

REGULATORY CONSIDERATIONS

SECURITIES REGISTRATION

Broadly defined, a security is an interest in, or an obligation of, the business entity that issues the security. Examples of securities are corporate stock, interests in a limited partnership, and corporate bonds and debentures. Note that the label assigned to an interest in a business is not necessarily determinative, and that the definition of a security is a very broad one; note that many seemingly innocent activities, such as the use of a website can constitute the “offer” of securities.

A business owner who is giving or selling ownership interests in a business to other persons, even to friends and family members, is strongly advised to seek the advice of counsel. This is true whether the ownership interests are transferred when the business is organized or later in its life. In general, securities must be registered with the federal Securities and Exchange Commission and the Minnesota Department of Commerce before they legally can be advertised or sold to investors unless the security or transaction qualifies for an exemption under state or federal laws. A security or transaction may qualify for a federal exemption but not a state exemption or vice versa. Again, given the highly technical laws, regulations, and judicial decisions in this area, as well as guidance from the SEC (such as that issued on the use of electronic media), the advice of counsel is very important.

The basic purpose of both state and federal securities laws is to protect the investor. Therefore, sales in violation of these laws, even if done through inadvertence or in good faith reliance, can create civil and criminal penalties on both the state and the federal level. If interstate sales are involved, civil and criminal penalties in multiple states may apply. The anti-fraud provisions of these laws apply even if the securities or the transaction are exempt from registration.

Securities registration is a sophisticated area requiring the services of experienced professionals. In some cases these professionals may be able to assist in structuring the offering and sale to qualify for an exemption. In other cases their services may be necessary to register and to sell the securities. In all cases involving the offer or sale of securities, discussing the matter with legal counsel is the best starting point.

Some of the common exemptions to the registration requirements of the federal and state laws are discussed below. Readers should be aware that this is not a comprehensive list of the exemptions. Minor changes in fact circumstances may result in the loss of the exemption. Also, both the Securities and Exchange Commission and the Minnesota Department of Commerce periodically amend their regulations in a way that may affect available exemptions. The business person contemplating the offer and sale of securities should consult with experienced professionals to determine the availability of any exemptions.

Further information on federal securities registration requirements and a pamphlet may be obtained from the publications office of the United States Securities and Exchange Commission.

Information on state regulations may be obtained from the Minnesota Department of Commerce Registration and Analysis Division. The addresses and telephone numbers of these agencies are provided in the Resource Directory section of the Minnesota Small Business Assistance Office publication, *A Guide To Starting A Business In Minnesota*.

The Minnesota legislature adopted the Uniform Securities Act.

See the section below on Minnesota Blue Sky Laws.

FEDERAL EXEMPTIONS (15 UNITED STATES CODE § 77)

Small Offerings – Regulation A

Regulation A (17 Code of Federal Regulations § 230.251 to § 230.263) permits the offering of up to \$5 million of securities in a year without complying with all registration and disclosure requirements. If the Regulation A exemption is available, a shorter form of federal registration is permitted. Full state registration may be required, however.

A simplified disclosure form may be used. Although the federal securities laws generally do not permit advertising prior to registration, recent amendments to Regulation A allow small companies to test investor interest through a written solicitation of interest document before proceeding with a full, and costly, registration.

The Intrastate Exemption

The intrastate exemption applies to securities offerings which are confined to a single state and which are purely local in nature. The scope of the intrastate exemption is extremely narrow, and even though the offering is exempt from federal regulation, it is subject to state law requirements. To qualify for the intrastate exemption, the securities must be part of an issue that is offered and sold only to residents of a single state. The issuer must be a resident of the same state and must have its principal place of business there. If the issuer is a corporation it also must be incorporated in that state. There are restrictions on subsequent sales of the securities, and the issuer must take certain precautions against interstate offers and sales.

Private Placements and Limited Offerings – Regulation D Exemption

The Regulation D exemptions (17 Code of Federal Regulations § 230.501 to § 230.508) authorize the offer and sale of securities through certain private placement transactions. There are restrictions on the number and amount of sales, and on publicity, advertising or solicitation, and resale. Notice of Regulation D offerings must be filed with the Securities and Exchange Commission, but the full registration and disclosure requirements of a public offering need not be met.

Regulation D includes three exemptions:

- **Rule 504** provides an exemption for offerings up to \$1 million during the twelve months before the start of and until the completion of the offering. Purchasers need not meet any suitability test and there is no limit on the number of purchasers to whom the offerer can sell.

- **Rule 505** provides an exemption for offerings up to \$5 million during the twelve months before the start of and until the completion of the offering. Sales may be made to an unlimited number of accredited investors (defined below), but may not be made to more than 35 non-accredited investors.
- **Rule 506** permits a company to sell an unlimited dollar amount of securities. Sales may be made to an unlimited number of accredited investors, but may not be made to more than 35 non-accredited investors, each of whom must be a “sophisticated investor.”

