

# Raising New Capital: Selling Stock Without Registration? Be Careful

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Among the myriad of issues you as an entrepreneur or business founder face when starting or growing your business is how to raise capital. Some options available include bank financing, owner contributions, and private securities offerings. No matter how small your company or the amount of money being raised, to raise capital through the sale of debt or equity securities (collectively referred to in this article as "securities"), you must register the securities with the Federal Securities and Exchange Commission ("SEC") under the Securities Act of 1933

("Act"), as well as with the applicable state securities administrators (which, in North Carolina, is the Secretary of State). You also must provide a prospectus to purchasers of the securities – unless you can find an exemption from the registration requirements. Compliance with the registration and prospectus delivery requirements can be expensive and time-consuming and can expose your company to additional oversight by federal and state regulators. Failure to comply with securities laws can result in fines, give investors a right to rescind their investments, and preclude the use of exemptions in future offerings.

## What Federal Exemptions are Available?

In 1982, the SEC adopted a set of rules known as Regulation D (usually referred to as "Reg. D"), which generally allow an exemption from federal registration for "private offerings." In order to qualify for the Reg. D exemptions, your company cannot place advertisements or otherwise offer the sale of the securities to the general public, including by means of any seminar or meeting whose attendees have been invited by any general solicitation or general advertisement. For the exemptions to apply, sales of the securities may be made to only a limited and private group of investors. Further, securities sold under these exemptions are restricted, meaning they cannot be resold unless they first are registered or are subject to an exemption on resale.

Reg. D provides three different exemptions from the registration and prospectus delivery requirements. They are set forth in SEC Rules 504, 505, and 506. Each Rule applies to different levels of investments being raised and to different types of investors.

### Rule 504

The first registration exemption under Reg. D is contained in Rule 504 which allows your company to offer and sell up to \$1,000,000 of its securities in any 12-month period to an unlimited number of persons. Although the amount of money that can be raised under the Rule 504 exemption is relatively small for technology companies, this exemption is important because it does not place requirements on the sophistication or net worth of the persons purchasing the securities. The Rule 504 exemption also is useful because it does not require that any specific information be disclosed to investors, only that the offering

comply with the same anti-fraud provisions that relate to all sales of securities.

## **Rule 505**

The second registration exemption is set out in Rule 505 of Reg. D. The Rule 505 exemption permits your company to offer and sell up to \$5,000,000 of its securities in any 12-month period to an unlimited number of "accredited investors" plus up to 35 other purchasers. "Accredited investors" includes individuals whose net worth (or joint net worth with spouses) at the time of the purchase exceeded \$1,000,000, or who had an individual income in excess of \$200,000 (or \$300,000 joint income with spouses) in each of the two most recent years and had a reasonable expectation of reaching the same income level in the current year. Directors and executive officers of the company selling the securities also are classified as accredited investors as to that company. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), signed into law on July 21, 2010, modified the definition of an "accredited investor" by requiring that an individual exclude the value of his or her primary residence when determining whether the individual's net worth exceeds \$1,000,000. The SEC interpreted this revision to be effective immediately. The Dodd-Frank Act also requires the SEC to review the definition of an "accredited investor" for individuals, and mandates such review beginning no earlier than four years after enactment of the Dodd-Frank Act and not less frequently than every four years thereafter, and to make appropriate revisions to the definition for the protection of investors.

Rule 505 requires the same disclosures as Rule 504 if sales are made to accredited investors only. If, however, any sales are made to non-accredited investors, then all potential investors, accredited and non-accredited, must receive, prior to any sale, an offering document which provides generally the same extensive information about your company as would be required in a prospectus for a registered offering. The offering document also must contain financial statements, including an audited balance sheet dated within 120 days before the start date for the offering. Further, your company must give each potential investor the opportunity to ask questions of, and receive answers from, your company concerning the terms and conditions of the offering and to obtain any additional information your company possesses or can acquire without unreasonable effort or expense if the information is necessary to verify the accuracy of information furnished to the potential investor. Because of these audit and disclosure requirements, the Rule 505 exemption is rarely used to sell to non-accredited investors.

## **Rule 506**

Rule 506 of Reg. D sets out the third registration exemption. Rule 506 allows your company to raise an unlimited amount of money from an unlimited number of "sophisticated investors," with no more than 35 of those investors being non-accredited. A "sophisticated investor" is an investor who either has sufficient knowledge and experience with investing to be able to evaluate the risks and merits of an offering or an investor who represents to the offering company, in writing, that he or she has obtained the assistance of a "purchaser representative" who possesses that knowledge and experience. All accredited investors are deemed to be sophisticated investors. Rule 506 imposes the same disclosure requirements as Rules 504 and 505.

The interesting difference between Rule 505 and Rule 506, other than the dollar limit on the total investments and the types of investors, is that Congress has pre-empted certain state regulation with respect to offerings made under Rule 506. Thus, states may not impose additional conditions beyond those specified by Rule 506 on a Rule 506 offering, other than requirements to make an advisory (non-reviewable) filing and payment of a filing fee. This has made multi-state offerings under Rule 506 far simpler than under Rules 504 and 505.

## **State Exemptions**

As indicated above, all sales of securities must be registered pursuant to the rules of the SEC and the state regulatory agencies for each state in which the securities are to be sold, unless an exemption to registration applies. State securities statutes (often referred to as "Blue Sky" laws because they are intended to protect investors from schemes that have "as much value as a patch of blue sky") govern registration of securities offerings in that state, as well as exemptions from the state registration requirements.

### **Filing Requirements**

If your company intends to offer or sell securities in reliance on Reg. D, it must file an SEC Form D with the SEC within 15 days after the first sale of its securities. The Form D must be filed electronically on the SEC's website using the EDGAR system. There is no fee for filing Form D. Form D generally is used by the SEC to collect empirical data and to provide it with a source of information to assess the effectiveness of Reg. D as a capital-raising device for small businesses. Although the obligation to file Form D is not one of the conditions for claiming a valid exemption under Reg. D, your company may be disqualified from use of Reg. D for future transactions for failure to file Form D.

### **Conclusion**

A Regulation D private offering can provide your small- or mid-sized company an attractive alternative for raising capital without incurring the time and expense of registering the securities. However, any company seeking to raise capital through a private offering should consult legal counsel to ensure that the offering meets the requirements of one of the three Regulation D exemptions, as well as any applicable parallel state exemptions.

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*For further information regarding the issues described above, please contact Richard J. Crow.*

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