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Equity Financing for Small and Mid-Size Businesses
Raising Money Through the Sale of Unregistered Securities

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EQUITY FINANCING FOR SMALL AND MID-SIZE BUSINESSES; RAISING MONEY THROUGH SALE OF UNREGISTERED SECURITIES

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I. SCOPE OF ARTICLE

This paper is intended to provide an overview of the most commonly used exemptions from registration used by small to midsized businesses when conducting offerings of the sale of securities to raise capital for their businesses. The paper will first discuss the source of the requirement that all sales of securities be registered with the Securities and Exchange Commission, unless an exemption from such registration requirement applies, and will then examine the commonly used exemptions from such registration requirement, including a thorough review of Regulation D and the safe harbors contained therein. The paper will also provide a high level review of possible civil liabilities and penalties associated with the failure to comply with the registration requirements of the Securities Act of 1933 (the "Securities Act") and the anti-fraud provisions in the Securities Act and in the Securities and Exchange Act of 1934 (the "Exchange Act"), including without limitation, Rule 10b-5 of the Exchange Act. Next, the paper will discuss a nagging topic affecting small and midsized businesses in connection with their raising capital through the sale of unregistered securities that being the use of unregistered "finders" as intermediaries in their offerings and paying them success based compensation. Finally, the last section of the paper provides a high level outline of the practical aspects of conducting an offering of the sale of unregistered securities from beginning to end. We hope you find this paper interesting and of value to you in your practice.

II. REGISTRATION EXEMPTIONS AND OVERVIEW OF REGULATION D

A. **General Rule**. Section 5 of the Securities Act provides that all securities offered for sale in the United States must be registered with the Securities and Exchange Commission (the "SEC"), unless an exemption to registration applies.

1. Offerings where the securities have been registered with the SEC pursuant to Section 5 of the Securities Act are commonly referred to as public offerings, which, generally speaking, will permit public advertising or general solicitation of investors by an issuer.

2. Offerings where the securities have not been registered with the SEC as a result of an exemption are commonly referred to as private offerings, which, generally speaking, will not permit public advertising or general solicitation of investors by an issuer and are subject to many other restrictions.[1]

Note: When considering whether to pursue a public or private offering, small to mid-size businesses should consider a number of factors, including, but not

[1] An exception to this statement is an unregistered offering pursuant to Regulation A, promulgated under Section 3(b) of the Securities Act ("Regulation A"), which permits the issuer to engage in limited general public solicitations of investors on account of the issuer having taken certain measures including the qualification of an offering statement by the SEC and an offering circular has been delivered to prospective investors. Also, Rule 504 offerings, discussed in greater detail herein, permit the issuer to engage public advertising and general solicitation under certain circumstances.

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limited to: (i) how much equity does the issuer intend to raise; (ii) whether the business can raise the equity sought without access to a public market in which it can freely advertise and solicit investors; (iii) whether targeted investors will likely be "accredited"[2]; and (iv) whether the business will be in a position to handle the financial and practical burdens associated with SEC registration and the periodic public filings required.

B. **Exemptions From Registration**. Small to mid-size businesses will avoid registration pursuant to Section 5 of the Securities Act where the conducted offering qualifies for one of the following common exemptions from the registration requirement[3]:

1. **Section 4(2)**. Section 4(2) of the Securities Act provides for an exemption from the registration requirement set forth in Section 5 of the Securities Act where the sale of the securities by the issuer does not involve any public offering.

   a. To qualify for the Section 4(2) exemption:

      (1) The purchasers of the securities must be sophisticated investors who have positioned themselves through prior investment experience and/or general investment knowledge to sufficiently evaluate the risks and merits of the proposed investment;

      (2) The purchasers of the securities must have access to the type of information typically provided in a registration statement or prospectus; and

      (3) General advertising and public solicitation in connection with the offering is prohibited.

2. **Section 3(a)(11)**. Section 3(a)(11) of the Securities Act provides an exemption from the registration requirement set forth in Section 5 of the Securities Act where the securities are offered exclusively intra-state.[4]

   a. To qualify for the Section 3(a)(11) exemption:

      (1) The issuer must be organized and doing a significant amount of business in the state where the securities are offered and sold; and

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[2] As defined in Rule 501(a) of Regulation D of the Securities Act.
[3] The exemptions listed herein are not inclusive of all available exemptions but are in the opinion of the authors the most commonly used by small to mid-sized businesses.
[4] Rule 147, adopted under the Securities Act, provides a helpful supplement to understanding the requirements of the Section 3(a)(11) exemption.

(2) Marketing the securities through general advertising or general solicitation must be limited exclusively to that state.

Note: In the context of a Section 3(a)(11) exemption, it is of critical importance to determine the residence of each targeted investor prior to offering the securities for sale. The exemption will not apply if even one non-resident is targeted for solicitation.

3. **Section 3(b)**. Section 3(b) of the Securities Act provides the SEC with the authority to create exemptions to the registration requirement set forth in Section 5 in connection with relatively modest offerings. It is pursuant to the authority vested by Section 3(b) that Regulation A and certain rules under Regulation D, including Rules 504 and 505, were adopted.

4. **Section 28**. Section 28 of the Securities Act, promulgated under the National Securities Markets Improvement Act of 1996, provides the SEC with the authority, *regardless of the amount raised by the offering*, to exempt offerings from the registration requirements where the exemption will serve the public interest and are consistent with the objectives of the Securities Act.

Note: The SEC has yet to adopt any new rules pursuant to the authority provided to it by Section 28, but the addition of Section 28 has laid a foundation for significant exemptions to be carved out in the future, including proposed Rule 507 to Regulation D, described in greater detail herein.

C. **Overview of Regulation D**. Since its adoption in April of 1982, small and mid-size businesses have often utilized one of the three categories of limited offerings provided under Regulation D to raise equity through the sale of securities they wish to exempt from registration. The regularity in which Regulation D is utilized by small and mid-size businesses is at least in part a product of the fact that offerings conducted under Regulation D do not require the filing of an offering statement with SEC[5] and, in the case of Rule 506 of Regulation D, do not cap the amount of capital that can be raised. The following is an overview of the exemptions provided by Rules 504, 505, 506, and newly proposed Rule 507[6] of Regulation D.

1. **Rule 504**. Rule 504 of Regulation D, adopted under Section 3(b) of the Securities Act ("Rule 504"), provides for an exemption from the registration requirement where not more than $1,000,000[7] will be raised in

[5] Note that the exemption to registration provided by Regulation A, adopted pursuant to Section 3(b) of the Securities Act, provides that the business conducting the offering must file an offering statement with the SEC. The waiting period for such statement to be qualified by the SEC can take up to 60 days.

