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September 17, 2003

AN OVERVIEW OF REGULATION D SAFE HARBOR EXEMPTIONS

Every offer and sale of common stock or other securities must be registered with the Securities Exchange Commission unless there is an applicable exemption from registration. This memorandum identifies and discusses the “safe harbor” exemptions from registration provided by Regulation D.

Legal Background. Section 5 of Securities Act of 1933, as amended (the “Securities Act”) requires that every offer and sale of securities be registered, unless the offer and sale is exempt from registration. Securities include common stock, preferred stock, warrants, options, bonds, promissory notes, and investment contracts. The Securities Act provides several statutory exemptions from registration. The most important of these is Section 4(2), exempting “transactions by an issuer not involving any public offering.” These statutory exemptions, especially Section 4(2), may be difficult to apply in many circumstances. Consequently, the SEC adopted Regulation D, which sets forth several easy-to-apply “safe harbors” from registration. Because an issuer always has the burden of proof to demonstrate that an exemption is applicable to an unregistered offering, it is usually better to rely on a “safe harbor” than solely on the statutory exemptions. This Client Memorandum restricts itself to the discussions of “safe harbor” exemptions from registration provided in Rule 504, Rule 505 and Rule 506 of Regulation D. For a variety of reasons and in most circumstances, Rule 506 is best choice among these safe harbors.

Exemptions From Registration Under Regulation D (Rules 504, 505, & 506).

Rule 506

An unlimited dollar amount may be raised in an offering exempt from registration under Rule 506. In order for an offering to be exempt from registration under Rule 506,

- The offering must involve no form of general solicitation or general advertising, including any advertisement, article, notice published in any newspaper, magazine, or broadcast or similar media, or any seminar or meeting whose attendees have been invited by any general solicitation or advertising.
- The issuer must exercise reasonable care to assure that the purchasers of the securities are not underwriters, and may demonstrate this by reasonable inquiry to determine if the purchaser is acquiring the securities for him or herself or for other persons, providing the purchaser with written disclosure of the restricted nature of the securities, and placing a legend on the securities stating that they have not been registered under the Securities Act and may not be resold without registration or an available exemption.
- Non-accredited investors who do not meet a sophistication requirement, either individually or with a “purchaser representative” may not invest.
- No more than 35 non-accredited investors may invest (and these must meet a sophistication requirement, described in the next bullet point).
- Each purchaser who is not an accredited investor either alone or with his or her “purchaser representative(s)” must have such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes prior to making any sale that such purchaser comes within this description. Investors satisfying this requirement are commonly referred to as sophisticated investors. The purchaser representative may be paid by, but must be independent of, the issuer and its affiliates.
- Specified items of information must be provided if there are any non-accredited purchasers of the securities.
- A Form D should be filed with the SEC, although failure to file the Form D does not cause loss of the exemption from registration.
- An “accredited investor,” defined in Rule 501(a) of Regulation D, includes
 - any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

- any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his or her purchase exceeds \$1,000,000;
- a corporation or partnership not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
- any director, executive officer, or general partner of the issuer; and
- any entity in which all of the equity owners are accredited investors.

Generally speaking, most issuers of private equity refuse to sell securities under Rule 506 to non-accredited investors. While Rule 506 technically permits up to 35 non-accredited investors to purchase in the offering, the non-accredited investors must meet a sophistication requirement. More importantly, if any non-accredited investors purchase securities, mandatory disclosure must be provided. Preparing this mandatory disclosure is usually time consuming and expensive, depending on the size of the offering.

If non-accredited investors purchase in an offering under Rule 505 or 506, regardless of the amount raised in the offering, they must generally receive detailed written information set out in an offering memorandum, circular or similar document.¹ Required items of disclosure include a description of the securities, the issuer, its business, properties, capital structure, officers and directors, managements' discussion and analysis, plan of distribution and risk factors. Additional, purchasers are entitled to receive certain financial information, which should be prepared in conformity with accounting standards generally applicable in the United States (GAAP). If the offering is for \$2,000,000 or less, non-accredited must receive financial statements for the issuer's last year and only the balance sheet must be audited. For offerings greater than \$2,000,000 and up to \$7,500,000, audited financial statements for the issuers last year are required. For offerings in excess of \$7,500,000, financial statements as would be required in a registration statement filed under the Securities Act on the form that the issuer would be entitled to use. If an issuer provides information to non-accredited investors, the issuer should provide the same information to accredited investors.²

The prohibition of general advertising or solicitation follows logically from the general concept of a private offering. Generally, the company and its promoters should limit their solicitation to those with whom they have prior contacts and those whose business or practice it is to make investments, such as angel capital investors or venture capital funds. While a wider distribution may be possible under some circumstances, those circumstances should be discussed with counsel.

¹ Rule 502(b) requires that non-accredited investors in an offering under Rule 505 or 506 receive the information set out in Part II of Form A-1.

² While Regulation D does not require that accredited investors receive any items of disclosure, all investors should be provided with the same types of written disclosure as a defense to a claim of actionable omission under Rule 10b-5 or other anti-fraud laws and regulations.

The limitations on resale requirement is not particularly burdensome or difficult to comply with. Typically, this requirement is addressed by requiring certain representations and warranties be made by the investor and by placing a restrictive legend on the back of the certificate evidencing the security (such as a stock certificate or note). The legend typically provides that the security may not be resold except in conformity with securities law and often requires a legal opinion satisfactory to the issuer. The relevant investor representation is that the securities are purchased for investment and not with a view to resale or distribution. Practically speaking, for most investors (except insiders and other affiliates of the issuer), the shares may be resold under Rule 144 after two years without violation of Federal securities laws.

