THE LOGIC OF SECURITIES LAWS

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Carol Bavousett Mattick has been practicing corporate and securities law for over 25 years, working primarily with privately held companies. The firm is a solo practice with of-counsel and other affiliations that can bring to bear the time and talents of a team with the particular legal and non-legal expertise needed by clients. A substantial part of Ms. Mattick's practice involves working with company CEOs to put themselves in a position to harvest the value created in their businesses – whether through purchase of equity by key employees; a sale of the business to a third party; or a strategic investment in the company by a larger company in the same or complimentary industry. She represents privately held companies with up to $50 million in annual revenues being acquired or on the "sell side".

Carol's assignments for clients have included acting as part-time in-house counsel for a medical device company and a rail logistics company; working with companies seeking private equity capital; representation of "angel" investors; representing senior executives with respect to employment and incentive compensation packages as they go from pre- IPO to post-IPO and cashing out those incentive packages; working with companies developing intellectual property assets and/or engaged in product development with a "license out" business model; forming non-profit entities complimentary to for-profit businesses and seeking tax exempt status for them; and other kinds of business transactions and contract drafting.

Her skill sets also include formation and registration of investment advisers; representation of registered investment advisers and their private funds, particularly with respect to compliance requirements; representation of bankrupt companies regarding securities issuances and reporting post-bankruptcy; representation of persons and companies in investigations by state and federal securities regulators; seeking no-action letter rulings from the SEC; and consulting expert witness engagements relating to securities law.

Carol Mattick graduated with a law degree and master's degree in business administration simultaneously from University of Texas at Austin. After a four year stint with a large law firm in San Antonio, Texas, she began a solo law practice dedicated solely to providing corporate and securities law advice to growing companies. Since 1998, she has maintained offices in two cities, Austin and San Antonio, and draws clients from both metro areas as well as around the state of Texas and beyond.

In order to teach, one really has to know a subject backwards and forwards. Ms. Mattick has taught the subjects in which she practices law to MBA level graduate students at UT Austin in the Masters in Science and Technology Commercialization offered by that institution's IC2 Institute. IC2 was founded by George Kozmetsky after his stint as dean of the UT business school and was the original parent organization for the Austin Technology Incubator and the Capital Network. Carol has also provided curriculum in these areas for IC2's Global Communications Group which teaches IC2's economic development lessons in countries around the world. In San Antonio, she was a founding board member of the San Antonio Technology Accelerator Initiative, now called StarTech, from its founding in 1999 to 2005 and a member of Geekdom beginning in 2012.

Carol teaches other lawyers in her areas of expertise through the continuing education programs all lawyers must take to maintain their licenses. She has been a member of the planning committee of UT Law's Conference on Securities Regulation and Business Law Problems for many years, has been a speaker at that conference and has or will co-chair it in 2010, 2011, 2012 and 2015; She was a creator and co-chair of the planning committee of UT

Law’s Private Companies Institute. Carol has been featured as a speaker multiple times at the State Bar of Texas’ courses in Advanced Business Law, the Essentials of Business Law and Representing Small Businesses, She has spoken at meetings of the ABA Section on Taxation, Closely Held Businesses committee and the ABA Section on Business Law, State Securities Regulation committee. Carol also serves on the advisory group to the Transactional Law Center at South Texas College of Law in Houston. That program teaches law students fundamental areas of business law through courses organized around structuring and completing particular kinds of business transactions.

Ms. Mattick has led the state bar committee most responsible for affecting federal and state securities law and regulation. Carol has been a member of the Securities Law committee of the Business Law Section of the State Bar of Texas for twenty years and chaired that committee from 2005 - 2013. Under Carol’s leadership, the Securities Law committee worked with state regulators to draft rules and proposed statutory changes to allow state law to work better with the recent changes on the federal level under the Dodd-Frank financial regulatory reform act and the more recent JOBS Act. As a member of the Business Law Section’s governing council since 2008, Carol is part of the leadership of the Section. At the same time, Carol serves as a member of the corporation laws committee of the Business Law Section.

Carol lives in San Antonio with her husband, Steve, and large hounds “Bella” and “Bruno”. She works in the community with a number of organizations, including with the Girl Scouts since 1992 and SA 2020.

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> *"R Allan Stanford ("Stanford") created and perpetrated a Ponzi scheme that has given rise to issues of fraudulent conveyance law which this appeal requires us to consider. What follows is a simplified overview of how the scheme operated: Stanford created and owned Stanford International Bank, Ltd ("SIBL") and a network of other entities (collectively, the "Stanford corporations") through which he sold certificates of deposit ("CD's") to the investing public, promising extraordinarily high rates of return. Through his corporations, Stanford represented to prospective investors that their funds would be re-invested in high quality securities so as to yield the high rates of return purportedly guaranteed by the CDs. The vast majority of the money thus raised was not invested in legitimate securities but rather was used mainly to pay investors the promised returns. This gave the scheme credibility, enabling Stanford to sell addtitional CDs. Although precisely when the scheme was launched is not certain, the Receiver presented the expert opinion of a certified public accountant.... who...***determined that the Stanford Ponzi scheme began and was insolvent as early as 1999*** *and that it was continuously operating in this manner and condition until it began to unravel in October 2008."*
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> *Janvey v Democratic Senatorial Campaign Committee, et. al. Case No 11-10704, 712 F.3d 185 (5th Cir. 2013).*

After the fact, it is relatively easy for regulators, accountants, and litigators to determine that a Ponzi scheme occurred and when a business was insolvent.[1] Perhaps Allan Stanford had fraudulent intent from the beginning. However, many business lawyers have represented growing businesses that were trying to raise equity capital and were technically or even obviously insolvent at the time of the capital raise. A business needing to raise equity capital is, by definition, undercapitalized. This is particularly true of smaller businesses.

Substitute these for some of the facts in the description of the Stanford Ponzi scheme: Stanford had a business that developed and sold software. Rather than take on "partners", Stanford decided that he would like to borrow from investors and entered into promissory notes with five investors that had interest rates of 10% and were due, principal and interest, in 2 years. The investors were happy because it was hard to obtain a 10% return in the market. Stanford was happy because he did not have to give up ownership to fund his business.

[1] See The SEC's Office of Inspector General, Report of Investigation, "Investigation into the SEC's Response to Concerns Relating to Robert Allan Stanford's Alleged Ponzi Scheme", Case No OIG-526, March 31, 2010, which details that the SEC had concerns as early as 1997 and tips or complaints as early as 2003.

During the first year, Stanford's business did not have a lot of sales and Stanford used the proceeds of the loans to pay operating expenses. During the second year, Stanford may progress in increasing sales but was still operating at an accounting loss. Furthermore, Stanford's balance sheet showed more debt than asset value. When it came time to pay off the original set of five notes, Stanford asked the investors whether they would like to be cashed out or receive their interest earned and lend their money for another 2 years. Some investors decided to cash out and some decided to re-invest. Stanford found other investors to take the place of some of the departing investors and used part of the proceeds from the new loans to pay off the departing investors and pay the return of the re-investing investors. Is this re-imagined Stanford operating a Ponzi scheme? If so, when did it start?

