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Regulation D and Private Placements

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Agenda

- Overview
- Regulatory Developments
- Issues to Consider with Private Placements Taking Place Prior to Going Public
- Techniques and Approaches for Satisfying Regulation D
- Recent Developments with Regulation D and Private Placements in the M&A Context

Overview

Securities Act of 1933 – Registration Framework

- Section 5 – Must register all transactions absent an exemption from the registration requirements.
- Section 4 – Transactional Exemptions.
- Section 4(2) – Private Placement Exemption.
  - "Transactions by an issuer not involving any public offering."
- Section 4(1½) exemption evolved in practice.
  - Not embedded in the Securities Act.
- Lack of access to public capital markets increases importance of exemptions from Section 5 registration requirements.

Regulation D – Rules 501-508

- Regulation D provides a non-exclusive safe harbor.
- The satisfaction of the conditions of the Regulation D safe harbor will ensure that there is an exempt offering.
- Section 4(2) is still available.
- Regulation D contains the following offering exemptions:
  - Rule 504: available for offerings of up to $1 million;
  - Rule 505: available for offerings of up to $5 million to an unlimited number of accredited investors and up to 35 other purchasers; and
  - Rule 506: available for private placement offerings of an unlimited amount of money to an unlimited number of accredited investors and up to 35 other purchasers that are sophisticated.

Rule 506 Safe Harbor Requirements

- Rule 506 is the most widely used exemptive rule under Regulation D, accounting for the overwhelming majority of capital raised under Regulation D.
- Requirements of a Rule 506 private placement include:
  - No dollar limit on size of transaction.
  - Unlimited number of accredited investors and no more than 35 unaccredited investors.
  - No general solicitation or advertising.
  - Resale limitations.
  - Disclosure required for non-accredited investors.
  - Form D filing within 15 days of first sale of securities.
  - Good faith effort to comply (Rule 508).

Rule 506 Purchasers

- Accredited Investors (Rule 501) include:
  - Institutional investors such as banks, S+Ls, broker-dealers, insurance companies, investment companies.
  - Corporations or trusts with assets in excess of $5 million
  - Directors and officers of the issuer.
  - Individuals with:
    - Income > $200,000 or joint income > $300,000.
    - Net worth or joint net worth > $1 million (excluding residence)
  - Entity in which all equity owners are accredited investors.

Regulatory Developments

Integration

Integration Doctrine

- The integration doctrine is designed to prevent an issuer from improperly avoiding registration by dividing a single offering into multiple offerings to take advantage of exemptions under the Securities Act that would not be available for the combined offering.
- The consequence of integrating a private offering with a public offering is that the private offering would need to be registered under the Securities Act.

Integration Guidance from the SEC

- The SEC confirmed its position that the filing of a registration statement does not, in itself, eliminate a company's ability to engage in a concurrent private offering, whether it is commenced before or after the filing of the registration statement.
- The SEC has indicated that the integration analysis for concurrent private/public offerings should focus on how the investors in the private offering are solicited, *i.e.*, whether by the registration statement or through some other means that would not otherwise foreclose the availability of the Section 4(2) exemption.

Accredited Investor Standard

Accredited Investor Reviews

- The Dodd-Frank Act provides that, upon enactment and for four years following enactment, the net worth threshold for accredited investor status will be $1 million, excluding the equity value (if any) of the investor's primary residence.
  - One year after enactment, the SEC is authorized to review the definition of the term "accredited investor" (as it is applied to natural persons) and to adopt rules that adjust the definition, except for modifying the net worth threshold.
  - Four years after enactment, and every four years thereafter, the SEC must review the "accredited investor" definition as applied to natural persons, including adjusting the threshold (although it may not be lowered below $1 million).

Accredited Investor – Guidance

- The SEC provided additional guidance regarding the net worth standard in Securities Act Rules CDI Question 179.01:

  "Section 413(a) of the Dodd-Frank Act does not define the term "value," nor does it address the treatment of mortgage and other indebtedness secured by the residence for purposes of the net worth calculation. As required by Section 413(a) of the Dodd-Frank Act, the Commission will issue amendments to its rules to conform them to the adjustment to the accredited investor net worth standard made by the Act. However, Section 413(a) provides that the adjustment is effective upon enactment of the Act. When determining net worth for purposes of Securities Act Rules 215 and 501(a)(5), the value of the person's primary residence must be excluded. Pending implementation of the changes to the Commission's rules required by the Act, the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home should be considered a liability and deducted from the investor's net worth. [July 23, 2010]"

Proposed Accredited Investor Definition

- On January 25, 2011, the SEC proposed amendments to the accredited investor standards to reflect the requirements of the Dodd-Frank Act.
- As amended, Rules 215(e) and 501(a)(5) would define as an accredited investor:

  "Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of purchase, exceeds $1,000,000, excluding the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property."

Bad Actor Disqualification

Section 926 of Dodd-Frank

- Requires the SEC to adopt rules that would make the exemption available under Rule 506 unavailable for any securities offering in which certain "felons" or other "bad actors" are involved.
- Requires the new rules to be substantially similar to the bad actor disqualification provisions of another limited offering exemptive rule, Rule 262, the bad actor disqualification provisions specified in Regulation A.

Proposed "Bad Actor" Disqualification

- On May 25, 2011, the SEC proposed amendments to rules promulgated under Regulation D to implement the Dodd-Frank Act's provision regarding 'bad actors' for Regulation D.
- Unlike Rule 505 of Regulation D, Regulation E and Regulation A, Rule 506 of Regulation D does not currently have any "bad actor" disqualification provisions.

