Chapter 14

SECURITIES LAW ISSUES FOR SMALL AND START-UP BUSINESS ENTITIES

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§ 14.1 • REGULATORY SYSTEM

§ 14.1.1—In General

In response to the stock market crash of 1929 and the Great Depression that followed, Congress enacted a number of statutes that form the basis for the regulation of securities in the United States. In addition, the multiple corporate accounting scandals of the late 1990s and early 2000s prompted Congress to add significantly to these statutes. These statutes are now the foundation of today's federal securities regulatory system.

The securities laws are intended to assist in facilitating capital formation by issuers (entities that issue securities to investors), while emphasizing the need to provide full and fair disclosure to potential investors and existing shareholders. The basic tenet of the U.S. securities laws is not to directly control or prevent investment or to substitute the judgment and values of the government for market forces. Rather, the legislation mandates disclosure standards and patterns of behavior so that information made available by issuers accurately reflects the business operations, risks, and benefits of a new investment or existing operation.

The objective is to make readily available sufficient accurate information so that potential investors can make a fully informed decision whether to buy, to continue to hold, or to sell a security. The U.S. securities laws also provide severe penalties to deter misrepresentation, deceit, and other fraudulent behavior and to penalize persons or entities that act outside the law and regulations.

Securities transactions in the U.S. are subject to regulation at both the federal and the state level. However, the primary regulation of securities laws is at the federal level. Federal preemption over competing states' interests stems from the Interstate Commerce Clause of the United States Constitution. Federal securities laws preserve the right of the various states to enact laws to regulate securities transactions, so long as such enactments do not conflict with the federal law.[1]

Those transactions that are wholly within a state, or which do not affect interstate commerce, are those primarily regulated by state securities laws, although the impact or applicability of state securities laws should be considered and evaluated on all transactions. Known as "blue sky" laws, the state laws regulate activities within each state, such as registration or exemption of securities transactions within the state and registration of brokers and dealers who operate within the state. Administration within a state is left to state securities law commissions that promulgate rules and regulations for securities transactions within those state borders.

This Chapter focuses on federal law and is intended to provide an overview of securities laws as applied to small or start-up business entities. A discussion of the rules and regulations governing public companies and the multitude of changes made under the Sarbanes-Oxley Act of 2002 would require a multiple volume treatise and is outside the scope of this work.

§ 14.1.2—Federal Law

From 1933 to 1940, Congress enacted a number of statutes that form the basis for securities regulation in the United States. These statutes, and the rules and regulations promulgated under the authority granted to the Securities and Exchange Commission (the Commission or SEC) as part of the applicable law, form the cornerstone of the modern federal securities regulatory system. These acts[2] are as follows:

- The Securities Act of 1933,[3] commonly known as the 1933 Act, regulates the activities of the issuers of securities and the offer and sale of securities;
- The Securities Exchange Act of 1934,[4] commonly known as the 1934 Act, established the Securities and Exchange Commission and regulates the trading of securities;
- The Investment Company Act of 1940,[5] commonly known as the Investment Company Act, regulates the activities of investment companies; and
- The Investment Advisers Act of 1940,[6] commonly known as the Investment Advisers Act, regulates the activities of investment advisers.[7]

In 2002, Congress added another element to the federal securities regulation system by passing the Sarbanes-Oxley Act of 2002 (known simply as Sarbanes-Oxley or SOX),[8] creating a new oversight board for public accounting firms, further regulating those accountants and attorneys practicing before the SEC, and adding additional requirements for publicly traded issuers. Upon signing Sarbanes-Oxley, President George W. Bush referred to it as the most far-reaching reform of American business practices since the time of Franklin Delano Roosevelt.

§ 14.1.3—Securities And Exchange Commission

The SEC was formed under the 1934 Act[9] and is charged with the administration and enforcement of the federal securities laws. The SEC has broad rule-making authority to accomplish its goals to provide protection for investors. Its primary focus is to ensure that securities markets are fair and honest. Rules and regulations promulgated by the Commission affect all aspects of the capital markets, including the issuance and after-market trading of securities, and the registration of brokers, dealers, investment companies, and investment advisors.[10]

Part of the authority of the Commission is carried out through management and oversight of "self-regulatory organizations" (SROs), which today include the major securities exchanges and the National Association of Securities Dealers, Inc. (NASD). Whether the issue is the sale of securities, the trading of securities, the organization of stock exchanges, the role of underwriters or broker-dealers, or the use of investment companies or advisors, it is primarily the Commission that proscribes behavior, monitors activities, and penalizes wrongdoers.

