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Direct Private Placements

William K. Sjostrom, Jr.¹

INTRODUCTION

The private placement of securities is an important capital source for many small businesses.² Oftentimes, the key to a successful private placement is attracting an investment banking firm to serve as placement agent on the deal. A placement agent brings two crucial attributes to a deal: a pool of accredited investors with whom it has a pre-existing, substantive relationship (a pool), and federal broker, state dealer, and agent registrations (registrations).³

Numerous companies, however, are unable to convince a placement agent to handle their private offerings. Thus, some of these companies pursue direct private placements, or DPPs.⁴ A DPP is a private securities offering to investors without the aid of a placement agent.⁵ In other words, it is an offering marketed and sold directly to investors by company personnel.

For most companies, pursuing a DPP is daunting because they have neither a pool nor registrations. Historically, the importance of a pool was greatly magnified by the ban on general solicitation and general advertising applicable to most types of exempt offerings. In July 2013, however, the Securities and Exchange Commission (SEC) adopted rule changes eliminating the ban for Rule 506 offerings limited to accredited investors.⁶ Hence, as discussed below, lack of a pool is now a less significant impediment to a DPP.

Conversely, the registrations impediment remains but has received little attention in the literature, perhaps because the efforts of the small business

¹ Professor of Law, University of Arizona James E. Rogers College of Law.
⁴ See Ivanov & Bauguess, supra note 3, at 3 (indicating that 87% of new Regulation D offerings since 2009 did not use an intermediary).
⁵ I believe that this Article coins the terms “direct private placement” and “DPP.” I view these terms as analogues to the previously coined terms “direct public offering” and “DPO” which refer to a public securities offering to investors without the aid of an underwriter. See generally William K. Sjostrom, Jr., Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?, 53 FLA. L. REV. 529 (2001) (discussing the emergence and stability of internet DPOs).
community were focused on eliminating the ban on general solicitation and advertising. Thus, below I examine federal broker and state dealer and agent regulations as applied to DPP companies and their personnel.

The Article proceeds as follows. Part I provides an overview of federal and state regulation of private placements. Part II examines the historical ban on general solicitation and advertising, its effect on DPPs, and the recent ban lifting. Part III summarizes federal and state broker, dealer, and agent regulations and discusses their application to DPP companies and personnel.

I. Private Placement Overview

Under the Securities Act of 1933 (Securities Act), every offer and sale of securities must be registered with the SEC unless the transaction or securities fall within an exemption from registration. Registering an offering with the SEC is expensive and time consuming and is therefore not an option for most small companies. Instead, these companies conduct their securities offerings in compliance with one of the registration exemptions included in the Securities Act or promulgated by the SEC under the Securities Act.

By far the most commonly utilized exemption for a capital raising transaction is the so-called private placement exemption provided by Securities Act Section 4(a)(2)/Rule 506. Section 4(a)(2) (formerly Section 4(2)) exempts from the registration requirement “transactions by an issuer not involving any public offering.” This means that, as a general matter, public offerings must be registered with the SEC but non-public offerings, or private placements, do not. The Securities Act is silent on what does and does not constitute a public offering, but the courts have filled in this omission.

The seminal opinion on the distinction is SEC v. Ralston Purina Co., which was issued by the Supreme Court in 1953. The case involved annual offerings by Ralston Purina, a manufacturer and distributor of feed and cereal products, of its common stock to select employees. In some years over 400 employees

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9 See Sjostrom, supra note 5, at 535–38.
10 See id. at 581–82.
11 See Ivanov & Bauguess, supra note 3, at 7 (“Most Regulation D offerings are issued under Rule 506, 94% since 2009 ... which provides a safe harbor for the private offering exemption under Section 4(a)(2) of the Securities Act ...”).
14 Id. at 120–21. The case focused on shares offered by Ralston Purina to employees who “without any solicitation by the Company or its officers or employees, inquire[d] of any of them as to how to purchase common stock of Ralston Purina Company.” Id. at 121.
purchased stock, including many in various low-level positions. At issue in the case was whether these offerings were nonpublic and therefore fell within the Section 4(a)(2) exemption. The lower court found that these offerings did fall within the exemption, reasoning that "the intra-organizational offerings of stock by [Ralston Purina], unaccompanied by any solicitation, which have resulted in a limited distribution of stock, for investment purposes, to a select group of employees considered by the management to be worthy of retention and probable future promotion" did not involve a public offering.

The Supreme Court reversed. It reasoned that the exemption should be interpreted in light of the statutory purpose of the Securities Act, which "is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions." "Since exempt transactions are those as to which 'there is no practical need for the bill's application,' the applicability of § 4(a)(2) should turn on whether the particular class of persons affected need the protection of the [Securities] Act." Hence, "a transaction 'not involving any public offering'" as used in Section 4(a)(2) is "[a]n offering to those who are shown to be able to fend for themselves . . ." The Court went on to say that the availability of the exemption "turns on the knowledge of the offerees," and that "[t]he focus of the inquiry should be on the need of the offerees for the protections afforded by registration." The Court concluded that the employees to whom Ralston Purina sold its stock "were not shown to have access to the kind of information which registration would disclose," and therefore the offerings were not exempt under Section 4(a)(2).

