Never Having To Talk To The Securities and Exchange Commission or California Department Of Corporations

San Fernando Valley Bar Association's "BarNotes"
September 2002

Whenever a transaction results in the issuance of securities (an "Issuer Transaction"), the attorney representing the Issuer must review both Federal and applicable state securities laws to determine whether the Issuer Transaction is exempt from the registration requirements of Section 5 of the Securities Act of 1933 (the "Securities Act") and qualification under state law.

There are a number of Issuer exemptions set forth in the Securities Act and state securities laws. Some of these exemptions are based on the type of security that is being issued, while others are based on the nature of the Issuer Transaction. This article will be limited to a discussion of those Federal and California securities exemptions most commonly used by securities attorneys in Issuer Transactions. While this article only discusses the most common California securities exemption, readers are cautioned that in an interstate Issuer Transaction, the securities laws of each state where prospective purchasers reside must be reviewed to determine whether the Issuer Transaction is exempt under applicable state law.

FEDERAL LAW

The Section 4(2) Exemption

Section 4(2) of the Securities Act exempts from registration "transactions by an issuer not involving any public offering." A party claiming this exemption has the burden of proof to establish its availability.

Unfortunately, the availability of the Section 4(2) exemption depends primarily upon judicial and administrative interpretations of this statutory provision. The benchmark Supreme Court decision in SEC v. Ralston Purina Co., 346 U.S. 119 (1953), established the basic principle that the private offering exemption is available only for offerings made exclusively to persons able to protect themselves. The ability to protect oneself depends on (1) access to the same kind of information as that which would be included in a registration statement and (2) the sophistication of the offerees.

Lawyers should be specifically aware that the Section 4(2) exemption is a "private offering" exemption and not a "private sales" exemption. Accordingly, the exemption will be lost if any offeree fails to meet the preceding criteria. This will result even if (1) the offeree does not ultimately purchase the securities and (2) all purchasers meet the standards described above.

Regulation D

In view of the subjective legal standards an attorney must consider in evaluating the availability of the Section 4(2) exemption, and the vagaries of ultimately being dependent on judicial and/or administrative interpretations of this exemption, securities attorneys have clamored for the adoption by the SEC of specific "safe harbor" rules that objectively can be relied upon in determining whether an Issuer Transaction is exempt from registration under Section 5 of the Securities Act. This has resulted in the SEC's adoption of Rules 501 through 508 under the Securities Act. These regulations are collectively referred to as "Regulation D".

Rules 501 and 502 of Regulation D set forth material definitions and common elements shared by more than one of the specific exemptions. Rule 503 provides for the filing of a notice on Form D with the SEC no later than 15 days after the first sale of securities in reliance on the Regulation D exemption. Rule 507 contains a disqualifying provision for an Issuer if the Issuer or any of its predecessors or affiliates has been subject to any order, judgment, or decree of any court temporarily, preliminarily or permanently

enjoining such person for failure to comply with Rule 503. Finally, Rule 508 keeps Issuers from losing the Regulation D exemption where there are insignificant deviations from a term, condition or requirement of Regulation D.

The substantive exemptions set forth in Regulation D are contained in Rules 504 through 506. These rules are briefly summarized below.

Rule 504

The Rule 504 exemption is available for all Issuer Transactions, other than offerings by companies subject to SEC reporting requirements, investment companies and "blank check" companies (i.e. development stage companies that either have no specific business plans or purposes or have indicated that their business plans are to engage in mergers or acquisitions with unidentified companies). A Rule 504 offering cannot exceed $1 million during any 12 month period. While Rule 504 does not impose any specific disclosure standards as a condition of the exemption (note that all securities transactions are subject to the general anti-fraud disclosure requirements of Federal securities laws), and does not mandate any limitation on the number of investors, the rule does generally require compliance with the terms and conditions of Rules 501 and 502. These include:

(1) Normal SEC "integration" standards will be applied in determining whether purported separate offers and sales of securities should be integrated for purposes of evaluating whether the Rule 504 exemption is available. In this regard, offers and sales of securities that are made more than six months before the start of the Rule 504 offering or are made more than six months after completion of the offering will not be considered part of the offering, so long as during those six months there are no offers or sales of securities by or for the Issuer that are of the same or similar class as those offered or sold in the Rule 504 offering. These integration standards apply to all other Regulation D offerings.