The Commission consists of five commissioners appointed by the President and confirmed by the Senate (each a Commissioner and, collectively, the Commissioners). The Commissioners serve staggered five-year terms.[11] To ensure that the Commission remains nonpartisan, no more than three Commissioners may belong to the same political party. The Commission headquarters are in Washington, D.C., and has numerous field offices throughout the

United States, including Denver. The staff of the SEC is organized into divisions and offices with specific areas of responsibilities. The major divisions are:

- The Division of Corporation Finance, which is responsible for ensuring that disclosure requirements are met by publicly held companies whose securities are registered with the Commission;
- The Division of Market Regulation, which is responsible for registration and regulation of broker-dealers and oversight of the nation's stock exchanges, transfer agents, and clearing organizations;
- The Division of Investment Management, which is responsible for administering investment companies and investment advisers; and
- The Division of Enforcement, which is responsible for enforcing the federal securities laws and regulations.

In addition, the Office of the Chief Accountant has the responsibility for advising the Commission on accounting and auditing matters while creating policies to achieve compliance with accounting and financial disclosure standards. This office oversees private-sector efforts at the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants to improve financial and auditing standards and financial disclosure of issuers of securities.

The Office of International Affairs of the Securities and Exchange Commission has primary responsibility for the international enforcement of securities laws and regulatory cooperation among international securities regulators. Its duties include the investigation of suspected unlawful conduct, market surveillance, and the oversight of regulated entities in cross-border transactions. The Office of International Affairs also assists with international litigation matters, including service of process, gathering of evidence, and enforcing judgments abroad.

As a result of Sarbanes-Oxley, a new entity, the Public Company Accounting Oversight Board (PCAOB), has been created for the purpose of overseeing and investigating audits and auditors of public companies and sanctioning firms and individuals for violations of its rules. The PCAOB is a five-member board — two CPAs and three non-CPAs — overseen by the SEC. It is charged with issuing its own standards for quality controls for the audits of public companies. In addition, it may inspect those public accounting firms that are required to register with the PCAOB for potential violations of securities laws, as well as the firms' standards, competency, and conduct. Finally, the PCAOB's jurisdiction covers both U.S accounting firms and non-U.S. firms that prepare or furnish audit reports involving issuers registered in the United States, as well as those non-U.S. firms the opinions of which are relied on by U.S. accounting firms.

In addition to its enforcement activities, staff members of the SEC engage in ongoing discussions with their non-U.S. counterparts, including the International Organization of Securities Commissions (IOSCO) and the Council of Securities Regulators of the Americas, to facilitate cross-border transactions and to assist other countries and their regulatory bodies in developing policies to provide for investor protection, education, and confidence.

The Commission has the preeminent role in the regulation of federal securities matters, including cross-border securities matters. It has power to:

- Make Rules;
- Examine and inspect regulated entities to determine compliance with the law;
- Interpret and provide guidance on the federal securities laws;
- Investigate complaints and indications of possible law violations;
- Provide statutory sanctions; and
- Enforce the federal securities laws and rules by administrative action, conducting civil litigation, and referring criminal conduct for potential prosecution.

Conspicuously absent from its duties and authority listed above is the ability of the Commission to approve, disapprove, or guarantee the value or merit of any security. Moreover, the Commission will not bar from sale any security, even if the security has questionable value, although it may halt trading in securities that are the subject of illegal market manipulation activities. This is because the Commission's role is to ensure that issuers and market participants fully comply with the federal securities laws and provide full and fair disclosure. The ultimate investment decision is left for the investor to make.

§ 14.1.4—State Law

Although federal law applies to securities transactions that take place across state borders, many states, including Colorado, have also enacted their own securities laws, commonly known as state "blue sky" laws, to cover the offer and sale of securities, registration of broker-dealers, and trading of securities by citizens within a state's boundaries. In addition, securities transactions that occur in multiple states (which is commonplace for a large offering or an IPO) will be subject to the blue sky laws in each of those states.

