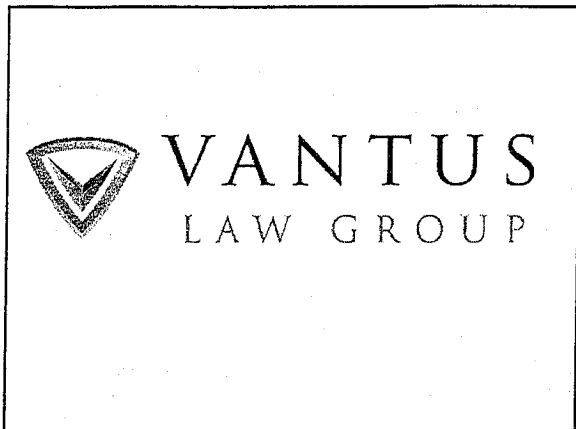




**Private Placement
Pitfalls-
Using Finders and
Other Hazards to
Avoid**

Brad Jacobsen
Vantus Law Group



- Brad Jacobsen
 - BYU 1993 (*summa cum laude*)
 - NYU 1996 (Morgan Stanley Intern)
 - Practiced in NYC, D.C., Boulder & SLC
 - Corporate, Securities, M&A
 - Fmr Chairman/Officer of Securities Law Section of Utah Bar
 - Founded Vantus Law Group 2008 - I'm a Capricorn, I like Piña Colodas and walks in the rain






The Basics

61-1-7 - Registration before sale

- Prior to offering or selling a security in Utah, the security or transaction must be:
 - Registered;
 - Exempt from registration; or
 - Be a federal covered security for which a notice filing has been made (if required by rule).



Definition of Security

- "Security" means any: [Note: the below is only an excerpt]
 - note;
 - stock;
 - bond;
 - debenture;
 - evidence of indebtedness;
 - certificate of interest or participation in any profit-sharing agreement;
 - preorganization certificate or subscription;
 - transferable share;
 - investment contract;
 - commodity contract or commodity option;
 - interest in a limited liability company;
 - vital interest; 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.

Definition of Investment Contract

- "Investment contract" includes:
 - any investment in a **common enterprise** with the **expectation of profit** to be derived through the **essential managerial efforts of someone other than the investor; or**
 - any investment by which:
 - an offeree furnishes initial value to an offerer;
 - a portion of this initial value is subjected to the risks of the enterprise;
 - expectation of a profit; and
 - passivity.

Credit as Consideration

- With reference to the extension of credit as "value" for a securities transaction, the following case provides some good background: *Hector v. Wiens*, 533 F.2d 429, 432 (9th Cir. 1976).
- The Division's current interpretive position as to the reading of "money" or "value" in the two tests for "investment contract" given in the Admin. Code is to define such terms to include any transaction that induces a party to subject himself or herself to financial loss.
- **Howey Test – 1946 Supreme Court Opinion**
 - In 1946, the U.S. Supreme Court stated in *Howey* that the test of an investment contract is "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

Security Broadly Defined

- Horizontal Commonality
 - Pooling of Assets - fortunes of investors tied to each other
- Vertical Commonality
 - Fortunes are tied to promoter's success or expertise [multiple LLCs, LPs or Investment Contracts]
- Edwards – U.S. Supreme Court 2003
 - "Encompass virtually any instrument that might be sold as an investment"
 - Pay Phones
 - Orange Groves
 - Live Beavers
- Short Answer:
 - If you are asking the question, it probably is a security

Registration

- Securities Registration
 - Registration by Coordination
 - Any security for which a registration statement or a notification under Regulation A has been filed under the Securities Act of 1933 may be registered in Utah by coordination.
 - Time consuming and expensive
 - Registration by Qualification
 - Any security may be registered by qualification. Securities should be registered by qualification when no other method is available
 - Time consuming and expensive
 - Registration by Notification
 - Very Narrow Qualification
 - Time consuming and expensive

Exemption from Registration

- The Utah Uniform Securities Act provides 31 exemptions from registration. The Division has created 6 additional exemptions by rule.
- Any person that relies on an exemption has the burden to prove they qualify for the exemption.
- There are no exemptions from the anti-fraud provisions of the Act. An exemption only permits a person to offer or sell a security without registering the security. Accordingly, individuals offering or selling exempt securities may have additional disclosure requirements to satisfy the anti-fraud provisions.

