CHAPTER 4

Mechanics of a Section 4(a)(2) offering

Section 4(a)(2) provides that the registration requirements of Section 5 do not apply to "transactions by an issuer not involving any public offering". This is often referred to as the private placement exemption for issuers. The breadth of this exemption makes it useful for issuers attempting to conduct a variety of financing transactions. The rationale for this exemption from registration is that the extensive regulation applicable to public offerings is not required when offerings are made to a limited number of offerees who can protect themselves. These exemptions are available to US and non-US public and private companies. In 1982, the SEC adopted Regulation D to provide issuers with safe harbours for conducting Section 4(a)(2) private placements.

A Section 4(a)(2) private placement provides an attractive capital-raising alternative for a foreign issuer considering offering securities in the United States. A private placement permits a foreign issuer to raise significant capital without the cost and delays of registration under the Securities Act and SEC review of offering documents. In addition, Section 4(a)(2) private placements also have the advantage of providing greater liquidity for foreign issuers and not requiring or triggering extensive ongoing registration or disclosure for foreign issuers. Section 4(a)(2) private placements for foreign issuers almost always involve the sale of debt securities given that many foreign issuers seek to avoid having a base of equity holders in the United States.

Section 4(a)(2) private placements

There are a number of ways FPIs can raise capital in the United States, including private placements under Section 4(a)(2) and Rule 144A offerings. Foreign companies that have a class of their securities registered in the United States may also raise capital through public offerings. Under Section 4(a)(2), the registration and related prospectus delivery requirements under Section 5 of the Securities Act are not applicable; however, statute itself provides little guidance as to the types of transactions that fall within the scope of Section 4(a)(2). Judicial and regulatory interpretations have produced a fact-specific analysis of the types of transactions that could be deemed a private offering, based on the following factors.[1] The factors are flexible, and no single factor is determinative.

- *The number of offerees and their relationship to each other and to the issuer*: This factor is significant. There is no maximum permitted number of offerees; however, the larger the number of offerees, the greater the difficulty sustaining the evidentiary burden. Offering to a large and diverse group with no preexisting relationship to the issuer suggests a public offering.
- *The number of securities offered*: The smaller the number, the less likely the offering will be deemed a public offering.
- *The size of the offering*: The smaller the size of the offering, the less likely the offering will be deemed a public offering.
- *The manner of offering*: There are two general conditions: (1) the offering should be made through direct communication with eligible offerees by either the issuer or the issuer's agent; and (2) the offering cannot include any general advertising or general solicitation.[2]
- *The sophistication and experience of the offerees*: General business knowledge and experience usually are sufficient. Important factors to consider are education, occupation, business and investment experience and net worth. An investor having a sophisticated representative probably (but not always) satisfies this test. Alternatives to sophistication are the financial ability to bear risks (in other words, the investor's wealth) and the existence of a special relationship to the issuer (for example, insider or privileged status, or personal relationship).
- *The nature and kind of information provided to offerees or to which offerees have ready access*: The disclosure need not be as extensive as that in a registered offering, but must be factually equivalent. Disclosing basic information regarding the issuer's financial condition, business, results of operations, and management is satisfactory. All information must be made available prior to sale.
- *Actions taken by the issuer to prevent the resale of securities*: Securities must come to rest in the hands of immediate investors. Premature re-sales of securities may be deemed a public distribution and considered part of the original offering. Failure to satisfy the conditions of Section 4(a)(2) with respect to the entire transaction will result in failure to qualify for the Section 4(a)(2) exemption. Investors who do not purchase with the requisite investment intent and who resell the securities

may be deemed statutory underwriters and may be unable to rely on the Section 4(a)(1) resale exemption. Issuers generally take certain precautions to prevent the resale of their securities, including obtaining a written representation from each investor that it is acquiring the securities for investment and not with a view to distribution, placing restrictive legends on the securities, and issuing stop transfer orders with respect to the securities. The nature of the securities (in other words, debt or equity) is irrelevant to the availability of the Section 4(a)(2) exemption.