Some of these blue sky laws, however, have now been specifically preempted under the National Securities Markets Improvement Act of 1996 (NSMIA).[12] For example, states may no longer regulate the availability or the substance of an offering of securities that is exempt from registration under Rule 506 of Regulation D promulgated under the 1933 Act. Rather, they may only require that a notice filing, along with a filing fee, be delivered to its state securities commissioner. For example, the Colorado Securities Division requires that an issuer offering securities under Rule 506 must file a Form D (see below), along with the current filing fee.[13]

These statutes also cover "intrastate" transactions in securities that are exempt from federal law by reason of the issue being offered and sold only to persons resident within a particular state or territory, where the issuer of the security is a person resident and doing business or, if a corporation, incorporated by and doing business within such state or territory.[14] Typically, these laws also have enforcement mechanisms that provide for penalties and sanctions for omissions or misrepresentations or other fraudulent behavior.

In addition to any applicable blue sky laws, individuals who act as "investment advisers" and are not otherwise registered with the Commission under the Investment Advisers Act may be

subject to certain state investment adviser statutes and regulations. Practitioners should consult the rules and regulations of the applicable state to ensure compliance with these directives. State securities regulation in Colorado is governed by the Colorado Securities Act.[15] The Colorado-specific exemptions to registration of offers of securities within the state are covered by §§ 11-51-307 and -308 of the Colorado Securities Act. While many states have passed a uniform form of the State Securities Act and are similar, there are significant variations among the states. Some offerings may be preempted from state law pursuant to NSMIA, but many are not. Thus, it is important to co-counsel with experienced securities practitioners to advise issuers on compliance with both federal and state securities laws.

§ 14.2 • EXEMPTIONS FROM REGISTRATION

Section 5(a) of the 1933 Act provides that it is unlawful for a person or entity to use the mails or any means or instrumentality of interstate commerce to sell unregistered securities, whether the issuer is a U.S. or a non-U.S. person or entity.[16]

§ 14.2.1—Securities Defined

The definition of a "security" is found in § 2(1) of the 1933 Act.[17] The broad parameters set forth in § 2(1) have resulted in a flexible and encompassing definition that subjects not only traditional investment vehicles such as stocks, bonds, and debentures to securities regulation, but also items such as land and service contracts for orange groves[18] and live beavers.[19] The body of case law since the seminal case of *SEC v. W.J. Howey Co.*[20] has generally looked for the following three elements as being indicative of a security: (1) there is a "common enterprise;" (2) there is an "expectation of profit;" and (3) the investor relies "solely on the efforts of others" for profits.

While this boundary remains purposely nebulous, what is clear is that without an exemption, no sale of a security, whether it is a share of stock in a publicly traded company or ownership of a local family-owned business, can take place unless the securities are registered for sale or are exempt from registration. No matter how simple or complex the construct of the security, this axiom will always apply, and the legislation provides both civil and criminal liabilities, depending on the circumstance, to ensure its compliance.

§ 14.2.2—Exemptions In General

There are numerous statutory provisions, rules, and interpretations that exempt certain transactions from § 5(a).[21] These exemptions relate only to the specified transaction and not to any future sale or transfer. As a result, the resale of the securities must be reviewed on a transaction-by-transaction basis and an exemption found for each resale or transfer. Securities sold in exempt transactions are generally deemed restricted securities, which may be resold only if registered or if another exemption is available.

The 1933 Act provides statutory authority for exemptions from the registration requirements under § 5. Section 3(a)(10) provides an exemption when securities are issued under a plan

of exchange approved by a court or other governmental authority. Section 3(b) provides authority for the Commission to exempt transactions where registration is deemed not necessary because of the small amount contemplated by the offering, under $5 million in value, or by the limited character of the offering.[22] Section 4(2) exempts transactions by an issuer not involving a public offering.[23] Section 4(6) exempts transactions with accredited investors.[24] While not an exhaustive list of the available exemptions from registration, these are some of the most commonly utilized by issuers.

Certain exemptions available for domestic entities are not available for non-U.S. issuers offering and selling securities within the United States, including the intrastate exemption set forth in § 3(a)(11) of the 1933 Act. This exemption from registration is available only to an issuer organized under the laws of a state or territory of the United States and doing business in that same state or territory.[25] Intrastate securities offerings will be governed by state blue sky regulations.

This patchwork of exemptions in the statute, and the rules and regulations promulgated by the Securities and Exchange Commission thereunder, form the basis for the exemption of certain offerings from the registration provisions of the 1933 Act.