It was, of course, left to the lower courts to flesh out how to determine which offerees can fend for themselves and/or have the requisite access to information, among other things. Approaches to applying Ralston Purina varied. Some courts emphasized the relationship between the issuer and the purchaser, some focused on the sophistication of the purchasers, and some

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15 Id. at 121. ("Among those responding to these offers were employees with the duties of artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer, and veterinarian.").
16 Id. at 120.
18 Ralston Purina, 346 U.S. at 127.
19 Id. at 124–25.
20 Id. at 125.
21 Id.
22 Id. at 126.
23 Id. at 127.
24 Id.
stressed the type of disclosure made to purchasers and the number of offerees.\textsuperscript{28} One attorney categorized the resulting Section 4(a)(2) jurisprudence as "a kind of mishmash. The issuer is now told that all of these factors have something to do with whether he has an exemption under Section 4[(a)](2), but he is never given a hint as to the proper proportions in the brew. The saving recipe is kept secret, a moving target which he can never be sure he has hit."\textsuperscript{29}

Fortunately, the SEC has largely cleaned up the "mishmash" by adopting, revising, and reconfiguring various rules, culminating with the adoption of Rule 506 of Regulation D in 1982.\textsuperscript{30} Rule 506 serves as a "safe harbor" for Section 4(a)(2); that is, if an offering complies with the conditions specified in Rule 506, the offering will be deemed exempt under Section 4(a)(2).\textsuperscript{31} To fall within the safe harbor, the offering must be limited to accredited investors and no more than thirty-five non-accredited investors.\textsuperscript{32} Rule 501(a) defines "accredited investor." The definition includes banks, insurance companies, mutual funds, and certain other specified institutional investors; individuals with net worths in excess of $1,000,000, not including the value of the person's primary residence;\textsuperscript{33} annual incomes in excess of $200,000, or joint annual incomes in excess of $300,000; and executive officers and directors of the issuer.\textsuperscript{34} The safe harbor also requires that all non-accredited investors in the offering

\begin{itemize}
  \item \textsuperscript{28} See, e.g., SEC v. Cont'l Tobacco Co., 463 F.2d 137, 157 (5th Cir. 1972).
  \item \textsuperscript{29} Ray Garrett, Jr., The Private Offering Exemption Today, in FOURTH ANN. INST. ON SEC. REG. 3, 10-11 (Robert H. Mundheim et al. eds., 1973).
  \item \textsuperscript{30} Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6189, 47 Fed. Reg. 11,251, 11,252 (Mar. 8, 1982) (to be codified at 17 C.F.R. pts. 230 & 239). Regulation D contains two additional exemptions, Rule 504 and Rule 505, both of which were promulgated under Section 3(b) of the Securities Act. Id. at 11,252. Section 3(b) empowers the SEC to adopt rules exempting offerings of certain classes of securities up to 45 million "if it finds that the enforcement of [the Securities Act] ... is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." 15 U.S.C. § 77c(b)(1) (2012).
  \item \textsuperscript{31} 17 C.F.R. § 230.506(a) (2014) ("Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of [Rule 506] shall be deemed to be transactions not involving any public offering within the meaning of section 4(a) of the [Securities] Act."). Note that compliance with Rule 506 is a nonexclusive means by which an offering falls within Section 4(a); as Preliminary Note 3 to Regulation D explains, "an issuer's failure to satisfy all the terms and conditions of rule 506(b) (§230.506(b)) shall not raise any presumption that the exemption provided by section 4(a) (a) of the [Securities] Act (15 U.S.C. 77d(a)(a)) is not available." 17 C.F.R. § 230.500, Regulation D, Preliminary Note 3 (2014), available at http://www.sec.gov/rules/final/2013/33-9415.pdf (outlining use of Regulation D in subsection (c)).
  \item \textsuperscript{32} See 17 C.F.R. § 230.501(e) (2014); § 230.506(b)(2)(i). Technically, there could be more than thirty-five non-accredited investors, or purchasers, so long as the issuer reasonably believes that there are no more than thirty-five. Id. § 230.506(b)(1).
  \item \textsuperscript{34} § 230.501(a)(6).
\end{itemize}
are sophisticated, or that the issuer reasonably believes they are sophisticated.\textsuperscript{35} Sophistication in this context means that a non-accredited investor "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment," either in his own right or with the aid of one or more purchaser representatives.\textsuperscript{36}

The accredited investor concept is central in cleaning up the "mishmash." If an issuer excludes non-accredited investors from its private placement, as many issuers do,\textsuperscript{37} it does not have to make a subjective sophistication determination that could later be disavowed by the SEC or by a court. As the SEC explained:

\begin{quote}
[The accredited investor] approach is based on the presumption that accredited investors can fend for themselves without the protections afforded by registration and thereby satisfy the requirements of proposed Rule 506(b)(1), without a separate subjective determination by the issuer. The majority of commentators believed accredited investors as defined in proposed Rule 501(a) have the ability to fend for themselves in larger offerings contemplated under a Section 4(1)(a)(2) exemptive rule. The Commission agrees with these commentators . . . \textsuperscript{38}
\end{quote}

As for access to information, Rule 506 requires the issuer to furnish any non-accredited investors that purchase securities in the offering with certain specified information about the issuer and the offering within a reasonable time prior to the purchase.\textsuperscript{39} The rule contains no specific requirement that the issuer furnish accredited investors with information, but it does essentially instruct an issuer to provide to accredited investors any information that it furnished to non-accredited investors.\textsuperscript{40} Further, the issuer is required to afford all investors, whether or not accredited, "the opportunity to ask questions and receive answers concerning the terms and conditions of the offering . . ."\textsuperscript{41}

Additionally, Rule 506 (via Rule 502) prohibits the issuer and anyone acting on its behalf from soliciting investors through "any form of general solicitation or general advertising . . ."\textsuperscript{42} I discuss this prohibition in more detail below.\textsuperscript{43}

As a general matter, anyone offering or selling securities must also comply with the securities laws of the states in which they are making the offers and

\textsuperscript{35} See § 230.506(b)(2)(ii).
\textsuperscript{36} Id. For the definition of "purchaser representative," see § 230.501(h).
\textsuperscript{37} See Ivanov & Bauguess, supra note 3, at 3 (stating that in 2012 only 10% of new Regulation D offerings included non-accredited investors).
\textsuperscript{40} Rule 502(b)(1) includes a note that provides as follows: "When an issuer provides information to investors pursuant to paragraph (b)(1), it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws." Id.
\textsuperscript{41} § 230.502(b)(2)(v).
\textsuperscript{42} § 230.502(c).
\textsuperscript{43} See infra Part II.
sales, all of which, except for the state of New York,44 require registration, or qualification,45 of the offering with state regulators unless the offering falls within an exemption.46 In 1996, however, Congress passed the National Securities Markets Improvement Act ("NSMIA"), which, among other things, preempts state registration requirements for "covered securities."47 The definition of "covered security" includes a security sold under Rule 506.48 In other words, Rule 506 offerings are exempt from state offering registration requirements.

