The Loev Law Firm, PC

Federal Offers and Sales of Securities and Exemptions from Registration

RULES AND REQUIREMENTS RELATING TO THE OFFER AND SALES OF SECURITIES UNDER FEDERAL LAW AND EXEMPTIONS FROM REGISTRATION ASSOCIATED THEREWITH

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Furthermore, the below only discusses federal securities laws and issues and often the offer and sale of a security is governed by not only federal law, but also state law. Each state has their own offering and sale requirements, notice and filing requirements and offering rules, all of which should be confirmed prior to proceeding with the offer or sale of any securities.

General Requirement to Register Securities

Under federal securities laws, every **offer and sale** of a security is required to be

- **registered** with the Securities and Exchange Commission (the Commission), or
- **subject to an exemption** from registration under the Securities Act of 1933, as amended (the Securities Act).

General Requirement to Register Securities (Continued)

That requirement applies to almost all offers and sales, including:

- the sale of securities to multiple high net worth individuals,
- the sale of a security to one person in a private transaction,
- the sale of a security to a family member and all offers and sales of securities of public and private companies, including organizations with only two or three persons.

Note that the requirement applies to an **offer** of a security which is ultimately rejected by a potential purchaser. I.e., it applies to "**offers**" and not just "**sales**".

Exemptions From Registration

Notwithstanding the above, a significant number of offers and sales may be exempt from registration under the Securities Act, pursuant to:

- **Section 4(a)(2)** of the Securities Act;
- **Rule 506** of Regulation D of the Securities Act;
- **Regulation A** of the Securities Act; or
- Certain **crowdfunding** exemptions.

Each of which will be discussed in further detail in this presentation.

Definition of Security

In order to understand the registration and exemption requirements under the Securities Act, one must first understand the definition of a "**security**".

"**Security**" is defined under Section 2(a)(1) of the Securities Act, and means:

Definition of Security (Continued)

"any 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,

Definition of Security (Continued)

any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or,

Definition of Security (Continued)

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."

Definition of Security (Continued)

That definition is not meant to encompass everything that may be a "**security**" though, as the United States Supreme Court has made clear that the definition of "**security**" is "**quite broad**" and meant to include "the many types of instruments that, in our commercial world, fall within the ordinary concept of a security."

"Securities" –include the offer and sale of:

- stocks
- bonds
- debentures
- ownership interests in limited liability companies and
- most notes with a maturity date over nine months (there is a rebuttable presumption that a promissory note with a maturity greater than nine months is a security)

Registration Process (General)

In order to register a security under the Securities Act, a company must file a registration statement with the Commission.

Typically the type of registration statement used for an initial public offering will be a Form S-1 Registration Statement (Form S-1).

A Form S-1 includes two parts (Part I and Part II).

Registration Process (Form S-1)

Part I is the prospectus, the legal offering or "**selling**" document. In the prospectus, the "**issuer**" of the securities must describe in important facts about:

- business operations
- financial condition
- results of operations
- risk factors
- Management and
- audited financial statements

The prospectus must be delivered to everyone who buys the securities, as well as anyone who is made an offer to purchase the securities.

Registration Process (Form S-1)(Continued)

Part II contains additional information that an issuer does not have to deliver to investors but must file with the Commission, such as copies of material contracts, signatures of management and other representations.

Some of the most common uses for Form S-1 Registration Statements are:

(1) Direct offerings; (2) Underwritten Offerings; and (3) Resale transactions.

Registration Process (Timing and steps)

Once an issuer files a registration statement with the Securities and Exchange Commission, the staff of the Commission examines the registration statement for compliance with pre-established disclosure requirements set forth in the form of registration statement (i.e., in Form S-1 itself) and in Regulation S-K.

The SEC does not however evaluate the merits of the securities offering or determine whether the securities offered are "**good**" investments or appropriate for a particular type of investor.

Registration Process (Timing and Steps Continued)

The staff of the Commission generally provides any comments or questions it has on the registration statement within 30 days after the filing date of the registration statement.

The issuer then responds to the questions and comments and amends the filing to address issues raised. The staff of the Commission may then have additional comments or questions and the process repeats itself until the staff of the Commission advises that the issuer has cleared all of its comments and the registration statement can be declared "**effective**". Once the offering is declared "**effective**" the offering described in the registration statement can proceed as a registered transaction.

Result of "Effective" Registration

Once the registration statement is declared "**effective**" the issuer is subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), which requires the filing of annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports (for disclosure of certain material transactions which occur between the filing date of quarterly and annual reports) on Form 8-K.

These filing obligations continue until the issuer falls below certain minimum record shareholder thresholds, subject to the requirements of the Securities Act and Exchange Act.

