AVOIDING THE SECURITIES MINEFIELD

In the 1970s and 1980s, the Fram oil-filter company used a very popular marketing campaign; its TV ads showed a mechanic holding a Fram oil filter while in the background, a second mechanic looked over an automobile engine that required very expensive repairs because its owner hadn't used a Fram oil filter. Fram oil filters were considered top of the line at that time, so they were a little more expensive. The tag line of the ad campaign was, "You can pay me now [as the mechanic pointed to the more expensive Fram oil filter], or you can pay me later [as he looked over his shoulder and pointed to the ruined engine block]!" What does that have to do with the securities laws? Over the years, we have encountered many who have chosen to avoid paying for a little advice from an experienced securities lawyer in order to save some money only to find out later that they have to pay a lot more to try to repair the damage from violating the securities laws. When it comes to complying with federal and state securities laws, "You can pay us now, or you can pay us later!"

Any financial instrument, ownership interest, or investment contract that is defined as a "security" is subject to the federal and state securities laws. The securities laws are complex, confusing, and treacherous, especially for the uninitiated, with many traps for the unwary. No one should enter the securities

minefield without an expert guide who knows where the mines are located and can help avoid and defuse them. As we have seen over and over again, many business people end up in the middle of this dangerous minefield before they even realize they're in one.

The primary federal securities law is the Securities Act of 1933 (the "1933 Act"), as amended, and the rules and regulations promulgated thereunder. In addition, each state has its own set of securities laws, rules, and regulations, which often, but not always, are very similar to the federal law but are separately enforced by that state. The two primary purposes of the securities laws are (1) to require sellers of securities to give investors all material information that a prudent investor would need about the issuer and its business, financial history, and management to make an informed investment decision and (2) to prohibit fraud, misrepresentation, and deceit in the sale of securities. To achieve both of these purposes, the 1933 Act and most other securities laws are liberally construed.

The 1st Mine: Do I Have a Security?

The starting point in understanding the securities laws is the prohibition at both the federal and state levels against selling a "security" unless it is legally registered. Thus, for the securities laws to apply, there must be a security involved—and the definition of a security is critical! The 1933 Act contains a descriptive definition of a security and lists various types of financial instruments that are securities. Some of these, such as stocks, notes, bonds, and debentures, are well defined in the law. However, the statutory definition also lists as securities "investment contracts and certificates of interest or participation in any profit sharing agreement," neither of which has a specific definition in law. To make it even less clear, the definition includes the clause "in general, any interest or instrument commonly known as a security."

With a traditional stock, bond, note, or debenture, it is very clear that a security is involved, but if it is a financial interest or other type of ownership interest, such as an investment contract, other factors have to be analyzed to determine if it is a security.

The term "investment contract" has been construed for securities purposes as a contract, transaction, or scheme whereby a person invests money in a common enterprise with the expectation of making a profit solely from the efforts of third parties. The form and title of the instrument are irrelevant. It is the substance of the transaction—the relationship between the person selling the instrument (called the issuer) and the purchaser of the instrument and the economic realities of the relationship—that determine whether or not a financial arrangement is an investment contract and, therefore, a security. Hence, a sale of a condominium can be a security under certain circumstances.

The key element is "solely from the efforts of other persons." However, "solely" does not really mean only. The real test is whether the efforts of third parties are undeniably the significant efforts essential to the success or failure of the venture, which is a legal conclusion based upon the particular facts and circumstances involved.

An ownership interest in a partnership or a limited liability company (LLC), for example, is a security if it constitutes an investment contract. Whether or not such interest is an investment contract is determined by whether the efforts of third parties are undeniably the significant ones that are essential to the success or failure of the venture. This determination is made by analyzing the management, governance, and control provisions of the applicable partnership or LLC company agreement.

