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Rule 504 Becomes Useful Tool for Smaller Capital Raising and M&A Transactions

SheppardMullin

Article By
Robert L. Wernli, Jr.
Sheppard, Mullin, Richter & Hampton LLP
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On October 26, 2016, the SEC amended Rule 504 of Regulation D under the Securities Act of 1933 (the "Securities Act") to increase the maximum amount of securities that may be sold thereunder in any 12-month period from $1 million to $5 million. Consequently, the rarely used Rule 504 may now prove useful to issuers of securities in smaller capital raising and M&A transactions.

As amended, an offer and sale of securities by an eligible issuer will be exempt from registration under the Securities Act pursuant to Rule 504 if:

- the aggregate amount of securities sold in the offering does not exceed more than $5,000,000 in any 12-month period;
- neither the issuer nor any person acting on its behalf offer or sell the securities by any form of general solicitation or general advertising;
- the offering is not disqualified as a result of the participation of certain bad actors (new requirement);
- the securities may not be resold without registration under the Securities Act or pursuant to an exemption therefrom;
- the issuer exercises reasonable care to assure that the purchasers of the securities are not underwriters; and
- the offering is not integrated with another offering in a way that would jeopardize the Rule 504 exemption.

Notably absent from the items listed above is the requirement to provide any particular disclosures to the investors participating in a Rule 504 offering, including to non-accredited investors. This is a meaningful difference when compared to Rule 506, the most widely used exemption under Regulation D.

Under Rule 506, an issuer can sell securities to an unlimited amount of accredited investors and up to 35 non-accredited investors. However, if any non-accredited investors participate in a Rule 506 offering, the issuer is required to provide to such investors in advance of the sale of securities (i.e., before the purchase agreement, merger agreement or similar agreement is signed) certain disclosures meeting the line item requirements of Rule 502(b)(2) of Regulation D. This is true irrespective of whether the non-accredited investors have a "purchaser representative" as contemplated by Rule 506(b)(2)(ii).

The required disclosures for non-accredited investors under Rule 506 can be costly and time-consuming to prepare and include the following:

- *Financial statements*. For offerings up to $2,000,000, the issuer is required to provide the financial statements required by Article 8 of Regulation S-X under the Securities Act (except that only the issuer's balance sheet, which must be dated within 120 days of the start of the offering, is required to be audited); and for offerings between $2,000,000 and $5,000,000, the issuer is required to provide the audited financial statements required on a Form S-1 registration statement for smaller reporting companies (unless such financial statements cannot be obtained without unreasonable effort or expense, in which case only the issuer's balance sheet, which must be dated within 120 days of the start of the offering, is required to be audited).
- *Non-financial statement information*. The issuer is required to provide "the same kind of information" as would be required in Part II of Form 1-A, if the issuer is eligible to use Regulation A, or Part I of a Form S-1 registration statement, if the issuer is not eligible to use Regulation A.
- *Business combinations and exchange offers*. If securities are issued in a business combination or exchange offer (i.e., issued in an M&A transaction), the issuer must provide the voluminous information required in a Form S-4 registration statement.

These burdensome disclosure requirements oftentimes make the participation of non-accredited investors in a Rule 506 offering impracticable, particularly in the M&A context.

Rule 504, however, does not require the issuer to provide any particular information to investors to establish the exemption. Accordingly, it may be used in transactions involving the offer and sale of smaller amounts of securities to non-accredited investors where the burden of preparing disclosures meeting the requirements of Rule 502(b)(2) would otherwise be cost prohibitive or take too much time.

It is important to note that the lack of required disclosures under Rule 504 does not mean that no disclosure should be provided to investors in the offering. The issuer will always need to mindful of its obligations under Rule 10b-5 under the Securities Exchange Act of 1934, which prohibits the purchase or sale of securities while in possession of material nonpublic information not known to the other party.

However, the issuer will be free from the line item disclosure requirements under Rule 502(b)(2) and will have flexibility to determine what information may be material to investors under the circumstances.

It is also worth pointing out that Rule 504 – unlike Rule 506 – does not preempt state blue sky laws. Accordingly, an issuer must ensure that the offering is exempt from registration or qualification in each state in which securities are offered and sold.

This article was written by Elizabeth Chase. Elizabeth Chase is a law clerk in Sheppard Mullin's Del Mar office.