

Private Placement – State and Federal Law Considerations

Corporate News: A Legal Update

By Daniel Spungen on February 1, 2023

Private placements can be a great resource for companies to raise capital in the current economic environment. They are cost effective in comparison to public offerings and provide greater decision-making latitude to current owners. Raising capital while keeping an entity private is an effective method for growing a business. Keeping a company private helps officers and directors take a long-term view of the company. Further, staying private has reduced administrative costs compared to public companies because private companies do not have the ongoing reporting obligations of public companies. Private placements allow companies to structure investments to meet their needs by issuing debt or equity investments under their terms. Whether the company is a newly formed start-up seeking the capital necessary to grow its business, or the company is more mature and would like to expand its ownership group by taking on new investors, private placements are versatile in how they serve companies.

Federal Regulation

The general rule for securities offerings at a federal level is that all securities must be registered, unless the offering or the securities are exempt. For example, Section 4(a)(2) of the Securities Act of 1933 exempts from federal registration “transactions by an issuer not involving any public offering.” This is commonly known as the private placement exemption. Whether an offering is private, and thus exempt under Section 4(a)(2), is determined on a case-by-case basis. Regulation D was enacted in part to provide certainty to companies issuing private placements, because compliance with Regulation D ensures that an offering is exempt. In addition to federal law exemptions, companies must analyze state blue sky law requirements prior to conducting the offering. This requires an analysis of blue sky laws in the state of the company’s operations as well as any state in which it is soliciting investors.

Regulation D

As mentioned previously, Regulation D provides a safe harbor to federal securities registration requirements. Rule 506(c) is the most commonly used exemption under Regulation D and is codified as 17 C.F.R. § 230.506(c). Below is a summary of key features of Rule 506(c) offerings:

- No limit to the amount of capital raised through a 506(c) offering.
- A company may engage in general solicitation of the 506(c) offering.
- A company may not have any “bad actor”, as defined in 17 C.F.R. § 230.506(d), involved in the company.
- An unlimited number of accredited investors can invest in a 506(c) offering.
- A Form D must be filed with the SEC within 15 days of the first sale.
- The securities are “restricted securities” and thus not able to be resold unless registered or under a resale exemption.

If a company wants to sell securities in a private placement to non-accredited investors, it would conduct the offering under 506(b). In contrast with 506(c), 506(b) offerings permit up to 35 non-accredited, but sophisticated, investors in any 90-day period. However, if non-accredited investors are included in the offering, the company must provide, to all investors in the offering, financial statements that meet the requirements for non-accredited investors consistent with Regulation A. Further, companies are not permitted to conduct a general solicitation (e.g., advertisements) of 506(b) offerings. Because of the additional requirements and limitations, many companies limit offerings to accredited investors only.

Regulation D offerings preempt state law requirements regarding registration and qualification of securities issued in private offerings, though states still have the authority to require a notice filing (and any fees imposed with the filing) and to investigate claims of fraud. As a result, nearly all states require a filing and most require payment of a filing fee.

Conclusion

Private placements are a great way to raise capital while retaining decision-making latitude in the manner in which the offering is conducted. The rules surrounding private offerings allow companies to remove uncertainty in conducting the offering. While many companies consider the federal law implications of conducting the offering, it is vital to review state blue sky laws prior to conducting an offering.

Private Placement – State and Federal Law Considerations