Exemptions From Registration

Instead of registering the initial offer and sale of securities under the Securities Act, a company can rely on an exemption from registration to avoid such registration requirements, if an exemption can be met. Some of the most widely used federal offering exemptions are summarized below:

Section 4(a)(2) Exemption

Section 4(a)(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering." To qualify for this exemption, which is sometimes referred to as the "private placement" exemption, purchasers of securities must:

- either have sufficient knowledge and experience in finance and business matters in order to be considered a "sophisticated investor" (i.e., be able to evaluate the risks and merits of the specific investment), or be able to bear the investment's economic risk;
- have access to the type of information normally provided in a prospectus in a registered offering under the Securities Act (for example, include similar information as would be required under Part I of Form S-1 described above); and
- agree to take the securities for long-term investment without a view to distribute the securities to the public, except pursuant to the applicable rules of the Securities Act relating to the resale thereof (including Rule 144 described below).

Section 4(a)(2) Exemption (Continued)

Additionally, except in a Rule 506(c) offering, described below, no general solicitation or advertising is allowed in connection with a Section 4(a)(2) offering.

If a company offers securities to even one person who does not meet the necessary conditions of a Section 4(a)(2) offering, the entire offering may be in violation of the Securities Act.

While the specific compliance with a Section 4(a)(2) exemption is somewhat open to interpretation, Rule 506(b) provides objective standards that can be relied upon to ensure that the requirements of Section 4(a)(2) are met.

Rule 506

Rule 506(b) of the Securities allows companies to raise an unlimited amount of money in private offerings if certain requirements of Rule 506(b) are met.

Those requirements include:

- generally prohibiting the use of general solicitation or advertising to market the securities; allowing the sale of securities to an unlimited number of "**accredited investors**" (described below);
- making knowledgeable persons available to answer questions of prospective purchasers; and
- requiring that investors receive "**restricted**" securities, i.e., securities which include a legend making clear that no sales of the securities can be made absent an exemption from registration (like Rule 144 as described below) or the registration of such securities under the Securities Act.

Rule 506 (Continued)

Alternatively, if the company includes a private placement offering document which sets forth substantially all of the information that would be required in a registration statement under the Securities Act (including audited financial statements), a Rule 506(b) offering can be made to up to, but to not more than, **thirty-five** non-"**accredited investors**".

The Commission requires companies to file a Form D within 15 days of the first sale under Rule 506, which requires the disclosure of certain information regarding the offering, securities to be sold thereunder, and management.

Rule 506 (Continued)

Under Rule 506(c), a company can broadly solicit and generally advertise the offering, but still be deemed to be undertaking a private offering if:

- The investors in the offering are all "**accredited investors**"; and
- The company 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 the like.

Rule 506 (Continued)

"**Accredited investors**" under the Securities Act include:

- any individual that earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence);
- certain entities such as a bank, insurance company, registered investment company, business development company, or small business investment company; partnerships, corporations and nonprofits, which generally are required to have assets in excess of $5 million or have equity owners that are all "accredited investors"; and
- any trust, with total assets in excess of $5 million, not formed to specifically purchase the subject securities, whose purchase is directed by a sophisticated person.

Regulation A

An exemption from registration for public offerings made by non-reporting companies, provided that offerings made pursuant to this exemption share many characteristics with registered offerings.

In March 2015, in order to implement Section 401 of the Jumpstart Our Business Startups (JOBS) Act, the Commission amended Regulation A by creating two offering tiers:

- Tier 1, for offerings of up to $20 million in a 12-month period (which require less disclosures and no on-going reporting requirements compared to Tier 2 offerings); and
- Tier 2, for offerings of up to $50 million in a 12-month period (which requires that companies file annual, semi-annual, and current reports with the Commission on an ongoing basis).

Revised Regulation A (Continued)

For offerings of up to $20 million, companies can elect to proceed under the requirements for either Tier 1 or Tier 2.

There are certain basic requirements applicable to both Tier 1 and Tier 2 offerings, including company eligibility requirements, bad actor disqualification provisions and other matters.

Additional requirements apply to Tier 2 offerings, including limitations on the amount of money a non-accredited investor may invest in a Tier 2 offering, requirements for audited financial statements and the filing of ongoing reports (as referenced above).

Revised Regulation A (Continued)

Securities in a Regulation A offering can:

- be offered publicly
- use general solicitation and advertising and
- be sold to purchasers irrespective of their status as "**accredited investors**", subject to certain limitations on the amount that non-"**accredited investors**" can invest under Tier 2 offerings.
- Securities sold in a Regulation A offering are not considered "**restricted securities**" (i.e., securities that must be held by purchasers for a certain period of time before they may be resold) for purposes of aftermarket resales.

Revised Regulation A (Continued)

Regulation A limits the amount of securities that an investor who is not an accredited investor under Rule 501(a) of Regulation D can purchase in a Tier 2 offering to no more than:

(a) 10% of the greater of annual income or net worth (for natural persons); or

(b) 10% of the greater of annual revenue or net assets at fiscal year end (for non-natural persons). This limit does not, however, apply to purchases of securities that will be listed on a national securities exchange upon qualification.

Revised Regulation A (Continued)

The Commission must issue a "**notice of qualification**" before any sales pursuant to a Regulation A offering (made on Form 1-A) can proceed, which requires that the Commission review the offering documents and results, in many cases, in the staff of the Commission providing questions and comments requiring amendments to a company's offering documents, similar to the process of obtaining "**effectiveness**" of a Form S-1 filing as described above.

