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Securities Law

Sale of Securities by Small Businesses
Under Federal and Florida Securities Laws

I. FEDERAL SECURITIES LAWS

A. Introduction

1. The federal securities laws were adopted in 1933 and 1934 to address the problems that led to the market failure of 1929. Prior to the enactment of these statutes, it was not uncommon for the stock markets to be manipulated and for corporate "insiders" to reap great profits at the expense of innocent members of the investing public.

2. Federal securities laws are based on a policy of "**disclosure**". Anyone who buys or sells a security must disclose all material information known to the buyer or seller. This policy of requiring disclosure is intended to assure that investors receive full and fair disclosure for informed investment decisions. The federal securities do not provide, however, for the Securities and Exchange Commission ("SEC") to evaluate the merits of the securities offerings.

3. Today's securities markets enjoy great integrity, to everyone's advantage, as a result of the vigorous enforcement of the federal securities laws by the SEC.

B. Publicly-Held Companies

1. Overview of the Securities Act of 1933, §§ 77a-77aa

a. The Securities Act of 1933 (the "33 Act") requires that unless a registration statement has been filed with the SEC regarding the common stock of a company (the "issuer"), no ***public offer*** of that security can be made.

b. A company's registration statement becomes a public document on filing. Copies of the registration statement can be obtained through the SEC's EDGAR system at the SEC's web site: www.sec.gov.

c. The SEC will review the registration statement and provide the company with comments on the registration statement.

d. The registration statement contains detailed information on the company. The regulations of the SEC specify the information to be set forth in the registration statement.

e. Unless the registration statement has been declared effective by the SEC, no *sale* of that security can be made.

f. The registration statement itself is not delivered to investors, but a "statutory prospectus" - drawn directly from the registration statement - must be. By means of the prospectus, a large body of information is made available to the potential investor, before the investor makes a final decision.

g. Under the 33 Act, the issuer has strict liability if it does not prepare the disclosure documents "diligently".

2. Small Business Public Offerings - 33 Act

a. On July 30, 1992, the SEC adopted substantial revisions to its rules and forms to facilitate capital raising by small businesses and reduce compliance burdens placed on these companies by the federal securities laws. (Securities Act Release No. 6949.)

b. A small business issuer is defined as an entity that meets the following criteria:

1. Has revenues of less than $25,000,000;

2. Is a U.S. or Canadian issuer;

3. Is not an investment company; and,

4. If a majority-owned subsidiary, the parent corporation is also a small business issuer.

Provided however that the entity is not a small business issuer if it has a public float (the aggregate market value of the outstanding voting and non-voting common equity held by non-affiliates) of $25,000,000 or more.

c. Small business issuers are allowed to register their securities using Forms SB-1 or SB-2, as appropriate.

1. While extensive disclosure is still required by these forms, the information required is somewhat reduced and simplified when compared to that which would normally be required.

2. One prime advantage of Forms SB-1 and SB-2 is that two years of audited financial statements are required, rather than three years. This can result in a significant savings for the small business issuer.

3. Overview of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78ll.

    a. After the public offering of a company's common stock, disclosure obligations shift to emphasize the protection of investors in the secondary markets (i.e. resales of the security in the trading markets).

    b. Public companies and companies with more than 500 shareholders and more than $1 million in assets are required to file periodic reports under the Securities Exchange Act of 1934 (the "34 Act").

    c. These mandated disclosures include an annual report on Form 10-K, quarterly reports on Form 10-Q, occasional reports on Form 8-K, proxy statements and annual reports to shareholders.

    d. The regulations of the SEC specify the information to be contained in these reports. Unlike review of the registration statements under the '33 Act, there is relatively little review of '34 disclosure documents by the SEC.

    e. Periodic reports filed by reporting companies are public documents and are available on line at the SEC's web site: www.sec.gov.

4. Small Business Issuers - 34 Act

    a. As in the case of public offerings by small business issuers, discussed above, the requirements of the 34 Act have been modified to lessen the regulatory burden on small business issuers.

    b. Small business issuers may utilize simplified forms to make their periodic reports. Thus, the small business issuer may use Form 10-KSB for its annual reports and Form 10-QSB for its quarterly reports.

C. Exemptions from Registration under the 33 Act

1. Section 5 of the Securities Act of 1933 provides that all securities must be registered unless there exists an exemption for the securities issued.