Proposed "Bad Actor" Disqualification

- "Bad actor" disqualification requirements prohibit issuers and others, such as underwriters, placement agents, directors, officers, and shareholders of the issuer, from participating in exempt securities offerings, if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.
- The SEC proposed similar amendments in 2007, but did not take final action on that proposal (SEC Rel. No. 33-8828).

SEC Proposed Amendments

- Proposed amendments would add a new Section 506(c) to Regulation D.
  - Comment period ended on July 14, 2011
  - The statutory deadline for adoption of the rules was July 21, 2011
- The new proposed amendments would encompass disqualification provisions that are currently codified in Rule 262 of Regulation A and in Section 926(1) of the Dodd-Frank Act.

Other Developments

SEC Review of General Solicitation

- In a letter dated April 6, 2011, SEC Chairman Schapiro advised an SEC staff review of whether the general solicitation ban should be revisited in light of the current technologies and capital raising trends.
- The SEC Chairman re-stated the justification for the ban:

  "The ban was designed to ensure that those who would benefit from the safeguards of registration are not solicited in connection with a private offering."

Regulation A – Rules 251-263 Conditional Small Issues Exemption

- The Small Company Capital Formation Act (introduced on March 14, 2011) would increase the offering threshold under Regulation A from $5 million to $50 million.
- Currently, Regulation A allows for an offering of up to $5M of securities of an issuer including up to $1.5M of securities offered by selling security holders in any 12-month period.
- Requires filing of a Form 1-A Offering Statement and delivery of Offering Circular to investors.

Regulation A – Rules 251-263 Conditional Small Issues Exemption

- Amendment (May 3, 2011) provides for a corresponding state "Blue Sky" exemption for Regulation A offerings offered by means other than through a broker dealer.
  - Many observers have been welcoming this change.

500-Holder Rule

- In light of the issues arising in connection with private companies choosing to stay private longer, pressure is being put on the 500-holder rule.
- Currently, there is proposed legislation that would amend the 500-holder threshold in certain contexts.

Issues to Consider with Private Placements Taking Place Prior to Going Public

Fundamental Question: How much control are you willing or will you have to give up?

- Assume private placement pre-IPO will be for preferred stock.
  - Scope of voting rights in addition to any voting rights provided under the DGCL (ex: will class of preferred stockholders have the right to approve the incurrence of indebtedness over a particular threshold or the annual budget).
  - Will the class of preferred stock have the right to appoint a Board member?
  - What are liquidation preferences including vis-à-vis prior equity rounds?
  - What conversion rights and conversion triggers will be granted and what events will trigger an adjustment to the conversion value?
  - Scope and timing of redemption rights.
- Stockholders Agreement
  - Will founders and other equity holders be required to sign a stockholders agreement?
  - Can contain restrictions on transfer and a right of first offer or right of first refusal and drag along rights.
  - Preemptive Rights with respect to future equity issuances.

Fundamental Question: How much control are you willing or will you have to give up?

- Voting obligations re: Board representation and/or the appointment of a non-voting board observer.
- Scope of information delivery requirements such as quarterly and annual financial statements and monthly financial statements and budgets and access by stockholders holding a specified amount of stock to members of senior management.
- Overall limitations on day-to-day business operations.
- Percentage of holders that may waive various agreement requirements.

- Registration Rights Agreement
  - Demand Registration Rights, number and timing (you may not want to file when someone asks).
  - Piggyback Registration Rights.
  - Could contain limitation on company's right to grant others registration rights (might mean you need approval to issue equity in a M&A transaction if issuance has associated registration rights).
  - Should contain agreement to execute form of Lock-Up Agreement required by the company's underwriters.

Importance of Properly Valuing Stock/Cheap Stock Issues

- The SEC is particularly focused on "cheap stock" issues when it reviews IPO registration statements.
- With no public market, you will need to defend the price at which you issued equity (and options) especially in the year before you file.
- To the extent possible, management should base its valuations on independent, third party valuations.

Techniques and Approaches for Satisfying Regulation D

Considerations for Effective Disclosure Drafting — Context and Overview

- The following quote, from remarks during the 1970s by a former Chairman of the Securities Exchange Commission, captures well a principal problem with most securities disclosure:

  > "The officers who planned this assault, including myself, have never before planned anything like this. In fact, I have never commanded troops in combat. The airborne and other methods being employed have never before been tried by our Army. The weather forecast is only slightly favorable and such forecasts have a high degree of unreliability. Therefore, there is no assurance that any of you will reach Normandy alive, or, if you do, that you will secure the beach."

- It is a parody of the disclosure General Dwight Eisenhower might have been counseled to make to his troops during World War II, if he needed to get clearance for his D-Day invasion order under prevailing securities law practice.

Considerations for Effective Disclosure Drafting — Context and Overview (Cont.)

