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# Private Placement Guidelines— A Lawyer's Letter To a First-Time Issuer

*By Marc H. Morgenstern**

A private placement of stock enables a company to raise capital. In many cases, the company is a start-up business and the issuer knows little or nothing about the securities laws regulating the private placement. In other cases, the company may need funds to acquire an existing business. While in the latter case the issuer may be more familiar with the relevant securities laws, the issuer likely will need a refresher course.

Regardless of the scenario, a private placement is time consuming and can be physically and emotionally draining—especially for the first-time issuer. The company simultaneously may be negotiating with a seller,[1] arranging for institutional debt financing, and worrying about whether it successfully will raise the equity portion of the start-up funds or purchase price. In addition, the issuer must become familiar with the federal and state securities laws as they relate to the private placement. The process is more difficult when the money is being raised without a broker-dealer whose knowledge and experience might otherwise assist in the education process.[2]

There are different ways of educating such issuers, ranging from single (exhausting) 3-hour information sessions, to meeting on several different

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The intellectual genesis of this article was a seminal publication entitled *Now That You Are Publicly Owned . . .*, co-authored by Carl W. Schneider and Jason M. Shargel, which appeared at 36 Bus. Law. 1631 (1981).

The text is for transmission from a lawyer to a client. The footnotes are intended to assist lawyers by directing their attention to relevant primary and secondary sources.

*Editor's Note:* Carl W. Schneider, a partner of Wolf, Block, Schorr & Solis-Cohen in Philadelphia, Pennsylvania, and Hugh H. Makens, a partner of Warner, Norcross & Judd in Grand Rapids, Michigan, served as reviewers for this article.

1. For an analysis of the emotional state of the seller, and the risk/reward perspective of a buyer of a financially-distressed business, see Marc H. Morgenstern, *Philosophy of Acquisitions*, 8 Corporate Counsel's Quarterly (1992).

2. *See* Matthew Joonho Jeon, *Broker-Dealer Responsibility in Regulation D Transactions*, 17 Fordham Urb. L.J. 63 (1988-89).

occasions to discuss different aspects of the applicable securities laws. Unfortunately, the client's interest in the private placement is functional rather than intellectual. Securities law is not the most gripping subject matter under the sun, particularly to goal-oriented, fast-moving entrepreneurs. The client's goal is to raise the money without going to jail and let the lawyers worry about complying with the securities laws. Bored looks and caustic comments are a staple response to all these educational techniques.

One of the more productive ways to educate a client is to meet at the very beginning of the transaction to explain the general securities law concepts. The client should be encouraged to listen and ask questions rather than take notes. People who are busy writing frequently do not hear very well. Many lawyers provide written materials to the issuer to aid in this process. Following the meeting, the lawyer should furnish the client with a letter summarizing the applicable federal securities law issues, as well as provide a separate blue sky memorandum explaining the applicable state blue sky laws. No transaction or client, however, requires the same explanations or warnings.

What follows, therefore, is an example of a letter explaining the compliance obligation in a specific private placement transaction. This method is not a perfect solution. This formal process does, however, tend to promote a genuine exchange of infomration and a better sense of the respective responsibilities of lawyer and client. It also permits a modest comfort that certain basic counseling, fiduciary, and legal obligations of the lawyer have been discharged by providing the fundamental securities law concepts in an understandable form to each client.



*This document is governed by attorney-client privilege*

President

ABC Corporation

Re: Private Placement (Private Placement) of Common Stock (Stock) of ABC Corporation, a Delaware corporation (Company) pursuant to Rule 506 of Regulation D[3]

Dear Client:

We have met with you, discussed the basic state and federal securities laws governing your offering of Stock, and determined how to structure the offering. Because the Regulation D exemptions under rules 504 and 505 of the Securities Act of 1933 (Securities Act)[4] are unavailable to you due to, among other things, the aggregate offering price,[5] we agreed to structure the offering to comply with rule 506 of Regulation D. The principal federal securities law issues applicable to this offering are summarized in this letter. The state securities law issues are examined in detail in a

3. 17 C.F.R. § 501 (1992). Regulation D was adopted effective April 15, 1982. SEC Release No. 33-6389, 1982 SEC LEXIS 2167 (Mar. 8, 1982). Minor amendments were made December 1982, SEC Release No. 33-6437, 1982 WL 35947 (Nov. 19, 1982), and November 10, 1986, SEC Release No. 33-6663, 51 Fed. Reg. 36,385 (1986). Major amendments were effective April 11, 1988, SEC Release No. 33-6758, 53 Fed. Reg. 7866 (1988), and April 19, 1989, SEC Release No. 33-6825, 54 Fed. Reg. 11,369 (1989). Regulation D rescinded prior rules 146, 240, and 242 and replaced them with rules 506, 504 and 505, respectively. The 1989 amendments added new rules 507 and 508 so that Regulation D now consists of eight rules: 501 through 508.

For articles discussing Regulation D generally, see Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 Wash. U. L.Q. 225 (1990); John D. Ellsworth & Philip Montelepre, *Use of Solicitations of Interest and Similar Pre-Offering Documents Prior to a Private Placement*, 5 Real Est. Sec. J. 68 (1984); and Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 Am. U. L. Rev. 355 (1984).

Not all states have adopted all of the amendments to Regulation D. The differences should be addressed by counsel in the separate blue sky memorandum.

4. 15 U.S.C. §§ 77a-77aa (1988 & Supp. II 1990).

5. Rule 504 is available only with respect to offerings up to $1,000,000, 17 C.F.R. § 230.504 (1992), while rule 505 is an option only up to $5,000,000, 17 C.F.R. § 230.505 (1992). These dollar limitations, however, are subject to further limitations set forth in the rules. The letter assumes that the lawyer already has examined all available approaches to an exempt transaction, including Regulation D, § 4(6) of the Securities Act of 1933, 15 U.S.C. § 77(d)(6) (1988), as well as the intrastate exemption of § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1988), and rule 147 thereunder, 17 C.F.R. § 230.147 (1992). Offerings conducted under any of the exemptions from registration require a similar letter, modified to reflect the important distinctions between the exemptive schemes. Rules 504 and 505 are promulgated under § 3(b), 15 U.S.C. § 77(c)(b) (1988), while rule 506 is promulgated under § 4(2), 15 U.S.C. § 77d(2) (1988). Different discussions therefore apply, particularly in Sections 2 and 3 of this letter. The § 4(6) exemption, while extremely useful, is available only in an offering limited to accredited investors. 15 U.S.C. § 77(b)(6) (1988).

separate blue sky memorandum,[6] but also are addressed briefly in Section 9. This letter confirms the substance of our discussions in nontechnical terms and outlines our respective responsibilities. Despite its foreboding length, this letter is not all-inclusive, and is not a legal opinion.

