



Getting to Know You (and Your Investors): Regulation D Disclosures and Investor Limitations

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Many startups and small businesses get to a point where they determine the best way to raise capital is to bring in an outside investor through a securities offering. Depending on the amount of disclosures you are willing to make to your potential investors and the amount of money you need to raise, both federal and state laws and regulations dictate who can—and who cannot—invest in your company.

Regulation D under the Securities Act of 1933 (the “Securities Act”) provides a number of “safe harbors” from federal securities registration for limited offerings that small businesses often rely upon. Generally, the issuer must provide enough information to potential investors to not violate the antifraud prohibitions of the Securities Act. But each Regulation D exemption has varying requirements both for additional information that the issuer must disclose as well as limits on the number and type of investors that can participate in the offering.

- **Rule 504:** Rule 504 allows for an offering of securities of up to \$5,000,000 during a 12 month period. There is no limit on the number of investors or the type of investors in a Rule 504 offering. And unlike Rule 505 and Rule 506(b), discussed below, Rule 504 does not place additional disclosure requirements on the issuer.
- **Rule 505:** Rule 505 also allows for an offering of up to \$5,000,000 during a 12 month period. Rule 505 offerings are limited to a total of 35 investors. Rule 505 further requires issuers to make additional financial and non-financial disclosures to investors, which come short of those in a registered offering but can still be burdensome on the issuer to compile. Drafting this disclosure document can take a significant amount of time and work between your company and your securities attorneys.
- **Rule 506(b):** Rule 506(b) places no limit on the dollar amount of an offering. The offering is limited to a total of 35 investors, all of whom must either (1) be an “accredited investor” as defined in Regulation D (which, for an individual, means they have an individual net worth exceeding \$1,000,000 or individual income in excess of \$200,000 in each of the two most recent tax years) or (2) have such knowledge and experience in financial and business matters, either alone or with a purchaser representative, that the investor is capable of evaluating the merits and risks of the prospective investment. Rule 506(b) also demands the same disclosure requirements as Rule 505.

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- Rule 506(c): Rule 506(c) again places no limit on the offering’s dollar amount, but all purchasers in the offering must be accredited investors. Rule 506(c) offerings do not need to comply with the disclosure requirements of Rule 505 and Rule 506(b). And unlike the other Regulation D exemptions, Rule 506(c) offerings are not limited by Regulation D’s prohibition against general solicitation and advertising. But there is one catch to Rule 506(c): the issuer must verify the accredited investor status of each purchaser. This requires reviewing either the investor’s tax returns for the two most recent years or such financial information as to determine the investor’s net worth. In the alternative, the investor can provide a written confirmation from his or her CPA or attorney that they have taken reasonable steps to verify the investor’s accredited investor status. Either way, the verification process places burdens on both your investors to document their personal financial information and you.

In addition, securities offerings are also subject to state registration requirements. Most states, including Iowa, provide for an exemption from registration for offerings conducted under Rule 505 or Rule 506. However, Iowa does not provide a similar exemption for Rule 504 offerings, which must instead find an independent exemption from state registration. Many Rule 504 offerings in Iowa can only take advantage of two exemptions: the “accredited investor exemption,” which exempts purchases in offerings by accredited investors, and the “limited offering exemption,” which limits the offering to 35 non-accredited investors. But if your Rule 504 offering requires more than 35 non-accredited investors, your offering will need to register with the state. Iowa offers a Small Company Offering Registration that is available to some Rule 504 offerings, the form of which is vastly more comprehensive than the disclosure requirements of Rule 505 and Rule 506(b)—and must be provided to each potential investor in the offering, essentially negating the very low disclosure requirements of Rule 504.

While investor and disclosure requirements can significantly impact which Regulation D exemption you choose to conduct your offering under, there are a number of additional factors, requirements, and limitations that should be considered before starting a securities offering. If you have any questions regarding a securities offering for your company, please contact Maggie Hibbs or any other BrownWinick attorney in the Corporate Finance and Securities Law Practice Group.

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