Where management, control, and governance are concentrated in third parties, the partnership or LLC interest will almost certainly be an investment contract and, therefore, a security subject to the securities laws. Where the applicable governing document allocates legal and practical management control and governance among *all* purchasers of the ownership interests, then the partnership or LLC interest might not be an investment contract. However, an interest in a noncorporate entity can also be structured in such a way that it so resembles shares of stock of a corporation and, on that basis alone, be deemed a security. Some of these attributes include the following:

- The right to receive profits based on the apportionment of the interest of the purchaser in the issuing entity,
- The power to vote in proportion to the percentage of ownership interest held,
- Whether or not the interest is assignable or negotiable, and
- The possibility of appreciation in value of the interest.

The 2nd Mine: Have I Made an Offer to Sell a Security?

The 1933 Act regulates the offer and sale of securities. The term "offer" has a different and far broader meaning in securities law than in basic contract law. Under the 1933 Act, an "offer to sell" or "offer for sale" includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The term "sale" or "sell" includes every contract of sale or disposition of a security or interest in a security, for value. Given these broad terms, almost any attempt to dispose of a security for value will amount to an offer or sale under the securities laws. Those who simply want to "test the water" to see if their idea has merit and can be sold often cross the line and constitute an "offer to sell" or an "offer for sale" of a security. This mine is very easy to trip and once tripped, it is very difficult to keep it from detonating.

The 3rd Mine: If I have a Security That Will Be Offered for Sale, What Then?

One of the primary purposes of the securities law is to require each seller of a security (referred to as the issuer) to disclose all material facts that a prudent person would need to know before making an investment decision. This is generally accomplished by requiring all issuers to prepare a written document, called a "registration statement," pursuant to a highly regulated registration process. This document is then filed with and reviewed by the United States Securities and Exchange Commission (SEC) and the securities regulatory authorities of each state in which the issuer intends to make or solicit offers to purchase its securities. The preparation and filing of this registration statement can be very time-consuming and expensive and will subject the issuer to further regulation and oversight by the SEC and other securities regulatory authorities.

The 1933 Act permits offers and sales of securities to occur without such SEC registration in some limited circumstances if the security or the transaction qualifies for a specific exemption from the registration process. The penalties for selling securities without the requisite approvals can be severe. The mere offer or sale of nonexempt securities without any fraudulent or criminal intent is sufficient to incur civil liability. Violations of federal and state securities laws are punishable by fines, which can be significant, prohibitions against future violations, and, in the case of willful violations, criminal prosecution and imprisonment.

The 4th Mine: Qualifying for an Exemption

Because of the number, size, and manner of many securities transactions, Congress and state legislatures have exempted certain types of securities and certain types of transactions from the registration requirements of the securities laws. In general, the types of securities that are exempt from registration are securities issued by governmental subdivisions, industrial revenue bonds, and securities issued by or for the benefit of certain not-for-profit entities. Business entities generally do not qualify for issuance of exempt securities.

Among the most common types of exemption from the registration process relied upon by issuers are exempt transactions, and the most common exempt transactions relied upon are those that do not involve a public offering. These are often referred to as private offerings and generally involve an offering to a small group of investors who have a pre-existing, substantive relationship with the issuer. If the transaction qualifies under one or more of the specific exempt transactions available, the issuer is not required to file a registration statement and go through the very expensive and time-consuming registration process.

To qualify for an exempt transaction, the issuer must satisfy all of the statutory, regulatory, and judicial requirements for that particular exempt transaction, of which there are several. Fortunately, the SEC has promulgated certain safe harbor exempt transactions under its Regulation D. Regulation D provides three distinct safe harbors: Rules 504, 505, and 506. By

far the most frequently used safe harbor under Regulation D is Rule 506.

The 5th Mine: Satisfying the Requirements of Rule 506

Rule 506 is the most frequently used exempt transaction safe harbor for good reason: when it applies, this transaction is exempt from the registration process under federal law, and all state regulators are preempted from reviewing and approving the transaction under their applicable state securities laws. There are actually two distinct exemptions that fall under Rule 506: the older Rule 506(b) and the newer Rule 506(c).

