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Securities Law Challenges in Mergers and Acquisitions: Navigating Exemptions for Transfer or Issuance of Securities

Regulation D, Section 4(a)(2), Integration, Disclosures, and Solicitation of Target Shareholders

WEDNESDAY, JANUARY 30, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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SECURITIES LAW CHALLENGES IN MERGERS & ACQUISITIONS (M&A)

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DO SECURITIES LAWS APPLY TO THE SALE OF AN ENTIRE BUSINESS?

OF COURSE THEY DO

In Landreth Timber Co. v. Landreth, 417 U.S. (1985), the U.S. Supreme Court rejected the sale of business doctrine, which had held that a stock transfer in connection with the sale of a business was not a security.

WHAT IS A SECURITY?

A security is "… any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement … ***investment contract***, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit …but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months ..."

SPOTTING SECURITIES LAW ISSUES IN MERGERS AND ACQUISITIONS

- The issuance by an M&A buyer of its stock to a seller of a business (including in the context of an asset sale) is always a security offering regardless if the seller is an individual or entity
- We advise always treating the sale of a business structured as a sale of all its equity interests by owners as a security offering
- An earn-out may be a security
- If the seller carries back financing (a seller note), it may be a security

TWO MAJOR FEDERAL SECURITIES LAWS

- **The Securities Act of 1933 (the Securities Act)** is intended to prohibit misrepresentation or fraud, and ensure that investors receive all material information, whenever there is an offer and sale of securities to the public.
- **The Securities and Exchange Act of 1934 (the Exchange Act)** administers a system of required disclosures for securities traded on the public markets, including periodic reporting (e.g., quarterly and annual reports, proxy solicitations, material events).

The Securities and Exchange Commission (SEC) expands, bends, and shapes these laws to protect investors and maintain fair and orderly capital markets.

“Securities laws are meant to be interpreted flexibly to effectuate their remedial purpose.” SEC v. Capital Gains Bureau (1963).

REGISTER OR FIND EXEMPTIONS

- Under **Section 5** of the Securities Act, any offering of securities must be registered with the SEC or be exempt from registration.

- Violating the Securities Act can lead to rescission, fines, and potential liability for "control persons."

STATE “BLUE SKY” LAWS

- Every state has laws regulating the sale of securities.
- Similar in nature to the federal laws, although that still results in a general lack of uniformity.
- Although navigating them can be challenging in a wide raise.

REGISTRATION
EXEMPTIONS

FRAMEWORK FOR FEDERAL EXEMPTIONS

- Section 3 of the Securities Act, which exempts certain types of securities (e.g., government, non-profits) and some transactions (e.g., intrastate offerings)
- Section 4 of the Securities Act, which exempts specific types of transactions

PRIVATE PLACEMENT EXEMPTION

- Section 4(a)(2) of the Securities Act
- First adopted by Congress as part of the original Securities Act of 1933
- Provides a statutory exemption for “transactions by an issuer not involving any public offering”
- **Rationale: I**n an offering with a limited number of offerees capable of protecting themselves, the compliance burden of a public offering is not necessary.

DO NOT BE MISLED BY THE PLAIN MEANING OF THE WORD PUBLIC.

“Public offering” is not defined by statute.
Courts and the SEC have developed standards over the years.

WHAT CONSTITUTES A PUBLIC OFFERING?

***SEC v. Ralston Purina* (1953)**

The Supreme Court established the general principle that the exemption under 4(a)(2) is available only for an offer and sale made privately to persons able to fend for themselves.

Whether a purchaser can fend for their self is based on factors such as:

- The purchaser's sophistication and ability to bear the economic risks of the investment
- The purchaser's access to the same kind of information that would be included in an SEC registration statement

Other factors used to determine availability of the private placement exemption (developed since Ralston Purina) include:

- The number of offerees and their relationship to each other and the issuer
- The number/amount of securities offered – size of the offering
- The manner of the offering (e.g. general solicitation or not)
- The sophistication and experience of the offerees
- The nature and amount of information provided (or made available) to the offerees
- The actions taken by the issuer to prevent the resale of the securities

