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Everything You Need to Know About Reg D Offerings

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Regulation D under the Securities Act provides the most important conduit for investment capital in the U.S. economy. The U.S. Securities and Exchange Commission (SEC), which regulates federal securities laws, estimated that $3.0 trillion was raised under Regulation D in 2017 alone. Companies relying on Regulation D range from the earliest and most speculative of start-ups, to venture-capital-financed emerging companies, to major companies offering rock-solid bonds to institutional purchasers. It has also been the most common method for offering digitized securities or "security tokens" in the U.S.

Regulation D allows companies to raise funds by selling securities with a minimum of delay and regulatory hassle, if they follow rules designed to avoid the making of a public offering. While historically the regulation has generally permitted only offerings that use no advertising or other "general solicitation," recent amendments allow a properly conducted offering to use advertising on the internet or any other medium in compliance with

Regulation D.

Regulation D provides two distinct exemptions: **Rule 506**, which allows an unlimited amount to be raised but restricts most sales to "accredited investors" (discussed under *Accredited Investors* below), and **Rule 504**, which affords more flexibility in including unaccredited investors, but is limited to $10 million per year and is subject to significant regulation at the state level. Each of the two offering exemptions has a path that prohibits advertising, and a path that may allow advertising if the issuer satisfies additional conditions (and in very narrow circumstances in the case of Rule 504).

Regulation D involves many complexities that may not be apparent to a first-time reader. Before delving into the details of what it permits and requires, it is helpful to understand its background and general principles.

Background

The core provision of the Securities Act is Section 5, which generally makes it illegal for a U.S. company to offer or sell its securities unless it registers the offering with the SEC. SEC registration is the expensive and time-consuming process most commonly associated with initial public offerings, or IPOs. It entails the preparation of a detailed prospectus, including multi-year audited financial statements, which the SEC staff reviews and must clear before the offering commences. The drafters of the Securities Act intended to impose this requirement only on *public* offerings, so they exempted all *private* offerings or "private placements." Specifically, Section 4(a)(2) of the Securities Act broadly provides that Section 5 does not apply to "transactions by an issuer not involving any public offering." Another provision, Section 3(b) of the Securities Act, has authorized the SEC to grant exemptions for small offerings, originally up to $100,000 and currently up to $5,000,000, which the SEC has further increased to $10,000,000 under its general regulatory authority.

The broad terms of Rule 4(a)(2) left the distinction between public and private offerings uncertain and subject to abuse. Over the years, the SEC promulgated several regulations to clarify the 4(a)(2) exemption. In 1953, the Supreme Court also weighed in. In *SEC* v. *Ralston Purina,* the Court held that sales to sophisticated investors who could "fend for themselves" and had access to information did not need the protection of the Securities Act and their purchases fell within Section4(a)(2). This gave rise to the concept of "accredited investors" in Securities Act exemptions.

The SEC adopted Regulation D in 1982 to unify and modernize the rules around private placements. It contains Rule 506, a safe harbor for compliance with the Section 4(a)(2) private offering exemption, and Rule 504, a safe harbor within the SEC's authority to grant exemptions for small offerings under Section 3(b) of the Securities Act. The regulation included a definition of accredited investor based on wealth for individual investors (either net worth or income), and for organizations based on the amount of total assets or type of entity (e.g., bank, investment company, etc.) The regulation has been amended a number of times, most significantly in 2014 to add the ability to advertise certain Rule 506 offerings under the crowdfunding provisions of the JOBS Act of 2012. Recently, the definition of accredited investor was also expanded to include individuals who can demonstrate sophistication through holding certain types of FINRA licenses.

Why You Need an Exemption

When your company raises investment capital, what the investor receives will almost certainly be considered a "security," whether it is stock, a note or other debt instrument, a digital "coin," an LLC membership interest, or any other designation. An unregistered securities offering that fails to conform to Regulation D or any other exemption may be deemed an illegal public offering, which can have dire consequences. The SEC can pursue civil enforcement, with penalties that can be a multiple of the funds raised in

the offering or refer the violation to the Department of Justice for criminal prosecution.

In addition, investors will have a private remedy of **rescission** — the ability to demand a refund simply on the basis that the offering was unlawful. Like liability for civil and criminal penalties, liability for rescission payments does not stay inside the issuer's corporate "shell" — the individuals who directed the illegal offering or benefited from it may be personally liable.

