemption is the “private offering exemption” under Rule 506 of the SEC’s Regulation D.

There are limitations on those who can claim the exemption, including:

- Limits on advertising and sales
- Restrictions on re-sales
- Minimum net worth or income requirements for prospective investors.

Nevertheless, despite the limitations, Rule 506 can provide a “safe harbor” that, if carefully followed, ensures that an offering of securities will be exempt from the burdensome SEC registration requirements.

### SOME IMPORTANT TERMS

There is a jumble of terms, rules and regulations in the securities laws. Here are definitions for three important terms:

**Issuer** - a company selling securities

**Offer** - any attempt to sell or otherwise dispose of a security for value

**Security** - any arrangement where a person invests money expecting to realize a profit through the efforts of others. Stocks and bonds are the most common type, but interests in limited partnerships and non-managerial interests in LLCs also can be securities

*The definitions are important. If what you are selling is a “security”, the securities laws will apply to all you do in offering them to investors.*

## THIS NEWSLETTER'S PURPOSE

This newsletter is a summary of the Rule 506 exemption. It is for clients or potential clients who have a serious interest in legal requirements about raising money from investors. As a summary, it is to be read only as a general primer on certain aspects of the securities laws for further discussion with the firm.

### Generally, how can the Rule 506 exemption help?

A Rule 506 private placement of securities is a common route that small to medium size businesses take to raise money. When bank loans and professionally managed venture capital are either not available or not wanted, a Rule 506 private placement can be a workable alternative for a startup or emerging growth company, or even for an established company needing money for a particular project, especially when all potential investors will be “accredited investors” (see the next column).

If you think you might have access to enough accredited investors, a Rule 506 private placement can be the easiest and least expensive way to raise business capital.

### What are some advantages?

- You can raise an unlimited amount of money.
- You may sell securities to any number of accredited investors and up to 35 other investors.
- You may decide what information you give to accredited investors, so long as you do not violate the anti-fraud prohibitions of the securities laws.



### WHO ARE “ACCREDITED INVESTORS”?

The SEC classifies some investors as “accredited,” meaning that they require less help than others when it comes to investing in securities.

Investors who are *not accredited* require special treatment, including detailed information like that given to investors in a registered public offering. This translates into extra time and expense for issuers. For that reason, many issuers in private placements will limit their offerings to **accredited investors only**.

Although the rules that separate **accredited investors** from other investors are somewhat arbitrary, they do give us objective standards to apply in deciding which investors require the extra time and expense.

**Accredited investors** are those investors who, because of their income, net worth, or experience, have a reduced need for the protections afforded by the SEC’s full registration requirements. The most common types of **accredited investor** include:

- A person with a single income of \$200,000 (or joint income with a spouse of \$300,000) in each of the past two years, and reasonable expectation of that level of income continuing for the current year.
- A person having at least one million dollars of net worth, *excluding* home equity.
- An executive officer or general partner of the issuer.
- Any legal entity, such as a corporation or LLC, in which all equity owners are **accredited investors in their own right**.

- State regulators have no authority to review or approve an offering of securities exempt under Rule 506, and no Federal or state regulator will dictate the content of your disclosure document, called a **Private Placement Memorandum**, or **PPM** (see the following page). However, again, you must provide sufficient disclosure to comply with state and Federal securities laws.

### Are there restrictions?

To claim the exemption, your offer and sale of securities must conform to the following restrictions:

- Although you may decide what information you give to accredited investors, you must give all other investors information similar to that given to investors in a public offering registered with the SEC. This is one reason why many issuers in a Rule 506 private placement limit their sales to accredited investors only.
- If you offer securities to investors who are not accredited, they must be “sophisticated” – that is, they must be better able than the average investor to evaluate the merits and risks of an investment in your securities.

However, unlike rules that identify accredited investors, there are no objective standards to tell which investors are *sophisticated* and which are not – another reason why many issuers restrict their offers to accredited investors only.

- Limited advertising. You cannot advertise your securities publicly; you must market them privately. This means no newspaper, TV, or radio ads; no “cold calls”; no seminars; and no email solicitations.

To be able to show that your offer was private, not public, it's critical to document all your sales contacts. Keep careful records identifying all those with whom you speak about your securities. When you give a PPM to a potential investor, write his or her name on a master list and number the PPM.

- You must have a “*pre-existing relationship*” with a potential investor before you offer your

**WHAT IS A “PRE-EXISTING RELATIONSHIP”?**

**A private placement is just that: private. You can't publicly search for investors.**

**Under SEC rules, you must have a “pre-existing relationship” with investors before you offer them securities.**

**In general, a pre-existing relationship means that, before you start your offering you know the investor well enough to understand his or her financial condition and business sense.**

**Because of this rule, most of your offers and sales in a private placement will be limited to friends and close acquaintances.**

securities.