2. Whether or not the securities are exempt from registration, the federal *anti-fraud* rules apply.

    a. Section 17 of the 33 Act - anti-fraud provision.

    b. 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.

    c. 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."

d. 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)).

3. **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 below) 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):

1. 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.

2. Relationship of Offerees to Each Other

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

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

c. 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).

3. Size of offering - If relatively small number of shares are being sold, offering is less likely to be public. Total dollar amount of offering is not a major factor. Rel. No. 33-4452 (1962).

4. Manner of Offering

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

   b. Cannot advertise.

5. Offeree qualification

   a. Sophistication - prior experience in investing; the ability to understand the risks and protect oneself. Representation by a sophisticated counselor is a factor to be taken into account (i.e. a purchaser representative). However, the investor must have both sophistication and access to the type of information that would be disclosed in a registration statement.

   b. Financial wealth and with it the ability to withstand a loss of amounts invested.

   c. 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.

6. Restriction on resale of securities

   a. Necessary to avoid a "**distribution**" (essential a public sale of the stock).

   b. 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.

4. **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 below with reference to Rule 503 of Regulation D, serves as the notice-of-sales form under Section 4(6).

5. 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:

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

   b. 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.

   c. 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.

   d. 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.

6. **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:

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

      2. <u>All</u> offers and sales must be to residents of the state;

      3. 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).

1. 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.

2. 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.

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

4. No filing with the SEC is required.

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

6. 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.

7. **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 below.

8. **Regulation D of the 33 Act - Limited Offering Exemptions**

a. **Preliminary Notes**:

1. Regulation D is not exclusive (See Sections 3(a)(11), 4(2) and 4(6) discussed above); it is a safe harbor. In other words, if an issuer follows the requirements set forth in Regulation D, the issuer will be deemed to be in

compliance with the 33 Act. Regulation D removes the uncertainty of compliance with Section 4(2) above.

2. Applies only to issuers. (Regulation D exemption is not available to any affiliate of the issuer or to any other person for resales of the issuer's securities.)

3. Exemption applies only to the transaction in which the securities are offered or sold by the issuer, not the securities themselves.

4. Exemption relates only to the requirement to register under the 33 Act. Such transactions are not exempt from the anti-fraud, civil liability or other provisions of the federal securities laws.

5. Issuers are required to provide such further material information, if any, as may be necessary to make the information required, under this regulation, in light of the circumstances under which it is furnished, not misleading.

6. Regulation D does not obviate the need to comply with applicable state laws.

b. **Rule 501 of Regulation D** - Definitions and terms used in Regulation D

1. Among other terms, the following are defined: Accredited Investor, Affiliate, Aggregate Offering Price, Calculation of Number of Purchasers, Executive Officer, Issuer, and Purchaser Representative.

c. **Rule 502 of Regulation D** - General Conditions for a Regulation D offering

1. Integration.

a. All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D.

b. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, *so long as during those six-month periods 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 under Regulation D.*

c. The following factors should be considered in determining whether offers and sales should be

integrated for purposes of exemptions under Regulation D:

i. Whether the sales are part of a single plan of financing;

ii. Whether the sales involve issuance of the same class of securities;

iii. Whether the sales have been made at or about the same time;

iv. Whether the same type of consideration is being received; and

v. Whether the sales are made for the same general purpose.

See Release No. 33-4552 (November 6, 1962).

2. Information requirements.

a. If the issuer sells securities under Rule 505 or Rule 506 to any purchaser that is not an accredited investor, the issuer shall furnish the information specified in paragraph (b)(2) (*see below)* of Rule 502 to such purchaser ***a reasonable time prior to sale***.

b. **The issuer is not required to furnish the specified information to purchasers when it sells securities under Rule 504 of Regulation D, or to any accredited investor.** However, a note to Rule 502(b)(1) cautions issuers that, if it is providing investors with the information called for by the Rule, it should also consider providing the information to accredited investors as well in view of the anti-fraud provisions of the federal securities laws.

c. Non-financial information required by an issuer that is not a reporting company under the 34 Act

i. If the issuer is eligible to use Regulation A (Rules 251-263 of the 33 Act), it may provide non-accredited investors with the same kind of information as is required under any of the three alternative disclosure formats set forth in Regulation A of the 33 Act.

ii. If the issuer is not eligible to use Regulation A, it is required to provide the same information to non-accredited investors as

required under Part I of a registration statement filed under the 33 Act on the form that the issuer would be entitled to use.

