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EXEMPT TRANSACTIONS FOR ISSUERS AND OTHER SELLERS OF SECURITIES
TRANSACCIONES EXENTAS PARA EMISORES DE TÍTULOS-VALORES
TRANSACCIÓNS EXENTAS PARA EMISORES DE TÍTULOS-VALORES

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INTRODUCTION

The aim of this dissertation is to review some of the exemptions to the prohibitions set forth in Section 5 of the Securities Act of 1933, which prevent the issuer from offering to sell or offering to buy any security[1] unless a registration statement [2] has been filed as to such security.

The starting point is that a public offering of securities by an issuer[3] implies the expenditure of a big amount of money on the part of such issuer. All the documents (mainly the registration statement) that accompany the public offering made by the issuer provide the potential investors with relevant and necessary information so that they can decide whether to invest or not on an informed basis. However, the elaboration of all those documents is very costly as they provide detailed and specific legal and financial information, which requires the issuer to hire highly qualified professionals (such as law firms, accountants, appraisers…) in order to prepare the registration statement.

Thus, the requirement of information is crucial to protect the interest of investors, as we will see all through this dissertation. In this sense, Section 5 of the '33 Act imposes the issuer, the adequate disclosure of information in order to offer to sell and offer to buy any security.

However, under the legal exemptions that I will examine below, some issuers can comply with the law by circumventing the costly requirements of Section 5, as long as the potential purchasers of the securities possess through other means the information that otherwise would be disclosed in the registration statement.

I will therefore, proceed to examine those exemptions some issuers can fall into, and, under what conditions they can benefit from them.

[1] According to Section 2(a)(1) of the Securities Act of 1933, the term security means *"any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, transferable share, investment contract…or in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."*

[2] Document containing information concerning the type of security, the issuer… and, in general, all the material information that a reasonable investor should consider relevant in deciding whether to invest or not.

[3] Pursuant to Section 2(a)(4) "*the term issuer means the owner of any security or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering."*

I. APPROACHING SECURITIES LAW

1.1 Overview

The securities laws exist because of the unique needs of investors. Unlike cars and other tangible products, securities are not inherently valuable. Their worth comes only from the claims they entitle their owner to make upon the assets and earnings of the issuer, or the voting power that accompanies such claims. Deciding whether to buy or sell a security thus require reliable information about such matters as the issuer's financial condition, products and markets management, and competitive and regulatory climate. With this data, investors can attempt a reasonable estimate of the present value of the bundle of rights that ownership confers.

As it is going to be shown all through this master's dissertation, securities regulation is an extremely complicated field. The statutes and rules are extremely complex and detailed. The case law is particularly perplexing because of the degree of detail and complexity the law imposes. However, it is not only the law that is difficult and elaborate, but the transactions that involve the securities laws are extremely complicated as well. The purpose of this dissertation is to review the law and its applications concerning the so-called "*exempt transactions from registration*" in an understandable manner.

Although the first laws in the United States aimed at securities regulation developed in the individual states[4], most securities regulation today is a matter of federal law even though the states retain influence in some selected areas.

1.2 Sources of Federal Securities Laws[5]

Although originating as a matter of state law, the vast majority of securities regulation in the United States is a matter of federal law. Thus, the starting point in analyzing any question of federal securities law is of course the statutes:

1. The Securities Act of 1933 ('33 Act or Securities Act hereinafter): which regulates the public offering and sale of securities in interstate commerce[6].
2. The Securities Exchange Act of 1934 ('34 Act hereinafter): which regulates the system of continuous disclosure for companies required to register under its provisions.

In the strictest sense, there is no federal "common law" of securities, and any rights or liabilities must find their source in the statutes themselves. The statutes are, however, quite

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[4] The state securities laws are also referred to as "blue sky" laws.

[5] This subsection is adapted from THOMAS LEE HAZEN & DAVID L. RATNER, Securities Regulation Cases and Materials 11-16 (6th Ed. 2003).

[6] According to Section 2 (7) of the '33 Act, "*the term interstate commerce means trade or commerce in securities or any transportation or communication relating thereto among the several States or between the District of Columbia or any Territory of the United States and any State or other Territory, or between any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia.*"

sketchy or ambiguous in many important areas, and hence it is necessary to draw on supplemental sources of law.

Beyond the case law in the federal courts, federal securities law exists in a large body of administrative law. The administrative law sources are of two kinds: rules and other statements of general applicability issued by the Securities and Exchange Commission[7](or applicable self-regulatory organizations[8]) and reports of cases decided by the SEC applicable self-regulatory organization.

The Securities Exchange Commission (the "SEC" hereinafter) is an independent agency devoted to exercising rule-making power. Pursuant to Section 19(a) of the Securities Act "*the Commission shall have authority from time to time to make…such rules and regulations[9] as may be necessary to carry out the provisions of this title…."*

1.3. The registration requirement

Section 5 of the Securities Act establishes some demands of those involved in distributing a security when neither the security nor the transaction is exempt from Section 5's registration and prospectus delivery requirements (those exemptions will be examined throughout this dissertation). In broad overview, absent an applicable exemption, Section 5 bars any offers to sell and sales of a security until a registration statement covering the security has become effective. The registration statement contains information about the security's issuer, the security, the contemplated uses of the offering's proceeds, and the manner of its sale (e.g., its underwriters and its compensation), all with the intended purpose of facilitating informed investment decisions and discouraging the fraudulent promotion of worthless securities.

The most salient parts of the registration statement are also set forth in the prospectus[10], which is an important medium to accompany any written offers to sell the registered

[7] Alternatively referred to as the "SEC" or "the Commission".

[8] Formerly the primary self regulators of the securities markets were the National Associations of Securities Dealers (NASD) and the New York Stock Exchange. In 2007 the regulatory arms of the NASD and the New York Stock Exchange merged into a single Financial Industry Regulatory Authority ("FINRA").

[9] In Commission usage, regulations are compendiums of rules or "items" covering a particular topic or purpose. For example, Regulation D is a series of rules relating to three exemptions from the Securities Act's regulation requirements, and Regulation S-K is the general repository of disclosure requirements under the Securities Act and the Exchange Act. Regulation S-K's components are called items, with item 102, for example, relating to disclosures concerning a company's properties.

[10] As defined in Section 2(a)(10) of the '33 Act *"the term prospectus means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that:* ***(a)*** *a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 10) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 10 at the time of such communication was sent or given to the person to whom the communication was made, and* ***(b)*** *a notice, circular , advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 10 may be obtained and, in addition, does no more*

securities. The focus of disclosure is not just those investors solicited to purchase the registered security. Among the objectives of Section 5's registration statement and the prospectus is informing all those involved in distributing the registered security of all material fact bearing on the issuer and the securities.

II. EXEMPT TRANSACTIONS

2.1. Introduction

Not every transfer of capital involving a security will fully activate the prohibitions of the 1933 and 1934 Acts. In many types of transactions, the disclosure requirements of the securities acts may seem less than compelling when balanced against other considerations, such as the sophistication of a given set of purchasers, the actual or theoretical likelihood of adequate state regulation, and the needs of business to raise relatively small amounts of capital without the burdens of registration. Accordingly, Sections 3 and 4 of the '33 Act set forth a series of exemptions relieving those involved in securities transactions of the need to comply with the registration provisions of the Act and, to a limited extent, the antifraud provisions of the '33 and '34 Acts.

The exemption fall into two classes. *Transaction exemptions*[11] provide an exemption only from the registration provisions of Section 5 of the '33 Act. Securities placed under one of these exemptions remain subject to both the '33 Act and the '34 Acts and, importantly, cannot be resold unless either they are registered or another exemption is available. *Exempt securities*, on the other hand, need not be registered, but also may be resold free of registration burdens. Determining that a security is exempt, however, does not negate application of the securities acts in their entirety, for exempt securities remain subject (to varying degrees) to the antifraud provisions of the '33 and '34 Acts.

This dissertation focuses on the more important of the transaction exemption that may be available to issuers and, to a lesser extent, other sellers of securities.

2.2. The Intrastate Offering Exemption: Section 3 (a) (11)

Section 3 (a) (11) of the '33 Act exempts:

> *Any security which is part of an issue offered and sold only to persons resident within a single State of 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.*

than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission deemed necessary or appropriate.

[11] The Rules that provide further clarification on these brief exemptions are also called "Safe Harbors."

Therefore, this definition does not work if the transaction is also carried out beyond the borders of one state**.** Put differently, if the issuer issues stock in different states this provision is not applicable.

