SECURITIES IMPLICATIONS INVOLVED IN RAISING MONEY FOR YOUR BUSINESS

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A Bit of Background

Securities regulation in the United States followed several centuries of regulation in England. Brokers were licensed in England as early as 1285. All such regulation was aimed at the curtailment of dubious money-raising schemes, such as the one in England during the early 18th Century when thousands of people were persuaded to purchase stock in a company based upon the representation that the company founders were preparing to carry "on an undertaking of great importance, but nobody to know what it is." The investors in this scheme, as well as many others who invested in similar schemes, had their bubbles burst, lost their money and, as a result, the "Bubble Act" was passed in 1720. The Bubble Act focused on "persons who contrive or attempt such dangerous and mischievous undertakings or projects, under false pretenses of public good, do presume . . . to open books for public subscriptions, and draw in many unwary persons to subscribe therein towards raising great sums of money . . . ".[1]

The Securities Act of 1933 (the "1933 Act") was prompted by the Wall Street crash of 1929. The first administrator of the newly created bureaucracy was Joe Kennedy. The pronounced goal of the legislation was consumer protection. Subject to certain exemptions, the 1933 Act requires registration of all securities being sold. The purpose of registration under the Act is "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails and to prevent frauds in the sale thereof...."[2] To achieve this goal, the 1933 Act generally requires a company which proposes to issue its securities to file a registration statement with the Securities and Exchange Commission. The registration process is designed to protect investors by providing them the information necessary to make informed investment decisions. The process, however, is time consuming and expensive. Therefore, when you have determined that you need to raise money for your business, you will want to answer two questions:

1. Whether your efforts will involve the offering of "securities" and, if so,
2. Whether your efforts can be undertaken either without registration or with an abbreviated registration.

What is a security?

Any instrument (agreement, certificate, interest etc) offered in exchange for capital could be viewed as a "security" and its issuance may therefore raise securities law concerns. Section 2(1) of the 1933 Act defines the term "security" as follows.

> The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security:, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. [3]

The term "investment contract" has become the catchall category and the focus of many courts considering whether a particular instrument is a security. An investment contract has been defined as any contract or profit-making scheme whereby a person invests his

1 The general information and the quotations in this paragraph are taken from Fundamentals of Securities Regulation by Louis Loss and Joel Seligman, Little Brown and Company, 3rd edition (1995) pp 1-8.
2 Securities Act of 1933, 15 U.S.C.A. §§ 77 et seq., Preamble.
3 Securities Act of 1933, 15 U.S.C.A. § 77B.

or her money in a common enterprise and expects to make a profit solely from the efforts of others. *S.E.C. V. W. J. Howey Co.*[4]

This test remains a useful guide in determining whether, for example, an interest in a limited liability company should be considered a security.

Any transaction in which an outside investor is asked to furnish money to a business likely involves either a public offering or a private offering of securities. Raising money for companies that chose not to (or are unable to) tap public markets can range from a simple cash contribution by a founder to a complex private offering. The latter circumstance may require the sacrifice of control and will likely raise concerns under applicable securities laws.

Various types of instruments can be used to attract capital. Equity interests in a corporation may be sold as common stock, preferred stock, options, or warrants. Equity interests in other types of entities could be (by way of example) “units” in a limited liability company or “interests” in a limited partnership. (A limited liability company is a hybrid entity that provides limited liability like a corporation but is taxed as a partnership.) Debt instruments can also be used to attract capital and provide investors the protection of guaranteed interest payments rather than the risk of uncertain dividends.

The sale of, or the offer to sell, any instrument that is classified as a security requires either registration or an exemption from registration.

Public markets are often unavailable for start-up companies and small businesses. Such companies must turn to the exemptions from registration. It is important to remember that if the requirements of the exemption are not met, companies are liable for securities sold in violation of the registration requirements. It is also important to note that securities acquired in a private offering are not immediately re-saleable by the investor. There are re-sale limitations on persons affiliated with the issuer that apply whether the offering was a registered public offering or a private offering.