d. Financial information required by an issuer that is not a reporting company under the 34 Act

i. For offerings up to $2,000,000, the issuer must furnish two years of financial statements, except that only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited;

ii. For offerings up to $7.5 million, the issuer must furnish an audited balance sheet as of the end of the most recent fiscal year, or as of a date within 135 days if the issuer existed for a period less than one fiscal year, and audited statements of income, cash flows and changes in stockholders' equity for each of the two fiscal years preceding the date of such audited balance sheet (or such shorter period as the registrant has been in business).

iii. For offerings over $7.5 million, the issuer must furnish three years of audited financial statements.

iv. If the issuer can not obtain the financial information required by ii) and iii) above *without unreasonable effort or expense*, certain leniency provisions permit modified financial information to be provided.

e. Information required if issuer is a reporting company under the 34 Act

i. Annual report to shareholders for the most recent fiscal year and, if requested in writing, the issuer's most recent Form 10-K or Form 10-KSB under the 34 Act; ***or***

ii. The information contained in an annual report on Form 10-K or Form 10-KSB under the 34 Act or in a registration statement on Forms S-1, SB-1, SB-2 or S-11 under the 33 Act or on Form 10 or Form 10-SB under the 34 Act, whichever filing is the most recent required to be filed; ***and***

iii. Any recent development filings filed since the filing of the above reports and a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuers affairs that are not disclosed in the documents furnished.

f. Exhibits that would normally be required to be filed by an issuer registering securities with the SEC in a public offering need not be furnished to each purchaser that is not an accredited investor if the contents of the material exhibits are identified and the exhibits are made available to the purchaser, upon his written request, a reasonable time prior to the purchase.

g. The issuer shall provided to any purchaser that is not an accredited investor a brief description in writing of any material written information concerning the offering that has been provided by the issuer to any accredited investor but not previously delivered to such unaccredited purchaser.

h. The issuer shall make available to each purchaser the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished as required under paragraphs (b)(2)(i) or (ii) of Rule 502 (described in this section in paragraphs (c)-(e) immediately above).

i. The issuer shall advise the purchaser of the limitations on resale in the manner contained in paragraph (d)(2) of Rule 502 (described in this section in paragraph (4) immediately below). This disclosure may be contained in other materials required to be provided by this paragraph.

3. Limitation on the Manner of Offering.

a. Except as provided in Rule504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to the following:

i. Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio, and

ii. Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

4. Limitations on Resale.

a. Except as provided in Rule 504(b)(1), securities acquired in a Regulation D offering have the status of securities acquired in a Section 4(2) transaction (discussed in this outline at I.G.3. above) and, therefore, cannot be resold by the holder of the securities without registration under the 33 Act (discussed in this outline at I.F.1 above) or an exemption therefrom. (See below Part IV, Sale of Restricted Securities by Non-Affiliates.)

b. The issuer is required to exercise *reasonable care* to assure that the purchaser of the securities are not underwriters within the meaning of Section 2(11) of the 33 Act. Reasonable care can be demonstrated by:

i. Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;

ii. Written disclosure to each purchaser, prior to sale, that the securities have not been registered under the 33 Act and, therefore, cannot be resold unless they are registered under the 33 Act or an exemption from registration is available; and

iii. A legend is placed on the securities certificate stating that the securities have not been registered under the 33 Act and setting forth or referring to the restrictions on transferability and sale of the securities.

The foregoing actions are not the exclusive method by which an issuer may demonstrate reasonable care. Other actions may satisfy this requirement. (Also above regarding Rule 502 at c.(2)(i).)

d. **Rule 503 of Regulation D** - Notices of sales to be filed with the SEC

a. An issuer is required to file five copies of Form D with the SEC within 15 days after the first sale of securities made in reliance on Rule 504, 505 or 506 of Regulation D.

b. If sales are made under Rule 505, the issuer must also file an undertaking to furnish the SEC, upon written request, the information furnished by the issuer under Rule 502(b)(2) to any purchaser not an accredited investor. (See above regarding Rule 502 at c.(2).)

e. **Rule 504 of Regulation D** - promulgated under Section 3(b) of the 33 Act

0. Rule 504 is the limited offering exemption designed to aid small businesses raise "seed capital". The general philosophy behind Rule 504 is to remove the federal government from involvement in small offerings of $1,000,000 or less by small businesses, leaving the regulation of this area exclusively to the states. Significant coordination between the states has been achieved through the North American Securities Administrators Association (NASAA). See joint report of SEC and NASAA issued April 26, 1984, 16 Sec. Reg. & L. Rep. (BNA) (April 27, 1984). Unfortunately, Florida has been slow to join this band wagon and has only recently enacted legislation, effective October 1997, permitting small offerings under Regulation A and Rule 504, with a number of strings attached. (See below, Part III, Florida Securities Laws.)

