

506 rule protects investors

A Securities and Exchange Commission exemption makes it easy for startups like Scuderi Group to raise money without government scrutiny, but revisions are constantly made to the law and companies must be careful to disclose all the downsides to the investment, or they could be sued for fraud.

Companies that file for the exemption, called Rule 506 of Regulation D, can sell their investments mostly to accredited investors – people whose net worth is at least \$1 million – and to 35 non-accredited investors – the less well-heeled. The rule was made to protect people from losing all their money by investing in high-risk ventures.

Changes were made to the law last year in the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as the financial overhaul bill. One of the bill's most important reforms prohibits people from including the value of their primary residence in net worth calculations to determine whether they're accredited investors, explained Joe Campolo, an attorney at Campolo, Middleton & McCormick in Bohemia. Members of the angel investor and venture capital communities have said the change could, in effect, reduce the pool of available investors, making it harder for small startups to find financing.

The change has a particularly chilling

effect on Long Island, where real estate values are high, Campolo said.

Another change, the details of which the SEC is still hammering out, prohibits companies with SEC orders against them from raising money under Rule 506.

Even with the alterations, Rule 506 is still most commonly used by companies and entrepreneurs to raise funds because of its relatively low cost, Campolo said. Companies can raise unlimited funds for a cost of tens of thousands of dollars. The other method of raising unlimited funds – a public offering of stock – costs hundreds of thousands of dollars, he said.

The cost difference is mainly due to the expense of hiring of attorneys and accountants who prepare audited financial statements necessary for going public. Mark Fasciano, an entrepreneur who started FatWire and Karma 411, has raised money for his own companies under Rule 506. He said only those companies with a significant revenue stream would benefit from going public. A technology company, for example, would require at least \$75 million to \$100 million in revenue.

"As a private company, it only makes sense to go public if you're big enough," Fasciano said.

When a company is going public, the SEC scrutinizes its prospectus, which discloses to investors every possibly risk

and downside, said Paul Rubell, an attorney at Meltzer Lippe Goldstein & Breitstone in Mineola. Under Rule 506, the same disclosures must be made only to the unaccredited investors in a document called a private placement memorandum. It's a move that protects the company from future lawsuits if the business fails, Rubell explained.

"It's self-compliance," he said.

Campolo said the disclosures make it far more difficult for investors to claim fraud when their investment tanks because the company can counter that it spelled out every possible downside in the memorandum. He explained many of the lawsuits relating to Long Island Ponzi scheme Agape World claimed fraud due to a lack of disclosure.

Agape World did not delineate who was an accredited investor and who was not, nor did it complete any sort of federal or state filings, said Campolo, who handled many of the fraud lawsuits in the wake of the \$400 million Ponzi scheme, orchestrated by convicted swindler Nicholas Cosmo.

Campolo noted that the guidelines relating to disclosures are what make Rule 506 the "Safe Harbor" law. Companies are protected from the scrutiny of the SEC, he explained.

– JESSICA DINAPOLI