- Effective disclosure drafting requires that one be cautious and careful, but not paranoid or fearful.
- It requires good faith and candid analysis of relevant considerations, sensible judgment and a proper sense of balance.
- It requires that one have the confidence and experience to make a reasonable determination of "when enough is enough".
- The key is hard-nosed *thoughtfulness*, based on facile knowledge of the relevant substantive securities laws and protocols.
- Both the Private Securities Litigation Reform Act of 1995 and the SEC's plain English initiative sought make disclosure writing less turgid and mind-numbing, while still fostering accuracy and completeness.
- As things were improving, along came Enron, Worldcom et al; the Sarbanes-Oxley Act of 2002 and its progeny; and the Great Recession of 2008 and, in its wake, the Dodd-Frank Act of 2010.
- Nervousness and paranoia among securities lawyers have been ignited anew, which is not good for effective disclosure writing.

Considerations for Effective Disclosure Drafting — Context and Overview (Cont.)

- Holy Trinity of Fundamentals
  - Know Whereof What It Speaks (Key Role of the Nature and Structure of Transaction)
  - Serving Well Two Contentious Masters (Balancing Marketing Needs with Liability Protection)
  - Material Information Without the “Kitchen Sink”
- Facile Knowledge of Requirements and Protocols for Registered Offering Disclosure Regime
  - 1933 Act SEC Forms
  - Regulations S-K and S-X
  - Consensus Disclosure Items
- Most Common Regulation D Disclosure Situations
  - PIPE Transactions
  - Placements by Private Companies
  - Rule 144A Transactions
- Principal Disclosure Approach Considerations
  - To PPM, or Not to PPM?
  - Preparation of a “Wrap” as the PPM
  - Risk Factors Drafting
  - Selective Disclosure Issues

Considerations for Effective Disclosure Drafting — Nature and Structure of Transaction

- It is not ordained that all or most disclosure documents, for all or most transactions, must look the same.
- The nature and structure of the particular transaction set the stage for the disclosure document. For example, each of the following factors should affect the approach to the disclosure document as well as the ultimate drafting of it:
  - Whether the securities are equity or debt.
  - Whether the transaction is to be eligible for Rule 144A (and thus is targeted only to “qualified institutional buyers” or “QIBs”).
  - Whether the transaction is designed to comply with a safe harbor of Regulation D, rather than Section 4(2) directly.
  - Whether any non-accredited investors will be permitted.
  - Whether a placement agent will be selling the securities.
  - Whether forecasts about future financial expectations are needed or desired to sell the securities to the target investors; and so on.

Considerations for Effective Disclosure Drafting — Nature and Structure of Transaction (Cont.)

- In addition to complying with express legal requirements, such transactional elements affect the disclosure approach decision because they relate directly to the following essential elements for any disclosure document:
  - the securities that must be described;
  - the terms of the offering that must be explained;
  - the roles of those who are authorized to be involved in the offering process;
  - the risks associated with the particular investment; and
  - the detail that is appropriate to make sure that the particular universe of target investors will understand sufficiently all of the above things and other material information.

- The disclosure approach decision then becomes how best to provide such information in light of the other disclosure fundamentals.

Considerations for Effective Disclosure Drafting — Marketing versus Liability Protection

- The marketing needs and the liability protection objective compete in the disclosure drafting process. Their competition underlies much of the historical prolixity in offering documents that led to the remarks of the former SEC Chairman quoted above.
- To harmonize them effectively, one must recognize that competition *at the beginning* of the drafting process, so that one does not lean too far in either direction when addressing a particular disclosure item.
- If one later recognizes a tilt too far in one direction, do not seek to counter-balance that excess by tilting with equal or greater excess in the other direction.
- Try to see a clear path to simply eliminating the initial excess. That requires confidence, exercising good judgment, built upon a facile knowledge of disclosure fundamentals.

Considerations for Effective Disclosure Drafting — Choosing the Disclosure Approach — Reg. D Flexibility

- Regulation D provides three basic safe harbor exemptions — Rule 504, Rule 505 and Rule 506 — that differ most fundamentally on the basis of the amount of securities being sold and the number and qualification of the investors.
- The Rule 506 Exemption is the most popular for private placements that seek to raise over the $1,000,000 limit applicable to the Rule 504 Exemption.
- Rule 502(b) of Regulation D sets forth the informational disclosure requirements (and exceptions thereto) for the Rule 506 Exemption.
- It begins by expressly excepting from its requirements an offering in which sales are made exclusively to accredited investors.
- It next draws a distinction between an issuer who is a private company and one who is a public company.

Considerations for Effective Disclosure Drafting — Choosing the Disclosure Approach — Reg. D Flexibility (Cont.)

- If the issuer is a private company, Rule 502(b)(2)(i) refers to providing purchasers "the same kind of information as would be required" by the applicable SEC 1933 Act Form for a public offering. It then describes the type of financial information required based on whether the offering amount crosses the respective thresholds of $2,000,000 and $7,500,000.

- All of the *requirements* of Rule 502(b) are subject to the undisputed Mother of All Exceptions — i.e., any and all of the above information must be furnished to a purchaser only ***"to the extent material to an understanding of the issuer, its business and the securities being offered."***

- There is the rub — tremendous discretion is given in deciding what and how much to disclose, but one's discretion is tied to the often slippery concept of "materiality".

- This is where the key of hard-nosed thoughtfulness and confidence — exercising good judgment, based on a facile knowledge of disclosure fundamentals — steps in to open the right door.

Considerations for Effective Disclosure Drafting — Material Information Without the "Kitchen Sink"

- The baseline reference for all offering disclosure decisions is the requirement that "material" information be provided to investors.
- The baseline reference for the definition of "material", articulated in *Basic v. Levison*, 485 U.S. 224 (1988), and massaged in other case law, yields the following practical test and analytical construct:

> A fact or other information is material if there is a substantial likelihood that a reasonable investor would consider it important; or, phrased another way, if there is a substantial likelihood that the fact or information would be viewed by a reasonable investor as significantly altering the "total mix" of information otherwise made available to the investor.