II. General Solicitation and Advertising

A. Overview

The ban on general solicitation and advertising appears in Rule 502 of Regulation D which is incorporated by reference into Rule 506. Rule 502 provides as follows:

Rule 502. General Conditions to be Met...
(c) Limitation on manner of offering...
[N]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:
(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. . . .

As you can see, the Rule does not define the phrase but does provide two examples of what constitutes general solicitation.

The scope of the ban is critical to the availability of Rule 506 (as well as some other exemptions) and thus the SEC has addressed it in a number of no-action letters and releases. For example, in a 2000 release the SEC stated: "[O]ne method of ensuring that a general solicitation is not involved is to

44 See 1 LOUIS LOSS ET AL., SECURITIES REGULATION 191 (4th ed. 2006) (noting that aside from the requirement that each dealer file a further state notice identifying each security offered and giving the name, address, and state of incorporation of its issuer, there are no other registration requirements in the state of New York for securities other than real estate syndication and intrastate offerings).


46 See generally LOUIS LOSS ET AL., supra note 44, at 155-222 (discussing states' Blue Sky Laws pertaining to (i) antifraud, (ii) registration of persons in the securities business, and (iii) registration of securities and identifying registration exemptions).


48 See 15 U.S.C. § 77r(b) (2012) (as mentioned above, the SEC issued Rule 506 under § 4(a)(2)).

establish the existence of a 'pre-existing, substantive relationship.' Even though the reference to "one method" indicates there are other ways to ensure general solicitation is not involved, the existence of a pre-existing, substantive relationship has become the de facto rule for establishing that a particular investor was not obtained through general solicitation.

The SEC considers a relationship pre-existing if it is established prior to the solicitation for the particular offering. The SEC considers a relationship substantive if it "would enable the issuer (or a person acting on its behalf) to be aware of the financial circumstances or sophistication of the persons with whom the relation exists or that otherwise are of some substance and duration." This is not the easiest standard to apply, but in a series of no-action letters the SEC has signed off on the use of an investor questionnaire asking about, inter alia, financial circumstances, education, occupation, and experience in investing in private placements as proof of the requisite relationship.

One of the effects of the SEC's narrow interpretation of what does not constitute general solicitation or advertising is greatly increasing the difficulty for a DPP company to secure investors for a Rule 506 offering. The company, for example, could theoretically send out questionnaires to every person in its region that owns a Ferrari sports car in an effort to establish the requisite pre-existing, substantive relationships with people who are likely to be accredited. However, it would have to do this well in advance of an actual offering because of the pre-existing requirement, and given identity theft and privacy concerns these days, it seems highly unlikely anyone would respond to a questionnaire from a random private company.

Placement agents do not face the same obstacles because they presumably have some name recognition, can offer the potential of multiple future investment opportunities, and are subject to regulation requiring the safeguard of client information. They also have a strong incentive to establish a pool of accredited investors with whom they have the requisite pre-existing, substantive relationships because they can essentially rent the relationships to a company undertaking a Rule 506 offering. This is because implicit in the language "by

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51 See 2 Securities Law Techniques: Transactions and Litigation § I.03[2] (A.A. Sommer, Jr. ed., 2003); see also Patrick Daugherty, Rethinking the Ban on General Solicitation, 38 Emory L.J. 67, 107 (1989) (emphasizing that the staff has never rendered a favorable Rule 502(c) opinion absent a pre-existing relationship).
or behalf of the issuer” in Rule 502(c) is the concept that the solicitor can be someone other than the issuer, for example, a placement agent.55

This regulatory channeling of Rule 506 deals through placement agents works out fine for those companies that can attract a placement agent. Many small companies, however, cannot and therefore may have no choice but to pursue a DPP.

B. LIFTING OF THE BAN

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (JOBS Act), a bipartisan bill designed “[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”56 In that regard, the Act created two new securities offering registration exemptions, relaxed certain requirements to make initial public offerings less burdensome for “emerging growth companies,” and increased the number of record shareholders threshold that obligates a company to register securities under the Securities Exchange Act of 1934.57

Additionally, the JOBS Act directed the SEC to eliminate the ban on general solicitation and advertising for Rule 506 offerings limited to accredited investors. Specifically, Title II, Section 201(a)(1) of the Act provides:

Not later than 90 days after the date of the enactment of this Act, the Securities and Exchange Commission shall revise its rules issued in section 230.506 of title 17, Code of Federal Regulations, to provide that the prohibition against general solicitation or general advertising contained in section 230.502(c) of such title shall not apply to offers and sales of securities made pursuant to section 230.506, provided that all purchasers of the securities are accredited investors. Such rules shall require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using such methods as determined by the Commission.58

The SEC proposed amendments to Rule 506 to implement Section 201(a) on August 29, 201259 and adopted them with minimal modification on July 10, 2013.60 The amendments went into effect on September 23, 2013.61 Among other things, the amendments added a new subsection (c) to Rule 506 providing that the prohibition on general solicitation and advertising

57 See id. tils. I, III, & VI.
58 Id. § 201(a)(1).
60 See Adopting Release, supra note 6.
61 Id.
generally applicable to Rule 506 offerings does not apply if: (1) all purchasers of securities sold in the offering are accredited investors; and (2) the issuer took reasonable steps to verify that all such purchasers are accredited investors. Requirement (2) seems redundant but is not because the definition of accredited investor includes an investor whom the issuer "reasonably believes" is accredited even though the investor is not actually accredited. For example, a person the issuer reasonably believes has a net worth in excess of $1 million excluding home equity, is an accredited investor even if her net worth is actually $500,000. Apparently, an issuer can form the requisite reasonable belief without taking reasonable steps to verify an investor's accredited status. Thus, the drafters of the JOBS Act presumably concluded a stricter requirement is warranted for Rule 506 offerings involving general solicitation. As the SEC stated, "we believe that the purpose of the verification mandate is to address concerns, and reduce the risk, that the use of general solicitation in Rule 506 offerings could result in sales of securities to investors who are not, in fact, accredited investors." The SEC decided to go with a "principles-based" approach to what constitutes reasonable verification as opposed to specifying required methods of verification. Thus, "whether the steps taken are 'reasonable' . . . [requires] an objective determination by the issuer (or those acting on its behalf), in the context of the particular facts and circumstances of each purchaser and transaction." The SEC reasoned that such an approach "give[s] issuers and market participants the flexibility to adopt different approaches to verification depending on the circumstances, to adapt to changing market practices, and to implement innovative approaches to meeting the verification requirement, such as the development of third-party databases of accredited investors." The SEC supplemented its principles-based approach by including a list of methods that are deemed reasonable for verifying that a "natural person" purchaser is accredited. The list consists of the following four methods:

