Reg D Offerings: Common Mistakes to Avoid

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Whether it's selling stock in exchange for equity of your company, selling notes to bring in money as a loan from private investors or whether other types of securities like preferred or convertible instruments are being offered, the process of raising money for your venture is made easier and safer for you if you comply with the requirements of Regulation D of the Securities Act of 1933 ("Reg D").

These Reg D requirements extend far beyond document format. In fact, you can have a document formatted as a Reg D private placement memorandum ("PPM"), yet your offering may still fail to comply with Reg D for a variety of reasons, either because of the way disclosures are made in the PPM or the way the offering is conducted by the company or otherwise. If your offering does not comply with Reg D, (i) you will not benefit from the protections provided by the Reg D "safe harbor" and (ii) your potential exposure to liability in the future from an unhappy investor increases greatly. (One of the prime reasons to raise funds through a proper Reg D offering is to reduce your exposure to liability while at the same time increasing your control over the investment process.)

Mistakes to Avoid

1. Going It Alone

Attempting to comply with a complicated, interwoven set of securities regulations and statutes without using a securities attorney does your company no good and sometimes may cause a good deal of harm. You have put time and money into your venture but here is absolutely the wrong place to cut costs. This logic applies equally to an accounting firm. You should have your securities attorney and your accountant involved at the earliest stage. You are seeking money from other people – do it right! Even though I am a securities attorney and can tell you about the multitude of sections throughout the PPM that need to be drafted with the correct "twist of the phrase" (and the numerous other sections that must be qualified, limited or expanded), there are many practical reasons why you should not proceed without securities counsel. As mentioned previously, you limit your exposure greatly by raising funds in compliance with Reg D. In addition, investors are likely to think twice about investing in a company or venture that has not retained counsel. From a business standpoint, your attorney can assist tremendously in the structuring of the deal, perhaps finding more value than you thought was there, planning the roll-out of the offering to match capital requirements or making sure that your desired exit strategy is factored properly into the transaction. From an organizational standpoint, your attorney serves as your quarterback in lining up all the required pieces and information, reporting the progress to you as needed and freeing up your time to concentrate on your core business.

A securities attorney will often be amenable to working out a flat fee arrangement with you so that you can budget out your expenses. (Since we do so many Reg D's, we have a good idea of what they will entail and have no problem offering the client a flat fee as an option to hourly billing but I can't speak for all attorneys of course.) I will close this section by simply remarking that the law always changes – just recently new changes were made affecting Reg D offerings. You need to make sure the attorney is a securities attorney – not someone whose practice is, for example, litigation or wills and estates. If you want to sue someone or need a will, that's the time to go to those specialists.

2. Use of a Business Plan Only

You may have a first-rate business plan but if you are seeking funding from a number of investors, it does not replace a PPM. While it may serve as an excellent internal document for determining attainment of sales or financial objectives, or to describe the business to a bank or another third party, it is not designed to satisfy the requirements of Reg D. In fact, a PPM is the ultimate business plan. It incorporates descriptions of management, the product or service, the competition and industry, the plan for marketing, sales and growth, and so forth and includes the many additional disclosures required by securities law as well (in a format experienced investors are used to seeing). It is not just the inclusion of additional information and disclosures that differentiates the PPM from the business plan. It is also the way the documents are written, which is actually a reflection of their intended use. The typical business plan is somewhat sales-oriented (appropriate for its intended reader) while a PPM is disclosure-focused and meant for review by investors. Because of this, some portions of a business plan may be used in a PPM as good supporting data but the actual text often requires a good bit of revision for a variety of reasons. This does not mean that a PPM can not be positive with respect to the market and potential growth of the company. Rather, favorable disclosure items are described consistent with securities law requirements and matters that may negatively impact the company are clearly disclosed as well – an investor reviewing a PPM for a Reg D offering knows he or she is getting the full story but a business plan will always leave questions.

3. Failure to Disclose

You must view the PPM's full disclosure of positive and negative aspects as your ally! When a client asks: "Do I really have to disclose that?" my response is always "Will it make a difference to the investor when considering whether or not to invest?" If it might make a difference, then it should definitely be disclosed. The PPM will also indicate there is no guarantee of success. Remember the end game – you are seeking investments from people who have money to invest (and have money for lawyers as well). You want to make sure that you decrease your exposure to liability during this process. If an unsatisfied investor comes to you in the future says "You never told me about ____," you can refer him to the PPM where he was informed, probably several times, in writing. While there is, understandably, some discomfort with the extent of disclosures made in a PPM, my personal experience leads me to believe that investors are rarely surprised that there are risks – it generally comes down to the merits of the deal and they would be surprised if there were no flaws in the company or the transaction..

