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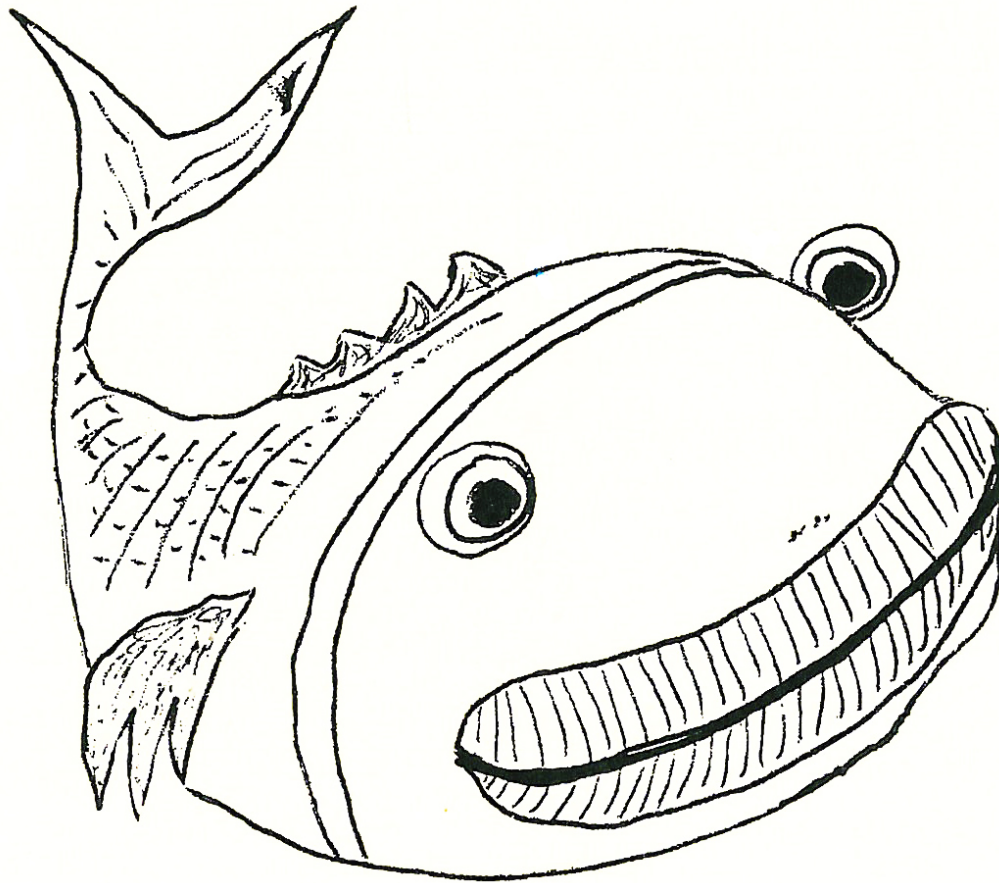
# SEC Considerations for Small and New Companies

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# What Is Your Environment?



# Environment

How the Securities Laws affect the  
Environment of Start-ups

# Securities Laws

Primary goal is prevention of fraud.

- For capital raising, three techniques to prevent fraud:
  1. Review by a securities regulatory agency.
  2. Prohibition against false statements and half-truths.
  3. Requiring securities salespersons to be licensed.

# What is a “security”

Section 2(a)(1) of the Securities Act of 1933:

- Share of stock
- Corporate bond
- Stock option
- Any interest or instrument commonly known as a “security”

# What is a “security”

- Howey test:

1. Investment contract
2. With an expectation of profit
3. (Solely?) From the efforts of others.

From SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

Courts use substance over form.

# “security”

- What about a membership interest in an LLC?
  - Actual management vs. passive investing.
  - What about an LLC where every member has a right to manage, but exercising that right is impractical?
- If the investment is passive, the membership interest is probably a security.

# Who regulates securities?

- Federal and state regulation is concurrent.
  - With some express Federal preemption.
- U.S.: 6 securities statutes, and the Securities and Exchange Commission
- State statutes (“blue sky laws”), and securities administrators.
  - In New York, the securities administrator is the Attorney General and the Department of Law.
- Private rights of action.



# Registration

- Section 5(a) of the 1933 Act:
  - (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly:
    - (1) To make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise ...

# Registration

- A start-up must avoid the legal obligation to register an offering of its securities.
  - Unless it can afford the cost and the delay.

# Disclosure

- Disclosure is the tail that wags the dog.

# Exemptions

- Regulation A
  - Originally adopted by the SEC under § 3(b) of the Securities Act.
  - Originally, exempted issues up to \$5,000,000 in any 12-month period.
  - Public advertising by means of a solicitation of interest document.
  - You could “test the waters” and you could publicly advertise.
  - So what was wrong with it?

