Evidence on the Use of Disclosure Documents in Private Securities Offerings to Accredited Investors

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Abstract

A company selling securities only to a category of buyers called accredited investors under the terms of a regulation of the Securities and Exchange Commission, Rule 506 of Regulation D, has no legal obligation to provide any information to prospective buyers. Nonetheless, anecdotal information indicated that, in practice, issuers have usually provided some amount of disclosure. The possibility that issuers actually supplied disclosure to accredited investors in private transactions when they had no legal obligation to do so suggested a need for empirical research. Did issuers provide disclosure to accredited investors in a few or many private offerings, and, if so, in what circumstances and in what detail was disclosure provided? For information on these topics, I interviewed a group of lawyers who represented clients in a large number of private securities transactions in which accredited investors were the only buyers. The practitioners reported that issuers nearly always provided some form of disclosure to accredited investors. The amount of disclosure depended on several factors, such as the participation of a financial intermediary in the transaction, the experience and sophistication of the buyers, and the issuer's resources and stage of development. In some types of transactions, issuers provided a full disclosure document resembling a prospectus in a registered offer. In other types, the quantity of disclosure was much smaller.

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Private Securities Offerings to Accredited Investors

Andrew N. Vollmer

Adequate and truthful disclosure about a company selling securities is the bedrock of the federal securities laws, but a major anomaly exists. An enormously popular method that issuers use to sell securities requires no disclosure at all. A company selling securities only to a category of buyers called accredited investors under the terms of a regulation of the Securities and Exchange Commission, Regulation D,[1] has no legal obligation to provide any information.

Disclosure is not required by law for those offerings, but a general impression in the market is that the practice is for the issuer usually to provide some amount of disclosure. The SEC's recent concept release on harmonization of securities offering exemptions said that "issuers and funds conducting private accredited investor-only offerings often provide prospective purchasers with information about the issuer."[2] The release did not elaborate, but the practice makes sense. Businesses want to sell their securities at a good price to raise money, and prospective securities buyers need information about a company, its business, and the securities to decide whether to buy and at what price.[3] Issuers also want a record of providing a sufficient amount of information as protection from liability for making a false or misleading statement.

The oddity of the absence of a legal obligation to disclose to accredited investors in private offerings combined with the anecdotal evidence that issuers in fact make disclosure in

[1] Regulation D includes Rules 500 through 508. 17 C.F.R. §§ 230.500–230.508.
[2] SEC, Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30,460, 30,480 (June 26, 2019) ("Concept Release").
[3] Issuers have incentives to provide information voluntarily to potential buyers of securities. *See* STEPHEN J. CHOI & A. C. PRITCHARD, SECURITIES REGULATION 22–23 (5th ed. 2019); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 683–85 (1984).

some of those transactions suggested a need for empirical research. Did issuers provide disclosure to accredited investors in a few or many private offerings? If they provided disclosure in a reasonable number of sales, in what circumstances and in what detail did they do so? I therefore decided to gather information to answer those questions and interviewed a group of lawyers who represented clients in a large number of private securities transactions in which accredited investors were the only buyers. The core question was whether issuers made disclosure of critical information in those transactions notwithstanding the absence of a legal obligation to do so.

The overwhelming answer was yes. The practitioners reported that issuers nearly always provided some form of disclosure to accredited investors. The amount of disclosure depended on several factors, such as the participation of a financial intermediary in the transaction, the experience and sophistication of the buyers, and the issuer's resources and stage of development. In some types of transactions, issuers provided a full disclosure document resembling a prospectus in a registered offer. In other types, the quantity of disclosure was much less.

During the course of the interviews, the practitioners also provided additional information. Most respondents said that natural persons were frequently present in accredited investor transactions. The time period for preparing disclosure materials and beginning the sales process was generally about three months but could be completed in three to four weeks. Cost estimates for preparation of a disclosure document covered a wide range.

As background to the survey results, Part I of this paper briefly traces the history of the SEC rules that allowed sales of securities to accredited investors with no mandatory disclosure. Part II.A describes the method of conducting the survey of practitioners experienced in private

transactions sold solely to accredited investors. Part II.B then reports the results of the empirical research, and part III concludes.

The SEC is considering proposals to amend the current exemptions from the registration provisions,[4] and it periodically reviews the accredited investor definition.[5] The information provided in the practitioner survey should be valuable to policymakers as they consider those proposals and similar efforts in the future.

