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Frank A. Taylor

Jeffrey D. Pflaum

Kevin C. Flesch

THE ISSUANCE OF SECURITIES BY SMALL AND GROWING BUSINESSES: A PRIMER

Frank A. Taylor†
Jeffrey D. Pflaum††
Kevin C. Flesch†††

† Shareholder at Popham Haik Schnobrich & Kaufman, Ltd., Minneapolis, Minnesota; J.D. 1977, University of Iowa, College of Law; B.A. 1974, University of Iowa.

†† Group Counsel, ADC Telecommunications, Inc., Minnetonka, Minnesota; J.D. 1990, William Mitchell College of Law, St. Paul, Minnesota; M.B.A. 1985, University of Minnesota.

††† Practicing attorney in Denver, Colorado, emphasizing in securities and corporate law. J.D. 1996, William Mitchell College of Law, St. Paul, Minnesota.

I. INTRODUCTION

Capital is the lifeblood of all business enterprises. For new, growing or well-established businesses, capital may be raised from a variety of sources that change over time as the enterprise evolves.[1] The ability to raise capital and to navigate successfully through the labyrinth of securities laws, rules, regulations, and safe harbors is critical to the success (or even survival) of the enterprise.

Capital formation is heavily regulated at both the federal and state level.[2] All businesses, even small, closely-held businesses, and their legal counsel must be aware of applicable securities laws, rules and regulations when raising capital. Failure to comply with applicable legal requirements could subject the enterprise, its principals, and the professionals representing the enterprise[3] to substantial liabilities and even criminal penalties. Actions taken in connection with an early round of financing

1. There are numerous sources of capital for the small and growing enterprise. The founders of a new business often provide the first capital in exchange for the initial ownership interests (whether shares of stock, partnership interests, limited liability company membership interests or otherwise) in the enterprise. Private investors contribute large sums to start-up ventures with the expectation that substantial returns will be generated in exchange for the significant risks that may be inherent in their early-stage investment in a business enterprise. Capital may be raised from the public markets through various mechanisms such as stock offerings, the sale of limited partnership interests and the issuance of debt instruments. Funds are available from a variety of federal and state governmental sources such as the Small Business Administration and, by way of example, the Iron Range Resources and Rehabilitation Board in Minnesota. *See* MINN. STAT. § 298.22, subd. 2 (1994).

2. *See* Mark A. Sargent, *A Sense of Order: The Virtues and Limits of Doctrinal Analysis*, 104 HARV. L. REV. 634 (1990) (reviewing LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION (3d ed. 1989)); David J. Porter, *The Business Roundtable v. Securities Exchange Commission: The Interpretive Principle of Corporate Federalism and Federal Securities Law*, 13 GEO. MASON U. L. REV. 413 (1990).

3. Although the judiciary has relaxed the extent to which liability can be imposed upon the professionals who represent an enterprise in an offering of securities that violates federal law, *see, e.g.*, Pinto v. Maremont Corp., 326 F. Supp. 165 (S.D.N.Y. 1971), the Securities Exchange Commission may still bar the professional from practicing before it, *see* Exchange Act § 19, 15 U.S.C. § 78s (1994).

could bar the use of various financing alternatives that would otherwise be available to the enterprise in subsequent rounds of financing.[4] For these reasons, it is critical that all business enterprises and their legal counsel have a basic understanding of the laws and regulations that govern capital formation. This article is intended to provide that basic understanding.[5]

Many law review articles identify a narrow issue for consideration and then analyze the issue in great detail. That is not the intent of this paper. As part of the Closely-Held Business Symposium sponsored by the *William Mitchell Law Review*, the authors of this article intend that it will be used by practitioners who ordinarily do not practice securities law, but who are called upon to advise and help a growing business client that needs to raise capital and is contemplating various financing alternatives. This paper should provide a useful outline of certain federal and state securities laws, rules and regulations governing capital formation.[6]

In Part II, we begin by providing an overview of the federal and state legal regulatory framework governing capital formation. In Part III, we suggest some practical considerations for the practitioner advising the newly-formed or growing small business. After these practical considerations have been reviewed, in Part IV we discuss the general registration requirements of the securities laws and identify various exemptions from such registration that may be available to small and growing businesses under the current securities laws. Within the text, we have summarized some of the potential liabilities under the securities laws. We conclude by offering some observations that may be of further aid to the practitioner.

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4. *See* 17 C.F.R. § 230.152 (1995); *infra* part IV.C.

5. This paper will focus primarily upon the two primary federal securities laws—the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994) (referred to as the Securities Act) and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1994) (referred to as the Exchange Act)—as well as the Minnesota securities laws, MINN. STAT. §§ 80A.01-.31 (1994 & Supp. 1995).

Other significant federal securities acts (not discussed herein) include the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1994), the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1994), the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (1994), and the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to -21 (1994).

6. This article cannot replace the necessary analysis of the specific facts and circumstances of a particular situation under governing law. It should be regarded only as a general primer or tool and does not constitute legal advice.

II. OVERVIEW OF THE REGULATORY FRAMEWORK

Companies generally issue financial instruments of some nature to raise capital for their everyday operations and to take advantage of business opportunities. A variety of financial instruments evidence this capital formation and may constitute a "security."[7] If a financial instrument is a security, both the instrument and the transaction through which the instrument was issued are subject to state and federal securities regulation, unless exempted from registration.[8]

Because securities and transactions involving the offer and sale of securities are regulated extensively under federal and state law, business enterprises and their counsel have, over the years, endeavored to create financial instruments that are not "securities" to avoid the proscriptions of federal and state securities laws. As a result, a large body of state and federal law has been developed that supplements and helps define the term "security."[9]

When it enacted the Securities Act and the Exchange Act, Congress recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of

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7. Both the Securities Act and Exchange Act define the term "security." *See* 15 U.S.C. § 77b(1) (1994); 15 U.S.C. § 78c(10)-(12) (1994). The Securities Act defines the term "security" as

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities . . . or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, 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.

15 U.S.C. § 77b(1) (1994). In addition, most states also have a statutory definition for the term "security." *See, e.g.*, MINN. STAT. § 80A.14, subd. 18 (1994).

8. *See, e.g.*, Securities Act § 5, 15 U.S.C. § 77e (1994).

9. *See, e.g.*, Reves v. Ernst & Young, 494 U.S. 56 (1990) (employing "family resemblance" test to determine if investment is a security); Marine Bank v. Weaver, 455 U.S. 551 (1982) (discussing which types of financial instruments are deemed to be securities); SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (recognizing investment contracts as securities and developing a four-part test).

others on the promise of profits."[10] To protect investors, Congress defined the term "security" in sufficiently general terms so as to encompass virtually any instrument that might be sold as an investment.[11]

Consistent with the Securities Act and the Exchange Act, most federal courts have expansively construed the term "security"[12] and view a financial instrument as a "security" if the financial instrument represents (i) an investment of money; (ii) in an enterprise; (iii) with an expectation of profit; (iv) created through the efforts of others.[13] Because the term "security" is so broadly defined, the applicability of federal and state securities laws[14] must be considered each time an enterprise raises capital.

A. *Federal Regulatory Scheme*

The Securities Act and the Exchange Act were enacted in the early years of the Great Depression and arose out of the economic woes then being faced by the nation.[15] Believing that the financial marketplace had been ruined by individuals who traded either on rank speculation and rumors or information

10. *W.J. Howey*, 328 U.S. at 299.
11. *Reves*, 494 U.S. at 61.
12. *See supra* note 7 and accompanying text.
13. *W.J. Howey*, 328 U.S. at 301.
14. Federal securities laws are based on Congress' power to regulate interstate commerce: "It cannot be doubted that Congress may close the channels of interstate commerce . . . to such transactions in corporate securities as it has reasonably found and declared to be directly detrimental to the financial health of the public generally." SEC v. Torr, 15 F. Supp. 315, 319 (S.D.N.Y. 1936), *rev'd on other grounds*, 87 F.2d 446 (2d Cir. 1937).

Federal securities laws specifically preserve the jurisdiction of states to regulate securities transactions, as long as their regulation does not conflict with federal law. *See* Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917) (upholding the constitutionality of state regulation under the Fourteenth Amendment and finding no burden upon interstate commerce). Because state regulation supplements—and in some instances duplicates—federal requirements, a company issuing securities must comply with federal regulations as well as the regulations in the states in which it offers and sells securities.