In spite of its apparent simplicity, the intrastate offering exemption has proven to be one of the more problematic of the '33 Act's exemptions[12]. The idea of relieving purely local financings from the '33 Act registration requirements is simply to express but poses numerous policy issues at the level of implementation. What is local financing? What does *doing business* mean? How is *residency* to be defined? May the securities be resold to nonresidents?

For these purposes, Rule 147 [13]provides further clarification on the meaning of "Part of an Issue", "Person Resident" and "Doing Business Within" of Section 3 (a) (11). As it can be seen, the wording of an exemption itself is very brief. For this very reason, some Rules (like Rule 147) also known as "Safe Harbors" provide us a detailed and thorough description of what transactions would fall within the scope of the exemption, and thus, would be exempted from the registration requirements of Section 5.

A) ANALYZING THIS EXEMPTION THROUGH RULE 147: ISSUE CONCEPT

A basic condition of the exemption is that the entire issue of securities be offered and sold exclusively to residents of the state in question. Moreover, since the exemption is designed to cover only those security distributions, which, as a whole, are essentially local in character, it is clear that the phrase "sold only to persons resident" as used in section 3 (a) (11) cannot refer merely to the initial sales by the issuer corporation to its underwriters, or even the subsequent resales by the underwriters to distributing dealers.

To give effect to the fundamental purpose of the exemption, it is necessary that the entire issue of securities shall be offered and sold to, and come to rest[14]only in the hands of residents within the state.

B) DOING BUSINESS WITHIN THE STATE

This requirement can only be satisfied by the performance of substantial operational activities in the State of incorporation.

C) RESIDENCE WITHIN THE STATE

Section 3 (a) (11) requires the entire issue to be confined to a single State in which the issuer, the offerees and the purchasers are residents. Mere presence in the state is not

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[12] In the words of a former chairman of the SEC, "*as a practical matter the intrastate exemption is loaded with dynamite and must be handled with very great care"*, The Securities Exchange Commission and the Financing of Smalls Business, 14 Bus. Law. 144, 148 (1958)

[13] Rule 147. "Part of an Issue", "Person Resident", and "Doing Business Within" for Purposes of Section 3 (a) (11).

[14] This expression used in Securities Regulations means that the investors have owned the securities for a long period of time, which excludes the hypothetical intent that such investors might have in reselling those securities.

sufficient to constitute residence as in the case of military personnel at a military post, for instance.

D) RESALES

Any offers or sales to a nonresident in connection with the distribution of the issue would destroy the exemption as to all securities which are part of that issue, including those sold to residents regardless of whether such sales are made directly to nonresidents or indirectly through residents who as part of the distribution thereafter sell to nonresidents…

E) CONCLUSION

In conclusion, the fact should be stressed that Section 3 (a) (11) is designed to apply only to distributions genuinely local in character. From a practical point of view, the provisions of that section can exempt only issues which in reality represent local financing by local industries, carried out through local investments…

2.3 The Rule 147 Safe Harbor

As mentioned above, the SEC adopted Rule 147 which defines certain terms in, and clarifies certain conditions of, Section 3 (a) (11) of the '33 Act. This kind of rules are also called "Safe Harbors" since they determine whether a specific transaction can fall within the scope of the exemption and therefore, it would be "safe" from all the countless registration requirements and prohibitions that Section 5 imposes.

Taking into consideration what has been put forward above, in this section it is important to point out the five factor test that Rule 147 establishes to determine whether offers and sales should be regarded as part of the same issue and thus should be "integrated" (the concept of integration will be discussed later on):

i. Are the offerings part of a single plan of financing;
ii. Do the offerings involve issuance of the same class of securities;
iii. Are the offerings made at or about the same time;
iv. Is the same type of consideration to be received; and
v. Are the offerings made for the same general purpose.

Rule 147 in its preliminary notes expressly adopts this five factor test and points out that *"any one or more of the factors may be determinative."*[15] The rule establishes a six-month safe harbor for avoiding integration with out-of-state sales[16]

Even where the above-mentioned statutory requirements in section 3 (a) (11) have been satisfied, the issuer still is not perfectly safe under the intrastate exemption. For example, it has been held that where an offering was made only to Minnesota residents and the issuer,

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[15] *See* preliminary note to Rule 147.

[16] *See* the nine-month limit on resales in Rule 147 (e). See also Busch v. Carpenter (out-of-state resale occurring seven months after intrastate offering did not destroy the exemption for the intrastate sales).

a Minnesota corporation, had its only office in Minnesota, the fact that the proceeds would be used outside of the state was sufficient to make the intrastate exemption unavailable[17]. The decision raises significant questions about the exemption's application to any issuer with out-of-state operations and if the offering proceeds may be even indirectly attributed to that portion of the business[18]. This use of the proceeds requirement is not as troubling as if it is viewed in terms of the overall business operations[19], but it seems to be overreaching if it will void the exemption for securities of an issuer who derives substantial income from in-state operations. For example, an issuer using the proceeds of the offering to purchase wine outside the state for resale within the state can still satisfy the in-state business requirement[20].

Below, the next table perfectly illustrates the Section 3 (a) (11) Intrastate Offering Exemption:

Statutory criterion	**SEC Release (1961)**	**Rule 147**
Doing business within the state	“substantial operational activities”	(c)(2)(i), (ii) & (iv) – 80% tests, principal place of business
Use of proceeds within the state	primary use outside state precludes exemption	(c)(2)(iii) – 80% of proceeds used within the state
Residence of offerees and purchasers	residence, not “mere presence”	(d) – offers only to residents of the state
Resales to nonresidents	Exemption only if securities “come to rest” in the state	(e) – no sale to nonresidents for 9 months after last sale by issuer
“Part of an issuer”	“related part of a plan or program”	“integration” factors, 6 months safe harbor in (b) (2)

[17] SEC v. McDonald Investment Co., 343 F.Supp. 343. Compare Rule 147 which imposes an eighty percent minimum on the proceeds to be used within the state.

[18] The issuer planned to use the proceeds for loans secured by real property outside of the state. Although the loan contracts were to be governed by Minnesota law and despite the fact that the issuer had in-state income as well, the court denied the exemption. In its broadest reading, the decision can be seen as adding to the statutory doing-business requirement a rule that the proceeds from the particular offering be used in the state.

[19] *See* SEC v. Truckee Showboat, Inc.

[20] *See* SEC v. Adventures in Wine.

2.4 The Private Offering Exemption: Section 4 (a) (2)

Section 4 (a) (2) of the '33 Act exempts from the provisions of section 5, *"transactions by an issuer not involving any public offering"*[21].

The notion that certain types of discrete, face-to-face transactions between an issuer and a sophisticated investor should not be subject to the time and expense problems of the registration process is uncontroversial and is premise accepted by all of the Western world's securities regimes. The easiest cases are those in which institutional investors, such as insurance companies and pension funds, are the purchasers in private placements. In such cases, the concern over information asymmetry (i.e., one party to the transaction is in possession of not known by the other party) is obviated to a considerable extent. Most institutional investors, it must be assumed, are sophisticated investors[22] who know what to ask and are capable of protecting their own interests. Accordingly, the protections afforded by the registration process are unnecessary because the purchasers have the requisite expertise and bargaining leverage to obtain relevant information and negotiate concessions necessary to protect their investments.

Institutional investors are the important players in the private placement market, but they are not the only players. Individual investors with varying degree of financial acumen and bargaining leverage are common targets of issuers seeking to sell securities under the private offering exemption. In this cases, the problem becomes one of defining the types of "private offerings" for which the protections of registration are unnecessary to correct informational asymmetry that may exist between the parties.

A) MAPPING THE SCOPE OF THE EXEMPTION

The first meaningful guidance on the circumstances under which the private offering exemption would be available came in the form of a letter by the general counsel of the SEC published in a 1935 release[23]. The opinion identified four factors of particular importance:

1. *The Number of Offerees and Their Relationship to Each Other and to the Issuer.* The number of offerees –not purchasers- is a critical inquiry. Since any attempt to dispose of a security is an offer, preliminary negotiations or conversations with a substantial number of offerees will cause the offering to be public in nature. Also important is the relationship between the offerees and the issuer; if the offerees are members of a class having special knowledge of the issuer, the case for a private offering is strengthened.

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[21] It has been aptly observed that these nine words support a substantial gloss. *See* L. Loss & J. Seligman, Fundamentals of Securities Regulation 538 (6th ed. 2011).

[22] Pursuant to Rule 506 (b)(2)(ii) sophisticated investors are those purchasers who have such knowledge and 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 the description.