[6] SEC Release Nos. 33-8828 and IC-27922 (Aug. 3, 2007), 72 Fed. Reg. 45116 (Aug. 10, 2007).

[7] All equity raised by an issuer from the sale of unregistered securities pursuant to any Section 3(b) exemption (i.e. Rule 505, Regulation A, etc.) must be considered when determining whether the $1,000,000 threshold has been met.

a 12-month period; provided, however, Rule 504 is not available to companies subject to the reporting requirements of the Securities Act, investment companies, or companies in the development stage that have no specific business plan or strategy or whose purpose is to merge or acquire unidentified companies.

Note: Since this is an exemption intended for very small offerings, the information requirements of Rule 502(b) do not apply, even if one or more purchasers are unaccredited investors, but the offering will, as always, remain subject to the applicable anti-fraud rules and regulations.

a. Pursuant to amendments to Rule 504 in 1999[8], companies conducting offerings under Rule 504 are permitted to use means of public advertising and general solicitation to market their securities in the following circumstances:

(1) Where every sale of securities is registered pursuant to the law of the state in which the applicable purchaser resides, which law requires that a substantive disclosure document is publicly filed and delivered directly to purchasers prior to sale; or, if a sale occurs in a state without such law, the sale is nonetheless registered in a state with such a law and a substantive disclosure document is delivered to every purchaser, regardless of state of residence, prior to the sale; or

(2) The securities are issued under a state law exemption that permits general solicitation advertising so long as sales are made only to "accredited investors" as defined under Rule 501(a) of Regulation D.

2. **Rule 505**. Rule 505 of Regulation D, adopted under Section 3(b) of the Securities Act ("Rule 505"), provides for an exemption from the registration requirement where not more than $5,000,000[9] will be raised in a 12-month period; provided, however:

a. The issuer must not be an investment company;

b. The issuer must not use general advertising or general solicitation to market the securities;

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[8] *See* SEC Release No. 33-7644 (May 21, 1998) (adopting amendment to Rule 504 under Regulation D, 17 CFR 230.504).

[9] All equity raised by an issuer from the sale of unregistered securities pursuant to any Section 3(b) exemption must be considered when determining whether the $5,000,000 threshold has been met.

c. No more than 35 purchasers of the securities may be non-accredited[10];

d. Purchasers must buy for investment only, and not for resale; and

e. If the issuer, promoter, officers, directors, general partner or 10% security holder or other persons associated with the offering have been the subject of certain administrative orders or actions this exemption is not available. This is commonly referred to as the "bad boy" provision.

3. **Rule 506**. Rule 506 of Regulation D, adopted under Section 4(2) of the Securities Act ("Rule 506"), is an exemption from the registration requirement available to all types of issuers, without regard to the amount of capital to be raised, provided the following conditions are met:

   a. The issuer must not use general advertising or general solicitation to market the securities;

   b. No more than 35 purchasers of the securities may be non-accredited *and* such non-accredited purchasers, either acting alone or with a purchaser representative, must be sophisticated investors who have positioned themselves through prior investment experience and/or general investment knowledge to sufficiently evaluate the risks and merits of the proposed investment[11]; and

   c. Purchasers must buy for investment only, and not for resale.

   Note: Rule 506 is often the preferred exemption to registration utilized by small and mid-size businesses raising equity because of the flexibility it provides by placing no cap on the amount of capital that can be raised by the offering.

   Note: As a result of Section 18(b)(4)(D) of the Securities Act, compliance with the Rule 506 exemption preempts state law registration and exemption requirements, meaning that there will be no need to further comply with state securities laws exemptions in connection with your offering. You will, however, continue to be subject to applicable state law filing and fee requirements.

4. **Rule 507**. Rule 507 of Regulation D, adopted under Section 4(2) of the Securities Act ("Rule 507"), currently provides that there shall be no

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[10] Additionally, all of the non-accredited investors must receive disclosure documents, including financial statements.

[11] Additionally, all of the non-accredited investors must receive disclosure documents, including financial statements.

exemption available under Rule 504, Rule 505 or Rule 506 for an issuer where such issuer or any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with Rule 503, which rule is more particularly described herein.[12]

5. **PROPOSED NEW RULE 507**: In addition to the those exemptions discussed above, a new Regulation D exemption, Rule 507[13], proposed by the SEC acting pursuant to its authority under Section 28 of the Securities Act, would offer a new exemption from the registration requirement for offers and sales to a narrow class of investors considered "large accredited investors". The following are some of the defining characteristics of the proposed Rule 507 exemption:

   a. The issuer would be limited to offering and selling its securities to only "large accredited investors". To qualify as a "large accredited investor", an entity or individual would have to meet a higher standard than as currently required to achieve "accredited investor" status under Rule 501 of Regulation D. Such standards would include:

      (1) Entities and institutions will be required to either:

         i. Have more than $10 million in investments; or

         ii. All of its equity owners must be large accredited investors.

      (2) Individuals will be required to either:

         i. Own more than $2.5 million in investments; or

         ii. Have had individual annual income of more than $400,000 (or aggregate income with a spouse in excess of $600,000) in the preceding two years, with a reasonable expectation of the same level in the current year.

   b. The issuer would be permitted to sell the securities to an unlimited number of large accredited investors;

[12] Paragraph (b) of Rule 507 provides that the SEC may determine in certain circumstances, upon a showing of good cause, that such exemptions are nonetheless available.
[13] *See* SEC Release No. 33-8828 (August 3, 2007).

c. There would be no cap on the amount of capital that could be raised by a Rule 507 offering; and

d. The issuer would be permitted to market the securities for sale by advertisement, through a limited announcement of an offering, but only to the extent such announcement:

(1) Is in writing;

(2) Prominently provides that:

i. Sales will only be made to large accredited investors;

ii. No money or other consideration is being solicited or will be accepted solely through the announcement; and

iii. The securities are not registered and will be sold pursuant to an exemption under the Securities Act.

(3) Is limited in substance to the following information:

i. The name and address of the issuer;

ii. A brief description of the business of the issuer (limited to 25 or fewer words);

iii. A brief description of the securities being offered (including price and aggregate amount being offered);

iv. The definition or a suitable description of a "large accredited investor"; and

v. The contact information of a representative of the issuer for additional information related to the offering.

e. The comment period for all proposed revisions to Regulation D, including proposed Rule 507, ended October 9, 2007, and the SEC Chair and Division Director of Corporation Finance have said that the proposal is in a "short list" and should be considered soon.