Central to the notion of exempt transactions is the concept of integration. If an issuer could selectively sell securities under one or more exemptions in a concerted scheme to evade the registration requirements or in contravention of any particular exemption, the objectives of the regulatory framework would not be met. The Securities and Exchange Commission has identified certain factors to determine whether the various offerings should be integrated, including whether the offerings represent a single plan of financing, are the same class of securities, are made at or about the same time, involve the same consideration, or are being made for the same general purpose. Each transaction and the history of the issuer needs to be reviewed to determine whether any or all of the offerings are integrated for federal securities law purposes.[26]

§ 14.2.3—Regulation A Exemption

Rules 251-264 promulgated under the 1933 Act are commonly referred to as Regulation A.[27] Regulation A is a partial exemption from registration. It provides a simplified form of registration that costs less to prepare and takes less time to complete than a full registration. An issuer is eligible to use Regulation A if the issuer (1) is a resident of, and has its principal place of business in, the United States or Canada; (2) is not a 1934 Act reporting company prior to the Regulation A offering; (3) is not a blank-check company (discussed below); (4) is not an investment company under the Investment Company Act of 1940; (5) is not issuing fractional undivided interests in oil or gas rights; and (6) is not disqualified by the "bad behavior" rules in Rule 262.[28]

The aggregate offering price, defined as the sum of all cash and other consideration at its fair market value, of a Regulation A offering is also limited. As a general rule, securities offered pursuant to Regulation A may not exceed $5 million in any one year. Rule 251(b) mandates that all security holders together may sell no more than $1.5 million worth of Regulation A securities

in any one-year period and that amount counts toward the issuer's aggregate offering price. The issuer can limit how much security holders sell under Regulation A in order to protect against their frustrating the Regulation A limited exemption. Furthermore, sales by affiliates (control persons) are prohibited if the issuer has not had net income from continuing operations in at least one of its last two fiscal years.[29]

There are no rules promulgated by the SEC that limit the scope of a Regulation A offering. An issuer could make a public Regulation A offering since there are no rules limiting the number of people who can buy or sell, or the manner of sale — just a limit on aggregate offering price and amount that can be sold in the secondary market in any given year. In practice, however, Regulation A offerings are typically limited in scope to a defined segment of the public. This is because there is concern, particularly from legal counsel and underwriters, that the advantages of the limited disclosure requirements of Regulation A may not be suited to a public offering of broad distribution. Regulation A does not contain an exemption from the antifraud provisions of the federal securities laws. Accordingly, the issuer must give consideration to the disclosure of all material information, regardless of whether required specifically by Regulation A.

If a Regulation A offering is limited to persons with intimate or substantial knowledge of the industry or specific business of the issuer, these people will already have knowledge of general information material to the industry or specific business of the issuer. This is the reason that Regulation A is sometimes used for employee stock option plans in private, non-reporting companies. Regulation A is not preempted by NSMIA and will be subject to state blue sky laws. Depending on the applicability of the exemptions in the states in which offers will be made in a Regulation A offering, registration at the state level may be required. For this reason Regulation A offerings have been largely replaced by Regulation D offerings, of which Rule 506 preempts state blue sky laws pursuant to NSMIA and are usually easier and less costly to conduct.

§ 14.2.4—Regulation D Exemptions

In 1982, the Commission adopted Regulation D under the 1933 Act to clarify certain statutory exemptions available for the sale of securities by issuers on a private or limited basis.[30] Among other things, these rules clarify the disclosure obligations for certain types of private or limited offerings, and they set forth clear criteria for integration of previous offerings. There are three exemptions under Regulation D — Rules 504, 505, and 506 — all of which may be used by domestic or non-U.S. issuers, as follows.

Rule 504

Rule 504 provides for an exemption from registration pursuant to § 3(b) of the 1933 Act.[31] This exemption from registration will apply to an offer of securities not exceeding $1 million (U.S.) during any 12-month period. The exemption is available to any issuer so long as it is not subject to the reporting requirements of §§ 13 or 15(d) of the 1934 Act and is not an investment company.[32] However, Rule 504 is not available for a "blank-check offering" by a development-stage company. A blank-check offering is an offering where no specific business plan or purpose exists or where a business plan exists to engage in a merger or acquisition with an unidentified company or companies.[33]