

REG. D – MORE POPULAR THAN EVER?

By John Washburn and David Brown

In 1982, the Securities and Exchange Commission issued a regulation to provide safe harbors to issuers of stock and other securities who desire to avoid having to register the securities under the Securities Act of 1933. More than 20 years later, this regulation, known as Regulation D or Reg D, still serves an important function in allowing entrepreneurs to raise money for new projects relatively inexpensively. Reg D allows an issuer of securities who follows certain rules to bypass the necessity of a full fledged SEC registration - often a long and costly process.

Perhaps the most popular feature of Reg D is the exemption provided for raising money from “accredited investors.” Rule 506 under Reg D is particularly appealing to investors because there is no dollar limit on the amount that can be raised when utilizing this exemption. Although 506 limits the number of purchasers to 35, “accredited investors” do not count towards reaching that limit. The definitions are somewhat technical but basically, any natural person, (i) whose net worth exceeds \$1,000,000 or (ii) whose individual income exceeded \$200,000 in each of the two most recent years (or joint income with his spouse in excess of \$300,000 in each of those two years) and who has a reasonable expectation of reaching the same level in the current year qualifies as an accredited investor. Whereas the dollar limit might have been fairly restrictive in 1982, the ability to solicit funds without registration from any number of investors with net worths in excess of \$1,000,000 makes this an extremely useful provision for the entrepreneurs today.

The key to utilization of the 506 exemption is taking reasonable steps in the document to assure that the investors are accredited. Rule 506 may be used with up to 35 non-accredited investors whom the issuer reasonably believes are “sophisticated,” but many funds avoid the difficulty of determining who is sophisticated and who isn’t by restricting their offering to accredited investors.

In addition to the exemptions for individual accredited investors, entities may qualify as accredited investors if they meet certain thresholds in terms of total assets.

Although Reg D does not limit the number of investors under a Rule 506 offering, the Investment Company Act of 1940 can come into play if the number of investors is over 100. Since it is often desirable to avoid characterization as an “investment company,” the 100-purchaser limit needs to be taken into account. Thankfully, the Investment Company Act allows for “qualified purchasers” to invest and not be counted against the 100-member cap. A qualified purchaser can be thought of as a “super accredited” investor. Such investor must have investable assets in excess of \$5,000,000. Together with the Rule 506 exemption itself, the qualified purchaser provisions of the Investment Company Act are very useful to hedge funds and other entrepreneurs raising significant amounts of cash in the current marketplace.

Equally important to Rule 506’s appeal is the federal preemption provided for by the 1996 National Stock Market Improvement Act (NSMIA), which overrides most state registration requirements for Rule 506 offerings, thereby offering a streamlined approach to raising capital.

Although registration is not required, utilization of Reg D requires the filing of Form D with the government. This form is rather simple and does not require much in the way of lawyer time to prepare and file.

Two general caveats are required in connection with considering the use of Reg D exemptions to raise money: First, the exemptions from registration do not exempt issuers from the general anti-fraud provisions of the federal securities laws, commonly referred to as “10(b)(5),” or their state law equivalents.

This article appeared in the Winter 2006 issue of the GR Review.

REG. D – MORE POPULAR THAN EVER? (CONTINUED)

Even though registration is not reviewed and approved by the SEC, disclosure documents need to be carefully prepared in order to protect the issuer from future fraud claims by disgruntled investors since securities fraud standards are less stringent than common law fraud standards. Secondly, even if federal registration is not required and preempts state registration requirements under state “blue sky laws,” a simple notice filing must still be provided to the SEC and, in some cases, to certain state securities officials.

In summary, Regulation D provides a useful mechanism for raising substantial sums to provide the necessary financial life blood for new projects and expansion. Some legal expense and time is required to provide proper disclosures to investors. Yet, for those circumstances where there is an identified group of accredited investors who would be interested in the opportunity to be part of new projects or business, Regulation D is an attractive alternative to borrowing from an institution or a public offering.

The following members of Gould & Ratner’s Corporate/Commercial Department would be happy to be of assistance to those interested in further information about Reg D private placements: Fred Tannenbaum (312.899.1613 or ftannenbaum@gouldratner.com), David Brown (312.899.1694 or dbrown@gouldratner.com), or John Washburn (312.899.1609 or jwashburn@gouldratner.com).

John Washburn is the Chair of Gould & Ratner’s Corporate and Commercial Group and Co-Chair of the Finance Group. David Brown is an Associate in the Corporate and Commercial Group.

This article appeared in the Winter 2006 issue of the GR Review.