15. The House committee report on the bill that became the Securities Act of 1933 complained of "the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment." Selling literature "was too often deliberately misleading and illusive." The committee concluded, "[W]hatever may be the full catalogue of the forces that brought to pass the present depression, not least has been this wanton misdirection of the capital resources of the [n]ation." H.R. REP. NO. 85, 73d Cong., 1st Sess. 2-3 (1933).

not generally available to the public,[16] the architects of the Securities Act and the Exchange Act had two basic objectives: (i) require companies to provide investors with the necessary material financial and factual information to permit the investors to make informed investment decisions; and (ii) prohibit the fraudulent sale of securities.[17] Although the Securities Act and the Exchange Act have been amended from time to time, the fundamental principles of complete disclosure and prohibition of fraud remain in place.

1. *The Securities Act of 1933*

The Securities Act was Congress' first attempt to regulate the offering and sale of securities. The Securities Act was created at the request of President Roosevelt in reaction to the stock market losses associated with the Great Depression. The losses were so staggering that in the two and one-half years following September 1, 1929, the value of the stocks listed on the New York Stock Exchange alone were reported to have fallen by $74 billion, with additional losses in the bond markets appraised at approximately $19 billion.[18] The Act's drafters reasoned that securities could not have fallen so far and so fast unless the instruments had been grossly overvalued by an investing public completely uninformed about the companies that had issued securities to the marketplace.[19]

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16. For a further discussion of the abuses at which the basic federal laws were aimed, see the testimony of Ganson Purcell (then SEC member and subsequent chairman) in 1 *Proposed Amendments to the Securities Act of 1933 and to the Securities Act of 1934: Hearings Before House Comm. on Interstate & Foreign Commerce*, 77th Cong., 1st Sess. 8-30 (1941).

17. These fundamental principles of the statutory scheme echo Justice Brandeis' eloquent view of the necessity of full and complete disclosure: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (Augustus M. Kelley Publishers 1971) (1914). Justice Brandeis' reasoned view still has merit when considering the disclosure to be made to the potential investor; when considering whether to disclose a fact, it is usually best to err on the side of disclosure and disclose the fact. *See* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

18. Gary L. Wood, *The Investment-Intent Dilemma in Secondary Transactions*, 39 N.Y.U. L. REV. 1043 (1964).

19. The Securities Act of 1933 has been sometimes called the "rotten egg" statute because its theory is that it is perfectly acceptable to sell rotten eggs to the public as long as you say clearly they are rotten. *New Approaches to Disclosure in Registered Security Offerings*, 28 BUS. LAW. 505 (1973) (citing A.A. Sommer, Jr.).

The Securities Act applies generally to transactions involving the "use of any means or instruments of transportation or communication in interstate commerce or of the mails."[20] Use of the mails to accomplish any part of the transaction, including payment or confirmation after a sale, is sufficient to confer federal jurisdiction and to subject the offer and sale of the financial instrument to federal regulation.[21] Even intrastate telephone calls have been held to involve the use of interstate facilities.[22] For this reason, federal regulation has to be considered whenever capital is raised and a financial instrument issued to the public.

The Securities Act and most other federal securities statutory schemes are influenced by the regulatory philosophy championed by Justice Brandeis.[23] The Securities Act seeks to accomplish the goals of full disclosure[24] and avoidance of manipulative schemes in essentially two ways: by requiring that companies issuing securities to the public provide full and complete disclosure to the marketplace through a registration process; and by creating an oversight body called the Securities and Exchange Commission (Commission), which has broad oversight, rulemaking, and enforcement authority.

Section 5 of the Securities Act[25] is intended to accomplish the goal of full and complete disclosure and is perhaps the most important provision of the Securities Act. Section 5 requires that (i) new issues of securities offered to the public through the instrumentalities of interstate commerce be registered with the Commission through a registration statement[26] (unless there is a specific exemption from registration); and (ii) a prospectus[27] be furnished to the purchaser prior to the sale of the security or, in some instances, at the time of delivery of the security after the

20. Securities Act § 5(a)(1), 15 U.S.C. § 77e(a)(1) (1994).

21. Franklin Sav. Bank v. Levy, 551 F.2d 521, 524 (2d Cir. 1977) (holding that although notes were primarily delivered by hand, confirmation of delivery by mail was sufficient to confer jurisdiction).

22. Dupuy v. Dupuy, 511 F.2d 641, 643 (5th Cir. 1975) (holding that intrastate telephone use may confer federal jurisdiction over a private action brought under § 10 and Rule 10b-5 of the Exchange Act).

23. *See supra* note 17.

24. *In re* Control Data Corp. Sec. Litig., 933 F.2d 616 (8th Cir.), *cert. denied*, 502 U.S. 967 (1991); Finne v. Dain Bosworth, Inc., 648 F. Supp. 337, 344 (D. Minn. 1986).

25. 15 U.S.C. § 77e (1994).

26. *See* 15 U.S.C. § 77b(8) (1994) (defining the term "registration statement").

27. *See* 15 U.S.C. § 77b(10) (1994) (defining "prospectus").

sale.[28]

There are, however, certain statutory and regulatory provisions that exempt either the security issued in the financing transaction or the transaction itself to be exempt from registration.[29] For example, Section 3 exempts from registration certain types of *securities*.[30] Section 4 specifically provides that the registration requirements of Section 5 shall not apply to certain *transactions*.[31] Although Sections 3 and 4 provide exemptions from registration, they do *not*, in most instances, eliminate the applicability of the antifraud provisions of the Securities Act to the exempt transactions and securities.[32]

Full and complete disclosure is also facilitated through the broad rule-making power of the Commission. Through this rule-making authority, the Commission prescribes certain rules and regulations and provides various forms that facilitate full and complete disclosure.[33]

Not only does the Commission provide the rules, regulations and forms that aid in making disclosure, it also has the authority under the Securities Act to compel disclosure. Sections 19(b) and 20(a) give the Commission the power to investigate situations that may result in "administrative proceedings looking

28. 15 U.S.C. § 77e (1994). To fully understand Section 5, the practitioner should refer to Section 2 of the Securities Act, which contains many of the technical definitions used in Section 5. *See* 15 U.S.C. § 77b (1994).

29. These provisions are often used by the emerging company in its initial attempts to first raise capital and are more fully discussed *infra* in Parts IV.B.-F.

30. 15 U.S.C. § 77c (1994).

31. 15 U.S.C. § 77d (1994). Sections 4(1) and 4(2) are the most important provisions. *See* 15 U.S.C. § 77d(1)-(2) (1994). There is also a hybrid exemption called, in the literature, the Section 4(1½) exemption. The United States Court of Appeals for the Eighth Circuit analyzed this hybrid exemption in Ackerberg v. Johnson, 892 F.2d 1328 (8th Cir. 1989). A useful discussion of the Section 4(1½) exemption also appears in Candela Laser Corp., SEC No-Action Letter, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,530 (Sept. 28, 1987). *See also* Securities Act Release No. 6188, 1 Fed. Sec. L. Rep. (CCH) ¶ 1051 (Feb. 1, 1980); Carl L. Schneider, *4(1½)—Private Resales of Restricted or Control Securities*, 49 OHIO ST. L.J. 501 (1988).

32. Thus, Sections 17 and 12(2) still apply to these transactions. *See* 15 U.S.C. § 77k (1994) (imposing civil liability upon persons preparing and signing materially misleading registration statements); 15 U.S.C. § 77*l*(1) (1994) (establishing civil liability for failure to comply with § 5 of the Securities Act). The procedures that confer concurrent state and federal jurisdiction are set forth in Sections 9 and 22. *See* 15 U.S.C. §§ 77i, 77v (1994).

33. For a discussion of the Commission's intent relating to disclosure, see American Sav. & Loan Ass'n, Exch. Act Release No. 25,788, [1987-1991 Acct'g & Auditing Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,663 (June 8, 1988) (admin. proceeding).

to the imposition of remedial sanctions, initiation of injunctive proceedings in the courts, and, in the case of a willful violation, reference of the matter to the Department of Justice for criminal prosecution."[34] The Securities Enforcement Remedies Act of 1990 also authorizes federal courts to issue cease and desist orders for violations of the securities laws, order payment of penalties, and prohibit persons from serving as officers and directors of public companies.[35]

In sum, the Securities Act requires that full and complete disclosure be made to the investing public. To do this, Section 5 requires that all securities be registered, unless exempt, through the instrument of registration, called a "registration statement." The rules promulgated under the Act and the forms written and published by the Commission help the practitioner determine the information that must be disclosed in the registration statement and the offering documents used if the transaction or the securities are exempt from registration.

2. *The Securities Exchange Act of 1934*

The Exchange Act[36] extends the regulation of securities from the initial offering of securities by a business enterprise to the regulation of trading of securities in the secondary markets. While the Securities Act is relatively coherent and straightforward, the Exchange Act is a "hodge-podge of different provisions, some of which are largely unrelated to others."[37]

The Exchange Act contains a number of distinct groups of provisions governing the different participants in the securities trading process. Other provisions of the Exchange Act impose disclosure and other requirements on publicly-held corporations;[38] prohibit various fraudulent activities in connection with

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34. 17 C.F.R. § 202.5(b) (1995).

