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OBTAINING MONEY FROM INVESTORS -

SECURITIES LAWS COMPLIANCE

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1. <u>In General</u>

An incorporator or subscriber to stock, even in a small company, often is surprised to learn that the initial issuance of stock and any later transfer of the stock is potentially subject to the registration requirements and antifraud provisions of federal and state securities laws. While most small stock issues will be exempt from the registration provisions, the antifraud provisions always apply. If you are planning to raise money from investors (for example, silent partners), who will own part of the business, there are securities laws issues, which must be addressed. This Part of the Guide will address the federal and state securities laws as they apply in obtaining money from investors.

A "security" is more than just stock in a corporation. It also includes a limited partnership interest. It can also include a general partnership interest, limited liability company membership or registered limited liability partnership interest (where there is centralized management) as well as notes, options, warrants, debentures and other "investment contracts." The U.S. Supreme Court has developed a 4-part test, called the *Howey* test, to determine if an investment constitutes a security:

(i) An investment of money;

(ii) In a common scheme or enterprise;

(iii) With an expectation of profits; and

(iv) Where the success of the investment is dependent on the efforts of others (a "passive" investment).

Active investments such as where 2 people form a partnership or a corporation and both run the business are not considered securities.

There are both federal and state securities laws (dual regulation). In any offering of securities you must determine how the federal securities laws apply to the offering. In addition, the laws of the state where the issuer of securities (for example, the corporation) is organized will also apply as well as the laws of each state where the investors reside. It is very important to retain an attorney knowledgeable in securities laws. If you sell an "unregistered" security that is not "exempt," you may have violated the securities laws. You may have inadvertently become a "guarantor" of the success of the business venture because disgruntled investors (when the deal isn't successful) may be able to sue you individually for rescission and attempt to get their money back from you.

2. <u>Federal Securities Laws</u>

Before the stock market crash of 1929, there were no securities laws. Investors were not given full and complete information about the stock offering so that an informed investment decision could be made. There was no registration of securities. Investors bought stock on margin (credit). Banks loaned people money on an unsecured basis to purchase speculative stocks. The stock market crash contributed to the failure of the banks and was the start of the Great Depression. As part of President Franklin D. Roosevelt's New Deal, comprehensive federal securities laws were passed in 1933 (the "Securities Act of 1933") and in 1934 (the "Securities Exchange Act of 1934").

Under the Securities Act of 1933, an offer of securities (for example, stock in a corporation, a limited partnership interest or a membership interest in a limited liability company) must be registered with the Securities and Exchange Commission ("SEC"), unless the securities are exempt ("exempt security") or the transaction is exempt ("exempt transaction"). The most typical exempt transaction is called a "private offering." Most small deals are exempt as a private offering. A private offering must comply with Subsection 4(2) of the Securities Act of 1933 and should also comply with one of the "safe harbor" provisions of Regulation D.

(a) <u>Regulation D</u>

Regulation D is a series of 8 rules (Rules 501 - 508) governing exemptions from registration for certain limited offerings of securities. Rules 501 through 503 provide certain definitions and general conditions applicable to all Regulation D offerings. Rules 504, 505 and 506 provide the actual exemptions from registration. Rules 507 and 508 address the consequences of non-compliance with certain conditions or requirements of Regulation D.

(i) <u>Rule 504</u>

An offering up to $1,000,000 may be conducted in reliance on Rule 504. Rule 504 exempts issuers that offer and sell up to $1,000,000 of securities during a 12-month period provided that no more than $500,000 of the offering price is attributable to offers and sales of securities without registration under a state's securities laws. The advantage of Rule 504 is that there is no ceiling on the number of investors and there are no restrictions on the manner of the offering (you can have general solicitation) and on resale. Rule 504 is not available to investment companies or "blank check" (blind pool) companies. An offering under Rule 504 will not be available to you if most of your investors are from Florida or other states that do not require registration of the offering. Also as a practical matter, the process for registration in a state is generally more time consuming and expensive than relying on another safe harbor provision under Regulation D such as Rule 505 or Rule 506.

