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M E M O R A N D U M

TO: Clients and Friends of the Firm

DATE: August 16, 2003

SUBJECT: Private Placements¹

I. General. In almost every instance, the sale of common stock, preferred stock, debentures, and limited liability company or limited partnership interests involves the sale of securities. The significance of an interest being deemed a "security" is that comprehensive federal and state regulatory provisions become applicable to the offer and sale of the security, unless exemptions from the registration requirements of applicable laws and regulations are available. Registration of the sale of a security with the Securities and Exchange Commission (the "SEC") is an expensive and time-consuming process. Therefore, an exemption from registration is often critical, especially for start-up and emerging companies.

II. Regulation D. SEC Regulation D is a series of six rules, Rules 501-506, establishing three transactional exemptions from the registration requirements of the Securities Act of 1933 (the "1933 Act"). Rules 501-503 set forth definitions, terms and conditions that apply generally throughout the Regulation. Specific exemptions are set out in Rules 504-506.

A. Rule 504 applies to transactions in which no more than \$1,000,000 of securities are sold in any consecutive twelve-month period. Rule 504 imposes no ceiling on the number of investors, permits the payment of commissions, and imposes no restrictions on the manner of offering or resale of securities. Further, Rule 504 does not prescribe specific disclosure requirements. Generally, the intent of Rule 504 is to shift the obligation of regulating very small offerings to state "Blue Sky" administrators, though the offerings continue to be subject to federal anti-fraud provisions and civil liability provisions of the Securities Exchange Act of 1934 (the "1934 Act").

B. Rule 505 applies to transactions in which not more than \$5,000,000 of securities is sold in any consecutive twelve-month period. Sales to thirty-five "non-accredited" investors and to an unlimited number of accredited investors are permitted. An issuer under Rule 505 may not use any general solicitation or general advertising to sell its securities.

C. Rule 506 has no dollar limitation of the offering. Rule 506 is available to all issuers for offerings sold to not more than thirty-five non-accredited purchasers and an unlimited number of accredited investors. Rule 506, however, unlike 504 and 505, requires an issuer to make a subjective determination that at the time of acquisition of the investment each non-accredited

1 This memorandum is not intended to provide legal advice on a particular matter. Its sole purpose is to provide general information and education on the subject. If you are contemplating a private placement, you are encouraged to seek legal advice for your particular transaction. For more information, please call Stanley B. Kay at (617) 928-3677.

purchaser meets a certain sophistication standard, either individually or in conjunction with a "Purchaser Representative." Like Rule 505, Rule 506 prohibits any general solicitation or general advertising.

D. "Accredited Investor" is defined in Rule 501(a). The principal categories of accredited investors are as follows:

- (1) Directors, executive officers, and general partners of the issuer, including general partners of general partners in two-tier syndications. (The term "executive officers" is more fully defined in the Regulation.)
- (2) Purchasers whose net worth either individually or jointly with their spouse equals or exceeds \$1 million. It is important to note that while there is no definition of "net worth" in Regulation D, there similarly is no requirement of liquidity in the calculation of net worth for this accreditation standard. Thus, a purchaser's home, furnishings, etc. are includable in the determination of net worth.
- (3) Natural person purchasers who have "income" in excess of \$200,000 in each of the two most recent years and who reasonably expect an income in excess of \$200,000 in current year (or \$300,000, jointly with their spouse).
- (4) A business entity will be treated as a single accredited investor unless it was organized for the specific purpose of acquiring the securities offered, in which case each beneficial owner of the security is counted separately.

E. SEC Filing Requirements. The issuer should file five copies of a notice on Form D with the SEC no later than 15 days after the first sale of securities in a Regulation D offering, although the failure to file the Form D on time may not affect the availability of the exemption. A notice is deemed filed with the SEC as of the date on which it is received by the SEC, or as of the date on which the notice is mailed by means of the United States registered or certified mail to the SEC. One copy of every notice must be manually signed by an authorized person of the issuer.