Federal Covered Security

- A security that is exempt from state registration because either
 - it is registered with the Federal government under the Securities Act of 1933 or
 - it is exempt from federal registration under the 1933 Act.
- Includes securities listed or authorized for listing on the NYSE, AMEX, the National Market System of Nasdaq®, registered investment company securities; securities offered or sold to qualified purchasers; securities with respect to certain transactions exempt from Federal registration, including some private placements; and securities that are exempt from Federal registration (Regulation D, Rule 506).
- Status as a federal covered security is not a preemption of the licensing or anti-fraud laws.
- Any person that sells a federal covered security must be licensed as a broker-dealer or agent and must also comply with the anti-fraud provisions

Securities Act of 1933

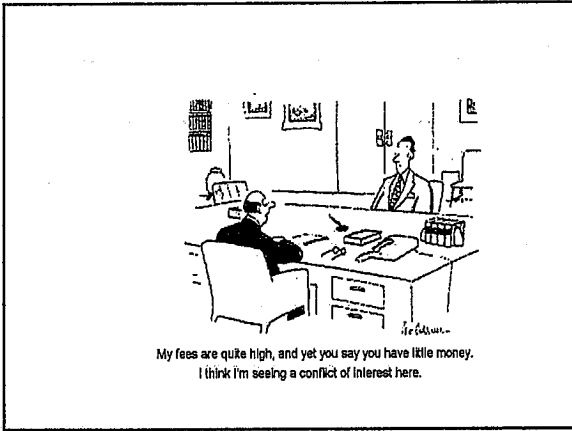
- General Rule: Transactions must be registered or exempt
- Exemptions
 - §4(2)
 - Regulation D

§4(2) Exemption

- §4(2) exemption available for transactions by an issuer not involving a public offering
- Not a safe harbor
- Based on common law (*i.e.*, more than 50 years of administrative and judicial interpretation)
- Most U.S. law firms will not give §4(2) opinions

§4(2) Exemption

- SEC v. Ralston Purina Factors (US Supreme Court 1953)
 - Do the prospective offerees need the protection from the 33 Act registration process?
 - The more sophisticated the offerees are in investing, the more likely §4(2) exemption applies
 - Are the prospective offerees capable of fending for themselves?
 - Both offeree sophistication and access to information must be demonstrated
- Other factors to consider
 - The number of offerees
 - 500 or more offerees may tip the balance regardless of other factors
 - The nature, scope, manner and size of the offering
 - The relationship of the offerees to the issuer and to each other



Reg. D/Rule 506 Exemption

- Safe Harbor for compliance with §4(2)
 - Noncompliance with Rule 506 does not mean §4(2) exemption is unavailable.
- No dollar limit on size of offering
- Issuer must make available to prospective offerees at a reasonable time prior to the sale the opportunity to ask questions and receive answers concerning terms and conditions of offering

Reg. D/Rule 506 Exemption

- Limited to Accredited Investors
- Up to 35 unaccredited investors
 - Disclosure requirements may make this impractical
 - For example, nonreporting issuers with offerings over \$7.5 million are required to furnish same financial statement information as would be required in a prospectus (try to limit to \$7.5 million)

Reg. D/Rule 506 Exemption

- Accredited Investor - Natural Persons
 - An individual with income in excess of \$200,000 (\$300,000 with spouse) during each of the 2 most recent years and who has a reasonable expectation of reaching the same income level in the current year
 - An individual whose individual net worth (or joint net worth with spouse) exceeds \$1,000,000
 - A director or executive officer of the issuer or its general partner
 - SEC proposal to revise criteria applicable to natural persons: Any natural person who (a) meets the net worth or income test specified above and (ii) owns at least \$2.5 million in investments

© Cartoonbank.com



"You're not in material breach, but you're not in full compliance, either."