Considerations for Effective Disclosure Drafting — Material Information Without the "Kitchen Sink" (Cont.)

- There is no bright-line or litmus test for what is material, even with respect to historical or known factual information. The difficulty is magnified for an inchoate event or pending development.
- The "probability/magnitude" test is a useful, and widely used, tool for assessing inchoate events or pending developments. Under that test, one assesses and balances both the indicated probability that an event will occur and the anticipated magnitude of the event.
- The good drafter begins with (and returns constantly to) the question of "what is material *here*?", which is short-hand for the totality of the circumstances in the current situation that are realistic and reasonable in the exercise of good faith and sensible judgment.

Considerations for Effective Disclosure Drafting — Consensus Presumptive Disclosure Items

The baseline for what should be *considered for possible* disclosure in connection with a private placement should reflect what is required in the registered offering regime, and thus it includes the following list of *possible* disclosure items:

- The company and its business, including major customers, suppliers and properties
- The company's competitors
- Risk factors affecting the above
- Governance matters
- Compensation of management and other insiders
- Control or other principal ownership of the company
- Company transactions with insiders or other parties related to the company
- The company's securities, including securities other than those being offered in the transactions
- Use of proceeds from the offering
- How the offering is being conducted, and those authorized to do so for the company and what they are being paid for doing so
- The company's financial statements and other possible important financial information
- An MD&A — management's discussion and analysis of financial condition and results of operation

Considerations for Effective Disclosure Drafting — To PPM, or Not to PPM?

Notwithstanding the flexibility permitted, the safe harbor of Regulation D has led to disclosure approaches that are fairly standard across the following spectrum of analysis:

- One must be thoughtful and careful in making the disclosure choices that Regulation D permits, and should ask and answer the following key questions:
  (i) What is it that any reasonable and witting investor must know in order to participate in this offering?
  (ii) Is the universe of target investors sufficiently small, select and sophisticated that it is possible and prudent to convey that essential information without preparing a formal PPM?
  (iii) What are the marketing needs to be balanced with liability protection objectives, and what is the best medium for doing so?

- It is risky to answer question (ii) “no”, if there are to be *any* non-accredited investors, *unless* one is dealing with a very small offering and a very small number of such investors.

Considerations for Effective Disclosure Drafting — to PPM, or Not to PPM? (Cont.)

- Where *only* accredited investors are targets for the offering, and their number is relatively small, it may be possible to convey the information suggested by questions (i) and (iii) in a manner other than preparation of a formal PPM. Some risks remain, but not nearly as much, and they are much more manageable.
- In the latter context, a good business plan — which implies thoughtfulness and balance in its preparation — coupled with a "Risk Factors Letter" and a good subscription or investment agreement can comprise an effective disclosure document.
- It is not necessary to style such a document as a "Risk Factors Letter", but it is important to prepare it in a form for ready delivery to prospective investors and ready reference in the subscription or investment agreement.
- Typically, however, even if only accredited investors are targets for the offering, a private company would still prepare a PPM that resembles very much a Form S-1 prospectus, notwithstanding the Mother of All Exceptions in Rule 502(b)(2)(i).

Considerations for Effective Disclosure Drafting — Whether to Include an MD&A

- Envision that a thoughtful prospective investor has company management in a room for a discussion of how the company is doing. What information would that investor want to know? How would management explain the information? What follow-up questions would the investor likely ask?
- If the transaction structure does not permit a *genuine* opportunity with *each* prospective investor for the kind of one-on-one dialogue reflected below, then an MD&A should probably be included as part of the disclosure document, even though not formally required by Regulation D.
- Prospective investor's hypothetical dialogue with senior management:
  - I understand the Company's business (and I appreciate, by the way, that you have not recited it verbatim from the "Business" section in beginning our discussion), but I want to understand more directly how the Company makes money and why it is (or expects to be) profitable.
  - Okay, I see how the Company was profitable last year, and the two prior years also, but are there things you know (or can reasonably anticipate) that could affect the company and its profitability differently going forward? And, if so, are they likely to occur?

Considerations for Effective Disclosure Drafting — Whether to Include an MD&A (Cont.)

– I see, but do you think those are trends affecting the industry generally, or just the company because of possible unique or isolated factors? In either case, without divulging secrets, what are the plans to meet those things in order to achieve the best results practicable for the Company?

– I understand the uses the Company plans for the proceeds from this offering, and it's good to see the liquidity that is currently reflected on the balance sheet, but how is the Company situated for its cash needs going forward? I don't expect you to read tea leaves, but I assume that you are operating pursuant to a plan or strategy that anticipates the next year or two.

– By the way, I can see in the financial statements the Company's cash and working capital at the end of the last reported period, and it's good to know the Company's borrowing capacity on that date, but what are these amounts as of a more recent, meaningful date? I'm frequently left guessing whether something significant may have occurred over the last couple of months.

– Going back to the Company's net earnings for a moment — which ultimately should determine the value I'm building with my investment — I guess what I'm driving at is the *quality* of those earnings. Are they solid? Are they repeatable? Or, are they attributable in significant part to factors that were unique for some reason, or that you can't count on in the future?