These factors, while helpful, do not provide certainty for an issuer that seeks to conduct a private placement. In response, the SEC adopted Regulation D in 1982 to provide issuers with safe harbours for conducting Section 4(a)(2) private placements.

The Section 4(a)(2) exemption is available only to the issuer of the securities. This exemption is not available for the resale of securities purchased by investors in a private placement. The issuer claiming the Section 4(a)(2) exemption has the burden of establishing that the exemption is available for the particular transaction. If securities are sold without a valid exemption from registration, Section 12(a)(1) of the Securities Act gives the purchaser the right to rescind the transaction for a period of one year after the sale. The rescissionary right may be exercised against anyone who was involved in the sale of the security, including issuer and any broker-dealer that may have acted as a financial intermediary or placement agent in connection with the offering. Further, transactions that are not deemed exempt under Section 4(a)(2) will be treated as an unregistered public offering, and the issuer may be subject to liability under US federal securities laws.

Regulation D

Regulation D is a non-exclusive safe harbour, which means an issuer that fails to satisfy the objective criteria of Regulation D still may rely on Section 4(a)(2). Regulation D is available only to issuers, and applies only to a particular transaction. Therefore, resales of securities must be registered or made pursuant to another exemption.

Regulation D does not exempt the issuer from any other applicable US federal or state laws relating to the offer and sale of securities. Regardless of whether an issuer relies on Section 4(a)(2) or Regulation D, an issuer must be able to document its compliance with the relevant exemption in the following ways: through record keeping with respect to investors; by controlling the distribution of the offering memoranda; and by receiving and retaining appropriate subscription documents evidencing the nature and qualification of investors. Regulation D is comprised of eight rules—Rules 501 through 508:

- Rule 501 sets forth definitions for terms used throughout Regulation D.
- Rule 502 sets forth the general conditions relating to integration of offerings, information requirements, limitations on manner of offering, and limitations on resale.
- Rule 503 requires notices for sales.
- Rule 504 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to $1 million.
- Rule 505 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to $5 million.
- Rule 506, which is the rule most often relied on for Regulation D private placements, provides an exemption for limited offerings and sales without regard to dollar amount, and with or without general solicitation.[3] Although the number of purchasers under Rule 506 is limited to 35, issuers may sell securities under Rule 506 to an unlimited number of "accredited investors" (AIs) which are typically institutional investors or high net-worth individuals.[4] Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.
- Rule 507 states that no exemption under Rules 504, 505 or 506 will be available for an issuer if such issuer or any of its predecessors or affiliates has been subject to any order, judgment or decree of any court of competent jurisdiction temporarily, preliminarily or permanently enjoining such entity for failure to comply with Rule 503.
- Rule 508 states that a failure to comply with a term, condition or requirement of Rules 504, 505 or 506 will not result in the loss of the exemption from registration if the person relying on the exemption shows that: (1) the failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; (2) the failure to comply was insignificant with respect to the offering as a whole; and (3) a good faith and reasonable attempt was made to comply with all the applicable terms, conditions and requirements of Rules 504, 505 or 506. A failure by an issuer to perform a factual inquiry and provide any disclosure regarding "bad actor" events required by Rule 506 would not be considered an "insignificant" deviation, and relief would not be available under Rule 508 if this disclosure is required and not adequately provided.[5]

The SEC used authority granted by Section 3(b) of the Securities Act to establish Rules 504 and 505 of Regulation D. Under Section 3(b), transactions can be exempted from registration based on the limited size or limited character of the offering. Therefore, Rules 504 and 505 exempt certain offerings with a total size of up to $5 million. These exemptions were created to help small businesses raise capital. In contrast, the SEC established Rule 506 as a non-exclusive safe harbour under Section 4(a)(2). Rule 506 provides the clearest guidance on the availability of Section 4(a)(2). Typically, issuers try to follow Rule 506 closely to conduct Section 4(a)(2) private placements. Like securities sold under Section 4(a)(2), securities sold under

Regulation D (except for certain securities sold under Rule 504 of Regulation D) are considered restricted securities for purposes of Rule 144 and cannot be freely resold to the public without registration or exemption from registration.