# Regulation A

- Under old Regulation A, there was no pre-emption of state securities regulation.
  - Required blue-sky compliance in every state where an offeree resided.
- Title IV, §401 of the JOBS Act required the SEC to expand Regulation A to \$50,000,000 in any 12-month period.

# Regulation A

- Amended SEC Regulation A
  - Sometimes referred to as “Regulation A +”
  - Amendments effective June 19, 2015.

# Regulation A

- File Preliminary Offering Circular with SEC
- SEC review of Preliminary Offering Circular
- No sales can be made until Offering Statement is “qualified.” [Rule 251(d)(2)]
- Offering Statement is “qualified” by action of the SEC staff. [Rule 252(e)]

# Regulation A

- If issuer selects Tier 1:
  - Up to \$20,000,000 in any 12 months.
  - Still subject to state blue sky review.
    - But note that North American Securities Administrators Association (NASAA) attempts to coordinate the review among those states which participate.
      - New York State does not participate, but then, New York has no specific formal requirements for the Offering Circular.
  - Issuer does not need to have its financial statements audited.



# Regulation A

- If Issuer selects Tier 2:
  - Up to \$50,000,000 in any 12 months.
  - Either:
    - The securities must be listed on a national securities exchange, or
    - The purchaser is an accredited investor, or
    - The purchaser does not buy more than the greater of 10% of such purchaser's annual income or net worth.
  - Exempt from state review of offering literature [new §18(b)(4)(D) of the Securities Act, as added by §401 of the JOBS Act].
  - Instead, issuer must provide audited financial statements in the Offering Circular. Thereafter, annually [Rule 257(b)(2)].

# Broker-Dealer Regulation

- Exchange Act § 15(a): every broker or dealer must be registered with the SEC.
  - You can check for free on-line whether an individual or a firm is registered, at FINRA's "broker check."
- A broker is a "person engaged in the business" of effecting transactions in securities, for the account of others. Exchange Act § 3(a)(4).
- Most state definitions are closely similar.

# Broker-Dealer Regulation

- A dealer is “a person engaged in the business of buying and selling securities” for such person’s own account. Exchange Act § 3(a)(5).
  - The issuer is itself a dealer (an “issuer-dealer”), but there are exemptions for an issuer-dealer.

# Broker-Dealer Regulation

- Case law defining what constitutes a “broker” uses multi-factor tests (not necessarily the same test in each case):
  - An employee of the issuer? (weighs against being a “broker”)
  - Receives a commission rather than a salary?
    - The SEC used to say that this alone would likely make a person a “broker.”
  - Sells securities of another issuer.

# Broker-Dealer Regulation

- Participates in negotiations between the issuer and an investor
- Provides either advice or a valuation as the merit of an investment
- Actively finds investors

This list comes from SEC v. Kramer, 778 F. Supp. 2d 1320 (M.D. Fla. 2011).

# Broker-Dealer Regulation

- Find out if your broker is registered:  
[www.finra.org](http://www.finra.org)
- What happens if your broker is not registered?
  - Neogenix Oncology.

# Broker-Dealer Regulation

- Practical point: can an unlicensed broker-dealer really pull it off?

# Full Disclosure

- Rule 10b-5 can be violated by an outright lie, an omission, an exaggeration, or a minimization.
- There is no comprehensive checklist.
- Start with the North American Securities Administrators Association (NASAA) “Small Company Offering Registration Form (U-7)” and “Issuer’s Manual for Form U-7” at: <http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/scor-forms>.



# Material Omissions

- Examples:
  - unrealistic and baseless projections for rates of return and potential buyout offers.
  - not disclosing that invested funds are used to pay commissions and management fees.
  - not disclosing interlocking relationships of entities and individuals.
  - not disclosing that invested funds will pay back insiders.
  - not disclosing prior felony convictions, regulatory problems, or bankruptcies of insiders.
  - not disclosing that company still needs to obtain licenses in order to do business.

# Full Disclosure

- Is a PPM really necessary?
  - Depends on who you ask, and when you ask them.
  - In a Rule 506 offering limited exclusively to accredited investors, a PPM is not technically required.
    - Legality and practicality summed up by the SEC's Office of Investor Education and Advocacy, "Investor Bulletin: Private Placements Under Regulation D," Sept. 24, 2014:

# No PPM? – For and Against

- “In practice, issuers often provide a document called a *private placement memorandum* or *offering memorandum* that introduces the investment and discloses information about the securities offering and the issuer. However, this document is not required and the absence of this document or similar disclosure may be a red flag to consider before investing.”

[http://www.sec.gov/oiea/investor-alerts-bulletins/ib\\_privateplacements.html](http://www.sec.gov/oiea/investor-alerts-bulletins/ib_privateplacements.html)

# No PPM? – For and Against

- Without a PPM, what risks?
  - The issuer failed to disclose a negative material fact
  - The issuer made an oral promise that was not fulfilled.
    - “You promised to take the company public within a year.”