What Offering Opportunities Are Available For You?

The type of offering you choose depends on a number of factors, such as:

- **How much money do you wish to raise?** The SEC has created certain registration formats and exemptions that are dependent upon established monetary limits. Companies can raise only limited dollar amounts using certain forms and federal registration exemptions.
- **Does your marketing plan require you to generally solicit potential customers?** If you want to advertise in newspapers or approach persons with whom you have no pre-existing relationship, you will not be able to use certain forms or certain exemptions from registration. General advertising and solicitation is currently only permitted in a public offering or under new Rule 506(c).
- **Where do you wish to sell the securities?** If you need the ability to solicit investors in more than one state, the intrastate exemption will not be available to you.

Intrastate Offerings

An offering only to persons where your company is organized is exempt from Federal securities laws. State laws, however, will apply.

Regulation D

Regulation D may provide the most common avenue for raising significant amounts of money through the sale of securities without registering the offering with the SEC. It contains three registration exemptions - Rules 504, 505 and 506.

4 328 U.S. 293 (1946).

In a February 2008 Release, the SEC has mandated electronic filing of Form D. Private companies wishing to use one of the Regulation D exemptions are required to obtain an EDGAR filing code and file the Form D on the SEC's EDGAR system.

Rule 506(a) and (b)

Private offerings for an unlimited dollar amount are governed by Rule 506. Such offerings cannot be made to more than 35 non-accredited investors but may be made to an unlimited number of accredited investors. There is an additional requirement that the purchaser be a "sophisticated person," i.e. a person with "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment."[5] The required level of sophistication can be provided by a purchaser representative such as a broker, accountant or attorney.

As with offerings under Rule 505, there are specific disclosure requirements for offerings to non-accredited investors and a note strongly suggesting that similar information be given to any accredited investors included in the same offering. The non-financial disclosure for offerings over $5,000,000 is that which is required by any available registration form, Part I. Financial information required is generally two years of audited income statements and an audited balance sheet. For offerings over $7,500,000, if the issuer does not qualify as a small business issuer, three years of audited income statements plus an audited balance sheet would be required. In certain circumstances, only an audited balance sheet within 120 days of the start of the offering is required.[6]

New Rule 506(c) [effective September 23, 2013]

Under limited circumstances, Rule 506(c)[7] will allow issuers to offer securities through means of general solicitation, without registration. All purchasers must be accredited investors and the issuer must have taken "reasonable" steps to verify that status." Rules regarding integration and re-sale of securities still apply. In a 506(c) offering, the rules regarding specific disclosure will not apply because all investors must be accredited. However, offerings under this new rule will still be subject to the antifraud and civil liability provisions of the federal securities laws.

Definition Of Accredited Investor

The concept of the accredited investor is key to the understanding of Rules 505 and 506 of Regulation D. An accredited investor is defined by Rule 501(a)[8] of Regulation D to include (but not limited to) the following:

(a) "Institutional Investors", such as banks, savings and loans, insurance companies, investment companies, employee benefit plans with total assets in excess of $5,000,000 and plans established by a state, its instrumentalities or any agency or instrumentality thereof, for the benefit of its employees, if the plan has total assets in excess of $5,000,000.

(b) Private Business Development Companies as defined in Section 202(a)(22) of the Investment Adviser Act of 1940.

(c) Tax Exempt Organizations and For-Profit Entities if the entity is not formed for the specific purpose of making the investment and its total assets exceed $5,000,000.

(d) Directors, executive officers and general partners and certain other insiders of the issuer.

(e) Any natural person whose net worth at the time of purchase or the joint net worth of the investor and the investor's spouse is $1,000,000 (not including the value of the principal residence).