(ii) <u>Rule 505</u>

Rule 505 provides an exemption for offers and sales not exceeding $5,000,000 in any 12-month period when sales are made to not more than 35 nonaccredited investors and an unlimited number of accredited investors. Rule 505 is available to corporations, partnerships, and any other issuer that is not an investment company. No general solicitation or advertising may be employed and resale is restricted. Rule 505 does not impose sophistication requirements for purchasers of securities, as does Rule 506. No particular information is required when solely accredited investors purchase the securities. In the case of sales to nonaccredited investors, however, nonreporting companies must furnish the information required in Part I of Form S-18 (or such other form as the issuer may be qualified to use) plus 2 years' financial statements with the last year audited. The issuer must also afford the investor an opportunity to ask questions and get answers from a knowledgeable source within the company.

(iii) <u>Rule 506</u>.

Rule 506 is similar to Rule 505 except that any purchaser who is a "nonaccredited" investor must be "sophisticated" under Rule 506. In addition, the exemption under Rule 506 is unlimited in amount. Rule 506 is available to all issuers for offerings sold to not more than 35 sophisticated purchasers, plus unlimited numbers accredited investors. Rule 506 requires the issuer to make a subjective determination that each purchaser, other than accredited investors, meet certain sophistication standards. The exemption retains the concept of a "purchaser representative" so that unsophisticated purchasers may participate with the aid of another person. Rule 506 has no maximum dollar amount limitation. The same disclosure is required under Rule 506 as under Rule 505 as to offerings of $5 million or less. For larger offerings, however, the information required in Part I of the available registration form must be furnished.

(iv) <u>35 Purchaser Limitation</u>.

Certain purchasers are excluded from the 35-purchaser limitation contained in Rules 505 and 506, as follows:

(1) Accredited investors;

(2) Non-United States citizens and residents where the offers and sales are made outside of the United States in a manner that will result in the securities coming to rest abroad;

(3) Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser;

(4) Any trust or estate in which a purchaser and any of the persons related to him or her as specified in (3) above or (5) below collectively have more than 50% of the beneficial interest (excluding contingent interests);

(5) Any corporation or entity of which a purchaser and any of the persons related to him or her under (3) and (4) above are beneficial owners of more than 50% of the equity interests; and

(6) An original limited partner where his or her participation is solely to ensure formation of the partnership before units are sold to investors, and where his or her interest is repurchased by the partnership.

For the purposes of counting purchasers, each corporation, partnership, or other entity is counted as one purchaser (unless such entity was organized for the specific purpose of acquiring the securities and is not an accredited investor and then each beneficial owner of an equity interest in the entity is counted as a separate purchaser).

(v) <u>Form D</u>.

These rules require the filing of a "Notice of Sale" on Form D with the SEC. The issuer must file with the SEC 5 copies of Form D no later than 15 days after the first sale of securities in a Regulation D offering. A notice is deemed filed with the SEC as of the date on which it is received by the SEC, or as of the date on which the notice is mailed by means of United States registered or certified mail to the SEC at its Office of Small Business Policy. An authorized person of the issuer, who can include the issuer's attorney, must manually sign one copy of every notice. Pursuant to Rule 507, the failure to file Form D within the requisite 15-day period will not destroy the availability of the exemption, although other penalties may apply.

For sales under Rule 505, the Form D notice contains an undertaking by the issuer to furnish the SEC, upon request, the information furnished to nonaccredited investors. Amendments to Form D filings need only report the issuer's name and the information required by Part C of the Form and any material change in the facts from those set forth in Parts A and B.

The SEC staff has noted that the receipt of the first subscription agreement and the acceptance of subscription funds into an escrow account pending receipt of minimum subscriptions trigger the filing requirements. The issuer should file its first Form D no later than 15 days after the receipt of the first subscription agreement.

(vi) <u>No General Solicitation</u>.

