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What Constitutes a Security and Requirements Relating to the Offer and Sales of Securities and Exemptions From Registration Associated Therewith

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Many people don't realize that every offer and sale of a security is required to either be (a) registered with the Securities and Exchange Commission (SEC); or (b) subject to an exemption from registration under the Securities Act of 1933, as amended (the Securities Act), under federal securities laws ("Small Business and the SEC"—a guide for small businesses on raising capital and complying with the federal securities laws). That requirement applies to 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. Furthermore, that requirement applies to an offer of a security which is ultimately rejected by a potential purchaser (*SEC v. Howey Co.*, 328 U.S. 293, 328 (1946)). Notwithstanding the requirements described above, a significant number of offers and sales may be exempt from registration under the Securities Act as described in greater detail below.

In order to understand the registration or exemption requirements set forth above, one must first understand the definition of a "security."

Definition of Security

Under Section 2(a)(1) of the Securities Act, the term "security" is defined as

> 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, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

That definition is not meant to encompass everything that may be a "security" though, as the U.S. Supreme Court has made clear that the definition of "security" is "quite broad" (*Marine Bank v. Weaver*, 455 U.S. 551, 555-556 (1982)) and meant to include "the many types of instruments that, in our commercial world, fall within the ordinary concept of a security" (H.R.Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)).

Clearly though the offer and sale of stock, bonds, debentures, ownership interests in limited liability companies and most notes with a maturity date over nine months are considered "securities" (Section 3(a)(3) of the Securities Act).

Registration Process

In order to register a security under the Securities Act, a company must file a registration statement with the SEC. 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). Part I is the prospectus, the legal offering or "selling" document. In the prospectus, the "issuer" of the securities must describe in the prospectus important facts about its business operations, financial condition, results of operations, risk factors, and management. It must also include 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. Part II contains additional information that an issuer does not have to deliver to investors but must file with the SEC, such as copies of material contracts, signatures of management and other representations.

Once an issuer files a registration statement with the SEC, SEC staff 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, but does not evaluate the merits of the securities offering or determine whether the securities offered are "good" investments or appropriate for a particular type of investor. Individual investors are required to make their own evaluation of the offering terms based on their own facts, circumstances and risk tolerance.

The SEC 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 SEC may then have additional comments or questions and the process repeats itself until the SEC 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. Additionally, 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 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. 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).

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 Act allows companies to raise an unlimited amount of money in private offerings if certain requirements of Rule 506(b) are met. Those requirements include 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. 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 35 non-"accredited investors."

The SEC 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.

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

4(a)(2) if all of the other requirements of Regulation D are met in the event: (a) the investors in the offering are all "accredited investors" (i.e., no non-"accredited investors" are allowed to participate in a Rule 506(c) offering); and (b) 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—which is a greater burden to meet versus the requirement for a Rule 506(b) offering that allows companies to rely on the self-certification of investors and potential investors that they are "accredited."

"Accredited investors" under Rule 501(a) of 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.

Revised Regulation A

Regulation A is 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 SEC 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, semiannual, and current reports with the SEC on an ongoing basis). 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).

Securities in a Regulation A offering can be offered publicly, using general solicitation and advertising, and can 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. The SEC 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 SEC review the offering documents and results, in many cases, in the staff of the SEC 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.

Crowdfunding

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 SEC and FINRA. These intermediaries are subject to a number of requirements including limiting the amount that can be invested based on an investor net worth. The only companies eligible for crowdfunding are companies that are non-Exchange Act reporting companies.

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 may also require a notice filing with the SEC 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 percent or more of an issuer's securities.

Conclusion

The process of complying with the 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. Instead, each and every offer and sale of a security is required to either be (a) regis-

tered with the SEC; or (b) exempt from registration under the Securities Act. 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. 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.

It should also be noted that the above discussion is only a summary of applicable rules and requirements and is for informational purposes only. Finally, the above only discusses federal securities laws and issues and readers should keep in mind that often times the offer and sale of a security is governed by not only federal law, but also state law, and that 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.

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