[23] *See* Securities Act Release No. 285, 1 Fed. Sec. L. Rep. (Jan. 24, 1935). Four nearly two decades, the general conunsel's opinion was the authoritative statement on the private offering exemption. Although courts continue to cite the factors outlined by the general counsel in 1935, the focus of the inquiry shifted with the 1953 decision of the Supreme Court in SEC v. *Ralston Purina Co.*

2. *The Number of Units Offered.* The issuance of securities in a large number of units of small denominations is an indication the issuer anticipates subsequent public trading in the securities. Conversely, an issuance of a small number of units in large denomination is evidence of a private offering.

3. *The Size of the Offering.* The exemption was intended to apply chiefly to small offerings.

4. *The Manner of Offering.* Transactions effectuated through direct negotiations are more likely to be private offerings than those made through the use of the machinery of public distribution (such as advertising).

In spite of these four factors, the decision of the Supreme Court in SEC v. *Ralston Purina Co.*, was a milestone to examine the fulfillment of the requirements of the 4 (a) (2) exemption. Below, I proceed to summarize the decision:

Brief Fact Summary[24]. The Securities and Exchange Commission (petitioner) brought this complaint seeking to enjoin unregistered offerings of treasury stock to by Ralston Purina Co., (respondent)

Facts. Respondent has facilities scattered throughout the nation staffed by 7,000 employees. The company has a policy of encouraging stock ownership among its employees. Selling nearly $2,000,000 of stock to them without registration. The company offers stock to "key employees." This characterization is not based on an organization chart. It includes an individual eligible for promotion, one who influence others, whom the employees look to in a special way, or who is sympathetic to management among other factors. The Securities and Exchange Commision brought this complaint seeking to enjoin Respondent's unregistered offerings. The District Court held the exemption applicable and dismissed the suit. The Court of Appeals affirmed. The SEC took the position that that was an IPO and, as a consequence a violation of section 5, because no Registration Statement was filed. Defendants reply saying, that it was not a public offering because the stock was only sold to "key employees"

Issue. Whether Respondent's offerings of treasury stock to its "key employees" are exempt of as transactions by an issuer not involving any public offering. As there is no definition of IPO on the statute, the judges had to make up a new definition.

Sypnosis of Rule of Law. Whether a transaction by an issuer involves a public offering depends on the need of the offerees for the protections afforded by registration.

Conclusion. About the criteria of identifying an IPO, the Court said that just because the offerees are very few people or many people does not mean that it is not a public offering. Instead, the Court said that what is important is that the offerees can fend for themselves. [25] This is important because if they cannot fend for themselves it is a public offering. However,

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[24] Extracted from *www.casebriefs.com*

[25] "Fend for themselves" means sophistication, that is to say, that the offerees have some basis of access to information or it could also mean that they already got the information.

if they can fend for themselves, is not a public offering. In general, the less access to information they have, the fewer offerees….the more likely to be a public offering.

B) THE RELEVANCE OF NUMBERS

The general conusel's 1935 opinion suggested that an offering to not more than 25 individuals is presumably not a public offering. Prior to *Raltson,* some issuer viewed this as a rule of thumb and concluded they could safely proceed with an offering directed to 25 or fewer people.

Although *Ralston* has had the effect of negating any numerically based guidelines for determining the scope of the statutory exemption (as opposed to the legitimacy of an SEC safe harbor), it may be read only as rejecting a quantity limit *above* which an offering is necessarily public in nature. That is, the *Ralston* Court rejected the SEC's argument that the large number of participant in the stock purchase was in itself conclusive proof that the offering was public.

Ralston eventually prompted the SEC to terminate the use of numerical tests to set a ceiling above which it would be deemed public or to establish a floor below which it would be considered private. Nevertheless, courts continue to view a large number of offerees as indicative of a public rather than a private offering[26]. As the number of offerees increases, the issuer's burden of proof that all offerees had the requisite access to information becomes more difficult to carry. A small number of offerees, on the other hand, does not negate the possibility of a public offering[27].

Much of the post-*Ralston* litigation concerning the private offering exemption has centered on identifying the types of persons in need of protection afforded by registration and therefore ineligible subjects of private offerings[28].

Although the Supreme Court in *Ralston* emphasized access to information as a critical inquiry, it also commented that an offering is not public when limited to those who are able to "fend for themselves".

Successive cases on this matter, provide that the relationship of the offerees to each other and the issuer was not sufficient, the court reasoned, to justify treating an offering as private rather than public. The offerees knew neither the issuer nor its business, and unlike insiders in a corporation, they lacked a *privileged relationship* with the issuer. Lacking access to information, the offerees were in need of the protections of registration. The fact that they were sophisticated[29], and therefore were arguably able to fend for themselves, was irrelevant:

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[26] *See, e.g.,* SEC v. Earthly Mineral Solutions, Inc*.,* 2011 U.S. Dist. LEXIS 36767.

[27] *" Two offerees may constitute a public offering*" See, e.g., Butler v. Phlo Corp., 2001 U.S. Dist. LEXIS 10809

[28] *"Mere acknowledgements by (investors) that they had the opportunity to ask questions and evaluate the merits and risks of the investment is not sufficient to demonstrate that they had access to the information that would be disclosed in a registration statement". See, e.g.,* Section v. Trujillo, 2010 U.S. Dist*. LEXIS 99208.*

[29] *See, e.g.,* Mark v. FSC Sec. Corp., (335-336) (6th Cir. 1989*).* Courts sometimes avoid the sophistication issue by simply stating the exemption was not satisfied because the defendant was unable to produce evidence that all the offerees were sophisticated.

"Obviously if the plaintiffs did not possess the information requisite for a registration statement, they could not bring their sophisticated knowledge of business affairs to bear in deciding whether or not to invest…"[30]In short, sophistication[31] of the purchasers is not substitute for information. The, the *Ralston* standard "is based more on access to information than a party's sophistication and wealth. Where a party has no ability to obtain the vital, material information about the investment, the exemption should not apply.

The issuer must affirmatively demonstrate by "explicit, exact" evidence that *each* person to whom unregistered securities were offered was able to "fend" for himself – in other words, that each offeree had a r*elationship* to the company *equivalent* to that of an "insider" in terms of his ability to know, to understand and to verify for himself all of the relevant facts about the company and its securities.

Sophistication, in short, does not eliminate the need for information. As to how an information standard is to be satisfied, *Doran v. Petroleum Management Corp.* concluded that availability of information means "either disclosure of or effective access to the relevant information". If the *disclosure* option is exercised, the absence of a relationship between the issuer and the offeree would not preclude the possibility that the offering was private. If *access* to information is the measure, on the other hand, the relationship between the issuer and the offeree becomes the critical question:

> Such access might be afforded merely by the position of the offeree or by the issuer's promise to open appropriate files and records to the offeree as well as to answer inquiries regarding material information. In either case, the relationship between the offeree and issuer now becomes critical, for it must be shown that the offeree could realistically have been expected to take advantage of his access to ascertain the relevant information. Similarly, the investment sophistication of the offeree assumes added importance, for it is important that he could have been expected to ask the right questions and seek out the relevant information.

III. REGULATION D AND THE LIMITED OFFERING EXEMPTIONS

Regulation D provides three exemptions (Rules 504, 505, and 506) that, taken together, cover the vast majority of offerings exempt from registrations. Rules 504 and 505 were promulgated on the basis of Section 3 (b) (1) of the '33 Act[32], which authorizes the SEC to

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[30] *See* Hill York Corp. V. American International Franchises Inc.

[31] The elusiveness of sophistication as a standard is aptly illustrated by Hedden v. Marinelli*,* 796 F. Supp. 432, where one of the investors had a bachelor's degree in economics from Standford as well as a law degree from Hastings; he also was the founding director of a bank and trust company. The other investor had invested in may stock transactions involving sums exceeding $50,000 and had been the CEO of the company the stock of which he was purchasing. Yet the court refused to conclude for summary judgement purposes that "these individuals were sufficiently sophisticated to not require the protections of the 1933 Act."

[32] "*The Commission may from time to time by its rules and regulations and subject to such terms and conditions as may be prescribed there in, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this tittle with respect to such securities is not necessary in the public interest*

develop exemptions covering offerings up to 5$ million in amount when registration is not necessary to protect the public interest of investors. Rule 506, on the other hand, represents a nonexclusive safe harbor for the private offering exemption of Section 4(a)(2).