Except as provided in Rule 504(b)(1) for certain 504 offerings and for 506 offerings , the issuer and any person acting on its behalf is prohibited from offering or selling the securities by any form of general solicitation or general advertising. The exclusion includes any advertisement, article, notice or other communication published in a newspaper, magazine, or similar media or broadcast over television or radio. However, seminars or meetings discussing the offering are allowed, so long as any general solicitation or general advertising has not invited those attendees. This provision requires that the issuer control the number and kind of offerees so as to show that no general solicitation existed even though no offeree qualification *per se* is present.

(vii) <u>Private Placement Memorandum</u>.

Depending upon the nature of the investors to whom you intend to sell, and the maximum amount of money sought to be raised, these rules may also require preparation of a detailed disclosure document, typically called a "private placement memorandum." If you intend to sell the stock only to "accredited investors," regardless of the amount to be raised, a private placement memorandum is not required but is strongly advisable to minimize future claims of fraud or misrepresentation. Accredited investors include: (a) a bank and certain other financial and investment institutions; (b) any director or executive officer of the issuing corporation; (c) any person whose individual net worth or joint net worth with that person's spouse at the time of the purchase exceeds $1,000,000; and (d) any natural person who has an individual income in excess of $200,000 in each of the two most recent years or joint income with his or her spouse of $300,000 and who reasonably expects at least the same income level in the current year.

If <u>all</u> of the investors do not qualify as accredited investors, a private placement memorandum containing all material information required to be disclosed to a potential investors must be prepared and given to the potential investor before the investment is made. For offerings up to $2,000,000, the private placement memorandum must include the same kind of information that is required in Part II of SEC Form 1-A. For offerings in excess of $2,000,000, the private placement memorandum must include the same kind of information that is required in Part I of SEC Form S-18. In either case audited financial statements are generally required. The information generally includes:

(i) Summary Information and Risk Factors.

(ii) Use of Proceeds.

(iii) Determination of Offering Price.

(iv) Dilution.

(v) Selling Security Holders.

(vi) Plan of Distribution.

(vii) Legal Proceedings.

(viii) Directors and Executive Officers.

(ix) Security Ownership of Certain Beneficial Owners and Management.

(x) Description of the Securities.

(xi) Description of Business.

(xii) Interest of Management and Others in Certain Transactions.

(xiii) Executive Compensation.

The offering is limited to no more than 35 unaccredited investors with no limit as to accredited investors.

(b) <u>Intrastate Offering Exemption</u>

An offering of securities by an issuer of a state to only investors resident of, or doing business in, the same state is exempt from federal registration and disclosure requirements. The intrastate offering exemption has the advantage of allowing certain general advertising, no investment sophistication requirement for purchasers, and no limitations on the number of purchasers. This offering will be subject to the federal antifraud provisions and the blue sky laws of the applicable state.

Rule 147 provides a non-exclusive safe harbor for an intrastate offering exemption. In order for Rule 147 to apply, an issuer must be able to sustain the burden of proving that it has satisfied all of the conditions set forth in the rule. These conditions generally are as follows:

(1) The issuer is a resident of and doing business in a state in which the securities are offered and sold.

(2) All offerees and purchasers (except for certain foreign investors) must be residents within the same state; and

(3) The issuer must take certain documentary precautions against interstate distribution, including limiting resales for a period of 9 months after the last sale that is part of the issue.

(c) <u>Regulation A</u>

Regulation A is an exemption from registration (like Regulation D) for offerings up to $5,000,000, but does require the preparation of a registration statement that must be filed with a regional office of the SEC.

A summary of the general features of Regulation A are as follows:

(1) Offerings of up to $5,000,000 by the issuer in a 12-month period are allowed, of which up to $1,500,000 may consist in secondary sales by shareholders.

(2) The offering may be made to an unlimited number of investors.

(3) There is no requirement of investor qualification.

(4) An offering circular is required and some advertising is allowed.

(5) There are no limitations on resale.