Reg. D/Rule 506 Exemption

- Accredited Investor – Entities
 - Banks, savings and loan associations, registered broker dealers, insurance companies, registered investment companies, and SBICs
 - A corporation, partnership, business trust, or §501(c)(3) organization (i) with assets in excess of \$5,000,000 and (ii) not formed for the specific purpose of investing in the fund
 - A trust (i) with assets in excess of \$5,000,000, (ii) not formed for the specific purpose of investing in the fund, and (iii) whose purchase is directed by a sophisticated person
 - Government plan with total assets in excess of \$5,000,000

Reg. D/Rule 506 Exemption

- Accredited Investor – Entities (cont'd)
 - An ERISA plan (i) with assets in excess of \$5,000,000 or (ii) whose investment decision is made by a plan fiduciary that is a bank, savings and loan association, insurance company, or registered investment adviser
 - Self-directed plan whose investment decisions are made solely by persons who are accredited investors
 - A private business development company
 - An entity owned by accredited investors
 - The general partner of the issuer or its general partner

Reg. D/Rule 506 Exemption

- No "General Solicitation" or "General Advertising"
 - Limited Solicitation/Advertising is Acceptable
 - Does the offeror (and/or its agent) have a preexisting relationship with the proposed offeree such that the offeror (and/or its agent) is in a position to know that:
 - the proposed offeree has knowledge and experience in financial and business matters and
 - the proposed offeree is capable of evaluating the merit and risk of the proposed investment
 - Focus on quality rather than quantity
 - Utah Bar Journal Article

Reg. D/Rule 506 Exemption

- Ok to engage in one-on-one marketing to investors:
 - With whom the issuer (and/or its agent) has a pre-existing business relationship, and
 - Whom the issuer (and/or its agent) reasonably believes are accredited investors
- No mass mailings
- No advertisements
- No press releases
- No informational seminars

Reg. D/Rule 506 Exemption

- Electronic media may be used to deliver information provided that there has been no general solicitation
 - OK to use password-protected website or e-mail to deliver offering materials once prospective investors have been identified without general solicitation
 - Procedures to follow when using electronic media:
 - Ensure that any website containing fund documents or offering materials is password-protected
 - Provide the password to a limited number of investors with whom you have some basis upon which to conclude that the investor is sufficiently sophisticated to satisfy the requirements of Regulation D
 - Avoid providing the password to investors with whom you have no pre-existing relationship whatsoever
 - Keep detailed records of each potential investor to whom you distribute the password
 - Request that the recipient not forward the e-mail message to anyone

Reg. D/Rule 506 Exemption

- Resale Limitations
 - "The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters."
 - Reasonable care =
 - Reasonable inquiry to determine if purchaser is acquiring interests in the Company for investment purposes rather than resale
 - Legend in offering document indicating that securities have not been registered and cannot be sold unless they are registered or exempt from registration
 - Transfer restrictions in place

Reg. D/Rule 506 Exemption

- Form D Filing
 - File with SEC no later than 15 days after initial sale of securities – EDGAR, initially will take a couple days
- State Blue Sky Laws
 - Uniform Limited Offering Exemption adopted by NASAA in 1983 contains an optional provision that would allow coordination with Rule 506
 - Offerings exempted under Rule 506 are not subject to state registration requirement, but state may impose notice filing requirements
 - Generally no pre-sale filings
 - Post-sale filings
 - Exemptions vary by state

Reg. D/Rule 506 Exemption

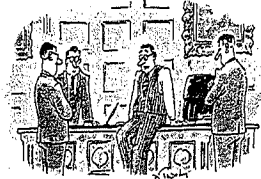
- Integration Rule
 - All sales that are part of the same Regulation D offering must meet all of the requirements of Regulation D
 - Prevents circumvention of registration requirements by separating single non-exempt offering into several exempt offerings
 - Safe harbor: Offers and sales made more than 6 months before start of offering and more than 6 months after completion of offering
 - Outside the safe harbor = Five-factor test:
 - single plan of financing
 - same class of security
 - made at or about the same time
 - same consideration
 - same general purpose

Other Statutory Issues

- Securities Exchange Act of 1934
- Investment Company Act of 1940
- US Patriot Act
- Privacy Rules

"We're too well connected for jail time,
but I worry a little about middle management."

© Cartoonbank.com



"We're too well connected for jail time, but I worry
a little about middle management."