35. *See* 15 U.S.C. §§ 77h-1, 78q-2, 78u-2, 78u-3 (1994).

36. 15 U.S.C. §§ 78a-78kk (1994).

37. RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 531 (7th ed. 1992).

38. *E.g.*, 15 U.S.C. §§ 78*l*(g)(1), 78n, 78o(d) (1994); *see also* Basic, Inc. v. Levinson, 485 U.S. 224 (1988); Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Kohn v. American Metal Climax, Inc., 322 F. Supp. 1331 (E.D. Pa. 1970), *modified*, 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

the purchase or sales of securities;[39] restrict the amount of credit that may be extended for the purchase of securities;[40] and regulate broker/dealers of securities.[41] The Exchange Act also transferred the administration of the filing requirements of the Securities Act from the Federal Trade Commission to the Commission.[42]

The Exchange Act also provides potent governmental agency and private enforcement schemes through Section 10b and Rule 10b-5[43] even though many commentators believe that the newly-enacted Private Securities Litigation Reform Act severely has limited these provisions.[44] Section 18 provides a

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39. 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1995); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

40. 17 C.F.R. § 240.15c3-1(a) (1995).

41. 15 U.S.C. §§ 78f(c)-(d), 78q, 78s(d)-(g) (1994); *see also* Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980); Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228 (D.C. Cir. 1949); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944).

42. As noted, the Commission is the regulatory agency that has the responsibility of administering and enforcing the federal securities laws and, through its rule-making function, promulgating the rules under both the Securities Act and the Exchange Act that give substance to the statutory scheme.

The Commission is an independent regulatory agency consisting of five members appointed for staggered five-year terms by the President with the concurrence of the Senate. Securities Exchange Act § 4, 15 U.S.C. § 78d (1994). The Commission's staff processes filings pursuant to the federal securities laws, including registration or exemption of securities under the Act, proxy soliciting material, and periodic reports filed pursuant to the Exchange Act. *See, e.g.*, 15 U.S.C. §§ 77h, 78o(b), 78o-4(a)(2), 78o-5(a)(2) (1994); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); Cady, Roberts & Co., Exchange Act Release No. 6668, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,803 (Nov. 8, 1961) (admin. proceeding); Jonathan Eisenberg, *Enforcement Issues and Litigation: Litigating with the SEC — A Reasonable Alternative to Settlement*, 21 SEC. REG. L.J. 421 (1994); Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149 (1990); Walter Werner, *The SEC as a Market Regulator*, 70 VA. L. REV. 755 (1984).

43. Interestingly, Rule 10b-5 was somewhat hastily drafted and adopted by the Commission. One authority relates an interesting historical note with respect to the promulgation of Rule 10b-5. After hearing of a company president who knew his company would quadruple its earnings and was buying up stock while telling shareholders that the earnings forecast was gloomy, the commissioners met that day, and after passing around the draft of the rule they all looked at each other and one of them said, "Well . . . we are against fraud, aren't we?" THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 13.2, at 670 n.22 (2d ed. 1990).

44. Among other things, the Private Securities Litigation Reform Act of 1995 creates a statutory safe harbor for forward-looking statements, requires appointment of

limited remedy for buyers and sellers of securities, which makes the section unattractive to private plaintiffs and has resulted in little case law under that section.[45]

B. State Regulatory Scheme

States began regulating the offer and sale of securities even before the U.S. Congress. In 1911, Kansas enacted the first state legislation regulating the distribution and sale of securities to prevent Easterners from selling to unsuspecting Kansans "speculative schemes which have no more basis than so many feet of blue sky."[46] Today, the states continue to regulate the purchase and sale of securities, because Section 18 of the Securities Act specifically preserves these state laws and provides that the Securities Act does not preempt state regulation.[47]

Over the years, each of the states has enacted securities laws[48] commonly referred to as "blue sky laws."[49] Blue sky laws

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"the most adequate plaintiff" to represent a class, and virtually eliminates securities fraud as a predicate offense for private suits under RICO. *See generally* Private Securities Litigation Reform Act, Pub. L. No. 104-67, 109 Stat. 737. Hence, the Act is certain to have a strong impact on securities fraud litigation. *See* Martha Cochran, *Sweeping Reform: Litigating and Bespeaking Caution Under the New Securities Law, in* OVERVIEW AND SUMMARY OF THE PRIVATE SECURITIES LITIGATION REFORM ACT, at 9 (PLI Corp. Course Handbook Series, No. 923, 1996); Nicholas Chimicles, *The Future of Securities Litigation Under the Private Securities Litigation Reform Act of 1995, in* OVERVIEW AND SUMMARY, *supra*, at 591.

45. The Exchange Act also provides for violations of the so-called proxy rules under Sections 13(d), 14(d), and 14(e), which were added to the Exchange Act through the Williams Act. 15 U.S.C. §§ 78m(d), 78n(d)-(e) (1994).

46. KAN. STAT. ANN. § 17-252 (1994). Similar legislation, passed in Ohio, was subsequently challenged and upheld. *See* Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917) (finding statute to be valid exercise of state's police power to protect its residents against "speculative schemes").

47. Securities Act § 18, 15 U.S.C. § 77r (1994).

48. For example, Minnesota Statutes chapter 80A, a modified version of the Uniform State Securities Act, regulates the state's securities industry in three primary areas. The regulation of securities agents, brokers/dealers, and investment advisors is done by licensure of the individuals and by registration of investment advisors. MINN. STAT. §§ 80A.04-.05 (1994 & Supp. 1995). In addition, all securities must be registered or exempt from registration if they are offered or sold in the state. MINN. STAT. § 80A.08 (1994).

49. "Blue sky" refers to what many early securities dealers attempted to sell to less sophisticated investors before protective legislation was enacted. Most statutes are based somewhat upon the American Law Institute's Uniform Securities Act. *See generally* UNIF. SECURITIES ACT, 7B U.L.A. 509-687 (1985 & Supp. 1996); HUGH L. SOWARDS & NEIL H. HIRSCH, BLUE SKY REGULATION (1977); LOUIS LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT (1976); Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471 (1993).

vary widely from state to state in their terms and scope. This disparity in blue sky laws creates a significant source of frustration for securities practitioners. Although the American Law Institute has endeavored to promote uniformity through the Uniform Security Act and its revisions, there is still significant variation among state securities laws.[50] As a result, a security that may have satisfied the registration requirements (or qualified for an exemption from registration) of one state may not satisfy the requirements of another state. Needless to say, the blue sky laws pose traps for the unwary practitioner who assumes that the laws are uniform.[51]

While the primary emphasis of the federal securities laws is complete and accurate disclosure, many states also permit a "merit" analysis of the investment[52] (in addition to disclosure requirements) before certain securities can be registered for sale within the particular state.[53] This substantive review goes further than the full disclosure requirements of the federal laws.[54] Through this "merit" review, a state may determine that a particular security offering does not satisfy the state's merit requirements and may prevent the sale of the particular security in that state.

Usually, there is a designated state official or administrator who performs securities registration and enforcement functions

50. Notable variations abound between states with significant numbers of transactions, *e.g.*, California and New York. *Compare* CAL. CORP. CODE §§ 25,000-25,705 (West 1977 & Supp. 1996) *with* N.Y. GEN. BUS. LAW §§ 352 to 359-h (McKinney 1988 & Supp. 1996).

51. Generally, a particular state's blue sky laws relate to the offering or sale of securities within that state's border. It is well-settled that if an offer or sale takes place within a state's border, the security has sufficient contact to trigger a state's jurisdiction. *See, e.g.*, Travelers Health Ass'n v. Virginia, 339 U.S. 643 (1950); Ansboro v. Southeast Energy Group, Ltd., 658 F. Supp. 566 (N.D. Ill. 1987); In re Activision Sec. Litig., 621 F. Supp. 415 (N.D. Cal. 1985); Lintz v. Carey Manor Ltd., 613 F. Supp. 543 (W.D. Va. 1985); Black & Co. v. Nova-Tech, Inc., 333 F. Supp. 468 (D. Or. 1971).

52. The Minnesota Commissioner of Commerce is given the power to deny, suspend, or revoke effectiveness of any registration statement under specified circumstances. MINN. STAT. § 80A.13, subd. 1 (1994); *see also* MINN. R. 2875.3010, 2875.3530 (1995) (relating to regulation of debt securities and cheap stock).

53. *See, e.g.*, North Star Int'l v. Arizona Corp. Comm'n, 720 F.2d 578 (9th Cir. 1983) (holding that Arizona's merit review of securities sold within or from the state does not conflict with federal securities laws).