I. History of Not Requiring Disclosure to Accredited Investors

The SEC developed the category of accredited investors as part of rules to give content and definiteness to a statutory exemption from the registration requirement in section 5 of the Securities Act. From an early stage, the rules did not require issuer disclosure to accredited investors.[6]

The definition of "accredited investor" was originally developed to implement the private offering exemption now in section 4(a)(2). Section 4(a)(2) exempts "transactions by an issuer not involving any public offering" from the section 5 requirement to have a registration statement in effect to sell a security. The leading judicial authority on that exemption is *SEC v. Ralston Purina*.[7]

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[4] See SEC, Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17,956 (Mar. 31, 2020) (proposing release) ("Exemption Release"); see also Concept Release, *supra* note 2, at 30,480.

[5] See SEC, Amending the "Accredited Investor" Definition, Securities Act Rel. No. 33-10824, at 34 (Aug. 26, 2020), https://www.sec.gov/rules/final/2020/33-10824.pdf (adopting release) ("Accredited Investor Adopting Release"); SEC, Amending the "Accredited Investor" Definition, 85 Fed. Reg. 2574, 2575 (Jan. 15, 2020) (proposing release) ("Accredited Investor Proposing Release").

[6] Some of the following history of the SEC regulations leading to Regulation D is from a comment I submitted to the SEC in response to the Concept Release. Andrew N. Vollmer, Public Interest Comment on SEC Concept Release on Harmonizing Private Securities Offering Exemptions, at 5–9 (Mercatus Center at George Mason University, Sept. 24, 2019), https://www.mercatus.org/system/files/vollmer-securities-offering-exemptions-mercatus-v1.pdf. Other sources for the developments include Accredited Investor Proposing Release, *supra* note 5, at 2577–78; Concept Release, *supra* note 2, at 30,479–80; SEC Staff, Report on the Review of the Definition of "Accredited Investor" 8–21 (2015); Christopher R. Zimmerman, Note, *Accredited Investors: A Need for Increased Protection in Private Offerings*, 114 NW. U. L. REV. 507, 513–19 (2019); Thaya Brook Knight, *Your Money's No Good Here: How Restrictions on Private Securities Offerings Harm Investors* 4–9 (Policy Analysis No. 833, Cato Institute, Washington, D.C., Feb. 9, 2018).

[7] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

Judicial constructions of the private offering exemption in section 4(a)(2) did not provide the marketplace with sufficient definiteness and certainty. The SEC addressed this problem with a series of rules leading to Regulation D and the concept of the accredited investor.[8]

One rule was adopted in 1974,[9] but the SEC, with assistance from Congress, moved further toward the current definition of accredited investor with developments in 1979 and 1980. The SEC proposed Rule 242 in 1979 and adopted it in 1980.[10] The Rule had a category of accredited person, which included institutional investors and any person buying $100,000 or more of the offered securities. No disclosure document was needed if sales were made only to accredited persons. Also in 1980, Congress passed the Small Business Investment Incentive Act, which exempted offers and sales solely to accredited investors and defined accredited investors as one of five types of institutional entities or any person who—on the basis of factors such as financial sophistication, net worth, knowledge and experience in financial matters, or amount of assets under management—qualified as accredited under SEC rules.[11]

The SEC then proposed Regulation D in 1981 and adopted it in 1982.[12] It was a series of rules with exemptions and a safe harbor from the section 5 registration process for certain securities sales by issuers. It defined a category of accredited investors that included institutional investors, any person who purchased $150,000 of the securities so long as the purchase did not exceed 20 percent of the person's net worth, and a natural person meeting either an income or net

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[8] A few paragraphs in this section appeared in substantially similar form in a companion paper, Andrew N. Vollmer, *Abandon the Concept of Accredited Investors in Private Securities Offerings* (Mercatus Center at George Mason University, Arlington, Va., Working Paper, 2020).
[9] *See* 17 C.F.R. § 230.146 (1979).
[10] *See* SEC, Exemption of Limited Offers and Sales by Qualified Issuers, 45 Fed. Reg. 6362 (Jan. 28, 1980) (adoption of final rules).
[11] *See* Small Business Investment Incentive Act of 1980, Pub. L. No. 96–477, 94 Stat. 2275 (1980).
[12] SEC, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251 (Mar. 16, 1982) (adoption of final rules).

worth test. The regulation also required that a non-accredited investor be sophisticated or have a sophisticated representative.