## *1. REGULATION OF SECURITIES—AN OVERVIEW*

The sale of securities, such as common stock,[7] is regulated by each state[8] as well as the federal government.[9] The regulation focuses on three key variables: the security (or transaction) itself, the persons and entities who sell the security, and the disclosures made to investors about the security.

6. For due diligence purposes, we suggest that the issuer certify in writing those states in which offers will be made. A state-by-state analysis of the exemption requirements for both the registration of the security as well as applicable broker-dealer exemptions then can be prepared. The blue sky analysis is critical because of the wide variation of exemptions and the differences in filing requirements, with the states differing in whether the filing is triggered by "offers" or "sales."

7. *Stock* explicitly is defined as a security under state and federal laws. *See* 15 U.S.C. § 77b(1) (1988). When the issuer is offering limited partnership interests or other investments which are securities because they are "investment contracts," it is helpful to explain in the letter *why* such investments are securities. Clients may be skeptical that non-traditional instruments are securities, even such fairly common instruments as notes, which sometimes are securities. *See* Reves v. Ernst & Young, 110 S. Ct. 945 (1990); *see also* Randell W. Quinn, *After Reves v. Ernst & Young, When are Certificate of Deposit "Notes" Subject to rule 10b-5 of the Securities Exchange Act?*, 46 Bus. Law. 173 (1990); Scott D. Museles, Comment, *To be or Note to be a Security: Reves v. Ernst & Young*, 40 Cath. U. L. Rev. 711 (1991); Robert M. Simmons, Comment, *When are Notes Securities?: Adding Certainty to the Process of Defining a Security Under the Federal Securities Laws*, 22 U. Tol. L. Rev. 1119 (1991).

The benchmark analysis of an "investment contract" was provided in SEC v. W.J. Howey Co., 328 U.S. 293 (1946), in which the Supreme Court held that an investment contract requires four elements: (1) an investment, (2) in a common enterprise, (3) with the expectation of profits, and (4) resulting solely from the efforts of another. *Id.* at 298-99. Based upon *Howey*, a limited partnership interest almost invariably constitutes an investment contract. Pursuant to the provisions of the Uniform Limited Partnership Act (1916) and the Revised Uniform Limited Partnership Act (1976), all management authority lies with the general partner of a limited partnership. A limited partner, therefore, anticipates making an investment in a common enterprise with other limited partners, with the expectation of making profits based on the efforts of "another," i.e., the general partner.

For consideration of when interests in partnerships, limited partnerships, or joint ventures constitute securities, see Joseph C. Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 Mo. L. Rev. 581 (1972), and Marc H. Morgenstern, *Real Estate Joint Venture Interests as Securities: The Implications of Williamson v. Tucker*, 59 Wash. U. L.Q. 1231 (1982).

8. *See* Uniform Securities Act § 301, Blue Sky L. Rep. (CCH) ¶ 5531 (1990). The Act has been adopted, in whole or in part, in 38 states, the District of Columbia, Puerto Rico, and Guam. *Id.* at ¶ 5500 (1989).

9. *See* Securities Act of 1933 (Securities Act), 15 U.S.C. § 77a-77aa (1988 & Supp. II 1990); Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78a-78jj (1988 & Supp. II 1990).



Every security sold in the United States either must be registered with the Securities and Exchange Commission (SEC)[10] or qualify for an exemption from registration.[11] In addition, the security either must be registered or exempt from registration in all applicable states, i.e., states in which investors are offered or sold the securities, or that have sufficient contacts with the sales process.[12] Unfortunately, state registration exemptions differ dramatically from state to state. A federal exemption does *not* guarantee a state exemption (or vice versa),[13] nor does an exemption in one state mean that a comparable exemption will be available in another.[14]

In addition, the person selling the securities must be registered with the state and federal government as a broker-dealer or agent *unless* an applicable exemption from registration in those capacities is available.[15] The term *person* can include the Company and any individuals involved in the selling process.[16] Broker-dealer and agent exemptions vary from state to state and may not parallel federal exemptions. Therefore, even if a federal broker-dealer exemption is available, there may not be a comparable state exemption.

An exemption from registration for the sale of the Stock at either the state or federal level does not mean that the *person* selling the securities is exempt from registration as a broker-dealer.[17] Similarly, exemption from registration does not relieve the Company of the state and federal antifraud provisions, which require the Company to provide all material information about the Company and the investment to allow investors to make an informed investment decision.[18]

10. Securities Act § 5, 15 U.S.C. § 77e (1988).

11. *Id.* § 3(a), 15 U.S.C. § 77c(6) (1988).

12. Uniform Securities Act § 301, Blue Sky L. Rep. (CCH) ¶ 5531 (1992).

13. *See* Securities Act § 18, 15 U.S.C. § 77r (1988); Uniform Securities Act § 414, Blue Sky L. Rep. (CCH) ¶ 5554 (1988).

14. The Uniform Securities Act does, however, attempt "to make uniform the law of those states which enact it." Uniform Securities Act § 415, Blue Sky L. Rep. (CCH) ¶ 5555 (1989).

15. Section 15(a)(1) of the Exchange Act provides:

> It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

§ 15 U.S.C. § 78o(a)(1) (1988).

16. Exchange Act § 3(a)(9), 15 U.S.C. § 78c(a)(1) (1988).

17. *Id.* § 15(a), 15 U.S.C. § 78o(a).

18. *See id.* § 10(b), 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5 (1992); Securities Act §§ 12(2), 17(a), 15 U.S.C. §§ 77*l*(2), 77q(a) (1988).