- Verifying the purchaser's annual income ($200,000 plus or $300,000 plus jointly with spouse) by reviewing copies of IRS forms that report income (e.g., 1040, W-2, 1099) for the two most recent years and obtaining a written representation from the purchaser that he or she expects the same or a greater level of income in the current year;
- For the purpose of verifying the purchaser's net worth ($1,000,000 plus excluding home equity), verifying assets by reviewing recent bank statements,
brokerage statements, tax assessments, and appraisal reports and verifying liabilities by reviewing a credit report on the purchaser and obtaining a written representation from the purchaser that "all liabilities necessary to make a determination of net worth have been disclosed;"  

- Obtaining a written confirmation from a registered broker–dealer, registered investment adviser, licensed attorney, or registered certified public accountant "that such person or entity has taken reasonable steps to verify that the purchaser is an accredited investor within the prior three months and has determined that such purchaser is an accredited investor;"  

- With respect to a person who purchased securities from the issuer in a Rule 506 offering as an accredited investor prior to adoption of Rule 506(c), "obtaining a certification by such person at the time of sale that he or she qualifies as an accredited investor."  

Note that "[t]he issuer is not required to use any of these methods in verifying the accredited investor status of natural persons who are purchasers. These methods are examples of the types of non–exclusive and non–mandatory methods that satisfy the verification requirement in §230.506(c)(2)(ii)."  

A key aspect of Rule 506(c) is its application to purchasers as opposed to offerees. This means a company can market a Rule 506(c) offering by any means and through any medium without concern for whether its marketing efforts reach non–accredited investors so long as it only allows accredited investors to purchase securities in the offering. Thus, a company, can for example, use Facebook, Twitter, LinkedIn, and even Google AdWords to market its offering. And, of course, it can contact all Ferrari owners too. The company will still have to convince potential investors to reveal information they likely view as private and sensitive. At least, however, a DPP company will get to pitch the investment opportunity and perhaps generate some excitement before making the delicate request for sensitive information, unlike pre–Rule 506(c) where it would have to make such a request well in advance of pitching a deal.  

Furthermore, as the SEC notes:

"[I]n the future, services may develop that verify a person’s accredited investor status for purposes of new Rule 506(c) and permit issuers to check the accredited investor status of possible investors, particularly for web–based Rule 506 offering portals that include offerings for multiple issuers. This third–party service, as opposed to the issuer itself, could obtain appropriate documentation or otherwise take reasonable steps to verify accredited investor status."  

Investors are likely to be more comfortable sharing information with an established and reputable third–party verifier as opposed to the company itself.  

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69 See id. § 230.506(c)(2)(ii)(B).  
70 See id. § 230.506(c)(2)(ii)(C).  
71 See id. § 230.506(c)(2)(ii)(D).  
72 Id. at Instructions to § 230.506(c)(2)(ii)(A)–(D).  
73 Adopting Release, supra note 6, at 33 n.113.
Such a verifier will undoubtedly charge a fee to the company for providing the verification but it will likely be significantly less than what a placement agent charges for accessing its pool of accredited investors. I also suspect that verifiers will be much less picky than placement agents as to the companies to whom they are willing to provide services.

Note that in connection with adopting Rule 506(c), the SEC put out for comment some amendments to Regulation D, some of which relate to Rule 506(c).

### III. Broker, Dealer, and Agent Regulation

Both federal and state law regulate persons who buy or sell securities for the accounts of others or their own accounts. This section discusses application of these laws to DPP companies and personnel. These laws are generally a non-issue with respect to a private placement undertaken for a company by a placement agent because the placement agent and its employees will already have the requisite registrations in place.

#### A. Federal Broker Regulation

Subject to limited exceptions, Section 15 of the Securities Exchange Act of 1934 (Exchange Act) makes it unlawful for a “broker” to effect transactions in securities unless registered with the SEC. Exchange Act Section 3(a)(4)(A) defines broker as “any person engaged in the business of effecting transactions in securities for the account of others.” The rub when it comes to DPPs is that the definition of broker arguably ensnares an employee of a company pursuing a DPP engaged in soliciting investors for the offering. Registering the employee...
as a broker is not really an option because of the time and expense involved.\textsuperscript{79} Furthermore, registration triggers a host of regulations whose compliance with involves substantial time and expense.\textsuperscript{80}

There is a fair amount of guidance from the SEC and courts on when an employee of an issuer falls under the definition of broker.\textsuperscript{81} This guidance indicates that it is a fact specific inquiry with the following factors relevant for making a determination:

- Has the person previously worked for a brokerage house?
- Was the person hired specifically to sell securities?
- Does the person have duties other than selling securities?
- Is the person's compensation tied to the sale of securities?
- Will the person's employment to continue beyond offering?\textsuperscript{82}

Previous work for a brokerage house, being hired by the issuer specifically to sell securities, having little or no duties other than selling securities, being compensated based upon success in selling the issuer's securities, and employment ending when the offering ends all point towards the person falling under the definition of broker.\textsuperscript{83}

does not fall under the definition of broker because it is selling securities for its own account and not for the account of others. \textit{See id.} ("[T]he Act has customarily been interpreted not to require the issuer itself to register as either a broker or a dealer; the issuer would not be effecting transactions for the account of others nor, generally, would it be engaged in the business of both buying and selling securities for its own account.").


