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SECURITIES RULES FOR PRIVATE EQUITY FINANCINGS

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Registration of the Sales of Securities

In order to sell securities (notes, common stock, preferred stock, membership interests in an LLC), a company must either register the sale under federal and state securities laws or find an exemption from such registration requirements. Complying with the securities registration provisions of federal and state law is a time-consuming and costly process. Most small to mid-size companies do not want to spend the money or time it would take to register such sales. In addition, the registration of such sales with the SEC may subject the company to continued SEC reporting requirements.

Federal law offers a number of exemptions from registration. These exemptions exempt the particular transaction (e.g., a sale to an investor in a private placement) not the underlying security.

Even if a federal exemption is available, a company must also comply with the securities laws of the state where the purchaser resides and obtain an exemption under the laws of that state. Furthermore, even though the sale may be exempt under federal and state law, the company is still subject to the anti-fraud rules and may face liability for securities fraud.

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

What is a Security

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

The most expansive element of the definition of "securities" under the 1933 Act is the term "investment contract." The Supreme Court has ruled that an investment contract consists of (i) an investment of money (or other value) (ii) in a common enterprise (iii) for profits (which may be solely tax benefits) (iv) that will come solely from the efforts of others. The courts have held that a common enterprise generally involves either a pooling of more than one investor's funds or in some circumstances a connection between the success of the promoter and the success of the investors. The fourth point (solely from the efforts of others) has been broadly construed so that the test is met if the investor only plays a small role in the transaction and significant efforts are made by these other than the investor, which efforts are likely to affect the success or failure of the business.

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

A membership interest in a LLC which is managed by managers is a "security" because the members are expecting to profit solely or nearly solely from the efforts of others and will not be involved in day-to-day management. A membership interest in an LLC which is managed by members some of whom do not actively participate in management may be a security with respect to the non-active members.

Regulation D

The SEC's Regulation D (Rules 501-508 under the 1933 Act offers three possible federal exemptions for a company that wishes to sell securities in a private placement.

Regulation D may also be used by companies to effectuate business combinations and acquisitions. A business combination is defined to mean any transaction involving the acquisition by one company, in exchange for all or a part of its own or its parent's stock, of stock of another company if, immediately after the acquisition, the acquiring company has control of the other company (whether it had control before the acquisition).

Rule 504

Rule 504 permits sales of up to $1 million of securities during any twelve month period to an unlimited number of investors who do not have to be sophisticated.

The company must file a Form D with the SEC and comply with the Regulation D resale, advertising and other restrictions discussed below.

Rule 504 works well for a company that only needs a small amount of capital and has a large number of potential investors.

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

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

In order to claim this exemption, the offers and sales of securities under Rule 504(b)(1) must be made:

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

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

sale to all purchasers (including those in the states that have no such procedure); or

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

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

Rule 505

Rule 505 allows a company to sell up to $5 million of securities in a single offering.

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

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

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

It should be noted that there are problems presented when selling to persons who are not sophisticated. The company should use a questionnaire or subscription form to satisfy itself that prospective investors are accredited or that non-accredited purchasers are sophisticated. Unsophisticated non-accredited investors can use a purchaser's representative (Rule 501(h)).

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

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

The company must file a Form D with the SEC and comply with the Regulation D resale, advertising and other restrictions discussed below.

Rule 506

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

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

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

Non-accredited investors must be reasonably sophisticated. A company should use a questionnaire or subscription form to satisfy itself that investors are accredited or that non-accredited purchasers are sophisticated. Unsophisticated non-accredited investors can use a purchaser's representative (Rule 501(h)).

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

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

The company must file a Form D with the SEC and comply with the Regulation D resale, advertising and other restrictions discussed below.

Accredited Investors

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

- A natural person whose individual net worth, or joint net worth with his/her spouse, at the time of purchase exceeds $1 million **(minus the net value of the purchaser's primary residence but including as a liability the amount of any indebtedness on the residence that exceeds its fair market value)**.