The SEC staff has noted that the receipt of the first Subscription Agreement and the acceptance of subscription funds into an escrow account pending receipt of minimum subscriptions (if required under the offering) would trigger the filing requirements. In such instances, the issuer should file its first Form D no later than 15 days after the receipt of the first Subscription Agreement

F. Additional Compliance Considerations Under Regulation D You should note the following important points about Regulation D:

- (1). Regulation D does not exempt offerings from the anti-fraud and civil liability provisions of the various federal securities laws.
- (2). Further, Regulation D in no way relieves issuers of their obligation to furnish to investors whatever material information may be needed to make any required disclosures not misleading.
- (3) Similarly, notwithstanding exemption from registration at the federal level, Regulation D in no way obviates an issuer's obligation to comply with applicable state law.
- (4) Regulation D is interpreted as providing "transactional" exemptions to issuers only. An investor whose purchase was exempt from registration cannot resell his or her interest

without establishing an independent basis of exemption.

(5) The three exemptions are not intended to be mutually exclusive, that a reliance on one exemption is not deemed to be an election to the exclusion of any other applicable exemption.

(6) Finally, the exemptions of Regulation D may not be claimed with respect to any plan or scheme to evade the registration provisions of the act.

III. Regulation A Exemption The other major set of exemptions from registering stock offering is contained in SEC Regulation A. However, it is not accurate to characterize Regulation A as a total "exemption"; it is rather a modified scheme of registration for offerings up to \$5 million (of which only \$1,500,000 can be secondary sales by shareholders). Section 3(b) of the 1933 Act and Regulation A provides for a public offering through the use of an "offering circular", sometimes referred to as a "short form" registration. A Regulation A offering requires filing and notification of an offering circular with less extensive disclosures than an S-1 or S-18 (under the registration regulations), and does not require audited statements. A Regulation A offering is a method by which an emerging company may effect a public offering of its securities without some of the restrictions on investor qualifications and numbers set forth in Rules 505 and 506 of Regulation D. Key features of a Regulation A offering are:

- A. The offering may be made to an unlimited number of investors.
- B. There is no requirement of investor qualification.
- C. Companies may "test the waters" for potential interest before preparing the required offering circular.
- D. Limited advertising is permitted (as long as the sales material is filed with the SEC).
- E. The offering circular need only be filed with a regional office of the SEC (which are generally believed not to scrutinize them as carefully as the main office.)
- F. There are no limitations on resales.
- G. Only United States and Canadian Companies may use the exemption. No investment companies may use the regulation. And, any company which has been disqualified by virtue of prior specified wrongdoing may not use the exemption (the so-called "bad boy" exception).
- H. Curiously, provisions of the 1933 Act concerning remedies for misstatements in registration statements do not apply, and thus the potential legal liability is less.

IV. Foreign Offering Exemption Under Regulation S. Effective May 2, 1990, the SEC adopted Regulation S which clarified the rules governing offers or sales outside the United States. All offers and sales exempt under Regulation S must be made in "of-shore transactions" which are defined to be those in which no offer is made to a person in the United States and the buyer is outside the United States or the transaction is executed on an off-shore securities exchange. In addition, there can be no "directed selling efforts" in the United States, i.e., advertisements designed to induce the purchase of the securities being distributed abroad.

V. Rule 147 (Intrastate Offering Exemption) Rule 147, under the 1933 Act, exempts

from registration a sale of securities solely to persons resident in one state, where the issuer has at least 80% of its assets in that state, and uses at least 80% of the proceeds of the sale within the state. Resales of such securities may be made only to persons within the state during the period of the offering and for 9 months thereafter. No SEC filing is required under a Rule 147 offering.

VI. Private Placement of Restricted Securities Outside the Regulations The specific requirements to be satisfied in establishing an exemption under Section 4(2) of the 1933 Act for a private placement are not stated in that section. By studying SEC interpretations and court decisions dealing with Section 4(2), the basic requirements which a private placement must meet can be determined. They are summarized below:

A. Access to Information. All the offerees and purchasers must have access to the same kind of information concerning the issuer which would appear in an SEC registration statement, and these persons must be able to comprehend and evaluate such information. It must be kept in mind that any offer to an offeree who would not qualify, as well as a sale to a purchaser who would not qualify, may destroy the private placement exemption and result in a violation of Section 5 of the 1933 Act.

