<u>A Primer on Securities Laws and Exemptions</u>

including recent changes made pursuant to the Jobs Act

By Romana Kaleem, Esq.[1]

On September 23, 2013, certain amendments to the Securities Act of 1933 (the "Securities Act" or the "'33 Act") became effective which lifted the 80-year ban on general solicitation in connection with certain narrowly defined sales of securities. The Securities and Exchange Commission (the "SEC") introduced these amendments in order to implement Section 201(a) of the Jumpstart Our Business Startups ("JOBS") Act.

The law, as amended pursuant to the JOBS Act, now allows general solicitation of investors in connection with an exempt securities offering under Rule 506 as long as the purchasers of securities are all "accredited investors".[2] Under the new changes, the issuer of the offered securities must take reasonable steps to verify that an investor is accredited. Prior to such changes, a potential investor could not be contacted through means of general solicitation nor did the issuer have any responsibility to verify an investor's status as an accredited investor.

Business owners seeking to expand their business through investment are elated about these new developments. However, in order for business owners to fully comprehend the impact of these changes on their businesses, a review of existing securities laws is necessary.

I. Background

The Securities Act of 1933, often referred to as the "truth in securities" law, governs the sale of securities. In its most basic form, the Act requires that every security be registered with the Securities and Exchange Commission (the "SEC") or fall under an exemption to the law. Registration of securities is a burdensome, expensive and public process, and typically not the route that small business owners wish to take. The '33 Act also prohibits deceit, misrepresentations and other fraud in connection with the sale of a security.

Under the Act, the definition of "security" is very broad. It includes:

> **…a**ny note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization 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

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[2] Rule 506 as well as the term "accredited investor" is discussed in depth below, but for individuals, an "accredited investor" includes a person with net worth of over $1,000,000 (excluding the value of a primary residence) or who earns more than $200,000 per year.

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 [emphasis added].

Though the definition of security includes nearly two dozen items, much of the early case law centered on the term "investment contract". In the seminal case of *SEC v. W.J. Howey Co., et al.*,[3] the SEC looked beyond the face of the contested business arrangement and focused on the economic realities of the situation. In the case, the SEC sought to enjoin an orange grove company from selling tracts of land coupled with a long-term service contract to investors. The essence of the transaction was that an investor would purchase a tract of land and be the sole individual named on the deed while the Howey Company would retain a possessory right to the land, perform labor on the land to grow and sell oranges, and both parties would share in the profits. The U.S. Supreme Court held that the arrangement contained all of the elements usually associated with a security. *Howey* set the tone for the SEC's broad reading of the term security under the '33 Act, which continues today.

Through *Howey*, a three-pronged test was established to determine the parameters of an investment contract. Such a contract existed when there was: (1) an investment of money; (2) in a common enterprise; (3) with profits to come solely from the effort of others. Later, the last prong was broadened to eliminate the word "solely" and to emphasize that an investment contract exists when the first two prongs are present and the efforts of those other than the investor are the undeniably significant ones.[4]

Over the years, federal and state courts have analyzed whether membership interests in LLCs constitute investment contracts and therefore are securities. Though there is no bright-line rule and a fact-intensive analysis is always necessary, the understanding is that usually, general partnership interests or interests in member-managed LLCs where all members have decision-making authority are not securities; limited partnership interests, interests in manager-managed LLCs or limited interests in member-managed LLCs are securities.

II. Exemptions Under the '33 Act

Given that the definition of security is broad under the Act and frequently would include a membership interest in an LLC, the exemptions to registration play an important role, especially for small businesses. Under the Securities Act, there are exempt securities and exempt transactions. Exempt securities include, among others, securities of municipal, state and federal governments. Exempt transactions include, among others, private offerings to a limited number of persons or institutions, offerings of limited size and intrastate offerings. To avoid registration, offerings of securities must be exempt under federal law as well as state "blue sky" laws.[5] However, issuers of securities are advised to tread carefully because if even the sale of securities to one investor falls outside of the guidelines, the entire offering may be deemed to be in violation

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[3] 328 US 293 (1946).
[4] SEC v. Glenn W. Turner Enterprise, Inc., 474 F.2d 476 (9th Cir.), cert. denied, 414 US 821 (1973).
[5] State securities exemptions are beyond the scope of this article.

of the '33 Act. Furthermore, securities offerings are always subject to antifraud laws which means, in general, that pertinent information must be provided to investors and the information provided must not be false or misleading.

A. Private Placement Exemption

Section 4(a)(2)[6] of the Securities Act, sometimes called the "private placement" exemption, exempts transactions by an issuer "not involving any public offering." The particular boundaries of Section 4(a)(2) are not defined by rule, but as the number of persons increases and their relationship to the company selling securities becomes more distant, it is less likely that an offering will qualify for this exemption.

In order to qualify, the following minimum guidelines must be met: (1) the investors must either have knowledge and experience in financial and business matters to be able to evaluate the risks and merits of an investment (i.e. they must be "sophisticated investors") or they must be able to bear the investment's economic risk (i.e. they must be "accredited investors"); (2) the investors must have access to the type of information normally provided in a prospectus for a registered securities offering; and (3) they must agree not to resell or distribute the securities to the public.[7]

Furthermore, under the Section 4(a)(2) exemption, "general solicitation" or "general advertising" is not allowed. Though the exact parameters of these terms are also unclear, Rule 502(c) includes within these terms: (1) any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. Through no action letters, the SEC has made clear that general solicitation does not only mean solicitation to large numbers of people. Even solicitation of one individual with whom an issuer does not have a substantial pre-existing relationship constitutes general solicitation. Print advertisements left in public places or e-mails about investment opportunities to contacts with whom there is no "substantial" nexus would constitute general solicitation, destroying any exemption under Section 4(a)(2).

