

Investor Bulletin: Private Placements Under Regulation D

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The SEC's Office of Investor Education and Advocacy is issuing this Investor Bulletin to educate investors about investing in unregistered securities offerings, or private placements, under Regulation D of the Securities Act.

What is a private placement?

A securities offering exempt from registration with the SEC is sometimes referred to as a *private placement* or an *unregistered offering*. Under the federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available.

Generally speaking, private placements are not subject to some of the laws and regulations that are designed to protect investors, such as the comprehensive disclosure requirements that apply to registered offerings. Private and public companies engage in private placements to raise funds from investors. Hedge funds and other private funds also engage in private placements.

As an individual investor, you may be offered an opportunity to invest in an unregistered offering. You may be told that you are being given an exclusive opportunity. The opportunity may come from a broker, acquaintance, friend or relative. You may have seen an advertisement regarding the opportunity. The securities involved may be, among other things, common or preferred stock, limited partnerships interests, a membership interest in a limited liability company, or an investment product such as a note or bond. **Keep in mind that private placements can be very risky and any investment may be difficult, if not virtually impossible to sell.**

Red flags. Fraudsters may use unregistered offerings to conduct investment scams. See our Investor Alert about red flags to watch out for in an unregistered offering.

Unregistered offerings often can be identified by capitalized legends placed on the offering documents and on the certificates or other instruments that represent the securities. The legends will state that the offering has not been registered with the SEC and the securities have restrictions on their transfer. You should read the offering documents carefully to understand the risks involved.

What is Regulation D?

When reviewing private placement documents, you may see a reference to *Regulation D*. Regulation D includes three SEC rules—*Rules 504, 505 and 506*—that issuers often rely on to sell securities in unregistered offerings. The entity selling the securities is commonly referred to as the *issuer*. Each rule has specific requirements that the issuer must meet. **If you have reason to believe that an unregistered offering claiming to rely on one of these rules does not satisfy the applicable requirements, consider this a red flag about the investment.**

Rule 504

Rule 504 permits certain issuers to offer and sell up to \$1 million of securities in any 12-month period. **These securities may be sold to any number and type of investor, and the issuer is not subject to specific disclosure requirements.** Generally, securities issued under Rule 504 will be *restricted securities* (as further explained below), unless the offering meets certain additional requirements. As a prospective investor, you should confirm with the issuer whether the securities being offered under this rule will be restricted.

Rule 505

Under Rule 505, issuers may offer and sell up to \$5 million of their securities in any 12-month period. There are limits on the types of investors who may purchase the securities. The issuer may sell to an unlimited number of *accredited investors*, but to no more than 35 non-accredited investors. If the issuer sells its securities to non-accredited investors, the issuer must disclose certain information about itself, including its financial statements. If sales are made only to accredited investors, the issuer has discretion as to what to disclose to investors. Any information provided to accredited investors must be provided to non-accredited investors.

Accredited investor. An individual will be considered an *accredited investor* if he or she:

- earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, **OR**
- has a net worth over \$1 million, either alone or together with a spouse (excluding the value of the person's primary residence and any loans secured by the residence (up to the value of the residence)).

Rule 506

An unlimited amount of money may be raised in offerings relying on one of two possible Rule 506 exemptions. Similar to Rule 505, an issuer relying on Rule 506(b) may sell to an unlimited number of accredited investors, but to no more than 35 non-accredited investors. However, unlike Rule 505, the non-accredited investors in the offering must be financially sophisticated or, in other words, have sufficient knowledge and experience in financial and business matters to evaluate the investment. This sophistication requirement may be satisfied by having a *purchaser representative* for the investor who satisfies the criteria. An investor engaging a purchaser representative should pay particular attention to any conflicts of interest the representative may have.

As with a Rule 505 offering, if non-accredited investors are involved, the issuer must disclose certain information about itself, including its financial statements. If selling only to accredited investors, the issuer has discretion as to what to disclose to investors. Any information provided to accredited investors must be provided to non-accredited investors.

General advertising. Issuers relying on the Rule 506(c) exemption can generally advertise their offerings. As a result, you may see an investment opportunity advertised through the Internet, social media, seminars, print, or radio or television broadcast. **Only accredited investors, however, are allowed to purchase in a Rule 506(c) offering that is widely advertised, and the issuer will have to take reasonable steps to verify your accredited investor status.**

What should you do before investing?

Private placements may be pitched as a unique opportunity being offered to only a handful of investors, including you. Be careful. Don't be fooled by this high-pressure sales tactic. Even if the deal is "unique," it may not be a good investment. **It is important for you to obtain all the information that you need to make an informed investment decision.** In fact, issuers relying on the Rule 505 and 506(b) exemptions from registration must provide non-accredited investors an opportunity to ask questions and receive answers regarding the investment. If an issuer fails to adequately answer your questions, consider this a warning against making the investment.