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5 Regulation D, Rule 506(b)(2)(ii), 17 CFR 230.506(b)(2)(ii).
6 Regulation D, Rule 502(b)(2)(B)(3), 17 CFR 230.502(b)(2)(B)(3).
7 Regulation D, Rule 506(c), 17 CFR 230.506(c), published July 24, 2013.
8 Regulation D, Rule 501(a), 17 CFR 230.501(a).

(f) A natural person who has an income in excess of $200,000 in each of the last two years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same level in the current year.

Determining Accredited Investor Status Under New Rule 506(c):

Your obligation to take "reasonable steps to verify that purchasers . . . are accredited investors" is key to the availability of new Rule 506(c). You will need to base this determination on objective, verifiable information; information that some of your potential investors will be reluctant to provide to you. The SEC has given examples of information gathering that they would accept as constituting "reasonable steps" to verify the accredited status of investors, including:

- Two years of tax returns, including W-2s, 1099s etc AND a written rep from the investor that he/she has a reasonable expectation of reaching that income level for the current year;
- Bank statement, brokerage statement or report from nationwide consumer reporting agency AND a written rep from the investor that all liabilities necessary to determine net worth are disclosed in the statement or report;
- Written confirmation from a registered broker-dealer, investment adviser, licensed attorney or certified public accountant in good standing.

If a person's qualification is based on joint ownership with a spouse, the written representation of the spouse should also be obtained. For a person who invested in one of your prior 506(b) rounds as an accredited investor, the verification requirement is satisfied by obtaining a certification from that person at the time of the 506(c) offering that he/she qualifies as an accredited investor.

The examples listed by the SEC are not exclusive, but you should be very certain that any other type of information upon which you may rely is at least as reliable as that which likely would have been obtained in the SEC examples.

Integration Doctrine

Under the integration doctrine, the SEC can treat two or more offerings as one. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be integrated. Integration is an important because, if applied, the number of offerees will be increased and the amount of the offering will be increased, thus possibly destroying an otherwise available exemption.

If you are considering a 506(c) offering and plan to engage in some general solicitation, remember that you will not be able to accept funds from non-accredited investors. Once you have started down the path of general solicitation, you cannot change your mind regarding that offering, or any offering that may be integrated with it.

General Regulation D Considerations

To obtain the safe harbor protection of Regulation D, Form D must be sent to the SEC 15 days after the first sale. The following should be noted about any Regulation D offering.

1. Regulation D offerings (even those with no specific disclosure requirements) are not exempt from antifraud or civil liability provisions of the federal securities laws. Issuers conducting Regulation D offerings must disclose whatever material information may be needed to make the available information not misleading. This will be equally true to any offering under new Rule 506(c).
2. An issuer is obligated to comply with applicable state laws for all private offerings other than those conducted under Rule 506. All states, however, have notice filing requirements that you will need to heed when relying on Rule 506.
3. Regulation D is available only to the issuer for the transaction in question and not to its affiliates or others for re-sales of the securities.

Form D is the official notice of an offering in reliance on Regulation D. Effective March 16, 2009, all Forms D must be filed electronically. Issuers will all need an EDGAR code in order to file. The information will become publicly searchable. A CRD number will be required for individuals receiving sales compensation.

Resale of Non-Registered Shares

Rule 144 applies to the resale of shares of stock acquired in a private (non-registered) transaction and to shares of stock held by "affiliates." An affiliate is a person who directly, or indirectly though intermediaries, controls, or is controlled by, or is under common control with the company (usually officers, directors and 10% holders). Rule 144 provides safe harbor "safe harbor" protection for the sale of restricted stock and for affiliates to sell their shares of stock (no matter how acquired).

Generally, the holding period for restricted securities of companies that report to the SEC under the Securities Exchange Act of 1934 will be shortened to six months, after which securities held by non-affiliates will, in most cases, be freely saleable. Securities held by affiliates will be saleable subject to other requirements of Rule 144.