## 2. *HOW DO I AVOID REGISTERING THE STOCK WITH THE SEC?*

Registration of the Stock with the SEC is expensive and time consuming. To avoid both problems, you are attempting to comply with an exemption from registration. The Company will be conducting a "private placement," either under rule 506[19] or the statutory provisions of section 4(2)[20] of the Securities Act, each of which permits the raising of unlimited funds without registering the security with the SEC.

The requirements for the section 4(2) exemption are vague and uncertain.[21] The statutory language provides that a "transaction . . . not involving any public offering" is exempt from the registration requirements of section 5.[22] The case law and administrative pronouncements are inconsistent and suggest that the exemption may be available where people to whom the securities are offered (offerees), as well as actual purchasers, have substantial financial means and are capable of evaluating the merits of the investment.[23] Additionally, offerees either must have "access" to all material financial and other pertinent information about the Company through their economic bargaining power or be provided with such information.[24] Under section 4(2) and rule 506, the Stock must be acquired for investment purposes and may not be resold for an indefinite period of time, which for persons not closely associated with the Company is generally not less than two years.[25] If the Stock is resold by an original

19. 17 C.F.R. § 230.506 (1992).

20. Securities Act § 4(2), 15 U.S.C. § 77d(2) (1988). Section 4(2) provides an exemption from registration for "transactions by an issuer not involving any public offering."

21. The law in this area is murky. The seminal case is SEC v. Ralston Purina, 346 U.S. 119 (1953), where the Supreme Court observed that the availability of the exemption hinges on whether the affected persons require the protection of registration. *Id.* at 126-27; *see also* Swenson v. Engelstad, 626 F.2d 421 (5th Cir. 1980); SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980); Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975); SEC v. Spence & Green Chem. Co., 612 F.2d 896 (5th Cir. 1980); Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977). For a practical discussion of how to preserve the § 4(2) exemption, see Herbert S. Wander, *Stringing a Safety Net for the Statutory Private Placement Under Section 4(2)*, 5th Annual Southern Securities Institute. *See generally* B.W. Nimkin, *Offeree Sophistication in Private Offering*, 15 Rev. Sec. Reg. 863 (1982); Carl W. Schneider, *The Statutory Law of Private Placements*, 14 Rev. Sec. Reg. 161 (1981).

22. Securities Act § 4(2), 15 U.S.C. § 77d(2) (1988).

23. *See, e.g.*, Schneider, *supra*, note 21.

24. 17 C.F.R. § 230.502(b)(1) (1992).

25. *See id.* § 230.502(d). Securities acquired in a Regulation D offering are restricted securities and cannot be resold without either registering the securities under the Securities Act or having an applicable exemption. Rule 502(d) provides that the issuer must "exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of Section 2(11) of the Act." The rule provides that one sure way this obligation can be satisfied is by: (1) inquiring whether the purchaser is acquiring the securities for himself or others, (2) providing written disclosure prior to sale that the securities have not been registered under the Securities Act and, therefore, cannot be resold without registration



investor in the Private Placement, the stock being resold either must be registered or exempt from registration at that time.[26]

The availability of a private placement under section 4(2) further hinges on the number and sophistication of *offerees*.[27] This is in sharp contrast to rule 506, which primarily deals with *purchasers*.[28] Theoretically, if an offer is made to even one "unsuitable" investor, i.e., an investor who is unsophisticated or without "access" to information, the section 4(2) exemption may be unavailable for the entire offering.[29] Under rule 506, in contrast, a private placement may be available if the unsuitable offeree does not actually purchase the security.[30]

Viewed most restrictively, a private placement under section 4(2) requires an offeree to meet certain wealth and sophistication standards.[31] Furthermore, there is an ill defined limit (perhaps thirty-five or fewer) on the total number of offerees.[32] Because you are uncertain about the fi-

or exemption, and (3) legending the security to indicate that the securities have not been registered, and indicating the restrictions on transferability and sale of the securities. *Id.*

26. Restricted securities can be sold under Securities Act § 4(1) and rule 144 promulgated thereunder. If the provisions of rule 144 are satisfied, then the resale by the investor is not deemed to be a transaction by an "underwriter" and is therefore permitted. Rule 144, however, is frequently unavailable to a holder of restricted securities, particularly for a non-SEC reporting company.

Industry custom has fashioned an exemption for sales of restricted securities that meet certain of the exemptive conditions under both § 4(1) and § 4(2), which is generally referred to as the 4(1-1/2) exemption. Report, *The Section '4(1-1/2)' Phenomenon: Private Resales of Restricted Securities*, 34 Bus. Law. 1961 (1979).

27. Doran v. Petroleum Management Corp., 545 F.2d 893, 900 (5th Cir. 1977).

28. 17 C.F.R. § 230.506(b)(2) (1992).

29. *See* Henderson v. Hayden, Stone Inc., 461 F.2d 1069, 1071-72 (5th Cir. 1972).

30. 17 C.F.R. § 230.506(b)(2) (1992) (limitation on the number of purchasers, not the number of offerees).

31. *See* C. Edward Fletcher III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 Duke L.J. 1081.

32. *See* Interpretive Release on Regulation D, SEC Release No. 33-6455, 1983 WL 35560 (Mar. 3, 1983) (Question and Answer Release), Question (73):

> Question: Rule 506 requires that the issuer shall reasonably believe that each purchaser who is not an accredited investor either alone or with a purchaser representative has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment. Former rule 146 required the issuer to make a similar determination with respect to each offeree. Rule 506 is not an exclusive basis for satisfying the requirements of the private offering exemption in § 4(2). *See* Preliminary Note 3 to Regulation D. What is the Commission's view of the relevance of the nature of the offerees in an offering that relies exclusively on § 4(2) as its basis for exemption from registration?
>
> Answer: Clearly, in an offering relying exclusively on § 4(2) for an exemption from registration, all offerees who purchase must possess the requisite level of sophistication. The sophistication of each of those to whom the securities are offered who do not purchase is not a fact that in and of itself should determine mechanically the availability of the exemption; the number and the nature of the offerees, however, are relevant in determining whether an issuer has engaged in a general solicitation or general advertising

nancial appetites of prospective investors, you do not know whether the offering may involve only a few people or substantially more than thirty-five offerees. The greater the number of offerees the more likely it is that the Private Placement may not comply with section 4(2).[33] The offering may nonetheless comply with rule 506, which provisions limit the number of *purchasers* rather than mere offerees.