3.1 An Overview of Regulation D

Rules 504, 505, and 506 must be read in conjunction with Rules 500-503 and 507-508, which provide conditions applicable, for the most part, to all three exemptions. The principal conditions of each of the exemptions are:

- Rule 504: maximum aggregate offering price of 1$ million; not available for reporting companies[33]; no limitations on the number of purchasers; no affirmative disclosure obligations.
- Rule 505: maximum aggregate offering price of 5$ million; no more than 35 purchasers (certain classes of individuals, including accredited investors [34]are not counted in computing the number of purchasers); affirmative disclosure obligations applicable when there are nonaccredited investors.
- Rule 506: no limitation on the maximum aggregate offering price; no more than 35 purchasers (certain classes of individuals, including accredited investors are not counted in computing the number of purchasers); affirmative disclosure obligations applicable when there are nonaccredited investors; nonaccredited investors or their representatives must be sophisticated.

Most Regulation D offerings are subject to broad prohibitions on general solicitation and advertising. Lately, Congress directed the SEC to remove these restrictions on Rule 506 offerings, provided that all investors are accredited and the issuer takes reasonable steps to verify that investors are accredited. Responding to this direction, the SEC in August, 2012 announced proposed rule changes that would give issuers the following choice:

- either structuring their offerings under existing Rule 506 (b) (with prohibitions on general solicitation and advertising) or,
- proceeding under a new Rule 506(c) (with no provisions on general solicitation and advertising) if all purchasers are accredited and the issuer takes steps to verify that each investor meets the standards for an accredited investor. Proposed Rule 506 (c) is discussed more fully below in the section on Limitations on the Manner and Scope of an Offering.

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and for the protection of investors by reason of the small amount of involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds 5,000,000$."

[33] The SEC has defined reporting companies as those "that file periodic reports under the Securities Exchange Act of 1934 into different categories based on size, among other factors."

[34] According to Section 2(a)(15), *the term "accredited investor" shall mean (i) a bank as defined in section 3(a)(2), an insurance Company… (ii)any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.*

3.2 Accredited Investors

As mentioned beforehand, the status of purchasers as accredited investors is important for purposes of both Rule 505 and Rule 506. Each rule limits availability of the exemption to offerings in which there are no more than 35 purchasers; accredited investors, however, are not included when computing the number of purchasers. Accordingly, there may be an unlimited number of accredited investors in a Rule 505 or 506 offering without jeopardizing the exemptions offered by these rules.

Accredited investors are conclusively presumed to be sophisticated, and it is only when a purchaser does not satisfy the standards of accreditation that an issuer must undertake the difficult, and risky, task of evaluating the sophistication of the purchaser.

Rule 501(a) defines *accredited investor.* The following are the more important classes of accredited investors:

- Financial Institutions. Tis category includes banks, savings and loan associations, registered brokers or dealers, insurance companies, and investment companies.
- Pension Plans
- Venture Capital Firms. A venture capital firm provides capital and loans to business that have significant growth potential, but are not yet large enough to havea public offering of their securities.
- Corporations and Other Organizations Exceeding a Certain Size. Any corporation, partnership, or tax-exempt organization with assets exceeding 5$ million is an accredited investor.
- Insiders of the Issuer. Certain insiders of the issuer and its affiliates are accredited investors. These include a director executive officer[35], or general partner of either the issuer or a general partner of the issuer.
- Natural Person with Wealth or Income Exceeding Threshold Standards. A natural person whose net worth exceeds 1$ million (excluding the value of the investor’s primary residence[36]) qualifies as an accredited investor. Similarly, an individual whose annual income exceeds 200,000$ (or 300,000$ when combined with spousal income) for each of the last two years may be an accredited investor if the current year’s income is likely to be above this level.

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[35] *Executive officer* is defined to include the president, vice president in charge of a principal business unit, and any other person who performs a policymaking function for the issuer.

[36] Regarding the exclusion of personal residence from the net worth calculation, Section 413 of the Dodd-Frank Wall Street Reform and Consumer Protection Act directed the Commission to adjust the net worth standard for an accredited investor who is a natural person (1$ million) by excluding the value of the investor’s primary residence. This reverses past SEC practice of allowing an investor to include the value of a primary residence in the net worth calculation.

- Entity Owned by Accredited Investor. An entity in which all of the owners are accredited investors in deemed to have the same status.

In connection with the wealth or income of a natural person, how, then, should the liability of a home mortgage be handled in the calculation of net worth? The amended rule directs that indebtedness up to the value of the personal residence and secured by the residence (i.e., a standard home mortgage) is not treated as a liability unless the borrowing occurred within sixty days prior to the purchase of securities in the Regulation D offering and is not in connection with the acquisition of the residence (i.e., is a refinancing). The sixty day exception is designed to prevent a homeowner from manipulating net worth on the eye of purchasing securities by borrowing against home equity and inflating net worth with the proceeds of the borrowing.

At this point, the following two problems will clearly illustrate this matter:

1º) The financial statement of Mel, a prospective participant in a Regulation D offering, shows the following assets:

Checking and savings acounts	25,000$
Estimated value of art collection	250,000$
U.S. Savings Bonds	125,000$
Household furnishings/personal effects	50,000$
Estimated value of house	600,000$
Vested interest in retirement plan	350,000$
Total assets	1,400,000$
Liabilities (balance on home mortgage)	245,000$
Net worth	1,155,000

Will Mel qualify as an accredited investor? What I the week before the exempt offering Mel takes out 250,000$ second mortgage on his home and places the loan proceeds in his savings account (increasing the account balance to 275,000$). Will this help him qualify as an accredited investor? What if the borrowing occurred three months before the exempt offering?

A. Is Mel an accredited investor?

Under Rule 501 of section D provides for 8 situations in which a legal entity or a private person may be deemed as an accredited investor.

In the case of Mel, situation 5 will be the only applicable situation. Rule 501(a)(5) indeed provides that any natural person whose individual net worth or joint net worth with that person’s spouse, exceeds $1,000,000. However, it must be specified that rule 501 does not take into account the value of the person’s primary residence.

According to the financial statement of Mel attached to the problem, it may be concluded that his net worth is tantamount to $1,155,000. However, by deducting the value of Mel's house which amounts to $600,000, his net worth decreases to $555,000.

It shall therefore be concluded than Mel does not falls within the scope of the definition of an accredited investor.

B. What if the week before the exempt offering Mel takes out a $250,000 second mortgage on his home and places the loan proceeds in his savings account (increasing the account balance to $275,000)?

On the one hand, taking out a $250,000 mortgage would increase the net worth amount up to $805,000. In any case, it would not meet the $1,000,000 requirement of Rule 501.

On the other hand, Rule 501(a)(5)(i)(B) provides that any secured indebtedness taken out less than 60 days before the exempt offering shall not be taken into account. In the present case, the mortgage has been taken out a week before (i.e. seven days) the exempt offering.

For the foregoing reason, Mel cannot be deemed as an accredited investor.

C. What if the borrowing occurred three months before the exempt offering?

According to Rule 501(a)(5)(i)(B), any secured indebtedness taken out less than 60 days before the exempt offering shall not be taken into account.

In the event that the borrowing occurred three months before the exempt offering, it would be made more than 60 days before the exempt offering.

In this case, Mel would be considered as an accredited investor.

2º) Three purchasers participate in a Rule 506 offering. The issuer was without legal counsel and made no attempt to assess whether the purchasers qualified as accredited investors or complied with the provisions of Regulations D applicable when purchasers are nonaccredited. In fact, each of the purchasers satisfied the accreditation standards at the time of the offering. The investment has soured, and the purchasers would now like to rescind. What is the relevance of the issuer's lack of reasonable belief that the investors were accredited?

The lack of reasonable belief from the issuer is relevant since the rescindment of the investment will depend on this reasonable belief.

According to Rule 506(c)(2)(ii), the issuers shall take reasonable steps to verify that purchasers of securities sold in any offering are accredited investors.

In other words, if the issuer had a reasonable belief that the purchasers were accredited investors, the investment will never be able to be rescinded. Contrarily, if the issuer lacks

reasonable belief and it turns out that the purchasers were not accredited purchasers, the investment may be rescinded.

In the case at stake, it is stated in the facts that the issuer has made no attempt to assess whether the purchasers are qualified investors. In such circumstances, the purchasers will be entitled to rescind the investment.

3.3 The Sophistication Standard of Rule 506 (b)

Rule 506 is alone among the Regulation D exemptions in requiring that either (1) each purchaser who is not an accredited investor, alone with a representative, have such knowledge and experience in financial and business matters to be able to evaluate the merits and risks of the prospective investment; or (2) the issuer reasonably believes this is the case. As to the latter requirement, some courts find that a sufficient basis for the issuer's reasonable belief exists if the prospective investor simply represents in the subscription document that she is an accredited investor[37].