The importance of complying with a Securities Act exemption when raising capital with digital assets became quite clear in the aftermath of the ICO or "initial coin offering" boom of 2017. In November of 2017, the SEC launched an enforcement initiative with its *DAO Report*, after which digital coin issuers who failed to treat their offerings as securities transactions faced enforcement actions, injunctions, and rescission demands, while issuers who structured their capital raising as compliant security token offerings (STOs) were able to proceed, albeit more cautiously.

The Regulation D Exemptions

We will first lay out the principal features and requirements of the two exemptions under Regulation D, then provide detail on specific areas of concern, like the accredited investor definition or avoidance of a general solicitation. Along the way you will find guidance on how to conduct your Regulation D offering together with some suggestions for best practices.

Rule 506 Exemption

The Rule 506 exemption is the centerpiece of Regulation D. Rule 506(b) is the "traditional" version of the rule in place since 1982, while Rule 506(c) is the newer variant created as part of the crowdfunding provisions of the

JOBS Act of 2012. To understand both, we will start with Rule 506(b).

Rule 506(b)

Rule 506(b) has the following principal features and requirements:

- Both private companies and public reporting companies can raise an unlimited amount of money through the offer and sale of any kind of securities.
- No advertising or general solicitation is permitted. This generally means that offers can be made only to investors who have a pre-existing relationship with the issuer or who are introduced by a registered broker-dealer.
- The offering may sell to an unlimited number of accredited investors, and up to 35 unaccredited investors within any 90-day period. However, if offers are made to any unaccredited investors, they must receive a disclosure document that generally conforms to a Regulation A offering circular, including audited financial statements. Because of this burdensome requirement, it is quite rare for a compliant Rule 506(c) offering to include non-accredited investors.
- If offered only to accredited investors, no prescribed form of disclosure is required. Nonetheless, a private placement memorandum is recommended to ensure uniform disclosure in conformity with general securities law requirements and anti-fraud regulation.
- Any non-accredited purchaser, "…either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." This is sometimes referred to as a "sophistication" requirement.
- All state securities law or "blue sky law" requirements are pre-empted, except states may require notice and payment of a fee for offers in

their states (and most do). As discussed below, this removes a major compliance headache.

- The securities will be "restricted securities" under Rule 144 in the hands of purchasers and subject to transfer restrictions. The issuer must take reasonable steps to ensure purchasers are not underwriters (i.e., purchasing with an intent to distribute or resell) and impose transfer restrictions.
- In sales to accredited investors, the issuer may accept an investor's self-certification of the facts demonstrating accredited investor status, so long as the issuer has a reasonable basis to believe the investor is accredited. It is not sufficient for an investor to check a single box indicating "I am accredited" without confirming the specific factual basis for accredited investor status.
- The issuer must report the offering by filing Form D on the SEC's EDGAR database within 15 days of the first sale.
- "Bad Actor" disqualifications apply; if the issuer or certain individuals have been convicted or sanctioned for specified securities or financial misdeeds, the exemption is not available.

Because Rule 506(c) removes constraints on advertising, many assumed that the new rule would supplant traditional Rule 506(b). But the old rule has proved resilient and remains more popular, at least in dollar volume, than its new, internet-ready sibling. Among the reasons for this, many companies have access to wealthy investors without advertising, and they would rather not have to request confidential financial information to comply with the investor verification requirements of Rule 506(c).

Preliminary test marking of an offering, usually called "**testing the waters**" is generally not possible under Rule 506(b) because offers, as well as sales, must be limited to persons having a pre-existing relationship with the issuer and, in most cases, are limited to persons known to be accredited investors. Nevertheless, prior to embarking on an offering, an issuer may gauge the market by sending targeted, confidential solicitations of interest

to accredited investors having a pre-existing relationship with the issuer and may also solicit interest through a registered broker-dealer.

Rule 506(c)

Rule 506(c) has the following principal features and requirements:

- Like Rule 506(b), both private companies and public reporting companies can raise an unlimited amount of money through the offer and sale of any kind of security.
- General solicitations and advertising in any medium *are* permitted — internet, television, radio, or print publications. Solicitations may be made to the general public, including unaccredited or otherwise unqualified investors.
- An unlimited number of accredited investors may purchase securities, but no unaccredited investors may purchase.
- The issuer must take "reasonable steps" to verify that each purchaser is an accredited investor before completing the investment and, unlike Rule 506(b), cannot rely on a purchaser's self-certification. Paragraph(c)(2)(ii) of Rule 506 provides several specifically approved verification methods, such as review of investor tax records, bank and brokerage statements, credit reports and the like, but, as further discussed below, allows issuers the latitude to choose other reasonably reliable methods including certification by third parties.
- Because of the broad latitude for advertising, "testing the waters" for a future offering is generally permitted under Rule 506(c). Potential investors who respond to advance public solicitations may be offered and sold securities pursuant to final offering materials without restriction, so long as they are verified as accredited investors at the time of sale.
- In all other respects, the requirements are the same as for Rule 506(b), including: Preemption of all state securities law (blue sky law) requirements except notice and fee; The securities will be "restricted securities" under Rule 144. The issuer must take reasonable steps to

