

In This Issue

- Letter from the Editor
- Fundraising and the Securities Laws

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Caplan Law is a business law firm dedicated to providing quality legal services to the private equity industry. The firm has a focus on early-stage investments in the technology, entertainment, energy, and real estate sectors.

Letter from the Editor

This newsletter addresses legal issues relevant to the private equity industry. The term "private equity" includes a variety of investment funds – venture funds, buyout funds, hedge funds, and other types.

The main focus of this newsletter is venture funds, especially those providing early-stage development capital to companies and projects. Such funds are common in the technology, entertainment, energy, and real estate sectors, among others.

Best regards,
Jeffrey E. Caplan, Esq.

Fundraising and the Securities Laws

When raising capital from investors, fund managers must comply with a comprehensive regime of state and federal securities laws. The securities laws have a broad scope – for example, they apply to offers as well as sales, and to debt as well as equity.

This article provides an overview of three major requirements: information disclosure, offering registration, and broker-dealer licensing. The focus is on private placements, as opposed to public offerings.

Information Disclosure

Fund managers and their agents must accurately disclose all material information to investors. The term "material" lacks a precise definition, but standards have evolved over time.

The fund personnel should draft a comprehensive Private Placement Memorandum ("PPM") with the assistance of an experienced attorney. A PPM covers such matters as offering terms, fund structure, fund management, exit strategies, financial projections, and risk factors.

Distribute the PPM to every investor as early as possible in the fundraising process. If subsequent changes occur, consider distributing an amended version of the PPM. The goal is to provide investors with sufficient information and time to digest the information.

Keep careful records of all PPM deliveries and significant communications with investors. If feasible, number each PPM.

Registration Exemptions

All securities offerings in the United States must be registered with the Securities and Exchange Commission ("SEC") and state agencies unless exemptions apply.

At the federal level, the exemptions most likely to apply to venture funds are Section 4(2) of the Securities Act of 1933, and Rules 504, 505, and 506 of Regulation D ("Reg D"). Additional exemptions may apply. Some of the exemptions are denied to certain types of issuers.

Section 4(2) exempts issuer transactions "not involving any public offering". Although the statute itself fails to define the term "public offering", the SEC and courts typically look for such factors as the absence of public solicitations, low number of investors, and the ability of the investors to bear the risks of the investment and protect themselves from fraud. The dollar amount of the offering is irrelevant.

General Rules

Reg D provides some clarity to non-public offerings. When conducting a private offering under Reg D, the following rules usually apply:

1. Do not market the securities to the general public.
2. Prohibit resales of the securities until the expiration of the applicable holding period (typically one year).
3. If the offering has a stated minimum amount, hold the investor capital in a separate bank or escrow account until reaching the threshold. If the fund manager fails to reach the threshold by its self-imposed deadline, it must either return the capital or get the written consent of the investors to an extension of the deadline.
4. Treat related offerings as the same offering. Offerings are "related" when, for example, they occur during the same period (typically six months).

Not every rule applies to every exemption. For example, Rule 504 allows public solicitations if every purchaser of securities is an "accredited investor". Accredited investors are company insiders, wealthy individuals, and certain types of institutions.

The rule against public solicitations prohibits advertisements, seminars, cold-calls, mass mails, and spam emails, among other things. To be safe, do not mention the pending offering in any marketing materials, media interviews, industry meetings, or other public communications. Also require investors to sign a non-disclosure agreement ("NDA") prior to receiving a PPM.

Specific Rules

Rule 504 exempts securities issued for less than \$1,000,000, regardless of the number of investors or their qualifications.

Rule 505 exempts securities issued for less than \$5,000,000. The issuer may sell to an unlimited number of accredited investors and up to 35 other investors.

Rule 506 exempts offers and sales of an unlimited dollar amount to an unlimited number of accredited investors and up to 35 "sophisticated" investors. Investors are "sophisticated" if they or their representatives have (or at least reasonably appear to have) sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the investment.

State Exemptions

Funds must satisfy exemptions in every state where investors reside. The possible exemptions vary by state but generally correspond to the federal exemptions. Additional exemptions may be available.

States may also impose additional restrictions on securities offerings within their borders. Common examples include requiring filings prior to first offers, limiting the number of offerees, reviewing the merits of offerings, and prohibiting the payment of commissions to placement agents. However, federal law prohibits restrictions on Rule 506 offerings.

Filings

Section 4(2) does not require any government filings, but issuers relying on the Reg D exemptions must file a "Form D" within 15 days after the first sale of securities in each applicable jurisdiction. Failure to file does not invalidate the exemptions, but may result in fines and the loss of the exemptions in future offerings.

Placement Agents

The laws generally require all persons offering or selling securities to register as "broker-dealers" at both the state and federal levels.

Exemptions usually cover funds, fund managers, and fund personnel. However, any placement agents assisting with fundraising may be deemed "broker-dealers" but not fall within any exemption. In such event, both the placement agents and the fund managers are exposed to the risk of liability.

To minimize this risk, a fund manager should do the following:

1. Limit the role of the placement agent to providing introductions to potential investors, not negotiating investment terms or giving investment advice.
2. Compensate the placement agent only with fixed fees, as opposed to percentage commissions.
3. Demand contractual indemnifications from liability, if allowed by applicable law.

Conclusion

When raising capital for a venture fund, the fund manager should be careful to structure the offering in compliance with securities laws. The fund manager should accurately disclose all material information, satisfy the exemptions from registration, and take care when using an unlicensed placement agent.

Any legal violations will, at a minimum, give your investors the right to demand a return of capital plus interest. They may also seek reimbursement of their legal fees. If the violations are intentional, the investors may be able to recover punitive damages in some states, and the fund personnel may incur personal liability and criminal penalties.

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