54. The merit review approach has been criticized. *See, e.g.*, Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395 (1993); Note, *At What Cost Paternalism? A Call to State Legislatures to Reconsider the Propriety of Merit Review of Securities Offerings*, 22 ARIZ. ST. L.J. 963 (1990).

similar to those performed by the Commission at the federal level. These individuals usually are called state securities commissioners. These state administrators are also vested with rule-making authority, similar to that given the Commission.[55]

C. Self-Regulatory Authorities

An issuer of securities must also consider the applicability of rules and regulations of self-regulatory organizations such as securities exchanges and the National Association of Securities Dealers (NASD). These rules may impose requirements on the issuer or on underwriters and broker/dealers who may assist the issuer in raising capital or effect trades in the issuer's securities. For example, each of the registered national securities exchanges[56] and the NASD must adopt rules "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest."[57]

Each exchange has the right to establish certain requirements to be met by a company that wishes to have its securities listed on the particular exchange. These rules may require that a company disclose more information than the Commission would otherwise require. For example, the NASD requires timely disclosure of material information relating to corporate developments.[58] Additionally, the stock exchanges and the NASD have rules that affect such substantive corporate matters as preemptive rights, voting rights, audit committees, and shareholder approval of the issuance of additional shares.[59]

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55. *See generally* UNIF. SECURITIES ACT (1985) § 705, 7B U.L.A. 151 (Supp. 1996).

56. The eight registered national exchanges are the New York Stock Exchange, the Boston Stock Exchange, the Chicago Board of Options Exchange, the Midwest Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, the Cincinnati Stock Exchange, and the Inter-Mountain Exchange.

57. Exchange Act §§ 6(b)(5), § 15A(b)(6), 15 U.S.C. §§ 78f(b)(5), 78o-3(b)(6) (1994).

58. NASD Conduct Rules 2120, 2210(d)(1) *in* NASD Manual (CCH), at 4141, 4173 (1996). For the New York Stock Exchange requirements relating to timely disclosure, see NYSE Rule 472.30, *in* New York Stock Exchange, Inc.: Constitution and Rules (CCH) (1995).

59. For an example of how these rules affect an issuer, see Chris-Craft Indus. Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

III. BUSINESS PLANNING

From its inception, a company should be structured in a manner consistent with its anticipated needs for future capitalization, business direction, and growth, and to provide for emergency situations that require additional capital. By planning ahead, problems can be avoided and the company can be better poised to take advantage of financing opportunities as they arise and to avoid the pitfalls created by regulation.

A. *Need to Anticipate and Plan for Future Financing Needs*

To be successful, any business must develop, at an early stage, a long-term business plan and strategy. While such a plan is certain to change as the company evolves, a carefully considered business plan is a critical tool in planning for the future, as it reflects management's expectations and objectives.

Initially, the practitioner representing the small business should ask to review management's business plan. If such a plan does not exist or is incomplete, the practitioner should ask detailed questions about management's expectations and objectives for the future of the business. After the questions have been fully explored and detailed answers given, management and the practitioner should endeavor to formalize, in writing, the business plan. The information derived from such an exercise will give both the practitioner and management insight into the company's anticipated needs for financing. This will allow the practitioner and management to spot issues at an early stage, which will help the company plan for its future capital needs and help avoid regulatory pitfalls.

Most business enterprises progress through various rounds of financing. In each round of financing, the type of security sold, the amount of money raised, and the nature and number of investors may vary significantly. By building flexibility into the company's capital and organizational structure and anticipating the needs of investors in various rounds of financing, company management and the practitioner can improve the ability of a company to raise capital.

B. *Common Planning Considerations*

There are numerous general business and business planning factors that may affect or be affected by the capital formation process. The following is a summary of some of the most common factors that should be considered by the practitioner who is organizing a new venture or assisting the venture in capital formation.

Management or advisors of a corporation should anticipate future needs for capital by giving the corporation the authority to raise additional and sufficient capital in the initial articles of incorporation or other governing instrument.[60] In this way, a corporation can avoid soliciting shareholder approval to increase authorized capital prior to subsequent rounds of financing.[61] The articles of incorporation or bylaws may also give the corporation's board of directors the authority to issue series of preferred stock with various rights and preferences.[62]

The practitioner should also consider whether protective rights such as preemptive and cumulative voting should be included in the articles.[63] Although such rights may be desired

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60. Today, businesses can function through a variety of organizational structures such as limited partnerships, general partnerships, limited liability partnerships, limited liability companies, sole proprietorships, and corporations. The characteristics of each type of organization and its structure is beyond the scope of this article.

Although issues regarding the choice of entity for a new business venture are beyond the scope of this article, it should be noted that the legal characteristics inherent in each type of legal entity may have an impact upon the amount of capital that a venture can raise and the nature and number of investors that the venture can attract. For example, characteristics of a corporation under general corporate law—such as the continuity of life of the organization and the relative ease of transferring ownership interests (shares of capital stock)—are often attractive to passive investors, especially investors who place a high value on the liquidity of their investment. On the other hand, the tax characteristics of a partnership or a limited liability company may be of significant importance to certain types of investors and business enterprises. Practitioners are cautioned to evaluate carefully these considerations, as well as other factors that influence the initial choice of entity for a new venture.

For purposes of this article, the authors will focus upon the corporate structure, since it remains the most common business structure.

61. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(a)(3) (1991); MINN. STAT. § 302A.501, subd. 1 (1994). Similarly, the founding partners or advisors of a partnership or limited liability company should anticipate the enterprise's need for additional capital and provide an acceptable mechanism for authorizing additional capital within the partnership agreement or the organizational documents of the limited liability company.

62. *See, e.g.*, MINN. R. 2875.3510, .3520 (1995) (addressing voting rights of preferred stock and protective provisions for preferred shares).

63. *See, e.g.*, MINN. STAT. § 302A.413 (1994) (providing preemptive rights to shareholders unless articles of incorporation state otherwise); MINN. STAT. § 302A.445 (1994) (establishing shareholder voting rights where articles of incorporation are silent).

in some circumstances, the existence of such rights may hinder financing plans. For example, if shareholders in early rounds of financing have preemptive rights and the corporation later determines to make a wider offering of its shares, the existence of those preemptive rights could hinder or delay the subsequent financing.[64] In some states, the articles of incorporation must be amended with shareholder approval prior to abolishing such rights as preemptive rights and cumulative voting.[65]

Debt instruments often contain covenants requiring the prior consent of lenders for a public offering or modification of capital structure. For this reason, counsel should review covenants in loan agreements, bank lines of credit, debentures, notes, mortgages, capital leases, and any other debt instruments. Understanding debt covenants is particularly important if part of an offering's proceeds is to be used to reduce debt. Repayment of loans or other transactions with insiders may present special problems under blue sky laws[66] and may trigger additional disclosure requirements.

Holders of common stock, preferred stock, warrants, options, or securities that have been previously issued may have registration rights, rights of first refusal, or other contractual rights that may affect a subsequent round of financing. For this reason, counsel should also review all documentation related to previous financings and should consider how granting such rights in a current financing could influence subsequent financings.

It is often advisable to adopt management incentive plans or other compensation programs such as stock option plans at an early stage, because the subsequent adoption or amendment of certain plans may require shareholder approval. Establishing those matters and programs that require shareholder approval usually is easier during the early stages of the business's life, when the number of shareholders is small and their interests are common. On the other hand, if previously adopted compensation programs appear excessive to new investors, such plans could hinder the company's ability to attract investors.

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64. *See, e.g.*, MINN. STAT. § 302A.413 (1994).

65. *See supra* note 63.

66. *See, e.g.*, Stroud v. Grace, 606 A.2d 75 (Del. 1992); Levy v. Stern, No. Civ. A. 11955, 1996 WL 118160, at *3-4 (Del. Ch. Mar. 12, 1996); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

Future investors may also be concerned about certain fundamentals that affect management. For example, if one or more key executives are critical to the success of the company, the company should consider whether it is appropriate to enter into an employment agreement or obtain "key man" life insurance on such executives. Investors are often attracted to these features if the company is highly dependent upon key individuals.

A corporation should also consider carefully the composition of its board of directors. New, outside investors often like to see board members who are independent from management because outside board members will provide independent judgment and valuable expertise to the company's management. Venture capitalists or other significant investors may also insist upon a right to designate one or more members of the corporation's board of directors as a condition of their investment. For publicly-held companies, the rules of certain exchanges require that the board of directors include a certain number of outside directors and that the board of directors have specified committees such as an audit committee and a compensation committee.[67]

Additionally, a company should always maintain, organize, and update corporate records, including a corporate minute book and financial statements. The lack of organized, up-to-date corporate records may receive a negative reaction from potential investors or professional advisors conducting a due diligence review in connection with a financing.