1. To be eligible to use Rule 504, an issuer must **not** be:

a. a reporting company under the 34 Act;

b. an investment company; or

c. a development stage company that either has **no specific business plan** or has indicated that its plan is to engage in a merger or acquisition of an unidentified company or companies.

2. Conditions to be met:

a. Offers and sales must satisfy the terms of Rules 501, 502(a), *Integration* discussed above. Moreover, as in the case of other Regulation D offerings, the resale of securities offered under Rule 504 are restricted and there is a prohibition on the general solicitation and general advertising of securities sold in a Rule 504 offering (see *"Limitations on Manner of Offering"* and "*Limitations on Resales*" above) unless the specific

conditions permitting a public offering are met. These conditions are:

i. The transactions are registered under a state law requiring public filing and delivery of a disclosure document before sale. For sales to occur in a state without this type of provision, the transaction must be registered in another state with such a provision and the disclosure document filed in that state must be delivered to all purchasers before sale in both states; or

ii. The securities are issued under a state law exemption that permits general solicitation and general advertising so long as sales are made only to "accredited investors" as that term is defined in Regulation D.

b. The *aggregate offering price*, as defined in Rule 501(c), does not exceed $1,000,000, **less** the aggregate offering price for **all** securities sold within the 12 months before the start of and during the offering of securities under this Rule 504 (either in reliance of an exemption under Section 3(b) or in violation of Section 5(a) of the 33 Act).

3. No limitation on number of offerees.

4. No limitations on nature of offerees.

5. No specific disclosure required; however, the anti-fraud requirements of the 33 Act and the 34 Act still apply.

6. **State law requirements (referred to as "Blue Sky" laws) are applicable and must be complied with**. (See Part III, Florida Securities Laws.)

7. Issuer must still file Form D, but this is not a condition to the offering (See Rule 503 above.)

f. **Rule 505 of Regulation D** - Offerings of up to $5,000,000 - promulgated under Section 3(b) of the 33 Act

0. Issuer may not be an investment company

1. The terms and conditions of Rules 501 and 502 must be met.

a. Integration of other securities sales;

b. Limitations on manner of sales including prohibition against general advertisements and solicitations;

c. Limitations on resales; and,

d. Information requirements with respect to non-accredited purchasers.

(See above discussion of Rule 502 regarding the terms and conditions of this rule.)

2. The aggregate offering price, as defined in Rule 501(c), for an offering under Rule 505 may not exceed $5,000,000, less the aggregate offering price fro all securities sold with the 12 months before the start of and during the offering of securities under this rule in reliance on any exemption under Section 3(b) of the 33 Act or in violation of Section 5(a) of the 33 Act.

3. There are no more than, or the issuer reasonably believes, that there are no more than 35 purchasers of the securities from the issuer in any offering under this rule.

    a. Rule 501(e) sets forth certain provisions regarding the calculation of purchasers.

        i. The following purchasers are to be excluded in calculating the number of purchasers: 1) any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser; 2) any accredited investor; and 3) certain trusts and corporations controlled by a purchaser or other person related to the purchaser as specified in the rule.

        ii. A corporation, partnership or other entity is counted as one purchaser (unless formed for the sole purpose of evading the limitation on purchasers).

4. The exemption provided by Rule 505 is not available if the issuer, its promoters, officers, directors or 10 percent security holders or certain other persons associated with the offering have been the subject of certain administrative orders or actions unless the SEC waives this prohibition. This provision is called the *Bad Boy Disqualification*. This disqualification provision is only found in Rule 505 and is not present in Rules 504 or 506.

g. **Rule 506 of Regulation D** - No limitation on dollar amount - promulgated under Section 4(2) of the Act

    0. Available to all companies

1. The terms and conditions of Rules 501 and 502 must be met
    a. Integration of other securities sales;
    b. Limitations on manner of sales including prohibition against general advertisements and solicitations;
    c. Limitations on resales; and,
    d. Information requirements with respect to non-accredited purchasers.