Non-affiliates of a reporting company: As of that date, a person who is not an affiliate (and has not been an affiliate for the preceding three months) of an issuer that has met reporting requirements for at least 90 days, may resell the securities after a six-month holding period. If the issuer has not filed all required reports for at least twelve months prior to the sale (or for a shorter period if the issuer has been subject to reporting requirements for less than twelve months), the holding period is extended to one year.

Non-affiliates of a non-reporting company: If the issuer is not subject to reporting requirements, a minimum of one year must elapse prior to resale of the securities.

Affiliates of a reporting company: If the issuer has met reporting requirements for at least 90 days and has filed all required reports for at least twelve months prior to the sale (or for a shorter period if the issuer has been subject to reporting requirements for less than twelve months), an affiliate can resale securities after the expiration *six months, subject to certain other conditions:*

- The number of securities to be resold must fall within specified volume limitations;
- The resale must comply with the revised "manner of sale" conditions; and
- The seller may be required to file a Form 144 reporting the sale (or proposed sale), subject to the new reporting threshold.

The provisions of Rule 144 are *not* available for the resale of securities initially issued by a *shell company* unless one year has elapsed from the date Form 10 information has been filed with the Commission.

Liabilities Under Federal Securities Law

In furtherance of the philosophy of the Securities Act, an issuer that raises capital through the use of a registration statement containing material misstatements or omissions is absolutely liable to the purchaser, unless the purchaser had knowledge of the truth and was therefore not misled by the prospectus. Directors, officers, underwriters and experts can also be liable for such material misstatements or omissions.[9] Any person who offers or sells a security without following the disclosure requirements of the Securities Act is liable in a civil action to the purchaser of the security.[10] A successful plaintiff under this section is entitled to rescission and return of the purchase price. The Securities Act also provides an express private remedy for a purchaser against the seller of a security for material misstatements or omissions in connection with the offer and sale of a security.[11]

Law suits for material misstatements or omissions or for violation of the disclosure

9 Securities Act of 1933, Section 11, 15 U.S.C.A. §77k.
10 Securities Act of 1933, Section 12(a)(1), 15 U.S.C.A. §77l(1).
11 Securities Act of 1933, Section 12(a)(2), 15 U.S.C.A. §77l(2).

requirements of the Securities Act must be brought within one year of discovery but in no event later than three years after a sale.[12]

Potential defendants in an action brought with regard to misstatements or omissions in a registration statement, other than the issuer, can avoid liability by demonstrating that they performed a reasonable investigation of the company and had no reason to believe (and did not believe) that the prospectus contained material misstatements or omissions.[13] Defendants in an action brought with regard to misstatement or omissions in a private placement disclosure document can avoid liability by demonstrating that they did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.[14] It is to preserve these defenses that a good deal of the time, effort and cost of preparing for an offering (either public or private) involves corporate housekeeping and fact gathering - a process known as Due Diligence.

In the context of a private placement, Due Diligence efforts will likely be confined to issuer's counsel and principal officers. These efforts likely will include providing counsel with all organizational documents and copies of all minutes of meetings of directors, shareholders and committees since the date of incorporation. Minutes may be missing and may have to be reconstructed. Accurate records of stock ownership will be necessary. Copies of all stockholder agreements; creditor arrangements; contracts between the issuer and its officers, directors, shareholders or members of their immediate families; appropriate records of property and equipment transactions; business operations information such as audited financial statements, insurance coverage, top customer lists and employment policies; copies of all authorities or licenses issued by any governmental entity as well as an explanation of any violations or alleged violation of governmental laws or regulations; information regarding any transportation or disposal of hazardous material; explanation of pending litigation; tax returns; material contracts and general operations statistics.

Gathering and reviewing this information will consume large amounts of your time and that of your counsel. The detail of the information requested by your counsel may, to some extent, depend upon the size of the offering and the nature of the offerees. Due Diligence remains the principal avenue for protecting yourself from potential significant liability.