6. **Rule 508**. Rule 508 of Regulation D addresses the consequences of an issuer failing to comply with all of the requirements of the Rule 504, Rule

505 or Rule 506 exemption it was relying on for non-registration. While reaffirming the SEC's right to pursue any failure of compliance regardless of perceived significance, Rule 508 of Regulation D provides that an issuer will not necessarily lose its exemption for a failure to comply where the issuer can show the following:

a. The failure to comply by the issuer did not involve a term, condition or requirement directly intended to protect the particular complaining individual or entity;

b. The failure to comply, in relation to the offering as a whole, was insignificant; and

c. The issuer made a good faith and reasonable attempt to comply with all of the terms, conditions and requirements of the applicable exemption it was relying on for non-registration.

Note: An issuer's failure to comply with the conditions relating to solicitation, amount of capital raised, or number of purchasers to an offering are always considered significant and thus fatal to an issuer hoping to benefit from the safe harbor provided by Rule 508.

III. MEETING CONDITIONS OF REGULATION D RULES 501, 502 AND 503

In order for an offering to qualify for an exemption provided in any of Rules 504, 505 or 506, such offer and sale of securities must satisfy the applicable terms and conditions of Rules 501, 502, and 503 of Regulation D, respectively. It is therefore imperative for an issuer anticipating conducting an offering pursuant to a Regulation D exemption to understand: (i) Rule 501, which provides the definitions of terms used in Regulation D; (ii) Rule 502, which provides disclosure requirements and general operational conditions that must be met by issuers conducting a Regulation D offering; and (iii) Rule 503, which provides for certain requirements relating to notice that a Regulation D offering is being conducted.

In regards to Rule 501, the definitions discussed in Sections III(A)–(D) of this Paper represent terms whose definitions which are, in the opinion of the authors, most frequently examined and interpreted in the context of Regulation D offerings.

A. **Introduction to Definition of Accredited Investor Under Rule 501(a)**. For issuers anticipating raising equity through a private offering exempt from registration pursuant to either Rule 504, Rule 505 or Rule 506, it is fundamental that the issuer have a keen understanding of the definition of "accredited investor" set forth in subsection (a) of Rule 501 of the Securities Act ("Rule 501"). As discussed in Article II above, issuers relying on any of Rule 504, Rule 505 or Rule 506 will inevitably have to make determinations relating to whether purchasers are accredited or unaccredited under Rule 501(a) as a consequence of the following:

1. Rule 505 and Rule 506 provide that an unlimited number of purchasers to an offering may be accredited but no more than 35 purchasers to an offering may be unaccredited;

2. Rule 506 further provides that all unaccredited purchasers, either acting alone or through a purchaser representative, must meet certain sophistication requirements set forth therein; and

3. The disclosure requirements of Rule 502(b)(1), which will be discussed in more detail below, are not applicable to offerings in which all purchasers are accredited investors.

B. **Rule 501(a) – Definition of Accredited Investor**. According to Rule 501(a), an "accredited investor" is any person who at the time of the sale of the securities to that person, falls into, or whom the issuer <u>reasonably</u> <u>believes</u> falls into, any one of the following eight categories:

1. Institutional investors, including banks, insurance companies, registered investment companies, business development companies, savings and loan associations, registered broker dealers acting in their individual capacity;

2. Private business development companies, commonly referred to as venture capital companies, which meet the definition in Section 202(a)(22) of the Investment Advisers Act of 1940;

3. Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

   <u>Note</u>: Although not specifically included the list of organizations provided in Rule 501(a)(3), a limited liability company may be treated as an accredited investor as determined by that rule if it satisfies the other requirements set forth therein. See SEC letter re *Wolf, Block, Schorr and Solis-Cohen*, Dec. 1, 1996.

4. Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

5. Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;

6. Any natural 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;

Note: Individual Retirement Accounts (IRAs) are accredited or unaccredited to the extent that the individual who owns the IRA is accredited or unaccredited.

7. Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506; and

8. Any entity in which all of the equity owners meet the criteria of being accredited investors.

Note: Generally speaking, the issuer will satisfy the requirement of "reasonable belief" that a prospective investor is accredited and sophisticated where the issuer requires and obtains certification from the prospective investor to that effect. Usually, certification can be accomplished by a completed investor qualification questionnaire, with supporting documentation where appropriate.

9. **PROPOSED NEW RULE**: The SEC has proposed adding an *investments-owned* standard in addition to the current total assets and net worth standards under which investors can qualify as "accredited" in Regulation D offerings. An individual would qualify as "accredited" if he or she owned $750,000 in investments[14] and an institution if it owned $5 million in investments. The proposal also includes a periodic adjustment for inflation to the monetary thresholds for accredited investors to begin in 2012. See SEC Release No. 33-8828 (Aug. 3, 2007).

C. **Rule 501(e) – Calculation of Number of Purchasers**. In calculating the number of unaccredited purchasers for purposes of determining compliance with the requirement provided in Rule 505 and Rule 506, respectively, that no more than 35 purchasers be unaccredited, the following shall apply:

1. The following purchasers shall not be included in the calculation:

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

   b. Any trust or estate in which a purchaser and/or any of the persons related to him as specified in Paragraph 1(a) above collectively have more than 50% of the beneficial interest (excluding contingent interests);

[14] "Investments" does not include personal residences.

c. Any entity of which a purchaser and any of the persons related to him as specified in Paragraph 1(a) above collectively are beneficial owners of more than 50% of the equity securities (excluding directors' qualifying shares) or equity interests; and

d. Any accredited investor.

2. A corporation, partnership or other entity shall be counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and not all of the equity owners meet the criteria of being accredited investors, then each beneficial owner of equity securities or equity interests in the entity shall count as a separate purchaser for all provisions of Regulation D, except to the extent provided in Paragraph 1(c) above.

3. A non-contributory employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974 shall be counted as one purchaser where the trustee makes all investment decisions for the plan.

D. **Rule 501(h) – Definition of Purchaser Representative**. According to Rule 501(h), a "purchaser representative" is any person who satisfies all of the following conditions or who the issuer reasonably believes satisfies all of the following conditions:

1. Subject to certain narrow exceptions[15], a purchaser representative may not be an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10% or more of any class of the equity securities or 10% or more of the equity interest in the issuer;

2. Has such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment; and

3. Is acknowledged by the purchaser in writing, during the course of the transaction, to be his purchaser representative and has disclosed to the purchaser in writing of any material relationship between himself or his affiliates and the issuer or its affiliates.[16]

Note: The acknowledgment and the disclosure must be made with specific reference to *each* prospective investment. An attempted advance blanket acknowledgment covering all securities transactions or all private placements would not be sufficient.