Under the current version of Regulation D, accredited investors continue to include legal entities and natural persons. For example, banks, registered broker-dealers, insurance companies, and registered investment companies are accredited investors. Tax-exempt charitable organizations and corporations with more than $5 million in total assets are accredited investors. Individuals with a net worth of over $1 million excluding the value of a primary residence and individuals with an annual income of more than $200,000 or joint income of over $300,000 are accredited investors.[13] The SEC has explained that accredited investors have "the ability to assess an investment opportunity—which includes the ability to analyze the risks and rewards, the capacity to allocate investments in such a way as to mitigate or avoid risks of unsustainable loss, or the ability to gain access to information about an issuer or about an investment opportunity—or the ability to bear the risk of a loss."[14]

In August 2020, the SEC adopted amendments to the regulatory definitions. For example, the new definitions cover natural persons with certain professional certifications or credentials from an accredited educational institution, such as investment adviser and broker-dealer employees holding a specified professional license,[15] and allow certain knowledgeable employees at private investment funds to invest in the funds.[16]

The category of accredited investors plays an important role in the operation of the safe harbor from registration in Rule 506 of Regulation D. One part of the Rule, Rule 506(c), allows

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[13] *See* Rule 501(a), 17 C.F.R. § 230.501(a).
[14] Accredited Investor Proposing Release, *supra* note 5, at 2577; Accredited Investor Adopting Release, *supra* note 5, at 6.
[15] Accredited Investor Adopting Release, *supra* note 5, at 26–31.
[16] *Id.* at 38–40.

an issuer to sell an unlimited dollar amount of securities to an unlimited number of accredited investors using general solicitation or advertising as long as all buyers are accredited investors and the issuer takes reasonable steps to verify that they are. The other part of the Rule, Rule 506(b), allows an issuer to sell an unlimited dollar amount of securities to an unlimited number of accredited investors and up to 35 non-accredited investors as long as the non-accredited investors are sophisticated or have sophisticated representatives and as long as the issuer does not use general solicitation or advertising. The SEC explained that qualifying "as an accredited investor is significant because accredited investors may, under Commission rules, participate in investment opportunities that are generally not available to non-accredited investors, such as investments in private companies and offerings by certain hedge funds, private equity funds, and venture capital funds."[17]

One other provision in Regulation D sets accredited investors apart. As originally adopted and in its current form, the regulation states that sales made only to accredited investors do not need any disclosure. Current Rule 502(b)(1) states, "If the issuer sells securities under Rule 506(b) to any purchaser that is not an accredited investor, the issuer shall furnish the information specified [in another part of the Rule] to such purchaser a reasonable time prior to sale. The issuer is not required to furnish the specified information to purchasers when it sells securities . . . to any accredited investor." The Rule has a note referring to the "anti-fraud provisions of the federal securities laws" and encouraging issuers to provide information to accredited investors when they provide information to non-accredited investors. Issuers may use Rule 506 to sell an unlimited dollar amount of securities to an unlimited number of accredited investors, and the issuers have no legal obligation to disclose anything.

[17] *Id.* at 2574–75.

The private offering exemptions in Rules 506(b) and 506(c) of Regulation D are frequently used. In 2018, the amount raised using Rule 506(b) was $1.5 trillion, and the amount raised using Rule 506(c) was $211 billion. These amounts were mostly for pooled investment funds. The amount raised under Rule 506 exceeded the amount raised in registered public offerings in 2018, which was $1.4 trillion.[18] In 2019, the amount raised under Rule 506 was $1.56 trillion, and the amount raised in public offerings was $1.2 trillion.[19] Only a small percentage of Rule 506(b) transactions have included non-accredited investors.[20] One study found that 88 percent of Rule 506 offerings of $1 million or less were limited to accredited investors.[21]

Regulation D does not forbid an issuer from providing disclosure to accredited investors, and anecdotal evidence revealed that practitioners often made disclosure even when the only buyers were accredited investors.[22] Natural questions then were how often was disclosure part of such transactions, what were the circumstances in which disclosure was made, and how extensive was the disclosure.