Questionnaires

The issuer typically uses investor questionnaires to help collect and verify information about potential investors' suitability to participate in the offering. A potential investor can qualify to participate in the offering if it is a sufficiently sophisticated investor or by using a purchaser representative. In such cases, a questionnaire is also sent to the purchaser representative to verify that it is qualified to participate.

The issuer has the burden of determining the status of potential investors. If the issuer sells unregistered securities to an unqualified investor, the issuer cannot rely on the private placement exemption. Selling without a registration statement or valid registration exemption gives each purchaser (not just the unqualified purchaser) the right to rescind or cancel its purchase and recover the purchase price (plus interest) from the issuer for one year after the sale. Under Section 12(a)(1) of the Securities Act, a purchaser no longer holding the securities can recover damages from the issuer regardless of whether or not its losses arise from the issuer's failure to register those securities. To avoid this strict liability, issuers rely on investor questionnaires to protect the availability of their registration exemptions. Together, the purchaser representative questionnaire and the investor questionnaire help the issuer establish the status of its investor base and avoid strict liability under Section 12(a)(1) of the Securities Act.

Information requirements for non-accredited investors

To use Rule 505 or 506, the issuer must provide each non-accredited investor with certain information. Rule 502(b)(2) of Regulation D requires disclosure similar to the type provided in a Securities Act registration statement. For example, depending on the size of the offering, issuers should provide non-accredited investor with the most recent balance sheet, income statements, statements of stockholders' equity and similar audited financial statements for the preceding two years, as well as a description of the issuer's business and the securities in the offering. The issuer must also provide non-accredited investors with a brief written description of any material information about the offering that is given to accredited investors. While disclosure requirements are not applicable to offerings made to accredited investors, it is best practice to provide the same information to both accredited and non-accredited investors in light of the antifraud provisions of the federal securities laws. More often than not, issuers will limit their offerings to accredited investors only and may not produce a disclosure document in connection with the financing.

Issuers must give all investors the opportunity to ask questions about the terms and conditions of the offering and to verify the accuracy of the disclosed written information. This due diligence is often done in a telephone conference call with members of the issuer's management team and counsel. For Regulation D offerings involving a business combination or exchange offer, the issuer must also provide written information about any terms or arrangements in the proposed transaction that are materially different from those for all other security holders.

The three Regulation D exemptions have the following limitations:

	Rule 504	Rule 505	Rule 506(b)	Rule 506(c)
Maximum size of offering	$1 million per year.	$5 million per year.	No limit on size of offering.	No limit on size of offering.
Issuers permitted to rely on this exemption	Non-reporting companies (including foreign private issuers that provide information under Rule 12g3-2(b) of the Exchange Act), companies that are not investment companies (as defined in the Investment Company Act of 1940, as amended) and blank check companies.	Companies that are not investment companies, subject to the following exception: Bad actor disqualification for companies where any officers, directors, general partners, 10% owners or underwriters have been convicted or subject to an SEC order within the past five to 10 years.	Any issuer. It is used by both reporting companies and nonreporting companies. Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.	Any issuer. It is used by both reporting companies and nonreporting companies. Rule 506(d) prohibits the use of the exemption by certain bad actors and felons.
Types of investors that can buy the securities	Any investor. No limitation on the number of investors or requirement of sophistication.	An unlimited number of accredited investors and up to 35 non-accredited investors.	An unlimited number of accredited investors and up to 35 non-accredited investors (who alone or together with their purchaser representatives must be sophisticated investors).	Purchasers must be accredited investors. Issuer must take reasonable steps to verify accredited investor status.
Issuer to furnish certain information?	No.	Yes, to non-accredited investors.	Yes, to non-accredited investors.	N/A
Prohibition on general solicitation or advertisement?	Yes, subject to the two exceptions provided by Rule 504(b)(1).	Yes.	Yes.	No.
Limitations on resale of securities?	Yes, subject to the two exceptions provided by Rule 504(b)(1).	Yes.	Yes.	Yes.
Subject to integration?	Yes.	Yes.	Yes.	Yes.
Form D filing?	Yes.	Yes.	Yes.	Yes.

