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Regulation D Offerings and Private Placements

March 14-16, 2013

Installment Payments in Public and Private Offerings

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I. Regulation T.

Section 7(c) of the 1934 Securities Exchange Act (the "1934 Act") makes it unlawful for any broker or dealer "to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer" on any security in contravention of the margin rules adopted by the Federal Reserve Board (the "Board"). Section 220.3(g) of the Board's Regulation T,[1] issued by the Board pursuant to its regulatory authority under Section 7(a) of the 1934 Act allows brokers or dealers to "arrange for the extension or maintenance of credit to or for any customer by any person, provided the creditor does not willfully arrange credit that violates parts 221 [Regulation U] or 224 [Regulation X] of this chapter."[2] Regulation T generally provides that a securities customer must pay at least 50 percent of the price of any "margin security"[3] purchased.[4]

Securities which are not margin securities, including most securities issued in private offerings, may not be the subject of an extension of credit by a broker or dealer.[5] Regulation T, however, does not prohibit a broker or dealer from arranging credit that does not violate Regulations U or X. Regulations U and X limit the credit (collateralized by securities) that may be extended by persons not brokers or dealers (and accepted by borrowers) for the purchase of margin securities.[6] These regulations, however, do not similarly limit the extension of credit by persons not brokers or dealers for the purchase of non-margin securities.[7]

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1 12 C.F.R. §§ 220.1-220.12.

2 63 Fed. Reg. 2806 (1998) (codified at 12 C.F.R. § 220.3(g)).

3 Generally "margin security" includes securities registered on a national securities exchange, non-equity securities, certain securities issued by investment companies, all foreign margin stock and debt convertible into margin securities. 12 C.F.R. § 220.2.

4 12 C.F.R. § 220.12.

5 12 C.F.R. § 220.12(e) (requiring a margin of 100% for non-margin, non-exempted securities).

6 Regulation X, 12 C.F.R §§ 224.1-224.3 (prohibiting non-exempt borrowers from knowingly borrowing in violation of Regulations T or U); Regulation U, 12 C.F.R. §§ 221.1-221.7 (limiting credit extended by banks and persons other than brokers or dealers to finance the purchase or carrying by customers of margin stock when the credit is collateralized directly or indirectly by margin stock).

7 See id. at § 221.1(b).

A. Arranging for the Extension of Credit.

A tax shelter program which provides for installment payments of the sale price of the interests purchased, but permits a customer to obtain the entire benefit of ownership before making all of the payments, has been interpreted by the Board to be "arranging for the extension of credit to purchase or carry securities in violation of the prohibitions of sections 220.7(a) and 220.8 of Regulation T."[8]

Neither the Securities and Exchange Commission (the "SEC") nor the Board has articulated clear guidelines for determining when a provision for deferred payment, or a provision for assuming or incurring indebtedness constitutes "arranging for the extension of credit." Interpretive rulings of the Board staff, however, appear to indicate that a provision for deferred payment generally will not be considered to constitute an extension of credit if (1) the deferred payment is made to purchase a "new" or separate security, (2) failure to make the deferred payment would not result in a forfeiture of the investor's existing interest, and (3) the amount and timing of the deferred payment are truly contingent, so that it may be considered a "bona fide contingent assessment." These three principles overlap substantially and are separately emphasized depending on the facts of each case.[9] While the importance of determining when a broker or dealer is "arranging for the extension of credit" has declined since "arranging" is no longer prohibited under Regulation T, these principles are still important in determining what transactions involve the "extension of credit" or constitute "arranging for the extension of credit" prohibited under other regulations.

II. Application of Regulation T to Offerings under Regulation D.

As noted above, brokers and dealers may not extend credit for the purchase of non-margin private placement securities, but may arrange for others to extend credit for such a purchase if they are not in violation of Regulations U or X. Regulation U does not place restrictions on the extension of credit by persons not brokers or dealers for the

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8 12 C.F.R. § 220.124.

9 See FRB Staff Op. of May 31, 1972, SCTH para. 5-607 (contingent assessment in an oil and gas program where payment of the assessment would provide an interest in wells drilled after a certain date, is "a security separate from the assessable interest," not an extension of credit); FRB Staff Op. of Oct. 30, 1973, SCTH para. 5-560 (where limited partnership interests are sold coupled with a warrant to purchase additional interests, if "the economic penalty for non-exercise of the warrant (when weighed against the new investment required) is such that the purchaser of the first interest would not have a genuine choice as to whether or not to put up the money for the second interest," there would be an extension of credit); FRB Staff Op. of May 31, 1972, SCTH para. 5-607 and FRB Staff Op. of July 10, 1972, SCTH para. 5-608 (bona fide contingent assessments are not an extension of credit even though they would be legally enforceable when called); FRB Staff Op. of Dec. 23, 1981, SCTH para. 5-606.17 (where the only consequence of failure to pay an assessment is a pro rata reduction of the investor's interest to the amount actually paid, there is no "arranging for credit," but where the failure to pay the assessment also makes the investor's interest nontransferable, the economic penalty for nonpayment makes it "arranging for credit.")

purchase of non-margin securities unless the credit is secured by margin securities. The result is that brokers and dealers may arrange for the extension of credit, such as an installment sale or deferred payment provision, in connection with a private placement of non-margin securities under Regulation D.