If an offering qualifies under Rule 506, it is deemed to be an offering “not involving any public offering” within the meaning of Section 4(2) of the Securities Act. In addition to an exemption from federal registration, an offering exempt from registration under Rule 506 will also preempt state registration requirements.³ If an offering is to be conducted in many states, a Rule 506 offering can eliminate the need to register in these states or isolate an exemption available in each of these states. However, a notice filing along with a fee to the states may still be required.

Rule 505

Up to \$5,000,000 may be raised in an offering of securities exempt from federal registration under Rule 505. Rule 505 is like Rule 506, except that non-accredited investors do not need to meet a sophistication requirement. In order for an offering to be exempt from registration under Rule 505,

- The offering must involve no form of general solicitation or general advertising, including any advertisement, article, notice published in any newspaper, magazine, or similar media or broadcast and any seminar or meeting whose attendees have been invited by any general solicitation or advertising.
- The issuer must exercise reasonable care to assure that the purchasers of the securities are not underwriters, and may demonstrate this by reasonable inquiry to determine if the purchaser is acquiring the securities for him or herself or for other persons, providing the purchaser with written disclosure of the restricted nature of the securities, and placing a legend on the securities stating that they have not been registered under the Securities Act and may not be resold without registration or an available exemption.
- No more than 35 non-accredited investors may invest.

³ See Section 18 of the Securities Act.

- Specified items of information must be provided if there are any non-accredited purchasers of the securities.
- No more than \$5,000,000 is raised in reliance on this exemption in any 6-month period.

Unlike Rule 506, an offering from registration exempt under Rule 505 does not preempt state registration requirements. However, many offerings under Rule 505 will qualify for one or more exemptions in most states. Determining these exemptions must be done with care and cannot be overlooked. Some exemptions may be lost if required filings are not filed on a timely basis.

Rule 504

Up to \$1,000,000 may be raised in an offering of securities exempt from federal registration under Rule 504. Except as noted below, Rule 504 is like Rule 505, except that non-accredited investors are not entitled to specified items of disclosure. A 504 offering, therefore, can be very useful under some circumstances. An offering will be exempt from federal registration under Rule 504 if the following conditions are met:

- The offering must involve no form of general solicitation or general advertising, including any advertisement, article, notice published in any newspaper, magazine, or similar media or broadcast and any seminar or meeting whose attendees have been invited by any general solicitation or advertising.
- The issuer must exercise reasonable care to assure that the purchasers of the securities are not underwriters, and may demonstrate this by reasonable inquiry to determine if the purchaser is acquiring the securities for him or herself or for other persons, providing the purchaser with written disclosure of the restricted nature of the securities, and placing a legend on the securities stating that they have not been registered under the Securities Act and may not be resold without registration or an available exemption.
- Non-accredited investors may invest and, unlike Rules 505 and 506, there is no limitation on the number of non-accredited investors, and unlike Rule 506, there is no sophistication requirement applicable to non-accredited investors.
- No more than \$1,000,000 is raised in reliance on this exemption in any 6-month period.
- No issuer may rely on Rule 504 if the issuer is

- a reporting company under section 13 or 15(d) of the Exchange Act,
- an investment company or
- a development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company.

It is also possible, under Rule 504, to use general advertising and solicitation and permit the shares to be resold free of limitations on resale under certain narrowly defined conditions. Rule 504 will exempt from registration an offering otherwise meeting its conditions that involves general advertising and/or does not place limitations on resale, if (i) the securities are registered in a state that requires public filing and delivery to investors of a substantive disclosure document before sale and made in accordance with those state provisions, (ii) if one or more of the states in which the offering occurs has no such provisions, the securities have been registered in at least one of such states that requires public filing and delivery of substantive disclosure document, the offering is conducted pursuant to such provisions, and the disclosure document is provided prior to sale to all purchasers, (iii) exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to “accredited investors”. Georgia, for example, has no such state law exemption permitting the use of general solicitation.

An offering exempt from Federal registration under Rule 504 may not necessarily be exempt from registration with the states in which the offering is made. It is helpful to remember that in a Rule 506 offering, state registration requirements are preempted, in a Rule 505 offering, there is usually (but not always) a state counterpart exemption, and in a Rule 504 offering, finding an exemption from registration can be a challenge.⁴

Important Related Securities Law Issues Not Addressed.

Anti-Fraud Laws and Regulations. This memorandum does not discuss anti-fraud laws and rules, such as Rule 10b-5, applicable to the offer and sale of securities. These laws generally prohibit misstatements of material fact and omissions of facts necessary to make the facts stated not misleading. These laws and rules apply whether or not the offer and sale of a security is exempt from registration.

State Registration. This memorandum does not discuss in detail exemptions from state law requiring the registration of the offer and sale of securities. Unless Federal preemption applies or a state exemption is available, states generally require the offer and sale of securities to be registered.

⁴ See, e.g., O.C.G.A §10-5-9(13), which exempts from registration private offerings to up to 15 persons in Georgia in a 12-month period, subject to certain restrictions, including a specific legend requirement.

Broker-Dealer Registration. This memorandum does not address whether the issuer, its officers or promoters are required to be registered as broker-dealers or whether an exemption from broker-dealer registration is applicable under the circumstances.

Integration. This memorandum does not address whether several offerings commenced within a 6-month period are deemed to be the same offering under the integration doctrine discussed briefly in the introductory notes to Regulation D.