The Company has the burden of establishing an exemption from registration.[34] The failure to satisfy even one element of the exemption (e.g., under rule 506 selling to more than thirty-five nonaccredited investors)[35] could destroy the availability of the exemption for the entire offering—*not just the single offer or sale in question.*[36] You must be extremely careful in your analysis and verification procedures for determining the status of investors and complying with the other pre-conditions to preserve the availability of the exemption.

that would preclude reliance on the exemption in § 4(2).

*Id.*

33. *Doran*, 545 F.2d 893, 900 (5th Cir. 1977) (citing Hill York Corp. v. American Franchises, Inc., 448 F.2d 680 (5th Cir. 1971)).

34. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).

35. 17 C.F.R. § 230.506(b)(2) (1992).

36. Since its promulgation, Regulation D always had required absolute compliance in order to obtain the benefits of its safe harbor protection. Failure to achieve such perfection resulted in the draconian remedy of rescission of the offering in its entirety at the election of the investors, even one unaffected by the rule violation.

In response to repeated requests by the bar and the securities industry, the SEC adopted rule 508, effective April 19, 1989. *See* 17 C.F.R. § 230.508 (1992). The adopting release summarizes the rule as follows:

> New rule 508 provides that an exemption from the registration requirements will be available for an offer or sale to a particular individual or entity, despite failure to comply with a requirement of Regulation D, if the requirement is not designed to protect specifically the complaining person, the failure to comply is insignificant to the offering as a whole and there has been a good faith and reasonable attempt to comply with all requirements of the regulation. Rule 508 specifies that the provision of Regulation D relating to general solicitation, the dollar limits of rules 504 and 505, and the limits on non-accredited investors in rules 505 and 506 are deemed significant to every offering and therefore not subject to the rule 508 defense. Further, the rule specifies that any failure to comply with a provision of Regulation D is actionable by the Commission under the Securities Act.

SEC Release No. 33-6455, 1983 WL 35560 (Mar. 3, 1983)

While not going as far as proponents of the bar would prefer, *see, e.g.*, Carl W. Schneider & Charles C. Zall, *Section 12(1) and the Imperfect Exempt Transaction: the Proposed I & I Defense*, 28 Bus. Law. 1011 (1973), the rule does eliminate civil liability of issuers for relatively modest compliance failures while preserving administrative remedies to the SEC, thus accommodating the most pressing needs of the industry and the regulators. *See* Carl W. Schneider, *A Substantial Compliance ("I & I") Defense and Other Changes Are Added To SEC Regulation D*, 44 Bus. Law. 1207 (1989); Stanley Keller, *Saga of a Substantial Compliance Defense*, Insights, August 1989, at 11.



## *3. WHO CAN BUY THE STOCK?*

We have recommended rule 506 because it has clearer and more objective standards than section 4(2). This is especially true with respect to the number and suitability of investors. For example, under rule 506, the Stock can be sold to no more than thirty-five nonaccredited *purchasers*.[37] Investors either are accredited or nonaccredited (see discussion below) for purposes of rule 506.[38] Generally, each nonaccredited investor is counted as a purchaser while accredited investors and foreign investors[39] are excluded in calculating the number of purchasers.[40] Assuming compliance with the prohibitions against advertising and general solicitation,[41] the Stock theoretically may be sold to an unlimited number of accredited investors.

Whether an investor is considered "accredited" depends on the investor's classification and whether the investor meets the requirements for that classification. Individuals (rather than entities) will be accredited investors if they satisfy any one of the following standards: (1) have a net worth (with their spouse) in excess of $1,000,000,[42] (2) *individual* income for the past two years and a reasonable expectation of income for the current year in excess of $200,000 (excluding spouse),[43] or (3) *joint* income with their spouse in excess of $300,000 for the past two years and a reasonable expectation of such income for the current year.[44] Directors and executive officers of the Company also are classified as accredited investors.[45]

37. 17 C.F.R. § 230.506(b)(2) (1992).

38. *Id.* § 230.506(b)(2)(ii).

39. Preliminary Note 7 to Regulation D provides that: "Offers and sales of securities to foreign persons made outside the United States effected in a manner that will result in the securities coming to rest abroad generally need not be registered under the Act." *See* Exchange Act Release No. 33-4708, 29 Fed. Reg. 9828 (July 9, 1964). This interpretation may be relied on for such offers and sales even if coincident offers and sales are made under Regulation D inside the United States. *Thus, for example, persons who are not citizens or residents of the United States would not be counted in the calculation of the number of purchasers.* Similarly, proceeds from sales to foreign purchasers would not be included in the aggregate offering price. The provisions of this note, however, do not apply if the issuer elects to rely solely on Regulation D for offers or sales to foreign persons. *See* American Real Estate 82-A, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2688 at *1 (Aug. 13, 1982) ("non-U.S. citizens and residents may be excluded from the calculation of the number of purchasers under rule 501(e) of Regulation D"). *See generally* Marc H. Morgenstern, *Real Estate Securities and the Foreign Investor—Some Problems and a Proposal*, 11 Sec. Reg. L. J. 332 (1984); Marc H. Morgenstern, *Extraterritorial Application of United States Securities Law: A Matrix Analysis*, 7 Hastings Int'l & Comp. L. Rev. 1 (1983).

40. 17 C.F.R. § 230.501(e)(iv) (1992).

41. *See* Securities Act § 6, 15 U.S.C. § 77f (1988).

42. 17 C.F.R. § 230.501(a)(5) (1992).

43. *Id.* § 230.501(a)(6).

44. *Id.* § 230.501(a)(7).

45. *Id.* § 230.501(a)(4).

There are different requirements for corporations, partnerships, trusts, and non-profit organizations.[46] Generally, these entities will be accredited investors only if: (1) all of the equity owners are accredited investors (not available for trusts),[47] or (2) the entity has assets (as distinguished from net worth) in excess of $5,000,000 and was not formed for the purpose of making this investment.[48] Employee benefit plans are accredited investors only if: (1) the investment decision is made by a plan fiduciary that is a savings and loan association, bank, insurance company, or registered investment advisor, (2) the plan has total assets in excess of $5,000,000, or (3) if a self-directed employee benefit plan, its investment decisions are made solely by one or more individuals who are accredited investors.[49] Finally, an IRA for an accredited investor also is an accredited investor.[50]

An investor who does not come within one of the accredited investor categories is a nonaccredited investor. There can be no more than thirty-five such investors[51] and you must "reasonably believe" that each of these investors (either individually, or with a "purchaser representative") has enough knowledge and experience in financial and business matters to evaluate the merits and risks of the investment.[52] An accredited investor, however, does not need to satisfy any such sophistication standards.