The purpose of this paper is to help business lawyers who are not securities law specialists to identify when they have securities law issues in their practices. It is divided into three sections: 1) When is your client issuing securities? (And, when could it, thereby, be engaged in a Ponzi scheme?) 2) When can someone involved in one of your clients' transaction take a success fee? 3) Under what circumstances can a group of people come together, pool their money and invest as a group?

I. WHEN IS YOUR CLIENT ISSUING SECURITIES? (AND WHEN COULD IT THEREBY BE ENGAGED IN A PONZI SCHEME?)

The Seminal Test

Every business lawyer should read the *Howey* case. [2] This is the seminal U.S. Supreme Court case that defines what combination of facts and circumstances can come together to result in a business having offered and sold securities and therefore, be subject to federal and state securities laws. The Howey case involved the sale of "units" of a tract of real property (which could be interpreted to be sales of parcels of land) coupled with a contract with the previous (or is it still the current?) owner of the property to manage, harvest and sell the citrus fruit produced by the grove of trees on the land. The Supreme Court decided that if a transaction involves an investment of money in a common enterprise with profits to come solely from the efforts of others, it constitutes an offer and sale of a security – regardless of the terms or structure of the transaction.

Lessons Learned: All Businesses Need Patient (Usually Equity) Capital

All businesses need equity capital. Businesses come in all shapes and with all kinds of characteristics. Some are capital intensive. Some are in industries

[2] S.E.C. v W.J. Howey Co. , 398 U.S. 293 (1946)

with razor thin profit margins. Alternately, some businesses are in industries with much larger marginal profit margins, meaning that once they develop their product, it costs almost nothing to produce another unit. Some businesses simply have a better business plan than their industry peers (or a revolutionary one) that allows them to be more profitable. Some may have to achieve economies of scale to achieve profitability. As a business lawyer, be aware of these differences because they play into whether it is going to be possible for your client to *return capital* *and* *an investment return* to outside investors. After all, that is what outside investors are looking for. These business characteristics will also inform how that goal might be achieved. If, for some reason, it will not be possible to give outside investors a return of their capital invested plus an investment return or profit, you can help your client avoid a lot of difficulty and potential liability by discouraging them from seeking equity capital from outside investors.

While all businesses need equity capital, the characteristics of different businesses mean they may go about it in a wide variety of ways: saving up money to start a business; getting a loan from friends or family; saving up net profits as the business operates and "plowing it back" into the business; selling equity interests in the business to friends and family; selling equity interests to a small group of outsiders such as angel investors or venture capital funds; selling equity interests to a wider group of people – the crowd or the public; selling a series of debt securities, whether simply promissory notes or subordinated debentures, to others or some combination of the above.

Loans – A Cautionary Tale

The need for equity capital sometimes becomes apparent in lending relationships or in the quest for a loan. When traditional lenders and their lending committees decline to make a loan, the underlying cause is often a lack of equity capital or experience in business or both. Traditional, regulated banks want to lend to clients in two situations: 1) to smooth out timing differences in cash inflows that a business is relatively certain are coming in vs its outflows; and 2) to finance long term assets. While traditional lenders advertise that they help their clients grow their businesses, it is important for business lawyers to realize that the statement is only true if the growth is relatively slow or if the anticipated large cash inflows are exceedingly certain. Conversely, it is important to realize loans from traditional lenders are not a method for funding a fast growing business. For that, a business client needs equity capital.

Experienced business lawyers all know clients that have stretched the limits of traditional bank financing, have robbed Peter to pay Paul and somehow always managed to meet their loan payments and covenants. Businesses may be able to strain their lending facilities for a short period of time and enable growth of the business as a result. The ability to do that depends a lot on the characteristics of the business that have been discussed earlier. However, those business lawyers also know clients that have gone into default, loan workouts and foreclosure.

A Fresh Start: Cautionary Tales

Business lawyers sometimes deal with a particular subset of businesses that don't have enough equity capital: people who have performed key roles in a much larger, more established organization who now want to go out and recreate the same business for themselves. Very often, they do not understand what a substantial balance sheet had allowed them to do in the context of a larger organization that they may not be able to do now. Nor do they understand that they are under greater securities regulatory risk than they would have been in the larger organization. Smaller businesses are more likely to be undercapitalized and are more at risk to go out of business – both facts that may put them in the crosshairs of securities regulators if they issue securities to enable growth of the business.

Every once in awhile, a business lawyer is confronted with an entrepreneur that has raised equity capital in the past and was not able to be successful with the business for which the money was raised. Now that entrepreneur is starting a new business and is seeking a business lawyer's help. It is very difficult to separate out the prototypical entrepreneur who had an ambitious idea for a business that failed and should be allowed to try again from the person who is just not very good at business and should not try again -- at least with other people's money. I believe business lawyers have an ethical obligation to do some due diligence about this issue and attempt to dissuade people who don't seem to have the best business mind from raising equity capital.

One key bit of information is what the investors in the former business think of the entrepreneur. Did they understand the risks they were taking and the business was simply overtaken by external factors? Another key bit of information is how did the entrepreneur treat the investors in the former business. If the new business is in the same industry or product area, did the entrepreneur include the investors from the former business in the new business in some way – through equity interests, or a royalty or through a material contract? Did the entrepreneur acknowledge any kind of obligation to the investors in the former business, even though it is not a legal obligation? On the other end of the scale, if the entrepreneur's primary skill seems to be raising money rather than running a business, it may be best to dissuade that person from raising capital or decline the representation. This is particularly true when the entrepreneur's primary skill is raising money in the $20,000 - $50,000 - $100,000 range from each investor. These could very well be ordinary people rather than professional investors.

People running and investing in technology-based or "new economy" businesses have a very different yardstick when considering these issues than people running and investing in "old economy" businesses. For instance, the 25 year old running a tech start up is not likely to have great skill in running a business. In these situations, the key bit of information is how sophisticated and professional are the investors. No one in these transactions seems to feel the entrepreneur owes something to investors in a failed venture.

How Can A Legitimate Business End Up Engaged in a Ponzi Scheme?

The answer to the question initially posed in this paper lies in the premise that all businesses need equity capital and many of them don't have enough of it. In the Stanford scenario I re-imagined, the test for securities regulators investigating complaints from investors would be whether the business had enough assets to pull re-payment of the investor from those assets already on the balance sheet rather than from new money coming in from new investors. Those additional assets can come from a long period of growing shareholders' equity on the balance sheet (otherwise known as re-investing profits) or they can come from an outside source – but only certain outside sources such as a loan from a bank or investment of savings of one of the principals.

