A REVIEW OF SECURITIES LAWS

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I. SECURITIES LAWS IN GENERAL

In general, both state and federal securities laws impose two requirements.

First, both state and federal securities laws generally prohibit the sale of securities, such as stocks, bonds, llc units, warrants, or options, (i) without the prior registration of those securities with state and federal securities authorities, or (ii) unless the transactions or securities are exempt from such registration. Registration is very expensive and time consuming. It is therefore important to find an exemption for the securities to be offered.

Second, both state and federal securities laws prohibit the offer and sale of securities without disclosing all material facts about the issuer and the securities. See for example Section 25401 of the California Corporate Securities Law. These laws are known as antifraud laws and apply to all issues of securities. As a practical matter, in order to comply with the antifraud laws, prior to offering or selling any securities, the issuer must prepare and deliver to investors a private placement memorandum describing the investment in detail.

II. REGRISTRATION UNDER FEDERAL LAW

A. REGISTRATION AND EXEMPTIONS UNDER FEDERAL LAW. Section 5 of the Securities Act of 1933 prohibits the sale of any securities unless the securities have first been registered with the SEC, or unless there is an exemption from such registration. The primary exemption is set forth in Section 4(2) of the Securities Act which exempts from registration a transaction not involving any public offering. SEC Regulation D further defines that exemption in Rules 504, 505, and 506. These rules do not impose a merit review of securities offerings, but require adequate disclosure. When an issuer issues some stock or other securities to a few founders for a small amount of capital, an attorney may provide an opinion to the issuer that the transaction does not involve any public offering. When, however, the issuer intends to raise millions of dollars in capital from many investors, the issuer must proceed under SEC Rules 504, 505, or 506.

1. RULE 504. Under SEC Rule 504, an issuer may within a twelve-month period issue up to $1,000,000 worth of securities to an unlimited number of unsophisticated investors who purchase the securities for their own account and not for resale. There are no required disclosures under Rule 504 except those that are necessary under the antifraud disclosure laws, and the issuer may use general solicitation advertising. (This advertising is, however, usually limited or prohibited by state law.) The securities are not “restricted securities,” and so are free of some restrictions on resale. A Form D

must be filed with the SEC within 15 days after the first sale of securities. The date of the first sale is the date on which the first investment agreement is signed by an investor, not necessarily the date on which the money is transferred. The issuer must comply with the securities laws of each state in which a purchaser is a resident, and must usually file a notice with that state's commissioner of corporations or similar official. The persons who acquire the securities must sign an investment agreement as proof of their investment intent and other required representations. It is always better practice if each of the investors is an accredited investor as defined in Rule 501 of SEC Regulation D.

2. RULE 505. Under SEC Rule 505, an issuer may a within twelve-month period issue up to $5,000,000 worth of securities to thirty-five unsophisticated investors plus any number of "accredited investors." If the sale of securities includes investors who are not accredited investors, there are a number of required disclosures, which are described below, Advertising and a general solicitation are prohibited. The securities are "restricted securities" and may not be readily resold. A Form D must be filed with the SEC within 15 days after the first sale. The Issuer must comply with the securities laws of each state in which a person who buys the security is a resident, and must usually file a notice with that state's commissioner of corporations or similar official. The persons who acquire the securities must sign an appropriate investment agreement.

3. RULE 506. For two reasons, SEC Rule 506 is the preferred Rule under which to issue securities to many investors in order to raise a great deal of capital. First, under Rule 506, an issuer may issue an unlimited amount of securities to thirty-five sophisticated investors plus any number of "accredited investors." Second, Rule 506 preempts all state securities laws. This is a very great advantage to the issuer and greatly reduces costs. If a sale of securities includes purchasers who are not accredited investors, there are required disclosures, described below. As a practical matter, an issuer should issue securities only to accredited investors. Advertising and a general solicitation are prohibited. The securities are "restricted securities" which may not be readily resold. A Form D must be filed with the SEC within 15 days after the first sale of securities and also with the commissioner of corporations of each state in which a purchaser is a resident. The persons who acquire the securities must sign an appropriate investment agreement. An issuer may use a securities broker to assist in raising capital and may pay a commission thereto.

4. REGULATION CE, RULE 1001. This is a recent Regulation and Rule, which is quite unusual. The SEC adopted Regulation CE specifically to approve offerings of securities which take place in California under Section 25102(n) of the California Corporate Securities Law. Under Section 25102(n), a California corporation may raise up to $5,000,000 from California accredited investors by means of a limited public offering. This limited public offering may include a form of general advertising solicitation by means of a written document, which may include a posting on the internet. This is very progressive legislation. It is the first break in the barrier created almost 70 years ago against general solicitation by advertisement of a private placement of securities. If a Caifornia issuer needs only $5,000,000 in capital or less, a limited public offering under Regulation CE and Section 25102(n) may be an attractive alternative.

B. THE DEFINITION OF ACCREDITED INVESTORS. For practical purposes, under SEC Rule 501(a), “accredited investors” are (i) individuals with a net worth that exceeds $1,000,000, (ii) directors and officers of the issuer, (iii) corporations, partnerships, and trusts with total assets in excess of $5,000,000, (iv) banks, insurance companies, venture capital funds, and similar financial institutions, and (v) a legal entity of which all the shareholders are accredited investors.