    (See above discussion on Rule 502 regarding the terms and conditions of this rule.)
2. There are no more than, or the issuer reasonably believes that there are no more than, 35 purchasers of the securities from the issuer in any offering under this rule.
    a. Rule 501(e) sets forth certain provisions regarding the calculation of purchasers. (See discussion above with regard to Rule 505.)
3. Rule 506 has additional requirement that any non-accredited must be *sophisticated*. Specifically, "Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) [as defined in Rule 501] has 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 reasonably believes immediately prior to making any sale that such purchaser comes within this description."
    a. Note that furnishing a purchaser representative to each non-accredited investor at the issuer's expense generally satisfies issuer's obligation. (See SEC no-action letter re *Ticket Master Company*, available April 2, 1984.)

h. **Rule 507 of Regulation D** - Disqualifying Provision
    0. Disqualifying provision whereby an issuer will be barred from making an exempt offering under Regulation D if a court enters an order enjoining the issuer for failing to file the required forms under Rule 503 discussed above.
    1. The SEC can waive this disqualification

i. **Rule 508 of Regulation D** - Insignificant Deviations
    0. Rule 508 provides that the failure to comply with all the terms, conditions and requirements of Regulation D will

not necessarily cause a loss of exemption for an offer or sale to a particular individual if the issuer shows:

a. The condition violated was not intended to protect the complaining individual or entity;

b. The failure to comply was insignificant in relationship to the offering as a whole (note: general solicitation, dollar ceilings and numerical purchaser limits are always significant to an offering as a whole);

c. A good faith and reasonable attempt was made to comply with all applicable terms, conditions and requirements of Rule 504, 505 or 506.

1. Rule 508 preserves the SEC's right to take enforcement action regardless of the significance of a violation.

j. **Federal preemption of state laws regarding Rule 506**

0. On October 11, 1996, the "National Securities Markets Improvement Act of 1996" ("NSMIA") became law. NSMIA provides for federal preemption of state laws with respect to a "covered security".

1. NSMIA defines a "covered security" to include a security that is exempt from registration under the 33 Act pursuant to SEC rules and regulations issued under Section 4(2) of the 33 Act.

2. NSMIA does not prohibit a state from imposing a notice filing requirement that are substantially similar to those required by rule or regulation under section 4(2) in effect on September 1, 1996.

3. NSMIA preserves for the securities commission of any state jurisdiction to investigate and bring enforcement actions with respect to fraud, deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

4. NSMIA preserves for the states the authority to collect filing or registration fees with respect to securities or securities transactions as in effect on the day before enactment of NSMIA (October 11, 1996).

5. As a result of NSMIA, all authority of the states regarding private placements under Section 4(2) of the 33 Act or under Rule 506 of Regulation D are now preempted by federal law.

D. Regulation A - Small Public Offering Exemption - promulgated under Section 3(b) of the 33 Act.

1. Rarely used exemption but deserves greater attention because of its flexibility.
2. Limits offerings under this exemption to $5 million in a 12 month period, including no more than $1.5 million in non issuer (selling shareholders) resales.
3. To utilize this exemption, a company must be:
    a. Organized under the laws of the U.S. or Canada, with its principal place of business in the U.S. or Canada.
    b. Not be a reporting company under the 34 Act.
    c. Not be an investment company, or an issuer of fractional undivided interests in oil or gas rights.
    d. Not a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company or companies.
4. Additionally, the company can not be subject to the *Bad Boy Disqualifications*, discussed above under Rule 505 of Regulation D and set forth in Rule 262 of the 33 Act.
5. Issuers are required to file a offering statement with the SEC as set forth in Form 1-A.
6. With respect to non-financial information, Form 1-A provides issuers with three alternative disclosure options, one of which closely resembles the question and answer format used in Small Corporate Offering Registration ("SCOR") offerings discussed below.
7. With respect to financial information, the offering statement must include a balance sheet as of the end of the most recent fiscal year and statements of income, cash flows, and other stockholders' equity for each of the two fiscal years preceding the date of the balance sheet. Financial statements must be prepared in accordance with generally accepted accounting principles in the U.S. *but need not be audited*. If audited financial statements are available, however, they must be provided.
8. The registration review and offering process is similar to that for companies filing registration statements for public securities offerings, discussed above under the 33 Act, with certain exceptions.
9. The offering statement must be signed by the issuer, its chief executive officer, chief financial officer, a majority of the members of its board and any selling security holder. A $500 fee must be paid with the initial filing.
10. An offering statement is qualified without SEC action 20 days after filing, unless the offering statement contains a notation, placed in it by the issuer/filing company, to the effect that the offering statement shall only be qualified upon order of the SEC. Note, however, that the issuer is

permitted to file an amendment to the offering statement removing this notation.

