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Securities Regulation

Statutory Exemptions From Registration Under the Securities Act

1. Overview
    a. Section 5 of the Securities Act of 1933 (the "33 Act") provides that all securities must be registered unless there exists an exemption for the securities issued.
    b. Whether or not the securities are exempt from registration, the federal *anti-fraud* rules apply.
        i. Section 17 of the 33 Act - anti-fraud provision.
        ii. Section 10(b) of the 34 Act and Rule 10b-5 - fraud provisions applicable to any transaction involving the purchase or sale of a security.
        iii. Rule 10b-5 provides, in relevant part: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, ...: 1) To employ any device, scheme, or artifice to defraud, 2) To make any untrue statement of a **material** fact or to omit to state a **material** fact necessary in order to make the statements made, in light of the circumstances under with they were made, not misleading, or 3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."
        iv. As a threshold issue, it should first be determined if the information is "**material**". Information will be considered material if the reasonable shareholder would consider the information important in deciding whether to purchase or sell securities. (*Basic Inc. v. Levinson*, 485 U.S. 224 (1988)).
2. **Section 4(2) of the 33 Act** - Private Placements
    a. Section 5 does not apply to transaction by an issuer not involving a public offering.
    b. Determination that a transaction is a private placement must be made under releases issued by the SEC and court cases. The statute and regulations do not define "transactions by an issuer not involving a public offering."
    c. The SEC has adopted Regulation D (see Regulation D outline) which, if followed, creates a "safe harbor" for private placement transactions; however, an issue can

rely directly upon Section 4(2) if, in doing so, the issuer engages in a genuine "private placement" as recognized by the SEC and the courts.

d. Factors identified by courts in determining if an offering is exempt under Section 4(2):

   i. Number of offerees: The number of *offerees*, not the number of *purchasers*, is the relevant number of persons involved in an offering. (See discussion below regarding Regulation D in which the number of purchasers is the relevant number.) The SEC originally suggested a rule of thumb of 25 offerees; however, this interpretative release is not binding. Rel. No. 33-285 (1935). The Supreme Court of the United States has rejected a numbers test as definitive. *SEC v. Ralston Purina*, 346 U.S. 119 at 125 (1953). For example, offering stock to one person was "public" for purpose of criminal prosecution under Ohio Securities Act.

   ii. Relationship of Offerees to Each Other

      1. Relevant relationship to each other and to issuer makes offer look less public. Rel. No. 33-285 (1935); Rel. No. 33-4452 (1962).

      2. It is not sufficient that all offerees are employees or existing stockholders.

      3. Class of person with a privileged relationship giving access to information. *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 688 n. 6 (5th Cir. 1971).

   iii. Size of offering - Smaller number of units less likely to be public. Total size of offering not a major factor. Rel. No. 33-4452 (1962).

   iv. Manner of Offering

      1. More likely to be private if offer is made directly. Rel. No. 33-285; *Hill York*, 448 F.2d at 689.

      2. Can not advertise.

      3. Venture capital deals usually utilize broker-dealer.

   v. Offeree qualification

      1. Sophistication - Ability to fend for oneself , i.e. the ability to understand the risks and protect oneself. Representation by a sophisticated counselor strengthens factor (e.g. offeree or purchaser representative). However, sophistication is not a substitute for access to the information that would be disclosed in a registration statement. Key is both sophistication and access to information.

      2. Wealth - the ability to assume the investment risk.

      3. Offerees must be either be given information about the company, or access to such information, of the type that would be contained in a registration statement. It has been suggested that, at a minimum, the company should provide information about its financial condition,

business, property and management.

vi. Restriction on resale of securities

1. Necessary to avoid a "**distribution**" (essential a public sale of the stock).
2. Rel. No. 33-5226 requires each purchaser of restricted stock to be informed of principal restrictions limiting right to sell or otherwise transfer stock. SEC encourages the use of restrictive legends, etc. to prevent illegal distributions.

e. Unclear as to the priority to be assigned the above factors.

f. Burden of proof rests with the one claiming the exemption.

3. **Section 4(6) of the 33 Act** - Accredited Investor Exemption

a. Section 5 does not apply to a transaction involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of the issue of securities does not exceed $5,000,000 and there is no advertising or public solicitation in connection with the transaction.

b. Issuer required to file notice-of-sales form with SEC. Form D, discussed in the Regulation D outline with reference to Rule 503 of Regulation D, serves as the notice-of-sales form under Section 4(6).

c. The term "**Accredited Investor**" is defined in Rules 215 and 501 of the 33 Act Rules. Note that Rule 501, which is part of Regulation D, provides for a "reasonable belief" test on the part of the issuer if it is subsequently learned that the investor is not, in fact, an accredited investor under the definition. In general, the term "accredited investor" means:

i. Certain specified institutional investors, as set forth in the Rules 215 and 501.

ii. 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 the issuer.

iii. 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.

iv. 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 two years and has a reasonable expectation of reaching the same income level in the current year.

4. **Section 3(a)(11) of the 33 Act** - Intrastate offering exemption

a. The registration requirements of the 33 Act do not apply to any security which is part of an issue offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within , such state or territory.

b. The three major requirements for this exemption are:

   i. The issuer must be doing business within the state, which has been interpreted as having substantial operational activities in the state;

   ii. All offers and sales must be to residents of the state;

   iii. After sale, the securities must "come to rest" in the hands of investors who are residents of the state.

c. **Rule 147**, promulgated under the 33 Act, was adopted to provide clearer guidelines for the exemption provided by Section 3(a)(11).

   i. To qualify for the exemption provided by this rule, the issuer must, at the time of any offers and sales, be a person resident and doing business within the state. The rule sets forth various factors which, if present, will deem to make the issuer a resident of the state.

   ii. The rule requires that the offerees and purchasers be residents of the state of the offering. The rule sets forth factors which, if present, will deem to make an offeree or purchaser a resident of the state.

   iii. No resales may be made outside the state for a period of 9 months.

   iv. No filing with the SEC is required.

   v. While intrastate offerings are exempt from federal regulation, such offerings are still subject to regulation by the state in which the offering occurs.

   vi. The federal intrastate offering exemption is primarily relied upon by issuers in large states in which the populations are not particularly mobile. Great care must be exercised in utilizing this federal exemption as one improper offer or sale can taint the entire offering, thereby destroying the exemption.

5. **Section 3(b) of the 33 Act - Authorization to the SEC to Create Exemptions**

   a. Section 3(b) authorizes the SEC, by means of rules and regulations, to add any class of securities to the securities exempted as provided in the 33 Act if the SEC finds that the enforcement of the 33 Act is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering, subject to the limitation that the aggregate amount at which the issue is offered to the public can not exceed $5,000,000.

   b. Acting pursuant to its authority under Section 3(b), the SEC has adopted Rules 504 and 505 under Regulation D and Regulation A, as discussed in the Regulation D and Regulation A outlines.

This outline summarizes and highlights the relevant Federal statutes providing statutory exemptions from registratin under the Securities Act of 1933. The date of this outline is March 1998. Readers should refer to the Federal statutes and regulations as the definitive source of the contents of these statutes and regulations. The contents of this outline should not be construed as legal advice. Readers should not act upon information presented herein without individual professional advice.

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