B. Complete and Accurate Information. The issuer and any parties acting for the issuer, including the broker-dealer, must take all reasonable steps to insure that the information given to the offerees and purchasers is complete and accurate. This is "due diligence." All information passed on in the course of the private placement, either orally or by memorandum (or offering circular), is subject to the anti-fraud provisions of the federal securities laws. The fact that the offering memorandum is not reviewed by the SEC does not lower the standards for accuracy which would be applicable to any registered offering.

C. Current Information. All of the offerees must have access to meaningful current information concerning the issuer. The fact that an offeree has considerable financial resources or is a lawyer, accountant or businessperson, and thus may be considered sophisticated, does not eliminate the need for appropriate information to be made available.

D. Limitation of Offerees. While there is no specific limitation on the number of offerees, the greater the number of offerees, the greater the likelihood that the offering will not qualify for the exemption. In this connection, a private placement cannot be the subject of advertising, general promotional seminars or public meetings in connection with the offering. This limitation does not preclude meeting with offerees to discuss the terms of the offer or to present information concerning the issuer or the offer. After the private placement has been completed, a general announcement (such as a tombstone ad) concerning it may be made if this is desired.

E. Investment Purpose. Purchasers in a private placement must acquire the securities for investment and not for the purpose of further distribution. If the purchaser acts in such a manner so as to participate in distribution of the securities to the public, either directly or indirectly as a link between the issuer and the public, he or she will be deemed to be an underwriter and the selling broker-dealer and other participants in the distribution, including the issuer, will be in violation of Section 5 of the 1933 Act. Each of the purchasers must intend to acquire for investment at the time the securities are purchased. Whether or not investment intent was present will be determined from all the circumstances surrounding the acquisition. Such circumstances would include the financial capability of the purchaser to hold the securities for the long term and whether the purchaser signed a letter of investment intent. The amount of time the securities have been held (the holding period) is one of the factors in a hindsight determination that an investment intent existed at the time of purchase. A two-year holding period is deemed to be the bare minimum.

VII. Integration. Since each of the private offering exemptions described above is based on each offering being separate and distinct, the concept of “integration” has been developed to determine whether or not an offering is part of another offering. Thus, for example, if two private offerings are consummated, each with 35 accredited investors, and the two offerings are deemed to be one offering, then the exemption under Rule 505 or 506 would not be available, since 70 purchasers would have been involved. This requirement of a separate offering is important in both the private offering and the intrastate offering exemptions. Whether a separate offering is considered as such or one of a related series of offerings depends on the facts and circumstances of such offerings. The SEC has adopted a five-factor test as follows:

- (1) Are the offerings part of a single plan of financing?
- (2) Do the offerings involve issuance of the same class of security?
- (3) Are the offerings made at or about the same time?
- (4) Is the same type of consideration to be received?
- (5) Are the offerings made for the same general purpose?

Regulation D provides a safe harbor from integration of two or more offerings where offers and sales are made more than six months after completion thereof, so long as during those six-month periods there are no offers or sales of securities by the issuer of the same or similar class as were sold in the Regulation D private offering.

VIII. Broker-Dealer Issues. Persons or entities selling the issuer’s securities, and particularly where commissions or compensation is received in connection therewith, may be required to register as “brokers,” “dealers” or “agents” under the federal or state securities laws.

However, if the issuer is going to sell the stock without a broker-dealer, then the issuer and related individuals may fall within a federal exemption and avoid having to register as “brokers,” “dealers” or “agents.” Directors and officers of the issuer may qualify for an exemption from broker-dealer registration if they: (1) have not relied on the issuer exemption in the preceding twelve months; (2) are not subject to a “statutory disqualification”; (3) are not compensated (directly or indirectly by paying commissions or other compensation based on sales of the securities; and (4) are not at the time of the sales of the securities, an “associated person of a broker or dealer,” nor were they “a broker or dealer, or an associated person of the broker or dealer” within the prior twelve months, all as defined under applicable SEC rules.