II. Survey of Practitioners on the Use of Disclosure Documents in Private Offerings Document

A. Methodology

My objective with this project was to obtain and report data on these questions. I decided to collect factual information about the actual disclosure practice in private securities offerings to

[18] *Id.* at 2576–77, 2603–04.
[19] Exemption Release, *supra* note 4, at 17,957–58.
[20] Accredited Investor Adopting Release, *supra* note 5, at 97 (stating "that, from 2009 to 2019, only between 3.4% and 6.9% of the aggregate number of offerings conducted under Rule 506(b) included non-accredited investor purchasers" for a negligible amount of capital in those transactions).
[21] Rutherford B. Campbell Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919, 930 table VII (2011).
[22] *See* Concept Release, *supra* note 2, at 30,480; ABA Section of Business Law, Committee on Federal Regulation of Securities, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors: A Report*, 66 BUS. LAW. 85, 108, 112–13 (2010) (recommending significant disclosure by non-reporting companies selling securities in a transaction relying on the exemption in section 4(a)(2) instead of Rule 506).

accredited investors by interviewing lawyers with extensive and recent experience representing participants in those offerings.

A Mercatus colleague and I identified lawyers to interview in several different ways. We made an effort to find lawyers with the relevant experience in different parts of the United States and in different sized law firms. We started with lawyers known to me or known by colleagues and practicing in the area. We identified additional lawyers not known to us. We searched the internet for small and medium-sized law firms in cities in different parts of the country likely to have a business, capital markets, or corporate finance practice. We searched the websites of the law firms for lawyers with experience in private offerings and compiled a list of such lawyers. We then sent an email to those lawyers asking if they would be willing to be interviewed for the survey. A few responded. We also located people to interview by asking respondents for suggestions of other lawyers.

From this group, we conducted separate interviews of 11 lawyers and asked about their experience with the use of disclosure in private securities offerings solely to accredited investors. The respondents had experience with a large number of such transactions. They worked on approximately 3,305 to 3,565 transactions during the past five years and somewhere in the range of 600 to 650 each year in recent years. Some lawyers did 3 or fewer transactions a year, while a few lawyers did from 15 to over 500 a year.

The respondents were from large, medium-sized, and small law firms and were located in Washington, D.C., New York, San Francisco, Chicago, and Atlanta. They had clients located around the country. For some respondents, the clients clustered in the lawyer's state or region. Most of the clients for nearly all the lawyers were issuers. Many of the transactions for three of the lawyers had venture capital (VC) buyers, and two of them sometimes represented the VC

buyers. One other lawyer also occasionally represented buyers, and one lawyer generally represented broker-dealer intermediaries. The offering amounts for the transactions ranged from $100,000 to several hundred million dollars. The transactions for three of the lawyers were usually under $1 million. The transactions for two of the lawyers were generally in the tens of millions, and two other lawyers had some transactions over $100 million.

The appendix has the description of the survey project sent to each lawyer interviewed. The respondents were asked not to identify any clients, issuers, or buyers. They were told that their names and the names of their law firms would be kept confidential. Some respondents were interviewed in person, but most sessions occurred on the telephone. The appendix also contains the questions covered during each interview. The interviews occurred from November 2019 into January 2020.

The respondents mainly complied with Rule 506, but five of them either frequently or occasionally used section 4(a)(2). One lawyer said that private offerings involving a broker-dealer usually relied on section 4(a)(2) because broker-dealers object to the "bad actor" disqualification provision in Rule 506(d). Another lawyer relied on section 4(a)(2) for nearly all transactions in a high volume practice, using Rule 506 when he or she filed a Form D or when the issuer engaged in a general solicitation. Respondents relying on section 4(a)(2) in some transactions and Rule 506 in others did not use different types of disclosure for the different types of transactions.

B. Survey Results

The following discussion reports results from the survey on four topics: (1) the use of specially prepared disclosure documents in offerings solely to accredited investors, (2) the extent to which natural persons participated in private offerings as accredited investors, (3) the legal expenses to

prepare disclosure in a private transaction with accredited investors, and (4) the length of time needed to prepare such a disclosure document.

1. Use of Disclosure Document

Information provided by the lawyer respondents allowed identification of several factors affecting the extent of disclosure in private offerings to accredited investors. This section of the paper first discusses those factors and then describes different categories of transactions using disclosure of different lengths.

Several different factors affected the extent of disclosure in private offerings to accredited investors. The factors were as follows:

- Whether the issuer was a reporting company. This paper will address transactions in which the issuer was not a reporting company and was not selling securities in a registered offering and a private offering at the same time. When an issuer was a reporting company or when an issuer combined a private transaction with a registered offering, buyers had access to a significant amount of information from the issuer. The buyers in the private offering might also have received financial projections.
- Whether an operating company issuer was in an early stage or was more developed.
- Whether the form of the transaction or security was standard or unusual. More disclosure typically accompanied an uncommon transaction structure or a complicated security.
- Whether a financial intermediary such as a broker-dealer was assisting the issuer.
- Whether the prospective buyers were institutional investors such as venture capital firms, a mix of institutional and other investors, or senior executives of the issuer.