In many financing circumstances, audited financial statements are required by the investors or by law. Even if a company is not required to have audited financial statements in its early stages, audited financial statements and well-organized accounting will significantly reduce the time and expense of procuring the needed statements when the company seeks financing.[68]

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67. *See* Herbert S. Wander & Jonathan I. Cope, *Developments in Disclosure*, 14TH ANN. FED. SEC. INST., C28 A.L.I.-A.B.A. 361 (1996); John F. Seegal, *Due Diligence Procedures in Initial Public Offerings*, *in* HOW TO PREPARE AN INITIAL PUBLIC OFFERING 1995, at 285 (PLI Corp. Law & Practice Handbook Series No. B-904, 1995).

68. In this regard, it makes sense to retain an accounting firm that is experienced in the general area(s) in which the company conducts its business.

IV. SECURITIES REGISTRATION AND EXEMPTIONS

A. *General Registration Requirement under Federal Law*

As previously noted, under the Securities Act every security must be registered with the Commission prior to an offer or sale through any means of transportation or communication in interstate commerce or of the mails, unless the security or transaction qualifies for an exemption.[69] Additionally, the regulations relating to registration detail the specific information that must be disclosed to the public.[70]

The Securities Act provides exemptions for particular types of securities that by their nature are exempt from the registration requirements of the Securities Act, and for particular types of transactions that are exempt from the registration requirements of the Securities Act.[71] State blue sky laws also usually provide exemptions for particular securities and transactions, and the terms and scope of such exemptions can vary significantly from state to state.[72] This portion of the article focuses on the exemptions from registration that are commonly utilized by small and growing businesses that do not desire to become publicly held or that are not yet prepared to make a general offering to the public of their securities. The following text summarizes the most commonly-used exemptions for types of securities and types of transactions that may involve small and growing business enterprises.[73]

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69. *See supra* notes 25-35 and accompanying text. Section 5 of the Securities Act requires that the registration statement be *filed prior to the offer* of such security and be declared *effective prior to the sale* of such security in interstate commerce or through the mails. 15 U.S.C. § 77e (1994).

70. *See* 17 C.F.R. §§ 229.10-.915, 230.408 (1995).

71. 15 U.S.C. § 77g (1994).

72. *See supra* notes 48-51 and accompanying text.

73. The exemptions from the registration requirements of the Securities Act include the following: Section 3(b)'s exemption for certain offerings not in excess of five million dollars, 15 U.S.C. § 77c(b) (1994); Section 4(2)'s exemptions for transactions not involving a public offering, 15 U.S.C. § 77d(2) (1994) (exempting small issues and, under certain circumstances, nonpublic offerings involving significant amounts of money); and Section 4(6)'s exemption for sales exclusively to accredited investors, 15 U.S.C. § 77d(6) (1994). In addition, issues that are limited to only one state may qualify for Section 3(a)(11)'s intrastate exemption. *See* 15 U.S.C. § 77c(a)(11) (1994).

B. *Exemptions from Federal Registration Requirements*

Exemptions from registration give companies the flexibility to raise capital without increasing the time and expense needed to file a registration statement and help them avoid the subsequent need to comply with reporting requirements. Companies must comply strictly, however, with the exemption requirements. Should securities be sold pursuant to an exemption and it is later determined that the company failed to comply with the exemption, the purchasers have the right to unwind and rescind the transactions.

1. *Exempted Securities under Section 3 of the Securities Act*

Section 3(a) of the Securities Act describes particular types of securities that are exempt from the registration requirements (and certain other provisions) of the Securities Act.[74] In addition, Section 3(b) authorizes the Commission to promulgate rules and regulations that exempt from registration issues where the aggregate offering price does not exceed five million dollars.[75] Section 3(b) of the Securities Act is considerably different than the other major exemptions from registration because it is not self-executing—*i.e.*, it depends on rules promulgated by the Commission for implementation.[76] The ability of the Commission to create exemptions under Section 3(b) is subject to the statutory requirement that "the enforcement of [the Act] with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."[77]

The exemptions that have been promulgated by the Commission under Section 3(b) include the qualified exemp-

74. 15 U.S.C. § 77c(a) (1994).

75. 15 U.S.C. § 77c(b) (1994). In 1992, the SEC recommended to Congress that the limit should be raised to ten million dollars; however, Congress has not yet acted upon the recommendation. *See* Small Business Initiatives, Securities Act Release No. 6924, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,931 (Mar. 11, 1992).

76. In contrast, the exemptions provided under Section 4(2) exist without further action by the Commission. *Compare* 15 U.S.C. § 77c(b) (1994) *with* 15 U.S.C. § 77d(2) (1994).

77. 15 U.S.C. § 77c(b) (1994).

tions for offerings up to five million dollars, as implemented by Regulation A,[78] and the exemption under Rule 504 for offerings not exceeding one million dollars.[79] Additionally, the exemption from registration under Rule 505 for certain offerings up to five million dollars are also deemed to be exempt pursuant to Section 3(b).[80]

2. *Regulation A*

An issuer that meets the requirements of Regulation A[81] may offer an aggregate amount[82] of five million dollars of unregistered securities in any year.[83] Regulation A offering circulars contain much of the information that would be included in a registration statement. Although the security is technically not registered with the Commission, the offering circular is filed with the Commission in a procedure analogous to the registration proceeding. In addition, the offering circular delivery requirements of Regulation A are analogous to the prospectus delivery requirements of Section 5 of the Securities Act.[84]

Regulation A exemptions are not available to every issuer. For example, the issuer must be organized under the laws of the United States or Canada and have its principal place of business within the United States or Canada.[85] In addition, the issuer cannot be subject to the Exchange Act's periodic reporting requirements immediately preceding the Regulation A offering[86] or be a "development stage company."[87]

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78. 17 C.F.R. §§ 230.251-.263 (1995).

79. 17 C.F.R. § 230.504 (1995); *see also infra* Part IV.B.3.e. (discussing Regulation D exemptions, including Rule 504).

80. 17 C.F.R. § 230.505(a) (1995); *see also infra* Part IV.B.3.e (discussing Regulation D exemptions, including Rule 505).

81. 17 C.F.R. §§ 230.251-.263 (1995).

82. For an extended discussion relating to the effects upon exemptions because of aggregation, see *infra* art IV.C.

83. 17 C.F.R. § 230.251 (1995). The exemption did not take full advantage of the five-million-dollar ceiling until the SEC revised Rule 251 in 1992. *See* Small Business Initiatives, Securities Act Release No. 6949, 7 Fed. Sec. L. Rep. (CCH) ¶ 72,439 (July 30, 1992); Small Business Initiatives, Securities Act Release No. 6924, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,931 (Mar. 11, 1992).

84. *Compare* 17 C.F.R. § 230.251(d)(2) (1995) *with* 15 U.S.C. § 77e(b) (1994).

85. 17 C.F.R. § 230.251(a)(1) (1995).

86. 17 C.F.R. § 230.251(a)(2) (1995).

87. 17 C.F.R. § 230.251(a)(3) (1995). "[A] development stage company . . . either has no specific plan or purpose, or has indicated that its business plan is to merge with

Moreover, Regulation A is not available to any issuer who has been subject to proceedings stemming from violations of any federal securities laws.[88] This provision is commonly called the "bad actor" provision. If the issuer, its predecessors, affiliates, or control persons have not been investigated or been involved with any type of activity that violated any securities laws (including blue sky laws) within five years of the offering, Regulation A may be used as a ground for exemption from registration.[89]

3. *Exempted Transactions under Section 4 of the Securities Act of 1933*

Because of the offering circular requirements and other limitations of Regulation A, issuers seeking to raise capital privately often search for alternative exemptions from registration, such as those under Section 4 of the Securities Act.

a. *Section 4(1) of the Securities Act*

Section 4(1) of the Securities Act provides an exemption from registration for "transactions by any person other than an issuer, underwriter, or dealer."[90] By its express language, this exemption is limited in scope to the secondary trading of securities. Section 2(11) of the Securities Act provides that anyone who purchases a security from the issuer with a view toward distribution may be deemed to be an underwriter since securities are to be held for investment purposes under section 4(1).[91] Thus, if a distribution is to be made, the exemption is lost.

To determine whether the securities were purchased for investment purposes, the courts require that the security must have "come to rest" in the hands of an investor. Following the lead of Professor Loss, the courts generally hold that if the

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an unidentified company or companies." *Id.*

88. 17 C.F.R. § 230.262 (1995). The "bad actor" provisions are also incorporated into Rule 505's exemption through Section 3(b). *See* 15 U.S.C. 77c(b) (1994); 17 C.F.R. § 230.505(b)(2)(iii) (1995).