Restriction on general solicitation and advertising

Rule 502(c) of Regulation D prohibits any general solicitation or advertising of the unregistered offering by the issuer or any person acting on its behalf. General solicitation is also prohibited in a Section 4(a)(2) offering. This prohibition extends to advertisements, articles, notices or other publication in any US newspaper, magazine or similar media (including the internet), broadcasts over US television or radio (including the internet) and any seminar or meeting in the US whose attendees have been invited by any general solicitation or advertisement.[6] The SEC Staff has provided guidance regarding the types of communications that would be viewed as constituting a "general solicitation." Effective September 2013, Rule 502(c) was amended to allow general solicitation under Rule 506(c) if all purchasers are accredited investors, or the issuer reasonably believes that they are, immediately prior to the sale, and certain other requirements are met. An issuer may still choose to conduct a Rule 506(b) offering without using general solicitation, in which case it may offer and sell securities to non-accredited and accredited investors.

For reporting companies offering securities to non-accredited investors, the prohibition on general solicitation is weighed against the issuer's obligation to inform its investors of material events, such as new securities offerings and the use of proceeds from such offerings. Rule 135c of the Securities Act addresses this tension by providing a safe harbour from the prohibition for certain public announcements of unregistered offerings. To use Rule 135c, the following conditions must be met:

- The issuer must be a reporting company under the Exchange Act or claim the Rule 12g3-2(b) exemption from registration under the Exchange Act.
- The press release cannot be made to condition or prime the US market for the offered securities. Given this condition, most issuers are advised to publish the notice only after completing the solicitation phase of the offering or excluding potential investors who start communicating with the offering participants after publication of the notice.
- The type of information disclosed must be of the same general type allowed in press releases for registered offerings, such as name of the issuer, title and amount of the offering, the interest rate and maturity date of the securities, closing date of the offering, the purpose of the offering without naming the initial purchasers or parties acting as underwriters for the unregistered offering and any statements or legends required by US state or non-US law. The type of information disclosed also depends on the offering type.
- The press release must contain a restricted legend stating: "The securities have not been registered under the Securities Act and cannot be sold in the US without registration or an applicable registration exemption."
- The issuer must file a copy of the press release with the SEC on Form 6-K if it is a reporting issuer, or must publish it electronically in accordance with Rule 12g3-2(b).

Six-month integration safe harbour

For a valid Regulation D offering, all sales that are part of the same Regulation D offering must satisfy all of the terms and conditions of Regulation D. To determine which sales form a part of the same Regulation D offering, Rule 502(a) of Regulation D provides a six-month integration safe harbour. It provides that offers and sales made more than six months before the start, and more than six months after the completion, of a Regulation D offering are not typically integrated with each other. This six-month rule is also relevant to the Section 4(a)(2) integration analysis. Offers and sales made under employee benefit plans are allowed during this six-month period and are not integrated with the Regulation D offerings. There also are a number of other specific integration safe harbours.

For offers and sales made during the six-month period, securities counsel can help determine if different offerings should be integrated. The integration analysis becomes important in certain situations, including:

- Where an issuer sells to non-accredited investors in a continuous offering, or in a series of private placements, the issuer must determine if it sold to more than 35 non-accredited investors. When computing the number of buyers under Rule 501(h), any Regulation D offerings made simultaneously, or within six months of offerings made outside of the US in compliance with Regulation S, are not integrated. In this case, non-US investors are not relevant to the 35 non-accredited investors limit.
- Where there may have been a violation of the prohibition against general solicitation or advertising. In this situation, the issuer must determine the scope of the offering with which the questionable communication is linked.
- Where the issuer conducts concurrent private and public offerings. Under certain circumstances, there can be a private offering under Rule 506 of Regulation D or Section 4(a)(2) and a registered public offering that are not integrated.[7] For example, the private and public offerings would not be integrated if the investors in the private offering were not solicited through the registration statement, but rather through a substantive, pre-existing relationship with the issuer.[8]

