EGS Private Offering Presentation

Securities Act of 1933 Section 4(a)(2) and Regulation D Rules 506(b) and 506(c)

Presented by: Joan Adler

Background of the private offering exemption

All securities must be registered with the SEC or exempt from registration. The predicate for most private placement exemptions is in Section 4 of the Securities Act of 1933.

Section 4(a)(2)[1] of the Securities Act of 1933, as amended, states:

SEC. 4. (a) The provisions of section 5 shall not apply to—

(1) ***
(2) transactions by an issuer not involving any public offering;

SEC v. Ralston Purina Co., 346 U.S. 119 (1953)

- To this day, this remains the leading case on the matter of transactions "not involving any public offering."
- The critical element was for offers to be made to those who are able to "fend for themselves."
- The Court stated that exemption must be interpreted in the light of the statutory purpose to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions" and held that "the applicability of section 4(1) should turn on whether the particular class of persons affected need the protection of the Act."
- The Court stated that the number of offers is not conclusive as to the availability of the exemption, since the statute seems to apply to an offering "whether to few or many." The number of persons to whom the offering is extended is relevant only to the question whether they have the requisite association with and knowledge of the issuer which make the exemption available.

See also, Nonpublic Offering Exemption, SEC Release No. 33-4552 (November 6, 1962) https://www.sec.gov/rules/final/33-4552.htm

1 Initially Section 4(1) clause 2, then Section 4(2), currently Section 4(a)(2).

Regulation D – Rule 506 Safe Harbor (adopted 1982)

- Rule 506 of Regulation D was created as a “safe harbor” under Section 4(a)(2).
- Companies conducting an offering under Rule 506(b) can raise an unlimited amount of money and can sell securities to an unlimited number of accredited investors and up to thirty-five non-accredited investors.
- Securities offerings under Rule 506(b), are subject to the following requirements:
- The issuer or its agent must have a “pre-existing and substantive relationship” with all investors – no general solicitation or advertising to offer or sell the securities.
- All non-accredited investors, either alone or with a purchaser representative, must meet the legal standard of having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment.
- If non-accredited investors are investing in the securities offering:
  - The issuer must provide non-accredited investors disclosure documents as detailed in Regulation D Rule 502, including the type of information provided in a registration statement under the Securities Act. Further, if the issuer provides any supplemental information to accredited investors then it must also present this information to the non-accredited investors in the securities offering.
  - The issuer must give non-accredited investors financial statement information specified in Rule 502.

Accredited investor definition was recently expanded to include additional categories of investors who can ‘fend for themselves’.

Regulation D Rule 506(c) (adopted 2013)

- Rule 506(c) is not predicated under Section 4(a)(2). It was enacted as Title II of the Jumpstart Our Business Startups Act of 2012 (JOBS Act) Title II Section 201.
- Companies conducting an offering under Rule 506(b) can raise an unlimited amount of money and can sell securities to an unlimited number of accredited investors and up to thirty-five non-accredited investors.
- Permits general solicitation and advertising to anyone/everyone.
- Sales are limited to only accredited investors that have been verified or the issuer has a reasonable basis for determining the investor's accredited status.
- The Rule 506(c) adopting release notes that these offerings should be deemed "private"
  - Section 201(b) of the JOBS Act added Section 4(b) to the Securities Act, which provides that "[o]ffers and sales exempt under [Rule 506 as amended] shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation."
  - Securities acquired under Rule 506(c) would also meet the definition of "restricted securities" under Rule 144(a)(3)(i) (i.e., "securities acquired directly or indirectly from the issuer … in a transaction or chain of transactions not involving any public offering").
- Legacy Rule 506 became Rule 506(b)

The Title II of the JOBS Act also added Rule 506(d) bad actor for all Rule 506 offerings.

Citizen VC, Inc. SEC No Action Letter (2015)

- This no action guidance emphasized the “substantive” relationship requirement so long as the relationship “pre-exists” the offering (i.e., the relationship must be established prior to commencement of the offering).
- The no action letter created a roadmap for conducting online “private” placement offerings similar in policies and procedures to an offline private placement.
- The no action request detailed certain procedures (which may include a questionnaire) which enable the issuer and the potential investor to develop a “pre-existing, substantive relationship” before any securities are offered.
  - These procedures need to enable the issuer or its agent to evaluate the prospective investor’s financial circumstances, sophistication, suitability, and his or her ability to understand the nature and risks of a potential investment – i.e., “fend for himself.”
- The relationship must pre-exist any offering. Any investment opportunity must be presented after the relationship is established.

Accredited Investor Self-Certification vs Verification

Rule 506(b) – Self-certification permitted because the issuer or selling agent has substantive knowledge about the investor.

Rule 506(c) – Marketing a deal via general solicitation means that the issuer or selling agent may not know the investor in an offering. This adds a burden for the issuer to confirm all purchasers are accredited investors whose status the issuer has taken reasonable steps to verify – Rule 506(c)(2)(ii).

- The principles-based approach to verification generally means that issuers are can apply a reasonableness standard directly to the facts and circumstances presented by the offering and investors in question. This principles-based method is intended to "provide issuers with significant flexibility in deciding the steps needed to verify a person's accredited investor status and to avoid requiring them to follow uniform verification methods that may be ill-suited or unnecessary to a particular offering or purchaser in light of the facts and circumstances."

- The following factors are among those that should be considered: (a) the nature of the purchaser and the type of accredited investor the purchaser claims to be; (b) the amount and type of information the issuer has about the purchaser; and (c) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering and the terms of the offering, such as the minimum investment amount.