ensure purchasers are not underwriters, (i.e., purchasing with an intent to distribute or resell), and impose transfer restrictions; The issuer must file Form D on the SEC's EDGAR database within 15 days of the first sale; "Bad Actor" disqualifications apply.

The principal additional compliance requirement added by 506(c) — the toll for putting the traditional prohibition on general solicitations in the rear-view mirror — is the requirement to verify each purchaser's accredited investor status. The regulation offers a non-exclusive list of accepted methods, including review of investor tax records, bank and brokerage statements, and credit reports. It also allows the issuer to choose other reasonably reliable methods, including a certification by a qualified third party that it took reasonable steps to verify. The issuer may accept certification from a registered broker-dealer, a registered investment adviser, a licensed attorney or certified public accountant. Third-party certification can reassure investors concerned about protecting the privacy of their financial records; for example, the investor's own attorney or financial adviser can provide the certification. Also, a number of web-based service providers have developed methods and expertise to provide outsourced Rule506(c)-compliant verification confidentially, efficiently, and relatively inexpensively.

Rule 504 Exemption

The Rule 504 small offering exemption has seen far less use than Rule 506, principally because of its low dollar limit (previously $1 million in 12 months) and its requirement that the offering also comply with state blue sky laws. Even for small offerings by start-up companies, other federal exemptions — like the intra-state exemption of Rule 147 — have been a more appealing alternative. Recent increases in the ceiling for Rule 504 — now $10 million within a 12-month period — may breathe new life into the

exemption.

Rule 504 generally prohibits any general solicitation except in limited circumstances. Rule 504 has the following features and requirements:

- Private companies may raise up to $10 million within a 12-month period.
- General solicitations and advertising are not permitted except in special circumstances under paragraph(b)(1) of Rule 504, separately discussed under *General Solicitation Rules* below.
- Any number of purchasers may participate, and they may be either accredited or unaccredited (except as discussed under *General Solicitation Rules*).
- State securities law requirements are *not* preempted and must be satisfied.
- The securities will be "restricted securities" under Rule 144 in the hands of purchasers and subject to transfer restrictions (except as discussed under *Rule 504 General Solicitation Rules).*
- Blank check companies, Exchange Act reporting companies, and investment companies cannot use the exemption.

Rule 504 General Solicitation Rules

In keeping with Rule 504's deference to state securities regulation, in some circumstances the rule permits crowdfunding and other general solicitations when permitted by a state. This is not a recent crowdfunding innovation; the general solicitation rules of Rule 504 have been in place since the adoption of Regulation D in 1982. Specifically, a general solicitation is allowed in the following circumstances:

- Exclusively in one or more states that require registration of the securities, public filing and distribution of a substantive disclosure document before sale, and the issuer complies with those requirements

(paragraph(b)(1)(i))

- In one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that has such provisions, the issuer makes compliant offers and sales in that state and delivers that same prospectus to all purchasers before sale (paragraph(b)(1)(ii))
- Exclusively in accordance with state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to "accredited investors" (paragraph(b)(1)(iii))

When securities are sold under the above rules, they will *not* be deemed restricted securities for purposes of Rule 144 and may be transferred without restrictions under federal law.

Costs and Benefits of Rule 504's Coordination with State Blue Sky Laws

The difficulties presented by blue sky laws are discussed further below. Because of the onerous nature of state registration and qualification, and the uncertainty of a favorable outcome, especially in "merit" review states, the option of a general solicitation under Rule 504 has limited utility when compared to other federal exemptions. For example, while paragraph(b)(1)(iii) of Rule 504 allows general solicitations without registration in the few states that permit such offerings when sales are made only to accredited investors, Rule 506(c) provides similar latitude in *all* states. The advantage of Rule 504 in this instance is that the securities will not be restricted after sale. This could be attractive for developing an aftermarket, as long as the right exemption is available in the right state.