\textsuperscript{80} \textit{See generally} David A. Lipton, \textit{A Primer on Broker-Dealer Registration}, 36 Cath. U. L. Rev. 899, 906–08 (1987).


\textsuperscript{83} \textit{Id.}
In 1985 the SEC adopted Rule 3a4–1 under the Exchange Act in an effort to provide further guidance in the area. The rule specifies a non-exclusive safe harbor under which "associated persons" of an issuer who participate in sales of that issuer's securities will not be considered to be acting as brokers for purposes of the Exchange Act. As the SEC explained:

Questions concerning the need for broker-dealer registration frequently have arisen when an issuer proposes to sell its securities through its officers, partners or employees rather than incurring the costs of employing the services of a registered broker-dealer. The staff has historically responded to these questions by providing interpretive advice or issuing no-action letters. The Commission believes that a safe harbor rule is an appropriate and efficient way to provide guidance in this area.

Associated persons of an issuer include officers, directors, and employees of the issuer or of persons controlling the issuer. However, in the DPP context, to fall within the safe harbor the associated person would need to meet each of the following six conditions: First, the person cannot have been barred from associating with a member of a self-regulatory organization, e.g., a brokerage house. Second, the person must not be a partner, officer, director, or employee of a broker or dealer. Third, the person cannot be paid a commission or other remuneration based on sales of securities. Fourth, the person must primarily perform substantial duties for the company other than selling its securities. Fifth, the person cannot have been a broker-dealer or an associated person of a broker-dealer during the preceding twelve months. Sixth, the person cannot have, with certain limited exceptions, participated in the sale of securities of any company during the preceding twelve months.

Obviously, the rule is narrow. Employees of a company that is constantly trying to raise money, which is the case for many small companies, will likely run afoul of the sixth condition. Specifically, these employees will have solicited investors in a different offering during the preceding twelve months and thus cannot rely on the safe harbor for the next offering. However, failing to fall within the safe harbor does not create a presumption that a person is a broker-dealer. A person involved in a DPP can still argue that her activities

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85 Id.
86 Id.
87 17 C.F.R. §§ 240.3a4–1(a)(i), (c)(i)(i), (c)(i)(ii), (c)(i)(iii) (2014).
88 See id. § 240.3a4–1(a)(1).
89 Id. § 240.3a4–1(a)(2).
90 Id. § 240.3a4–1(a)(3).
91 Id. § 240.3a4–1(a)(4)(i).
92 Id. § 240.3a4–1(a)(4)(ii)(A).
93 See id. § 240.3a4–1(a)(4)(ii)(B).
94 See id.
95 Id. § 240.3a4–1(b).
do not amount to engaging in the business of selling securities based on her particular circumstances. The problem with going the facts and circumstances route is that it injects uncertainty into the offering, uncertainty that can give future potential investors, such as venture capitalists, pause. This is because investors who bought through an unregistered broker may be able to rescind their purchases under §29(b) of the Exchange Act.96

B. State Dealer and Agent Regulation

1. Overview.—All states require the registration of dealers and agents subject to various exclusions and exemptions. For example, the Georgia Uniform Securities Act (GUSA) provides: “It is unlawful for a person to transact business in this state as a broker-dealer unless the person is registered under this chapter as a broker-dealer or is exempt from registration as a broker-dealer . . . .”99 The GUSA defines broker-dealer, subject to specified exclusions, as “a person engaged in the business of effecting transactions in securities for the account of others or for the person's own account."100 A company undertaking a DPP is selling securities for its own account and therefore falls under this language. The issue then becomes whether another provision of the GUSA takes a DPP company out of the definition of broker-dealer or exempts it from registration. The answer is yes, the GUSA states that the term broker-dealer does not include an issuer.101

Likewise, the GUSA provides: “[i]t is unlawful for an individual to transact business in this state as an agent unless the individual is registered under this chapter as an agent or is exempt from registration as an agent under subsection (b) of this Code section.”102 The GUSA defines agent, subject to specified exemptions, as “an individual, other than a broker-dealer, who represents a broker-dealer in effecting or attempting to effect purchases or sales of securities or who represents an issuer in effecting or attempting to effect purchases or sales of the issuer’s securities.”103 An employee of a company who solicits investors in the company's DPP is effecting or attempting to effect purchases of the company's (issuer's) securities and therefore falls under the preceding language.

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96 Securities of Exchange Act of 1934, 15 U.S.C. § 78cc(b) (2012) (“Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder . . . shall be void . . . .”).
101 Id. § 10-5-2(3)(B).
103 § 10-5-2(3).
The issue then becomes whether another provision of the GUSA takes a DPP soliciting employee out of the definition of agent or exempts him or her from registration. The answer is yes, if the person is not compensated for selling securities in the DPP. Specifically, GUSA § 10–5–31(b)(3) exempts from registration as an agent "[a]n individual who represents an issuer with respect to an offer or sale of the issuer's own securities . . . and who is not compensated in connection with the individual's participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities."\(^{104}\)

Most states have taken an approach similar to that of the GUSA in this area, for example, provisions requiring the registration of dealers and agents broadly defined subject to exclusions and exemptions. While the applicable regulations are based on some version of the Uniform Securities Act in forty states,\(^ {105}\) the regulations in nineteen states are based on the 1956 version,\(^ {106}\) the regulations in four states are based on the 1988 version,\(^ {107}\) and the regulations in seventeen states are based on the 2002 version.\(^ {108}\) That leaves ten non-uniform act states in addition to quite a bit of variability among uniform act states. Hence, it is not really possible to generalize in this area. Instead, each state needs to be separately examined. Consequently, to get a flavor for variability from state to state in this area, I examined the relevant regulations of the fifteen largest states by population. Specifically, as I did for the Georgia statute above, I analyzed (1) whether a DPP issuer has to register as a dealer in the state, and (2) whether a DPP issuer employee who solicits investors in the DPP has to register as an agent in the state.

2. Florida Case Study.—Given time, space, and tedium constraints, I have not included an analysis of each state statute similar to that of the Georgia statute above. The Georgia analysis was fairly straight-forward. Thus, to give an example of a more complicated scheme, below is the analysis under the Florida

\(^{104}\) § 10–5–31(b)(3).