[15] *See* Rule 501(h)(i)-(iii).

[16] A note to Rule 501(h) expressly provides that a disclosure of this nature does not relieve the purchaser representative of his obligation to act in the interest of the purchaser.

E. **Rule 502**. Rule 502 of the Securities Act ("Rule 502") sets forth certain general guidelines applicable to any Regulation D offering.

1. **Integration**. All sales that are part of the same Regulation D offering will be combined for the purpose of determining whether such offering complies with the terms and conditions of Regulation D; provided, however, sales made more than six months prior to or six months after the completion of a Regulation D offering will not be combined as part of that Regulation D offering, so long as during those six month periods[17] the issuer has not offered or sold securities that are of the same or a similar class as those offered by such Regulation D offering (other than under certain employee benefit plans[18]).

<u>**Note**</u>: The integration doctrine is intended to prohibit an issuer from dividing a single offering into multiple offerings for the sole purpose of qualifying each offering, and thus the transaction as a whole, for exemption from registration that would not otherwise be available if such equity sought to be raised was offered in one offering.

a. SEC Release No. 33-4552, released November 6, 1962, offers guidance to an issuer seeking to determine whether offers or sales of securities will be considered integrated into a single offering, by examining whether:

(1) The sales are part of a single plan of financing;

(2) The sales involve issuance of the same class of securities;

(3) The sales have been made at approximately the same time;

(4) The same type of consideration is received; and

(5) The sales are made for the same general purposes.

<u>**Example**</u>: An offering for the purpose of raising working capital or raising capital for the acquisition of company assets differ in purpose from an offering for the purpose of offering equity benefit plans to a company's employees in order to engender loyalty.

b. Though never endorsed or adopted by the SEC, a proposal of an ABA subcommittee included in a report in the July 1982 Business

[17] In the recent SEC proposed changes to Regulation D (SEC Release No. 33-8828 (Aug. 3, 2007), this six month time period would be reduced to three months.
[18] As defined in Rule 405 under the Securities Act.

Lawyer suggested that offerings by entities sharing common general partners or sponsors, would not be integrated so long as:

(1) The entities being considered are separate legal entities and maintain all corporate formalities relating to such separate legal existence;

(2) At the time of the offerings and sales, the entities being considered shall be capable of meeting their primary investment objectives without being substantially dependent on the investments of the other commonly-sponsored entity; and

(3) No material portion of the funds raised by an offering related to one of the entities being considered shall be used to invest in properties in which the other entity in question has also invested a material portion of its funds raised by its own offering.

2. **Information Requirements**. Rule 502(b)(1) provides that an issuer conducting a Regulation D offering, other than a Rule 504 offering, must provide the potential investors with certain information when it intends to make a sale to even one investor that is not accredited.[19] The type of information required to be disclosed will depend on the size of the offering and whether the issuer is subject to reporting requirements of the Exchange Act.

Note: Where an issuer is conducting a Rule 504 offering or a Rule 505 or Rule 506 offering to strictly accredited investors, no specific disclosures of information is mandated by the Securities Act.

a. **Non-financial and Financial Information**. Where information must be furnished to the investors pursuant to Rule 502(b)(1) and the issuer is not subject to the reporting requirements of the Exchange Act, the issuer must provide, to the extent material to an understanding of the issuer, its business and the securities being offered[20], the following information to the purchaser at a reasonable time prior to the sale:

(1) **Non-financial information**. If the issuer is eligible to use Regulation A, the issuer must provide the same kind of information as would be required in their offering statement

[19] As defined in Rule 501(a).

[20] Disclosures of certain information by the issuer, though may otherwise be required, may be withheld in certain circumstances where such disclosure would not be material to the investor's understanding. *See* Question No. 43, SEC Release No. 33-6455, "Interpretive Release on Regulation D", March 3, 1983.

filed with the SEC in accordance with Regulation A. If the issuer is not eligible to use Regulation A, the issuer must provide the same kind of information as required in Part I of a registration form filed under the Securities Act.

(2) **Financial information**.

i. In offerings for sales up to $2,000,000, the issuer must provide the information required in Article 8 of Regulation S-X, except that only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited.

ii. In offerings for sales up to $7,500,000, the issuer must provide two years audited balance sheets and income statements, the same kind of information required in Form S-1 for smaller reporting companies. However, if the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may alternatively provide to purchasers financial statements that have been prepared on the basis of Federal income tax requirements and examined and reported in accordance with generally accepted auditing standards by an independent public or certified accountant. If an issuer, other than a limited partnership, cannot obtain the required financial statements without unreasonable effort or expense, only the issuer's balance sheet, dated within 120 days of the start of the offering, must be audited.

<u>**Note**</u>: The provision permitting an issuer to furnish alternative financial information where audited financial statements cannot be obtained without undue effort or expense is available to all financial statements that an issuer presents in an offering document, including the financial statements of a business that the issuer is acquiring with the proceeds of the offering. *See* Question No. 49, SEC Release No. 33-6455, "Interpretive Release on Regulation D", March 3, 1983.

iii. In offerings for sales over $7,500,000, the issuer must provide two years audited balance sheets and three years audited income statements, the same

kind of information required by Part I of registration forms filed under the Securities Act.

b. **Exhibits**. In regards to those certain exhibits that are required to be filed with the SEC as part of a registration statement or report[21], such exhibits will generally not need to be furnished to purchasers where the contents of such exhibits are identified and the exhibits are made available to the purchasers, upon written request, a reasonable time prior to the requesting purchaser's purchase.

c. **Information Provided to Accredited Investors**. In any Regulation D offering, other than a Rule 504 offering, the issuer must furnish to the purchaser a brief description in writing of any material written information concerning the offering that has been provided by the issuer to any accredited investor but not previously delivered to such unaccredited purchaser, upon his written request a reasonable time prior to his purchase.

d. **Questions and Additional Information**. In any Regulation D offering, other than a Rule 504 offering, the issuer must provide the purchasers, at a reasonable time prior to purchase, the opportunity to: (i) ask questions and receive answers concerning the terms and conditions of the offering; and (ii) obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished by the issuer pursuant to Rule 502(b).

e. **Restrictions on Resale**. In any Regulation D offering, other than a Rule 504 offering, the issuer must provide written disclosure of the limitations on resale to any purchaser that is not an accredited investor, at a reasonable time prior to the sale of securities.

3. **General Solicitation**. With the exception of a Rule 504 offering in which certain specific conditions have been met, Rule 502(c) prohibits use of general solicitation and general advertising by an issuer conducting a Regulation D offering.