Securities Exchange Act of 1934

- Rule 10b-5
 - Unlawful to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading
- 12(g) - <500 investors

Investment Company Act of 1940

- 3(c)(1) Exclusion: The 100 Person Fund
 - No public offering
 - ≤ 100 beneficial owners
 - >10% beneficial owners
 - "Formed for the purpose of"/40% rebuttable presumption test
 - Individualized investment decisions/self-directed plans

Investment Company Act of 1940

- 3(c)(7) Exclusion: The Qualified Purchaser Fund
 - No public offering
 - Qualified purchasers only
 - Individuals: \$5 million in investments
 - Entities: \$25 million in investments (or \$5 million for family companies)
- Knowledgeable Employees

Patriot Act

- Anti-Money Laundering (AML) Procedures for Financial Institutions
- Typical private equity fund exempt from formal requirements
- Executive Orders regarding Drug Kingpins/Terrorists
- Common to ask for AML representations and remedies

Privacy Rules

- Applies to individual investors/IRAs/401(k)s
- Privacy Policy regarding use of personal information

Licensing Requirements

- Issuer Agent
- Investment Advisor
- Broker Dealer



Issuer Agent

- Utah Uniform Securities Act 61-1-13 (2)
(2) "Agent" means any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities.

Investment Advisor

- any person who, for compensation, engages in the business of advising others ..., as to the value of securities or as to the advisability of investing in, purchasing, or selling securities,
- 'investment adviser' also includes financial planners and other persons who, as an integral component of other financially related services, provide the foregoing investment advisory services to others for compensation and as part of a business or who hold themselves out as providing the foregoing investment advisory services to others for compensation.

Broker-Dealer

Utah Uniform Securities Act 61-1-13 (3)

(3) "Broker-dealer" means any person engaged in the business of effecting transaction in securities for the account of others or for his own account...

Utah Uniform Securities Act 61-1-13(19)

(19) "Person" means an individual, a corporation, a partnership, a limited liability company, an association, a joint-stock company, a joint venture, a trust where the interest of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government.

Finders – No such thing

- Black's Law Dictionary, Sixth Edition, defines a finder as "an intermediary who contracts to find, introduce and bring together parties to a business opportunity, leaving ultimate negotiations and consummation of business transactions to the principals."
- Finders usually charge a transaction fee based on the amount of capital which the finders are responsible for bringing to the company. This type of compensation is commonly referred to as a "finders fee" and is usually paid in either securities or in cash (or a combination of both) as a percentage of the money raised (generally around 5-10%).
- Unlike a registered broker-dealer, a finder is an unregistered intermediary that assists companies in raising capital. Within certain limits, a finder may operate within applicable legal requirements. The SEC has recognized that a person who only occasionally makes mere introductions of potential investors to issuers, either for free or under a non-contingent fee arrangement, and not more, is a finder who does not need to register as a broker. Through the use of No-Action letters, the SEC has attempted to promote additional standards by which finders may legally operate and, in certain circumstances, receive a transaction based fee.

Paul Anka – Put Your Head on My Shoulder

The following summarizes the important factors considered by the SEC when issuing the Anka No-Action letter:

- Anka only provided names and contact information for prospective purchasers;
- The sales of the securities were to be made in compliance with the Securities Act of 1933;
- There was a bona fide, pre-existing relationship between Anka and his referrals;
- Anka would not advertise, endorse or solicit investors;
- Anka would not have personal contact with prospective investors regarding the investment;
- Only officers and directors of the Senators would contact the potential investors;
- Compensation paid to the Senators' officers and directors would comply with SEC Rule 3a-1, which governs compensating issuer agents;
- Anka would not provide financing for an investor;
- Anka would not perform due diligence on the Senator's offering; and
- Anka had never been a broker-dealer or registered representative of a broker-dealer.
- While the Utah Division of Securities has stated that it will respect the Anka No-Action letter, it must be emphasized that the exception to using finders in capital raising transactions offered by such Letter is extremely narrow and the SEC has said it would rule differently today.

Civil Liabilities



As your attorney, Roger, I feel it's my duty to charge you an enormous amount of money.



Horizontal lines for notes.

61-1-22 Rescission Offering Statute

- (1) (a) This Subsection (1) applies to a person who:
 - (i) offers or sells a security in violation of:
 - (A) Subsection 61-1-3(1) [using unlicensed persons];
 - (B) Section 61-1-7 [not registering or qualifying for an exemption];
 - (C) Subsection 61-1-17(2);
 - (D) a rule or order under Section 61-1-15, which requires the affirmative approval of sales literature before it is used; or
 - (E) a condition imposed under Subsection 61-1-10(4) or 61-1-11(7); or
 - (ii) offers, sells, or purchases a security in violation of Subsection 61-1-1(2) [10(b)-5].
- (b) A person described in Subsection (1)(a) is liable to a person selling the security to or buying the security from the person described in Subsection (1)(a). The person to whom the person described in Subsection (1)(a) is liable may sue either at law or in equity to recover the consideration paid for the security, together with interest at 12% per year from the date of payment, costs, and reasonable attorney fees, less the amount of income received on the security, upon the tender of the security or for damages if the person no longer owns the security.