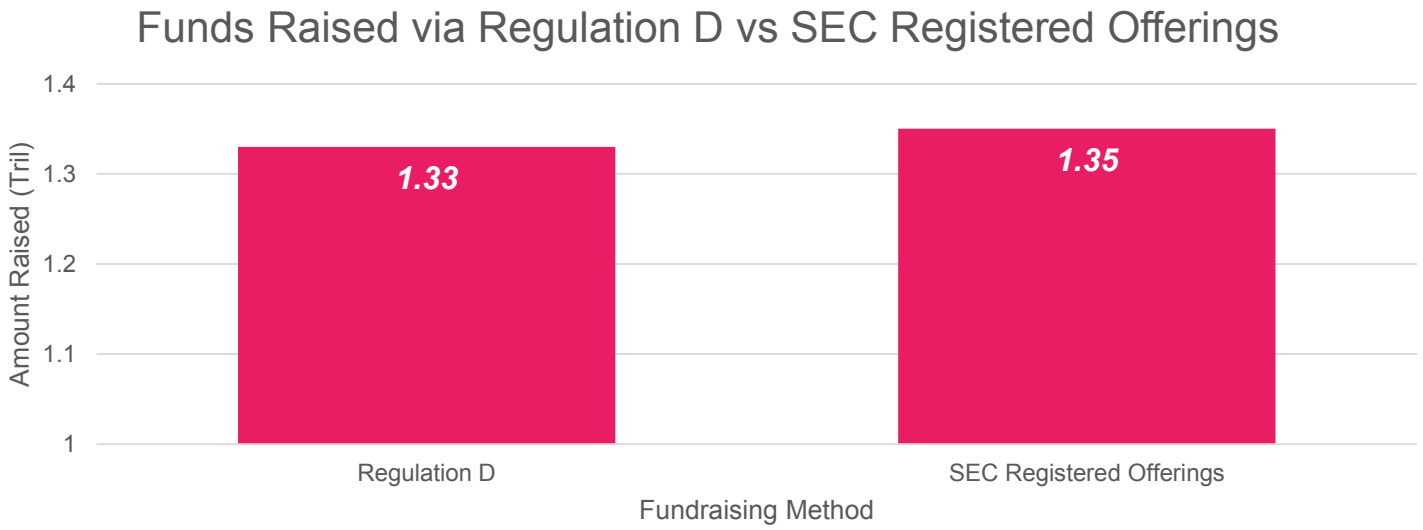
WHAT CONSTITUTES A PUBLIC OFFERING?

- Each factor is flexible and highly fact-dependent.
- No single factor alone is determinative.
- Availability of the 4(a)(2) exemption, “should turn on whether the particular class of persons … need the protection of the 1933 Act” and whether the offerees “are shown to be able to fend for themselves.”

REGULATION D

In 1982, the SEC adopted **Regulation D** to provide greater certainty regarding which transactions are exempt from registration.

Of the private placement exemptions, Regulation D continues to reign supreme.



REGULATION D EXEMPTIONS

	Rule 504	Rule 506(b)	Rule 506(c)
Limit on Number of Investors	No	No limit for accredited / 35 non-accredited	No
Non-Accredited Investors Allowed	Yes	Yes	No (must verify)
General Solicitation	Possible	No	Yes
State "Blue Sky" Preemption	No	Yes	Yes
Specific Disclosure Requirements	None	For non-accredited investors	None

REGULATION D DEFINITIONS

- **Accredited investor**:
  - Salary test for an individual = $200K+ ($300K+ with spouse) in each of last two years and reasonable expectation of same during the current year
  - Net worth test for an individual = $1MM+ without including equity of primary residence)
  - Director, executive officer, or general partner of the issuer or of the issuer's general partner
  - An entity whose equity owners are all accredited investors
- **General solicitation**: Any advertisement, article, notice or other communication published on the internet (including certain online platforms) or in any newspaper, magazine or similar media or broadcast over television or radio or any seminar or meeting whose attendees have been invited by general solicitation. "Prior substantive relationship" is key.
- **Integration**: Several private placements offered within a short period of time may be integrated and deemed to constitute a single offering.
- **Purchaser Representative**: A representative of the investor who is sophisticated on business and financial matters and is unaffiliated with the issuer.
- **Sophistication**: A judgment call regarding the level of knowledge and experience an investor has in business matters. An investor who lacks the sophistication needed to effectively evaluate the investment opportunity must be represented by a purchaser representative.