Unlike registered offerings in which certain information is required to be disclosed, investors in private placements are generally on their own in obtaining the information they need to make an informed investment decision. Investors need to fully understand what they are investing in and fully appreciate what risks are involved.

Some things to consider.

- What do the financial statements, if provided, tell you about the business?
- Are the claims and expectations reasonable?
- How reasonable is the issuer's reliance on a particular technology, customer, product or natural resources claim?
- Who are the issuer's competitors?
- What is the experience and background of management?
- How long has the issuer been in business and has the issuer conducted prior offerings?
- How does the issuer plan to use the money raised?
- If the securities you are investing in have transfer restrictions, when will and how may the restrictions be lifted?
- Because you may not be able to resell your investment easily, are you comfortable holding it indefinitely?

In practice, issuers often provide a document called a *private placement memorandum* or *offering memorandum* that introduces the investment and discloses information about the securities offering and the issuer. However, this document is not required and the absence of this document or similar disclosure may be a red flag to consider before investing. ***Moreover, private placement memoranda typically are not reviewed by any regulator and may not present the investment and related risks in a balanced light.***

All issuers relying on a Regulation D exemption are required to file a document called a Form D no later than 15 days after they first sell the securities in the offering. The Form D will include brief information about the issuer, its management and promoters, and the offering itself. If the offering you are considering has prior sales, you can search for the Form D filing on the SEC's website at sec.gov/edgar/searchedgar/webusers.htm.

Form D is not registration. Fraudsters may try to lure you into investing with them by falsely claiming to be registered, or that the offering is registered, with the SEC. In a recent case, *SEC v. Fleet Mutual Wealth*, the SEC obtained a federal court order freezing stolen investor money. The SEC alleged that the defendants falsely promised investors guaranteed returns of 2%-3% per week through the use of a high frequency trading strategy, but instead used investors' money to operate a pyramid scheme. The defendants allegedly recruited investors by falsely claiming that their firm was "registered" or "duly registered" with the SEC and pointing to the firm's Form D filings to support this misrepresentation.

What if my broker recommends the investment?

If your broker recommends the investment, you should know that your broker, along with his or her firm, has a duty to conduct a reasonable investigation of the investment and the issuer's representations about it. The scope of the investigation depends on the circumstances of the investment, including its complexity and the risks involved. For example, the private placement of shares by a large public company may warrant less investigation than a start-up with little or no track record. Generally, a broker should not just rely blindly on the issuer for information but should separately investigate and verify an issuer's statements and claims. If your broker is recommending the investment and fails to satisfy its duties to investigate the issuer and the offering, this failure could constitute a violation of the antifraud provisions as well as other federal securities laws.

In addition, your broker must determine whether an investment in the private placement is *suitable* for you. This means your broker will have to consider factors such as your age, financial situation, current and future needs, investment objectives and tax status.

Your broker's duties, however, should not substitute for your own judgment in making the investment. ***Your broker can assist and enable you to better understand the opportunity and risks, as well as investigate and gather additional information, but it is your money,***

your risk and your decision whether to invest. You should also ask about the compensation your broker is receiving for the transaction and any relationships, business ties or other conflicts of interest that may exist between your broker and the issuer.

Brokers' misconduct. In *SEC v. Provident Royalties, LLC*, Provident allegedly raised \$485 million through various unregistered offerings from at least 7,700 investors nationwide, promising high returns and misrepresenting how investor funds would be used. In a separate case, the Financial Industry Regulatory Authority (FINRA)—a body that regulates brokers—sanctioned a number of brokers involved in the offerings for selling securities without having a reasonable basis for recommending the securities.

In another case, *In the Matter of Advanced Equities, Inc.*, the SEC charged a broker with allegedly making exaggerated misstatements to investors when pitching an unregistered offering of securities in a non-public alternative energy company. The SEC alleged, for example, that the broker said the company had more than \$2 billion in order backlogs when the backlog never exceeded \$42 million.

Investment advisers. *Investment advisers* are subject to different duties than brokers. Investment advisers have a fiduciary duty to act in the best interests of their clients. The background and qualifications of an investment adviser registered with the SEC are available through the Investment Adviser Public Disclosure website.

What should I know about restricted securities?

Generally, most securities that you acquire in a private placement will be *restricted securities*. **You should not expect to be able to easily and quickly resell your restricted securities. In fact, you should expect to hold the securities indefinitely.**

There are two principal things to think about before buying restricted securities. The first is that unless you have made arrangements with the issuer to resell your restricted securities as part of a registered offering, you will need to comply with an exemption from registration to resell. One *rule* commonly relied upon to resell requires you to hold the restricted securities for at least a year if the company does not file periodic reports (such as annual and quarterly reports) with the SEC. You may wish to hire an attorney to help you comply with the legal requirements to resell restricted securities. Issuers may require a legal opinion that you satisfy an exemption to resell your restricted securities.