The Framework or Structure of Securities Offering Regulation

The framework of securities regulation was first instituted in the early 20th century. That framework, much of which is still in operation, assumes that every time a business raises capital that business is an "issuer" issuing securities or a stake of some sort in that business. And, whether the effort to raise capital is organized and has a beginning and end or is more haphazard, it is considered to be a securities "offering". These assumptions apply whether the business raises *equity* capital from one person or many persons. It also applies when a business owner sells all of his or her business to another person *by means of transferring the equity ownership.* The only commonly used exception is a one-on-one "business to lender" transaction. When a business obtains a loan from a single lender, it is not issuing securities. When a business arranges multiple loans from multiple lenders at one time where the terms of the notes are substantially the same (as in the re-imagined Stanford example), it is issuing securities in the form of notes. They are simply debt securities instead of equity securities.

When the securities regulatory framework was originally set up, the states led the way. States were the first to enact laws that set up a process for raising capital with which businesses had to comply and that dealt with fraud in the process (often called "Blue Sky" laws).[3] After the 1929 stock market crash, the federal government enacted a similar and parallel system of regulation of offerings as well as regulation of many other participants in the markets. For a time, it was assumed that states could regulate securities offerings because it was possible for a company to raise capital entirely within one state. The

[3] Hall v Geiger-Jones Co, 242 U.S. 549 (1917); Jonathan R. Macey, Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 Tex L Rev 348 (1991)

federal government's right to regulate "interstate commerce" under the U.S. Constitution was litigated as the country became more and more connected and the federal government prevailed. As broader interpretations of the concept were accepted, the SEC took the position that any issuer that used the U.S. mail or other common carrier systems in the course of raising capital was engaging in "interstate commerce" and had to comply with the federal securities laws and regulations.[4] Now, with enactment of intrastate crowdfunding statutes and rules[5], advocates and regulators alike are dusting off the idea that a business can raise capital entirely within one state.[6] However, an issuer would still have to be in compliance with a federal exemption from registration of the offering.[7]

To that point, the securities regulation framework provides that any attempt to offer securities has to comply with registration or an exemption from the requirement to register *the offering* at both the state and federal levels. Companies that do registered offerings are called "public" companies and are considered to be "publicly held" or "publicly traded.[8] Prior to the Jumpstart Our Business Startups Act (or "JOBS" Act), businesses that raised capital in non-registered or exempt offerings were considered "privately held" and the offerings were called "private offerings". Now, courtesy of the JOBS Act of 2012, Rule 506(c) of Regulation "D" ("Reg D") and equity crowdfunding, businesses may act more publicly as they try to attract investors through exempt offerings.[9]

The purpose of this paper is not to teach the reader how to do a securities offering or what all of the options are for meeting exemptions from the requirement to register an offering. Instead, we will cover the basic precepts of securities offerings: information disclosure and avoidance of misleading statements and omissions.

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4 NLRB v Jones & Laughlin Steel Corp, 301 U.S. 1(1937)

5 Texas' new intrastate crowdfunding rule for issuers, 7 Tex. Admin. Code Sec §139.25

6 SEC Release 33-9973, 80 F.R.69786 (October 30, 2015), *Exemptions to Facilitate Intrastate and Regional Securities Offerings*.

7 On the federal level, there is a statutory exemption under the Securities Act of 1933, Section 3(a)(11) that provides: "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." and an accompanying rule, Rule 147, 17 CFR 230.147.

8 Businesses that reach a certain size in terms of assets or that have a base of security holders as large as 2,000 also have to subject themselves to registration, meaning that they must comply with the ongoing reporting requirements of the Securities Exchange Act of 1934 (the "'34 Act"), Section 12(g)(1). 15 USC 78l(1)

9 JumpStart Our Business Start-Ups Act (the "JOBS" Act) Titles II and III, 17 CFR 230.506(c) and 17 CFR 227.400 et. al.

The Need to Disclose Information to Prospective Investors

A fundamental requirement of a securities offering is that the issuer must put together some package of information about the business, its past performance and future plans and give that information to investors prior to their commitment to invest. In SEC v. Ralston Purina, 346 U.S. 119, 124 (1953), the U.S. Supreme Court said that the federal securities laws exist "to protect investors by promoting full disclosure of information thought necessary to informed investment decisions." Business lawyers need to help their clients pull together the information – whether positive, flattering, damaging or relating to potential risks. The standard is *all of the information necessary for the investor to make an informed investment decision.*[10] The type of narrative and financial information required will depend, in part, on the exemptions (state and federal) with which the issuer is complying and the type of investor to which it is selling. Despite what business lawyers may have heard, it is simply untrue that some situations *do not require* information disclosure.[11]

Avoid Misstatements or Omissions That Would Make the Information Actually Presented Misleading.

Another fundamental principal of securities offering regulation is that when an issuer discloses the information about its business to prospective investors, the issuer has a responsibility to ensure that information contains no affirmative misstatements nor any omissions of information that would make the information actually provided misleading.[12] If the information provided

[10] Different securities lawyers have different methods for eliciting this information. One of my favorites is to ask a client to engage in a timeline exercise: What has to happen, what material contracts need to be entered into, what permit is necessary, what document needs to be filed, what expenses need to be incurred etc. in order for the business growth you are seeking to come to fruition? And for investors to receive a return on capital plus an investment return? Others ask the client, "What keeps you up at night?"

[11] Rule 502(b)(1), 17 CFR Sec 230.502(b)(1), specifies the same type of information that issuers must provide under Regulation A or under the particular registration statement that the issuer would otherwise have to file *if it is offering securities to non-accredited investors*. The subsection further states that "The issuer is not required to furnish the *specified* information to purchasers when it sells securities under §230.504, or to any accredited investor". However, the issuer is still subject to the antifraud provisions of the '33 Act when it is offering to accredited investors. As a practical matter, issuers who offer to accredited investors still have to give them the information necessary for them to make an informed investment decision. They are simply free to do so in whatever format and with whatever information is relevant to their businesses.

[12] Section 17 of the '33 Act is the general antifraud provision relating to securities offerings. Section 17(a)(2) states, in part, that "it is unlawful for any person…. Directly or indirectly…to obtain money… by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading.". On the state level, Texas Securities Act ("TSA") §33(a)(2) contains similar language

contains misstatements or omissions and an investor sustains a loss in the value of his or her interest in the business, that person can sue business and perhaps the principals of the business for fraud.[13] In addition, the investor can complain to federal and/or state securities regulatory authorities that can take action on their own.[14] Typically, an investor complaint will trigger at least an investigation of the business and its offering.

II. WHEN CAN SOMEONE INVOLVED IN ONE OF YOUR CLIENTS' TRANSACTIONS TAKE A SUCCESS FEE?

Why is this topic important? If you talk to any entrepreneur who has a growing business, he or she will tell you that raising equity capital is one of the hardest things to do and takes up an incredible amount of time. People who know potential investors and/or make a business out of cultivating potential investors for a particular type of business are very useful to know. They help make the process of raising equity capital easier.