Conditioning the Rule 506 exemption on the sophistication of purchasers introduces elements of uncertainty that issuers will attempt to minimize or eliminate. The best tactic for an issuer seeking to eliminate any question about the exemption's availability is to limit an issuance to accredited investors, however, not all issuers are able to do that.

An issuer forced to include nonaccredited purchasers in an offering may, of course, negate the sophistication problem by structuring the offering to comply with Rule 505, rather tan Rule 506. But the aggregate offering price limitations of Rule 505 may prove problematic and justify the costs and risks that arise when the sought-after exemption is conditioned on the sophistication of each purchaser or purchaser representative.

3.4 Calculating the Number of Purchasers

Bothe Rules 505 and 506 are available only if the number of purchasers does not exceed 35 or, alternatively, the issuer reasonably believes the number of purchasers does not exceed 35. Rule 501 (e) however, provides that certain types of purchasers are excluded for purposes of this calculation. The excluded classes include accredited investors, trusts or estates in which purchasers have beneficial interests exceeding 50 percent, spouses and certain relatives of purchasers, and corporations or other organizations in purchasers are at least 50 percent beneficial owners. A corporation, partnership, or other entity that is not accredited is counted as a single purchaser unless it was formed for the purpose of purchasing securities in the offering.

[37] *See, e.g., Supernova Systems, Inc. v. Great Am. Broadband, Inc., 2012 U.S. Dist. LEXIS 16182 (N.D. Ind. Feb. 9, 2012)*

Below, there is a problem to illustrate this question:

A partnership not qualifying as an accredited investor has 10 partners. If the partnership purchases securities, will the transaction be regarded as one by a single purchaser, 10 purchasers, or 11 purchasers? Must the individual partners satisfy the accreditation standards? What if the partnership was form for the purspose of acquiring the securities being offered?

A. Whether the purchasing securities by the partnership regarded as a single purchaser, or 10 purchasers (number of the partners), or 11 purchasers (number of the purchasers and the partnership entity)?

In order to calculate the number pf purchasers, we need to look at rule 501 (e) (2) which indicates that:

> (e) *Calculation of number of purchasers.* For purposes of calculating the number of purchasers under §§230.505(b) and 230.506(b) only, the following shall apply:
>
> (2) A corporation, partnership or other entity shall be counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor under paragraph (a)(8) of this section, then each beneficial owner of equity securities or equity interests in the entity shall count as a separate purchaser for all provisions of Regulation D (§§230.501-230.508), except to the extent provided in paragraph (e)(1) of this section.

According to facts, the partnership is not an accredited investor and was not formed for the purpose of purchasing securities in the offering. As a result, the partnership transaction is counted as 1 purchaser.

B. Whether the accreditation standards must be satisfied by the individual partners?

Rule 506 requires that each purchaser who is not accredited investor must have such knowledge and experience in financial matters to be able to evaluate the merits and risks of the prospective investment, or the issuer reasonably believe this is the case after verifying the purchaser's subscription document. However, Purchasers can avoid the sophistication standards as long as the offering meets the requirements in Rule 504 or 505.

C. What if the partnership was formed to acquire the securities being offered?

From the facts, we know that the partnership is not an accredited investor, but we don't know about the partners if they are accredited investors or not. If they are not accredited investors under paragraph (a) (8) of rule 501 "Any entity in which all of the equity owners are accredited investors.", then each partner of the entity shall count as separate purchasers. As a result, the transaction shall be counted as 10 purchasers. With exclusion of each one of the following purchasers: Any relative, spouse or relative of the spouse of a purchasers, any trust or estate in which the purchaser or his relatives collectively have more than 50% of the beneficial interest, any corporation or other organization of which purchasers or his relatives

collectively are beneficial owners of more than 50% of the equity securities or the equity interest, and any accredited investor.

3.5 Limitations on the Manner and Scope of an Offering

A) IN GENERAL

The sophistication standard of Rule 506 and the limitations on the number of purchasers standards of Rules 505 and 506 refer to purchases rather than offerees. This must suggest that an issuer need not be concerned with the manner and scope of an offering so long as the limitations pertaining to purchasers are satisfied. Such a conclusion, however, is undermined by Rule 502 (c), which limits the process by which purchasers, are solicited by prohibiting an issuer, or any person acting on its behalf, from offering to sell securities by any form of general solicitation or general advertising.

Rule 502 (c)'s restrictions apply to all three of the Regulation D exemptions, with two exceptions. First, Rule 506 eliminates the solicitation and advertising restrictions, provided that the issuer takes reasonable steps to verify that all investors are accredited, and second, the restrictions do not apply to an offering under Rule 504 (b)(1) (in general, offerings limited to states that provide for registration and a disclosure document, or states that permit general solicitation and advertising but limits sales to accredited investors).

To the end of the first purpose above, there are three suggested factors that may be relevant in evaluating the reasonableness of steps taken:

1. *The nature of the purchaser and the type of accredited investor the purchaser claims to be.*

2. *The amount and type of information that the issuer has about the purchaser.* Examples of information an issuer may rely on include publicly available information (e.g., public filings revealing an individual is an executive officer) and third party information providing "reasonably reliable" evidence that an individual falls within one of the categories of accredited investors (e.g., an industry publication that discloses annual compensation of an individual at a level exceeding the income threshold for an accredited investor).

3*. The nature and terms of the offering*. An issuer that solicits investors through a website accessible to the general public of through a widely disseminated email or social media solicitation presumably must take greater measures to verify accredited investors than an issuer that solicits investors from a database of pre-screened accredited investors created and maintained by a reasonably reliable third party, such a registered broker-dealer[38]. As to the terms of the offering, imposition of a high minimum investment standard that could only

[38] According to Section 2 (a) (12) of the '33 Act, the term "broker dealer" means *"any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person."*

be met by an accredited investor could be a relevant factor in verification of accredited investor status.

The proposed approach to verification of accredited investor status is controversial. The flexible facts and circumstances approach preserves the SEC's enforcement options but leaves issuers wondering what, exactly, is expected of them in order to satisfy the new verification requirements. In particular, a large number of comments on the proposal have urged the Commission to establish concrete safe harbors that would allow issuers to proceed with some assurance that they have taken the reasonable steps that are required in order to verify the accredited status of an investor.

The following <u>three problems</u> tackle this issue:

1) J.R is a promoter of oil drilling ventures and a member of the Houston Petroleum Club. He has sent as offering circular to the Club's members (approximately 200 individuals) describing the "deal" he is now putting together and soliciting their interest in participation as investors. J.R. is confident that all of the Club's members are accredited investors for purposes of Regulation D, but to avoid any problems, he has stamped, in red, on the first page of the offering circular: "FOR ACCREDITED INVESTORS ONLY". If the offering is under 506(b) has J.R. engaged in a general solicitation? Does it make a difference if all of the offerees are in fact accredited investors? If the offering is under Rule 506 (c) as proposed what steps does J.R. need to take to verify the qualification od the purchasers?

1. If the offering is under 506(b), has J.R. engaged in a general solicitation?

No, J.R. has not engaged a general solicitation. Rule 506 (b) titled *"Conditions to be met in offerings subject to limitation on manner of offering"* establishes both general and specific conditions that must be complied for the issuer in order to benefit of this exemption.

The first one of these specific conditions is stated in Rule 506 (b)(i) *"Limitation on number of purchasers"*. The content of this Rule is the following: "*there are no more than or the issuer reasonably believes that there are no more 35 purchasers of securities from the issuer in any offering under this § 230.506".*

The number or purchasers must be calculated according to § 230.501 (e). This Rule (501 (e) (1) (iv)) establishes that accredited investors shall be excluded for purposes of calculating the number or purchasers under §§ 230.505 (b) and 230.506 (b).

Definition of *"accredited investor"* is set forth in Rule 501 (a). According to this Rule, "*accredited investor shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person: […]".*

In this case, J.R. was confident that all of the Club´s members who sent the offering were accredited investors for purposes of Regulation D. Moreover, according to the description of the case, J.R. had a reasonably reason to reach this conclusion, because all of them were members of the Houston Petroleum Club1. Assuming that Club´s purpose or entrance requirements are related with investment or finance.

Thus, if effectively J.R. reasonably believed that all the members of the Club were accredited investors, it can be considered that J.R. complied with the requirements stated in the previously quoted definition of *"accredited investor".*

Therefore, having in mind that accredited investors are excluded for purposes of calculating the number of purchasers under § 230.506 (b), all the conditions required for applying Rule 506 (b) are satisfied. In conclusion, J.R. has not engaged in a general solicitation.