Considerations for Effective Disclosure Drafting — PIPE Transactions

- When a public company desires to raise capital privately using its publicly held equity security, a frequently used transaction structure is the so-called PIPE — "private investment in public equity".
- A PIPE transaction typically targets a select number of sophisticated investors who would qualify as accredited under Rule 501(a) of Regulation D.
- PIPE transaction disclosure documents typically follow a Regulation D, accredited investor format that relies heavily on the company's existing 1934 Act disclosures and leads to a preparation of a formal private placement memorandum ("PPM") that is designed as a so-called "wrap" of key 1934 Act documents.

Considerations for Effective Disclosure Drafting — Preparation of a "Wrap" as the PPM

- The company's existing 1934 Act disclosures are reviewed to confirm their current accuracy and completeness.
- Updates or supplements are prepared in order to make the existing documents current and/or to cover recent material developments that have yet to be reported.
- Such updating and/or supplemental information is prepared along with
  - a description of the terms of the new offering;
  - the use of proceeds from it;
  - the compensation arrangements with any placement agent;
  - the terms for possible (indeed, likely) registration rights to be given to the investors; and
  - conspicuous disclosure about the risks associated with these resale restrictions.
- The PPM is completed by attaching to the above document (or by wrapping with it) the company's key existing 1934 Act disclosure documents. These will always include the last Form 10-K (and Form 10-Q, if subsequent to the Form 10-K) and most recent proxy statement.
- If there has been a subsequent significant Form 8-K, then it will be included. Otherwise, important intervening matters will typically be written as part of a "Recent Developments" section for placement in the wrap portion of the PPM.

Considerations for Effective Disclosure Drafting — Selective Disclosure Issues

- Having existing 1934 Act disclosures is a significant benefit for a public company conducting a private placement because it permits utilization of the wrap approach to prepare a PPM. However, it also brings along issues for thoughtful consideration by securities counsel.
- If such existing public disclosures are changed or otherwise updated for the current private placement, there are risks of making inappropriate selective disclosure.
- Investors in the private placement — who typically are not subject to a binding “standstill” arrangement with respect to trading — might use information from the PPM to trade in the public market for the company’s securities.
- Such risks existed before Regulation FD, but the requirements of Regulation FD place the risks under a brighter light.
- The principal risk is that the new (and presumptively better) disclosure made in the PPM will be deemed *material per se*, so that all who relied (or who are now left to rely) upon the existing public version of the subject disclosure might arguably be misled.
- That should temper the zeal with which one might otherwise approach preparing an update or supplement for the PPM, although it certainly must *not* deter correcting a previous flaw.
- The thoughtful decision to be made is whether Regulation FD, or other good disclosure practice, warrants immediate public disclosure of the changed information included in the PPM.
- Doing so should not be automatic or presumed.

Considerations for Effective Disclosure Drafting — Risk Factors

- There are two categorical types of risks: (i) those relating to the company and its business generally (which would be material to any investor in the company), and (ii) those relating to the particular securities involved in the transaction.
- These two categories should be clearly distinguished, and the distinction should be reflected in the disclosure document. I recommend that they be allocated separate subsection headings in the overall "Risk Factors" discussion.
- The type and terms of the securities being offered in the transaction will control what risks are relevant and material in the second category.
- Look at what others are doing or have done in similar transactions. Be thoughtful about what to select to include, and about how much to say about what is selected.
- It is not necessary to "reinvent the wheel" with respect to many items in a risk factors discussion, but it also is not necessary to become a robot or parrot.

Considerations for Effective Disclosure Drafting — Risk Factors (Cont.)

- Ask and guide management to answer thoughtfully the following question, which is far from being a cliché when presented strategically and sincerely, and which does *not* make you a robot or parrot:

  > "What concerns you about the company or its prospects for success before you go to sleep at night and/or when you head to the office in the morning?"

- Probe the answers you receive as an initial matter in order to ascertain why the particular items cause management such concerns, and then discuss what management is doing to address them.
- If the answer is initially, and remains, "nothing", you are in trouble.
- Risk factor disclosure has *only one* master. Despite the temptation, do not slip into counter-risk discussion in the risk factors portion of the disclosure document.

Considerations for Effective Disclosure Drafting — Spectrum of Possible Rule 144A Disclosure Documents

- The most prevalent type of Rule 144A transaction involves debt securities issued by public companies. This typically means that the starting point for disclosure drafting is conceptually very similar to that for a PIPE transaction.
- There are two basic options for approaching the disclosure document, which I call the "S-1 Comprehensive Approach" and the "S-3 Summary Approach".
- The S-1 Comprehensive Approach essentially treats the Rule 144A disclosure document — almost always styled as an "Offering Circular" — as if it were a prospectus in a Form S-1 registration statement.
- The S-3 Summary Approach anchors the other end of the spectrum, taking its cue from the SEC's Form S-3 prospectus requirements. It leads to an Offering Circular that contains a detailed description of the Rule 144A securities and the terms of the offering, but only a capsule description of the company and its business.
- Frequently, the S-3 Summary Approach also contains a "Recent Developments" section that updates and/or supplements existing disclosures and provides information about key data points widely used in the financial community.
- Key existing 1934 Act disclosures are incorporated into the Rule 144A Offering Circular by reference to them, but typically they are *not* bundled physically into the Offering Circular.