Under either 506 exemption, an issuer can raise an unlimited amount of money. However, under Rule 506(b), an issuer:

- cannot use general solicitation or advertising to market the securities,
- may sell its securities to an unlimited number of "accredited investors" and up to thirty-five other purchasers (all nonaccredited investors, either alone or with a purchaser representative, must be sophisticated—that is, they must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment), and
- must be available to answer questions by prospective purchasers.

Under the more recently adopted Rule 506(c) exemption, an issuer can broadly solicit and generally advertise the offering but still be deemed to be undertaking a private offering not requiring registration if:

- the investors in the offering are all accredited investors and
- the issuer has taken reasonable steps to verify that its investors are accredited investors, which could include reviewing documentation—such as W-2s, tax returns, bank and brokerage statements, credit reports, and other similar documents.

What constitutes reasonable verification methods will depend on the facts and circumstances of each case, but they generally involve a more intrusive inquiry than an offering under traditional Rule 506(b), which is why most private offerings are still being conducted under Rule 506(b) despite the prohibition on general solicitation.

Purchasers of securities offered pursuant to either Rule 506 exemption receive “restricted” securities, meaning that the securities cannot be sold for at least a year without registering them. Issuers relying on the Rule 506 exemption do not have to register their offering of securities with the SEC, but they must file what is known as a “Form D” electronically with the SEC within a certain period of time after they first sell their securities.

What qualifies someone as an "accredited investor"? Regulation D describes specific requirements. For example, for an individual, it is a person who qualifies under one or more of three tests:

- the “net worth” test, by having a net worth of at least $1 million (excluding such individual’s personal residence),
- the “income” test, by having made at least $200,000 in each of the past two years and with the reasonable expectation of making at least that amount in the current year (or $300,000 when combined with a spouse’s income in each such year), and
- the “insider” test, by being a director or executive officer of the issuer or a general partner of the issuer or a director, executive officer, or general partner of the general partner of the issuer. The “insider” test applies to persons holding those specific titles who, based upon all of the applicable facts and circumstances, are deemed not to need the protections provided by registration because their positions should provide them with access to information about the issuer and the securities offered. However, a person’s title alone is not always sufficient to qualify for this test. Thus it is not always possible to create an accredited investor solely by naming the person as an executive officer or director. Other definitions apply to different types of entities.

A nonaccredited investor is an investor who does not meet the definition of an accredited investor.

The 6th Mine: Integration

Sometimes issuers will try to avoid the thirty-five nonaccredited investor limitations in Rule 506(b) by structuring multiple transactions. If multiple transactions are part of the same plan to raise money, they can be integrated and treated as the same transaction by federal and/or state regulators. But if there are more than thirty-five nonaccredited investors, the transaction will not qualify for the Rule 506(b) exemption.

The 7th Mine: Entities Formed to Invest in the Transaction

Frequently entities (usually LLCs) are formed for the purpose of aggregating individuals to make an investment in a transaction. These entities are generally disregarded for purposes of determining the status of the investor as accredited or non-accredited, and the owners of that entity will each be treated as separate investors in the transaction.

The 8th Mine: General Solicitation

Regulation D does not define the term "general solicitation" or "general advertising," though it does offer a nonexhaustive list of what would be considered to be so, including the use of "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio." Some SEC guidance has been issued regarding what can be done without violating the prohibition on "general solicitation," but many questions still remain. The greater the number of people with whom an issuer does not already have a pre-existing, substantive relationship, the more likely it will be that the SEC will find that there has been general solicitation. There is, of course, no predetermined number; as with everything else, the determination will depend on the specific facts and circumstances of each case.

A relationship with an offeree is "pre-existing" (for purposes of demonstrating the absence of general solicitation) when the relationship was formed prior to the commencement of the securities offering or, alternatively, when it was established through either a registered broker-dealer or investment adviser prior to the registered broker-dealer or investment adviser participating in the offering. Similarly, a relationship is "substantive" when the issuer (or a person acting on the issuer's behalf) has sufficient information to evaluate, and does in fact evaluate, a prospective offeree's financial circumstances and sophistication, in determining the offeree's status as an accredited or sophisticated investor. Self-certification alone (by checking a box) without any other knowledge of a person's financial circumstances or sophistication is not sufficient to form a "substantive" relationship.

