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Risk Factors in Unregistered Offerings

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I What Are They?

Risk factors are specific cautionary statements that a business makes regarding the risks inherent in its business operations, financial position, industry and securities. A business is required to make these statements in writing as a part of its disclosure documents when it is seeking equity or debt capital and, when it is a large publicly held company, required to report to its equity holders on a continuous basis.

Risk factors provide critical information to prospective (and current) investors, because they address the challenges of the business. They are important to the business and its management, because they may protect against claims of liability in connection with the offering.

II Sources of Law and Guidance

The Basic Requirement

Regardless whether a business is raising capital through a registered offering or a non-registered offering, through an offering using general solicitation of the public or an offering using the connections of the business' management, the SEC's regulations on information disclosure contained in Regulations S-K and S-X govern the basic set of information to be disclosed to potential investors. Specifically, Item 503(c) of Regulation S-K (17 CFR § 229.503) provides that:

> "The registrant must furnish this information in plain English. See § 230.421(d) of Regulation C of this chapter.
> ……..
> (c) Risk factors. Where appropriate, provide under the caption "Risk Factors" a discussion of the most significant factors that make the offering speculative or risky. This discussion must be concise and organized logically. **Do not present risks that could apply to any issuer or any offering.** Explain how the risk affects the issuer or the securities being offered. Set forth each risk factor under a sub-caption that adequately describes the risk. The risk factor discussion must immediately follow the summary section. If you do not include a summary section, the risk factor section must immediately follow the cover page of the prospectus or the pricing information section that immediately follows the cover page. Pricing information means price and price-related information that you may omit from the prospectus in an effective registration statement based on § 230.430A(a) of this chapter. The risk factors **may** include, among other things, the following:
>
> (1) Your lack of an operating history;
>
> (2) Your lack of profitable operations in recent periods;
>
> (3) Your financial position;
>
> (4) Your business or proposed business; or
>
> (5) The lack of a market for your common equity securities or securities convertible into or exercisable for common equity securities.
> ……"

In a registration statement,,separately labeled section of risk factors is required to be placed immediately after the summary of the primary information disclosure document so that investors are more likely to see that section and review it.

"Plain English" Guidance

The plain English requirements are found in SEC Rule 421(d) (17 CFR § 230.421). The rule requires businesses to use "plain English" in drafting the risk factors, summary and other specific portions of information disclosure to potential investors. The SEC has set forth specific tenets of "plain English", including:

1) Short sentences;

2) Use of definite, concrete everyday words;

3) Active Voice. In other words, organize the sentences as Subject – Verb – Object;

4) Tabular presentation or bullet lists for complex material, whenever possible;

5) No legal jargon or highly technical business terms; and

6) No double negatives.

Additional information about this initiative and how to implement it can be found in *Plain English Disclosure,* SEC Release No. 33-7497 (Jan. 28, 1998), 66 SEC Docket 777; SEC Staff Legal Bulletin No. 7A (Corporation Finance), 1999 WL 34766637 (June 7, 1999).

Examples of risk factors in "plain English" prepared by the SEC is attached as Exhibit "A". It is worth noting that, according to the SEC, the purpose of the "plain English" requirement is to enhance clarity, not to shorten disclosure. The accuracy and completeness of the disclosure is critical; risk factors should not be abbreviated in the name of "plain English".

Other Relevant Guidance

According to its terms, the Private Securities Litigation Reform Act of 1995 ("PSLRA") deals with private investors' litigation against businesses that <u>have</u> done registered offerings and are therefore "publicly traded" or "publicly held". It is possible to do a *private* private placement on behalf of a publicly traded company. However in this course, we are assuming the reader will be doing *private* private placements for businesses that are privately held and have never done a registered offering.

By providing a safe harbor against litigation about "forward-looking" statements of publicly traded businesses, the PSLRA provides guidance about risk factors in *private* private placements as well. If one thinks about it, risk factors are speaking about the likelihood of certain events, plans or performance happening in the future. They could be considered a type of "forward-looking" statement a business may make or as a counterbalancing factor. In order to gain the protection of the safe harbor, Section 27A of the Securities Act of 1933 (added by PSRLA) requires that the statements be identified as "forward – looking" and be accompanied by meaningful statements of cautionary factors. The case law under Section 27A about what constitutes a meaningful statement of a cautionary factor will be helpful in designing risk factors. Taking another approach, SEC Rule 175 states that the safe harbor is <u>not</u> available if there is <u>not</u> a reasonable basis for the "forward-looking" statements or if the statement is <u>not</u> made in good faith. A drafter should think about and take into account whether the original claim or plan (about which he or she is drafting a risk factor) was reasonable and made in good faith in the first place.

Prior to the PSLRA, there was development of a case law doctrine called the "bespeaks caution" doctrine that was designed to limit the number of lawsuits brought because a business' projections about the future did not pan out. The idea was that if there was specific disclosure of risks involved in the investment, that should "bespeak caution" about the risks facing the business and in turn, about the risks of investing to the potential investor. Courts have found that risk factors and other disclosures would provide sufficient warning to that investor. (*In re Worlds of Wonder Securities Litigation, 35 F.3d 1407 (9th Cir. 1994), Truk International Fund, LP v Wehlmann, 737 F. Supp 2d. 611 (N.D. Texas, 2009))*

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