11. *Test-the-Water Rule* - Rule 254 of the 33 Act

    a. Prior to filing the offering statement with the SEC, an issuer may publish or deliver a written document or make scripted radio or television broadcasts to determine whether there is any interest in the securities intended to be offered.

    b. The written document may include a coupon, returnable to the issuer, indicating interest in a potential offering.

    c. No sales may be made until 20 days after the last publication or delivery of the document or radio or television broadcast.

    d. A copy of the document should be filed with the SEC.

    e. Rule 254 contains specific requirements regarding the content of the test-the-water documents.

    f. While the issuer may obtain indications of interest in a proposed offering prior to filing an offering statement with the SEC, no offers may be made until the offering statement is filed with the SEC and no sales may be made until the offering statement has been qualified by the SEC and an offering circular delivered to the prospective investor.

12. While not a condition to an exemption under Regulation A, the issuer and/or each selling shareholder is required to file a report with the SEC concerning sales and use of proceeds on Form 2-A. This report must be filed every six months after qualification until substantially all the proceeds have been applied. A final report, which should be so labeled, is required 30 calendar days after termination, completion or final sale of securities, or the application of proceeds, whichever is the latest event. The temporary investment of proceeds is not considered an application of proceeds for this reporting requirement.

13. Regulation A provides a substantial good faith compliance defense, similar to that provided by Rule 508 of Regulation D, discussed above.

14. ***Caution****:* Regulation A offerings are subject to the Blue Sky laws of the individual states. Thus, any state securities laws requiring registration must be complied with. Additionally, applicable state laws must be consulted to determine if the special test-the-water provisions of Regulation A are permissible in a given state. Florida does not permit testing of the water. See below, Part III, § 517.081, Registration Procedure.

II. UNIFORM LIMITED OFFERING EXEMPTION

A. Section 19(c) of the 33 Act, adopted as a part of the Small Business Investment Incentive Act of 1980, directs the SEC to cooperate with state securities officials to develop a uniform exemption from registration for small issuers.

B. Regulation D of the 33 Act is intended to be the basis for such a uniform exemption.

C. At a meeting held in September 1983, the North American Securities Administrators Association (NASAA) endorsed revised Uniform Limited Offering Exemption ("ULOE"). ULOE provides that an offering would be exempt from state registration if it complies with Rule 501, 502, 503, 505 and/or 506 so long as certain additional conditions are complied with. (However, see above regarding federal preemption of state securities registration and merit review laws with respect to Section 4(2) and Rule 506 offerings by virtue of Section 18 of NSMIA.) On April 22, 1988 and April 29, 1989, NASSA adopted resolutions which make all subsequent amendments to Regulation D a part of ULOE.

III. FLORIDA SECURITIES LAWS

A. Florida is a "merit" state, as compared to the federal statutes which are "disclosure" statutes. (See discussion at the beginning of this outline under Federal Securities Laws.)

1. Paragraph (7) of § 517.081, Registration procedure, (discussed below) provides that:

"If upon examination of any application the department shall find that the sale of security referred to therein would not be fraudulent and would not work or tend to work a fraud upon the purchaser, that the terms of the sale of such securities would be fair, just, and equitable, and that the enterprise or business of the issuer is not based upon unsound business principles, it shall record the registration of such security in the register of securities; and thereupon such security so registered may be sold by any registered dealer, subject, however, to the further order of the department."

2. The regulations governing the registration of securities in the State of Florida are set forth in the Florida Administrative Code at Chapter 3E-700. These regulations contain various provisions and requirements designed to protect prospective investors. For example, there are requirements regarding the ratio of equity investment held by the promoters to the aggregate public offering, requirements for voting rights except in specified situations, limitations on the granting of options or warrants to underwriters and to officers and employees, requirements for the proceeds of the sale of securities to be placed in escrow, limitations on the issuance of preferred stock or debt securities, requirements on the offering price of equity securities, prohibitions on the registration of securities of issuers in unsound financial condition, and requirements regarding loans and material transactions with affiliates of the issuer.