However, it is also true that coverage of particular markets or classes of companies by what we will call "securities intermediaries" is spotty at best. The financial incentives for securities intermediaries are greater the larger the capital raise and greater with respect to publicly trade-able securities. This topic is also long and complicated and requires companies raising equity capital to know whether people involved with the equity raise are qualified to act in a support role -- or not. This is important because some (if not all) of the exemptions from securities offering registration which companies will be using are now conditioned on "bad actors" not being involved in the transaction.

Is There a Security Involved?

The threshold question is whether the transaction involves the purchase or sale of a security. In Article I, we have set out the general parameters and a number of fact situations in which the purchase or sale of a security occurs. However, this Article deals with third parties that are not issuers themselves (and may or may not be affiliated with an issuer) and whether these persons can take a success fee when they are involved in some way in a capital raising transaction. First, let's rule out those transactions in which such a person

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[13] It is well established that investors have a private clause of action to sue an issuer under §17 of the '33 Act. See Dorfman v First Boston Corp 336 F. Supp 1089 (E.D. Pa, 1972) And, under §10(b) of the '34 Act. See Superintendent of Ins. v Bankers Life and Casualty Co 404 U.S. 6 (1971). On the state level, TSA §33(a)(2) Geodyne Energy Income Production Partnership – E v Newton 97 SW 3rd 779 (Tex Civ App – Dallas 2003) petition denied.

[14] The securities regulatory agencies all have the ability to initiate and pursue violations of these statutes. See §§8A and 20 of the '33 Act. See §§23, 28,29, 32, 33.

could receive a success fee and not be a securities intermediary. A third party could be acting as a real estate broker or as an employee or consultant who is instrumental in landing a material contract for the business. Those don't have to involve a sale of a security although the first example could. In fact, one could even take a percentage of the gross revenues (or more likely, profit) experienced by the company as a result of the performance of the contract and not be considered a securities intermediary.

Second Level Inquiries

However, if the employment relationship or consulting transaction *is not clearly something other than* a transaction involving the purchase or sale of a security, there is a second level of inquiries that must be made:

1. For whom is the third party working, either as an employee or engaged as a third party consultant?

In the purchase and sale of a security, the third party will typically work for either the issuer or the potential investor but not both. The paradigm when dealing with publicly traded securities is that a securities broker works for the investor. However, in equity capital raising transactions by non-public companies, a securities broker is more likely to be working for the issuer and could be working for either. Even though it is possible for someone to act as a "finder" or to be tasked with "looking for deal flow" for a private equity firm investor, a person is more likely to be considered a securities intermediary in a non-public capital transaction if working for an issuer.

2. From whom is the third party's compensation being paid?

If a third party is helping an issuer in a non-public capital raising transaction and is taking a commission equal to a percentage of the monies raised for the issuer, one could argue that the investor is really paying the third party. That is certainly a fact that needs to be disclosed to a potential investor. However, the key question is who has the legal obligation to pay the third party. In most of those cases, the issuer has the legal obligation.

3. What is the stated purpose of the employment or engagement?

A third party may start his or her relationship with the issuer as a management consultant, helping a company create a strategic plan or helping that company obtain bank financing; as a valuation expert helping a company value itself; as a marketing adviser helping the company market itself and its products or services; as a lawyer or as an accountant. However, people in these positions often know wealthy individuals, professional angel investors, venture capital and private equity firms and people in larger companies that would be good strategic partners. Business lawyers need to ask what facts and circumstances would change the purpose of the employment or engagement from one of these above-mentioned endeavors to primarily one of helping raise equity capital.

4. How is the third party's compensation calculated?

Compensation that is based on the dollar value of investments coming in to a company and only paid when those investments are made is obviously related to the purchase and sale of a security. However, there are many ways in which compensation can be calculated and many points in the transaction at which compensation may be paid.

5. Given all of the facts and circumstances, is the third party involved in enough of the indices of being a securities broker laid out by the SEC in prior enforcement actions or no-action letters that the SEC would deem him or her (or his or her firm) a broker?

During a flurry in the 1970's and 1980's[15] and again more recently[16], the SEC has dealt with different fact patterns and determined what factors it considers in determining whether a person or firm is acting as a securities broker and should be registered. In very distilled terms, they ask whether the intermediary has been: (1) involved in negotiations; (2) engaged in solicitation of investors; (3) discussed details of the nature of the securities or made recommendations to the prospective buyer or seller; (4) compensated on a transaction-related basis; and (5) previously involved in the sale of securities and/or was disciplined for prior securities activities.[17]

One can see that the professional services listed in step 3 above could involve some of these factors. The last factor relates to whether the intermediary might have previously had his or her broker's license suspended and is now trying to do the same work without being licensed. This factor is in line with the recent efforts to impose new requirements on issuers to determine whether anyone involved in their offerings of securities (including intermediaries) have been "bad actors" and to deny the use of certain exempt offering provisions (like Reg D) to those issuers.[18]

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15 *Mike Bantuveris,* SEC No-Action Letter (Oct. 23, 1975); *Paul Anka*, SEC No-Action Letter (July 24, 1991); *May-Pac Management Co*., SEC No-Action Letter (Dec. 20, 1973); *Caplin & Drysdale, Chartered*, SEC No-Action Letter (Apr. 8, 1982); *Victoria Bancroft*, SEC No-action Letter (August 9, 1987); *Ewing Capital, Inc*., SEC No-Action Letter (Jan. 22, 1985).

16 See the exposition of four more recent no action letters relating to Finders, below.

17 See ABA Report and Recommendations of the Task Force on Private Placement Broker Dealers, June 7, 2005. ("Task Force Report")

18 Under Dodd Frank, Congress added a requirement that all issuers raising equity capital under Reg D Rule 506 must ensure that no one associated with the issuer can have had any one of a number of negative events relating to securities or financial fraud on their records. Otherwise, the exemption is not available. See Rule 506(d), 17 CFR §230.506(d).

All Securities Intermediaries Are Required to Register on Federal or State Level -- or Both

If a business lawyer determines through the foregoing analysis that someone involved in a client transaction is acting as a securities intermediary, we must go back to that securities regulation framework mentioned earlier. Both state and federal securities laws require *any person who operates as an intermediary in a securities transaction be registered* as a securities broker, dealer or other securities intermediary or be able to claim an exemption from regulated persons registration.

If you have been practicing law or have otherwise been involved in business for awhile, your reality and what you have seen transpire in transactions may not square at all with the careful inquiry set forth above and the proposition that securities intermediaries must be registered. However, it is the truth. And, federal and state securities regulatory agencies absolutely believe it to be the truth. The plausible explanations for this mis-match of reality to regulation are that securities regulatory agencies: 1) have prosecutorial discretion, including when to press registration violations, and have determined not to do so in every case; and 2) have small staffs and therefore have to pick and choose which violations within all of their jurisdictions they are going to go after.