IX. State Blue Sky Laws. In addition to the federal securities laws, both private and public offerings must either be qualified under the securities laws of those states in which the offering is made, or an exemption from qualification must be found. Up until recently, an offering which was to be made in more than one state would require the issuer to evaluate the requirements of each applicable state. Now, significant limitations on the authority of the states to regulate securities in their jurisdictions will result from the passage of **The National Securities Markets Improvement Act of 1996** (“NSMIA”). NSMIA replaces existing section 18 of the 1933 Act -- which previously authorized state governments to maintain their individual securities laws, or blue sky laws -- with a new section 18 that effectively preempts the authority of state governments to regulate most securities offerings.

Although there are several aspects of the states' regulation of securities that are changed by

NSMIA, for purposes of this memorandum, the most relevant change is the preemption of state securities regulators' authority to require registration of private placements exempt under Rule 506 of Regulation D discussed above. Now, states are prohibited from requiring registration or qualification, or from imposing any conditions on the use of any offering document prepared by the issuer, or on any disclosure document relating to a covered security or its issuer that is required to be filed with the SEC.

X. Private Placement Offering Memorandum or Circular. To meet the requirement of the Regulations, or the requirements of Section 4(2) of the 1933 Act (the private placement exemption), the issuer is almost always required to make extensive disclosures regarding the nature, character and risk factors relating to an offering. The disclosure document often is labeled "Offering Memorandum", or "Offering Circular" (Form 1-A), or given a similar title, which, in the normal course, is based upon information provided to counsel to the issuer. While a properly executed private placement is exempt from the registration provisions (i.e. Section 5 of the 1933 Act) of the federal securities laws, the transaction (and the disclosures made or not made) is subject to the anti-fraud provisions. If the offering memorandum or similar document in a particular private placement turns out to be materially misleading in terms of disclosures which have been made (or which should have been made), the issuer, or its broker-dealer and its principals may be deemed to have violated or aided or abetted violations of the anti-fraud provisions of the federal securities laws.

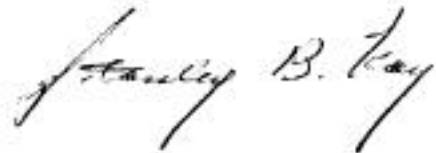
XI. Offeree Access To Information. Most private placement offering memoranda state that it has been prepared by counsel to the issuing company from documents which have been provided by its representatives. Offerees are invited to meet with representatives of the issuer to make an independent investigation and verification of the matters disclosed in the offering memorandum. Courts, reviewing private placements when challenged, weigh investor access to underlying information about the transaction very heavily in the determination of whether there has been compliance with the private placement exemption. The Issuer must ensure that potential purchasers and their representatives shall be given access to underlying information about the transaction if they desire to pursue such information. The fact that information is available to offerees should be specifically disclosed to the offerees at a conspicuous point in the offering documents.

XII. Backup Documents for the Offering. An issuer claiming an exemption from the securities laws has the burden to show that the exemption was available. A detailed file should be established to document the availability of the exemption (typically called a "Burden of Proof File"). The Burden of Proof File will contain supporting documentation in the event of any litigation or regulatory enforcement; and it will typically contain many documents in connection with the offering, including the following:

- A. A Control Sheet for Private Placement Memoranda designed to record the distribution of Private Placement Memoranda, and to show that offerings were only made to a limited number of individuals who met the suitability standards established by the issuer.
- B. A procedure to determine the qualification of offerees and whether they merit inclusion in the offering. The procedure should identify that a prospective offeree has sufficient experience, business knowledge, and investment sophistication to allow the him or her to make a reasonable informed investment decision. To determine that subscribers are in fact suitable investors, a confidential questionnaire soliciting financial, investment, and educational information about the subscriber should generally be required to be completed by each prospective investor.
- C. All broker-dealers, registered representatives, or other persons connected with the offering

should be instructed as to the limitations on the manner of the offering. All selling agreements with participating broker-dealers should obligate the broker-dealer to comply with the requirements of the applicable regulations

- D. In the event a purchaser representative represents the prospective investor, there should be an acknowledgment that the purchaser representative is acting for the offeree, as well as a disclosure of any material relationships between the purchaser representative and the issuer.

A handwritten signature in black ink, reading "Stanley B. Kay". The signature is written in a cursive style with a large, sweeping initial 'S'.