4. Procedural Requirements

The general rule is that an entity may not make a public offering of its securities (stock, bonds, LLC interests, etc.) unless (i) the securities are registered with the SEC or (ii) the company is exempted from registering the securities being offered because the offering is deemed to be a private offering. Many factors determine whether this is the case and, if ever necessary, a company may have to prove those factors existed and it was therefore exempt from registration requirement. Recognizing the need for small companies to raise capital more easily, the SEC enacted Regulation D as a “safe harbor.” Reg D is not the only way to conduct a proper limited offering but if a company complies with Reg D, it will not have to prove it was exempt from full registration, if ever necessary in the future. This was a huge boon to the small to mid-size company capital market and Reg D continues to be revised in response to the market. While the format and content of the PPM are extremely important, the actions taken afterwards during the process of seeking investment are equally important in order to comply with Reg D. Advertising for investors, improper use of electronic media or the use of improperly drafted marketing pieces or executive summaries can be fatal to your attempts to comply with Reg D. In addition, the failure to make appropriate filings with the SEC and the states where your prospective investors reside can also preclude you from the benefits of Reg D. Following all the hard work by the company and its securities counsel during the preparation of the PPM, many mistakes can still be made – company and counsel must continue to dot the i’s and cross the t’s throughout the offering process to insure the Reg D exemption remains intact.

5. Use of Finders

Many companies, complying with Reg D in other respects, go astray with their use of finders. The use of finders, even if you call them consultants, advisers, wholesalers or some other name, is a tricky matter and needs review on a case-by-case basis. It is not a question of integrity of the finder or amount of fee. (Value delivered deserves proper compensation). Rather, this is an issue related to the manner of your offering which, by its nature, must be non-public and limited in order to comply with Reg D. Remember that your company (through its key officers and directors) is one of the principals in the transaction, selling securities, and the other principal is the investor as buyer of the securities. Third party intermediaries presenting the offering, providing information, answering questions and otherwise facilitating the transaction are brokering the transaction between the two principals. When you buy stock in an exchange-listed company, you buy it through your broker representative who is licensed by the Financial Industry Regulatory Authority ("FINRA"). Brokerage firm representatives are regulated, are presumed to know the investment intentions and risk tolerance of their client investors and are traditionally paid a fee based on the amount of the purchase transaction (typically referred to as “transaction-based compensation”).

In the typical finder scenario, however, the finder often acts in a manner similar to a licensed broker, presenting the investment transaction, answering questions and then arranging a conference call or an initial meeting. If an investment follows, the finder expects transaction-based compensation (cash and/or stock), which is typically negotiated by a finder to be a percentage of the investment. The problem here, however, is that the typical finder is not licensed with FINRA. Nevertheless, if a finder is acting like a securities broker, the law generally requires the finder to qualify and register as a broker. This is clearly the case if a finder is providing this kind of service on a regular basis. If the finder is actually “in the business” of providing the services of a broker then he or she must be licensed. Both state law and federal law require it. The Reg D filing with the SEC requires a listing of the brokers in your offering and the states, in particular, have a strong interest in protecting their residents by regulating the parties who seek investments from them.

It is far preferable to utilize a licensed FINRA broker to sell all or a majority of your securities. Simply said – just agree to pay the brokerage firm its standard fee for monies raised and let it present your deal to the firm's investor pool in an organized, professional manner. If you cannot interest a broker in your deal, there are situations where isolated transactions, special provisions in state law or specific situations may allow a company to use the services of a finder. You may feel the pressure to accept funds through a finder but seek the advice of counsel and move forward cautiously. One complaint to one state securities administrator can lead to a real problem.

Conclusion

Despite your best efforts, a number of mistakes can be made when undertaking a Reg D offering. The positive side, however, is that Reg D offerings are conducted successfully every day throughout the country. They are flexible enough to suit most any company's needs and can be structured as the financing component of a larger business objective such as a merger or PIPE transaction. In short, Reg D continues to be the best show in town for private financings.

Be sure to send me an e-mail and let me know if this article on Reg D was helpful to you or if you have other questions before embarking on your own funding efforts.

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This article should not be construed as legal advice. Due to the complexities of Regulation D, the specific facts and circumstances and the current status of the law must be carefully considered when seeking to benefit from the Regulation D safe harbor exemption.