On the other hand, a private offering under Rule 504 could be attractive for many early-stage companies because of the ability to include unaccredited investors without extensive disclosure requirements. Most states have adopted a "limited offering" exemption from state securities qualification for

offerings made to wealthy investors (based on criteria similar to Regulation D's accredited investors) and made to a limited number of investors who are not wealthy but are "sophisticated" — either on their own or through engagement of a financial expert. Many states have limited offering exemptions that can be used in coordination with Rule 504 and allow a limited number of unaccredited investors, though these state exemptions often require the issuer to determine that investors are "sophisticated" or that the investment is "suitable" for the investors and may impose additional conditions. While relying on Rule 504 and these state exemptions may sound similar to relying on Rule 506(b)'s allowance of 35 unaccredited investors, there is a crucial difference. If a Rule 506(b) offering includes any non-accredited investors, the issuer must produce and distribute a detailed offering memorandum that satisfies the requirement of Regulation A — a document that is excessive in cost and scope for most private placements and is impractical for many early-stage companies to prepare. On the other hand, state limited offering requirements generally do not require any similar kind of extensive, prescribed disclosure. This creates an opportunity to conduct a multi-state offering under Rule 504 that includes "friends and family" and other unaccredited investors in the many states that have a limited offering exemption allowing purchases by non-accredited investors. Many believe that the recent increases in the maximum raise under Rule 504 will make it an attractive alternative for early-stage investment.

For Rule 504 offerings that are not exempt in the relevant states, and must be qualified under state law, the North American Securities Administrators Association (NASAA) has organized a process for simplified and coordinated state review of Rule 504 offerings under SCOE (Small Corporate Offering Exemption). While this requires preparation of an offering circular meeting specified requirements on NASAA Form U-7, which must be reviewed and cleared by a state securities agency, the disclosure requirements are not as onerous as those for a Rule 506 offering that includes unaccredited investors, and the review process is intended to be less burdensome than typical state qualification requirements.

General Concepts and Issues in Regulation D Offerings

The basic outline of the exemptions provided above introduced a number of concepts and issues that must be explained in further detail.

Accredited Investors

Rule 501(d) sets out in detail the criteria for an individual or entity to be an "accredited investor." For individuals, wealth or income were the only available metrics to qualify until August 2020, when the SEC began adding accreditation categories based on sophistication or professional status. Here is a brief summary of the categories more fully described in Rule 501(d):

- A natural person having more than $1 million in net assets (excluding principal residence), either individually or with spouse or spousal equivalent; a natural person who had more than $200,000 in income in the previous two years, or $300,000 jointly with spouse or spousal equivalent, and reasonably expects that income to continue in the current year.
- Any director, executive officer or general partner of the issuer
- A trust with more than $5 million not formed for the purpose of holding the offered securities and directed by a financially sophisticated person; a "family office" (as defined in the Investment Advisors Act) with more than $5 million in assets under management whose investment in the securities is directed by a person capable of evaluating their merits and risk; a "family client" (as defined in the Investment Advisors Act) of such a family office.
- A corporation, limited liability company or other business entity or nonprofit corporation with more than $5 million in total assets and that was not formed for the specific purpose of investing in the securities offered, or any entity of which all equity owners are accredited investors.
- A bank, registered broker, dealer or investment advisor, registered investment company, business development company, Small Business

Investment Company, or specified retirement plan with more than $5 million in assets.

- SEC and state-registered investment advisers, exempt reporting advisers, and rural business investment companies (RBICs).
- Any entity, including Indian tribes, governmental bodies, funds, and entities organized under the laws of foreign countries, that own "investments," as defined in Rule 2a51-1(b) under the Investment Company Act, in excess of $5 million and that was not formed for the specific purpose of investing in the securities offered.
- A natural person with a professional certification, designation or credential that the SEC determines to confer accredited investor status; as of the date of this writing, the SEC has designated holders in good standing of the FINRA Series 7, Series 65, and Series 82 licenses as accredited in this category.

General Solicitation

Except for offerings under Rule 506(c) or Rule 504(b)(1), Regulation D prohibits making an offering through any "form of general solicitation or general advertising, defined as follows:

1. Any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
2. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising…

The definition goes on to say that minimal "tombstone" advertisements, Form D reports (published available on the SEC's EDGAR website) and offshore press conferences will *not* be deemed "general solicitation."

To demonstrate that an investor was not obtained through a general solicitation, the issuer must show that it had pre-existing relationship

with the investor, predating any offer of securities, or that the investor was introduced by a registered broker-dealer. If an issuer attracts new potential investors to its website, the potential investors cannot participate in any Rule 506(b) offering visible on the website before a relationship was established. Rather, the issuer must generally have the potential investor register, confirm accredited investor status, and go through a cooling-off period before a sufficient relationship is established for participation in the issuer's future 506(b) offerings.

PPMs, Disclosure, and Avoidance of Fraud

Regulation D sets out extensive disclosure requirements for Rule 506(b) offerings that include non-accredited investors but is silent as to disclosure in other situations. However, any offering — and any offer or sale of securities — is governed by Rule 10b-5 under the Exchange Act. Rule 10b-5 says, "It shall be unlawful . . . [t]o 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."

The dense language of 10b-5 prohibits not only outright lies, but also misleading omissions and half-truths. After all, the issuer is recommending an investment in itself — doing so while concealing known risks and problems is inherently deceptive. If you tout the location of your planned health spa project, you cannot omit that a capped oil well has been discovered on the property. If you have been notified your tech company's crown jewel software is about to be hit with an infringement lawsuit, you must disclose it. Rule 10b-5 is imperative to provide complete, warts-and-all disclosure to insulate against future claims. Sophisticated investors are used to it — they routinely buy securities after wading through pages of risk factors that would seem to make success all but impossible.

What makes an item for potential disclosure **material?** In general, infor-

mation that a reasonable investor would consider important in making an investment decision is material. Paradoxically, the instinct to leave something out ("they'll never invest if I tell them that") is usually an indication that it is material. It is helpful to note that materiality is ultimately determined *in hindsight*, after an investment has soured. A disappointed investor, enforcement officer, judge or jury will inquire, "what did management know, and when did they know it?"

It is **best practice** to prepare a private placement memorandum (PPM) to ensure that all investors receive complete and uniform disclosure. You should work with experienced securities counsel who understand what types of information are essential. For example, failing to disclose management conflicts of interest, or that a portion of proceeds will be paid to brokers or other intermediaries, would always be deemed a material omission in a lawsuit or agency enforcement action.

Preparing your PPM will usually be the most expensive and time-consuming part of your offering. Here is the best way to proceed:

- Assemble a team that includes your CEO, CFO, and other officers most familiar with your business, inside counsel, and securities counsel.
- Compile materials you already have that tell your business's story, for example, business plan, slide deck, and (if applicable) white paper. Make sure they are up to date and provide them to securities counsel.
- Work out the structure of the offering and Securities Act exemption strategy *before* drafting of the PPM begins.
- Prepare the team to respond quickly to requests for follow-up information and to review drafts of the PPM.
- Designate one staff member to rigorously fact check the PPM and build a file of all backup and due diligence information supporting the PPM.

Some Regulation D offerings do not use PPMs. For example, "angel investor rounds," where little information is available, the investors are small in

number, highly sophisticated and they perform extensive due diligence (they may even be informal advisors to the issuer) seldom employ PPMs. However, foregoing a PPM always increases risk, and the decision to do so should be made only with advice of securities counsel.

Reporting on Form D

Within 15 days of the first sale under either of the Regulation D exemptions, the issuer must file a notice of the offering on Form D. Among other things it contains identifying information for the issuer, the type of securities offered, and the size of the offering. The size of the offering is to be stated in good faith — if the issuer fails to raise the targeted amount it is not require to amend Form D. However, the issuer must file an amendment if it changes the offering amount by more than 10%, if the offering continues for more than a year, to correct a material mistake or for other material changes.

How to File Form D:

Form D is completed and submitted interactively on the SEC's EDGAR database system. This requires the issuer to submit a Form ID application to obtain an EDGAR account and filer number ("CIK number"), which is often a time-consuming and cumbersome process. To meet the 15-day filing deadline, issuers and their advisers are urged to submit Form ID well ahead of the first sale. If the filing deadline is missed, Regulation D does not provide a late filing procedure — issuers are advised simply to file as soon as possible. There is no fee for obtaining an EDGAR account or filing Form D.

Failure to file Form D will not result in a loss of the Rule 504 or Rule 506 exemption from registration. This means that failure to report will not lead to enforcement action for an illegal offering or rescission rights on the part of investors. However, Rule 507 allows the SEC to seek an order against an issuer that fails to file Form D, barring the issuer from further offerings in reliance on Regulation D.

Blue Sky Laws

The U.S. has two layers of securities regulation: federal and state. State securities laws, called "blue sky laws," differ greatly from state to state. These laws often predate the Securities Act and often have their own registration requirements — typically called "qualification" at the state level — as well as their own exemptions from qualification. Some state regulators will, like the SEC, review offerings based on the quality and completeness of disclosure. Other states' qualification procedures involve regulators reviewing the "merits" of an offering and judging whether the investment is worthy of investment by citizens of the state. Also, some states assert regulatory jurisdiction over an offering that targets investors in the state, while others focus on the location of the issuer or (as in the case of California) both. Because of the complexity, uncertainty, and expense of complying with multiple states' blue sky laws, issuers generally pursue strategies that avoid state qualification and compliance with state-specific exemptions. Rule 506 offers such a strategy: Rule 506 offerings are exempt from all state securities regulation, except state regulators may require notice of a Rule506 offering in their state (usually provided via a copy of Form D and payment of a fee).

Rule 504 offerings are *not* exempt from blue sky laws. Rather, Rule 504 coordinates with and defers to state law. This can be an advantage where state law is more flexible than the Securities Act in allowing participation by non-accredited but sophisticated investors or permitting crowdfunding.

Failing to Satisfy the Safe Harbor

Because Rule 506(b) is a safe harbor within the private offering exemption of Section 4(a)(2) of the Securities Act, an issuer can often show that a near-miss on a Rule 506(b) offering still falls within the broad exemption for non-public offerings under 4(a)(2). Crucial to this position is that there must have been absolutely no advertising or general solicitation. Reliance on 4(a)(2) is usually a fall back when things have gone wrong and should not

be adopted as an advance planning strategy.

Unfortunately, there are no near misses in a Rule 506(c) offering that uses crowdfunding or other general solicitation. Because of the clearly public nature of the marketing, there is no fallback to Section 4(a)(2) or any other exemption. For example, if the issuer fails to reasonably verify that all purchasers of securities are accredited, it has conducted an illegal public offering.

Rule 508 provides that the exemptions will remain available despite an issuer's "insignificant deviation" from the requirements of the rules. However, it specifically states that it will be a *significant* deviation to exceed the $10 million limit in a Rule 504 offering or to exceed 35 unaccredited investors in a Rule 506(b) offering.

Restricted Securities and Compliance with Rule 144

Regulation D and the broader exemption under Section 4(a)(2) are not available to "underwriters," which the Securities Act defines as a person who purchases securities "with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking…" The term "underwriter" may include any purchaser who buys with the intent to resell. Affiliates of the issuer may also be considered underwriters because of the risk a company may try to avoid registering a public offering by transferring securities to an affiliate who resells them rather than selling them directly. A Regulation D offering may not include any person deemed to be an underwriter, and the regulation requires issuers to take affirmative steps to avoid sales to persons deemed to be underwriters.

Rule 144 under the Securities Act provides a safe harbor allowing purchasers to resell their securities without being deemed underwriters. First, Rule 144 under the Securities Act classifies all securities acquired in transactions

"not involving any public offering" as "**restricted securities**." Persons unaffiliated with the issuer are permitted to resell their securities after a specified holding period: generally, one year from purchase for non-public companies and six months for public companies. Additional conditions apply. The holding periods derive from a doctrine developed over the years that if a purchaser holds the securities and bears risk of loss for a significant period of time, the purchaser will have demonstrated it is not an underwriter. This is sometimes referred to as a requirement that the securities "come to rest" with the initial purchaser and not immediately be passed off. Affiliates of the issuer — anyone controlling the issuer or controlled by or under common control with it — cannot freely sell even after the expiration of the holding periods and must satisfy additional conditions for as long as they remain affiliated with the issuer. Among other things, they are limited in the volume they sell and must sell in a "brokered transaction." Securities held by affiliates, which remain subject to restrictions even after the holding periods have passed, are often referred to as "**control securities.**"

All securities issued under Regulation D exemptions are deemed restricted securities, except those rare few issued under Rule 504(b)(1). Those latter securities are deemed to be issued in state-qualified public offerings rather than in private offerings.

Paragraph (d) of Rule 502 requires an issuer (except in the case of 504(b)(1)) to exercise care in avoiding sales to underwriters. If an issuer fails to do so, and an investor quickly "flips" the securities, the offering may have become an unregistered an illegal public offering.