Whether general solicitation exists can be an important issue, because (as mentioned above) the SEC takes a very broad view of what constitutes an "offer" to sell securities. Information designed to arouse or that can have the effect of arousing investor interest in an issuer, even if no actual mention of any securities being offered or sold is included, may in some instances be considered to be "general solicitation or advertising." An example might be a press release that includes rosy projections about future potential growth or future earnings. The idea is that if an issuer is considering raising capital in the near term, widely distributed communications that have (or appear to have) the intent of stirring up interest may be deemed to be "general solicitation," which again would preclude the issuer from relying on the registration exemption under Rule 506(b). As the SEC puts it, information that serves to "condition the public mind or arouse public interest" in a securities offering (even where the offering is not mentioned or alluded to) would result in a violation of the general solicitation ban.

The 9th Mine: The Use of Finders

One of the most persistent "urban legends" in the private placement arena is the notion that an individual who is not a licensed broker can be paid to assist an issuer in locating investors, so long as he or she is "just a finder" and is not acting as a broker-dealer. The problem with this notion is that it is truly just an urban legend. The SEC has never formally recognized the concept of a "finder" and has repeatedly stated that persons paid to find investors in a securities transaction must be duly licensed. The SEC *has* issued a few isolated "no-action" letters in which it chose to take no enforcement action against an individual for involvement in a securities transaction,

despite the person being compensated for that involvement. But the facts in each of these cases are very specific; they should not be treated as precedent for the position that a finder can be paid to assist an issuer in finding investors. State securities administrators generally take the same position and are very aggressive in pursuing violations. We have handled numerous cases in which the Alabama Securities Commission has accused an individual of violating the law by receiving compensation in some form as an unlicensed broker-dealer in the State of Alabama. Under no circumstances can any type of remuneration or compensation be paid to anyone for helping find investors, unless that person is a duly licensed broker-dealer salesman.

The 10th Mine: Exemption from Registration Does Not Equal Exemption from Antifraud Provisions

The exemption from registration enables the issuer to avoid the registration process, but it does not exempt the issuer from the other main purpose of the securities laws: the prohibition of deceit, misrepresentations, and other fraud in the sale of securities. These are known collectively as the antifraud provisions of the federal and state securities laws. The antifraud provisions work by requiring issuers to deliver adequate disclosures to prospective investors. All information passed on in the course of a private offering, either orally or in writing (in an offering memorandum, circular, or other form of disclosure document), is subject to these antifraud provisions. An issuer's officers and directors may be personally liable for an investor's damages in a fraud case, so providing the reasonably necessary information is obviously crucial here.

Regulation D requires that in transactions in which nonaccredited investors are offered the opportunity to invest, an issuer must provide prospective investors with disclosure documents that generally are the same as those used in registered offerings. In addition, an issuer must provide certain audited financial statements, depending upon the total amount sought to be raised. If securities are only being offered to accredited investors, an issuer is not required to furnish any specific information, but the antifraud provisions still apply. Accordingly, it is very important for an issuer to provide in some form all of the material information that a prudent investor would want to see before making a decision to invest. It is generally advisable to provide such information in written form, because the burden of proving delivery of such information falls upon the issuer. It is also important to ensure that all information that is provided is not misleading in any material way. It is equally misleading to omit a material fact as it is to misrepresent a material fact.

Final Thoughts

Any issuer desiring to raise capital from investors must be careful about how it goes about that task, what information it provides or chooses not to provide, and to whom it provides that information. As this article has hopefully made clear, there are numerous land mines that must be avoided in the process of raising capital, and it is always prudent before starting the process to consult with experienced securities counsel who can serve as "mine detectors" to safely guide issuers through the securities-law minefield.

If you have questions or comments about the article or are interested in learning more about this topic, feel free to contact its authors, John H. Cooper and Peter J. Hardin.

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