Note: "General solicitation" and "general advertising" are not defined in the Securities Act. Therefore, an issuer should examine SEC releases, cases, and other interpretive authority before conducting a Regulation D offering.

[21] E.g., an opinion of counsel regarding the legality of the securities being issued or an opinion regarding tax consequences of an investment. *See* Question No. 52, SEC Release No. 33-6455, "Interpretive Release on Regulation D", March 3, 1983.

a. Generally, it is the facts and circumstances surrounding particular activities, not the activities themselves that determines whether such activities amount to general solicitation.[22]

b. Though not the exclusive means of establishing that a sale or offering is not the product of general solicitation, demonstrating a pre-existing relationship between the issuer and the prospective investor commonly serves that purpose.[23]

<u>Notes</u>: (1) For a relationship to be pre-existing, it will have been established before the terms of the offering are developed and the offering commences.[24]

(2) In *Woodtrails*, a general partner of a limited partnership who solicited investors whom he had a pre-existing relationship with through other active investments in which it was the general partner and the investors were limited partners was not deemed to be general solicitation.

(3) Distributing brochures to members of trade or professional associations or advertising in trade journals would constitute general solicitation.[25]

(4) Newsletters prepared by unaffiliated third parties that include information about issuing entities within a state without analyzing such issuers or the offerings would not amount to general solicitation.[26]

(5) In *Jack B. Strauss Jr., Esq.*, SEC No-Action Letter (Jul. 22, 1985), no consensus was reached regarding whether an issuer who used a foreign publication to publicly solicit an offering concurrently being conducted in the United States was engaged in public solicitation for purposes of Rule 502(c) since the effect of the proposed advertising may or may not have been a solicitation of United States citizens.

(6) In *Robert T. Willis, Jr., P.C.*, SEC No-Action Letter (Dec. 17, 1987), no consensus was reached regarding whether an issuer who made offers to investors it did not have a prior relationship with, but who were instead referrals from existing clients, would constitute public solicitation.

c. An issuer can also avoid violating the prohibition of general solicitation in a Regulation D offering where the issuer is

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[22] SEC Release No. 16825 (Mar. 14, 1989).
[23] *See Woodtrails-Seattle, Ltd.*, SEC No-Action Letter (Aug. 9, 1982).
[24] *See Ovation Cosmetics, Inc.*, SEC No-Action Letter (Feb. 6, 1976).
[25] *See* letter re *Aspen Grove* dated Nov. 8, 1982.
[26] *See* letter re *Richard Daniels* dated December 19, 1984.

approached by a prospective investor about purchasing a security without having been solicited.

d. The preexisting relationships of registered broker dealers and placement agents engaged by an issuer may be solicited without violating the probation against general solicitation, even if the issuer itself is not party to that preexisting relationship.

F. **Rule 503**. Rule 503 of the Securities Act ("Rule 503"), requires that issuers file a Form D, a form of which is attached as **Appendix "A"**, no later than fifteen days from the date of the first sale of a Regulation D offering. The purpose of the Form D is to provide notice to the SEC of an unregistered offering of securities conducted in reliance on a Regulation D exemption.

1. For purposes of Rule 503, the "first sale" occurs upon the deposit of subscription funds into an escrow account or segregated account even if the closing of the sale is conditioned upon the issuer's receipt of a minimum subscription amount not yet attained.[27]

2. **NEW RULE**: On February 6, 2008, the SEC adopted amendments to the Form D, simplifying the form and requiring that it be filed electronically.[28] On September 15, 2008, use of the new Form D shall become mandatory. From September 15, 2008 through March 15, 2009, issuers may voluntarily file their Form D electronically through the SEC's website. Beginning March 16, 2009, the electronic online filing of the Form D shall become mandatory.

IV. ANTI-FRAUD AND CIVIL LIABILITY FOR NON-COMPLIANCE

Civil liability may be imposed on issuers conducting an unregistered offering for two types of infractions: (i) violations of the registration and prospectus delivery requirements under Section 5 of the Securities Act; or (ii) violations of the anti-fraud provisions of the Securities Act and the Exchange Act.

A. **Section 12(a)(1) of the Securities Act**.[29] Section 12(a)(1) of the Securities Act ("Section 12(a)(1)") provides certain purchasers of unregistered securities the express right of action to recover damages from an issuer who has violated Section 5 by virtue of the issuer failing to prove that the security offered or sold, or the transaction itself, should be exempt from

[27] SEC Release No. 33-6455, "Interpretive Release on Regulation D", March 3, 1983.
[28] *See* SEC Release No. 33-8891 (Feb. 6, 2008).
[29] In addition to Section 12(a)(1), Section 12(a)(2) of the Securities Act ("Section 12(a)(2)") imposes liability upon any person who offers or sells a security by means of a misstatement or omission of a material fact. However, in *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995), the Supreme Court departed from the traditional understanding of Section 12(a)(2) by interpreting it to apply to public offerings by an issuer or a controlling shareholder, but not to private transactions among sophisticated parties or to ordinary aftermarket trading. Presumably, Section 12(a)(2) is applicable to an unregistered *public* offering made in reliance of an exemption under Section 3, but it will likely not be applicable to private offerings exempt from registration pursuant to Section 4(2) of the Securities Act.

registration pursuant to a specified exception.[30] If successful, the purchaser may be entitled to rescissionary damages.[31]

1. **Prima Face Case**. In order to demonstrate a prima face right of action under Section 12(a)(1), a plaintiff must prove the following:

   a. No registration statement covering the security offered or sold was in effect;

   b. The defendant offered or sold the security at issue to the plaintiff;

   Note: Recently, the Supreme Court held that liability for a violation of 12(a)(1) extends only to "the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interest or those of the securities owner." *Pinter v. Dahl*, 486 U.S. 622, 647 (1988). Accordingly, a complaint will be dismissed unless it alleges the defendant directly and actively participated in the solicitation of the immediate sale. The Seventh Circuit has held that attorneys who furnish advice are not "sellers" for purposes of violations of Section 12 of the Securities Act. *Ackerman v. Schwartz*, 947 F.2d 841 (7th Cir. 1991).

   c. The mails or facilities of interstate commerce were used in connection with the offer or sale (see, e.g. *Swenson v. Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980)); and

   d. The action was timely filed under the statute of limitations set forth in Section 13 of the Securities Act ("Section 13") (see, e.g. *Piper Acceptance Corp. v. Slaughter*, 600 F.Supp. 169, 172 (D. Colo. 1985)).

      i. Pursuant to Section 13, a Section 12(a)(1) action must be brought within one (1) year of the violation and in no event shall a Section 12(a)(1) action commence any later than three (3) years after the security was offered to the public.[32]

      ii. In the context of determining whether a 12(a)(1) violation occurred within the year preceding the filing of the action, the plaintiff must first determine whether the defendant violated the registration and prospectus delivery

[30] Section 12(a)(1) imposes civil liability on "[a]ny person who offers or sells a security in violation of Section 5…"

[31] Section 12(a)(1) provides that the plaintiff can recover "the consideration paid for such security with interest thereon, *less the amount of any income received thereon*…or for damages if he no longer owns the security." In *Randall v. Loftsgaarden*, 478 U.S. 647 (1986), the U.S. Supreme Court held that a successful plaintiff's damage recovery should not be reduced by any tax benefits he received as a result of the investment.