The second thing to think about is whether they are easy to sell. This issue primarily affects the sale of restricted securities in private companies. Information about a private company is not typically available to the public, and a private company may not provide information to you or your buyer. The restricted status of your securities may also transfer to your buyer. For these reasons, it may be difficult to attract buyers.

In addition to these considerations, specific contractual restrictions that you may enter into when investing may prevent you from freely transferring the securities.

What else should I know?

Despite not being subject to the same disclosure obligations as registered offerings, private placements are subject to the antifraud provisions of the federal securities laws. Any information provided must be true and may not omit any material facts necessary to prevent the statements made from being misleading. **You should be aware that it may be difficult or impossible to recover the money you invest in an offering that turns out to be fraudulent.** In addition, even though the offering may be exempt from SEC registration, the offering may have to separately comply with state securities laws, including state registration requirements or a state exemption from registration.

Background check. It is always a good idea to check on the background of an investment professional. It is easy and free. Details of an investment professional's background and qualifications are available through the Investment Adviser Public Disclosure website and FINRA's BrokerCheck. If you have any questions on checking the background of an investment professional, call the SEC's toll-free investor assistance line at (800) 732-0330. You can also check with your state securities regulator regarding the person soliciting your investment.

Private placements may offer great opportunity. However, the attractive potential rewards often come with high risks of loss.

Additional Information

For more information about Regulation D offerings, please visit sec.gov/answers/regd.htm.

For our Investor Alert about red flags to watch out for in an unregistered offering, visit investor.gov/news-alerts/investor-alerts/investor-alert-10-red-flags-unregistered-offering-may-be-scam.

For our Investor Bulletin about hedge funds, visit investor.gov/news-alerts/hedge-funds.

For more information about restricted securities, visit sec.gov/investor/pubs/rule144.htm.

For our Investor Bulletin about accredited investors, visit investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors.

For our Investor Alert about generally advertised unregistered offerings, visit investor.gov/news-alerts/investor-alerts/investor-alert-advertising-unregistered-securities-offerings.

For the SEC release regarding *SEC v. Provident Royalties, LLC*, visit sec.gov/litigation/litreleases/2009/lr21118.htm.

For FINRA's news releases regarding the sanctioning of brokers in connection with the Provident Royalties offerings, visit finra.org/newsroom/newsreleases/2011/P123441 and finra.org/newsroom/newsreleases/2011/P125193.

For FINRA's regulatory notice regarding a broker-dealer's obligation to conduct reasonable investigations, visit finra.org/Industry/Regulation/Notices/2010/P121299.

For the SEC release regarding *In the Matter of Advanced Equities, Inc.*, visit sec.gov/News/PressRelease/Detail/PressRelease/1365171484816.

For more information about investment advisers, visit investor.gov/researching-managing-investments/working-investment-professionals/brokers-advisors/research-advisor.

For our Investment Adviser Public Disclosure (IAPD) website, visit adviserinfo.sec.gov.

For FINRA's BrokerCheck resource, visit www.finra.org/Investors/ToolsCalculators/BrokerCheck/.

For more information about recovering funds from fraudulent investment schemes, visit sec.gov/answers/recoverfunds.htm.

For our Investor Alert about false claims of SEC registration, visit investor.gov/news-alerts/investor-alerts/investor-alert-beware-false-claims-sec-registration.

For the SEC release regarding *SEC v. Fleet Mutual Wealth*, visit sec.gov/News/PressRelease/Detail/PressRelease/1370540883619.

For our Investor Alert about pyramid schemes, visit investor.gov/news-alerts/investor-alerts/investor-alert-beware-pyramid-schemes-posing-multi-level-marketing-progr.

For our Investor Alert about marijuana-related investments, visit investor.gov/news-alerts/investor-alerts/investor-alert-marijuana-related-investments.

For our Investor Alert about Bitcoin and other virtual currency-related investments, visit investor.gov/news-alerts/investor-alerts/investor-alert-bitcoin-other-virtual-currency-related-investments.

For our Investor Alert about private oil and gas offerings, visit investor.gov/news-alerts/investor-alerts/investor-alert-private-oil-gas-offerings.

For FINRA's investor alert about private placements, visit finra.org/Investors/ProtectYourself/InvestorAlerts/PrivateOfferings/P339650.

For NASAA's investor alert about private placements, visit nasaa.org/wp-content/uploads/2013/04/Private-Placements.pdf.

For additional educational information for investors, see the SEC's Office of Investor Education and Advocacy's website for investors, Investor.gov.

The Office of Investor Education and Advocacy has provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.