46. *Id.* § 230.501(a)(1)-(3), (7), (8). For an analysis of the rules under Regulation D with respect to entities, *see* Marc H. Morgenstern, *Corporations, Partnerships, and Trusts as Purchasers under Regulation D*, 7 Real Est. Sec. J. 46 (1986). Portions of that analysis were superseded by the 1988 and 1989 amendments to Regulation D, which, among other changes, added savings and loans, broker-dealers, and municipalities to the definition of accredited investors under rule 501(a)(1).

47. 17 C.F.R. § 230.501(a)(8) (1992).

48. *Id.* § 230.501(a)(3), (7). A curious anomaly of defining status by reference to assets rather than net worth is that a bankrupt company with assets in excess of $5,000,000 but even greater liabilities is an accredited investor. There is an additional requirement that the entity can qualify as a single purchaser *only* if it were *not formed* for the specific purpose of acquiring the securities sold in this offering. With respect to trusts, rule 501(a)(7) adds the additional requirement that the purchase be "directed by a sophisticated person as described in § 230.506(b)(2)(ii)." *Id.* § 239.501(a)(7).

49. *Id.* § 239.501(a)(1). The 1988 amendments to Regulation D eliminated a previously important category of accredited investor, namely, a purchaser of $150,000 of securities whose purchase constituted less than 20% of the purchaser's net worth. Under prior law, Regulation D had followed the lead of numerous states in recognizing that purchasers of substantial dollar values of securities had sufficient leverage with issuers to obtain access to those facts which the investor believed material to the investment. The elimination of this category had its largest impact on entities, which now can only be accredited investors under the $5,000,000 asset test, or if all of the equity owners of the entity are accredited investors. *See id.* § 239.501(a)(3), (8). This change eliminated as accredited investors numerous profitable companies owned by individuals, not all of whom are accredited investors, but which companies were nonetheless able to purchase $150,000 of securities in an offering.

These amendments had the practical effect of eliminating as accredited investors certain businesses for which asset accumulation is not necessary to the business, i.e., service, distribution, and brokerage companies who may have substantial incomes but no need to retain or build asset bases. It also penalizes subchapter S corporations whose shareholders frequently distribute cash and therefore maintain low corporate assets and net worth.

50. Question and Answer Release, *supra* note 32, provides in part that "where the purchase of Regulation D securities is made by an Individual Retirement Account and the participant is an accredited investor, the account would be accredited under rule 501(a)(8)." *Id.* Question 30.



## *4. WHO CAN SELL THE STOCK?*

You told us that the Company will sell the Stock without a broker-dealer. The Company and the individuals selling the Stock will avoid registering as broker-dealers or agents by complying with a federal exemption available to issuers and related individuals.[53] This exemption usually is referred to as the "issuer" exemption and is available to individuals who are not engaged in the business of effecting transactions in securities.[54]

There is a narrowly-defined, federal safe-harbor exemption available only if the Company sells securities once in a twelve-month period.[55] You have advised us that the Company neither has sold its own securities within the past twelve months, nor will it sell its securities within the next twelve months. If this is the case, you should fall within the safe harbor rule. If your plans change and you decide to sell the Company's securities again in the next twelve months, however, we will need to discuss the alternatives available under the broader concepts of the issuer exemption outside of the safe harbor.[56]

The Stock can be sold by the Company's executive officers, directors, and full-time employees who perform substantial duties for the Company other than selling these securities provided, however, that those individuals have not relied on the issuer exemption in the last year.[57] There are three other highly technical conditions relating to individuals involved in the

51. 17 C.F.R. § 230.506(b)(2)(i) (1992). The calculation of the number of purchasers requires consideration of family relationships and other factors, the result of which may permit aggregation of investors and either decrease the number of purchasers or permit certain otherwise nonaccredited investors to be treated as accredited investors. *See* rule 501(e), 17 C.F.R. § 230.501(e) (1992); Question and Answer Release, *supra* note 32, Questions 54-59.

52. 17 C.F.R. § 230.506(b)(2)(ii) (1992).

53. *Id.* § 240.3a4-1 (1992). For a thorough discussion of the issuer exemption, see Marc H. Morgenstern, *The Real Estate Syndicator as a Securities Broker-Dealer*, Small Business Counselor (July 1986). If the Company engages the services of a broker-dealer to sell a portion of its securities, the Company nonetheless may continue to claim the issuer exemption with respect to sales made by its own officers and directors under certain circumstances. The rules with respect to this situation are quite complex and need to be discussed in detail with the client should the situation arise.

54. 17 C.F.R. § 240.3a4-1(a)(4)(ii)(B) (1992) (implicitly incorporating Exchange Act § 3(a)(4)-(5), 15 U.S.C. 78c(a)(4)-(5) (1988)).

55. *Id.* § 240.3a4-1(a)(4)(ii)(C).

56. *Id.* § 240.3a4-1(a)(4)(ii)(C).

57. *Id.* § 240.3a4-1(a)(4)(ii).

selling effort. No such person can: (1) be subject to a "statutory disqualification,"[58] (2) be compensated (directly or indirectly) by paying commissions or other compensation based on sales of the securities,[59] or (3) at the time of selling the securities (or within twelve months before), be an "associated person of a broker or dealer,"[60] or have been "a broker or dealer, or an associated person of the broker or dealer" within the prior twelve months.[61] Many states also have disqualification standards.

Many (but not all) states exempt issuers and their employees who sell their own securities in a transaction that is exempt from federal registration.[62] The state-by-state analysis of registrations and exemptions applicable to the offering are detailed in the blue sky memorandum.