Form D filing

Regulation D requires an issuer (whether or not it is a reporting company) to file with the SEC a notice on Form D no later than 15 days after the first sale of securities made under Regulation D. Typically, issuers often comply with Regulation D in all other respects, other than this filing requirement. However, there can be instances when issuers prefer to make a Form D filing to give the SEC notice of their unregistered offerings and ensure their private placements fall within the black letter of Regulation D.

In connection with the amendments to Rule 506 effective September 2013, Form D was amended to add a check box to Item 6 for specifying the use of Rule 506(c) (offerings to accredited investors using general solicitation). The signature box was also amended to add a certification that the issuer is not disqualified from relying on Rule 506 due to the disqualification provisions of Rule 506(d).

The Form D filing is no longer a condition to the availability of Regulation D for a particular offering. However, under Rule 507, the SEC can prohibit an issuer who was previously subject to an injunction for failing to file Form D, from future reliance on Regulation D (unless the SEC determines, on a showing of good cause, that the exemption should not be denied).

Private placement documentation

Securities acquired pursuant to a Section 4(a)(2) offering may be immediately resold under Rule 144A. The intent to resell under Rule 144A is not inconsistent with Section 4(a)(2) and does not affect the availability of the issuer's exemption. In a Rule 144A transaction, an investment bank, acting as the initial purchaser, will agree to purchase on a firm commitment basis in a Section 4(a)(2) private placement unregistered securities from an issuer and the investment bank then immediately resells these securities only to QIBs (or to other purchasers that the investment bank and any persons acting on its behalf reasonably believe to be QIBs). As a result, Rule 144A transactions are structured as principal transactions. In a Section 4(a)(2) transaction, an investment bank will agree to place the unregistered securities, on a best efforts basis, with investors who may choose to hold the securities for the long-term or resell the securities to a purchaser pursuant to another exemption from registration (usually, a Rule 144A resale to a QIB).

Some 4(a)(2) transactions may be structured so that the initial purchasers are all QIBs; in these "144A qualifying" transactions, the investment bank will act on an agency basis to arrange the sale of the securities directly by the issuer to the QIB investors. Each QIB investor, in its securities purchase agreement, will make the usual representations made by a purchaser in a Section 4(a)(2) offering – including that it understands that the securities are restricted securities and cannot be freely resold, that it can fend for itself in the transaction and that it has such knowledge and experience in business matters so as to be capable of evaluating the merits and risks of the prospective investment and that it has the ability to bear the economic risks of the investment, including the complete loss thereof. When all of the investors in a 144A qualifying Section 4(a)(2) private placement are QIBs, the securities will be eligible for settlement and transfer through The Depository Trust Company.

The following is a description of Section 4(a)(2) private placement documentation. For a discussion of documentation for a Rule 144A offering, please refer to Chapter 5 (Mechanics of a Rule 144A/Regulation S offering).

The documentation typically used in Section 4(a)(2) private placements includes a private placement memorandum, a securities purchase agreement and a placement agency agreement, along with legal opinions, comfort letters, and other ancillary documentation.

Private placement memorandum

Section 4(a)(2) does not require specific disclosure for an offering document. The information that is included in a private placement memorandum (PPM) will vary greatly depending on the type of offering. For example, an offering memorandum used for a Rule 144A offering will be very different from a PPM used for a Section 4(a)(2) offering to a small number of investors.[9] By and large PPMs or offering circulars used in a Rule 144A offering will be detailed and may be similar to the type of the disclosure contained in a prospectus. However, a PPM for a 4(a)(2) offering may contain an abbreviated business description, risk factors, some financial information and possibly incorporate other publicly available information about the issuer.