- Whether the issuer had the resources to be able to hire a legal adviser. An issuer unable to afford a lawyer might make no or only minimal disclosure.

A very high percentage of transactions had a disclosure document of some type. In a few types of transactions, no disclosure document existed, but, by and large, the factors discussed above affected the extent of the disclosure rather than its existence. One respondent said, “You need a good reason not to have an offering document.” The paragraphs that follow describe several different categories of transactions, starting with those that frequently involve a thorough disclosure document and ending with those that have less disclosure.

The disclosure practices of the respondents did not vary significantly based on the geographic location of the lawyer. A tendency to provide slightly less disclosure for high tech offerings on the West Coast might exist.

In general, many respondents noted that issuers typically provided prospective buyers with an opportunity to ask questions and receive answers and additional information. Rule 502(b)(2)(v) imposes this obligation in Rule 506(b) transactions.

a. Disclosure resembling a prospectus in a registered offering. A disclosure document is nearly always used when a broker-dealer is acting as an intermediary in a private offering. When the issuer is not a reporting company, the disclosure is extensive and follows Form S-1, the most complete form for a registration statement, as a guide.

An extensive disclosure document is also usually used when the potential buyers lack investment experience, knowledge, or sophistication but still qualify as accredited investors. The disclosure document for offerees without experience or sophistication follows the registration Form S-1 or real estate guidelines. It looks like a prospectus and is long. Lawyers gave different

ranges for the length of disclosure documents: 40–60, 75–100, or approximately 200 pages. The document includes some financial information, a review or audit by an accounting firm when the company has an operating history, and a financial forecast. The issuer generally offers to answer questions or to allow due diligence on company records. Potential buyers have taken up this offer and have sometimes recommended or suggested items for disclosure.

The same sort of prospectus-like disclosure is made to investors in new or young retail companies, such as coffee shops, bars, and restaurants. The private placement memorandum is long, has financial statements if the company is not new, and sometimes has financial projections.

b. Reduced disclosure from start-up companies or to sophisticated buyers who are not institutions. Some respondents said they used a level of disclosure short of a full prospectus for sales to senior executives of the issuer or investors who are experienced and sophisticated but are not full-time, institutional, or professional investors. The disclosure covers the issuer, business, market, competition, risk factors, plan for making money, and available financial information. Issuers with no meaningful financial information often retain an accountant to prepare financial projections with assumptions fully disclosed. The disclosure sometimes is a specially prepared text in the range of 10 pages plus financial statements, but it can also be a summary document attaching a package of other documents.

When buyers are not venture capital firms or professional investors, the amount of disclosure depends on the size of the offering and the amount of legal and accounting fees the issuer is able and willing to spend on preparation of disclosure. Early stage companies often have limited resources to hire a lawyer or accountant. The priority disclosures are risk factors and use of proceeds. A typical budget for a start-up is about $10,000. When an issuer can afford

additional disclosure, it covers (a) the issuer's business, (b) the issuer's management, (c) the terms of the offering, (d) financial statements or other financial information (including projections) available at an acceptable cost, and (e) the terms of the securities, with more description for debt than equity.

The most common form of disclosure is textual, although early-stage companies commonly use a business plan "wrapped" by disclosure of risk factors and offering terms. The textual disclosure can take the form of an offering memorandum, "brochure," or package of subscription documents including an investment letter with risk factor disclosure. According to one respondent, disclosure documents do not usually take the form of slide presentations. Disclosure can be as short as 10 pages or as long as 150 pages. Offerings usually provide some opportunity for investors to ask questions.