89. *See* 17 C.F.R. § 230.262 (1995). The disqualification of issuers is not absolute under Rule 262. Application can be made to the Commission to waive the "bad actor" provisions. The Commission will lift the disqualification "upon a showing of good cause . . . that it is not necessary under the circumstances that the exemption . . . be denied." *Id.*

90. 15 U.S.C. § 77d(1) (1994).

91. 15 U.S.C. § 77b(11) (1994).

purchaser has held the security for at least three years, the security has "come to rest" and the requirements of the exemption have been met.[92] Most courts have held that a security must be held a minimum of two years, provided that the investor can show that it had the requisite intent to hold the security as an investment at the time the investment decision was made.[93] Furthermore, anyone who sells securities on behalf of a controlling person of the issuer is deemed an underwriter, and thus, the Section 4(1) exemption cannot be invoked.[94]

b. Section 4(2) of the Securities Act

Section 4(2) of the Securities Act provides an exemption from registration for "transactions by an issuer not involving any public offering."[95] Although this exemption is frequently used by issuers, its applicability is sometimes uncertain because whether a particular transaction constitutes a public offering requires an analysis of the specific facts and circumstances. For this same reason, a shorthand definition of the private offering exemption is impossible.[96] Nonetheless, the principal require-

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92. *See, e.g.*, Ackerberg v. Johnson, 892 F.2d 1328, 1336 (8th Cir. 1989) (finding that securities held by the purchaser for more than four years plainly had "come to rest").

93. *See, e.g.*, *Ackerberg*, 892 F.2d at 1336 ("[T]he courts look to whether the security holder has held the securities long enough to negate any inference that his intention at the time of acquisition was to distribute them to the public. Many courts have accepted a two-year rule of thumb to determine whether the securities have come to rest."); Hedden v. Marinelli, 796 F. Supp. 432, 437 (N.D. Cal. 1992) (applying two-year criterion to determine that securities were held for investment); *cf.*, *e.g.*, McDaniel v. Compania Minera Mar de Cortes, Sociedad Anonimo, Inc., 528 F. Supp. 152, 161-62 (D. Ariz. 1981) ("The juxtaposition of acquisition and resale of stock on precisely the same date leaves only one reasonable conclusion—that the securities were acquired with a view toward[] distribution.").

94. Securities Act § 11(a)(5), 15 U.S.C. § 77k(a)(5) (1994); *see also* United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969); SEC v. Netelkos, 592 F. Supp. 906 (S.D.N.Y. 1984) (holding that status as an underwriter also provides the basis for liability for misstatement in connection with a registered offering).

95. 15 U.S.C. § 77d(2) (1994).

96. In 1975, an American Bar Association committee concluded that the four essential attributes of a private offering exemption were 1) offeree qualification; 2) availability of information; 3) manner of offering; and 4) absence of redistribution. *Position Paper of the Federal Regulation of Securities Committee*, A.B.A. SEC. CORP., BANKING & BUS. L., *in* 31 BUS. LAW. 485 (1975). The cases that sustain an issuer's claimed private offering exemption invariably involve similar elements of planning, pre-clearance of the offerees, limited solicitation, and full disclosure. *See, e.g.*, Mary J. Kretch Trust v. Lakes Apartments, 642 F.2d 98 (5th Cir. 1981); Weprin v. Peterson, 736 F. Supp. 1124 (N.D. Ga. 1988).

ments of the 4(2) exemption can be described in the following manner:

1) There can be no general advertising or public solicitation of offerees;
2) Each of the offerees and purchasers must have access to or be given full disclosure of all material information about the issuer;
3) The offerees should have sufficient knowledge and experience to understand the risks of the offering. This is often referred to as "sophistication."[97] Through judicial and administrative interpretations, the 4(2) exemption is generally limited to transactions in which the persons purchasing from the issuer are "able to fend for themselves";[98] and
4) The distribution must "come to rest" in the hands of the qualified purchasers. If it is determined that the qualified purchasers are nothing more than a conduit to unqualified purchasers, the exemption will be lost.[99]

Although Section 4(2) contains no reference to the personal attributes of offerees and purchasers or their knowledge of the issuer, these elements have become the principal factors considered in the judicial interpretation of Section 4(2). The focus on the nature of the purchaser began in 1953 with the U.S. Supreme Court's decision in *SEC v. Ralston Purina Co.*[100] Finding that the Securities Act was designed to protect investors by promoting full disclosure, the Court held that eligibility for

97. It is disputed whether "sophistication" is needed to comply with the private offering exemption. However, prudent issuers should be aware of the investor's financial acumen before allowing them to invest, so a sympathetic court is not able to extinguish the exemption judicially after the fact.

98. *E.g.*, SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953); Factors Involved in Determining Whether Transaction is "Public Offering," Securities Act Release No. 285, 1 Fed. Sec. L. Rep. (CCH) ¶ 2740 (Jan. 24, 1935); Non-public Offering Exemption, Securities Act Release No. 4552, 1 Fed. Sec. L. Rep. (CCH) ¶ 2770 (Nov. 6, 1962).

99. Because of these requirements, issuers often require that prospective investors make written representations regarding their ability to understand the risks of the investment, the fact that they have been given access to information relevant to their investment decision, and their investment intent (*i.e.*, no view toward distribution).

100. 346 U.S. 119 (1953). From 1947-1951, Ralston Purina sold approximately two million dollars of common stock through an employee stock purchase program to employees at all levels of the company. *Id.* at 121. The number of purchasers ranged from 20 in 1948 to 414 in 1949. *Id.*

the private offering exemption should turn on whether offerees need the protection of the Act.[101] If the offerees lack access to the same kind of information provided in a registration statement, they cannot "fend for themselves," and many purchasers (in this case, employees of the issuer) would not be in a position to have access to such information.[102] Thus, in *Ralston*, the Section 4(2) exemption did not apply and registration was required.[103] Over time, the *Ralston* standard has been broadened by case law within the various circuits.[104]

Clearly, the safest course for issuers is to provide complete and accurate disclosure of material information to all offerees and purchasers whenever possible. For this reason, issuers relying upon an exemption from registration provide potential investors with a disclosure instrument called a "private placement memorandum" or other disclosure materials to ensure that investors have access to material information concerning the issuer. In addition, an issuer will often make additional information available upon request by potential investors. Through "private placement memoranda" and other disclosures documents, the company issuing the security endeavors to provide the potential investor with all "material" information—that information that is necessary to enable the investor to make an informed decision.[105] Should a transaction and sale be subsequently challenged, the private placement memorandum provides evidence of the disclosure which was made at that time of the offer and sale of the security.

The primary areas of disclosure that are the touchstones of materiality include the following:[106] risk factors relating to the business; a description of the issuer's business; information about the management of the issuer; the issuer's intended use of the offering's proceeds; information regarding sales arrangements or plan of distribution of the security; description of the securities offered; control persons of the issuer; and financial statements

101. *Id.* at 124-25.

102. *Id.* at 125.

103. *Id.* at 127.

104. *See, e.g.*, SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971).

105. *See* Parker v. Broom, 820 F.2d 966 (8th Cir. 1977) (concluding that geological report provided sufficient information to investor who knew the history of the oil wells in the area and knew the issuer's background).

106. *See* Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (discussing materiality).

related to the financial condition and results of the issuer's operation.[107] Information not material for potential investors can usually be excluded from private placement memoranda even if such information would be required in a registration statement.

c. The Section 4(1½) Exemption

When purchasers of securities sold in a private placement exempt from registration cannot rely on a Section 4(1) or Section 4(2) exemption for resale,[108] they may attempt to exempt the securities pursuant to the "Section 4(1½)" exemption. The 4(1½) exemption is a hybrid exemption not specifically created by the Securities Act but nonetheless within the statute's intended purpose.[109] Under the Section 4(1½) exemption, affiliates of the issuer that originally issued the securities may privately sell securities they hold to others, as long as some of the established criteria for sales under both Sections 4(1) and 4(2) are met.[110]

d. Accredited Investors and Section 4(6)

Securities may be sold in a transaction exempt from registration under Section 4(6) of the Securities Act.[111] To qualify for this exemption, the securities must be offered only to "accredited investors"[112] and the offering must be limited to five million dollars.[113] Additionally, there can be no public

107. Private placement memoranda used in connection with a Regulation D exempt offering should contain any financial statements or other information required to be disclosed under Regulation D. *See* Regulation D, 17 C.F.R. §§ 230.501-.508 (1995); *infra* Part IV.B.3.e.

108. *See* 17 C.F.R. § 230.144 (1995).