Horizontal lines for notes.

61-1-22 Rescission Offering Statute

- (4) (a) Every person who directly or indirectly controls a seller or buyer liable under Subsection (1), every partner, officer, or director of such a seller or buyer, every person occupying a similar status or performing similar functions, every employee of such a seller or buyer who materially aids in the sale or purchase, and every broker-dealer or agent who materially aids in the sale or purchase are also liable jointly and severally with and to the same extent as the seller or purchaser, unless the nonseller or nonpurchaser who is so liable sustains the burden of proof that the nonseller or nonpurchaser did not know, and in exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

Horizontal lines for notes.

Time Restrictions



- **61-1-22. Sales and purchases in violation - Remedies - Limitation of actions.**

(7) (a) An action may not be maintained to enforce liability under this section unless brought before the earlier of:

(i) the expiration of five years after the act or transaction constituting the violation; or

(ii) the expiration of two years after the discovery by the plaintiff of the facts constituting the violation.

Criminal Liabilities

- **“It’s the S.E.C. How do you plead?”**

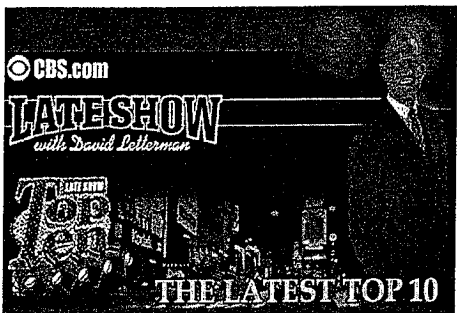


61-1-21 – Criminal Penalties for Violations

- A person is guilty of a third degree felony (0-5 years) who willfully violates...[the State Securities laws] (other than 61-1-1)
- A person who willfully violates Section 61-1-1 (basically fraud or you make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading)
 - is guilty of a third degree felony (0-5 years)if... [security] was worth less than \$10,000;
 - is guilty of a second degree felony (1-15 years)if:
 - ...[the amount] was worth \$10,000 or more; or
 - ...[the amount] was worth less than \$10,000; and
 - in connection with that violation, the violator knowingly accepted any money representing (i) equity in a person's home; or (ii) a withdrawal from an IRA or other retirement account.
 - is guilty of a second degree felony punishable by imprisonment for an indeterminate term of not less than three years or more than 15 years if:
 - ... [the amount] was worth more than \$10,000; and
 - in connection with that violation, the violator knowingly accepted any money representing (i) equity in a person's home; or (ii) a withdrawal from an IRA or other retirement account.



Utah Division of Securities Top Ten Investment Scams



Utah Division of Securities Top Ten Investment Scams

10. Promissory Notes or Guarantees

- More than 40% of frauds prosecuted in 2006 involved the sale of promissory notes or guarantees given by promoters.
- When promissory notes or guarantees are given to investors in return for an investment of money, the notes are securities and the sellers must comply with securities laws.

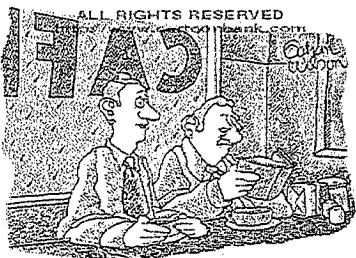
9. Deceptive Internet Investing

- Many internet web sites offer investment programs; few are managed by licensed securities brokers; many are completely fraudulent.

8. Oil and Gas Investments

- The high price of gasoline is leading to a spurt of investment frauds relating to claims the investor can own part of an oil well. Fraud is expected to increase, including claims of new technology for extracting oil from tar sands or oil shale. Investors should consult with experts before making any investment in this highly technical area and make sure the securities are registered.

"I've just joined a support group for boring people"



"I've just joined a support group for boring people."

Utah Division of Securities Top Ten Investment Scams

7. Foreign Currency Trading

- Beware of promoters claiming special expertise in buying and selling international currencies as there has been an increase in people claiming to make huge profit trading currencies.

6. Church Frauds/Affinity Frauds

- One of the most effective ways to defraud others is to belong to their church or have some other shared association such as serving on the PTA, coaching kids' sports or being co-workers; people naturally trust those with whom they associate and ask fewer questions.

5. "Hot-Tip" Stock Recommendations via E-mail

- The most prevalent unsolicited e-mails now offer stock tips
- Some e-mails pretend to confirm inside information directed to another person.

Utah Division of Securities Top Ten Investment Scams

4. Prime Banks

- Investors are told they will receive high-yield, tax-free returns through trading by international elite or "prime" banks and are told there is no risk because their money will never leave their control in bank accounts.

3. "Free Meal" Seminars for Seniors

- Many seniors receive invitations to seminars offering investment advice and are told they can increase investment income, avoid taxes and earn safe and guaranteed returns.

2. Note Brokering

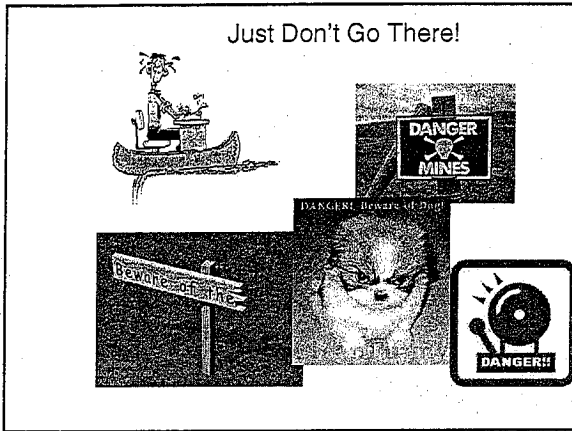
- Loan brokers must be licensed as securities brokers to sell notes.
- The buying and selling of notes for investments requires a securities license and full disclosure to customers.

Utah Division of Securities Top Ten Investment Scams

1. Real Estate Investments

- Scams take several forms:
 - Using credit (or credit score) to allow promoters to buy and resell homes. (Case law equates credit score to cash investment, See Hector v. Wiens, 533 F.2d 429, 432 (9th Cir. 1976))
 - Borrowing money to buy and sell (flip) real estate.
 - Buying homes at inflated prices in names of investors with expectation that money will be left over to invest.
 - Investments in "hard money" lending used to finance high-interest home loans (promising investors 2-4% interest per month).
 - Claiming that real estate collateral means the investment has no risk.
- Investors should beware of any promoter suggesting that the investor borrow money from home equity to make an investment.

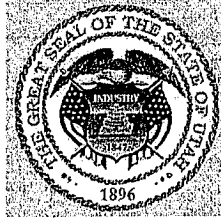




- Seven Most Common Warning Signs of Investment Fraud**
1. Promises of high returns. Any claim that money can be doubled in six months is a fraud.
 2. Claims that the investment is guaranteed or that it has little or no risk.
 3. Pressure to invest immediately because there is a deadline or only a few openings left.
 4. Encouragement to borrow money from home equity to maximize profit. Because all investments involve risk, no legitimate securities broker will recommend using home equity to make an investment.
 5. Vague descriptions about how money will be used or what the company does.
 6. Claims that other people have already checked out the investment and are investing. These may include well known members of the community or people within your affinity group (church, workplace or service organization).
 7. The assertion that this investment involves new technology that can solve a problem that big companies in this industry have been unable to solve (such as drilling for oil in new places, new pharmaceuticals that cure well known diseases or high-tech inventions).

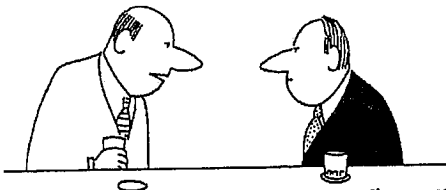
- What Can Investors Do to Protect Themselves?**
- Three questions every investor should ask:
1. Is the person offering the investment licensed?
 2. Is the stock offering registered?
-- All securities sold in the state must be registered or exempt.
 3. What Information am I receiving:
 1. Did the promoter give a written prospectus summarizing the investment?
 2. Did he or she give a copy of the financial statements showing how the company is doing?
 3. Has the promoter disclosed prior business success or any previous criminal convictions or bankruptcies?

Utah Division of Securities



(801) 530-6600

<http://www.securities.state.ut.us/>
(Contact for a second opinion - very helpful staff!)



I consider myself a passionate man, but, of course, a lawyer first.

Cravotto