C. RESTRICTED SECURITIES. The securities purchased in a private placement (except pursuant to Rule 504) are restricted against resale. This means that the person who purchases those securities can resell them in only in two circumstances, that is, (i) when those securities are registered at a later date or (ii) under Rule 144. Pursuant to Rule 144, a purchaser who is not an insider may resell the securities when two conditions have been met: (i) after he or she has held the securities for more than one year and (ii) after the company makes public reports. Under judicial precedent, a person who purchased restricted securities may also resell them to another person who undertakes makes all the same investment representations that were made by the original purchaser.

D. OTHER FEDERAL EXEMPTIONS.

1. Under Section 3(a)(11) of the Securities Act of 1933 and SEC Rule 147, a corporation in a given state may issue securities without federal registration as an "intrastate offering" to residents of only that state. The issuer must, however, comply with that state’s securities laws. The persons who acquire the securities should sign an appropriate investment agreement containing proof of their residence and other important representations.

2. Under Section 4(b) of the Securities Act, an issuer may sell securities of up to $5,000,000 only to accredited investors. This exemption is not very useful. If an issuer intends to sell securities only to accredited investors, doing so under Rule 506 is a much better choice.

3. Under Rule 701, an issuer may sell securities to officers, directors, employees, and advisors under a written compensation plan or stock option plan. Securities sold under Rule 701 enjoy favorable terms with respect to resale. The persons who acquire such securities must sign appropriate agreements which meet and reflect the specific provisions of Rule 701 as well as the provisions of any applicable state laws or regulations.

III. REGISTRATION UNDER STATE LAW (“BLUE SKY” LAWS)

A. **State Securities Laws in General.** In order to protect investors, each state has some form of securities laws. Most such laws require registration or qualification or some of form of state approval, and frequently impose a merit review upon securities offerings. This can be very costly and burdensome. State laws usually prohibit general solicitation and place restrictions on the resale of the securities. All state securities laws have one

kind or another of exemption from the registration requirement. Unless an issuer sells securities under Rule 506, it must satisfy the securities laws of every state in which a purchaser of the securities resides. This can be quite expensive and time-consuming. However, most states have adopted some form of the Uniform Securities Act that includes an exemption for any sale of securities to not more than ten persons in the state. In most cases, the filing of a notice and the payment of a filing fee are required for any state in which a purchaser resides. In New York, the sale of securities must be registered before the offer may take place.

B. **California Law.**

1. Under Section 25102(f) of the Corporate Securities Law, a California corporation may without registration raise start-up capital from up to 35 investors plus accredited investors. All that is required is the filing of a notice with the Commissioner of Corporations.

2. As noted above, under Section 25102(n) of the Corporate Securities Law, a California company may raise up to $5,000,000 from accredited investors in California by means of a limited public offering that may include a written form of general solicitation. Under Section 25102(n), the Issuer must be a California business entity which is not a blind pool, and the securities must be sold only to "qualified purchasers" as therein defined (which include accredited investors) who purchase the securities for their own account and not for resale or distribution. The written announcement **must** include the name of the issuer, a description of the securities offered, the suitability standards for investors, a statement that no investment funds will be accepted until after a disclosure document has been delivered to the investor. and the name, address, and telephone number of the person to call about the investment. The written announcement **may** include a description of the business of the issuer, the location of the issuer, and the price of the securities, A notice must be filed with the Commissioner of Corporations when the offering begins and ends.

3. Section 25102(p) of the Corporate Securities Law has been recently enacted to authorize the formation of venture capital companies in California for investment in California start-ups.

4. As noted above, SEC Rule 506 preempts state securities laws.

IV. STATE AND FEDERAL ANTIFRAUD LAWS.

Both state and federal laws impose antifraud disclosure requirements on issuers. Before any sale of securities, the issuing corporation is required to disclose to investors all material facts about the issuer and the securities. As a practical matter, this requires that a private placement memorandum be prepared and delivered to each prospective investor before the investment is made that includes at least the following:

1. The name, address, and telephone number of the issuer.
2. The description and price of the securities offered.
3. A description of the issuer's business, products, and markets.
4. Current and projected financial statements.
5. A statement that neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of the securities or passed on the adequacy or accuracy of the disclosures.
6. An exhaustive recitation of relevant risk factors
7. The use of the proceeds of the offering.
8. A description of the capital structure.
9. How the offering price was determined.
10. Dilution.
11. The amount of the offering (minimum and maximum amounts, if any).
12. The plan for and the cost of the distribution of the securities.
13. Restrictions on the resale of the securities and the fact that no market exists for them.
14. An offer to answer questions.
15. Exhibits, such as corporate Articles of Incorporation, founders agreements, LLC operating agreement, tax opinions (if any), et cet.

V. CONCLUSION

In raising capital from outside investors, it is very important for an issuer to do so with meticulous attention to detail and with careful compliance with all the relevant laws, rules, and regulations. There are two matters to which an issuer must pay careful attention. The first is to comply very carefully with the registration exemptions. The second is to make every material disclosure, which requires a private placement memorandum. A private placement memorandum is not a sales document, it is an insurance policy. It must be designed to inform a prospective investor about all the bad things that can happen in the investment so that he can never say that he was not fully informed. In addition, after the investment, the issuer must use the proceeds of the offering and conduct the business plan exactly as it has been represented. If an issuer is careful about the exemption and disclosures and scrupulous in the post-investment execution of the business plan, then the capital project can be a great success.