109. *E.g.*, Ackerberg v. Johnson, 892 F.2d 1328 (8th Cir. 1989).

110. *See* Employee Benefit Plans, Securities Act Release No. 6188, 1 Fed. Sec. L. Rep. (CCH) ¶ 1051, at 2073-27 n.178 (Feb. 1, 1980).

111. 15 U.S.C. § 77d(6) (1994).

112. The term "accredited investors" has been defined by the SEC in Rule 215, 17 C.F.R. § 230.215 (1995); *see also* 15 U.S.C. § 77b(15) (1994) (delegating power to SEC to determine who qualifies as an "accredited investor"). Additionally, Rule 501 provides a parallel definition that is applicable to exemptions pursuant to Regulation D. *See* C.F.R. § 230.501(a) (1995). The definition includes those who are presumed to have sufficient sophistication and/or access to information concerning the issuer. The rules also deem certain individuals and entities to be accredited investors based solely upon their wealth.

113. 15 U.S.C. § 77d(6) (1994); *see also* 15 U.S.C. § 77c(b) (1994) (establishing five-million-dollar cap).

advertising or solicitation of the offering, and an appropriate notice of reliance upon the exemption must be filed with the Commission.[114]

e. Regulation D

Regulation D contains rules promulgated by the Commission to provide certain guidance and "safe harbors" for transactions exempted from the registration requirements of Section 5 of the Securities Act.[115] Regulation D was "designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions."[116] Because of the uncertainty surrounding individual facts and circumstances, issuers often will try to qualify for a Regulation D "safe harbor" in addition to a Section 4(2) exemption.[117]

The exemptions within Regulation D combine the elements of the qualified exemptions under Section 3(b) for small issues,[118] the exemption under Section 4(6) for offerings to "accredited investors,"[119] and the exemption provided by Section 4(2) for issuer transactions that are considered private

114. 15 U.S.C. § 77d(6) (1994). Although this exemption has become somewhat redundant in light of Rule 505, 17 C.F.R. § 230.505 (1995), there are occasions when the exemption could be used by those who do not otherwise qualify for the exemption provided by Rule 505. For example, Section 4(6) may be available to investment companies and issuers who have previously committed misconduct under the Securities Act or the Exchange Act and are not allowed to offer and sell securities through the exemption provided by Regulation D.

115. 17 C.F.R. §§ 230.501-.508 (1995). The preliminary notes to Regulation D specifically provide that transactions exempt under Regulation D are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. *See id.* at preliminary note 1. Furthermore, although no registration statement is required in connection with transactions qualifying for exemption under Regulation D, the issuer still must file a Form D with the Commission pursuant to Rule 503. 17 C.F.R. § 230.503(a) (1995). In addition, Rule 502 of Regulation D contains certain information delivery requirements and an obligation to inform all investors of the restricted nature of the securities. 17 C.F.R. § 230.502 (1995).

116. Regulation D—Revision of Certain Exemptions . . . for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 (Mar. 8, 1982).

117. The preliminary notes to Regulation D expressly state that an issuer may rely upon a Section 4(2) exemption in addition to a Regulation D exemption. 17 C.F.R. §§ 230.501-.508 preliminary note 3 (1995). There is no presumption that failure to satisfy Regulation D makes a Section 4(2) exemption unavailable. *Id.*

118. *See* 15 U.S.C. § 77c(b) (1994).

119. *See* 15 U.S.C. § 77d(6) (1994).

placements.[120] The exemptions provided by Regulation D are found within Rules 504 through 506.[121] These "safe harbors" provide greater certainty as to the availability of an exemption under other provisions such as Section 4(2), which requires analysis of the facts and circumstances unique to each case.

The following table summarizes the significant attributes of the exemptions provided by Rules 504, 505 and 506:

	RULE 504	RULE 505	RULE 506
Aggregate Offering Price Limitation	$1 million (per twelve-month period)	$5 million (per twelve-month period)	No limit
Number of Investors	Unlimited	35, plus unlimited accredited investors	35, plus unlimited accredited investors
Investor Qualifications	None	None for up to 35; others must be accredited investors (see Rule 501(a) for definition)	All non-accredited purchasers must be "sophisticated" investors or be represented by a purchaser representative (see Rule 501(h))
Limitation on Manner of Offering	None	General solicitation not permitted	General solicitation not permitted
Limits on Resale	None	Restricted	Restricted
Information Delivery Requirements	See Rule 502	See Rule 502	See Rule 502

120. *See* 15 U.S.C. § 77d(2) (1994). Rule 506 chiefly acts to provide a "safe harbor" for the Section 4(2) exemption. *See* 17 C.F.R. § 230.506 (1995).

121. *See* 17 C.F.R. §§ 230.504-.506 (1995).

	RULE 504	RULE 505	RULE 506
Issuer Qualifications	No investment companies; not available to 1934 Act reporting companies. Development stage company must have specific business plan or purpose	No investment companies; no issuers disqualified under Reg. A. wrongdoing rules	None

Rule 502 establishes conditions that apply to the exemptions provided by Rules 504, 505, and 506.[122] These conditions relate to the information supplied to offerees, the solicitation of purchasers, limitations on resales, and integration[123] of offerings. Different types of information are required, depending upon the specific rule relied upon under Regulation D.[124] For example, if *all* purchasers are accredited investors,[125] then Rule 502 does not require that any specific financial information be furnished to them by the issuer.[126] On the other hand, if sales under Rule 505 or 506 are made to any non-accredited investor, then Rule 502 imposes certain financial disclosures.[127] In addition, those issuers that are subject to the periodic reporting requirements of the Exchange Act are required to make any information contained in the most recent annual and quarterly reports—as well as any disclosures pursuant to the proxy rules—available to the offerees prior to or at the time of the offer.[128]

When an issuer relies upon an exemption provided by Rule

122. 17 C.F.R. § 230.502 (1995).

123. For a further explanation of integration, see *infra* Part IV.C.

124. 17 C.F.R. § 230.502(b) (1995).

125. *See* 17 C.F.R. § 230.501(a) (1995) (defining "accredited investors").

126. *See* 17 C.F.R. § 230.502(b)(1) (1995). Often, securities offered for sale through the Rule 505 and Rule 506 exemptions are offered to both accredited and non-accredited investors. The non-accredited investors must be given certain information which does not need to be given to the accredited investors. Nonetheless, it is advisable to disclose the same information to the accredited investors that is disclosed to the non-accredited investors. *See id.* at note.

127. 17 C.F.R. § 230.502(b) (1995).

128. 17 C.F.R. § 230.502(b)(2)(ii) (1995). These informational requirements do not apply to offerings of up to one million dollars made pursuant to Rule 504. 17 C.F.R. § 230.502(b)(1) (1995); *see also* 17 C.F.R. § 230.504(a) (1995).

505 or 506, Rule 502 prohibits the offer or sale of securities through a general solicitation or advertising.[129] If there has been a general solicitation of the public in the offering process, the exemptions are lost.[130] Additionally, although a general solicitation is not prohibited under Rule 504, state securities regulation may affect the general solicitation of exempt securities pursuant to Rule 504, because general solicitation may not be acceptable in some states.

Shares of stock sold in reliance upon the exemptions from registration under Rule 505 and 506 are "restricted securities."[131] As restricted securities, such shares can only be resold upon registration or upon application for an exemption.[132] Under Rule 502, an issuer of restricted securities is obligated to inform investors and possible purchasers of the restricted nature of the securities and to take "reasonable care" to ensure that the purchasers of the restricted securities "are not underwriters within the meaning of Section 2(11) of the [Securities] Act."[133] If purchasers of restricted securities are deemed underwriters, the exemption may be lost.[134]

The difficulty in resale of the securities exempted by Regulation D can be a significant drawback for small issuers. Generally, a private, unregistered placement of a company's securities does not create a market for easy liquidation of the securities by the initial investors. The exemption may be lost through an improper resale of the restricted securities. For this reason, only investors who are willing and able to invest in an illiquid security provide a viable source of capital under the Rule

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129. 17 C.F.R. § 230.502(c) (1995); *see also* Kenman Corp., Exchange Act Release No. 21,962, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,767 (Apr. 19, 1985); Texas Capital Network, Inc., SEC No-Action Letter, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,857 (Feb. 23, 1994).

130. *See, e.g.*, SEC v. Interlink Data Network, Inc., [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,049 (C.D. Cal. Nov. 15, 1993).

131. 17 C.F.R. § 230.502(d) (1995).

132. *Id.* In such situations, shares usually are resold after being held at least two years pursuant to Rule 144. *See* 17 C.F.R. § 230.144 (1995).

133. 17 C.F.R. § 230.502(d) (1995); *see also* Securities Act § 2(11), 15 U.S.C. § 77b(11) (1994).