B. **Registration of securities** - §517.07 Florida Statutes

1. It is unlawful for any person to sell or offer a security within the State of Florida unless the security is exempt under § 517.051 (exempt securities),

is sold in a transaction exempt under § 517.061, is a federally covered security, or is registered pursuant to this statute.

2. Statute requires delivery of a prospectus to purchaser prior to sale.

3. When a registration of securities has been granted, the Department of Banking and Finance issues a permit to sell securities which is effective for 1 year.

4. Offers of securities which are required to be registered may be made before registration if the offers are made in conformity with rules adopted by the Department of Banking and Finance.

5. *Note*: The term "federally covered security", mentioned above, refers to "covered securities" defined in NSMIA, discussed above. In addition to defining securities offered under Rule 506 of Regulation D, NSMIA also defines as a "covered security" any security that is listed on a national securities exchange or on the National Market System of the Nasdaq Stock Market, a federally registered investment company, sales to qualified purchasers (to be defined by the SEC), and securities in connection with certain specified exempt offerings. As discussed above, NSMIA provides for federal preemption with respect to the regulation of such securities and has removed all authority from the states except as provided in limited circumstances.

C. **Registration procedure** - § 517.081 Florida Statutes

1. Securities required to be registered in State of Florida, and not entitled to registration by notification (see below § 517.082, Notification Registration), must be registered in the manner provided by this section.

2. § 517.081(3) sets forth the information on the issuer to be disclosed in the registration.

3. § 517.081(3)(g)2 - Small business issuer registration procedure

   a. Effective October 1997, Florida adopted its version of SCOR - "Small Corporate Offering Registration

   b. While most states have based its SCOR requirements on the federal exemption provided Rule 504 of Regulation D discussed above, Florida's SCOR is modeled after Regulation A, Rule 251 et seq., of the 33 Act, discussed above.

   c. Under § 517.081(3)(g)2, offerings in any consecutive 12-month period may not exceed the lesser of the aggregate offering price in Rule 251 of the 33 Act or $5 million.

   d. § 517.081(3)(g)2 is prohibited to:

      0. An issuer seeking to register securities for resale by persons other than an issuer.

      1. Issuers subject to the Bad Boy Disqualifications of Rule 262 of the 33 Act or subject to enforcement activity under §

517.111 Florida Statutes. For purposes of this section, issuer is defined to include its directors, officers and any shareholder holding 10% or more of the outstanding shares, its promoter or selling agent or any officer, director or partner of such selling agent.

2. An issuer that is a development-stage company that either has no specific business plan or purpose or has indicated that its business plan is to merge with an unidentified company or companies.

3. An issuer of offerings in which the specific business or properties cannot be described.

4. Any issuer the department determines is ineligible if the form would not provide full and fair disclosure of material information for the type of offering to be registered by the issuer.

5. Any corporation that has failed to provide the department the reports required for previous offerings registered pursuant to this subparagraph.

e. As a condition to qualifying for use of the simplified offering circular, a corporation must agree to provide the Department of Banking and Finance annual financial statements for 5 years following the effective date of the registration.

f. A filing fee of $1,000 is due at the time of filing the registration.

4. The regulations governing the registration of securities in Florida are contained in the Florida Administrative Code at Chapter 3E-700, discussed in general above.

5. SCOR offerings are governed by 3E-700.028.

a. Under this regulation, applicants must submit a Form DOSIP-S-12-97. This application requires 3 copies of a Form U-7, which is presented in a fill-in-the-blanks, question and answer format.

b. In theory, Form U-7 is designed to be completed by an issuer without the assistance of attorneys or accountants.

c. **If the offering is "self-underwritten", the issuer must register with the State of Florida as a "dealer", in compliance with § 517.12 Florida Statutes.**

0. Special provisions of the regulations governing the registration of dealers apply to issuer/dealers. See Florida Administrative Code, Chapter 3E-400.002, 3E-600.001 and 3E-600.004(1), among others.

d. All offerees must be furnished both with a copy of a prospectus approved by the Department of Banking and Finance **and** a copy of Florida's Guide to Small Business Investments.