Due to the vague boundaries of the Section 4(a)(2) exemption, unless an offering clearly falls within the provision, issuers are best advised to seek exemption under other more precise rules under the Securities Act. Most issuers end up relying on Rule 506(b) of Regulation D (described below) which provides a safe harbor under Section 4(a)(2); that is, if an offering meets the parameters of Rule 506, it is considered exempt under Section 4(a)(2).

B. Regulation D

Regulation D contains Rules 504, 505 and 506, each of which exempt specific offerings of securities. All of these exemptions require that a notice filing, Form D, be filed with the SEC within 15 days after the first sale of securities. This is a simple form that notifies the SEC of the

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[6] Formerly 4(2) but amended under the Jobs Act.
[7] See, e.g., *SEC v. Ralston-Purina Co.*, 346 U.S. 119 (1953); Sorrell v. SEC, 679 F.2d 1323 (1982).

amount and nature of offering being made under Regulation D. Typically, states also require that this form be filed with the applicable state division of securities.

Prior to September 23, 2013, none of the rules under Regulation D allowed general solicitation. That is still generally the case, but the ban has been lifted if certain narrow circumstances are present (discussed below). Also, for the most part, purchasers of securities must be restricted from reselling the securities.

1. *Rule 504*

Rule 504 is sometimes referred to as the "seed capital exemption." It exempts sales of securities up to $1,000,000 in any 12-month period. Public offerings of unrestricted securities can be made under Rule 504 if the sale is made under a state law that requires a substantial disclosure document to be delivered to investors and publicly filed with the relevant state securities division. Furthermore, a public offering can be made under this Rule if it is made in compliance with a state law allowing general solicitation as long as it is limited to only "accredited investors".[8]

2. *Rule 505*

Rule 505 offers an exemption for sales of securities up to $5 million in any 12-month period. The number of investors that are not "accredited investors" must not exceed 35 persons. The non-accredited investors must receive disclosure documents that generally contain the same information as required in a registered offering. Such investors must also receive certain financial information pertaining to the issuer.

3. *Rule 506 and Recent Developments*

As mentioned earlier, Rule 506 offers a safe harbor under Section 4(a)(2) of the Securities Act. Offerings that meet the requirements of Rule 506 are considered "non-public offerings" exempt from registration. Furthermore, state laws are preempted by Rule 506.[9] Rule 506 is the most popular Regulation D exemption representing 99% of capital raised under exempt offerings under Regulation D between 2009 and 2012.[10] Since September 23, 2013, there are two different ways to conduct a securities offering under this rule.

Rule 506(b) is a longstanding rule which allows an offering of securities unlimited in dollar amount to an unlimited number of "accredited investors" and up to 35 "sophisticated persons". Under this type of offering, general solicitation is strictly prohibited. Like Rule 505, the non-accredited investors must receive disclosure documents that generally contain the same information as that required in a registered offering. Such investors must also receive certain financial information pertaining to the issuer.

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[8] "Accredited investor" is defined more fully in the discussion of Rule 506.

[9] However, states still have authority to investigate and bring enforcement actions for fraud, impose state notice filing requirements and collect state fees.

[10] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144(a) Offerings Release No. 33-9415; No. 34-69959, page 64 (July 10, 2013).

Under the definitions accompanying the Rules, an "accredited investor" includes several types of institutional investors as well as (1) any director, executive officer or general partner of the issuer of securities; (2) any person whose individual net worth, or joint net worth with that person's spouse, at time of the securities purchase exceeds $1,000,000 (excluding the value of a primary residence); and (3) any person who had an individual income in excess of $200,000 in each of the two most recent 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 income level in the current year. A "sophisticated person" is an investor who either alone or with his purchaser representative, has sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of an investment.

Rule 506(c) is a new addition to Rule 506 made pursuant to the Jobs Act. It allows offerings of securities unlimited in dollar amount and allows general solicitation of investors, but only if all of the purchasers are accredited investors and if the issuer takes reasonable steps to verify that status. This is in contrast to Rule 506(b) where issuers can rely on investors' statements regarding their accredited investor status. An issuer's due diligence could include reviewing an investor's tax returns, bank statements, brokerage statements and credit report and/or relying on the statement of a broker-dealer, investment adviser, licensed attorney or CPA that he or she has taken reasonable steps to verify the accredited investor status.

Additional changes to Rule 506 disqualify felons and other bad actors from seeking Rule 506 exemption.

III. Consequences of a Non-Exempt Offer

Consequences of a non-exempt sale of securities can be severe. As mentioned earlier, if even the sale to one investor falls outside of the exemptions, the entire offering can be held to be violative of the securities laws. An offering conducted outside of the protection of the securities laws exemptions creates a recission right in the investor, i.e., the investor can demand a return of his/her money. In such a circumstance, the issuer and its directors and officers may be held personally liable for such funds. The issuer could also become the subject of an SEC investigation and could face civil fines and criminal penalties. Furthermore, the issuer could be prevented from participating in securities offerings in the future.

IV. Conclusion

With a goal towards safeguarding unwary investors, securities laws are nuanced and particular. Small business owners can easily run afoul of these laws if they are not careful and well-advised by legal counsel. Recent changes are intended to make it easier for small businesses to seek capital by allowing them to generally solicit potential investors for offerings limited to only accredited investors. The benefits may also reach accredited investors as they are able to be approached by issuers with whom they do not have a pre-existing substantial relationship. Though it is too early to predict the effect of these changes, time will tell whether they have the intended result.