Considerations for Effective Disclosure Drafting — Choosing the Rule 144A Disclosure Approach

- The principal factors in deciding on the Rule 144A disclosure approach have more to do with marketing needs than with liability protection. These factors are:
  - The relative seasoning of the company.
  - The financial community's familiarity with the company, including as an issuer of the type of Rule 144A securities being offered.
  - Whether the initially private Rule 144A transaction will be followed by a registered exchange offer for the Rule 144A securities, in order to make the securities salable to (and freely tradable by) non-QIBs.
  - Implicit in the above, the position of any investment bankers who are serving as the underwriters or placement agents (called "initial purchasers") for the private Rule 144A offering.

Considerations for Effective Disclosure Drafting — Choosing the Rule 144A Disclosure Approach (Cont.)

- If a company is more seasoned, very well-known in the institutional financial community, and has previously issued Rule 144A securities of the subject type, then an S-3 Summary Approach is more likely. If these factors are the opposite, then an S-1 Comprehensive Approach is more likely.
- If there is to be a subsequent exchange offer, the Offering Circular disclosure will anticipate the requirements of the prospectus for the Form S-4 registration statement that will be used to conduct the exchange offer.
- Form S-4, depending upon the company's profile, requires different levels of disclosures along a de facto spectrum that also is anchored by the Form S-1 and Form S-3 requirements outlined above.

Considerations for Effective Disclosure Drafting — Concluding Observations

- Drafting good and effective disclosure documents for a Regulation D private placement — or for any other securities offerings, for that matter — is much more art than science.
- There are essential tools for the requisite facile knowledge of disclosure fundamentals, which may be considered the science of the process.
- The art of disclosure drafting requires respect for the complexity of such drafting, and caution and care in exercising permitted discretion. But, it also requires thoughtfulness and confidence, rather than fear or robotic behavior, in order to know when enough is enough.

Recent Developments with Regulation D and Private Placements in the M&A Context

Recent Developments with Reg. D and Private Placements in the M&A Context

- As credit markets remain tight and buyers find it more difficult to access capital for M&A activity, using securities as acquisition currency has become a more attractive option.

- If the consideration in M&A transactions includes the buyer's securities, issuing the securities to the seller in a private placement instead of a registered offering can benefit the parties because they will not have to:
  - incur the costs of preparing and filing a registration statement with the SEC;
  - publicly disclose all of the information required under a registration statement before the deal closes; and/or
  - delay closing the transaction until the SEC declares the registration statement effective.

Recent Developments with Reg. D and Private Placements in the M&A Context

- Considerations buyers and sellers should be aware of in connection with private placements in the M&A context include:
  - Integration of Multiple Offerings
    - Regulation D is unavailable if two or more offerings that satisfy the Regulation D requirements separately are actually part of the same offering and, when integrated do not satisfy the Regulation D requirements.
    - Likelihood of integration in the M&A context is remote unless the acquisitions involve related companies.
    - Issuers should exercise caution if the same stockholders own targets acquired by the issuer or if there are other facts which may cause separate offerings to be viewed as part of as a single plan of financing.

Recent Developments with Reg. D and Private Placements in the M&A Context

- Identity of Target Shareholders – Implications for Rule 506
  - The issuer's ability to rely on the safe harbor under Rule 506 depends on the number and accredited status of the target shareholders.
  - Target shareholders are usually asked to complete questionnaires to determine their status as sophisticated or accredited or make a rep/warranty in the definitive documents to this effect.
  - If any of the target shareholders are not accredited, Rule 506 requires that the issuer provide them with the same disclosure they would receive in a registered offering.

Recent Developments with Reg. D and Private Placements in the M&A Context

- Restricted Securities
  - Because securities issued in a private placement are “restricted securities” under Rule 144 and are not immediately freely tradable, valuation of such securities may be subject to an illiquidity discount.
  - Amendments to Rule 144 shortened the holding period for restricted securities.
  - Restricted securities generally cannot be resold in the public market for six months, if the issuer is a reporting company, or twelve months, if the issuer is not a reporting company.
  - If none of the Target Shareholders are not affiliates of the issuer (and have not been affiliates during the 3 months prior to the sale, the shares may be sold with regard to Rule 144 volume limitations.
  - Because the Rule 144 holding period is now significantly shorter, issuers of securities in private placements should generally encounter less pressure to grant resale registration rights to target shareholders.
  - Issuers are required to use reasonable care to assure that the recipients will not publicly resell the securities. Reasonable care can be demonstrated e.g., by placing a legend on stock certificates referring to the restrictions on transferability and adding appropriate covenants to the shareholders agreement.

Recent Developments with Reg. D and Private Placements in the M&A Context

- Earn-outs - Recent volatility in the markets has made valuation issues more difficult. Earn-outs can enable the parties to address valuation issues in a particular transaction.
  - The right to receive deferred consideration could be considered a security whose issuance must be registered or qualify for an exemption from registration, e.g., comply with Regulation D.
  - The following factors have been considered important by the SEC in granting no-action relief from the requirement to register the right to receive the earn-out with the SEC:
    - the earn-out should be structured as an integral part of the consideration to be received in the transaction;
    - the earn-out right should not be represented by any form of certificate or other instrument, and should not represent an ownership interest in the buyer;
    - the earn-out right should not provide holders of the earn-out right with any rights as stockholders, such as voting and dividend rights;
    - the earn-out right should not bear a stated interest rate; and
    - the earn-out right should not be assignable or transferable, except by operation of law.