On the federal level, the SEC has delegated much of its intermediary regulatory authority to the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization of broker-dealer members. On the state level, any person engaged in selling, soliciting subscriptions or inviting offers to buy securities must register as a "dealer". Unlike the registration of offerings, efforts to pre-empt regulation on the state level have not touched registration requirements for relevant kinds of intermediaries.

For purposes of the discussion in Article II, let's set aside securities intermediaries who are investment advisers. While their role in recommending investments has become more similar to the role of a broker – particularly with respect to private investment funds they may advise – investment adviser compensation has generally been a small percentage of the assets they "manage" for their investor clients and is earned over time. Even when they receive "performance fees", investment advisers make money when their clients' investments appreciate in value – not when the investment is made.

What constitutes acting as an securities intermediary who could legally take a success fee in a business law client's transactions? The relevant kinds of securities intermediaries are: 1) brokers, defined differently on the federal vs state level; 2) business brokers or mergers and acquisition professionals who operate in a specific type of transaction; 3) finders, who typically engage in smaller transactions and have received limited relief from full broker regulation in some state jurisdictions; and 4) capital acquisition brokers, a new category of intermediary created and proposed by FINRA, which are expected to engage in large transactions involving institutional investors.

Persons acting as securities intermediaries are not entitled to commissions or other kinds of success fees unless they are registered before they engage in any activities as an intermediary. And, if they do not register, they are subject to claims that they should disgorge their fees because they are not entitled to them if they are unregistered.

Brokers

The standard for who or what kind of entity is required to register as a securities intermediary is located in the definition of the term “broker” in §3(a)(4)(A) of the federal Securities and Exchange Act (the “34 Act”):

> The term "broker" means any person *engaged in the business* of effecting transactions in securities *for the account of others*.[19]

Historically, the SEC has taken the position that many people in many situations are “engaged in the business”.[20] It has delegated most of its regulatory authority over brokers to FINRA, a self-regulatory organization of broker dealer members that, in turn, is regulated by the SEC. Every registered broker must become a member of FINRA.[21] Unfortunately, many observers believe that FINRA’s approach to regulation makes being a registered broker very expensive and difficult to maintain.[22]

In contrast, the Texas term “dealer” is defined in Subsection (C) of Article 581-4 of the Texas Securities Act and includes:

> *every person or company* other than an agent, *who engages in this state*, either for all or part of his or its time, directly or through an agent, *in selling, offering for sale or delivery or soliciting subscriptions* to or orders for, or undertaking to dispose of, or to invite offers *for any*

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[19] Section 3(a)(4)(A) of the ’34 Act, 15 U.S.C. §78c(a)(4)(A).

[20] The standard regarding “engaged in the business” has been regularity of participation. Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp., 411 F. Supp. 411 (D. Mass. 1976) . The SEC has historically considered “effecting transactions to include anything in the distribution process and has been interpreted to include assisting in structuring a transaction, identifying potential purchasers, soliciting transactions (including advertising) and participating in the order taking or order routing process

[21] Rule 15b7-1 under the ’34 Act, 17 CFR 240.15b7-1.

[22] See Proskauer Rose’s “Broker Dealer Concepts” series, http://www.proskauer.com/SiteSearchResults.aspx?kw=broker+dealer+concepts; Brian Kelly, “DOL Fiduciary Rule Could Take $2.4 Billion Bite Out of Financial Services Industry” Investment News http://www.investmentnews.com/article/20151230/FREE/151239992/dol-fiduciary-rule-could-take-2-4-billion-bite-out-of-financial

> *security* or securities and every person or company who *deals in any other manner in any security* or securities *within this state*.

Importantly, Texas does not require that an intermediary be engaged in the securities business to be required to register, but rather, it subsumes the definition of a federal "broker" and includes anyone else in the chain of sale. [23] Even though a Texas dealer does not necessarily have to be in the securities business, *every Texas dealer must have registered before it engages in any activities of a dealer.*

If an intermediary operated entirely within a state, it could theoretically register only with the state in which it operated. That would mean that its offices were in the state, any investors with whom it dealt also resided within the state and any issuer with whom it dealt was doing business primarily within the state.

Currently, the number of federal registered brokers operating in the state of Texas is somewhere between 40 and 60 while the number of registered investment advisers has swelled to over 2,400.[24] Also, the brokerage industry nationwide is undergoing a wave of consolidation sparked in part by the Department of Labor's drive to make brokers be subject to a fiduciary duty to their clients akin to the duty of an ERISA retirement fund fiduciary to its beneficial holders.[25] Consequently, it is not surprising that individuals and firms try mightily to avoid broker status and especially FINRA membership. That leads to the next three categories of securities intermediaries that could take a success fee.

Business Brokers

The term "business broker" is not a defined term in securities statutes or regulations, but is generally thought to mean a person or entity that engages in the business of selling entire businesses. In 1985-1986, two events happened that ensured regulation but also gave license to do this work without being registered as a broker on the federal level.

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[23] Brown v Cole, 276 SW2d 369 (Tex 1956)

[24] FINRA 2014 Year in Review and Annual Financial Report, https://www.finra.org/sites/default/files/2014_YIR_AFR.pdf which tallies 4,100 broker members across all states., Carol Mattick, *An Interview with Denise Voight Crawford, Former Securities Commissioner of Texas,* February 11, 2015.; The website www.brokerdealerfirms.com boasts a listing of 1,200 and has 40 located in Texas.

[25] See Note 22, Supra, Bruce Kelly, *DOL Fiduciary Rule Could Decimate Number of IBDs,* Investment News, Nov 18, 2015, http://www.investmentnews.com/article/20151118/FREE/151119912/dol-fiduciary-rule-could-decimate-number-of-ibds

In Landreth Timber Co v Landreth[26], the U.S. Supreme Court had an opportunity to consider whether a family who sold all of the equity interests in an entity which housed its family owned business was selling securities to the purchaser of the business. The federal District Court and the Court of Appeals determined that this transaction did not involve the "sale of securities" as meant under the federal securities laws and instead came under a doctrine called the "sale of business" doctrine because 100% of the equity interests in the business were sold to a single entity. The Supreme Court reversed the lower courts based on: 1) the fact that what the seller sold had all of the usual characteristics of equity interests; and 2) because the "sale of business" doctrine as developed by the lower courts depended on control of the business changing hands, such a doctrine would interject uncertainty about when federal securities laws apply or do not apply. While it was focused on the securities offering, this decision also meant that whatever else business brokers were doing, they were selling securities on behalf of sellers or buying securities on behalf of buyers.