One lawyer we interviewed represented clients selling securities over online investment platforms. The buyers were accredited investors, but the amounts they invested tended to be smaller than in most private offerings. The transactions complied with Rule 506(c). The website of the investment platform had an offering page with basic information about the issuer, offering, and risk factors. The lawyer said a typical offering page also had pictures, a video, and a slide deck. The materials did not include any financial statements. The goal of the presentation was to make the disclosure in a form that would encourage more potential investors to read them.

c. Limited disclosure to venture capital buyers. Transactions in which the buyers are venture capital firms have limited disclosure. The disclosure approach has a few variations. In seed or early-stage financings, the potential buyers perform due diligence on the founders rather than the company. When a business has matured from its earliest stage, some issuers make corporate

records available for inspection in a data room but do not provide a separate disclosure document. Issuers generally offer to answer investor questions, and sometimes investors ask a lot of questions. Transactions in these circumstances involve the supply of some information but are the closest to sales to accredited investors with no specially prepared disclosure document.

A more common approach with VC buyers is to make corporate records available for inspection in a data room and also to use a stock purchase agreement (SPA) with representations and warranties from the issuer, together with a disclosure schedule to modify or qualify the representations and warranties. The representations and exception schedule function as disclosure.

One respondent referred to using the simple agreement for future equity on the Y Combinator website,[23] and another pointed to a model SPA on the internet site of the National Venture Capital Association.[24] The National Venture Capital Association SPA proposes company representations and a disclosure schedule on a lengthy and detailed list of topics, including, among other things, litigation, capital structure, use of intellectual property, agreements with officers and directors, the company's ownership of property, financial information, relationships with and compensation of employees, payment of taxes, insurance, and compliance with environmental and personal privacy laws. The SPA might also contain a representation that the issuer provided complete information in response to requests from the buyers.

A third variation in deals with VC buyers is to use a data room, an SPA and disclosure schedule, and a limited amount of additional disclosure. The disclosure has a short business plan and unaudited financials if the company has been in existence for a few years. Financial forecasts might be supplied but are not warranted.

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[23] *See* Carolyn Levy, *Safe Financing Documents*, Y COMBINATOR (Sept. 2018), https://www.ycombinator.com /documents#safe.
[24] *See* National Venture Capital Association, Stock Purchase Agreement, *Model Legal Documents*, https://nvca.org /model-legal-documents/ (last visited August 12, 2020).

2. Presence of a Natural Person as a Buyer in the Transaction

We asked about the extent to which accredited investors who are natural persons, as opposed to legal entities, participated in private offerings, and the respondents provided useful but not detailed information. The SEC does not have information about the rate of participation of individuals.

The current definition of accredited investor in Rule 501(a) includes natural persons as well as legal entities. Individuals with income of $200,000 per year (or joint income of $300,000 per year) or a net worth of over $1 million excluding the value of a primary residence and directors, executive officers, and general partners of an issuer qualify as accredited investors. The August 2020 amendments added other natural persons as accredited investors.[25]

At the time of the August 2020 amendments, the SEC did not know how many natural persons invest in Rule 506 transactions as accredited investors. Form D does not request information about natural persons who are accredited investors.[26] The SEC also did not have data to estimate the number of individuals who qualified under the financial tests in current law as accredited investors.[27] It was able to estimate the number of U.S. households, rather than individuals, that qualified as accredited investors: "we estimate that under the current income and wealth thresholds . . . , approximately 16.0 million U.S. households, representing 13% of the total population of U.S. households, qualify as accredited investors."[28] Finally, the SEC was not able to say how many individuals who were not accredited investors under the wealth tests would become accredited investors because of the amendments.[29]

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[25] See text accompanying notes 15 and 16 above.
[26] Accredited Investor Adopting Release, *supra* note 5, at 103.
[27] *Id.* at 102.
[28] *Id.*
[29] *Id.* at 104, 105.

The lawyers in the survey were able to provide some information on the frequency with which natural persons invest as accredited investors. The information was less consistent and less detailed than the information on the types of disclosure, and the reason for the different experiences was not clear. As a result, more work could be done to identify the types of offerings in which natural persons participate in higher numbers.

Several respondents said that natural persons were present in all or a high percentage of their accredited investor transactions. From 50 to 90 percent of the number of investors were natural persons. That is a significant percent of the number of buyers, but natural persons bought a much lower percentage of the offering amount.

Different respondents associated natural persons with seed financings for early stage operating companies. They observed that investors in these transactions often had natural persons in the form of an angel investor or another type of ultra-high net worth individual, members of management, or family and friends of the founders.

Still other respondents saw similar categories of natural persons (angel investors, members of management, and friends and family) in later stage financings when the main buyers were VC firms. One respondent said natural persons typically bought 30 percent of the offering amount in this type of offering, and another said individuals frequently accounted for 20 percent of the number of investors. One way to reconcile the responses on early and later stage companies is to surmise that offerings for early stage companies had a higher proportion of individuals than companies in later stages of development.