APPENDIX

Details on the
Bad Actor Disqualification
Rule Proposals

SEC Proposed Amendments

- Proposed amendments would add a new Section 506(c) to Regulation D.
  - Comment period ended on July 14, 2011
  - The statutory deadline for adoption of the rules was July 21, 2011
- The new proposed amendments would encompass disqualification provisions that are currently codified in Rule 262 of Regulation A and in Section 926(1) of the Dodd-Frank Act.

Covered Persons

- The disqualification provisions in proposed Rule 506(c) generally correspond to the persons currently covered under Rule 262 and would thus apply to the following "covered persons":
  - the issuer and any predecessor of the issuer or affiliated issuer, any director, or any officer;
  - any director, officer, general partner, or managing member of the issuer;
  - any beneficial owner of 10 percent or more of any class of the issuer's equity securities;
  - any promoter connected with the issuer in any capacity at the time of the sale;
  - any person that has been or will be paid, directly or indirectly, remuneration for solicitation of purchasers in a securities offering; or
  - any director, officer, general partner, or managing member of any compensated solicitor.

Covered Persons (cont'd)

- The SEC has sought to clarify in the proposed rule that for entities organized as limited liability companies, managing members would be covered expressly, as are general partners of partnerships.
- Clarifies that the disqualification provisions do not apply to certain events prior to an offering.
- SEC is seeking comments on:
  - whether other categories of persons should be included in Rule 506(c);
  - whether the term "officer" (as currently defined in Securities Act rules) as it applies to financial intermediaries in private offerings should be reserved for "executive officers" only (i.e., those performing policy-making functions);

Covered Persons (cont'd)

- whether the proposed coverage of 10 percent shareholders is appropriate;
- whether any exceptions need to apply for actions entered into prior to affiliation; and
- whether it would be appropriate to extend coverage to investment advisers and their directors, officers, general partners and managing members.
  - currently, the rule would not (in the context of private funds) apply to investment advisers and usually it is the investment advisors that control private funds.

Disqualifying events

- The proposed rule includes seven categories of disqualifying events
  - Criminal convictions;
  - Court injunctions and restraining orders;
  - Final orders of certain state regulators (such as securities, banking, and insurance) and federal regulators;
  - Commission disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons;
  - Suspension or expulsion from membership in, or suspension or barring from association with a member of, a securities self-regulatory organization (“SRO”);
  - Commission stop orders and orders suspending a Regulation A exemption; and
  - U.S. Postal Service false representation orders.

Disqualifying events (cont'd)

- Section 926(2)(B) of the Dodd-Frank Act provides for disqualification if any covered person "has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the Commission."
- Also includes a five-year look-back period for criminal convictions of issuers and a ten-year look-back period for other covered persons.

Disqualifying events (cont'd)

- SEC is seeking comments on:
  - whether a longer look-back period is appropriate;
  - whether the inquiry should focus on the beneficial ownership structure of an entity at the time of the disqualifying event, on the application of the rule to the date of the relevant sale, on the scope of the application; and
  - whether corresponding convictions in foreign courts should trigger disqualification.

Court Injunctions and Restraining Orders

- Proposed Rule 506(c)(1)(ii) reflects the substance of Rule 262, but also includes in its application orders arising out of the conduct of business of paid solicitors of purchasers of securities.
- SEC is seeking comments on:
  - whether a look-back period of five years for injunctions and restraining orders is appropriate; and
  - whether foreign court orders and injunctions should have any consequences when subject to disqualification.

Final Orders of Certain Regulators

- Codifies Section 926(2)(A) of the Dodd-Frank Act and seeks to eliminate ambiguities
  - the order must bar the person “at the time of [the] sale” from one or more of the activities
  - the bar must be disqualifying only for as long as it has continuing effect
  - the ten-year look-back period applies from the date of the order and not the date of the underlying conduct
- SEC is seeking comments on:
  - whether the rule should clarify what constitutes a “bar”
  - whether a cut-off date for permanent bars is appropriate
- Proposed Rule 501 defines “final order” to mean the final steps taken by a regulator. The proposed definition is based on the FINRA definition of “final order.”

Final Orders of Certain Regulators (cont'd)

- *Fraudulent, Manipulative, or Deceptive Conduct*: Section 926(A)(ii) of the Dodd-Frank Act provides that disqualification must result from final orders of the relevant regulators that are "based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct." Proposed Rule 501 does not differentiate between technical violations, and intentional or other more egregious conduct.

* In addition, investment company bars, civil penalties, and disgorgement under Sections 9(d) and (e) of the Investment Company Act, and censures of persons under Rule 102(e) of the Commission's Rules of Practice, are also not currently disqualifying.

Final Orders of Certain Regulators (cont'd)

- *Orders of Other Regulators*: Commission orders in cease-and-desist proceedings are not disqualifying under current rules.* This distinction has the effect of subjecting individuals outside the securities industry to bad actor disqualification rules only if those persons are subject to court orders.
  - However, the SEC seeks comments as to whether final orders from the SEC and the CFTC should be included as disqualifying events

Commission Disciplinary Orders

- Currently under Rule 262(b)(3), issuers and other covered persons that are subject to an SEC order entered pursuant to Section 15(b), 15B(a), or 15B(c) of the Exchange Act, or Section 203(e) or (f) of the Advisers Act, are disqualified from relying on the exemption available under Regulation A.