Therefore, the central problem with a private placement is how to reach enough potential investors while being limited to only those with whom you have a pre-existing relationship (see “*Can I use an agent to help sell my company's securities?*” on the following page.)

Another complication is that the required pre-existing relationship must exist before you make the

potential investor aware of your securities offering. In other words, you can't establish the required relationships with potential investors when your investment project is already in the works; the relationship must have existed before you envisioned your investment project.

- A knowledgeable company representative must be available to answer questions from potential investors.
- Even though your securities are exempt from the SEC's registration requirements, you still must file with the SEC a form known as Form D. Relatively short, Form D mainly contains a list of the names and addresses of your company's owners and promoters. The SEC does not charge a fee to file a Form D.
- Although state regulators may not review or approve your Rule 506 offering, Utah and most other states require that you file with them a copy of your Form D, along with a filing fee. You must file *in each state* in which your investors live.
- Investors receive “restricted” securities, meaning that they cannot be sold for at least a year without first registering them with the SEC.

**What about financial statements?**

You must follow special rules for the financial statements you provide to potential investors:

1. If your offer includes investors who are not accredited, audited financials



**WHAT IS A PRIVATE PLACEMENT MEMORANDUM?**

**A Private Placement Memorandum, or PPM, is a confidential sales document that you provide to a potential sophisticated investor for a Rule 506 private placement of securities. Like a prospectus, it contains legally required information about the securities being offered.**

**Specifically, a PPM provides the investor with what he or she needs to know to make an informed investment decision, including:**

- Information about the securities
- Information about the company
- Information about the company's business and operations
- SEC required disclosures
- Risks of the investment
- Information about senior management
- Company financials
- How the company will use the investment money

**A PPM also includes a Subscription Agreement, which is the actual sales contract for buying the securities. The Subscription Agreement is the document the investor will sign and send in with his or her investment money.**

1. They must be certified by an independent public accountant.
2. Except for limited partnerships, if a company cannot obtain audited financial statements without unreasonable effort or expense, only the company's balance sheet must be audited.
3. Limited partnerships unable to obtain required financial statements without unreasonable effort or expense may provide audited financial statements prepared under the federal income tax laws.

- What will the business do?
- How will it do it?
- How much money do you need?
- What will you do with my money?
- What do I get for my money?
- How do I get out?

While drafting your business plan, remember to “hedge”; that is, make clear that there is no assurance your idea is a guaranteed winner.

Your attorney will use your plan to help prepare your Private Placement Memorandum, which will describe the offering terms, risk factors, dilution, capitalization, use of investment money, and other required information.

**Can I use an agent to help sell my company's securities?**

One way to increase your pool of potential investors (*pre-existing relationships*) is to have your company's principals offer and sell the securities. In Utah your officers, directors and managers may offer and sell your company's securities without becoming licensed as broker-dealers or agents, so long as you do not pay them commissions or other extra compensation for acting in that capacity.

Another way to broaden your search for potential investors is to enlist the support of a licensed broker-dealer or other agent who has a list of potential investors with whom he or she has the required “pre-existing

*If my company's officers and directors help sell my company's securities, must they be licensed?*

**In Utah your company's officers and directors may offer and sell your company's securities without becoming licensed as broker-dealers or agents, so long as you do not pay them commissions or other extra compensation for acting in that capacity.**

relationship.”

It's not always possible, but in some instances a licensed broker-dealer will be willing – for a commission or other fee – to act as your agent and approach his or her own customers about your securities.

**Summary**

Although it won't fit every company's needs, and not every company will qualify, every company should consider a Rule 506 private placement when planning to raise money from investors. □

If you want more information, contact Rob Youngberg at the telephone number or address below.

**This is one of a series of articles meant to provide a brief and informative summary of certain laws for clients and friends of Robert A. Youngberg Attorney & Counselor at Law, PLLC. The articles are not intended to provide specific legal advice. Before relying on any of the information discussed in these articles, consult with an attorney to ensure that your use of the information is appropriate in your situation.**

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**As a business owner, what can I do to prepare for a private placement of my company's securities?**

Write a detailed business plan.

In a simple, straightforward but thorough manner, develop a written plan of action explaining – in as much detail as possible – your business idea and how it will accomplish its goals.

Keep in mind every investor's basic question: “Why should I invest?” And don't forget the other questions every informed investor will ask: