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SECURITIES RULES FOR PRIVATE EQUITY FINANCINGS

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October 14, 2010

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What is a Security

Section 2(1) of the Securities Act of 1933, as amended (the "1933 Act"), defines a "security" to include "any note, stock, bond, evidence of indebtedness, participation in a profit sharing agreement (or) investment contract.... or in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

This definition is quite broad and includes the many types of instruments that fall within the ordinary concept of a security, including stocks and bonds, along with the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits. Thus, the federal securities laws define security in both specific (any "stock," "bond," "note," "debenture," etc.) and general (e.g., any "investment contract" or "instrument commonly known as a "security") terms. The most expansive element of the definition of "securities" under the 1933 Act is the term "investment contract."

The Supreme Court has ruled that an investment contract consists of (i) an investment of money (or other value) (ii) in a common enterprise (iii) for profits (which may be solely tax benefits) (iv) that will come solely from the efforts of others. The courts have held that a common enterprise generally involves either a pooling of more than one investor's funds or in some circumstances a connection between the success of the promoter and the success of the investors. The fourth point (solely from the efforts of others) has been broadly construed so that the test is met if the investor only plays a small role in the transaction and significant efforts are made by these other than the investor, which efforts are likely to affect the success or failure of the business.

Under the definition of "security" in Section 2(1) of the 1933 Act and court rulings, corporate stock is nearly always a "security". An interest as a limited partner in a limited partnership is a "security." However, an interest as a general partner in a general or limited partnership generally is not a "security" primarily because a general partner normally has the right to participate in the day-to-day management of the enterprise and is not expecting to profit solely or nearly solely from the efforts of others.

In connection with LLC's, one needs to determine whether the membership interest is a security. It would seem that any membership interest in a LLC which is managed by managers is a "security" because the members are expecting to profit solely or nearly solely from the efforts of others and will not be involved in day-to-day management. A membership interest in an LLC which is managed by members some of whom do not actively participate in management may be a security with respect to the non-active members.

A capital raising technique for small business operators is to borrow funds from family, friends and business associates and issue promissory notes in exchange therefor. These notes are "securities" and should be treated accordingly. As a practical matter, you should assume that any instrument issued in connection with the raising of funds (e.g., stock, note, membership interest) is a security.

In order to issue securities, an issuer must either register the issuance under federal and state securities laws or find an exemption from such registration requirements. The issuance of a security pursuant to the registration provisions of federal and state law is a time-consuming and costly process. Most small to mid-size businesses do not want to spend the money or time it would take to register the securities. In addition, the registration of securities with the SEC will subject the issuer to continual reporting requirements.

The question is how do you avoid registering the securities under federal or state law.

Federal and state law offer a number of exemptions from registration. These exemptions exempt the particular transaction (e.g., a sale to an investor as an exempt transaction) not the underlying security. Subsequent sales of the security may have to be registered if no exemption is available.

This article will review some common federal exemptions as well as exemptions provided under Illinois law.

Regulation D

Regulation D (Rules 501-508 under the 1933 Act) exempts sales of securities if the Regulation is followed. Regulation D is only available to "issuers" as defined in Rule 501(g).

It may be used by issuers in business combinations and acquisitions. A business combination is defined to mean any transaction involving the acquisition by one issuer, in exchange for all or a part of its own or its parent's stock, of stock of another issuer if, immediately after the acquisition, the acquiring issuer has control of the other issuer (whether it had control before the acquisition) - Rule 501(d).

There are three possible federal exemptions offered by Regulation D under Rules 504, 505 and 506.

Rule 504

Rule 504 permits sales of up to $1,000,000 of securities during any twelve month period.

Rule 504 offerings may not be made by a company which files reports under Section 13 of 15(d) of the Securities Exchange Act of 1934 (i.e., a public company).

Issuers need to be careful to insure that a Rule 504 offering is not integrated with another offering. If a Rule 504 offering and another offering are integrated, the issuer could lose the Rule 504 exemption. See "***Integration***" below for discussion of the SEC's integration factors.

Under Rule 504, a company may sell to an unlimited number of investors. Moreover, there is no sophistication requirement – the buyers do not have to be sophisticated. However, no general solicitation or general advertising is permitted - Rule 502(c).

Securities sold under Rule 504 are "restricted" securities. Resales must be either registered under federal and state securities laws or exempt from registration. The issuer must

follow procedures set out in Rule 502(d) to insure that buyers are aware of the resale restrictions (see "***Resales***" below).

All sales under Rule 504 are subject to anti-fraud rules. Even though the transaction may be exempt, the issuer is still subject to liability for securities fraud.

Rule 504(b)(1) provides a separate state offering exemption for sales up to $1,000,000 which may allow some advertising and solicitation. The state exemption requires registration with a state securities commission. This exemption also provides that the resale rules set out in Rule 502(d) do not apply.

In order to claim this exemption, the offers and sales of securities under Rule 504 must be made:

- Exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions;

- In one or more states that have no provision for the registration of the securities or the public filing or delivery of a disclosure document before sale, if the securities have been registered in at least one state that provides for such registration, public filing and delivery before sale, offers and sales are made in that state in accordance with such provisions, and the disclosure document is delivered before sale to all purchasers (including those in the states that have no such procedure); or

- Exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to "accredited investors" as defined in Rule 501(a).

Rule 505

Rule 505 permits sales up to $5 million in a single offering.

Issuers need to be careful to insure that a Rule 505 offering is not integrated with another offering. If a Rule 505 offering is integrated with another offering, the issuer could lose the Rule 505 exemption. See "***Integration***" below for a discussion of the SEC's integration factors.

Offers and sales under Rule 505 may be made an unlimited number of accredited investors. **Offers** may be made to an unlimited number of non-accredited investors but **sales** may only be made to 35 non-accredited investors.

There are special rules involved in counting the number of non-accredited investors (see "***Purchasers and Offerees***"). For a description of who is an accredited investor, see "***Accredited Investor***" and **Appendix A**.

Non-accredited investors need not be sophisticated. In Illinois, however, an issuer might have to insure that the non-accredited investors are sophisticated. See "**Illinois Exemptions--*Rule 505***."

However, there are dangers of selling to persons who are not sophisticated. The issuer should use a questionnaire or subscription form to satisfy itself that prospective investors are accredited or that non-accredited purchasers are sophisticated.

Unsophisticated non-accredited investors can use a purchaser's representative — see Rule 501(h).

Rule 505 does not allow any general solicitation or advertising. Moreover, the SEC has taken the position that, although Rule 505 in theory allows **offers and sales** to an unlimited number of accredited investors and **offers (but not sales)** to an unlimited number of non-accredited investors, offers to a large number of prospective buyers may violate prohibitions against advertising and solicitation. The SEC likes for issuers to have a "nexus" to offerees: Picking up the phone book and contacting every doctor to see if they want to buy shares.

If non-accredited investors are going to purchase shares, specified disclosures must be made - see Rule 502(b). These disclosures are fairly extensive and are set out at **Appendix B**.

If only accredited investors are involved, no set disclosures are required but the issuer is still subject to anti-fraud rules. The issuer still has a duty to describe material facts. Even though the transaction may be exempt, the issuer is still subject to liability for securities fraud.

Securities sold under Rule 505 are "restricted securities". Resales must be either registered under federal and state securities laws or exempt from registration — Rule 502(d). The issuer must follow procedures set out in Rule 502(d) to insure that buyers are aware of the resale restrictions (see "***Resales***" below).

Rule 506

Rule 506 permits sales of any amount in a single offering.

Rule 506 sales are exempt under Section 4(2) of the 1933 Act and are, therefore, "Covered Securities." Covered Securities sold under Rule 506 are largely exempt from state regulation (see "**Covered Securities"** below).

An issuer needs to be careful to insure that the Rule 506 offering and another offering are not integrated. If a Rule 506 offering and another offering are integrated, the issuer might lose the Rule 506 exemption. See "***Integration***" below for a discussion of the SEC's integration factors.

Offers and sales under Rule 506 may be made an unlimited number of accredited investors. **Offers** may be made to an unlimited number of non-accredited investors but **sales** may only be made to 35 purchasers.

There are special rules involved in counting the number of non-accredited investors (see "***Purchasers and Offerees***"). For a description of who is an accredited investor, see "***Accredited Investor***" and **Appendix A**.

Non-accredited investors must be reasonably sophisticated. An issuer should use a questionnaire or subscription form to satisfy itself that investors are accredited or that non-accredited purchasers are sophisticated.

Unsophisticated non-accredited investors can use a purchaser's representative — see Rule 501(h).

Rule 506 does not allow any general solicitation or advertising. Moreover, the SEC has taken the position that, although Rule 506 allows in theory **offers and sales** to an unlimited number of accredited investors and **offers (but not sales)** to an unlimited number of non-accredited investors, offers to a large number of prospective buyers may violate prohibitions against advertising and solicitation. The SEC likes for issuers to have a "nexus" to offerees: Picking up the phone book and contacting every doctor to see if they want to buy shares.

If non-accredited investors are going to purchase shares, specified disclosures must be made - see Rule 502(b). These disclosures are fairly extensive and are set out at **Appendix B**.

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Securities sold under Rule 506 are "restricted securities". Resales must be made either registered under federal and state securities laws or exempt from registration — Rule 502(d). The issuer must follow procedures set out in Rule 502(d) to insure that buyers are aware of the resale restrictions (see "***Resales***" below).

Accredited Investors

There are a number of categories of accredited investors (see Rule 501(a)). The most common ones for individuals are set forth below:

- A natural person whose individual net worth, or joint net worth with his/her spouse, at the time of purchase exceeds $1,000,000 **(minus the net value of the purchaser's primary residence)**.

- A natural person who had an individual income in excess of $200,000, or joint income with his/her spouse in excess of $300,000, in each of the two most recent years and reasonably expects the same income level in 2011.

- Any director, executive officer or general partner of the issuer of the securities being sold. Executive Officer is defined in Rule 501(e).

Additional categories of accredited investors are set out in **Appendix A**.

Purchasers vs. Offerees

In counting for purposes of Rule 505 and 506 of Regulation D, an issuer is counting non-accredited **purchasers** not **offerees**. Under Rules 505 and 506, an issuer may **sell** to up to 35 non-accredited investors but can **offer** to more than 35.

For purposes of calculating the number of non-accredited purchasers under Rule 505 and Rule 506 only, the following rule applies:

- The following purchasers shall be excluded when counting non-accredited purchasers:
    - Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser;
    - Any trust or estate in which a purchaser and any of the persons related to him as specified in the first and third points collectively have more than 50 percent of the beneficial interest (excluding contingent interests);
    - Any corporation or other organization of which a purchaser and any of the persons related to him as specified in the first and second points collectively are beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; and
    - Any accredited investor.
- A corporation, partnership or other entity shall be counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor (because all of the equity holders are not accredited investors), then each beneficial owner of equity securities or equity interests in the entity shall count as a separate purchaser for all provisions of Regulation D.
- A non-contributory employee benefit plan within the meaning of Title I of ERISA shall be counted as one purchaser where a trustee makes all investment decisions for the plan.

You can **offer** and **sell** to an unlimited number of accredited investors.

Under Section 4(6), an issuer must make sure your **offers** and **sales** are only made to accredited investors (see "**Section 4(6)**" below).

Under Rule 147, an issuer must make sure **offers** and **sales** are only made to residents of one state (see "**Rule 147--Intrastate Offerings**" below).

Integration

If different offerings are integrated, the issuer could lose its federal exemption.

Under the SEC's rules, all sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D.

Offers and sales (i) that are made **more than six months before the start of a Regulation D offering** or (ii) that are made **more than six months after completion of a Regulation D offering** will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those offers or sales of securities under an employee benefit plan.

If an issuer offers or sells securities and the safe harbor rule description in the preceding paragraph is not available, the determination as to whether separate sales of securities are part of the same offering (and, therefore, integrated) depends on the particular facts and circumstances. The SEC will look at the following factors when determining whether offers and sales should be integrated for purposes of the exemptions under Regulation D:

- Whether the sales are part of a single plan of financing;
- Whether the sales involve issuance of the same class of securities;
- Whether the sales have been made at or about the same time;
- Whether the same type of consideration is being received; and
- Whether the sales are made for the same general purpose.

Resales

Securities acquired in a Reg D transaction are "restricted" and cannot be resold without registration under the Act or an exemption therefrom. The issuer must exercise reasonable care to insure that the purchasers of the securities are not underwriters within the meaning of section 2(a)(11) of the 1933 Act. Reasonable care may be demonstrated by the following:

- Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons.
- Written disclosure to each purchaser prior to sale that the securities have not been registered under the 1933 Act and, therefore, cannot be resold unless they are registered under the 1933 Act or unless an exemption from registration is available.
- Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the 1933 Act and setting forth or referring to the restrictions on transferability and sale of the securities.

Notice of Sales — Rule 503

A notice on Form D must be filed with the SEC within 15 days of the first sale under Rules 504, 505 or 506. If funds are being held in escrow, the first sale is deemed to occur when funds and subscription agreement are deposited in escrow.

The failure to file a Form D will not render the Regulation D exemption void but continued filing violations could be a problem. (See also "***Rule 508***" below.)

An issuer may file an amendment to a previously filed notice of sales on Form D at any time.

According to the SEC, material changes in business transactions being financed or changes in the maximum on a mini-max offer should be reported on an amended Form D.

An issuer **must** file an amendment to a previously filed notice of sales on Form D for an offering:

- To correct a material mistake of fact or error in the previously filed notice of sales on Form D, as soon as practicable after discovery of the mistake or error.

- Annually, on or before the first anniversary of the filing of the notice of sales on Form D or the filing of the most recent amendment to the notice of sales on Form D, if the offering is continuing at that time.

- To reflect a change in the information provided in the previously filed notice of sales on Form D, as soon as practicable after the change.

However, no amendment is required to reflect a change that occurs after the offering terminates or a change that occurs solely in the following information:

- The address or relationship to the issuer of a related person identified in Item 3 of the notice of sales on Form D;

- An issuer's revenues or aggregate net asset value;

- The minimum investment amount, if the change is an increase, or if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in a decrease of more than 10%;

- Any address or state(s) of solicitation shown in response to Item 12 of the notice of sales on Form D;

- The total offering amount, if the change is a decrease, or if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in an increase of more than 10%;

- The amount of securities sold in the offering or the amount remaining to be sold;

- The number of non-accredited investors who have invested in the offering, as long as the change does not increase the number to more than 35;

- The total number of investors who have invested in the offering; or

- The amount of sales commissions, finders' fees or use of proceeds for payments to executive officers, directors or promoters, if the change is a decrease, or if the change, together with all other changes in that amount since the previously filed notice of sales on Form D, does not result in an increase of more than 10%.

An issuer that files an amendment to a previously filed notice of sales on Form D must provide current information in response to all requirements of the notice of sales on Form D regardless of why the amendment is filed.

Electronic Filing

A company must file the Form D electronically with the SEC by means of the Commission's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) in accordance with EDGAR rules set forth in Regulation S-T.

In order to do so, an issuer must register with the SEC and obtain special access codes.

Rule 508

Insignificant deviations from all of the terms of Regulation D might not cause the loss of the exemption.

A failure to comply with a term, condition or requirement of Rule 504, Rule 505 or Rule 506 will not result in the loss of the exemption for any offer or sale to a particular individual or entity, if the person relying on the exemption shows:

- The failure to comply did not pertain to a term, condition or requirement directly intended to protect that particular individual or entity; and

- The failure to comply was insignificant with respect to the offering as a whole, provided that any failure to comply with paragraph (c) of Rule 502 [prohibition against advertising or general solicitations], paragraph (b)(2) of Rule 504 [sales exceed $1,000,000], paragraph (b)(2)(i) of Rule 505 [sales exceed $5,000,000], paragraph(b)(2)(ii) of Rule 505 [sales to more than 35 non-accredited investors] and paragraph (b)(2)(i) of Rule 506 [sales to more than 35 non-accredited investors] shall be deemed to be significant to the offering as a whole; and

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

The loss of Regulation D exemption does not mean sales are not exempt. There may be other exemptions — see Note 3 to Regulation D.

State Laws

Even if an offering is exempt under Regulation D, you still have to check state law. See Preliminary Note 2 of Regulation D; see also "**Covered Securities"** below.

Rule 701- - Offers to Employees, etc.

Rule 701 exempts sale of securities pursuant to written benefit plans and compensation contracts for the benefit of employees, officers, directors, consultants or advisors and family members of these individuals who acquire the shares through gifts or domestic relations orders. The benefit plan or contract cannot be used as a capital raising device.

Rule 701 is not available to public companies — Rule 701(b)(1).

Any amount of securities can be offered under exemption — Rule 701(d)(1). However, sales during any 12-month period may not exceed the greater of:

- $1,000,000;
- 15% of the issuer's total assets; or
- 15% of the outstanding securities of that class — Rule 701(d)(2).

701 securities may be transferred to family members (as defined in Rule 701(c)(3)) in the form of gifts or pursuant to a domestic relations order — see Rule 701(c).

The issuer does not count Rule 701 sales when aggregating sales under other exemptions and does not count sales under other exemptions when calculating 701 sales limit — Rules 701(d)(3)(iv) and 701(f). Thus, an issuer can raise capital in a private placement under Regulation D and issue 701 shares to employees.

Specific disclosure must be made to participants if the aggregate sales price exceeds $5 million during any 12 month period (see **Appendix C)**.

Compensation to consultants and advisors is a very tricky issue. SEC is very wary of compensating consultants or advisors for selling stock by giving them Rule 701 shares. Rule 701 is available to consultants and advisors, provided:

- They are natural persons;
- They provide bona fide services to the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent; and
- The services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer's securities.

701 securities are "restricted securities"-- 701(g)(1). Resales of the securities must be registered or exempt.

All sales under Rule 701 are subject to anti-fraud rules. Even though the transaction may be exempt, the issuer is still subject to liability for securities fraud.

Even though exempt under Section 701, sales must still comply with state securities laws.

Rule 147 - - Intrastate Offerings.

Under Rule 147, the securities may only be offered and sold to residents of one state (Rule 147(a)).

Two or more exempt offerings (one of which relies on Rule 147) may be integrated. If so, the Rule 147 exemption could be lost. (See "**Regulation D** -- ***Integration***" for a discussion of the SEC's integration factors.)

Rule 147 is a transactional exemption that only applies if all conditions are satisfied throughout the entire transaction.

The issuer must be a resident of state where offer made — Rule 147(c).

- State where it is incorporated.
- Where its principal office is located if a general partnership.

The issuer must be doing business within the state.

- Very difficult concept.
- Must derive at least 80% of consolidated gross revenues within the state within specified time frames — Rule 147(c)(2)(i).
- 80% of its assets must be located within the state — Rule 147(c)(2)(ii).
- At least 80% of net proceeds from the sale must be used within the state — Rule 147(c)(2)(iii); and
- The principal office of the issuer must be located within the state — Rule 147(c)(2)(iv).

Offerees and purchasers must be residents of the same state as the issuer.

- Corporation, other entities are residents where principal office located --see Rule 147(d)(1).
- Individuals are residents of state of principal residence -- see Rule 147(d)(2).

During the nine months following the last sale, resales can only be made to persons residing within same state — Rule 147(e). The issuer must establish safeguards to police this requirement (Rule 147(f)). These include:

- Placing a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the 1933 Act and setting forth the limitations on resale contained in Rule 147(e);

- Issuing stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, make a notation in the appropriate records of the issuer; and

- Obtaining a written representation from each purchaser as to his residence.

The issuer must, in connection with the issuance of the new certificates for any of the securities that are part of the same issue that are presented for transfer during the time period specified in Rule 147(f), take the steps required by the first and second bullet points. The issuer must disclose, in writing, the limitations on resale contained in Rule 147(e) and the provisions of the first and second bullet points and in the provisions sentences.

All sales under Rule 147 are subject to anti-fraud rules. Even though the transaction may be exempt, the issuer is still subject to liability for securities fraud.

The issuer must also ensure that it has an exemption for the sales under state law.