## *5. HOW DO I SATISFY DISCLOSURE OBLIGATIONS?*

State and federal securities laws require the Company to provide investors with full, fair, and complete disclosure of all "material" facts about the offering and the Company, its management, business, operations, and finances.[63] Information is material if a reasonable investor would consider the information important in making an investment decision.[64] While materiality is a difficult concept to define precisely, at a minimum a fact is "material" if you do not want to disclose the information because if the investors know about it they would not buy the Stock.[65] Facts which are disclosed must be developed fully. At the obvious level, you cannot state that the Company owns a manufacturing facility and not disclose that the building is uninsured, has been hit by lightning, and has been condemned by the health department. At the more subtle level, you cannot state that the company owns a building and not disclose that the property is subject to a mortgage, a fact that does not conflict with ownership but affects the

58. The basis for statutory disqualification is found in § 3(a)(39) of the Exchange Act. *See* Exchange Act § 3(a)(39), 15 U.S.C. § 78c(a)(39) (1988). Generally, the section delineates a series of "bad boy" provisions relating to various violations of SEC or self-regulatory organization rules.

59. 17 C.F.R. § 240.3a4-1(a)(2) (1992).

60. *Id.* § 240.3a4-1(a)(3).

61. *Id.* § 240.3a4-1(a)(4)(ii)(B). This latter rule eliminates numerous persons who are registered representatives for a brokerage house and who are serving as directors of a company or general partners in a syndication. Because such individuals' primary employment involves selling securities, it would be inappropriate to permit them to rely on the issuer exemption. The theoretical basis behind this policy is that the person relying on the exemption is not engaged in the business of selling securities.

62. An invaluable source of information about Regulation D, which is updated annually, is J. William Hicks, *Limited Offering Exemptions: Regulation D* (Clark Boardman Callaghan 1991). Table 9-8 in the 1991 edition summarizes the broker-dealer and agent registration requirements and exemptions for all 50 states.

63. 17 C.F.R. § 230.405 (1992).

64. TSC Indus. v. Northway, 426 U.S. 438 (1976) (statement of the standard of materiality).

65. *Id.*



economic value and other attributes of ownership. Because the securities will be sold to both accredited and non-accredited investors, under rule 506 the Company must provide written disclosures that contain substantially the same information as disclosure statements from companies that are registering their securities with the SEC.[66]

Even though the Stock is not required to be registered with the SEC, you must comply with state and federal antifraud provisions. The federal antifraud provisions arise primarily from the well known section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act),[67] as well as the lesser known section 12(2) of the Securities Act.[68] Failure to comply with these provisions can result in civil liabilities (i.e., money dam-

66. 17 C.F.R. § 230.502(b)(2) (1992). If the offering were sold exclusively to accredited investors, rule 502(b)(1) provides that no specific information need be provided to satisfy the *registration* exemption. Even in a transaction limited to accredited investors, however, the prudent counsel and issuer are well advised to provide written materials to comply with the *antifraud* provisions of the state and federal securities laws, particularly providing information in sensitive areas such as conflicts of interest, source and use of funds, and compensation and other ownership and benefits to management and promoters. In many transactions with sophisticated buyers, additional information may be requested by the buyer even beyond that found in a registration statement, including projections and other similar information.

67. *Id.* § 240.10b-5, commonly referred to as rule 10b-5, provides:

> [I]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

68. Securities Act § 12(2), 15 U.S.C. § 77*l*(2) (1988). Section 12(2) provides as follows:

> Any person who . . .
>
> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

*Id.*

ages). The liability can be personal as to corporate officers, directors, principal shareholders, promoters, and others associated with the offering.[69] These antifraud provisions collectively prohibit any person in connection with the purchase or sale of any security from misrepresenting or omitting a material fact or engaging in any act or practice that constitutes a "fraud" or deceit upon any other person.[70] Fraud, for securities law purposes, is much broader than you would believe. It includes omissions in disclosure (sometimes even unintentional ones) rather than just deliberate misrepresentations.[71] Therefore, regardless of whether you intend to defraud an investor, should you fail to disclose a material fact, you will be liable.

To satisfy the disclosure requirements and comply with the antifraud provisions, a Private Placement Memorandum (PPM) must be prepared.[72] The directors and officers of the Company will provide us with the facts about the Company, its employees, management, operations, and finances. The PPM and related documents will be prepared from this information. We also will review the background and ownership of the directors and officers as provided in their responses to Directors and Officers Questionnaires. We then will prepare an initial draft of the PPM using that information, and will review and revise future drafts with the Company's principal officers and accountants. While we will ask numerous questions, remember that you are the industry expert. If we ask the wrong question, tell us the right question, and give us the right answer. Your industry has specific key financial ratios and risks which you must help us understand. The process will be more efficient, and the disclosure more complete, if you volunteer questions and information. Despite the extensive involvement of lawyers and accountants, the offering documents generally are the Company's responsibility. You must be satisfied that the disclosures are balanced, set forth all the material pros and cons, and take all material facts and circumstances into consideration.

The PPM functionally serves two purposes which are inherently in sharp conflict with each other. First, the PPM is a marketing tool to sell the

69. For a discussion of "control person" liability under the federal securities laws, see Richard W. Jennings et al., Securities Regulation 1131-34 (7th ed. 1992).

70. *See* Exchange Act § 10(b), 15 U.S.C. § 78j (1988); 17 C.F.R. § 240.10b-5 (1992); Securities Act §§ 12(2), 17(a), 15 U.S.C. §§ 77*l*(2), 77q(a) (1988).

71. For a discussion of the differences between common law and SEC fraud concepts, see 7 Louis Loss & Joel Seligman, Securities Regulation 3,421-48 (3d ed. 1991).

72. Sale of the securities in some states may require specific information and legends to be added to the Private Placement Memorandum. The North American Securities Administration Association (NASAA) and individual state guidelines do not apply to private offerings. Many (though not all) states now have a version of the simplified procedures and exemptions contained in the Uniform Limited Offering Exemption (ULOE). For a review of the ULOE exemption and its growing importance in achieving consistency and predictability with state exemptions, see Mark A. Sargent & Hugh H. Makens, *ULOE: New Hope, New Challenge*, 45 Bus. Law. 1319 (1990).



Stock. Because selling the Stock is your primary goal, your tendency will be to create a PPM that describes the company in an overly-positive way. The PPM, however, also is a document that protects you from being sued by disappointed investors if the investment is not successful. Because protecting you is our primary goal, our tendency will be to create a PPM that discloses as much as possible to investors, even if it causes the PPM to be a less effective marketing tool.