\(^{107}\) These states are Louisiana, Nevada, Rhode Island, and Utah. See Heinrich, supra note 106.

\(^{108}\) These states are Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, Vermont, and Wisconsin. Heinrich, supra note 106.
Securities and Investor Protection Act (FSIPA). My findings for the rest of the fifteen states I examined are summarized in the table appearing after this section.

**Question (1): Does the FSIPA require a DPP issuer to register as a dealer in Florida?**

The starting point for the analysis is FSIPA § 517.12(1) which provides as follows:

No dealer, associated person, or issuer of securities shall sell or offer for sale any securities in or from offices in this state, or sell securities to persons in this state from offices outside this state, by mail or otherwise, unless the person has been registered with the office pursuant to the provisions of this section.108

Unlike every other state I looked at where Question (1) turns in part on whether a DPP issuer falls under the definition of dealer, Florida specifically requires an issuer to register. FISP section 517.021(14) defines “issuer” as “any person who proposes to issue, has issued, or shall hereafter issue any security.” Florida statutes section 1.01 defines “person” to include firms, associations, partnerships, corporations, and “all other groups or combinations.”109 Thus, a DPP company is a “person” who proposes to issue securities, is therefore an “issuer,” and thus appears to have to register. The analysis, however, does not end there because FSIPA section 517.12(3) states: “Except as otherwise provided in s. 517.061(11)(a) 4., (13), (16), (17), or (19), the registration requirements of this section [i.e., the requirements quoted above] do not apply in a transaction exempted by s. 517.061(1)–(12), (14), and (15).”110

Here is some background on FSIPA section 517.061. As mentioned above, all states except New York generally require anyone offering or selling securities in the state to register the offering with state regulators unless the offering falls within an exemption.111 FSIPA section 517.061 sets forth Florida’s offering exemptions. Section 517.061(11) is the exemption applicable to a private placement by a business, and it closely tracks the requirements of a traditional Rule 506 offering (i.e., one not involving general solicitation).112 Thus, historically, an issuer would not need to register a Rule 506 offering in Florida because of this exemption. Since the passage of NSMIA in 1996, an issuer does not technically even have to rely on this exemption because, as discussed above, NSMIA preempted state offering registration requirements for Rule 506

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111 FLA. STAT. § 1.01(3) (2007).
112 § 517.12(3).
113 Supra notes 44–46 and accompanying text.
offerings.\textsuperscript{115} Whether an offering has to be registered in Florida is, however, a separate issue from whether an issuer has to register. NSMIA only preempts state offering registration requirements.\textsuperscript{116} This distinction is inconsequential for an issuer undertaking a traditional Rule 506 offering in Florida because the issuer is exempt from registering by virtue of FISP § 517.12(3). This is because its offering falls under section 517.061(11) and thus is “a transaction exempted by s. 517.061(1)-(12), (14), and (15).”\textsuperscript{117} However, one of the requirements of section 517.061(11) is that “[n]either the issuer nor any person acting on behalf of the issuer offers or sells securities pursuant to this subsection by means of any form of general solicitation or general advertising in this state.”\textsuperscript{118} Thus, a DPP company who engages in general solicitation in Florida, as allowed by Rule 506(c), will have to register in Florida because its DPP will not fall within § 517.061(11).

Question (2): Does the FSIPA require a DPP issuer employee who solicits investors in the DPP to register as an agent in the state?

As quoted above, FSIPA section 517.12(1) requires the registration of an “associated person.”\textsuperscript{119} Section 517.021(2)(a)(3) defines “associated person” to include “[a]ny natural person, other than a dealer, employed, appointed, or authorized by a dealer, investment adviser, or issuer to sell securities in any manner . . . .”\textsuperscript{120} A DPP issuer employee who solicits investors in the DPP is, at a minimum, “authorized by a[n] . . . issuer to sell securities,” therefore falls under the definition of “associated person,” and thus appears to have to register.\textsuperscript{121} As was the case under Question 1, the registration requirement, however, does not apply to an associated person if the offering at issue is exempt under § 517.061(11), but this exemption does not allow general solicitation in Florida.\textsuperscript{122} Thus, if the DPP involves general solicitation in Florida, a DPP employee will have to register as an associated person.

There is another wrinkle to the FSIPA analysis that potentially applies to both Question (1) and Question (2). Specifically, section 517.061(11) is not available for an offering where a “person defined as a ‘dealer’ in this chapter is paid a commission or compensation for the sale of the issuer’s securities unless such person is registered as a dealer under this chapter.”\textsuperscript{123}

\textsuperscript{116} Id.
\textsuperscript{117} § 517.12(3).
\textsuperscript{118} § 517.061(11)(a)(2).
\textsuperscript{119} § 517.12(1).
\textsuperscript{120} FLA. STAT. § 517.021(2)(a)(3) (2007).
\textsuperscript{121} See id.
\textsuperscript{122} See id. § 517.061(11).
\textsuperscript{123} Id. § 517.061(11)(a)(4).
Section 517.021(6)(a) includes within the definition of “dealer” “any person, other than an associated person registered under this chapter, who engages, either for all or part of her or his time, directly or indirectly, as broker or principal in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.” The FSIPA does not define the term broker but the term typically means a person who buys and sells securities for the account of others. A DPP issuer employee who solicits investors in the DPP would fall under this meaning because the person is selling securities for the account of the issuer. Thus, the person is seemingly a “dealer” unless he or she is a registered “associated person” (because of the carve-out from the definition of dealer for registered associated persons). However, section 517.021(6)(b) provides:

> The term 'dealer' does not include ... any person associated with an issuer of securities if such person is a bona fide employee of the issuer who has not participated in the distribution or sale of any securities within the preceding 12 months and who primarily performs, or is intended to perform at the end of the distribution, substantial duties for, or on behalf of, the issuer other than in connection with transactions in securities.

The bottom line is that compensating a DPP employee for selling securities further complicates the issuer/employee Florida registration analysis in that it may trigger required registration for both depending on whether the employee falls under the language of section 517.021(6)(b) quoted above.