Section 4(2)

Section 4(2) of the 1933 Act exempts transactions by an issuer not involving a public offering (see Rule 506 discussion above). This was the traditional private placement exemption before Regulation D. The exemption offered by Section 4(2) is still available. When determining whether the exemption is available, the factors to be examined are:

- Manner of offering —how are the purchasers identified—e.g., general solicitation, advertising, seminars, etc.?

- Eligibility of the purchasers —does each purchaser **(not all offerees)**, either alone (or with a qualified advisor), have such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the investment?

- Information —does each purchaser (or his qualified advisor) receive, or has meaningful access to, such information so that the purchaser may make an informed decision?

- Resales —Are appropriate steps taken to prevent resales that are not registered or exempt?

Manner of Offering

As with Regulation D, the issuer may not offer or sell the securities by any form of "general solicitation" or "general advertising," including, but not limited to:

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

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

Although Section 4(2) in theory allows **offers and sales** to a large number of investors, offers to a large number of prospective buyers may violate prohibitions against advertising and solicitation. The SEC likes for issuers to have a "nexus" to offerees: Picking up the phone book and contacting every doctor to see if they want to buy shares.

Eligibility of Purchasers

Purchasers, either alone or with their qualified advisors, must have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment.

As long as all the purchasers (or their advisors) qualify, the number of purchasers should be irrelevant. Of course, the larger the number of purchasers, the greater the burden of establishing that they qualify. See "***Manner of Offering***," above.

Information

In the case of a non-reporting issuer that is selling securities, the issuer should consider furnishing to these purchasers substantially the same information as is contemplated by Rule 502(b) to the extent material to an understanding of the issuer, its business, and the securities being offered. The disclosures to be made to non-accredited investors are fairly extensive and are set out at **Appendix B**.

The issuer should also consider (a) furnishing to each purchaser that is not an accredited investor a brief written description of any material written information provided to any accredited investor and, upon request, furnishing this information to the non-accredited investor, (b) advising each purchaser of the limitations on resale of the securities, and (c) making available to each purchaser the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and obtain any additional information the issuer possesses, or can acquire without unreasonable effort or expense, that is necessary to verify the accuracy of the information furnished.

Resale

Securities sold under Section 4(2) are "restricted securities". Rule 502(d) sets forth procedures that should be followed to insure that buyers are aware of the resale restrictions (see "**Regulation D -- *Resales***" above). The issuer should disclose the limitations on resale, i.e., that

the securities are not being registered under the 1933 Act and may not be resold except (i) in accordance with an effective registration statement, or (ii) in accordance with Rule 144.

Integration

An issuer needs to be careful to insure that the Section 4(2) offering and another offering are not integrated. If a Section 4(2) offering and another offering are integrated, the issuer might lose the exemption. See "**Regulation D** -- ***Integration***" above for a discussion of the SEC's integration factors.

State Laws

Even if an offering is exempt under Section 4(2), you still have to check state law.

Sales to Accredited Investors

Section 4(6) of the 1933 Act permits sales by an issuer to accredited investors.

- Exempt sales of up to $5 million.
- No advertising or public solicitation is allowed (see "**Section 4(2)** -- ***Manner of Offering***," above).
- Issuer must file a Form D (see "**Regulation D** -- ***Electronic Filing***," above).
- Section 4(6) purchasers acquire "restricted securities" and the issuer must ensure that the purchasers are aware of these restrictions and take steps to enforce them (see "**Regulation D -- *Resales***," above).

The issuer must also ensure that it has an exemption for the sales under state law.

Covered Securities

With the passage of the National Securities Markets Improvement Act in 1996 ("NSMIA"), jurisdiction over the issuance of "covered securities" has been taken away, to a large extent, from the states. Covered securities include the following types of securities:

- Securities listed on the national stock exchanges and the Nasdaq.
- Securities sold to "qualified purchasers" are covered securities — Section 18(b)(3) of the 1933 Act. SEC has proposed a regulation that would define a "qualified purchase" as an "accredited investor". If adopted, the offer or sale of a security to accredited investors would be "covered securities" and therefore largely exempt from state regulation.
- Securities exempted by the SEC under Section 4(2) of the 1933 Act — Section 18(b)(4)(D) of the 1933 Act.