2. Does it make any difference if all of the offerees are in fact accredited investors?

Regarding to the second question asked about if it makes a difference if all the offerees were in fact accredited investors, the answer is NO. It wouldn´t make a difference seeing that the exemption provided by the Rule 506 would still be applied equal as in the first question.

As it was exposed in the previous question, the qualification of the offerees as accredited investors is absolutely essential in order to apply Rule 506 (b) in this particular case.
If more than 35 purchasers were not accredited investors, the condition stated in Rule 506 (b)(2)(i) would not be complied and therefore the offering exemption could not be applied to this case.

On the other hand, as it is set forth in Rule 506 (b)(2)(ii), the purchasers who are not accredited must be sophisticated or have a sophisticated representative: "*Nature of purchasers: Each purchaser who is not an accredited investor either alone or with his purchaser representative 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".*

In conclusion, if the offerees are or are not in fact accredited investors it would make a difference in order to consider the compliance of the Specific Conditions in Rule 506 (b).

3. If the offering is under Rule 506 (c) as proposed, what steps does J.R. need to take to verify the qualifications of the purchasers?

Subsection (c) (ii) of Rule 506 set forth the accredited investor verification requirements and lists some non-exclusive and non-mandatory methods of verifying that a natural person

who purchases securities in such offering is an accredited investor. The content of this Rule is the following:

"(ii) Verification of accredited investor status. The issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under paragraph (c) this section are accredited investors. The issuer shall be deemed to take reasonable steps to verify if the issuer uses, at its option, one of the following non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor ; *provided, however, that the issuer does not have knowledge that such person is not an accredited investor (Rule continue listing the methods of verifying if the investor is accredited or not)."*

As it was said, the methods listed in Rule 506 (c)(ii)(A to D) are non-exclusive, therefore the issuer could follow other different processes in order to determinate if the purchasers of securities are really accredited investors.

Taking into account the flexible approach that the SEC allows, it often results difficult for an issuer to be sure if the requirement has been satisfied properly. To this end, there are three factors that may be relevant in evaluating the reasonableness of the steps taken:

- ✓ The nature of the purchaser and the type of accredited investor the purchaser claims to be.
- ✓ The amount and type of information that the issuer has about the purchaser.
- ✓ The nature and terms of the offering.

In conclusion, to verify the qualifications of the purchasers, J.R. has to take the steps set forth in Rule 506 (c)(ii).

2) Assume J.R. proceeds with an offering under Rule 506(c) as proposed but does nothing to verify that the purchasers are accredited. Assume further that all purchasers in fact are accredited. Is the exemption available?

Rule 506 (c) establishes the conditions to be met in offerings not subject to limitation on manner of offering.

This Rule requires that the offering has to comply with a series of conditions in order to be applied. Under Section (1), titled *"General Conditions",* the rule establishes that *sales must satisfy all the terms and conditions of §§ 230.501 and 230.502 (a) and (d).* There is nothing in the case that indicates the contrary.

On the other hand, Section (2), titled *"Specific Conditions"* are listed two more requirements[39]: *(i) Nature of purchasers: All purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors.* As the own case states, this requirement is satisfied, therefore, it does not pose a problem.

"*(ii) Verification of accredited investor status. The issuer shall take reasonable steps to verify that purchasers of securities sold in any offering under paragraph (c) of this section are accredited investors. The issuer shall be deemed to take reasonable steps to verify if the issuer uses, at its option, one of the following non-exclusive and non-mandatory methods of verifying that a natural person who purchases securities in such offering is an accredited investor; provided, however, that the issuer does not have knowledge that such person is not an accredited investor: (Rule continue listing the methods of verifying if the investor is accredited or not)".*

Therefore, as the previously quoted paragraph states, if J.R. proceeds with an offering under Rule 506 (c) with absolutely lack of knowledge about if the purchasers are or are not accredited; the exemption that this Rule provides is not available. There wouldn´t make a difference even though the purchasers were, at the end, accredited.

Notwithstanding, if the issuer is reasonably confident that all of the purchasers are accredited investors (according to Rule 501 (a)), the exemption provided by Rule 506 (c) would be available. This is because verification requirement is flexible and it is satisfied if the issuer reasonably has knowledge that they are qualified, for instance, because purchasers are Houston Petroleum Club´s members.

3) Assume as above that J.R. does nothing to verify that the purchasers are accredited other than establishing a minimum investment amount of 1$ million. His belief is that anyone with 1$ million to invest must satisfy the net worth standard for an accredited investor. He feels that by setting the 1$ million investment minimum he has taken sufficient steps to verify that purchasers are accredited. Do you agree?

Under Rule 506(c)(2)(ii), an issuer must take reasonable steps to verify that purchasers of securities sold in any offering under paragraph (c) are accredited investors. Under Sec. 2(15)(ii), an accredited investor who is a natural person is "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matter, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." Rule 506(c)(2)(ii)(A) through (D) is a non-exclusive and non-mandatory list of methods of verifying that a natural person who purchases securities in a paragraph (c) offering is an accredited investor. An issuer can verify whether a person is an accredited investor by (A) income, (B) net worth, (C) by obtaining a written confirmation from a particular person or entity or (D) by obtaining a

[39] Moreover, Section (d) of Rule 506 (d) Bad Actor Disqualification) has to be complied in order to apply the exemption provided by the Rule.

certification of the person at the time of the sale that he or she qualifies as an accredited investor. An issuer is not required to use any of these methods in verifying the accredited investor status of natural persons who are purchasers.

J.R. believes that anyone with $1 million to invest satisfies the net worth standard for accredited investor under Rule 506(c)(2)(ii)(B). However, in order to "take reasonable steps" under this section, J.R. would have to review one or more of the documents listed in subsection (B) (bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, etc.) *and* obtain a written representation from the purchaser that all liabilities necessary to make a determination of new worth have been disclosed. Since J.R. did not review *any* documents nor did he obtain a written representation, he did not take the steps listed under Rule 506(c)(2)(ii)(B). While he was not required to use this method to verify the accredited investor status, he did not take any steps whatsoever to determine whether the investors were accredited. Because the purpose of the verification mandate is to reduce the risk that the use of general solicitation under Rule 506 may result is sales to investors who are not, in fact, accredited investors, J.R. should have to do more. He is essentially assuming that all of the investors would be accredited because of the minimum investment amount and because of the club they belong to. Therefore I do not agree that he has taken sufficient steps to verify that the purchasers are accredited because his assumption does not help to serve the purpose of the verification mandate.

B) WHAT IS "GENERAL SOLICITATION"[40] OR "GENERAL ADVERTISING"?

Court interpretations have consistently emphasized the importance of a *existing relationship* between the issuer (or person acting on its behalf) and the offeree in establishing the limited nature of a communication. Requiring a pre-existing relationship is a way of ensuring that issuers will have the opportunity to evaluate the suitability of offerees as purchasers.

3.6 Determining the Aggregate Offering Price in Offerings Under Rules 504 and 505

Rules 504 and 505 limit the aggregate offering price on offerings within any 12-month period. In the case of Rule 504[41], the maximum aggregate offering price on securities that can be sold in reliance upon the Rule during any 12-month period is 1$ million. Rule 505 (b)

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[40] *See, e.g., Cobalt Multifamily Investors I, LLC v. Arden*, 2012 U.S. Dist. LEXIS 125278 (mass mailings and cold calls are the easy cases). Or, *In the Matter of Priority Access, Inc.,* Release No. 33-7904 (Oct. 3, 2001) (two million spam e-mails attempting to attract investors*). See also Black Diamond Fund* (general solicitation existed because invitations to free meal seminars were addressed anonymously to "Dear Valued Client").

[41] *Rule 504 (b)(2): "the aggregate offering price for an offering of securities under this rule 504 defined in rule 501 (c), shall not exceed 1,000,000$, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this 504, in reliance on any exemption under Section 3(b), or in violation of section 5(a) of the Securities Act."*

(2)[42] sets forth a parallel limitation (in this case, 5$ million) for Rule 505 offerings. The aggregate offering price limitations for offerings under either rule are reduced by the aggregate offering price of securities sold within the previous 12 months in reliance upon any of the Section 3(b) exemptions or in violation of the registration requirements of Section 5(a).

Aggregation is a principle often confused with integration, but the two are actually distinct. Integration means that two ostensibly distinct offerings will be treated as one for purposes of determining the availability of an exemption from registration requirements.