3. Summary of Findings.—Below is a table summarizing my findings from analyzing the securities laws of the fifteen largest states by population. The “DPP issuer registration?” column refers to whether a DPP issuer has to register as a dealer in the specified state. The “DPP employee registration?” refers to whether a DPP issuer employee who solicits investors in the DPP has to register as an agent in the specified state.

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124 § 517.021(6)(a).
125 Id. § 517.021(6)(b).
Table I

<table>
<thead>
<tr>
<th>State</th>
<th>DPP Issuer registration?</th>
<th>DPP employee registration?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>Yes if transaction involves public offering¹²⁶</td>
<td>Yes if transaction involves public offering¹²⁷</td>
</tr>
<tr>
<td>California</td>
<td>No¹²⁸</td>
<td>No if not compensated¹²⁹</td>
</tr>
<tr>
<td>Florida</td>
<td>Yes if offering involves general solicitation¹³⁰</td>
<td>Yes if offering involves general solicitation¹³¹</td>
</tr>
<tr>
<td>Georgia+</td>
<td>No¹³²</td>
<td>No if not compensated¹³³</td>
</tr>
<tr>
<td>Illinois</td>
<td>No¹³⁴</td>
<td>Yes if offering involves general solicitation¹³⁵</td>
</tr>
<tr>
<td>Massachusetts*</td>
<td>No¹³⁶</td>
<td>Yes if more than twenty-five non-institutional offerees in last twelve months¹³⁷</td>
</tr>
<tr>
<td>Michigan+</td>
<td>No¹³⁸</td>
<td>No if not compensated¹³⁹</td>
</tr>
<tr>
<td>New Jersey</td>
<td>No¹⁴⁰</td>
<td>Yes if offering involves general solicitation¹⁴¹</td>
</tr>
<tr>
<td>New York</td>
<td>Yes¹⁴²</td>
<td>Yes¹⁴³</td>
</tr>
<tr>
<td>North Carolina*</td>
<td>No¹⁴⁴</td>
<td>No¹⁴⁵</td>
</tr>
<tr>
<td>Ohio</td>
<td>No¹⁴⁶</td>
<td>No if not compensated¹⁴⁷</td>
</tr>
<tr>
<td>Pennsylvania*</td>
<td>No¹⁴⁸</td>
<td>No if not compensated¹⁴⁹</td>
</tr>
<tr>
<td>Texas</td>
<td>Yes if offering involves public solicitation¹⁵⁰</td>
<td>Yes if offering involves public solicitation¹⁵¹</td>
</tr>
<tr>
<td>Virginia*</td>
<td>No¹⁵²</td>
<td>Yes if offering involves general solicitation¹⁵³</td>
</tr>
<tr>
<td>Washington*</td>
<td>No¹⁵⁴</td>
<td>Yes if transaction involves public offering¹⁵⁵</td>
</tr>
</tbody>
</table>

*Uniform Securities Act (1956) state
+Uniform Securities Act (2002) state
Per ARIZ. REV. STAT. ANN. § 44-1801(9)(b) (2013), the term dealer includes "an issuer who, directly or through an officer, director, employee or agent who is not registered as a dealer under this chapter, engages in selling securities issued by such issuer." However, per ARIZ. REV. STAT. ANN. § 44-1844(A)(1) (2013), the dealer registration requirement does not apply to "transactions by an issuer not involving any public offering."

Per § 44-1801(22), the term salesman includes issuer employees. However, per § 44-1844(A)(1), the salesman registration requirement does not apply to "transactions by an issuer not involving any public offering."


See CAL. CORP. CODE § 25003(a) (2006) (including within the definition of "agent" any individual who for compensation represents an issuer in effecting or attempting to effect purchases or sales of securities in this state.").

See supra notes 110–112 and accompanying text.

See supra note 43–45 and accompanying text.

Per GA. CODE ANN. § 10-5-2(3)(B) (2009), the term broker-dealer does not include an issuer.

Per GA. CODE ANN. § 10-5-31(b)(3) (2009), an employee who represents an issuer in a DPP is not required to register as an agent if he or she "is not compensated in connection with the individual's participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in [the issuer's] securities . . . ."

Per 815 ILL. COMP. STAT. 5/2.7 (2008), the term dealer is limited to those "offering, selling, buying and selling, or otherwise dealing or trading in securities issued by another person . . . ." (emphasis added). In a private placement, an issuer is selling its own securities and not those "issued by another person." Id.

Per 815 ILL. COMP. STAT. 5/8A (2008), an employee of an issuer does not have to register as a salesperson for offerings that fall under specified exemptions. 815 ILL. COMP. STAT. 5/4G(i) (2008) is the principal exemption for a private placement and it does not allow general solicitation. In other words, if the private placement does not involve general solicitation it falls under 815 ILL. COMP. STAT. 5/4G(i) and therefore the employee would not have to register as a salesperson per 815 ILL. COMP. STAT. 5/8A.

Per Mass. GEN. LAWS ch. 110A, § 401(c)(2) (2005), the term broker-dealer does not include an issuer.

Per § 401(b)(1), an employee of an issuer is not required to register as an agent for an offering that falls under specified exemptions. Mass. GEN. LAWS ch. 110A, § 401(b)(9) (2005) is the principal exemption for a private placement. It applies to an "offer directed by the offeror to not more than 25 persons other than those designated in clause (8) [i.e., institutional investors] in the commonwealth during any period of 12 consecutive months . . . ."


Per Mich. COMP. LAWS § 451.2402(2)(c) (2011), an employee who represents an issuer in a DPP is not required to register as an agent if he or she "is not compensated in connection with the individual’s participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in [the issuer’s] securities."

Per N.J. STAT. ANN. § 49:3-49(c) (West 2013), the term broker–dealer does not include an issuer.