In one lawyer's practice, high net worth individuals were a majority of the buyers in investment funds, and all the buyers in compensatory offerings were individuals. For another

respondent working mainly on transactions with financial intermediaries, individuals were buyers only occasionally.

3. Expenses

We asked about an issuer's total out-of-pocket costs to prepare disclosure documents and specifically mentioned legal, accounting, printing, and expert costs. Some respondents had information about legal costs or legal and accounting costs only. The responses covered a wide range, from $3,000 to $250,000. Keep in mind the expense numbers were estimates.

The respondents attached different factors to the cost estimates. They said an issuer's costs depended on the size of offering, the amount of risk or complexity involved in the company's business or securities, the sophistication of the buyers, the stage of development of the company, and the extent of the disclosure document. In general, larger offering amounts had higher costs.

Early stage operating companies with limited resources had the smallest transaction costs. The range was $3,000 in legal costs to $25,000 in total costs. More mature operating companies spent between $25,000 in legal costs and $100,000 in total costs. One respondent gave the larger range of $45,000 to $175,000 for the legal costs of later stage companies.

Other respondents connected transaction costs more directly to the extent of the disclosure document. One respondent cited a total cost (including legal fees, accounting costs and other expenses) to prepare disclosure furnished to accredited but nonsophisticated investors to be between $50,000 and $70,000. The total cost for a shorter form for more sophisticated investors was in the range of $25,000. Costs for a stock purchase agreement with no additional disclosure document were approximately $30,000 to $75,000.

Transactions with larger offering amounts and disclosure resembling the prospectus for a Form S-1 had the highest out-of-pocket costs. Several respondents said the cost of preparing a disclosure document in these circumstances was in the range of $150,000 to $250,000.

4. Time to Complete Disclosure Document

We asked the lawyers about the time period needed to prepare disclosure materials and begin the selling process. In general, transactions did not take a great deal of time.

A few respondents said that an average transaction took about three months to complete. Several remarked that deals can occur more quickly. One respondent said the preparation of the disclosure document took 15 to 60 days, while another said that transactions with VC buyers took six weeks from term sheet to closing. Others said the speedy end of the range for private offerings was three to four weeks.

III. Conclusion

The private offering safe harbor in Rule 506 of Regulation D created a type of buyer called an accredited investor and simplified sales to them. One simplification was not to require any disclosure to accredited investors.

That raised the question of whether issuers nonetheless provided disclosure to accredited investors and, if so, in what circumstances and to what extent. To answer those questions, I surveyed 11 lawyers with extensive practices representing clients in exempted private offerings sold only to accredited investors.

The results of the survey showed that the deals always involved the supply of some information. The minimum was investor due diligence on founders or corporate records, and the maximum was a placement memorandum resembling a prospectus for a registered offer. Various

factors, such as the nature of the buyers and the maturity and risks of the company's business, were important considerations in determining the amount of disclosure. Other factors were the size of the offering and the amount of legal and accounting fees the issuer was able to spend on preparation of disclosure. Transactions with a financial intermediary or sales to less sophisticated accredited investors had more extensive disclosure. Sales to venture capital buyers often did not have a specially prepared disclosure document but involved a stock purchase agreement with representations and warranties from the issuer together with a disclosure schedule to modify or qualify the representations and warranties.

Appendix: Survey of Disclosure for Accredited Investors

Survey Explanation

As an academic research topic, I am looking into the use of disclosure documents in Regulation D offerings, particularly Rule 506 offerings solely to accredited investors. The question I am considering is to what extent disclosures are made as a matter of practice in Rule 506 offerings to accredited investors.

This is academic research supported only by the Mercatus Center. The research is not for a client, and no one else has a financial interest. My plan is to write and publish an article with the results. The purpose of the research and the article is to collect and disseminate factual information about actual practice in the market.

The extent to which disclosures are made in Rule 506 offerings to accredited investors might bear on policy considerations such as the SEC's review of the exemptions from the section 5 registration requirement. In my comment to the SEC in response to the concept release, I expressed my understanding that some disclosures are typical in Rule 506 transactions with accredited investors.

When I ask about numbers, I appreciate that you will rely on your best memory unless you have records to check. Use your internal records if they help you. Estimates or ranges will be fine. Please let me know if you consulted records to refresh your memory.