- The third party verification option provides for a licensed party (e.g., accountant, financial adviser, attorney, etc.) to provide a written statement that they have verified the investor's accredited status (based on tax documents, investment accounts, other) to confirm the investor's accredited status.

- The SEC added a safe harbor in 2020, allowing an issuer to rely on reasonable steps that it took within the prior five years to verify the investor's accredited status so long as the investor provides a written representation that it still qualifies as an accredited investor and the issuer is not aware of information to the contrary.

General solicitation and advertising

Rule 506(b)

- Not permitted
- Networking may be permissible if contacts have pre-existing and substantive relationship – e.g., angel investor networks
- Rule 148 excludes certain "demo day" communications from general solicitation or general advertising.
  - No advertising about the event can refer to a specific offering of securities.
  - Sponsor of the event must not make investment recommendations, charge any fees (other than administrative fees) or receive compensation for making introductions.
  - Issuer can only inform attendees that it is offering or planning to offer securities, the type and amount of securities offered, the intended use of proceeds and any unsubscribed amount.
  - If the event allows virtual participation, those attendees must be associated with the sponsor, accredited investors or individuals who have been invited based on their industry or investment experience.

Rule 506(c)

- Broadly permitted communications to any one in any manner (internet, radio, television, mailers, etc.)

Integration

- The longstanding five-factor test[2] for assessing whether two separate offerings should be integrated have been replaced with a general principle. In considering whether two or more offerings should be treated as one, the issuer should look at each offering separately to determine whether it meets the requirements either for registration or for a particular exemption.
- For every offering under Rule 506(b), the issuer must have a reasonable belief that each purchaser in the offering either (1) was not solicited through the use of general solicitation and (2) had a substantive relationship with the issuer or its agent before the exempt offering commenced.

2 The traditional test for integration was whether (1) different offerings are part of a single plan of financing; (2) the offerings involve issuance of the same class of security; (3) the offerings are made at or about the same time; (4) the same type of consideration is to be received in each offering; and (5) the offerings are made for the same general purpose.

Rule 152 Safe Harbors

Recent amendments to Rule 152 set forth four specific safe harbors that permit issuers to dispense with any analysis under the general principle set out above:

- 30-Day Safe Harbor. Offerings separated by more than 30 calendar days will not be integrated. However, for an exempt offering that does not permit general solicitation, the issuer must perform the analysis of whether a purchaser was solicited by means of a general solicitation or whether it had a pre-existing, substantive relationship with the purchaser.
- Subsequent general solicitations. Another safe harbor provides for non-integration of any exempt offering for which general solicitation is permitted with any prior offering that was terminated or completed. This means an issuer conducting a Rule 506(b) offering can switch to Rule 506(c) so long as any sales made after the switch are only to accredited investors whose status the issuer has taken reasonable steps to verify.

Assessments of commencement, termination, or completion falling outside the safe harbors depend on the particular facts and circumstances that apply at the time.

Switching exemptions

Section 4(a)(2) or Rule 506(b) to Rule 506(c)

If originally relying on Rule 506(b) and a Form D was filed, must amend asap so that investors that were not generally solicited can rely on self-certification of accredited status and do not have to be verified. All investors post amendment must be duly verified as accredited.

Rule 506(c) to Rule 506(b)

Amendments to Rule 152 now enable companies to commence a new Rule 506(b) offering at least 30 days after the termination of a Rule 506(c) offering if the investors in the later offering were not generally solicited and the issuer or its agents established a substantive relationship prior to the commencement of the Rule 506(b) offering.

	Section 4(a)(2)	Rule 506(b)	Rule 506(c)
Permitted Investors	Limited number of sophisticated investors; large number of investors creates impression that the offering was generally solicited	Unlimited number of accredited investors and up to 35 non-accredited investors who are sophisticated and received prescribed offering information	Unlimited number of accredited investors only
Confirmation of Accredited Status	Not applicable; issuer needs pre-existing relationship that supports knowledge of investor's sophistication	Self-certification	Verification of accredited status (usually by licensed third party) or Reasonable basis for belief investor is accredited
Dollar Limits	No limit on offering size or investment amount	No limit on offering size or investment amount	No limit on offering size or investment amount
Offering Information Required	None – Investor must be able to ask questions and request information	None – Accredited investors must have ability to ask questions and request information. However, if one or more non-accredited investors – must provide information consistent with disclosure in offering documents under Regulation A or Reg S-K and financial statements consistent with Regulation A (see Regulation D Rule 502(b))	None – Accredited Investors are assumed to be sufficiently sophisticated to ask questions and request information
Solicitation and Marketing	Confidential materials presented to offerees and investors that have a pre-existing and substantive relationship with issuer	Confidential materials shared with offerees and investors that have a pre-existing and substantive relationship with issuer or agent	General solicitation and advertising permitted to everyone
Federal Filings Required	None	Form D	Form D
Bad Actor Disqualification	Not applicable on federal level (may be a consideration for state level exemption)	Yes – Rule 506(d)	Yes – Rule 506(d)
State Filings Required (Blue Sky Filings)	Possibly – need to comply with private offering exemptions in state where issuer is based and all investors reside	Form D and fee required unless an alternative exemption is available – look to states where issuer is based and all investors reside	Form D and fee required unless sold solely to institutional investors – look to states where issuer is based and all investors reside
Switching Exemption	Can use safe harbor under Rule 506(b) or transition to Rule 506(c)	Can transition to Rule 506(c) but must amend Form D if already filed	Cannot switch to Section 4(a)(2) or Rule 506(b) unless 30 day cooling off period observed and investors were not generally solicited and have pre-existing and substantive relationship with issuer or its agent