(6) Only United States and Canadian companies may use the exemption provided the company is not disqualified by virtue of prior specified wrongdoing. No investment companies may use the rule.

(7) Form 1-A must be filed with the SEC regional office at least 20 days before the offering, and sales materials must be filed upon use.

(d) <u>Uniform Limited Offering Registration - (SCOR Form U-7)</u>

Form U-7 is the general registration form for corporations registering under state securities laws securities that are exempt from registration with the SEC under Rule 504 of Regulation D. It is designed to be used by companies, the attorneys and accountants for which are not necessarily specialists in securities regulation.

A Form U-7 format is similar to a business plan. It is set up on a plain English question and answer format designed to be drafted by the company's management or its financial team rather than attorneys. A Form U-7 is used as the registration statement and the investor prospectus. In the states which accept a Form 7 (listed below), some states deal solely with disclosure made to investors and other states also apply substantive fairness standards to public offerings to assure that the terms and structure of the offering are fair to investors. In particular, those standards are designed to require the promoters of the company to share its potential risks and rewards fairly with the public investors. Those standards vary from state to state and as a general rule must be complied with by a company in order to register its securities in those states.

Any U.S. corporation may use U-7 with certain exceptions. Specifically, the form may not be used:

(i) To register securities for resale on behalf of anyone other than the corporation;

(ii) By partnerships;

(iii) By companies in the business of petroleum exploration or production, those engaged in mining or those in other extractive industries;

(iv) By "blind pool" offerings (for which the specific business or properties cannot be described); and

(v) If the company, or any of the company's management or 10% or greater stockholders, have had certain past regulatory problems.

Additionally, investment companies (mutual funds, etc.) may not use Form U-7, nor may public companies that report to the SEC under Section 12 or 15(d) of the Securities Exchange Act of 1934.

Up to $1,000,000 may be raised by a company every 12 months. The offering price must be at least $5.00 per share. The company may not split its stock or declare stock dividends for 2 years, except with permission of the Securities Administrator. For offerings under $500,000, the company is allowed to submit reviewed financial statements rather than audited financial statements. A Form D must be filed with the SEC.

One of the advantages of using a limited offering registration over a Regulation D Rule 504 offering is the right to advertise the offering. An issuer can place "tombstone" advertisements in publications, send out direct mailings, issue press releases, and conduct investor meetings. It is also possible to form a broker/dealer syndication to sell in the states where a Form U-7 registration is accepted.

The Form-7 must disclose the following information concerning the offering:

(i) The Company

(ii) Risk Factors

(iii) Business and Properties

(iv) Offering Price Factors

(v) Use of Proceeds

(vi) Capitalization

(vii) Description of Securities

(viii) Plan of Distribution

(ix) Dividends, Distributions and Redemptions

(x) Officers and Key Personnel of the Company

(xi) Directors of the Company

(xii) Principal Stockholders

(xiii) Management Relationships, Transactions and Remuneration

(xiv) Litigation

(xv) Federal Tax Aspects

(xvi) Miscellaneous Factors

(xvii) Financial Statements

(xviii) Management Discussion and Analysis of Certain Relevant Factors

The registration of securities pursuant to a Form U-7 is available in the following states and District of Columbia:

Alaska	Nevada
Arizona	New Hampshire
Arkansas (unofficial recognition)	New Jersey
California	North Carolina
Colorado	North Dakota
Connecticut	Ohio
Georgia (unofficial recognition)	Oklahoma
Idaho	Oregon
Indiana	Pennsylvania
Iowa	Rhode Island
Kansas	South Carolina
Kentucky	South Dakota (unofficial recognition)
Louisiana (unofficial recognition)	Tennessee
Maine	Texas
Maryland	Utah
Massachusetts	Vermont
Michigan	Virginia (unofficial recognition)
Mississippi	Washington
Missouri	West Virginia
Montana	Wisconsin
Nebraska	Wyoming