- Rule 506 of Regulation D specifically states that offers and sales of securities pursuant to Rule 506 are exempt under Section 4(2) of the 1933 Act in that they are not transactions involving a public offering. Securities sold pursuant to Rule 506 are "covered securities" and, therefore, largely exempt from state regulation.

Section 18(a) of the 1933 Act preempts the application of state registration requirements with respect to covered securities, state regulations relating to the content of any offering document used with respect thereto and state regulations relating to the merits of a sale of covered securities.

States may require issuers of covered securities to file documents filed with the SEC and may require the payment of limited fees of Section 18(c)(2) of the 1933 Act.

Sales of covered securities are still subject to the anti-fraud rules.

Illinois Exemptions

Once an exemption from the federal securities laws has been secured, the issuer needs to review the laws of the states where the securities will be sold in order to see if there is a corresponding exemption under state law. For purposes of this presentation, only Illinois will be considered.

Under Illinois law, there are a variety of exemptions available from registration. These are set out in Section 4 of the Illinois Securities Law of 1953, as amended (the "Illinois Act"). These exemptions exempt the transaction (e.g., a sale to an existing shareholder) not the underlying security. Subsequent transactions may have to be registered if no exemption is available.

Set forth below the most commonly used exemptions available under Illinois law. It is possible to pyramid these exemptions.

Sales exempted under the Illinois Act are still subject to anti-fraud rules.

Sales to Existing Shareholders

Offers, sales, issuances or exchanges with existing shareholders, if no commission is paid (Section 4B).

Sales to Corporations, Banks, etc.

Offers, sales or issuances to certain entities as described in Section 4C (e.g., banks, savings and loans, employee benefit plans).

Rule 506

Issuers relying on Rule 506 of Regulation D (issuing covered securities) need only file a Form D with a $100.00 fee — Section 130.293(a)(1) of the Illinois Blue Sky Regulations.

Exchange Traded Securities

Regulation 130.293(d) exempts exchange traded (NYSE, NASDAQ, etc.) securities from the Illinois filing requirements.

Rule 505

Rule 505 offerings are exempted under Regulation 130.420 if all criteria are satisfied.

- Form D filed with Illinois following the SEC filing rules — Regulation 130.420(b)(1).
- A fee of $100.00 must be paid — Regulation 130.420(b)(3).
- Issuer must agree to provide disclosure statement to Illinois Securities Department if so requested but only with respect to information provided to non-accredited investors — Regulation 130.420(b)(2).
- Issuer must comply with Rules 501-503 and 505.
- Issuer must be satisfied that a non-accredited investor (or his purchaser representative) is reasonably sophisticated (see Regulation 130.420(c)).
- Failure to comply with all requirements of Regulation 130.420 might not cause loss of exemption — Regulation 130.420(d).

Section 4G-Limited Offering

Offers, sales or issuance to residents (or non-residents) where:

- All sales to Illinois residents during the preceding 12 months have been made to fewer than 35 persons in Illinois or (regardless of how many people buy in Illinois) involve sales of less than $1,000,000 (Section 4G).
- When counting the 35 people or the amount of the sales, the issuer excludes sales exempted under other subsections of Section 4.
    - A sale to joint tenants with right of survivorship is one sale — Regulation 130.441(a).
    - Purchases by relatives or spouses who share same residence shall not be a sale to an additional purchaser — Regulation 130.441(b).
- No general advertising or solicitation.
- No commissions in excess of 20% of sale price.

- A report on Form 4G must be filed (alternatively issuer may file a Form D--Regulation 130.440(a)).
    - A $100.00 fee must be paid.
    - Report due within 12 months of first sale.
    - Only report 4G sales (do not report sales exempted under other subsections of Section 4).
    - Failure to file report or filing of inaccurate report does not give right of rescission.
    - By filing issuer agrees to deliver disclosure materials to the Illinois Securities Department if so requested.

Accredited Investors

Section 4H exempts sales to accredited investors who meet income and net worth tests discussed above (see "**Regulation D -- *Accredited Investors***," above). Under Illinois law, net worth does not include the value of the purchaser's principal residence. Securities may not be sold by means of general advertising or solicitation.

Shareholder Approval

Offers, sales or issuance pursuant to shareholder vote, e.g., a merger, consolidation, etc. (Section 4I).