At the same time, business brokers and others were trying to avoid being categorized as brokers at all on the federal level. One of the primary ways in which securities law practitioners attempt to limit the reach of securities regulation is through the no-action letter process. One party's lawyers set forth in a letter to the SEC what their client intends to do - a business, a transaction, etc – and their best arguments why a particular series of statutes and/or regulations should not apply to this fact situation. Typically, there is a series of conversations between the client's lawyers and the SEC staff in the particular division's office of chief counsel. If the SEC can be persuaded, it will respond to the original letter with a letter of its own. Often, the SEC will set forth particular fact patterns or rationales which are conditions to its statement that it will take "no action to recommend" the case to the SEC's enforcement division. While the SEC's responses to so called "no-action" requests are specifically qualified as applying only to the situation and party presented to the agency, securities lawyers rely on these letters to discern the contours of transactional securities regulation.

In 1986, the SEC released the International Business Exchange Corp no-action letter (publicly avail. Dec 12, 1986). IBEC was a business broker which had real estate licenses in the states in which it operated and which took a commission based on the gross value of the business sold. IBEC asked the SEC to consider substance over form in sale of business transactions and not require registration as a broker. Although the transactions sometimes involved sale of equity interests, IBEC promised the SEC that it would not: 1) list or advertise corporate stock for sale (although it did list or advertise its business clients as selling the assets of the business); 2) it would not seek or accept the authority to close the transaction on behalf of its client; 3) handle any cash or

[26] 471 U.S. 681 (1985)

securities on behalf of the client or other party; 4) offer stock as an investment; 5) negotiate terms of the sale of securities on behalf of its client; or 6) advise the business being sold or its equity holders about the value of securities that would be changing hands. The SEC accepted these conditions and added several of its own: 1) the business broker would have a limited role in negotiations of any kind between the seller and purchaser; 2) the business being sold was not a shell company, but rather a going concern; 3) If the transaction involved the sale of securities, the business broker would not provide any assistance; 4) the business broker would not advise regarding whether to structure the transaction as a sale of securities or value the securities to be sold; 5) the compensation of the business broker did not vary with the form of conveyance; and 6) the business broker had limited role in assisting its client or the other party to obtain purchase financing.

Until 2014, most business brokers and their counsel relied on the IBEC letter to avoid broker registration on the federal level. In 2012 and 2013, the Alliance of Mergers and Acquisitions Advisors (the "AMAA") began to circulate legislation on Capitol Hill that would specifically exempt business brokers from the definition of "broker" on the federal level. It is widely thought that Congress' willingness to entertain enactment of such an exemption led to the SEC's publishing of a no-action letter entitled M&A Brokers (publicly avail. January 31, 2014)

After IBEC, the Texas State Securities Board continued to require business brokers to register as dealers but waived its requirement that such dealers take the Series 63 State Securities Law exam. Otherwise, business brokers were subject to the same requirements regarding books and records, inspections and other matters as any other dealer operating in the state. After M&A Brokers, the Board's policy has remained the same.

Finders

Prior to the IBEC No-Action Letter, the SEC had considered the requests of a number of different persons or entities with different business models to be exempt from federal broker registration. In almost all cases, the SEC denied their requests. The report of the ABA Task Force on Private Placement Broker Dealers[27] collected the types of activities that the SEC has historically determined are factors in determining whether a person is acting as a broker dealer (and therefore) required to register, including whether the person was: (1) involved in negotiations; (2) engaged in solicitation of investors; (3) discussed details of the nature of the securities or made recommendations to the prospective buyer or seller; (4) compensated on a transaction-related basis; and (5) previously involved in the sale of securities and/or was disciplined for prior securities activities. The category of persons deemed "Finders" is

[27] See Note 17, Supra

expected by securities lawyers and regulators alike to include those people who have a primary purpose of raising equity capital for issuers in non-public capital raising transactions but who are not acting in all of the areas mentioned above and who therefore do not need to register as broker dealers.

At the Federal Level

With respect to persons or entities that are not engaged in selling control of a business but rather are simply helping businesses raise equity capital, there has been little movement in the SEC's position since 2000. At that time, it withdrew a No-Action Letter that it had given to Dominion Resources in 1985, which had given some amount of relief. A recitation of the facts in each of the cases considered since 2000 will give readers a sense of the contours of the Finder's category on the federal level.

1. Dominion Resources, Inc. (publicly avail July 23, 1985 and March 7, 2000)
   Dominion Resources, Inc. ("DR") was a separate company formed by a utility and staffed with utility employees to provide advice in structuring and completing bond issues to finance the operations of the utility. DR wanted to take its accumulated expertise and offer it to third party companies and governments in the utility business. It promised it would recommend bond lawyers, underwriters, brokers and commercial banks to its clients but would not take on those roles; would not take transaction based compensation for these activities; would provide financial advice, prepare the offering documentation and explain or defend negotiating proposals; but would not negotiate or take action on behalf of the issuer. The SEC initially allowed DR to engage in those activities. Then, fifteen years later, the SEC withdrew that position, stating that the rise of the internet and developments in the securities markets had allowed more and different types of person to provide securities related services. Therefore, DR's activities would require registration as a broker.

2. John W. Loofbourrow Associates, Inc. (publicly avail. Mar 7, 2006)
   JWL was a registered broker that wanted to pay a finders fee to Eagle, a mortgage banking business that was not a registered broker. Eagle represented that it would introduce clients to JWL and nothing else. JWL represented that Eagle would receive a fee based on the size of the deal which JWL does for the referral and only when the deal got done. The SEC refused to allow payment of that fee without Eagle being registered as a broker.

3. Hallmark Capital Corporation (publicly avail. Mar 9, 2007)
   HCC was in the business of helping issuers put together confidential summaries of information about their businesses and introducing

them to registered brokers for which specific task it received no compensation. It also helped companies arrange bank financing, sell the entire company and provided strategic consulting services, for which it received small upfront retainers and a fee based on the outcome of the transaction. The SEC stated that HCC would have to register as a broker.

4. Brumberg, Mackey and Wall, PLC (publicly avail. May 17, 2010) BMW was a law firm that proposed to introduce potential investors to one of its clients in exchange for a percentage of the amounts raised by the client. However, BMW is not a securities law firm and would not negotiate on behalf of the client; provide the investor with information; make recommendations about the provisions of the agreements between the investor and law firm client; nor provide help with finding financing for the investor's investment. The SEC said that it felt that BMW would have to engage in pre-screening of investors and pre-selling and that the transaction based compensation would give BMW the incentive to sell more and more. Based on those rationales, the SEC stated that BMW would have to register as a broker.

The common thread is that regardless of the small scope of activity, if one is taking transaction-based compensation (even transaction based compensation in the areas of your business that arguably would not involve the purchase and sale of a security) that person must register as a broker on the federal level.