It is **best practice** for a Regulation D issuer to do the following to avoid selling to an underwriter and enforce resale restrictions:

- Place restrictive Rule 144 legends in offering documents, in the subscription agreement, and on the reverse of the securities certificate
- If there are no certificates, place a similar restriction with the transfer

agent or registrar of the securities that will provide legend information to a prospective transferee before completing the transfer. In the case of digital tokens representing securities, code the restriction into the digital security

- Include in the subscription agreement a representation and warranty that the purchaser is not purchasing with a view to resale and a covenant not to resell except in accordance with Rule 144 and an available exemption

Market Liquidity

Expiration of transfer restrictions does not automatically lead to tradability. If a public company listed on an exchange privately sells securities under Rule 506, the securities may be traded on the exchange once the holding periods and other conditions of Rule 144 are satisfied. However, for non-public companies, expiration of Rule 144 holding periods (or immediate transferability following a Rule 504(b)(1) offering), will not allow for purchases and sales in a trading forum. To list the securities on an exchange like NYSE, NASDAQ, or an "over the counter" market like OTCQX, the issuer will need to register under the Exchange Act, begin full public reporting, and satisfy the listing requirements of the exchange or market.

After expiration of holding periods, securities may trade on an Alternate Trading System (an "ATS") without Exchange Act registration and reporting, but the issuer will need to make specified company information publicly available and meet the listing requirements of the ATS.

Other options for limited liquidity include offshore resales under Rule 904 of RegulationS, the newly added Section 4(a)(7) of the Securities Act and the commonly referenced Section 4(a)(1½). Regulation S resales are subject to limited U.S. regulation, so long as the transactions take place exclusively with offshore buyers on offshore forums. Section 4(a)(7) allows

trading among accredited investors 90 days after issuance — even during the Rule 144 holding period — under the auspices of an ATS with specified public information provided by the issuer. "Section 4(a)(1½)" is not an actual provision of the Securities Act but derives from court decisions that determined an exemption for private sales between individuals logically follows from Sections 4(a)(1) and 4(a)(2) of the Securities Act.

"Bad Actor" Disqualification and Due Diligence

The exemptions of Rule 504 and Rule 506 are unavailable if an issuer or specified "covered persons" committed any of the "bad acts" listed in Rule 506(d). A private offering that claims reliance on Rule504 or Rule 506, but involves a disqualified issuer or individuals, may be an illegal offering.

The disqualifying acts under Rule 506(d) generally include criminal convictions and court orders involving securities, disciplinary actions by state or federal securities regulators or by banking or insurance regulators, expulsion from membership in a securities exchange, or a national securities association for failing to follow just and equitable principles of trade and mail fraud.

Covered Persons

Covered persons who are subject to disqualification or disclosure under 506(d) generally fall into four broad categories:

- the issuer itself
- individuals who control the issuer
- beneficial owners — individuals or companies that control 20% or more of the issuer's voting securities
- individuals and companies associated with the offering

The Bad Acts

The bad acts generally fall into the following categories, which are described in terms of the sanctions imposed by courts or administrative agencies:

- Convictions for crimes — either felonies or misdemeanors — involving securities
- Court orders or decrees that bar the covered person from specific activities involving securities
- Orders of state and federal banking, insurance, and commodities regulators
- SEC orders that prohibit a covered person from engaging in specified business activities or order a person to stop committing fraud or illegal offerings
- Expulsion from membership in a securities exchange or a national securities association for failing to follow just and equitable principles of trade
- Making or underwriting a registered offering that was stopped or suspended by the SEC or is currently the subject of investigations or proceedings for a stop order or suspension
- Orders of the U.S. Postal Service related to false representations (i.e., mail fraud)

The rule has varying "look back" periods for the bad acts. Generally, a bad act disqualifies the covered person if it occurred within five years of the contemplated Regulation D offering. However, criminal convictions for covered persons other than the issuer have a look-back period of ten years. Orders that bar the covered person from business activities or enjoin the covered person from committing wrongful acts will be disqualifying bad acts if the bar or injunction is effective at the time of the contemplated Rule 506 offering.

Bad Actor Due Diligence

An issuer that embarks on a Rule 506 offering that has — even unknowingly — engaged a bad actor as an officer or director, has a bad actor directly or indirectly owning a large number of shares or engages a bad actor to solicit investors, could embroil the company and otherwise blameless officers and directors in the criminal enterprise of an illegal securities offering. The issuer can avoid these consequences by exercising reasonable care to identify bad actors in its midst, and a reasonable due diligence inquiry should be considered mandatory in all Regulation D offerings.

- **Best Practices for Bad Actor Due Diligence**

Regulation D issuers should, at a minimum, do the following with the assistance of counsel:

- Perform a basic background search on each covered person.
- Prior to the offering, provide a questionnaire to each covered person to uncover potential bad acts.
- Diligently follow up on any "red flags" uncovered in the background check and, if bad acts occurred, dissociate the bad actor from the issuer or the offering as necessary.