[32] Not only must the plaintiff file the claim within one year of the violation, he must also file it "no more than three years after the security is bona fide offered to the public." *P. Stolz Family Partnership L.P. v. Daum*, 355 F. 3d 92 (2d Cir. 2004).

requirements of Section 5 during the offer, the sale or the delivery. If the plaintiff's complaint was filed within one year of the last violation of these events, the action will not be barred by the statute of limitations. See, e.g. *Doran v. Petroleum Management Corp.*, 576 F.2d 91, 93 (5th Cir. 1978).

iii. Section 13 does not expressly provide for tolling of the statute of limitations in the context of Section 12(a)(1) violations and courts are divided on whether the doctrine of equitable tolling for the one year limitation should apply. See *Gale v. Great Southwestern Exploration*, 599 F.Supp. 55, 58 (N.D. Okla. 1984) (rejected the equitable tolling doctrine). See *Stoppelman v. Owens*, 580 F.Supp. 944 (D.D.C. 1983) (applied the equitable tolling doctrine).

Where the plaintiff has successfully proven the foregoing factors, the burden shifts to the defendant to prove that it satisfied all of the conditions of an exemption for the transaction at issue and that therefore the sale or offering of the unregistered security was not in violation of Section 12(a)(1).

2. **Defenses**. The common law defense of in pari delicto is available under any of the federal securities laws. *Pinter v. Dahl*, 486 U.S. 622 (1988). Where a defendant bearing the burden of proof proves an exemption to registration is applicable, the plaintiff's Section 12(a)(1) action is defeated. See, e.g. *Smith v. Jackson Tool & Die, Inc.*, 419 F.2d 152, 153 (5th Cir. 1969).

Note: Often times at issue in determining whether or not an offering is in violation of Section 12(a)(1) is whether multiple offerings conducted by a single issuer was purposely broken into smaller pieces to avoid the registration requirements and should be "integrated" and treated as a single transaction in connection with considering whether an exemption applies. See *Donohoe v. Consolidated Operating & Prod. Corp.*, 982 F.2d 1130, 1140 (7th Cir. 1992).

B. **Section 17 of the Securities Act**. Section 17 of the Securities Act ("Section 17") provides that it is unlawful for any person to engage in fraudulent practices in connection with the sale of securities. While the SEC clearly may impose administrative sanctions for Section 17 violations, the Supreme Court has not yet addressed whether there is a private cause of action under Section 17(a). *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n.2 (1983).

C. **Section 10(b) and Rule 10b-5 of the Exchange Act**. According to Section 10(b) and Rule 10b-5 of the Exchange Act, a party is liable for damages where, in connection with a purchase or sale of a security, such party directly or indirectly either: (a) employs any device, scheme, or artifice to defraud; (b) makes any misstatements or omissions of material fact; or (c)

engages in any act, practice or course of business which operates as a fraud or deceit upon a person.

1. **Prima Face Case**. In order to demonstrate a prima face right of action under Rule 10b-5, a plaintiff must prove the following:

a. **Duty**. In order for a person to be liable for a Rule 10b-5 violation for making false or misleading statements of material fact, that person must either:

i. Actually make false or misleading statements of material fact; or

Note: *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) held that there is no civil liability for aiding and abetting under Section 10(b) and Rule 10b-5, and thus to be liable accountants and attorneys would have to be the primary offenders. For decisions concerning the liability of attorneys see: *In re Tyson Foods, Inc.*, 2005 WL 2994493 (3d Cir. 2005); *Ziemba v. Cascade International, Inc.*, 256 F.3d 194 (11th Cir. 2001); *Wenneman v. Brown*, 49 F.Supp.2d 1283 (D.Utah 1999).

ii. Where a duty of disclosure exists, omit to state material facts. See, e.g. *Rudolph v. Arthur Anderson & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986).

Note: The failure to disclose material information is actionable only "when [one] is under a duty to do so." *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

The duty arises "when one party has information that the other party is entitled to know because of a fiduciary duty or other similar relation of trust and confidence between them." Id.

Without a duty to disclose, silence cannot be fraudulent. See, e.g., *Dirks v. SEC*, 463 U.S. 646 (1983). However, the Supreme Court has held that a silent, third party actor who directly or indirectly engages in a "scheme to defraud" has used or employed a deceptive device within the meaning of 10(b) and can thus be liable. *SEC v. Zandford*, 535 U.S. 813, 821-22 (2002).

b. **Materiality**. A plaintiff asserting a Rule 10b-5 cause of action must establish that the misstatements or omissions involved material facts. A material fact is one to which a reasonable investor would attach importance in determining his choice

whether or not purchase or sell a security. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1979).

<u>Note</u>: While mere "puffery" is not actionable,[33] a projection, forecast or opinion is actionable as misleading if it constitutes a factual misstatement.

The Reform Act of 1995, provides a safe harbor for issuers who make written or oral forward-looking statements that project financial performance, such as earnings, revenues, and dividends, or which describe an issuer's "plans and objectives." In order to qualify for protection, (1) the statement at issue must be "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement;" and (2) the issuer did not issue the statement with "actual knowledge" of their falsity.

c. **Scienter**. Section 21D(b)(2) of the Exchange Act provides that a cause of action alleging a Rule 10b-5 violation must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

<u>Note</u>: Where the defendant has traded the securities at issue, courts have applied a recklessness standard rather than intentional fraud to satisfy the element of scienter. See, e.g., *Rowe v. Maremont Corp.*, 850 F.2d 1226 (7th Cir. 1988).

Where the defendant has not traded the securities at issue, some courts require that a fiduciary duty exist before they are willing to apply the recklessness standard in place of the intentional fraud standard. See, e.g., *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 44 (2d Cir.), <u>cert</u>. <u>denied</u>, 439 U.S. 1039 (1978).