At the State Level

On the state level, the Texas State Securities Board ("TSSB") has enacted a series of rulemakings that are relevant: 1) Rule 109.5 which exempts persons or firms from dealer registration when the transactions involve certain types of investors in 2005[28]; and 2) Rules 115.1(a)(9) and 115.11, collectively called the "Texas Finder Rule" in 2006.[29]

TSSB Rule 109.5 is an exemption from dealer registration available when persons or firms sell or offer to sell securities to: 1) institutional Accredited Investors as defined in SEC Rule 501(a)(1)-(4), and (7)-(8)[30]; 2) "Qualified

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[28] 7 TAC §109.5

[29] 7 TAC §115.1(a)(9) and §115.11

[30] Reg D Rule 501(a), 17 CFR §501(a) which lists the types of persons or entities that come within the definition of "Accredited Investor". Rule 109.5 allows persons to avoid dealer registration if they are selling to banks and other financial institutions, self directed IRAs if the decisions are made by an Accredited Investor, 501(c)(3) non-profits with assets in excess of $5 million, corporations or other business entities with assets in excess of $5 million, persons who are insiders of the issuer, trusts with assets in excess of $5 million and entities whose equity holders are all Accredited Investors.

Institutional Buyers" as defined in SEC Rule 144A[31]; and 3) corporations, trusts, partnerships, estates and other entities that have a net worth of not less than $5 million and that were not formed for the purpose of investing. Notably, neither individual accredited investors nor their self directed IRAs are included in the definition of acceptable investors in this dealer exemption.

TSSB Rules 115.1(a)(9) and 115.11define the term "finder" and describe the contours of transactions, respectively, in which the "finder" will be allowed to operate. Finders are required to register with the TSSB but not as a "dealer". The term "finder" is limited to individuals (not firms) who introduce issuers to accredited investors (or accredited investors to issuers) but who also does not participate in negotiations or advise either party about making the investment.

In addition to negotiating and advising, Rule 115.11 prohibits Finders from conducting due diligence or advertising for accredited investors or issuers. Finders may not take custody of investor funds or securities nor serve as an escrow agent.

Texas Finders <u>must</u> disclose a certain set of information that includes the Finder's compensation and any conflicts of interest he or she may have as well as the fact that the Finder cannot advise an investor about the securities being offered. The Finder <u>may</u> disclose any or all of the information from another list. It is a very spare set of information, including: 1) the name, address, and telephone number of the issuer of the securities; 2) the name, a brief description, and price (if known) of any security to be issued; 3) a brief *description of the business of the issuer in 25 words or less*; 4) the type, number, and aggregate amount of securities being offered; and/or 5) the name, address, and telephone number of the person to contact for additional information. A Finder may also provide contact information regarding an accredited investor to an issuer.

Texas Finders must submit a fee and register by filing out a Form BD on the online central registration depository ("CRD"), submitting to a criminal background check and fingerprinting. The individual or principals of a firm must also file a Form U-4, which contains personal information and any disciplinary history. The Texas State Securities Board has retained the right to add additional requirements at a later date. There are limited record keeping and requirements to be open to regulatory inspection. And, these Finders are not required to take a securities law exam as a part of the registration process.

The key takeaway with respect to Finders on the state level is that the exemptions for the securities intermediary are dependent on *what type of investors are involved* in the transaction. But, the exemptions are both

[31] 17 CFR §230.144A(a). Qualified Institutional Buyers include financial institutions which own and invest at least $100 million in securities of companies not affiliated with the company in which an investment is being contemplated.

unconcerned with the type or size of issuer. The exemption that would allow a Finder to offer investment opportunities to natural person Accredited Investors is very restricted. Essentially, the Finder must introduce, provide very limited information to the investor and then step away. However, if the Finder registers in advance and jumps through these hoops, he or she can receive compensation based on the size of the investment made.

Capital Acquisition Brokers

In late 2015, FINRA published proposed self regulatory rules for a separate set of broker dealers which it called "Capital Acquisition Brokers"[32] Under the new rules, Capital Acquisition Brokers ("CABs") will only be subject to a core group of the current set of FINRA rules. This new rulemaking is subject to approval by the SEC, as the regulator of so called self regulatory organizations. FINRA expects them to be operational within 60 to 180 days after SEC approval.

A broker that engages in *solely* one or more of the following activities would be considered a CAB:

1) advising an issuer, including a private fund, concerning its securities offerings or other capital raising activities;

2) advising a company regarding its purchase or sale of a business or assets or regarding its corporate restructuring, including a going-private transaction, divestiture or merger;

3) advising a company regarding its selection of an investment banker;

4) assisting in the preparation of offering materials on behalf of an issuer;

5) providing fairness opinions, valuation services, expert testimony, litigation support, and negotiation and structuring services;

6) qualifying, identifying, soliciting, or acting as a placement agent or finder with respect to *institutional investors* in connection with purchases or sales of unregistered securities; and

7) effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company in accordance with the terms and conditions of an SEC rule, release, interpretation or "no-action" letter that permits a person to engage in such activities without having to register as a broker or dealer

Obviously, many of the activities discussed in the section on Finders are now included in the scope of activity in which CABs can engage. However, the "last frontier" of brokers that work with privately held companies raising

[32] SR-FINRA-2015-054, Proposed Rule Change to Adopt the Capital Acquisition Broker Rules, https://www.finra.org/industry/rule-filings/sr-finra-2015-054

capital through the sale of unregistered securities is covered in item 6) of the list *and is limited in scope*. This is the capital raise where the company is not being sold entirely to another owner.

Brokers would qualify for CAB regulation if they sold the unregistered securities to "institutional investors" only. Although the list includes banks and other financial institutions and larger ERISA qualified retirement plans or employee benefit plans, the primary category of "institutional investors" for this purpose includes persons (including natural persons) and entities with at total assets of at least $50 million.

III.
WHEN CAN A GROUP OF PEOPLE COME TOGETHER, POOL THEIR MONEY AND INVEST AS A GROUP?

There are many opportunities for persons or entities to co-invest with others in particular asset classes. Of course there have been mutual funds available to the public for a long time, but now there are also "exchange traded funds" which are mutual funds that are priced throughout the day and can be bought and sold throughout the day at the price available at that time. This contrasts with traditional mutual funds which are priced at the end of each day of trading.

However, these vehicles do not address the question whether and how one can co-invest on a more local level.

Adviser / Manager Requirements

The key inquiry here is whether there is any person or entity in the group or who organized the group *who will be receiving compensation* for managing the group investment. Section 202(a)(11) of the Investment Adviser's Act of 1940 (the "Advisers Act") sets forth a definition of "investment adviser" which (if one meets it) requires a person or entity to register as a federal investment adviser. That section provides:

> " "Investment adviser" means any person *who, for compensation, engages in the business of advising others*, either directly or through publications or writings, as to the value of securities or *as to the advisability of investing in, purchasing, or selling securities,* or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities;….."[33]

TSSB Rule 116.1(a)(6) provides that an investment adviser on the state level is defined as:

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[33] 15 USC 80b-2(a)(11)

> "A person who, *for compensation, engages in the business of advising others*, either directly or through publications or writings, with respect to the value of securities or *to the advisability of investing in, purchasing, or selling securities* or a person who, for compensation and as part of a regular business, issues or adopts analyses or a report concerning securities………" [34]

These definitions are exactly alike, in contrast to the federal and state definitions of broker / dealer. Persons or entities that meet these definitions are required to register as investment advisers. The current regulatory framework requires that smaller investment advisers (those that manage under $100 million in investor assets) must register with the state in which they have their place of business and any state(s) in which their investors reside.[35] The SEC directly regulates investment advisers with $100 million or more in assets under management. Larger advisers must register with the SEC and give notice registrations in state(s) in which they operate or have investors.