Preincorporation Sales

Offers or sales of preorganization subscriptions prior to incorporation or organization (Section 4M).

- Limited to 25 people.
    - A sale to joint tenants with right of survivorship is one sale — Regulation 130.441(a).
    - Purchases by relatives or spouses who share same residence shall not be a sale to an additional purchaser — Regulation 130.441(b).
- No commission can be paid.
- If commission paid, securities not sold by way of general advertising or solicitation.

Minimum Purchase

Any offer, sale or issuance to anyone who purchases more than $150,000 provided purchase does not exceed 20% of buyer's net worth (Section 4R).

Sales to Executive Officers and Directors

Offers, sales or issuances to any person who is a director, executive officer or general partner of the issuer (Section 4S). The term "executive officer" is defined in the statute and could include an executive officer of a subsidiary provided he performs policy making functions for the parent. See "**Regulation D -- *Accredited Investors*,**" above.

There are other exemptions available in Section 4 of the Illinois Act.

Exempt Securities

Both federal (Section 3(a) of the 1933 Act) and Illinois securities laws (Section 3 of the Illinois Act) establish types of securities that are deemed to be "exempt" from the registration requirements. These securities may be issued without the issuer having to secure an exemption or registering them under federal or Illinois law. Even though these securities are exempt from the registration requirements, they are still governed by the anti-fraud rules.

Appendix A -- Accredited Investors

a. *Accredited investor. Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

1. Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

2. Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

3. Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

4. Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

5. Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000 **(exclusive of the net value of the person’s primary residence)**;

6. Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's

spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

7. Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii) and

8. Any entity in which all of the equity owners are accredited investors.

Appendix B -- Information Requirements for Rule 505 and 506 Offering

If sales are being made under Rule 505 or Rule 506 to any purchaser that is not an accredited investor, the issuer must furnish the information described below to such purchaser a reasonable time prior to sale.

The issuer is not required to furnish the specified information to purchasers when it sells securities under Rule 504, or to any accredited investor.

When an issuer provides information to non-accredited investors pursuant to this rule, it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws.

Non-financial statement information

If the issuer is eligible to use Regulation A, the same kind of information as would be required in Part II of Form 1-A.

If the issuer is not eligible to use Regulation A, the same kind of information as required in Part I of a registration statement filed under the Securities Act on the form that the issuer would be entitled to use.

Financial statement information

Offerings up to $2,000,000

The information required in Article 8 of Regulation S-X, except that only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited.

Offerings up to $7,500,000

The financial statement information required in Form S-1 for smaller reporting companies. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of Federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

Offerings over $7,500,000

The financial statement as would be required in a registration statement filed under the Act on the form that the issuer would be entitled to use. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements

that have been prepared on the basis of Federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

Public Companies

If the issuer is a public company, it must provide the information specified in Rule 502(b)(2)(ii).

Information; Communications

At a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction under Rule 505 or Rule 506, the issuer shall furnish to the purchaser a brief description in writing of any material written information concerning the offering that has been provided by the issuer to any accredited investor but not previously delivered to such unaccredited purchaser. The issuer shall furnish any portion or all of this information to the purchaser, upon his written request a reasonable time prior to his purchase.

The issuer shall also make available to each purchaser at a reasonable time prior to his purchase of securities in a transaction under Rule 505 or Rule 506 the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished under paragraph (b)2(i) or (ii) of this section.

Appendix C -- Information Requirements for Rule 701

1. If the plan is subject to the ERISA, a copy of the summary plan description required by ERISA;

2. If the plan is not subject to ERISA, a summary of the material terms of the plan;

3. Information about the risks associated with investment in the securities sold pursuant to the compensatory benefit plan or compensation contract.

4. Financial statements required to be furnished by Part F/S of Form 1-A (Regulation A Offering Statement) under Regulation A. The financial statements required by this section must be as of a date no more than 180 days before the sale of securities in reliance on this exemption.

   If the sale involves a stock option or other derivative security, the issuer must deliver the disclosure a reasonable period of time before the date of exercise or conversion. For deferred compensation or similar plans, the issuer must deliver disclosure to investors a reasonable period of time before the date the irrevocable election to defer is made.