For the purpose of Rules 505 and 506, an “accredited investor” includes:

- certain types of financial institutions such as banks, broker-dealers and investment companies;
- entities with total assets in excess of \$5 million (not formed for the purpose of investing in the offering);
- any director, executive officer or general partner of the company;
- any natural person whose net worth (alone or jointly with spouse) exceeds \$1 million not including the value of the investor’s primary residence. The exclusion of the value of the primary residence was added by Section 413 of the Dodd Frank Wall Street Reform and Consumer Protection Act which was signed into law on July 21, 2010. The Securities and Exchange commission has indicated that the new exclusion has immediate effect;
- any natural person whose individual income exceeds \$200,000 (or jointly with spouse, \$300,000) for each of the past two years, and is expected to exceed that amount in the current year;
- any trust with assets greater than \$5 million that are managed by a sophisticated trustee (and not formed for the specific purpose of investing in the offering); and
- any entity in which all of the equity owners are accredited investors.

MINNESOTA BLUE SKY LAWS

A company selling securities to residents of the state of Minnesota must comply with federal and state securities laws. State securities laws are collectively and individually referred to as “Blue Sky Laws.” These Blue Sky Laws vary among the states, sometimes to a significant degree. It is important to note that the Minnesota Legislature recently enacted a version of the Uniform Securities Act, which provides for substantial revisions to the current version of the Minnesota Securities Act. The Minnesota Uniform Securities Act (“MUSA”) became effective in August 2007. This section highlights the most frequently used exemptions from the securities laws of the state of Minnesota and summarizes certain changes that will result from the enactment of MUSA, where applicable.

The securities laws of Minnesota require registration with the Minnesota Department of Commerce of all offers and sales of securities made to residents of Minnesota unless a particular exemption is available. If registration is required, it should be noted that, prior to the passage of MUSA, Minnesota was a “merit” review state, Minnesota is now a “disclosure” only state. Generally, this means that as long as the issuer satisfies the information disclosure requirements under MUSA, the Minnesota Department of Commerce cannot prohibit the issuer from selling its securities within the state.

Isolated Sales and Limited Offerings

Sales by a nonissuer of securities to no more than ten purchasers in Minnesota during any period of twelve consecutive months are exempt from registration as are nonissuer transactions by or through a broker dealer where the security has been in the hands of the public for at least 90 days. The exemption covers sales or offers to sell to an institutional investor; an accredited investor; a federal covered investment advisor, or any other person exempted by rule promulgated by the Commissioner of the Minnesota Department of Commerce.

Sales by a company to no more than 35 persons in Minnesota during any consecutive twelve month period are exempt from registration if the following conditions are met:

- the company reasonably believes that all the buyers in Minnesota (other than institutional investors) are purchasing for investment;
- no commission or remuneration is paid or given directly or indirectly to a person other than a broker-dealer or a registered agent for soliciting a prospective purchaser in Minnesota;
- no general solicitation or general advertising is made in connection with the sale or offer to sell the security; and
- notice has been filed with the Minnesota Department of Commerce at least ten days in advance of any sale or such a shorter period as permitted by the Department. However, an issuer who makes sales to ten or fewer purchasers in Minnesota during any twelve consecutive months is not required to provide this.

SCOR (SMALL CORPORATE OFFERING REGISTRATION)

The Small Corporate Offering Registration (SCOR) is a simplified procedure for registering stock offerings which enables small, start-up companies to raise up to \$1 million in a 12-month period.

SCOR: Access to Capital for Small Businesses

Increased Access to Capital

A SCOR offering is a tool for small businesses to raise capital without the prohibitive costs involved in traditional stock offerings.

Regulatory Relief and Streamlining

Because the offering is registered solely with the state, multiple reporting requirements are eliminated. In addition, the enhanced form U-7 disclosure document is simply formatted into 50 detailed questions designed to satisfy the necessary disclosures without burdensome requirements.

Completing the Form U-7

The process of completing a SCOR offering is centered around the form U-7. The Form U-7 is less complex than traditional stock prospectuses. The Form U-7 consists of 50 detailed questions designed to provide the state and the investor with important information regarding the company's operations. The questions in the U-7 form consist of items such as the company's history; its business and properties; risk factors facing the company; use of the offering proceeds; description of the securities being offered; dividend history; key personnel; principal stockholders; and pending or threatened litigation.

Answering the Form U-7 questions adequately and completely will satisfy the required disclosures in law.

Once the Form U-7 is completed, it is submitted, along with reviewed or audited financial reports, and the required fee to the Minnesota Department of Commerce Registration Division. The Department reviews and provides comments on the documents. So long as no stop order is in effect and no proceeding is pending under Minn. Stat. § 80A.13 a SCOR registration statement becomes effective automatically at 5:00 p.m. on the twentieth full business day after the filing of the registration statement, or the last amendment of it, or at some earlier time determined (by order) by the Commissioner of the Minnesota Department of Commerce.

For purposes of a nonissuer transaction, other than a transaction by an affiliate of the issuer, all outstanding securities of the same class identified in the small corporate offering registration statement as a security registered under Minn. Stat. § 80A are considered to be registered while the small corporate offering registration statement is effective. The registration statement is effective for one year after its effective date or for a longer period designated by an order of the Commissioner of Commerce. The registration statement may be withdrawn only with the approval of the Commissioner of Commerce.

An issuer can raise up to \$1 million in a 12 month period, and offerings must sell for at least \$1 per share.