

Private Placements

Capital means JOBS — so things are about to change **Interviewed by Jayne Gest**

The way business owners can raise private capital is undergoing an unprecedented expansion.

Pursuant to the Jumpstart Our Business Startups (JOBS) act, the Securities and Exchange Commission (SEC) has proposed new rules that would permit general solicitation and general advertising for certain private placements.

Comments were due by Oct. 5, with the final rules due out shortly.

“It should certainly spur investment,” says Peter J. Smith, a member at Semanoff Ormsby Greenberg & Torchia, LLC.

“The average small business owner might have a \$10 million per year company and want to raise a million dollars for an acquisition, a new product line, division or plant, or want to hire or need to grow,” he says. “They may not know the kind of people who can write those checks, and if they don’t, they can now advertise for investors.”

Smart Business spoke with Smith about how private placements work and what the future holds.

What is a private placement?

Under the Securities Act of 1933, the sale of securities must be registered or meet a ‘safe harbor’ exemption.

These exemptions are primarily contained in Rules 504, 505 and 506, although Rules 504 and 505 are not often used. Rule 506 provides that a company can sell an unlimited dollar amount of securities to an unlimited number of ‘accredited’ investors, and up to 35 nonaccredited investors.

An individual accredited investor is someone who meets one of the qualification criteria, including:

- Net assets in excess of \$1 million, excluding private residence.

- An individual annual income of \$200,000 per year or a joint income of \$300,000 per year for the last two years and anticipate reaching that level again in the current year.

Entities have to meet different criteria to be considered accredited. Under current rules, companies can take up to 35 purchasers who do not meet the accredited investor test. If you are issuing securities to nonaccredited investors, however, you will want to provide adequate disclosures.

Additionally, there are prohibitions on general advertising and solicitation. This significantly restricts who you can solicit.



Peter J. Smith
Member
Semanoff Ormsby Greenberg & Torchia, LLC

Why might a business owner utilize a private placement to raise capital?

Growing companies in need of capital and not in a position to borrow could benefit from a private placement. In this lending environment, banks are extremely conservative in their underwriting criteria. So, if a company is growing quickly, capital is generally not available to it through traditional means if it doesn’t have the collateral.

Smaller, privately held companies can’t afford a public offering’s cumbersome registration and reporting requirements. By doing a private placement, the business can raise additional capital through the issuance of equity. Owners give up a piece of their company, but theoretically, are growing the company, so the owner has a smaller piece of a larger pie.

By retaining an experienced attorney, you can structure a private placement in a way that meets your long-term business goals and is attractive to potential investors.

The attorney can assist the business with preparing a private placement memorandum, describing who they are, what they do, why they’re raising capital, the uses of the funds, and includes their business plan, projections, financial statements and risk factors.

This information becomes part of the solicitation materials used to attract potential investors and also protects the company from liability.

PETER J. SMITH is a member at Semanoff Ormsby Greenberg & Torchia, LLC. Reach him at (215) 887-4132 or psmith@sogllaw.com.

What are the new rules for private placements?

The new SEC proposed rules will permit the use of general solicitation and general advertising to offer and sell securities so long as you meet specific criteria, including:

- The securities can only be sold to accredited investors.

- The issuer of the securities has an obligation to take reasonable steps to verify that an investor is in fact accredited. For example, if a purchaser claims his net worth is in excess of \$1 million, the issuer should ask for a personal financial statement and supporting documentation to demonstrate that net worth.

The intent is to open up additional avenues of capital for small business in order to stimulate the economy and job growth.

How much will the solicitation rule change private placements?

Most small businesses don’t have a group of high-net-worth individuals waiting to invest. It’s hard to go to your friends and family and ask for a million dollars. There are a lot of companies with good stories to tell and solid financial statements, but without the right kind of investor contacts. So, if they could go to an attorney or investment banker, put together a package, advertise and openly solicit accredited individuals and companies, it’s going to significantly increase the flow of funds into small businesses.

What are the risks regarding general solicitation and advertisement?

It does create an environment where there is more opportunity for fraud and misrepresentation. Investors will have to be careful and do their due diligence to assure they are making good investments in good companies. The documentation and disclosures will become that much more important. If we weren’t coming off a very difficult recession and sluggish economy, it’s unlikely this rule would have been implemented. For now, it is a way to get capital to small businesses to spur growth. Banks can say they have money to lend, but they’re not lending it. There are many companies that are struggling to get capital; they’ve had lines of credit reduced and borrowing bases limited. It’s very difficult for a growing company to get enough capital to continue on its growth cycle. This new rule should help. <<