For example, assume an issuer completes two offerings over a relatively short period of time. The first issuance is in compliance with the Rule 147 safe harbor for the intrastate offering exemption; proceeds from the offering total 10$ million, and there are 50 purchasers. The second offering is under Rule 505.The aggregate offering price is 5$ million, and purchasers, which total 30 in number, include both residents and nonresidents. If the two offerings are integrated and treated as one, the availability of an exemption for either becomes problematic. The intrastate offering exemption will fail because of offers of nonresidents. Rule 505 will not be available for a number of reasons, including the presence of more than 35 purchasers, and an aggregate offering price exceeding 5$ million.

Thus, if the integration phenomenon occurs, the two offerings become a single non-exempted transaction.

A) CALCULATING THE AGGREGATE OFFERING PRICE

Rule 501(c) defines *aggregate offering price* as the sum of all cash, services, property, notes, cancellation of indebtedness, and other consideration the issuer receives for the securities. Determining the aggregate offering price if consideration paid for shares is limited to cash presents little difficulty. If securities are offered for both cash and non-cash consideration, Rule 501 (c) requires that the aggregate offering price be determined on the basis of the price at which securities are offered for cash.

B) RELEVANT AMOUNT AND TIME PERIOD

Recall that the maximum aggregate offering price is lowered by the amount of any other securities sold within specified time periods in reliance upon any of the Section 3(b) exemptions. Aggregation occurs with respect to offerings pursuant any of the Section 3(b) exemptions that take place within the 12-month period preceding the start of the offering under Rule 504 or 505.Two time periods are relevant in applying the aggregate offering limitations of either Rule 504 or Rule 505:

1. the 12-month period preceding the commencement of the offering under Rule 504 or 505, as the case may be, and,

[42] *Rule 505 (b)(2): "the aggregate offering price for an offering of securities under this rule 505 defined in rule 501 (c), shall not exceed 5,000,000$, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under this 505, in reliance on any exemption under Section 3(b), or in violation of section 5(a) of the Securities Act."*

2. the period of time during the offering of the securities under the applicable rule.

The second of the two relevant time-period limitations is needed to prevent an issuer with no offerings during a preceding 12-month period from commencing a Rule 504 or Rule 505 offering simultaneously with a second offering purportedly exempt under Section 3(b)[43].

For example, assume an issuer commences a Rule 504 offering on April 1. By June 1, 1$ million in securities has been sold, and the offering is terminated. To avoid aggregation, the issuer must have had no sales pursuant to a Section 3(b) exemption:

1. in the 12-month prior to April 1 and,
2. between April 1 and June 1, the period during which the Rule 504 offering took place.

After June 1, the issuer may proceed with a Rule 505 offering. For the second offering, however the maximum aggregate offering price will be 4$ million because of the Rule 504 sales occurring in the preceding 12-month period. Assuming the issuer is unaware of the aggregation rules and sells 5$ million in securities in the second offering, the Rule 504 offering will not be affected, but the second offering will not meet the conditions of Rule 505.

Calculations aside, what policy objectives are advanced by the aggregation rules? Consider the following comment: "assuming that there are no disclosure issues as to potential dilution, voting, control, or other concerns as a result of the multiple offerings, it is difficult to find a justification for the aggregation doctrine other than the doctrine itself."[44]

The following problem reflects how aggregation works in practice:

An issuer has not offered or sold securities in the preceding 12 months. On January 1, it begins a Rule 505 offering that remains open until June 1; it sells 4.5$ million in securities in the offering. On May 1 of the same year, the issuer begins a Rule 504 offering; in this second offering, which is open for two months, the issuer sells 750,000$ in securities. What is the effect of the aggregation rules on each of these offerings?

JANUARY 1 - JUNE 1	MAY 1 - JULY 1
Rule 505 4.5$ million	Rule 504 750,000$

[43] Recall that Section 3(b) authorizes the SEC to develope exemptions covering offerings up to 5$ million in amount when registration is not necessary to protect the public interest of investors.

[44] COHN & YADLEY, Capital Offense: The SEC's Continuing Failure to Addres Small Business Financing Concerns, 4 N.Y.U. J.L. & Bus. 10, 11-12 (2007) (also pointing out that the aggregation rules provide special hardships for smaller issuers because they are the most likely issuers to be raising capital under one of the monetarily restricted exemptions.)

Rule 504 (b) (2) states that *"The aggregate offering price (…) shall not exceed $1,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering (…)".* As we can see in the facts, the issuer has already sold $4.5 million in securities in the previous 4 months. Seeing that, the offering wouldn't meet the conditions in Rule 504 (b) (2) and this exemption cannot be applied for the second offering under Rule 504.

Regarding to the first offering, as it is stated in Rule 505 (b) (2) (i) and in concordance with Sec 3 (b) (1)- *"…but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $5,000,000".-* the offer of securities started in January 1 cannot beneficiate from the exemption provided in Rule 505, seeing that the final amount of securities issued in the same year exceeds the $5 million permitted under this Rule.

Nevertheless, when analyzing closer the schedules, it is remarkable that the end of the first offering occurs in June, just one month before the second offering ends. Thus, as we don´t know how many securities were sold during the period that the offer was open we cannot guarantee that the offer is valid under Rule 505.

Rule 505 stablishes that the prohibition applies to the securities *"(…) sold within the twelve months before the start of and during the offering of securities (…)".*

As we do not have enough information to know the exact amount of securities sold in the period mentioned we cannot know if the exemption under Rule 505 is valid for this particular case.

On the one hand, if the aggregation of both issues is less than 5,000,000$ the exemption will be valid, but, on the other hand, if it is over 5,000,000$ the exemption will not be applied.

The calculation of the aggregate offering price as it is explained in Rule 501 (c) is *"the sum of all cash, services, property, notes , cancellation of debt, or other consideration to be received by an issuer for issuance of its securities (…)"*, in order to calculate it, we need the accurate information of the amount of securities sold in that month.

In conclusion, the aggregation of both offers makes impossible the application of the exemption in Rule 504, nevertheless the exemption in Rule 505 could be applied if the final amount of securities sold does not exceed the quantity noted above.

IV. INTEGRATION OF OFFERINGS

Like Rule 147, the safe harbor for intrastate offerings under Section 3 (a) (11), Rule 502 (a) of Regulation D provides a six-month look-forward and look-backward guideline for defining when another offering by the issuer will not be regarded as part of the same issue in measuring compliance with the conditions of the safe harbor. Securities offered less than six months before the *start* or six months after the *completion* of a Regulation D offering may be integrated with the offering (with the likely result that the conditions of the Regulation will not be satisfied) if it is part of the same issue. A number of factors are relevant in determining , outside of a safe harbor, whether offerings are part of the same issue:

1. *whether the sales are part of a single plan of financing*: the fact that two offerings had the same timing, purpose, and consideration indicates they were part of "one integrated scheme of financing". In other cases, the inquiry has focused on the purposes of the offerings, and on this question, the intent of the issuer at the time of the issuer may prove dispositive[45]. Since the existence of a *plan* presupposes an intent, there is logical appeal to this approach. Focusing on the intent of the issuer, however, poses some problems, for in the absence of either an admission by the issuer or documentation establishing a plan, the evidentiary balance on the existence of a plan tilts sharply in favor of the issuer.

2. *whether the offerings involve the same class of securities*: generally, an offering of debt instruments will not be integrated with an offering of common stock, even if the purposes, timing, and consideration received are the same.

3. *whether the sales have been made at about the same time*: if offerings are separated by a substantial period of time, the spacing is sufficient to create a presumption against integration. A six-month lapse appears sufficient to create a rebuttable presumption. The presumption may become irrebuttable if offerings are separated buy at least a year. Conversely, the proximity in time of two offerings normally will not, of itself, create a conclusive presumption that the offerings should be integrated.

4. *whether the same type of consideration is received*: since the most common form of consideration is cash, the fact that two offerings involve cash is not a factor supporting integration. The use of non-cash consideration in one offering and cash consideration in the other also suggests the offering should not be integrated. Non-cash consideration of a similar type, on the other hand, increases the possibility that multiple offerings will be integrated.

5. *whether the sales are made for the same general purpose*: this factor might refer to the existence of a common enterprise, a single plan of financing, and a single issuer. Nevertheless, it is not entirely clear what function this factor is designed to perform and how it differs from the first factor (single plan of financing).