III. Section 11(d) of the 1934 Act.

It should be noted that, while Regulation T does not prohibit the arranging of credit, Section 11(d)(1) of the 1934 Act prohibits a broker-dealer from arranging for the extension of credit in connection with a "new issue." That section states in pertinent part that "[i]t shall be unlawful for a member of a national securities exchange who is both a dealer and a broker, or for any person who both as a broker and a dealer transacts a business in securities through the medium of a member or otherwise, to effect through the use of any facility of a national securities exchange or of the mails or of any means or instrumentality of interstate commerce, or otherwise in the case of a member, (1) any transaction in connection with which, directly or indirectly, he extends or maintains or arranges for the extension or maintenance of credit to or for a customer on any security (other than an exempted security) which was a part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within thirty days prior to such transaction. . . .."

For a transaction to violate Section 11(d)(1), it must be effected by one who acts both as a broker and a dealer, in connection with a "new issue in the distribution of which he participated as a member of the selling syndicate or group." One who acts only as a broker, and not as a dealer, does not come within the prohibition.[10]

IV. Application of Section 11(d)(1) to Offerings Under Regulation D.

The SEC staff has taken the position that if no public market exists for the securities, and the offering does not constitute a "public distribution" (which term is not defined), it will not recommend any action under Section 11(d)(1).[11] The Board Staff has taken the position that it has no responsibility for interpretation of Section 11(d)(1).[12]

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10 See Saul, Ewing, Remick & Saul, SEC No-Action Letter (available Nov. 12, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 79,564; State of Ohio, Department of Commerce, Division of Securities, SEC No-Action Letter (available Oct. 27, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 79,558.

11 See Saul, Ewing, Remick & Saul, supra; Great Plains Western Corp., SEC No-Action Letter (available Dec. 9, 1973) ("It is our view . . . that Section 11(d)(1) does not apply to transactions which do not constitute a distribution of securities to the public . . .. The ultimate responsibility for determining whether a particular offering of securities constitutes a distribution to the public for purposes of Section 11(d)(1) must rest with the issuer.").

12 FRB Staff Op. of Apr. 17, 1981, SCTH para. 5-606.15; FRB Staff Op. of Dec. 4, 1981, SCTH para. 5-606.16.

The staff of the SEC's Division of Market Regulation has not provided any written advice regarding the application of Section 11(d)(1) to offerings made pursuant to Regulation D. The staff has given oral advice that it would mirror the interpretations of the Board staff under Regulation T regarding what type of transactions would constitute "arranging for the extension of credit," and also has given oral advice that offerings made pursuant to Rule 505 and Rule 506, but not Rule 504, would be exempt from the application of Section 11(d)(1).[13] In discussions the staff has affirmed that the changes to Regulation T have not changed the SEC position with respect to Section 11(d)(1), but cautioned that the SEC has required the submission of letter ruling requests even for transactions exempt under Rule 506 because what constitutes a "distribution to the public" is so unclear.[14]

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13 Historically, offerings that are exempt under Section 4(a)(2) (private placements) or 4(a)(6) of the Securities Act of 1933, as amended (the "1933 Act") were considered private placements and therefore exempt from Regulation T. 12 C.F.R. d 220.13(b); see FRB Staff Op. of Sept. 13, 1978, SCTH d 5-595 (Section 4(a)(2)); FRB Staff Op. of Mar. 29, 1979, SCTH d 5-598 (Section 4(a)(2)); FRB Staff Op. of Apr. 1, 1981, SCTH d 5-606.12 (Section 4(6)). The Federal Reserve Board staff also took the position that the "private placement" exemption from Regulation T was available for offerings that complied with either Rule 505 or Rule 506 under Regulation D, even though Rule 505 was promulgated under Section 3(b) of the 1933 Act rather than Sections 4(a)(2) or 4(6). SEC Securities Act Release No. 6389, 47 Fed. Reg. 11251, 11258 n. 33 (1982); FRB Staff Op. of Jan. 8, 1982, SCTH d 5-606.18 (Rule 506); FRB Staff Op. of Apr. 1, 1982, SCTH d 5-606.19 (Rule 505). While Rule 505 was not adopted pursuant to Section 4(a)(2) or 4(6), the FRB staff chose to extend the private placement exemption to Rule 505 on the ground that its provisions were substantially similar to Rule 506. The Federal Reserve Board staff refused, however, to extend the private placement exemption from Regulation T to offerings made pursuant to Rule 504, on the ground that the SEC has not characterized Rule 504 offerings as private offerings. FRB Staff Op. of May 20, 1982, SCTH d 5-606.2; see SEC Securities Act Release No. 6455, 48 Fed. Reg. 10045, 10054 nn. 50-51 (1983).

14 See e.g., Synergia Resources XX, 1986 SEC No-Action Letter, LEXIS 6 (Mar. 1, 1986) (granting the no-action request).