Securities purchase agreement

The form, organisation, and content of a securities purchase agreement for a Section 4(a)(2) private placement will differ depending on the type of offering. Many foreign issuers offer debt securities in cross-border debt private placements. The buyers in these offerings usually are institutional investors, often including insurance companies and pension funds. These cross-border private placements are often referred to as "insurance private placements". The documentation for these cross-border private placements has become quite standardised over the years.

The securities purchase agreements in these transactions are typically based on approved forms that contain standard representations and warranties related to the issuer, the securities offered, the business and other representations designed to supplement the due diligence investigation of the placement agent (if applicable) and the purchasers. In addition, the agreement will contain representations, warranties and covenants specific to the Section 4(a)(2) offering, including, the issuer has not engaged in general solicitation or general advertising, the issuer has not engaged in other offerings that may be "integrated" with the Section 4(a)(2) offering and the offered securities qualify for the Section 4(a)(2) exemption. Unlike an underwriting agreement for a public offering, the purchasers in a Section 4(a)(2) private placement will also make limited representations to, and warranties and covenants with, the issuer, including that the purchasers are accredited investors and the purchasers understand the risks of an investment in the securities.

Placement agency agreement

A placement agency agreement may be used in the context of certain private placements, although it is not common to use a placement agency agreement in the context of cross border debt private placements. More often than not, the issuer will enter into an engagement letter with the placement agent, which will address the fees and expenses to be paid by the issuer in connection with the transaction, as well as the term of the engagement. The engagement letter may contain certain basic representations and warranties from the issuer to the placement agent. The engagement letter generally also will provide that the placement agent will receive the benefit of and be entitled to rely on the representations and warranties of the issuer and of the investor made in the securities purchase agreement as well as on any legal opinion delivered by the issuer's counsel to the investors.

Comfort letters and legal opinions

While a comfort letter (a letter from the issuer's independent certified accountants that the financial statements included in an offering document meet specified applicable standards) will almost invariably be delivered in connection with a Rule 144A offering, it is usually not requested in a 4(a)(2) offering to institutional investors.

In a Section 4(a)(2) private placement, counsel to the issuer and, to a more limited extent, counsel to the placement agent (if applicable) or the purchasers, are required to provide standard corporate and transaction opinions. In addition, to the extent that a PPM was prepared and used in connection with the offering, financial intermediaries may require that issuer's counsel deliver negative assurance letters (also referred to as 10b-5 letters).

ENDNOTES

1. *See* SEC Release No. 33-3825; SEC Release No. 33-4552; and SEC Release No. 33-5121.

2. General solicitation is permitted in Rule 506 offerings, but not in 4(a)(2) offerings.

3. Rule 506 of Regulation D is based on Section 4(a)(2), while Rules 504 and 505 were promulgated under Section 3(b) of the Securities Act.

4. Rule 501 promulgated under Regulation D sets forth the definition of an "accredited investor." In order for an individual to qualify as an accredited investor, he or she must : (1) earn an individual income of more than $200,000 per year, or a joint income of $300,000, in each of the last two years and expect to reasonably maintain the same level of income; (2) have a net worth exceeding $1 million, either individually or jointly with his or her spouse; or (3) be a general partner, executive officer, director or a related combination thereof for the issuer of a security being offered. Accredited investors are not counted as "purchasers" for purposes of counting purchasers under Regulation D.

5. *See* SEC Release No. 33-9414; File No. S7-21-11 (September 23 2013).

6. We discuss the SEC Staff's guidance regarding the types of communications that constitute a general solicitation in "Practice Pointers on Navigating the Securities Act's Prohibition on General Solicitation and General Advertising," available at

7. *See* SEC Release No. 33-8828 and the Black Box Incorporated (June 26 1990) and Squadron, Ellenoff, Pleasant & Lehrer (February 28 1992) SEC no-action letters.

8. *Id.*

9. We discuss offering circulars in the context of a Rule 144A offering in Chapter 5 (Mechanics of a Rule 144A/Regulation S offering).