# No PPM? – For and Against

- With a PPM:
  - “In making the decision to purchase the securities, the undersigned relied solely on the information set forth in the Offering Memorandum.”
- Defendant wins on the papers:
  - Cobalt Partners v. GSC Corp., 97 A.D.3d 35, 944 N.Y.S.2d 30 (1st Dep’t 2012).
  - Basel v. Traders Commercial Capital, LLC, No. 602861/05 (Sup.Ct. N.Y. Cnty. 2006).

However ...

Prior results do not guarantee  
future performance.

# Crowdfunding

## JOBS Act of 2012:

- a public offering to all investors through “funding portals”
  - Status: SEC has proposed regulations.
- a public offering to accredited investors only, without registration, under Rule 506
  - Status: SEC-approved and operating.
- to expand the mini-registration requirements of Regulation A to offerings of up to \$50,000,000.
  - Status: SEC-approved and will be available June 19.

# Title III Crowdfunding

- To all investors, through funding portals.
- Up to \$1,000,000 total.
- Requirements for issuer:
  - To raise more than \$500,000, must include audited financial statements.
  - Disclose:
    - Directors and officers.
      - Business experience of each in the previous three years.
    - Identification of each owner of 20% or more of the business.



# Title III Crowdfunding

- Narrative discussion of financial results.
- The offering.
  - How much money the Company plans to raise.
  - How the Company plans to use the money.
  - What happens if the Company raises less, or more, than it expects.
- Existing debt.
- Risk factors.
- Insider transactions.
- Annual updates are required to be filed each year with the SEC and posted on the Company's website.
- Termination report filed with the SEC.

# Title III Crowdfunding

- Requirements for the funding platform:
  - No solicitation of investors.
  - No investment advice (which stocks are better?)
  - No handling of cash.
  - Register with the SEC as a broker or as a funding portal.
  - Register with any applicable self-regulatory organization (as defined in section 3(a)(26) of the Securities Exchange Act of 1934).

# Title III Crowdfunding

- More requirements for the funding portal:
  - ensure that each investor —
    - reviews investor-education information supplied by the portal in accordance with SEC requirements.
    - affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor can bear such a loss.
    - answers questions demonstrating —
      - An understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers;
      - an understanding of the risk of illiquidity; and
      - an understanding of anything else the SEC requires.

# Title III Crowdfunding

- More requirements for the funding portal:
  - obtain a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity.
  - ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest (close only after a minimum amount sold).

# Title III Crowdfunding

- More requirements for the funding portal:
  - ensure each issuer sells to each investor in a 12-month period nor more than:
    - If the investor's annual income or net worth is less than \$100,000, the greater of:
      - \$2,000 or
      - 5% of the investor's annual income or net worth
    - If the investor's annual income or net worth is greater than \$100,000, the greater of:
      - 10% of the annual income or net worth, but no more than \$100,000
  - The ambiguity is in the original language of Title III itself.

# Title III Crowdfunding

- And finally:
  - Provide a chat room for each issuer.
  - Not compensate promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor.
  - Prohibit its directors, officers, or partners from having any financial interest in an issuer using its services.

# One-State-Only Platforms

- §3(a)(11) of the Securities Act exempts:

[A]n 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.

# Intra-state offering exemption

- SEC Rule 147: a “safe harbor” for §3(a)(11).
  - No part of the issue shall be offered to non-residents of the state.
  - The issuer must derive at least 80% of its gross consolidated revenues from the operation of a business or of real property within the state.
  - The issuer must have at least 80% of its consolidated assets in the state.
  - The issuer must have intended to use, and must use, at least 80% of the net proceeds of the securities sold under Rule 147 in connection with the operation of a business within the state.
  - The issuer must have its principal office located within the state.



# Other current hot topics

- Title III crowdfunding.
  - Is it worth the hassle?

# Other current hot topics

- “Regulation A +”
  - Will start-ups use it?
    - After the company is successful, a mini-IPO under Regulation A might be cost-effective as an exit option for investors.

# Other current hot topics

- Will bad deals crowd out good? Will there be a Gresham's Law of investment opportunities?
  - Because a funding portal is prohibited from picking out deals to pitch to investors (“Stocks are not bought, they're sold”), investors have to find the deals themselves.
    - Will investors screen disclosures for higher promised returns and fewer disclosed risk factors?
    - As a consequence, will deals be rewarded for exaggerating their rewards and hiding their risks?

# How Do You Comply?

- **Disclose!**
  - A good securities lawyer will tell you what you have to file, where, and when.
- **Use only a registered broker-dealer.**
  - Or a crowdfunding platform that you have checked out for their securities law compliance.