In *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044-45 (7th Cir.) <u>cert</u>. <u>denied</u> 434 U.S. 875 (1977), the Seventh Circuit defined the recklessness standard, in the context of omissions, as a "highly unreasonable omission involving not merely simple or even inexcusable omission, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."

d. **Reliance**. In order to assert a private right of action under Rule 10b-5, the plaintiff must establish reliance on the misleading statement or omission at issue. *Basic Inc. v. Levinson*, 485 U.S.

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[33] *See*, e.g., *Lasker v. New York State Electric & Gas Corporation*, 85 F.3rd 55, 59 (2d. Cir. 1996).

224, 243 (1988). How the reliance standard is met depends on whether it is a misleading statement or an omission at issue:

i. **Misrepresentations**. Where the plaintiff relies on a material misrepresentation made by the defendant as the basis for its Rule 10b-5 cause of action, the plaintiff must show that (1) he relied upon the misrepresentation(s); (2) he was justified in relying on them; and (3) that it was reasonable for him to rely on them. See, e.g., *Gochnauer v. A.G. Edwards & Sons,* 810 F.2d 1042 (11th Cir. 1987).

ii. **Omissions**. Where the plaintiff relies on the defendant's failure to disclose a material fact as the basis for its Rule 10b-5 cause of action, the Supreme Court has held that if the omission is material, reliance upon the omission will be presumed. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153 (1972).

e. **Loss Causation**. Section 21D(b)(4) of the Exchange Act provides that a cause of action for a Rule 10b-5 violation must allege that the defendant's acts "caused the loss for which the plaintiff seeks to recover damages."

2. **Damages**. Section 28(a) of the Exchange Act limits a successful plaintiff's recovery to actual damages, and thus, punitive damages are barred.

Typically the measure for damages for a 10b-5 cause of action is limited to the out-of-pocket losses suffered by the plaintiff, however, some courts have allowed a rescissionary measure of damages where the defendant owes some fiduciary duty to the purchaser. See, e.g., *Stone v. Kirk*, 8 F.3d 1079 (6th Cir. 1993). Punitive damages are not permitted.

Pursuant to 21D(f)(2)(B) of the Exchange Act, a successful plaintiff to a 10b-5 cause of action has an indemnification claim for attorney's fees if a contractual relationship existed with the defendant. See, e.g., *Fischler v. Amsouth Bancorporation*, 971 F.Supp. 533 (M.D. Fla. 1997).

3. **Defenses**.

a. **No Reliance**. Where the plaintiff relies on the defendant's failure to disclose a material fact as the basis for its Rule 10b-5 claim, the plaintiff's reliance is presumed. However, if the defendant can overcome the presumption by proving that even if all material facts had been disclosed the plaintiff would not have acted differently or that the alleged omission did not cause the injury suffered, such proof will provide a defense to the plaintiff's Rule 10b-5 claim. *Wollins v. Antman*, 638 F. Supp. 989 (E.D.N.Y. 1986).

b. **Unjustified Reliance**. Where the plaintiff relies on a material misrepresentation made by the defendant as the basis for its Rule 10b-5 claim, an available defense may be that the plaintiff should have discovered the true facts. *Royal American Managers, Inc. v. IRC Holding Co.*, 885 F.2d 1011, 1015 (2d Cir. 1989).[34]

c. **Statute of Limitations**. Claims brought by plaintiffs pursuant to Section 10(b) and Rule 10b-5 must be brought within one year after the discovery of the facts constituting the violation and within three years of the violation itself. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

d. **In Pari Delicto**. The common law defense of in pari delicto is available to sellers under any of the federal securities laws. *Pinter v. Dahl*, 486 U.S. 622 (1988). In order to utilize this defense, the defendant would have to show that: (1) the plaintiff bears at least substantially equal responsibility for the violations subject to the suit; and (2) the preclusion of the suit would not significantly interfere with the effective enforcement and protection of the investing public. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985).

e. **Indemnification**. There is no implied right to indemnification under the federal securities laws. See, e.g., *Eichenholtz v. Brennan*, 52 F.3d 487 (3rd Cir. 1995). In regards to providing for a contractual obligation in the subscription agreement that the purchaser indemnify the seller for attorney's fees relating to breaches of representations or warranties made by the purchaser, it is unresolved whether such clauses contravene federal policy.

V. STATE BLUE SKY REGULATIONS

[34] In *Royal American Managers, Inc.*, the court found that the plaintiff company, which was controlled by sophisticated businessmen and an attorney, could not prevail on their claim of reliance on an oral statement where the controlling individuals should have read the applicable statute.

In addition to the extensive federal regulation of the sale of securities by the SEC, each state also has its own particular regulations, commonly referred to as Blue Sky Laws, which include notice and filing requirements that must be considered at the outset of an offering and ultimately complied with. While Blue Sky Laws are similar in that their purposes tend to be the regulation of the registration of securities, securities brokers, finders and investment advisers, as well as enforcing anti-fraud regulations, the particulars of each state's Blue Sky Laws vary.

Generally, every offer or sale of securities must be registered in the state(s) where the securities are being offered or sold, unless it is exempt from registration under the Securities Act or under the applicable Blue Sky Laws of such state(s) in which the securities are offered and sold. Additionally, every issuing company, securities broker, finder and investment adviser engaged in securities transactions must be registered in such state(s), or otherwise exempt from such registration requirements. However, many transactions are exempt from state securities registration requirements where the requirements of the Securities Act have been complied with.

Note: Section 8(a)(1) of the Securities Act preempts state laws, rules, orders, or other administrative actions which require or are in respect to registration, or qualification of covered securities transactions. Subsection 18(b)(4)(D) of the Securities Act states that a transaction that is exempt from registration under the Securities Act pursuant to rules under Section 4(2) is a covered security. Accordingly, compliance with Rule 506 of Regulation D which was adopted under Section 4(2), will preempt all state law rules and requirements relative to registration and exemption. However, such preemption does not prohibit a state from imposing notice, filing and fee requirements or from investigating and bringing enforcement actions with respect to fraud, deceit or unlawful conduct of an issuer or broker dealer in connection with securities transactions.

VI. FINDERS

A. **Brief History and General Proposition Regarding Persons Selling Securities**. Federal and state laws expressly prohibit any person from accepting a commission or any other form of transaction-based compensation for effecting transactions in securities unless such person is a licensed securities broker or a representative of a licensed broker.[35] Additionally, people or firms in the business of providing securities investment advice, commonly referred to as investment advisers, generally must register with either the SEC or in the state where they are conducting the majority of their business.[36] However, historically, a distinct class of persons who are neither brokers nor investment advisers, referred to as finders, have been able to perform limited securities brokerage activities without registering with the SEC as security brokers and, accordingly, without SEC regulation.