INTEGRATION

- All sales that are part of the same offering must be integrated for purposes of determining the offering size and duration
- SEC uses a five-factor balancing test
  - Are the offerings part of a single plan?
  - Do they involve the same type/class of security?
  - Are the offerings made around the same time?
  - Do investors pay the same type of consideration (e.g., cash vs. property vs. intellectual property)
  - Are the offerings made for the same general purpose?
- Rule 502 of Regulation D creates a type of “safe harbor” with a six-month look back and six-month look forward

RESTRICTED SECURITIES

- Securities sold in a private placement may not be resold/transferred unless they are subsequently registered or pursuant to exemptions from registration
- Rule 144 is a safe harbor for selling restricted securities by an affiliate of the issuer and by anyone and subject to strict volume, information, and reporting requirements

OTHER REGISTRATION EXEMPTIONS

Regulation CF

- Regulation Crowdfunding (Title 3 under the Jobs Act)
- No more than $1MM raised in any consecutive 12-month period.
- Must be conducted through approved Reg CF portals or registered broker-dealers
- Non-accredited investors allowed subject to investment limitations
- Form C is the required disclosure document

Regulation A+

- Considered a ”mini IPO”
- Replaced Regulation A in October 2015
- Increased maximum fundraising amount from $5MM to $20MM (Tier 1) and $50MM (Tier 2)
- General solicitation and “testing the waters” are allowed
- Tier 2 offerings preempt state review
- U.S. and Canadian companies only; no blank check or investment companies; bad actor disqualification
- Main disclosure document is the Offering Circular
- A small fraction of total private offering activity, although may be increasing

OTHER REGISTRATION EXEMPTIONS IN THE SECURITIES ACT

- 4(a)(5) is a statutory exemption for offerings involving only accredited investors, although it has limited value
- 3(a)(11) is an intrastate offering exemption. Rule 147 is a safe harbor for 3(a)(11) offerings)
- Rule 701 is for offers and sales of securities for compensation purposes (e.g., stock option plans)
- Regulation S is a safe harbor for offshore transactions

STATE “BLUE SKY” LAWS

- Under the National Securities Markets Improvement Act of 1996 (NSMIA), "covered securities" are not subject to blue sky registration or review.
- ”Covered securities" includes securities issued under 506(b) and 506(c), but not 4(a)(2) or 504.
- States still have the right to bring enforcement actions with respect to fraudulent or deceitful conduct.
- State notice filings may still be required depending on the requirements of each state.

PRIVATE OFFERING DOCUMENTATION

THE IMPORTANCE OF DISCLOSURE

- US Securities laws are based on the belief that investors should have access to basic facts about an investment before and after making the investment
- It is not a mandatory (guaranteed) disclosure regime
- Anti-fraud provisions apply to all securities transactions
- Must not make a materially false statement or omit to state a material fact (necessary to make the statements not misleading)
- The test for materiality is whether there is a substantial likelihood that the disclosure would have been viewed by a reasonable investor as having significantly altered the “total mix” of information available. It is not required that a reasonable investor who have changed their investment decision without the misstatement or omission

PRIVATE PLACEMENT DELIVERABLES

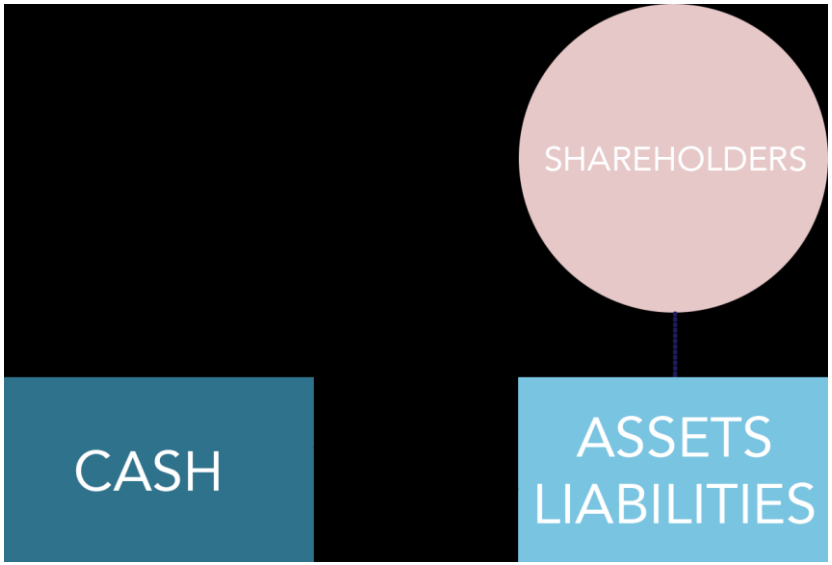
- Prospective Investor Questionnaire
- Subscription or Purchase Agreement
  - Purchaser representations
  - Issuer disclaimers
  - Resale restrictions
  - Legends
- Private Placement Memorandum (other risk factor-related documentation)
- May include registration rights agreement, stockholders agreement (voting agreement), legal opinion

RULE 506(B) INFORMATION REQUIREMENTS FOR NON-ACCREDITED INVESTORS

- **Financial Statement Information**
  - Offerings up to $2MM require disclosure of the information in Article 8 of Regulation S-X (audited balance sheet)
  - Offerings greater than $2MM and less than $7.5MM require disclosure of the financial statement information required in Form S-1 for small reporting companies
  - Offerings over $7.5MM require disclosure of the financial statement information that would be required in a registration statement filed under the Securities Act
- **Non-Financial Statement Information**
  - Description of the company
  - Risk factors
  - Description of the securities
  - Use of proceeds
  - Officers and key personnel
  - Federal tax issues
  - Management's discussion and analysis

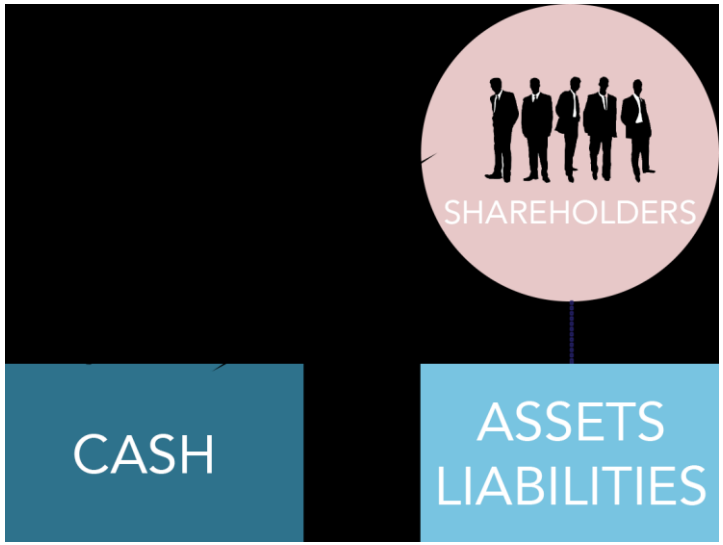
APPLYING SECURITIES LAW CONCEPTS TO M&A CONTEXTS

NOTHING TO WORRY ABOUT HERE



An asset sale with a private buyer and a private seller with few equity owners without an earnout or seller financing (note) ***IS NOT a securities offering***.

CLEAR AND RELATIVELY SIMPLE



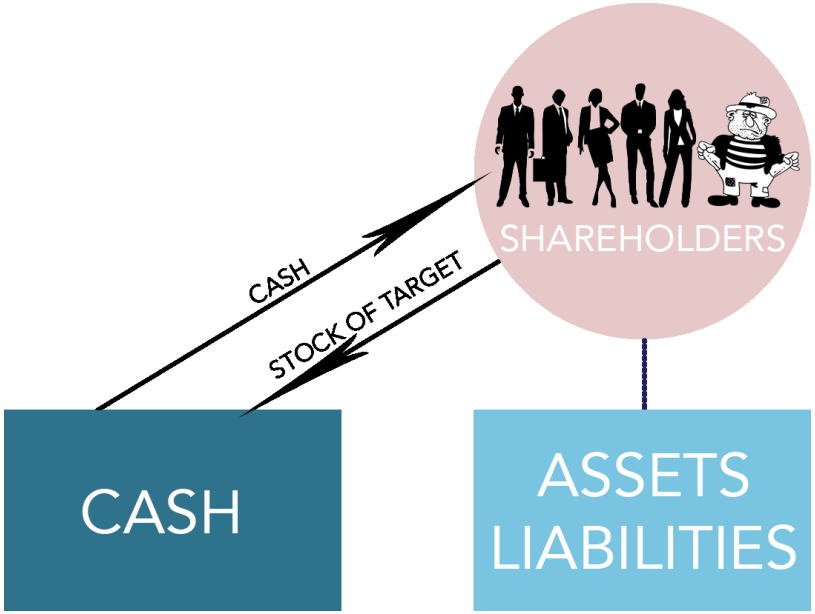
A stock sale with a private buyer and a private seller with five shareholders (all accredited investors) ***IS a securities offering***.

Possible exemptions: Federal under 4(a)(2) and applicable state exemptions vs. Regulation D Rule 506(b) vs. Regulation D Rule 504 and applicable state exemptions.