The PPM must satisfy the specific SEC disclosure requirements of the registration exemptions in order to shield you and the Company from liability for violating the registration requirement. Compliance with those specific disclosure regulations will also help protect you from liability under the antifraud statute. The protective value of the disclosure documents may be damaged severely or completely destroyed if you or any person involved in the selling effort makes oral or written representations different from those in the PPM. All sales presentations, both oral and written, should be governed by the content and general thrust of the PPM. This includes any transmittal letters to investors or any deal summaries you prepare. If you use summaries, in any form, you should clear them with us prior to distribution.

During the offering period, if it subsequently is discovered that the PPM contains inaccurate information or new material information occurs with respect to the Company's business, management, financial condition, or other matter, the PPM *immediately* must be amended and updated to reflect those changes. When in doubt, assume the changes are material and check with us. If the information is material, then you must circulate a supplement to the PPM which discloses the new or changed information.

## *6. WHAT OTHER LIMITS ARE THERE ON MY CONDUCT?*

A short document, called a Form D, must be filed with the SEC within fifteen days after the first "sale" of securities.[73] Failure to file on time, however, does not affect the availability of the exemption.[74] Placing subscription funds into an escrow account pending receipt of minimum subscriptions triggers the filing requirements, even though you have not yet "sold" the security.[75] To avoid timing problems, we advise filing Form D on the date the PPM is finalized, and amending it thereafter.

Another important precondition to the availability of the exemption under section 4(2) and rule 506 is the prohibition against the Company, or any person acting on its behalf, offering or selling securities by any

73. 17 C.F.R. § 230.503(a) (1992).

74. For a discussion of the rule changes that led to this result, see Sargent, *supra* note 3, at 264-65.

75. *See* Question and Answer Release, *supra* note 32, Question No. 82.

form of "general solicitation or general advertising."[76] For example, the Company cannot advertise, engage in a mass mailing, conduct informational meetings with potential investors, or issue a press release that discusses the existence of the private placement until after the offering has been concluded and all sales to investors have been finalized.[77] A conservative interpretation of the SEC's view is that all potential investors should be people with whom the Company, its directors, officers, or full-time employees have a pre-existing business relationship.[78]

76. 17 C.F.R. § 230.502(c) (1992). Many practitioners believe that the SEC's interpretation of general solicitation is far too narrow and impractical, and does not reflect the reality of industry custom. For articles reviewing the history of the prohibition against general solicitation and offering some interesting alternatives to the concept of general solicitation, see Rutheford B Campbell, Jr., *The Plight of Small Issuers (And Others) Under Regulation D: Those Nagging Problems That Need Attention*, 74 Ky. L.J. 127, 137-143 (1985); Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. Fla. L. Rev. 1 (1986); Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 Emory L.J. 67 (1989); Gary D. Lipson & Leslie Scharfman, *General Solicitations in Exempt Offerings*, 20 Rev. Sec. & Comm. Reg. 8 (1987); Peter Romeo, *Advertising of Real Estate Offerings*, 18 Rev. Sec. and Comm. Reg. 17 (1985); Sargent, *supra* note 3, at 229-302; Michael E. Schoeman, *The First Amendment and Restrictions on Advertising of Securities Under the Securities Act of 1933*, 41 Bus. Law. 377 (1986); *see also* Question and Answer Release, *supra* note 32, Question 60, and the comments thereto. For a partial list of the numerous SEC No-Action letters and secondary sources dealing with general solicitation, see Leslie A. Grandis, Bibliography, General Solicitation in Private Placements, 9th Annual Southern Federal Securities Institute (1989).

77. *See supra* note 76.

78. SEC No-Action letters dealing with the pre-existing business relationship concept include the following: H.B. Shaine & Co., Inc., SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2004 (May 1, 1987) (satisfactory response to a questionnaire from a broker-dealer including information about the respondent's employment history, business experience, business or professional education, investment experience, income, net worth, and sophistication within the meaning of rule 506, combined with sufficient time between the Regulation D offering and the response would by itself be sufficient to establish a substantive relationship); Webster Management Assured Return Equity Management Group Trust, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 1595 (Feb. 7, 1987) (staff unable to concur that there was no general solicitation when selling agent proposed to solicit only highly sophisticated offerees, primarily employee benefit plans whose investment decisions were made by banks, insurance companies, or registered investment advisers, but where there was no prior relationship and no limitation proposed in the manner of contacting the trusts); Mineral Lands Research & Marketing Corp., SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2811 (Dec. 4, 1985) (no view expressed when officer of company making a rule 504 offering was an insurance agent who wanted to contact 600 of his clients who would not qualify as accredited investors or sophisticated investors because there were insufficient facts to determine whether the offeror's pre-existing relationships with the offerees were of the type that would permit the issuer to be aware of the financial circumstances or sophistication of the persons with whom the relationships exist or were otherwise of some substance and duration); Bateman Eichler, Hill Richards, Inc. SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2918 (Dec. 3, 1985) (program to obtain new tax sheltered investment clients would not violate rule 502(c) provided that: (1) proposed solicitation would be generic; (2) no reference to current investments; (3) no offering of current investments; and (4) furnishing of satisfactory responses to a sufficiently detailed questionnaire that enables Bateman Eichler to evaluate the prospective offerees' sophistication and financial circumstances); E.F. Hutton and Company, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917 at *1-2 (Dec. 3, 1985) ("[I]t is not necessary that offerees have previously invested in securities offered through Hutton. Substantive relationships may be established with persons who have provided satisfactory responses to questionnaires that provide Hutton with sufficient information to evaluate the prospective offerees' sophistication and financial circumstances."); Gerald F. Gerstenfeld, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2790 (Dec. 3, 1985) (proposed ad indicating that syndicator sells securities in private placements and inviting inquiries is a general advertisement, and constitutes an offer in violation of rule 502(c) for current offerings and would constitute an offer for future securities when the syndicator expects to sell securities in the near future); *In re* Kenman Corp., Exchange Act Release No. 21962, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,767, at 87,427-28 (held, broker-dealer engaged in general solicitation when investors were solicited from: (a) investors in prior deals; (b) a list of Fortune 500 executives; (c) a purchased list of real estate investors who had purchased $10,000 in offerings of other issuers; (d) California doctors; (e) a list of managerial engineers employed by major companies; and (f) a directory of presidents of businesses in Morris County, New Jersey); Woodtrails-Seattle, Ltd., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2662 (July 8, 1982) (no general solicitation when general partner solicited 330 persons, each of whom had invested with the general partner during the last three years).