Please do not disclose any client confidences to me. No client or buyer names are necessary. I plan to take notes and aggregate the information from several sources. I will put your name, firm name, and the city in which your office is located in my notes but will keep your name and firm name confidential.

We want you to understand the purpose of the interview, the nature of the information I would like to learn, and the planned use for information you provide. A draft of a very short consent form is at the end of this document. Please send an email saying you agree or do not agree to its terms, or we can discuss the consent at the beginning of an interview.

All questions below are about transactions during the past five years.

About the Researcher

I am a senior affiliated scholar with the Mercatus Center at George Mason University. For over five years, I was a professor of law, general faculty, at the University of Virginia School of Law. Before that, I was deputy general counsel of the Securities and Exchange Commission and a partner in the securities enforcement practice of Wilmer Cutler Pickering Hale and Dorr LLP.

Questions

1) How many public offerings did you work on?

2) Of those, approximately how many used Form S-1, S-3, etc., or a form for a foreign private issuer?

3) How many Rule 506 offerings solely to accredited investors did you work on?

4) Do you categorize those offerings in any way, such as by number of buyers, amount of offering, or business of the company?

5) If you do categorize the offerings, approximately how many of the Rule 506 transactions that you worked on fell into your different categories?

6) For the Rule 506 offerings solely to accredited investors, in what state was the issuer's headquarters?

7) Was a natural person a buyer in any of the Rule 506 transactions? Please do not reveal the names of any buyers.

    a) How many transactions took place?

    b) On average, approximately how many natural person buyers were there in a single transaction?

    c) What percentage of the total number of buyers were natural persons?

    d) What percentage of the total amount of the offering did natural persons buy?

8) In how many Rule 506 transactions solely to accredited investors did the issuer use a disclosure document of any sort?

9) Answer the next few questions for each of the Rule 506 transactions solely to accredited investors that involved some type of disclosure. If that is not feasible, please describe the general practice and any important exceptions.

    a) How did you decide what the document would disclose, what items it would address, or what financial statements it would include?

    b) Did prospective buyers request or suggest types of information that a disclosure document should contain?

    c) How many items from Form S-1 did the document cover? Which ones?

    d) About how long was the document (in words or pages)?

e) What was the form of the document? Textual like a prospectus for a registered offering, PowerPoint presentation, business plan, or some other form?

f) When an issuer used a disclosure document, did prospective buyers also conduct due diligence on issuer records?

g) When an issuer did not use a disclosure document, did prospective buyers also conduct due diligence on issuer records?

h) Are you able to send me any examples of disclosure documents?

10) The next few questions are about the client's out-of-pocket and other expenses to prepare the disclosure document for each of the Rule 506 transactions solely to accredited investors on which you worked in the past five years. Out-of-pocket expenses include legal, accounting, printing, and experts. Please give a reasonable estimate for each transaction if you can. If that is not feasible, please give as much detail for those transactions as you can.

    a) What were the client's approximate out-of-pocket costs to prepare the document (such as legal, accounting, printing, experts)?

        i) $24,999 or less

        ii) $25,000–$49,999

        iii) $50,000–$99,999

        iv) $100,000–$249,999

        v) $250,000 or more

    b) Did the out-of-pocket costs tend to increase as the amount of the offering increased?

    c) Did the client in any of those cases or other cases devote significant internal resources to preparing the documents?

    d) How long did preparation of the document take?

11) Please identify lawyers at other law firms who would be good sources for this project.

Consent Form

You agree to participate in an interview about the use of disclosures in Rule 506 transactions made solely to accredited investors.

You understand that no identifying information about clients or buyers in transactions will be requested.

Information you provide will not be made available to other researchers.

The notes of the interview will contain your name, your law firm's name, and the name of the city where your office is located. Your name and your law firm's name will be kept confidential in Mercatus records.

Information you provide will be made public in an article or publication. For the most part, information from several sources will be aggregated. For example (hypothetically), "Out of 100 Rule 506 offerings solely to accredited investors, 63 used some type of disclosure document. Of the 63, 35 were PowerPoint presentations with basic information about the company. Twenty disclosure documents were extensive and resembled standard disclosures for registered offerings."

A publication probably would report some specific examples with no identifying information, such as, "One company used three transactions to raise money to conduct clinical trials on a new drug." A publication also might make an anonymous reference to a lawyer who participated in the survey with a sentence such as "Lawyer A located in New York City said five clients used short PowerPoint disclosures."