Risk profile: low to medium

Compliance burden: low to medium

MURKIER AND MORE CHALLENGING



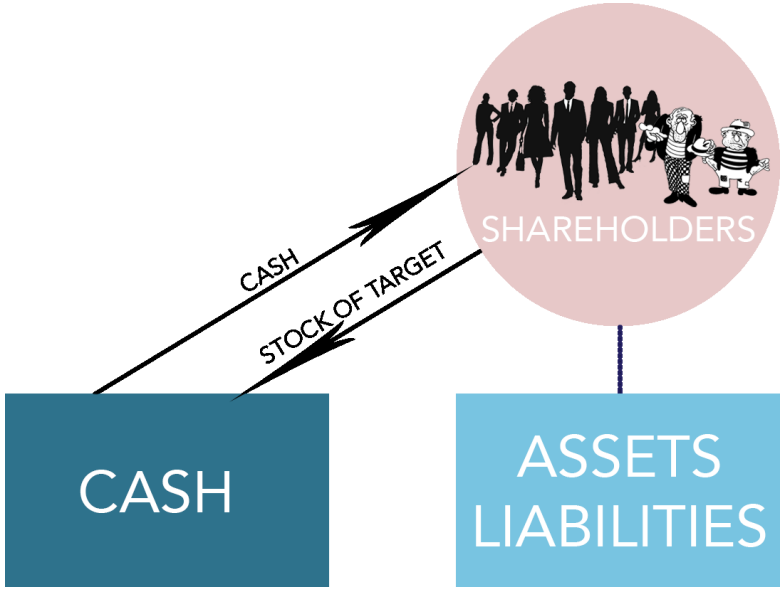
A stock sale with a private buyer and a private seller with 20 shareholders (some non-accredited investors) ***IS a securities offering***.

Possible exemptions: Regulation D Rule 506(b) vs. Regulation D Rule 504 and applicable state exemptions

Risk profile: medium

Compliance burden: medium+

THERE MUST BE EASIER WAYS TO EARN A LIVING



An asset sale with a private buyer and a private seller with hundreds of shareholders (some non-accredited investors) where the buyer issues stock to the seller ***IS a securities offering***.

Possible exemptions: Regulation D Rule 504 (likely challenges with navigating blue sky laws and subject to $5MM limit) or Regulation D Rule 506(c) if buyer cashes out non-accredited shareholders

Risk profile: medium to high

Compliance burden: high

M&A ADVISORS: UNSETTLED TERRITORY

M&A ADVISORS ARE CAUGHT IN THE GENERAL NET OF SECURITIES COMPLIANCE

The SEC's Broker-Dealer Guide states that finders, business brokers, and other M&A advisors must register with the SEC if they are engaged in finding buyers and sellers of businesses where securities are involved.

As with securities registration issues, states also regulate this arena, which makes it necessary to consider federal and state exemptions.

We often do not know until well into the deal if it will be an asset sale or a stock sale.

PROFESSIONAL ORGANIZATIONS ACTIVELY SEEK CLARITY

- ABA Broker-Dealer Lite (2005)
- SEC CBI No Action Letter (2006)
- M&A Broker Proposal (2006-2012)
- The Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act of 2013/2015
- SEC M&A Broker No Action Letter (2014)
- NASAA Model State Rule (2015)

SEC NO ACTION LETTER (2014)

- The broad takeaway is that M&A brokers who advise solely on private company M&A deals do not need to register with the SEC
- Qualification requirements:
  - Only private company transactions
  - Broker may not organize a buy-out group
  - Broker may not provide financing (may assist)
  - Broker may not bind the principals or possess client funds or securities
  - Bad boy disqualification
  - No shell companies (no other size limits)
  - Buyer must acquire at least 25% control and cannot be a passive investor
  - Consent required for joint representation
- Acceptable M&A broker conduct
  - Providing financial advice
  - Soliciting buyers
  - Participating in negotiations
  - Helping to structure the transaction
  - Providing valuation and/or fairness opinions
  - Helping to arrange financing (from sources other than broker)

NASAA MODEL RULE

- Adopted in September 2015 by the North American Securities Administrators Association
- States must adopt it (not self-executing)
- Key differences between the NASAA Model Rule and the SEC 2014 No Action Letter include:
  - Model rule has a size limitation of $25MM in earnings or $250MM in gross revenue
  - M&A broker only needs a reasonable belief that the buyer will control the target and be actively involved in management
  - Control of the acquirer = 20% vs. 25%

STATE M&A ADVISOR CONSIDERATIONS

The SEC No Action Letter does nothing to preempt state requirements, making the federal exemption of somewhat limited value.

States that have adopted (or are considering adopting) the NASAA Model State Rule:

- California, which has exempted “M&A” specialists from state registration if they are already registered as real estate brokers
- Colorado, Ohio, and South Dakota, which exempt business brokers from registration as securities broker dealers based generally on the SEC 2006 CBI No Action Letter
- Utah, Texas, and Florida, which have exemptions based on the NASAA Model State Rule
- Other states are working on exemptions

Questions?

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