## *7. WHAT INFORMATION AND COMMITMENTS DO I NEED FROM THE INVESTOR?*

The Company must have a reasonable basis for believing that the investor satisfies the suitability standards enunciated in the PPM and that the investor understands the risks of the offering and the information presented to him.[79] This depends upon information that only can be provided by the prospective investor. In addition, the prospective investor must acknowledge the limited resaleability of the Stock.[80] The Stock cannot be resold by the investor without registration under the Securities Act or an exemption from registration.[81] Several important elements of private placements (such as investor sophistication, investment intent, and ability to bear the economic risk of an investment) depend on facts that only the individual investor will know. You must ascertain and confirm these elements. That is why there are so many seemingly intrusive and personal questions in the confidential purchaser questionaire about the investor's occupation, educational background, net worth, income, and investment experience.

The investor questionnaire and the other subscription documents, which each prospective investor must complete and sign, are designed to elicit this information and other appropriate representations from investors. The maintenance of contemporaneous records, such as the confidential purchaser questionnaires, especially will be valuable if the registration exemption ever is challenged. The absence of appropriate written records might make it impossible for the Company to defend itself successfully against a future challenge. Furthermore, the more information provided

79. 17 C.F.R. § 230.506(b)(2)(ii) (1992).

80. *Id.*

81. 17 C.F.R. § 230.502(d) (1992).

by the investor in writing, the better able the Company subsequently will be to defend its exemption. This includes the Company carefully reviewing the subscription documents, making sure that all the information is obtained and is internally consistent, and that based on the documents and the Company's personal knowledge of the investor, the Company has a reasonable basis for believing that the investor is suitable, either as an accredited or non-accredited investor.

## *8. WHAT PAPER TRAIL SHOULD BE CREATED?*

Before the offering begins, you should establish internal procedures and checklists that make it easier for you to comply with the rules concerning the conduct of the offering and the information sent to, and received from, prospective investors. Only specifically designated persons should distribute the PPM, each copy of which should be numbered. Copies for internal use also should be numbered. A list of each person to whom the PPM is sent should be maintained and should indicate whether it is for internal use, bankers, purchaser representatives, lawyers, accountants, or specified investors. A file should be maintained for each potential investor containing accurate records of correspondence, meetings, phone calls, etc., to record what questions were asked, what additional material was provided, and what due diligence was performed to determine each investor's sophistication and accreditation.

Prior to beginning the offering, we need to discuss the extent, if any, to which we will monitor your record keeping procedures or other sales procedures and the effect it may have on our respective liabilities.

## *9. WHAT ARE THE STATE REGISTRATION REQUIREMENTS?*

You have advised us that the securities will be offered only to residents of those states listed in the blue sky memorandum. The cover page of the PPM will have the appropriate legends required by the blue sky laws of such states.[82] Generally, state exemptions are obtained by filing a notification of exemption with the appropriate state agency within a specified time period after the date of first sale of the Stock in the state, although some states have pre-sale or pre-offering filing requirements.[83]

Certain states also have unique requirements regarding net worth, income, or sophistication standards for investors.[84] Before you make an *offer* (not sale) in any state, you should inform us so that the appropriate reg-

82. Sargent & Makens, *supra* note 72, at 1324.

83. For a survey of state exemption filing regulations, albeit somewhat dated, see Therese H. Maynard, *The Uniform Limited Offering Exemption: How "Uniform" is "Uniform?"—An Evaluation and Critique of the ULOE*, 36 Emory L.J. 357, 378-379 (1987).

84. *See id.*



ulatory notification can be filed. Failure to do so may violate the applicable registration provisions of the state and give the investor a right of rescission or a damages remedy.[85]

## *10. WHY AM I READING THIS LETTER?*

The penalty for violating the registration or anti-fraud provisions of the securities laws is that, at a minimum, investors can rescind their purchase and receive a refund of their investment.[86] Additionally, the state and federal regulatory agencies have enforcement rights and, in extreme and aggravated circumstances, may fine and enforce criminal penalties.[87]

The first rule of securities law is that investors never sue when they make money—only when they lose it. Rescission never sounds threatening to clients because all clients believe their deal will succeed. Without that belief, you would not pursue the offering. You must remember that it is when things go wrong, frequently for reasons you did not predict or could not control, that regulators or disappointed investors may seek remedies. The right to rescind based on a technical failure to comply with the securities laws may be unrelated to the real reason why the investor wants his or her money back. If remedies are sought, it usually will be when you and the Company can least afford to fulfill the demands.

## *CONCLUSION*

We know the securities laws can be bewildering. We are confident, however, that you understand the importance of compliance with them, and can and will comply. This is an exciting transaction, and we are pleased

85. *See* Uniform Securities Act § 410, Blue Sky L. Rep. (CCH) ¶ 1550 (1990).

86. Section 12 of the Securities Act provides that "[a]ny person who (1) offers or sells a security in violation of § 5 [the registration provisions] shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." 15 U.S.C. § 77*l* (1988).

87. In addition to the Securities Act and the Exchange Act, certain other of the federal statutes give the SEC a broad range of enforcement remedies. Other relevant statutes which contain remedies for violation of the federal securities laws, and which are applicable to private placements, include The Securities Law Enforcement Remedies Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931, as amended, and the Racketeer Influenced and Corrupt Organizations Act (RICO), Pub. L. 91-452, 84 Stat. 941, 18 U.S.C. §§ 1961-68 (1988). These acts have bolstered the enforcement powers of the SEC and have provided substantial remedies including civil money penalties in federal court actions against violators, imposition of penalties (fines) in administrative proceedings, temporary and permanent cease and desist orders, authority to seek court orders, forfeiture of property used in violation of RICO, as well as rescission, damages, interest, and attorneys' fees.

to be assisting you with it. We look forward to answering any other questions you may have during the offering process.

Best regards,