[35] A securities broker dealer must be a member of the National Association of Securities Dealers ("NASD") or hold one or more appropriate licenses that allow him to be a representative of a NASD member. Currently, licensing of securities brokers is conducted by the Federal Securities Industry Regulatory Authority ("FSIRA").

[36] Investment advisers managing $25,000,000 or more in clients' assets generally must register with the SEC.

B. **Definition of Finder**. A "finder" is a company, service or individual who collects a "finder's fee" as a result of introducing, strictly as an intermediary, an issuer and a potential investor where such introduction materializes into a sale of securities.[37]

1. A finder is not registered as a securities broker with the SEC.

2. A finder is not engaged in the business of selling securities for compensation.

C. **State Registration**. Presently, Texas and Michigan are the only states that require those persons falling within each state's respective definition of "finder" to register and abide by certain minimum requirements relating specifically to the activities of the finder.

1. Michigan defines a finder as "a person who, for consideration, participates in the offer to sell, sale or purchase of securities by locating, introducing or referring potential purchasers or sellers."

2. Texas defines a finder as an individual "who receives compensation solely for introducing accredited investors to a company issuing securities and/or introducing an issuer to accredited investors."

D. **Factors of Determination of Broker-Dealer and SEC No Action Letters**. Determining whether a finder's role in a transaction has exceeded the parameters of permissible finder activity can have serious implications. For that reason, it becomes important to consider a number of factors, as well as SEC No Action Letters which have addressed this topic:

1. Has the person whose conduct is in question accepted a fee for introduction of a source of capital on more than one occasion;

Note: The receipt of commission-based compensation related to securities transactions is a key factor that may require an entity to register as a broker-dealer.[38] However, in *Paul Anka*, SEC No-Action Letter (July 24, 1991), a commission-based compensation for a finder was upheld. In *Anka*, the finder in question was retained to find potential purchasers of limited partnership interests in the Ottawa Senators Hockey Club. The finder's participation was limited to providing only names and telephone numbers of persons he believed to be accredited and that he perceived, through bona fide, pre-existing business or personal relationships with such persons would maybe be interested in the investment. The staff's decision to uphold the commission was likely based in large part to: (i) the limited role the finder played in the transactions, and (ii) the finder's assurance that he had not previously been engaged in such compensation arrangements for finder activities and would not do so in the future.

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[37] *See* Use and Compensation of 'Finders' To Locate Purchasers in Private Placements, Westlaw SG022 ALI-ABA 415 (2001).

[38] Herbruck, Alder & Co., SEC No-Action Letter, 2002 SEC No-Act. LEXIS 598 (June 4, 2002).

2. Did the person whose conduct is in question engage in solicitation of investors;

Note: When attempting to determine whether certain activities constitute solicitation or advertising of the nature which would require broker-dealer registration, the focus is on the content and extent of the solicitation.

3. Was the person whose conduct is in question actively involved in the negotiations between issuer and purchaser; or

Note: The distinction is whether the person whose conduct is in question played an integral role in the negotiations or merely performed the "ministerial function of facilitating the exchange of documents or information."[39]

4. Did the person whose conduct is in question offer recommendations relating to the transaction?

E. **Task Force Report**. An excellent reference source including a thorough analysis of the law and SEC letters relating to finders and securities broker dealer registration requirements is the Report and Recommendation of the Task Force on Private Placement Broker-Dealers, 60 Bus. Law. 959 (May 2005).

VII. PRACTICE OF CONDUCTING OFFERINGS FOR SMALL AND MID-SIZED BUSINESSES

A. Preparation for Offering

1. Come up with an overall strategy for conducting the offering:

   a. Determine the parties that will have a role in preparing the investment materials or compiling information necessary for the offering, such as officers or employees of the issuing company, attorneys, and accountants; and

   b. Collaborate with such parties and delegate responsibilities, determine applicable timelines.

2. Decide on the appropriate structure for the transaction, which will be a product of the following determinations:

   a. The offering amount, considering the availability of registration exemptions;

[39] Samuel Black, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 104 (December 20, 1976).

b. Whether or not there will be different classes of securities being offered, and if so, what rights and/or preferences owners of those particular classes of securities will have;

c. What type of investors will be offered the opportunity to participate in the offering, such as accredited versus unaccredited investors, considering the availability of registration exemptions;

d. How long the offering period will be and whether to provide for a right to extend;

e. Whether to provide for alternative means for the issuing company to raise additional capital, such as third-party financing, subsequent offerings[40], or requirements of additional capital contributions;

f. In what location the investors are located considering the applicable state's Blue Sky registration requirements; and

g. The corporate structure of the issuing company, considering if it is a new entity, whether it should be formed as a partnership, limited liability company or corporation.

3. Understand and clearly define the business subject of the offering:

a. Define a business plan for the issuing company;

b. Incorporate business plan into an executive summary to be included with the offering materials, which should set forth sufficient information to provide potential investors with a clear understanding of the issuing company's strategy, financial goals, key personnel and experience;

c. Determine appropriate investment risks to disclose to potential investors in the offering materials;

d. Compile financial statements and/or projections where available; and

e. Decide on a marketing strategy for the sale of the securities, considering whether the issuing company intends to utilize an exemption to registration.

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[40] If the issuing company anticipates subsequent offerings, it should consider the integration concept discussed herein. It is also particularly important to disclose such information in the investment materials if the investors' ownership interests could be diluted as a result of such subsequent offering.

4. Prepare the investment materials to be provided to potential investors, which may include:

    a. A term sheet;

    b. An offering memorandum;

    c. An executive summary;

    d. Financial statements and/or projections;

    e. A subscription agreement, an accompanying cover letter with instructions; and

    f. The partnership agreement, company agreement, bylaws or other applicable document setting forth the investors' rights as an investor with the issuing company.

B. Conduct the Offering

1. Distribute the investment materials to potential investors, keeping track of outstanding materials using an investment memorandum tracking chart;

2. Set up a subscription bank account to deposit funds received from investors to the offering;

3. Collect executed subscription documents and funds, confirming that all required information has been provided by investors; and

4. Close the offering upon receipt of subscriptions and funds representing the amount offered.

C. Comply with Post-Closing Requirements

1. File Form D upon first sale of securities subject to the offering;

2. File whatever paperwork is required, if any, pursuant to the investors' state applicable Blue Sky laws; and

3. Issue certificates to investors representing their purchased securities if the securities are certificated.