Securities Regulation In Iowa

Each state and most foreign jurisdictions have securities laws and regulations that need to be considered any time you are preparing to offer securities to residents of that jurisdiction. Following is a short summary of state law issues in Iowa.

The Iowa Uniform Securities Act is found in Chapter 502 of the Iowa Code. The Iowa Act was enacted in 2004, became effective January 1, 2005, and is patterned largely on the 2002 version of the Uniform Securities Act. The Iowa Act is based upon a regulatory approach that is common to many other state securities statutes.

Under the Iowa Act securities sold to Iowa residents must be registered with the Iowa Securities Bureau unless: (i) the securities qualify as "federal covered securities"; or (ii) the securities, or the transaction through which the securities are sold, qualify for an exemption from registration under the Iowa Act.

The term "federal covered securities" includes securities sold under Rule 506 of Regulation D of the federal Securities Act of 1933. Rule 191-50.14 (IAC) contains the notice filing procedures for Rule 506 offerings in Iowa. An issuer offering securities under Rule 506 must file a notice on SEC Form D, a consent to service of process on a form U-2, and pay a fee of $100 to the Iowa Securities Bureau no later than 15 days after the first sale of the federally covered security in Iowa. Filing requirements vary from state to state.

There are a variety of exemptions under the Iowa Act that may apply to the offering of

12 Securities Act of 1933, Section 13, 15 U.S.C.A. §77m.
13 Securities Act of 1933, Section 11(b), 15 U.S.C.A. §77k(b).
14 Sanders v. John Nuveen & Co., 619 F.2d 1222 (7th Cir. 1980).

securities to Iowa residents. Once such exemption is the private placement exemption found in Iowa Code Chapter 502.202(14). Under this exemption, an issuer may sell unregistered securities, as part of a single issue, to no more than 35 purchasers (plus an unlimited number of “institutional investors”) in Iowa during any twelve consecutive month period. The term “institutional investor” under Iowa law has generally the same meaning as does the term “accredited investor” under federal law. The Securities Bureau has indicated that persons who purchase at different times should be counted as a separate “purchaser” for each such transaction. The owners of entities formed for the purpose of making an investment will each be counted as a separate “purchaser” for purposes of this exemption. No general solicitation is allowed and no commissions or other remuneration may be paid (other than to broker-dealers registered in Iowa) in order to qualify for this exemption. The issuer must have taken reasonable steps to ascertain that each purchaser is purchasing the securities for investment purposes, and not with an intent to distribute.

Regardless of whether the offering of securities is exempt from either Iowa law or US federal law regarding registration, no offering is ever exempt from the anti-fraud provisions of federal and state securities laws. All issuers must provide adequate disclosure to each prospective investor to assure that the investor has the information necessary to make an informed decision.

Persons and entities involved in the business of distributing and trading securities are required to be registered under the Iowa Act. The Iowa Act also contains the typical prohibitions against use of fraudulent practices in the issuance and distribution of securities. Please refer to the Iowa Act and accompanying regulations regarding these matters.

This summary is intended only to alert readers to the general applicability of Iowa law to these matters. Please refer to Iowa Code Chapter 502, the Iowa Administrative Code and applicable US statutes and regulations.

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Bev is a senior shareholder of the Firm. She works with business organizations in a variety of areas, including securities, mergers and acquisitions, corporate governance and general transactional matters. Bev has assisted companies in a number of initial and secondary securities offerings, both public and private. She has assisted a number of public companies with periodic reporting, governance and compliance matters. Bev has worked with companies in a variety of industries including manufacturing, trucking, technology, banking and financial services. As the Firm’s appointed representative for Lex Mundi, a global association of 160 leading independent law firms in more than 100 countries, Bev enhances the Firm’s ability to provide service to businesses interested in engaging in international transactions. In recognition of her work, Bev is A/V Preeminent rated by Martindale-Hubbell and has been recognized by Chambers USA, Best Lawyers and Super Lawyers in the areas of securities, corporate finance and mergers and acquisitions.