6. Unlike Federal law that permits the filing of a Regulation A offering with unaudited financial statements, Florida requires audited financial statements be provided for a SCOR registration. The only exception to this requirement is when a registrant files an offering statement, with unaudited financial statements, with the SEC under Regulation A. In that limited situation, Florida will accept a SCOR registration with unaudited financial statements.

7. Florida law and regulations do not contain a *Test-the-Water* Rule similar to that found in Rule 254 of the 33 Act with respect to Regulation A offerings, discussed above. As such, Florida SCOR issuers may not "test-the-waters" in Florida.

8. Federal laws governing Florida SCOR offerings

   a. If a Florida SCOR offering is $1 million or less, Rule 504 of Regulation D will apply. Essentially, only a Form D must be filed with the SEC.

   b. If a Florida SCOR offering is over $1 million, up to $5 million dollars, Regulation A will apply, necessitating the filing of an offering statement with the SEC as set forth in Form 1-A.

D. **Notification registration** - § 517.082

1. Securities registered with the SEC pursuant to the 33 Act or the Investment Company Act of 1940 are entitled to register with the State of Florida by notification filing as provided in this subsection.

2. A fee of $1,000 is due.

E. **Exempt Transactions** - §517.061 Florida Statutes

1. This statute sets forth specific transactions which are exempt from the securities registration requirements of the Florida statutes.

2. The exemptions are self-executing and do not require any filing with the State of Florida prior to claiming the exemption.

3. Any person who claims entitlement to any of the exemptions bears the burden of proving such entitlement.

4. §517.061(11)(a) provides an exemption from registration for the offer or sale by, or on behalf of, an issuer of its own securities which offer or sale is part of an offering made in accordance with all of the following conditions:

   a. There are no more than 35 purchasers, or the issuer reasonably believes that there are no more than 35 purchasers, of the securities of the issuer in the State of Florida during an offering made in reliance upon this subsection or, if such offering continues for a

period in excess of 12 months, in any consecutive 12-month period.

0. Offers or sales occurring more than 6 months prior - or 6 months after - are not considered to be part of same offering, provided there are no offers or sales by or for the issuer of the same or similar class of securities during such 6-month period.

1. In calculating the number of purchasers, exclude:

a. Any relative or spouse, or relative of such spouse, of purchaser who has same principal residence as such purchaser.

b. A trust or corporation controlled by a purchaser, or any of the persons listed in (a) above, as more specifically described in the statute.

c. Any person who invests $100,000 or more, provided the purchaser has access to the information specified below.

d. Accredited investors, as defined in Rule 501 of Regulation D of the 33 Act, discussed above.

b. There is no general solicitation or general advertising of the securities in the State of Florida.

c. Prior to the sale, each purchaser or the purchaser's representative, if any, is provided with, or given reasonable access to, full and fair disclosure of all material information. *Note*: the term "purchaser's representative" is not defined in either the Florida securities statutes or the regulations promulgated thereunder. However, it is defined in Rule 501 of Regulation D of the 33 Act.

5. No person defined as a "dealer" under the Florida securities laws is paid a commission or compensation for the sale of the issuer's securities unless such person is registered as a dealer under such laws.

a. § 517.021 contains the definitions of terms used in the Florida securities laws. § 517.021(6)(b) provides that the term "dealer" does not include, pursuant to § 517.061(11), any person associated with an issuer of securities if such person is a bona fide employee of the issuer who has not participated in the distribution or sale of any securities within the preceding 12 months and who primarily performs, or is intended to perform at the end of the distribution, substantial duties for, or on behalf of, the issuer other than in connection with transactions in securities.

6. When sales are made to five or more persons in the State of Florida, any sale in the state made pursuant to this subsection is voidable by the purchaser in such sale either within 3 days after the first tender of

consideration is made by such purchaser to the issuer, an agent of the issuer, or an escrow agent or within 3 days after the availability of that privilege is communicated to such purchaser, whichever occurs later.

7. Offers or sales of securities made pursuant to, and in compliance with, any other subsection of § 517.061 or any subsection of § 517.051, Exempt Securities, shall not be considered part of an offering pursuant to this subsection, regardless of when such offers and sales are made.

This outline summarizes and highlights the relevant Federal and Florida statutes and regulations governing the sale of securities. The date of this outline is March 2001. Readers should refer to the Federal and Florida 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 advise. Readers should not act upon information presented herein without individual professional advice.