3. State Securities ("Blue Sky") Laws

Federal securities laws specifically allow the states to also regulate securities transactions, so long as state regulation does not conflict with federal law. The states remain free to add to or duplicate federal requirements to a considerable extent. State securities laws, commonly known as "blue sky" laws, generally provide for the registration of broker-dealers, the registration of securities to be offered or traded in the state, and sanctions against fraudulent activities. Regulation D does not relieve an issuer from satisfying the registration obligations of each state where the issuer plans to offer or sell its securities. In many instances, a securities offering that is exempt under the Federal Securities Act will be exempt from registration at a state level by a comparable exemption. Because many states securities laws provide greater protection for investors, it is possible that an offering that is exempt at the federal level will require registration in some or all of the states where the issuer intends to market its securities. Furthermore, regardless of the status of the offering, under federal and state securities laws, an issuer, and/or those persons who act for it, might be subject to state broker-dealer regulations.

Unlike federal regulations, the state statutes generally permit a merit analysis of the investment before securities can be offered for sale. This type of substantive scrutiny goes further than full disclosure; registration by qualification actually permits the state securities administrator to look to the merits of the investment being offered. As is the case with federal registration provisions, the state acts generally provide numerous exemptions.

State securities regulations generally provide for 3 types of securities registrations. These 3 alternatives are known as registration by qualification, registration by notification, and registration by coordination with federal registration. Registration by qualification may be used for any security not covered by one of the blue sky laws exemptions. Registration by notification is generally only available to issuers that have been in an established business for 5 years or more.

The simplest form of registration under state acts is coordination with federal registration. The state registration will become effective concurrently with federal registration. It is important to note that coordination is only available for a 1933 Act registration and thus <u>will not apply</u> to offerings subject to a federal exemption.

There are generally 2 types of private placement exempt transactions under state blue sky laws. The first exemption applies to an offer directed to not more than 10 persons within the state within any 12-month period. The exemption is further qualified in that purchasers must be buying for investment rather than resale and there can be no promoters' fees for soliciting potential purchasers, subject to waiver by state administrators. It is important to note that the 10-person limit applies only to offers to persons within that state; actual sales are not counted (although the offer to the purchaser is counted). In addition, certain categories of offerees are to be excluded from the 10-person count, including offers to a bank, savings institution, trust company, insurance company, investment company, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer. Some states have expanded the number of offerees that may be counted in qualifying for this exempt transaction. Some states have placed limits on the number of actual purchasers rather than offerees.

The second type of exempt transaction for private placements under blue sky laws allows sales of up to a specified dollar limitation, usually $1,000,000, to a specified number of offerees, usually 35. Restrictions on this type of exempt transaction are generally similar to those for the exemption available for a 10-person offeree transaction.

Under either type of private placement exemption available under blue sky law, common restrictions on the offering include prohibition against general solicitations or general advertising and prohibitions against the payment of sales commissions or other remuneration to brokers or salesperson. Many states also impose suitability requirements for investors. Each state's law should be consulted prior to commencing any offers or sales to persons residing within that state.

In certain states, there is a "pre-filing requirement" meaning that all required documents must be filed with the state before an offer can be made in the state. These documents usually include a special state form, copies of the private placement memorandum and the payment of a filing fee. Special legends advising an investor that state registration does mean the state endorses the investment and/or giving a prospective investor a rescission period (for example, 3 days in Florida) are required to be included in the private placement memorandum.

In addition, if financial forecasts are used in the private placement memorandum, the forecast must be examined by a certified public accountant in accordance with A.I.C.P.A. guidelines for review engagement of financial forecasts. If sales are to be made only to accredited investors, forecasts may be used without the accompanying review of the C.P.A.

In other states, there is a "post-filing requirement" meaning that within a certain period of time after the first sale to a person resident in the state a notice form (similar to Form D filed with the SEC) must be filed with the state. In still other states (such as Florida), there is no pre-sale or post-sale filing document. You must merely comply with that state's exemption requirements.

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