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Alternatives to Registering a Security Offering

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There are many ways for a company to raise capital.

Two common ways are for the principals to inject their own cash or arrange for the company to borrow it. But most banks are unwilling to lend to a company that does not have positive cash flow, at least without personal guaranties from its principals. Another option is raising capital from others by offering and selling debt or equity securities. Entrepreneurs need to know that the path to raising capital from others is highly regulated by both the federal government and the individual states. With the exception of banks and a few other narrow examples, the registration and exemption requirements apply regardless of industry.

The basic rule: any ***offer*** or ***sale*** of a security must be registered with the U.S. Securities and Exchange Commission (the "SEC") and the states where offers and sales will be made, ***or*** qualify for an exemption from registration.

Registering a securities offering offer involves spending tens, if not hundreds, of thousands of dollars on accounting, legal, and other fees to draft a disclosure document that includes audited financial statements, file a registration statement with the SEC and possibly individual states, and comply with strict corporate governance requirements imposed by NASDAQ or the New York Stock Exchange.

This article focuses on exemptions from federal and state registration requirements.

Regulation D / Rule 506(b)

Regulation D ("Reg D") is a set of rules promulgated by the SEC which sets a series of rules governing the limited offer and sale of securities without registration. The most commonly relied upon provision of Reg. D is Rule 506(b), which provides a "safe harbor" for the private offer and sale of securities (sometimes referred to as a "private placement"). Under Rule 506(b), there is no limit on the offering amount and there may be an unlimited number of accredited investors. Accredited investors include banks, certain types of trusts, individuals who satisfy a certain net worth or annual income requirements, a director, partner, or executive officer of the company offering the security, and licensed security professionals. As long as there are only accredited investors, the company does not have to meet any specific disclosure requirements. However, if a Rule 506(b) offering is opened to unaccredited investors, the company must provide formal disclosure materials that approach the level of detail (and cost) required for a registered public offering. Under Rule 506(b), a company can permit up to 35 unaccredited investors if the specific disclosure requirements are met.

As noted above, under 506(b), there can be no general solicitation (*i.e.*, advertising) to find investors and offerees should have a pre-existing relationship with the company, its principals, or the broker-dealer assisting the company with the offering.

If the above requirements are met then the company does not have to register its offering of securities with the SEC but must file a notice on "Form D" with the SEC after it sells its first security. The Form D includes very basic information about the company, names and addresses of its promoters, executive officers and directors, and some general information about the offering.

The individual states are generally preempted from regulating Rule 506(b) offerings, although they may require a notice filing comparable to Form D and the payment of modest fees. Securities sold in a Rule 506(b) offering are subject to restrictions on transfer for up to twelve months following the offering and, as practical matter, maybe restricted indefinitely due to the absence of public information about the company.

Lastly, Rule 506(b) offerings are subject to general anti-fraud provisions of state and federal law—which means that any disclosure provided to prospective investors must not contain any materially misleading information, or omit information that an investor should have in order to make an informed investment decision. Similarly, companies and principals that have been subjected to criminal or administrative proceedings involving securities or financial fraud are generally ineligible to rely on the Rule 506(b) and most other registration exemptions.

Rule 506(c)

A fairly recent liberalization of Reg. D permits companies to conduct an exempt offering with some general solicitation or advertising. However, the company or a broker acting on its behalf must take additional steps to verify the accredited status of any purchasers. This typically requires prospective investors to share copies of their tax returns or individual financial statements or other detailed financial information, which is often objectionable to high net worth individuals.

Other Registration Exemptions

Other exemptions from the registration requirements for a securities offering include Rule 504 limited offerings, crowdfunding offerings, and Regulation A offerings. They are briefly described below.

Rule 504. Rule 504 allows private companies to raise up to $10 million in a twelve-month period, but the company cannot use general solicitation. There are no federal requirements for the company and offering, which means the offering must comply with small offering exemptions of each state where the offering is conducted. The lack of consistency among the various state limited offering exemptions.

Crowdfunding. Crowdfunding offerings were authorized at the federal level in 2012 by the Jumpstart Our Business Startups (JOBS) Act and the corresponding rules were promulgated by the SEC in 2015. The crowdfunding rules:

- require all transactions to take place online through an SEC-registered intermediary, either a broker-dealer or a funding portal;
- permit a company to raise a maximum aggregate amount of $5 million through crowdfunding offerings in a 12-month period;
- limit the amount individual non-accredited investors can invest across all crowdfunding offerings in a 12-month period; and
- require disclosure of information in filings with the SEC and to investors and the intermediary

facilitating the offering.

Securities purchased in a crowdfunding transaction generally cannot be resold for one year. A company conducting a crowdfunding offering must meet both state and federal exemption requirements. Most state crowdfunding laws are linked to the federal “intrastate” offering exemption. A few are tied to the federal Rule 504 exemption described above.

Regulation A. Regulation A is an exemption from registration for public offerings. Regulation A offerings are sometimes referred to as a "mini-IPO" because the filing, disclosure, and post-offering reporting requirements mimic, in an abbreviated fashion, those applicable to registered initial public offerings. Regulation A has two offering tiers: Tier 1, for offerings of up to $20 million in a 12-month period; and Tier 2, for offerings of up to $75 million in a 12-month period. For offerings of up to $20 million, companies can elect to proceed under the requirements for either Tier 1 or Tier 2. There are certain basic requirements applicable to both Tier 1 and Tier 2 offerings, including company eligibility requirements, disclosure, and other matters. Additional requirements apply to Tier 2 offerings, including limitations on the amount of money a non-accredited investor may invest in a Tier 2 offering, requirements for audited financial statements, and the filing of ongoing reports. Issuers in Tier 2 offerings are not required to register or qualify their offerings with state securities regulators.

Conclusion

There are many avenues available for private companies to raise capital. One way is by offering securities, a form of ownership in the company. It is very expensive and cumbersome to register an offering with the SEC but if your company can meet certain requirements, then it can be exempt from registering the offering. Contact your attorney or us if you need assistance in navigating the securities regulatory world.

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