Note that actions taken after completion of a Regulation D offering may result in the denial of the exemption for the offering because of integration. A good example of how this may occur is provided by *Risdall v. Brown-Wilbert, Inc.*, 753 N.W.2d 723 (Minn. 2008), where funeral.com completed a private offering in apparent compliance with Rule 506. Two months later, the issuer attempted to raise additional funds through another private placement in which investors were sought through Internet postings and general e-mail solicitations. When informed that the solicitation tactics violated the ban on general solicitations, the issuer terminated the second offering. Although no sales had been made under the second offering, the court concluded the second offering could be integrated with the first, with the consequence that the solicitation activities subsequent to the completion of the first offering may result in the loss of the Regulation D exemption for that offering.

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[45] *See, e.g., Risdall v. Brown-Wilbert, Inc.*, 753 N.W.2d 723 (Minn. 2008)"the issuer can show that there was no single plan of financing by demonstrating that no subsequent offering was contemplated at the time of each offering".

Thus, integration of two offerings by an issuer may destroy the availability of an exemption for either or both of the offerings. Earlier, it has been discussed integration in the in the context of Rule 147 and Regulation offerings, both of which have six-month safe harbors for testing whether offerings will be integrated. Outside of these rules, the integration analysis typically begins, but rarely ends, with the application of the abovementioned factors.

5. Regulation A: Mini-Registration

Regulation A is an administrative exemption promulgated under Section 3(b) authorizing the SEC to exempt from registration a class of securities if the aggregate offering price of the issuance does not exceed 50$ million. This exemption is not available for offerings by reporting companies under the ’34 Act. As follows, Regulation A foresees two types of protection:

Tier 1 Offerings. Tier 1 is available for offerings up to 20$ million (including no more than 6$ million on behalf of sellers who are affiliates of the issuer) over a twelve month period. There are no qualification requirements for investors or limits on the amount a person may invest. Compliance with state blue sky laws[46] is required.

Tier 2 Offerings. Tier 2 is available for offerings up to 50$ million (including no more than 15$ million on behalf of sellers who are affiliates of the issuer) over a twelve month period. There are no investment limitations for accredited investors. For an investor who is not accredited, the purchase limit is no more than: (a) 10% of the greater of the investor’s annual income or net worth (for natural persons); or (b) 10% of the greater of the investor’s annual revenue or net assets at fiscal year-end (for non-natural persons). The purchase limits do not apply to purchases of securities that will be listed on a national securities exchange. Tier 2 offerings are exempt from blue sky laws.

Regulation A vs. Regulation D
• No prohibition against general solicitation (even 506 (c) is limited to accredited investor purchasers) • No resale restriction (like a registered public offering) • Partial availability to selling security holders (unlike Regulation D, which is only for issuer offerings) • More favorable (2-sided) integration protection
BUT
• Unavailable for reporting companies (like Rule 504) • Delay pending review by SEC staff • 20$/50$ million cap (none for 506)

[46] The Blue Sky Laws are state regulations designed to protect investors against securities fraud by requiring sellers of new issues to register their offerings and provide financial details. This allows investors to base their judgments on trustworthy data.

The problem below goes on to give further detail on the working of Regulation A:

Brocon is proceeding with a Tier 1 Regulation A offering of common stock that will include a large number of investors who are not accredited. One of the likely investors is Carl, whose annual income as a high school teacher is 60,000$. Carl is a friend of one of Brocon's officers. Carl has no investing experience but is interested in purchasing 20,000$ of common stock in the offering. Is there anything about Carl that should concern Brocon? What if it is a Tier 2 offering?

Tier 1

It is unlikely that Brocon should have anything to be concern about with its offer to Carl under a Tier 1 offering. Carl is an non-accredited investor and a teacher with an income of $60,000. He is a friend of one of the Brocon officers and desires to purchase $20,000 in Brocon stock. He has no investing experience.

Tier 1 offerings are available for offerings up to $20 million (including no more than $6 million on behalf of sellers who are affiliates of the issuer) over a twelve-month period. There are no qualification requirements for investors or limits on the amount a person may invest. Blue sky laws apply to these offerings. Rule 251(a)(1).

First, the facts do not state the duration of the offering or the amount. If the offering is over $20 million and not in compliance with the twelve-month period, then the offering would not fall into a Tier 1 offering. However, there are no facts that suggest this. Also, to have a Tier 1 offering, Brocon would be required to submit an offering statement (251(d)(1)) to make an offer, and that statement must be qualified (251(d)(2)) before the sale of the securities. The facts do not state whether or not these steps have been completed.

Second, there could be an issue if Carl is defined as an "affiliate," although this is unlikely. Under Regulation D, an affiliate is defined as: "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified." If this definition applies to an affiliate under Regulation A, and Carl is found to be an affiliate, then Brocon should be concern about whether his purchase would exceed Brocon's sale to affiliates to over $6 million. Although Carl is a friend of an officer, it is very unlikely that he would be found to be an affiliate of Brocon. Therefore, this should not be a concern of Brocon.

Lastly, Brocon should be aware of any Blue Sky laws that might affect the offering to Carl, since these compliance with these laws are required for Tier 1 offerings. With the facts presented, Brocon should have no trouble with its offer to Carl under a Tier 1 offering.

Tier 2

Brocon should be concerned about the amount of securities Carl wishes to purchase because it may not be in compliance with the Tier 2 offering.

The same possible concerns as above could apply here. The facts do not state whether or not an offering statement has been made or qualified. (251(d)(1-2)). Also, the facts do not state how much the offering is for and its time span. However, it is unlikely these would be issues in this fact problem.

However, there could be a concern with Carl's income and the amount he wishes to purchase. Tier 2 offerings are available for offerings up to $50 million (including no more than $15 million on behalf of seller who are affiliates of the issuer) over a twelve month period. There are no investment limitations for accredited investors. For non-accredited investors (natural persons), the purchase limit is no more than 10% of the greater of the investor's annual income or net worth. Blue sky laws do not apply to these offerings. Rule 251(a)(2).

Carl earns $60,000 in income and wishes to purchase $20,000 in securities from Brocon. The purchase amount is greater than 10% of his income, which would not be in compliance with Rule 251(a)(2) because he is a non-accredited investor.

If Brocon wishes to proceed with the sale with Carl, it should limit his purchase to at least $6,000, which would be 10% of his income.

CONCLUSION

1-. The availability and disclosure of information plays a key role in Securities Regulations Law. A public offering of securities made by an issuer requires the issuer to furnish potential purchasers of such securities with all the information that they may consider important in deciding whether to invest or not in those securities.

2-. All the securities laws are drafted in a way to protect investors. For that reason, the information requirement appears in every single provision. In this sense, Section 5 sets forth a group of prohibitions that every issuer has to respect with regard to the offering of securities to potential purchasers. As Section 5 provides, "*it shall be unlawful for any person, to offer to sell or offer to buy any security unless a registration statement* (information requirement) *has been filed as to such security."* Therefore, here, again, the principle behind these mandates is the adequate disclosure of information that every purchaser is entitled to before making an investment.

3-. Although these prohibitions may seem very strict and difficult to circumvent, the reality is that due to the ambiguity of the wording of securities law, there are a few exemptions (also called "safe harbors") from which some issuers can benefit.

4-. Under those exemptions the issuer does not have to comply with the requirements of Section 5 (mainly the need for filing a registration statement) as long as, the purchasers of that issuer possess the information that otherwise would be available and disclosed via registration statement.

5-. The intrastate offering exemption of Section 3(a)(11), more thoroughly developed by the safe harbor provided in Rule 147, exempt from registration "*any security which is part of an issue offered and sold only to persons resident within a single State of 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."*

6-. On the other hand, Section 4 (a) (2) of the '33 Act exempts from the provisions of section 5, *"transactions by an issuer not involving any public offering."*

7-. The vast majority of offerings exempt from registration are covered by the so-called "Regulation D" which provides three exemptions (Rules 504, 505, and 506). Rules 504 and 505 were promulgated on the basis of Section 3 (b) (1) of the '33 Act, which authorizes the SEC to develop exemptions covering offerings up to 5$ million in amount when registration is not necessary to protect the public interest of investors. Rule 506, on the other hand, represents a nonexclusive safe harbor for the private offering exemption of Section 4(a)(2).

8-. Another phenomenon that may occur is the "integration of offerings", which takes place when an issuer makes two offerings in a short period of time, complying just one of two with the exemptions. In that case, both offerings are merged into a one non-exempt offering.

9-. Regulation A is an administrative exemption promulgated under Section 3(b) authorizing the SEC to exempt from registration a class of securities if the aggregate offering price of the issuance does not exceed 50$ million.

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