Revised Regulation A (Continued)

Issuers whose securities have not been previously sold pursuant to a qualified offering statement under Regulation A or an effective registration statement under the Securities Act are allowed to submit to the Commission a draft offering statement for non-public review by the staff.

Crowdfunding

Allows companies to raise funding through a large number of small transactions.

Under the JOBS Act crowdfunding provisions, companies are limited to raising $1 million in any 12-month period.

Companies cannot crowdfund on their own, but are required to engage an intermediary that is either a registered broker-dealer or registered with the Commission and FINRA. These intermediaries are subject to a number of requirements including limiting the amount that can be invested based on an investor's net worth.

The only companies eligible for crowdfunding are companies that are not already Exchange Act reporting companies.

Crowdfunding (Continued)

The crowdfunding rules permit individual investors, over a 12-month period, to invest in the aggregate across all crowdfunding offerings up to:

- If either their annual income or net worth is less than $100,000, than the greater of: (a) $2,000 or (b) 5 percent of the lesser of their annual income or net worth.
- If both their annual income and net worth are equal to or more than $100,000, 10 percent of the lesser of their annual income or net worth; and
- During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed $100,000.

Crowdfunding (Continued)

Companies that rely on the SEC's recommended rules to conduct a crowdfunding offering must file certain information with the Commission and provide this information to investors and the intermediary facilitating the offering, including among other things, to disclose :

- The price to the public of the securities or the method for determining the price,
- the target offering amount,
- the deadline to reach the target offering amount, and
- whether the company will accept investments in excess of the target offering amount;
- A discussion of the company's financial condition;

Crowdfunding (Continued)

- Financial statements of the company that, depending on the amount offered and sold during a 12-month period, are accompanied by information from the company's tax returns, reviewed by an independent public accountant, or audited by an independent auditor. A company offering more than $500,000 but not more than $1 million of securities are generally permitted to provide reviewed rather than audited financial statements, unless financial statements of the company are available that have been audited by an independent auditor;
- A description of the business and the use of proceeds from the offering;
- Information about officers and directors as well as owners of 20 percent or more of the company; and
- Certain related-party transactions.

In addition, companies relying on the crowdfunding exemption would be required to file an annual report with the Commission and provide it to investors.

Crowdfunding (Continued)

Each Crowdfunding offering must:

- be exclusively conducted through one online platform and
- the intermediary operating the platform must be a broker-dealer or a funding portal that is registered with the SEC and FINRA
- Any issuer conducting a Crowdfunding offering must electronically file an offering statement on Form C through the SEC's EDGAR system and with the intermediary facilitating the crowdfunding offering.

Resales of Restricted Securities

Assuming restricted securities are acquired pursuant to one of the private offering exemptions from registration described above

- those securities are not freely tradable and
- can **only be sold** pursuant to an effective resale registration statement filed by the issuer or
- **pursuant to a resale exemption** from registration under the Securities Act

The main resale exemption used for the resale of restricted securities is Rule 144.

Rule 144

Provides an exemption that permits the resale of restricted securities if a number of conditions are met, including:

- requiring that the holder of the securities paid the full acquisition price of such securities at least six months prior to any sale
- assuming the issuer is a reporting company under the Exchange Act and is current in its filings and at least one year prior to any sale in the event the issuer is not a reporting company or not current in its filings, and
- provided that certain other requirements for resale are met not described herein

Rule 144 (Continued)

- may also require a notice filing with the Commission prior to any sale of securities
- may limit the amount of securities that can be sold at one time and
- may restrict the manner of sale, depending on whether the security holder is an "**affiliate**" of the issuer

An "**affiliate**" is a person that, directly, or indirectly through one or more intermediaries controls, or is controlled by, or is under common control with, the issuer, and generally includes officers, directors and those persons who hold 10% or more of an issuer's securities.

Civil Penalties; Liability

The penalties for violating the securities laws can be very severe. Liability for these violations is generally based on selling unregistered securities without having an applicable exemption. For example, Section 12 of the Securities Act establishes liability for unregistered securities sales, creates a purchasers' right of rescission and establishes liability for fraud regarding the offer or sale of a security. Moreover, where unregistered securities are sold and the company fails to comply with an applicable exemption from registration, not only the company, but also its officers and directors may incur severe civil and criminal fines and penalties. Additionally, attorneys who prepare transaction documents and advise clients can have liability as well.

Conclusion

The process of complying with the federal rules and regulations relating to the offer and sale of securities is complicated and no exception from compliance with the federal securities laws is provided for small transactions or transactions involving family members.

Failure to comply with the rules and regulations of the Securities Act can lead to an issuer (and in some cases its officers and directors) being subject to civil and criminal penalties and fines and can further create rescission rights for investors in the non-compliant offering.

Conclusion (Continued)

As such, a competent securities attorney should always be contacted prior to any offer or sale of securities to determine and confirm that all applicable rules and requirements are being followed.

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