(2) With limited exceptions beyond the scope of this article, neither the Issuer nor any person acting on its behalf may offer or sell the securities by any form of general solicitation or advertising. The prohibition on general solicitations or advertising applies to all other Regulation D offerings.

(3) With limited exceptions, securities acquired in a Rule 504 offering will have the status of "restricted securities" acquired in a transaction under Section 4(2) of the Securities Act and cannot be resold without registration under the Securities Act or an exemption therefrom. The same restricted securities status also applies to any securities issued pursuant to Rules 505 or 506.

Rule 505

Rule 505 is available for Issuer Transactions of not more than $5,000,000 in any 12 month period. The exemption cannot be used by investment companies or an Issuer disqualified because of certain prior conduct of persons affiliated with the Issuer or a party receiving remuneration in connection with the offering. The specific disqualifications are detailed in Rule 262 under the Securities Act.

A Rule 505 offering can be made to an unlimited number of offerees, provided there is no general solicitation or advertising. The offering can involve an unlimited number of "accredited investors" as well as a maximum of 35 non-accredited investors. The term accredited investor is defined in Rule 501(a) of Regulation D. As to natural persons, an accredited investor is:

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

(2) Any person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with the 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.

Non-accredited investors do not have to meet any sophistication or suitability requirements. However, if the offering is sold to any non-accredited investors, the Issuer must furnish written disclosure information that is specified in Rule 502(b)(2) at a reasonable time prior to sale. The specific mandated disclosures

differ depending on the dollar amount of the offering and the nature of the Issuer. If the offering is sold only to accredited investors, no specific disclosure is mandated.

Rule 506

The Rule 506 exemption is identical to Rule 505 except:

(1) The offering can be unlimited in dollar amount;

(2) There are no Issuer disqualification standards; and

(3) Each purchaser who is not an accredited investor, either alone or with his purchaser representative(s), must have such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the Issuer must reasonably believe immediately prior to making any sale that such purchaser comes within the description.

CALIFORNIA LAW

Section 25102(f)

Section 25102(f) is the most commonly relied upon exemption under the California Corporate Securities Law of 1968 (the "California Act"). This section exempts from the Issuer qualification requirements of Section 25110 of the California Act any offer or sale of any security in a transaction that meets the following criteria:

(1) Sales of the security cannot be made to more than 35 persons, including persons outside of California. Rule 260.102.13 excludes from this count certain enumerated investors including "any person who comes within one of the categories of an accredited investor in Rule 501(a) of Regulation D".

(2) All purchasers must have either a preexisting personal or business relationship with the offeror or any of its affiliates, or by reason of their business or financial experience or the business or financial experience of their professional advisors, they can be reasonably assumed to have the capacity to protect their own interests in connection with the transaction. If any one purchaser fails to qualify, the exemption is unavailable.

(3) Each purchaser must represent that he is purchasing the security for his own account and not with a view for the sale or distribution of the security.

(4) The offer and sale of the security cannot be accomplished by the publication of any advertising or other general solicitation.

In addition, under Rule 260.102.14, the Issuer who relies on Section 25102(f) is required to file, no later than 15 calendar days after the first sale in California, a notice with the California Department of Corporations either by filing a separate copy of the Form D notice filed with the SEC or by utilizing the form specified in the rule. The fee required by Section 25608(c) of the California Act must accompany the filing.

- - - - - - - -

The exemptions described in this article are technical and detailed, and necessitate careful analysis and understanding of Federal and state securities laws to assure compliance with their requirements. This legal responsibility should not be undertaken by attorneys generally unfamiliar with these requirements.