It may be possible for a group of people to co-invest if they can avoid compensating someone to manage the investments. Short of that, a group may compensate one of their own who co-invests to manage only this group's investments so that the compensated individual is not "engaged in the business" of providing advice. However, even if the group gets over those hurdles, it faces other obstacles in terms of the co-investing vehicle.

After the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), if a person or firm is compensated for managing investments in a private investment fund or other pooled investment vehicle described below, that person or firm has to register as an investment adviser on either the federal or state level.

The only exceptions are when a person or firm giving advice and managing investments is doing so for a family office or a venture capital fund. When and under what circumstances would either exception be available for non-professionals or newly minted professionals starting out to create a co-investing opportunity?

At the Federal Level

The federal venture capital exception is found in Advisers' Act Section 203(l) and SEC Rule 203(l)-1. The adviser must be advising a private fund, meaning that the investment fund has not and will not engage in a public offering of its securities. The adviser must tell current and prospective investors that the

[34] 7 TAC 116.1(a)(6)

[35] Dodd Frank , Title IV, Section 410; SEC Release IA-3221, 76 FR 43012 September 19, 2011 adopting Rule 203A-5, 17 CFR 175.203A-5

investment fund has had/ will have a venture capital strategy but the Rule does not spell out what would qualify as a venture capital strategy.[36]

A venture capital fund cannot hold more than twenty percent (20%) of its aggregate capital contributions and uncalled committed capital in investments other than "qualifying investments." In most situations, those are defined as an equity securities invested in a "qualifying portfolio company". In turn, a "qualifying portfolio company" would be any company that: 1) is not a publicly reporting company in the U.S. nor foreign traded nor under common control with a reporting or foreign traded company; 2) does not borrow or issue debt securities and then distribute proceeds of the loan(s) to the private fund; and 3) is not an investment company, commodity pool or private fund itself.

A venture capital fund cannot borrow, issue debt securities, provide guarantees or otherwise use leverage in excess of fifteen percent (15%) of its aggregate capital contributions and uncalled committed capital. The only significant exception is that the fund may guarantee the obligations of a qualifying portfolio company up to the amount of its investment in such company.

A venture capital fund cannot issue securities to its holders that can be redeemed, withdrawn or repurchased except in extraordinary circumstances. There is some specific guidance on what would be deemed extraordinary circumstances.[37]

Neither a registered investment company nor a company that has elected to be a business development company under the "40 Act can be a venture capital fund which exempts its adviser from being registered.

The other category of exception is the category of family offices. Persons making recommendations or advising which securities to purchase or sell can do so without registering on the federal level as an investment adviser if the investment fund or group of investors they are advising are part of their own family. The SEC Rule 202(a)(11)(G)-1 sets forth how this exception is defined.[38]

A family office is a company that (including its directors, officers, partners managers, trustees and employees):

1. only has "family clients". In turn, "family clients" is a group that includes family members and former family members; key employees

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[36] SEC Release IA-3222, the release in which the SEC adopted Rule 202-(a)(11)(G)-1, chronicles a lively debate among commenters to exclude private equity funds from the definition as well as those that utilize a large amount of leverage.

[37] In the adoption release Ia-3222, the SEC says it expects these circumstances to those that could be foreseeable but are unexpected or unknown when they will occur. p 61

[38] 17 CFR 275.202(a)(11)(G)-1

and former key employees; nonprofits, foundations and remainder trusts funded exclusively by family clients; estates of current and former family members; estates of current and former key employees; both revocable of which family clients are the sole grantors; irrevocable trusts of which family clients are the only beneficiaries; any company wholly owned and operated for the sole benefit of family clients, including private investment funds; and trusts of key employees.

2. is wholly owned by family clients and exclusively controlled by family members or family entities. Family members are lineal descendants and spouses for 10 generations from the youngest generation. Family entities are entities owned by all types of family clients except those relating to key employees.

and

3. does not hold itself out to the public to be an investment adviser.

It is possible that the group of people coming into a business lawyer's office wanting to co-invest could come under one of these exceptions, but not every client will fit in these categories.

At the State Level

Remember that even if persons could meet the requirements of the venture capital or family office exceptions on the federal level, groups of people who want to co-invest must also designate someone to register at the state level or comply with a state exemption. We have already covered the circumstances that would normally require someone to register as an investment adviser in Texas. However, we have not considered any exemptions that might be available.

TSSB Rule 109.6

Rule 109.6 exempts persons who are giving investment advice as defined above if they provide that advice to some of the institutions or entities included in the definition of "Accredited Investor", Qualified Institutional Buyers as defined in SEC Rule 144A or corporations and other business entities that have at least $5 million in total assets. Unlike Rule 109.5, the list of Accredited Investors that are approved clients are those under Rule 501(a) (1)-(3) and (7)-(8). This definition excludes all natural persons including those that could be considered insiders of an issuer such as directors, officers or managers.

Investment Entity Requirements

The Investment Company Act of 1940 (the "40 Act") covers pooled investment vehicles and requires them to register as a mutual fund or meet one of the exemptions from '40 Act registration. Pooled investment vehicles or "investment companies" are defined in the '40 Act as businesses that have more than 40% of their assets invested in investment securities (such as equity interests in other companies). Section 3(c) of that act provides that certain described entities will not be investment companies under the meaning of the statute, despite meeting the 40% rule. These include so called "3(c)(1)" funds that cannot have made a public offering and cannot have more than 100 beneficial owners. Most co-investment groups form an entity to hold their investments and avail themselves of this exemption from the '40 Act.

Like any other privately held issuer of securities, a Section 3(c)(1) fund must comply with an exemption from the requirement to register the securities offering that occurs when the investment fund offers equity interests to its beneficial owners. Section 3(c)(1) specifically states that a pooled investment vehicle seeking to meet its requirements may not be publicly traded or do a public offering. As stated in Article I, that process may be more involved when the fund is seeking outside investment and less involved when a group of friends is coming together to co-invest. But, the requirement is still there.

Of note, the 3(c)(1) exemption makes all those pooled investment vehicles meeting its requirements subject to the antifraud rules of the '40 Act but not the registration requirements. [39]

IV SUMMARY

Armed with this information, business lawyers should be able to spot securities law-related issues with confidence. The Business Law Section of the State Bar of Texas has a large and vibrant community of lawyers that practice primarily or significantly in the area of securities law. Large firms, small boutique firms and solos are represented. Call us! We will be glad to help if you have a securities law issue in your practice.

[39] 15 U.S.C. §80a-3(c)(1).