For a company that may have a Regulation D offering in its future (which is most companies that may raise capital), it is also a best practice to include in any employment agreements with covered persons a representation that the officer has not committed any bad acts and reserving the right to do what is necessary to dissociate the covered person if bad acts would impede an exempt offering.

No Exit for Existing Security Holders

Neither Regulation D nor the broader exemption under Section 4(a)(2)

allows sales by existing owners of securities. These exemptions apply only to issuers. If founders, early investors, and other holders wish to sell their shares or other securities as part of offering sponsored by the issuer, they can do so only in a public offering registered under the Securities Act or qualified under Regulation A. They may also be able to privately sell to third parties under Section 4(a)(1) or 4(a)(7) of the Securities Act, or so-called "Section 4(a)(1-1/2)".

Global Capital Raising - Concurrent Regulation S Offers

Regulation S provides a safe harbor for unregistered offshore offerings of securities, imposing few U.S. law restrictions if an offering is truly directed outside the U.S. A Rule 506 or Rule 504 offering may be conducted simultaneously with a Regulation S offering by the same issuer and for the same class of securities, so long as each offering separately and fully complies with its governing regulation.

- **Best practices for global offerings**. When planning a private offering that includes both U.S. and offshore purchasers, consider using Regulation S for the offshore sales to take advantage of the broad exclusion from U.S. jurisdiction
- You can use a single PPM that discusses both the Regulation D and Regulation S segments of the offering but take care to keep the conduct and closing of the offers and sales separate. For example, if a website is used for the offering, visitors should as a first step identify themselves as U.S. persons or non-U.S. persons, then be directed to separate offering procedures for each
- The SEC has instructed issuers to use URLs to identify U.S. investors and screen them from Regulation S offerings. When issuing digital securities, it is a best practice to leverage digital KYC (know your customer) techniques to separate U.S. and non-U.S. investors and meet the separate compliance requirements

Integration - When Does One Regulation D Offer End and Another Start?

Many early-stage companies engage in a continuous program of capital raising or do multiple offerings close together in time. This creates a pitfall for compliance with the specific limits on offering size, type of investor, and manner of offering for the Regulation D exemptions: what seems like two or more compliant offerings may be deemed one big non-compliant offering. Until recently, Regulation D included "integration" rules that often required a six-month pause between offerings to assure that each would qualify for exemption. Recently the SEC substantially simplified and modernized these rules with Rule 152, a comprehensive integration framework covering both registered and exempt offerings. Replacing the integration rules formerly included in Regulation D itself, Rule 152 shrinks the safe harbor waiting period between offerings from six months to 30 days in most cases.

New Rule 152 has rules governing concurrent and sequential offerings of many kinds, not just Regulation D. The most important provisions of the rule affecting Regulation D offerings include the following:

- A general principal (Rule 152(a)) that two or more offerings will not be integrated if (i) the issuer can establish through "facts and circumstances" that each of the two offerings separately satisfied its exemption requirements, and (2) that in any of the offerings that prohibited general solicitation there was, in fact, no general solicitation and the issuer established a substantive relationship with each investor prior to commencing the offering
- A safe harbor providing that any offering made more than 30 calendar days before the commencement of any other offering, or more than 30 calendar days after the termination or completion of any other offering, will not be integrated with the other offering, provided that for any exempt offering prohibiting general solicitation, the issuer must comply with same requirements stated above: there must actually be no general solicitation, and the issuer must have established a substantive

relationship with each investor prior to commencing of the offering for which general solicitation is not permitted

The SEC has specifically stated that Rule 152 permits an issuer to conduct concurrent Rule 506(b) and Rule 506(c) offerings if each separately complies — in particular, the issuer must be able to demonstrate that the purchasers in the Rule 506(b) offering were not obtained through the general solicitation in the Rule 506(c) offering. An issuer who intends to rely on the 35-non-accredited-investor provision of Rule 506(b) should be aware that even if a series of Rule 506(b) offerings are deemed separate offerings, no more than 35 unaccredited investors in total may participate in any 90-day period among all the issuer's 506(b) offerings.

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An entrepreneur who has successfully built and exited his own startup, Jor combines his experience as a corporate/securities attorney, tech investor, startup founder, and product manager to bring additional depth to management teams as a consultant. Jor is a pioneer in creating the ecosystem for digitizing and trading securities on the blockchain and other

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