Commission Disciplinary Orders

- Under the cited provisions of the Exchange Act and the Advisers Act, the SEC has the authority to order a variety of sanctions against registered brokers, dealers, municipal securities dealers, and investment advisers, including the suspension or revocation of registration, censure, placing limits on their activities, imposing civil money penalties and barring individuals from being associated with specified entities and from participating in the offering of any penny stock.

Suspension or Expulsion from SRO or Association with an SRO Member

- Rules 262(b)(4) imposes disqualification on an offering if any covered person is suspended or expelled from membership in, or suspended or barred from association with a member of, an SRO for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade.
- The proposed rule covers expulsion from FINRA and seeks comment on whether the rule should cover expulsion from any other organization, including foreign exchanges, and whether a look-back period is appropriate.

Stop Orders and Orders Suspending the Regulation A Exemption

- Rule 262(a)(1) and (a)(2) impose disqualification on an offering if the issuer or any predecessor or affiliated issuer filed a registration statement or other Regulation A offering statement that is subject to a Commission refusal order, stop order, or order suspending the Regulation A exemption within the last five years, or is the subject of a pending proceeding to determine if such an order should be issued. Paragraphs (c)(1) and (c)(2) extend disqualification to an underwriter under similar circumstances.

Stop Orders and Orders Suspending the Regulation A Exemption

- Proposed Rule 506(c)(1)(vi) incorporates the substance of paragraphs (a)(1), (a)(2), (c)(1), and (c)(2) of Rule 262, thereby imposing disqualification on an offering pursuant to Regulation A under the circumstances discussed above on both issuers and underwriters.
- The SEC seeks comment on whether the look-back period is appropriate, and whether this provision should cover action by other regulators, including commodities and foreign regulators.

U.S. Postal Service False Representation Orders

- Paragraphs (a)(5) and (b)(5) of Rule 262 impose disqualification on an offering if the issuer or another covered person is subject to a U.S. Postal Service false representation order entered within the preceding five years, or to a temporary restraining order or preliminary injunction with respect to conduct alleged to have violated the false representation statute that applies to U.S. mail.
- Proposed Rule 506(c)(1)(vii) incorporates the substance of these paragraphs and mirrors the current five-year look-back period.

Measuring dates

- For purposes of ascertaining compliance, the measuring period begins on the date on which the issuer seeks the exemption.
- The SEC measures the bad act from the date of a final order and not from the date of the bad act.

Reasonable Care Exception

- Proposed Rule 506 incorporates a reasonable care exception that would apply if an issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed because of the presence or participation of a covered person.
- The reasonable care exception would help preserve the intended benefits of Rule 506 and avoid creating an undue burden on capital-raising activities, while giving effect to the legislative intent to screen out felons and bad actors.
- Issuer would need to conduct a factual inquiry.

Satisfying reasonable case burden

- Issuers will be required to implement new procedures in connection with any Rule 506 offering.
  - this may be especially burdensome for private funds that regularly conduct private offerings in reliance on Rule 506.
- Issuers may consider:
  - adding additional questions to D&O questionnaires;
  - requiring placement agents to complete a questionnaire or provide a representation; and
  - requiring other participants (that may be covered persons) to complete questionnaires or provide representations.

Waivers

- Currently, issuers may seek waivers of disqualification under Regulation A if the issuer shows good cause.
- Proposed Rule 506(c)(2)(i) carries over the current waiver provisions of Regulation A.
- Waivers under the new rule will be issued by the Commission.

Transition Issues

- Disqualifying Events that Predate the Rule
  - Under the proposal, the disqualification provisions would apply to all sales under Rule 506 after the effective date of the new provisions.
  - Offerings made after the effective date would be subject to disqualification for all disqualifying events that had occurred within the relevant look-back periods, regardless of whether the events occurred before the enactment of the Dodd-Frank Act.
- Effect on Ongoing Offerings and Timing of Implementation
  - The proposed bad actor disqualification provisions would apply only to sales of securities made in reliance on Rule 506 after the rule amendments go into effect. If disqualifying events occur while an offering is underway, only sales made after the event will be impacted.
  - The proposal does not contemplate any phase-in period or delay before issuers would be required to comply with the new disqualification rules.

Amendment to Form D

- The signature block of current Form D contains a certification that applies to transactions under Rule 505, confirming that the offering is not disqualified from reliance on Rule 505.
- Under the proposal, this certification would be broadened, so that issuers claiming a Rule 506 exemption would also be required to confirm that the offering is not disqualified from reliance on the Rule 506 exemption.

Possible Amendments to Increase Uniformity

- Uniform Application of Bad Actor Disqualification to Regulations A, D, and E
  - Currently, all bad actor disqualification provisions are substantially similar in language and effect to those in Rule 262.
  - The proposal seeks to preserve this uniformity by conforming all existing bad actor disqualification requirements to the standards proposed in Rule 506 offerings.

Possible Amendments to Increase Uniformity (cont'd)

- Uniform Look-Back Periods:
  - The SEC is proposing to add a uniform ten-year look-back period for all disqualifying events and is soliciting comment on whether this is appropriate.

Blue Sky Considerations

- Securities that are sold pursuant to Rule 506 are considered “covered securities” for purposes of Section 18(b)(4)(D) of the Securities Act.
  - this means that securities sold in reliance on Rule 506 are exempt from state securities review.
- An issuer that relies on Section 4(2) will need to consider state securities requirements.