134. *See* 17 C.F.R. § 230.502(d) (1995). Issuers usually attempt to satisfy the requirements of Rule 502(d) by having potential investors execute a subscription agreement that would contain, among other things, investment representations, representations regarding status as an accredited investor, and an acknowledgment of the unregistered or restricted nature of the securities.

504 and 505 exemptions.

C. Integration and Aggregation of Exempt Transactions

"Integration" and "aggregation" are means by which seemingly separate securities transactions are combined for purposes of determining the availability of an exemption from registration. The principles of integration and aggregation can operate to divest transactions and securities of exempt status. Integration relates to the combination of seemingly separate offerings, because of their timing, and the appearance of a single transaction. Aggregation relates to the specific temporal limits given to certain exemptions, and the limitation upon dollars offered in the time surrounding the offers. These two principles are often confused when considering numerous exemptions and their individual dollar and investor limitations.

Regulation D exemptions are susceptible to integration and aggregation problems because all offers made pursuant to Regulation D must meet all of the terms and conditions set forth therein. For example, Rules 504 and 505 contain maximum offering price limitations.[135] When calculating these limitations, the specific offering will be aggregated with other applicable offerings within a twelve-month period.[136] If the total amount of the offerings exceeds the maximum offering price limitations set forth in Rules 504 or 505, then the exemption is lost.[137] Additionally, offerings pursuant to Section 3(b) may be aggregated with Rule 504 or 505 offers when they occur within the twelve-month time frame delineated in Regulation D.[138]

Integration of individual offerings can occur if fewer than six months separates each, possibly causing the loss of either or both exemptions based upon the dollar or investor limits relied upon in either offering.[139] If the offerings are within six months of each other, the Commission applies a five-factor test to determine if integration should occur. The Commission considers whether:

1) the sales are part of a single plan of financing;

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135. 17 C.F.R. §§ 230.504(b)(2), 230.505(b)(2)(i) (1995).

136. *Id.*

137. *See id.*

138. *Id.*

139. Unless specifically excluded by an exemption, integration potentially can occur where several different exemptions are involved. *See* 17 C.F.R. § 230.701(b)(6) (1995).

2) the sales involve issuance of the same class of securities;
3) the sales have been made at or about the same time;
4) the same type of consideration is received; and
5) the sales are made for the same general purpose.[140]

If more than six months separate the offers, they are presumed to be separate, the offerings should not be integrated, and the offerings should not be lost.

The problems related to integration and aggregation can be minimized by careful planning and management of the timing of offerings and sales. In addition, the careful practitioner should, at the time of the offering of securities under an exemption, determine whether more than one exemption is available to the issuer. If an offering can be structured to fall within more than one exemption, the issuer may be protected if it should be determined that one of the exemptions was unavailable to the issuer.[141]

D. *General Registration Requirement under State Laws*

Most state securities laws require all securities to be registered if they are offered or sold in the state, unless there is an exemption from registration.[142] The practitioner must review the requirements of each state prior to offering securities within any particular state. The staff at the applicable state agency can be a helpful resource in analyzing potential exemptions from registration or in complying with a state's registration or notification requirements.

E. *State Exemptions*

The availability of exemptions from registration for a particular security or transaction varies from state to state. For this reason, the practitioner must take care to ensure that there is an applicable exemption in all desired states. By way of example, Minnesota's blue sky laws provide various

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140. *See, e.g.*, Donohoe v. Consolidating Operating & Prod. Corp., 982 F.2d 1130 (7th Cir. 1992); Circle Creek Aquaculture V, L.P., SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,665 (Mar. 26, 1993).

141. *See, e.g.*, Circle Creek Aquaculture V, L.P., SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,665 (Mar. 26, 1993).

142. *E.g.*, MINN. STAT. § 80A.08 (1994); *see also* UNIF. SECURITIES ACT (1985) § 301, 7B U.L.A. 116 (Supp. 1996).

exemptions for particular types of securities[143] and particular types of transactions.[144] Some of the most commonly used exemptions from registration in Minnesota include an "isolated sales exemption" that permits up to ten sales by the same issuer within a twelve-month period;[145] an exemption for sales to "institutional investors" only;[146] and an exemption that allows sales to up to twenty-five persons if the issuer files a statement of issuer with the Minnesota Department of Commerce.[147]

F. *Advantages and Disadvantages of Going Public*

It is not within the scope of this article to discuss the process of registering securities under federal and state securities laws. Registration generally involves the preparation and filing of a registration statement pursuant to the requirements of the particular statute and to the rules and regulations promulgated by the appropriate agency.[148]

With the existence of exemptions from registration, the closely-held company often can choose whether to file a registration statement and make a public offering of its securities or, at least, it possesses the ability to control the timing of its initial registration and public offering. If a company has the option of whether to make a public offering or to raise capital in an exempt transaction, the company should consider some of the advantages and disadvantages of going public.

A common advantage of going public is access to greater amounts of capital at a lesser cost than private placement. In turn, increased funds will be available for working capital, repayment of existing debt, marketing or research and development activities, diversification of operations, and other activities. Another clear advantage to the public company is the market that is created for its stock. The value of the stock may be increased to investors, since they receive an

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143. *See* MINN. STAT. § 80A.15, subd. 1 (Supp. 1995).

144. MINN. STAT. § 80A.15, subd. 2 (1994).

145. MINN. STAT. § 80A.15, subd. 2(a) (1994). This exemption applies as long as "(1) the seller reasonably believes that all buyers are purchasing for investment, and (2) the securities are not advertised for sale to the general public." *Id.*

146. MINN. STAT. § 80A.15, subd. 2(g) (1994); *see also* MINN. R. 2875.0170 (1995) (deeming "accredited investors," as described in Regulation D, to be "institutional buyer[s]" within Minnesota's blue sky statute).

147. MINN. STAT. § 80A.15, subd. 2(h) (1994).

148. *See, e.g.*, Securities Act § 7, 15 U.S.C. § 77g (1994).

investment which can be readily liquidated. Moreover, if the stock performs well, the company may be able to obtain additional capital more easily through future public offerings.

There is also a certain amount of prestige and increase in public awareness that goes along with the public ownership of a company stock. Additionally, a company's new status as a publicly-owned entity may give it a competitive advantage over other companies in the same field by providing it with greater visibility among vendors and customers. Of course, the shareholders of a closely-held company lose significant control when the company is taken public. When shares are widely held, ownership (including the right to elect directors) is also diffused.

On the other hand, going public requires the disclosure of significant amounts of information regarding the company and its management. Highly compensated executives lose privacy with respect to compensation. Initial financial statements are filed with the SEC, and there is an ongoing requirement to file financial statements on a quarterly and annual basis. Material contracts and other information that could put the company at a competitive disadvantage against privately-held competitors will have to be disclosed. The costs of initial registration—including registration fees, legal fees, accounting fees and financial printing expenses—can be quite high. There are also expenses on an ongoing basis related to the preparation, filing, and distribution of reports to be filed with the SEC and materials such as proxy materials and annual reports to be distributed to the shareholders.

In addition to the expense, management will have to devote a considerable amount of time to public relations matters, keeping analysts, investment bankers, and shareholders informed about recent developments. Furthermore, following registration of the publicly-offered securities under the 1934 Act, officers, directors, and ten-percent owners will be subject to the Act's short-swing profit provisions.[149] Insiders will also be subject to civil and criminal liability if they trade in company stock on the basis of material nonpublic information.[150]

When taking a company public, myriad issues must be considered to properly capitalize on the financial transaction. Going public may require a change in organizational struc-

149. *See* Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1994).
150. MINN. STAT. §§ 78p(b), 78ff(a) (1994).

ture (*e.g.*, from a partnership to corporate form). Aside from the organizational change, certain tax benefits previously available could be lost, and this expense should be taken into consideration when weighing the pros and cons of public financing. As discussed, many states regulate the offer and sale of securities by "merit review" and authorize their securities laws administrators to deny qualification of an offering based on a substantive review of fairness of the offering.[151] Qualifying certain offerings may be difficult, if not impossible, under some states' laws, or may require the imposition of unacceptable restraints on the issuer or its shareholders, especially relating to penny stocks, management underwriter options, selling expenses, dilution, or existing insider loans. If the issue will be popular enough without the states in which qualification will be difficult, it would be advisable to sell the securities in the states easily accessible, and blue sky qualification should not be a significant factor.

V. CONCLUSION

The numerous state and federal securities laws create both a myriad of opportunities to raise capital and myriad of pitfalls for the unwary issuer and counsel. Through careful planning and management, any business should be able to navigate successfully through the federal and state securities laws and raise sufficient capital for its needs.

151. *See supra* notes 52-54 and accompanying text.