Per § 49:3-49(b), an employee of an issuer does not have to register as an agent for offerings that fall under specified exemptions. N.J. STAT. ANN. § 49:3-50(b)(12)(iii) (West 2001) is the principal exemption for a private placement and it does not allow general solicitation. In other
As the above table indicates, throwing general solicitation into the mix makes it trickier and, therefore, more expensive for a DPP issuer to navigate state dealer and agent registration requirements. Specifically, two states, Texas and Florida, essentially condition their issuer registration exemptions for a Rule 506 offering on the absence of general solicitation. Likewise, six states, Florida, Illinois, New Jersey, Texas, Virginia, and Washington, or 40% of those words, if the private placement does not involve general solicitation it falls under §49.3-30(b)(12) and therefore the employee would not have to register as an agent per §49.3-49(b).

See N.Y. GEN. BUS. LAW § 359-e(1)(a) (McKinney 2012) ("A 'dealer' shall mean and include any person, firm, association or corporation engaged in the business of buying and selling securities from or to the public within or from this state for his or its own account . . . .").

See id. § 359-e(1)(c) ("A 'salesman' shall mean and include every person employed by a broker or dealer as said terms are defined in this section, for the purpose of representing such broker or dealer in the sale or purchase of securities to or from the public within or from this state.").


Per §78A-1(g), the term salesman is limited to individuals who represent dealers.

Per OHIO REV. CODE ANN. § 1707.01(E)(1)(a) (LexisNexis 2009), the term dealer does not include an issuer.

Per § 1707.01(E)(1)(a), the term dealer does not include an employee of the issuer if the employee is not compensated in connection with the offering.

Per 70 PA. CONS. STAT. § 1-102(e)(ii) (2013), the term broker-dealer does not include an issuer.

Per § 1-102(c)(i), the term agent does not include an employee of a DPP company who solicits investors in private placement "if no compensation is paid or given directly or indirectly for soliciting . . . ."

Per Texas REV. CIV. STAT. ANN. art. 581-4, § C (West 2010), an issuer falls under the definition of dealer but not with respect to transactions that are exempt under § 5 of the Texas Securities Act. A Rule 506(c) offering will not fall under any of the § 5 exemptions unless the offering does not involve public solicitation.

Per art. 581-4, § D, the term agent includes employees of a dealer who solicit investors in an offering. As discussed in note 139 above, an issuer falls under the definition of a dealer for a private placement that involves public solicitation. In other words, if an issuer is a dealer, a soliciting employee is an agent. Otherwise, the soliciting employee is not an agent.

Per VA. CODE ANN. § 13.1-514(B) (2011), the term broker-dealer does not include an issuer.

VA. CODE ANN. § 13.1-514(B) (2011) exempts from agent registration requirements specified transactions. Section 13.1-514(B)(7)(a) is the principal exemption for a private placement, and it does not allow general solicitation.

Per WASH. REV. CODE § 21.20.005(1)(a) (2012), the term broker-dealer does not include an issuer.

Per § 21.20.005(15), an employee of an issuer is not required to register as a salesperson for offerings that fall under specified exemptions. WASH. REV. CODE § 21.20.320(1) (2011) is the principal exemption for a private placement, and it does not apply to sales involving a public offering. In other words, if the private placement does not involve a public offering, it falls under § 21.20.320(1) and therefore the employee would not have to register as a salesperson per § 21.20.005(15).

See supra Table I, notes 150-51, 130-31 and accompanying text.
examined, essentially condition their employee registration exemptions for a Rule 506 offering on the absence of general solicitation.\textsuperscript{157}

Additionally, two states, Washington and Arizona, essentially condition their employee registration exemptions for a Rule 506 offering on the offering "not involving any public offering."\textsuperscript{158} As discussed above, this phrase is a term of art under federal securities law.\textsuperscript{159} Historically, an offering involving general solicitation has been considered a public offering. As the SEC has stated, "we have long construed general solicitation or advertising to impart a public character to an offering."\textsuperscript{160} Congress, however, broke from this history in lifting the ban on general solicitation under the JOBS Act. Specifically, it included an amendment to the Securities Act providing that "[o]ffers and sales exempt under section 230.506 of title 17, Code of Federal Regulations (as revised pursuant to section 201 of the Jumpstart Our Business Startups Act) shall not be deemed public offerings under the Federal securities laws as a result of general advertising or general solicitation."\textsuperscript{161} Thus, the issue is settled under federal law but Washington and Arizona courts and regulators are not obliged to follow federal law when interpreting analogous state law. In other words, the question of whether a Rule 506(c) offering that involves general solicitation is a public offering is unsettled under Washington and Arizona securities laws.

Further, five states, California, Georgia, Michigan, Ohio, and Pennsylvania, essentially condition their employee registration exemptions for a Rule 506 offering on the employee not being compensated for selling securities.\textsuperscript{162} State securities regulators in any of these states who look disfavorably on DPPs could apply an aggressive interpretation of compensation to force employee registration and thereby stretch the regulatory net. For example, a regulator could take the position that all employees of a company were compensated in connection with an offering if the company would have had trouble making payroll for a particular period if it had not closed on a DPP offering. I could see this aggressiveness in light of the lifting of the ban on general solicitation. In other words, these states may respond to the elimination of that impediment by increasing the intensity of the dealer/agent impediment. You can imagine why a state might so respond—a DPP company has avoided the gatekeeping function served by a placement agent. Investors will be foregoing the protections that come from transacting through a registered broker-dealer, mainly, know your client, suitability, and due diligence obligations.

\textsuperscript{157} See supra Table I, notes 126–55 and accompanying text.

\textsuperscript{158} See supra Table I, notes 126–55 and accompanying text.

\textsuperscript{159} See supra note 31 and accompanying text.


\textsuperscript{162} See supra Table I, notes 126–55 and accompanying text.
Conclusion

The advent of Rule 506(c) makes DPPs more workable, given companies can now market them by any means and through any medium. In other words, the importance of having access to a pre-existing pool of accredited investors has decreased. However, adding general solicitation and advertising into the mix makes state dealer and agent regulation tougher and therefore more expensive to navigate. And things may get even tougher in this area for DPP companies if state regulators decide to up regulatory intensity in response to the lifting of the ban on general solicitation and advertising. Put differently, the registrations impediment remains in full force and may get stronger.