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

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

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

Purchasers vs. Offerees

For purposes of Rule 505 and 506, when counting non-accredited investors, a company counts non-accredited **purchasers** not **offerees**. Under Rules 505 and 506, a company may **sell** to up to 35 non-accredited investors but can **offer** to more than 35.

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

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

Under Rules 505 and 506, a company can **offer** and **sell** to an unlimited number of accredited investors.

Integration

On occasion, a company may complete an offering and shortly thereafter determine it needs additional capital. If different offerings are integrated, the company could lose its federal exemption.

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

Because of financing needs, it may not be possible for a company to comply with the six-month safe harbor rule. If the safe harbor is not available, the determination as to whether separate sales of securities are part of the same offering (and, therefore, integrated) depends on the particular facts and circumstances. The SEC will look at the following factors when determining whether offers and sales should be integrated for purposes of the exemptions under Regulation D:

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

Resales

Securities sold in a Regulation D transaction are "restricted" and cannot be resold without registration under the 1933 Act or an exemption therefrom. Generally speaking, investors who resell their shares after holding them for a reasonable period of time should qualify for the private placement exemption available under Section 4(1) of the 1933 Act which exempts any sale of securities by a person other than the issuing company, underwriter or dealer.

Under Rule 502(d), a company must exercise reasonable care to insure that the purchasers of the securities are not viewed as buying the securities for the purpose of reselling them to others (thereby acting as underwriters). Reasonable care can be demonstrated by the following:

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

Advertising

A company conducting an offering under Regulation D may not conduct any general solicitation or advertising. This rule prohibits any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media, or broadcast over TV

or radio. The SEC has taken the position that, although Rule 505 and Rule 506 in theory allow **offers and sales** to an unlimited number of accredited investors and **offers (but not sales)** to an unlimited number of non-accredited investors, offers to a large number of prospective buyers may violate prohibitions against advertising and solicitation. The SEC prefers for companies to have a "nexus" with offerees.

Notice of Sales — Rule 503

A notice on Form D must be filed with the SEC within 15 days of the first sale under Rule 504, 505 and 506. If funds are being held in escrow, the first sale is deemed to occur when funds and subscription agreement are deposited in escrow. As discussed below ***(Rule 508)***, the failure to file a Form D will not render the Regulation D exemption void, but continued filing violations could be a problem.

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

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

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

- To report material changes in business transactions being financed or changes in the maximum on a mini-max offer.

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

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

An amendment need not be filed to reflect a change that occurs after the offering terminates or a change that occurs solely in the following information:

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

- A company's revenues or aggregate net asset value;

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

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

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

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

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

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

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

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

Electronic Filing

A company must file the Form D electronically with the SEC by means of the agency's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) in accordance with EDGAR rules set forth in Regulation S-T (Rule 503(b)(1)). In order to do so, a company must register with the SEC and obtain special access codes.

Rule 508

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

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

- The failure to comply was insignificant with respect to the offering as a whole, provided that any failure to comply with: (1) the prohibition against advertising or general solicitations; (2) sales made under Rule 504 which exceed $1 million; (3) sales made under Rule 505 which exceed $5 million; and (4) sales under Rule 505 or Rule 506 to more than 35 non-accredited investors shall be deemed to be significant to the offering as a whole; and

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

A failure to file (or timely file) a Form D will not cause the loss of the exemption if the conditions described above are satisfied.

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

Compliance with State Securities Laws

Even if a federal exemption is available, a company must also comply with the securities laws of the state where the purchaser resides and obtain an exemption under the laws of that state.

Rule 701- - Offers to Employees, Officers, Directors or Consultants

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

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

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

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

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

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

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

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

- They are natural persons;
- They provide bona fide services to the company, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the company's parent; and

- The services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the company's securities.

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

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

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

Rule 147 - - Intrastate Offerings.

Under Rule 147, provides an exemption for securities offered and sold to residents of one state (Rule 147(a)).

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

The company must be a resident of and incorporated in the state where offer is made (Rule 147(c)).

The company must be doing business within the state.

- The company must derive at least 80% of its consolidated gross revenues within the state within specified time frames (Rule 147(c)(2)(i)).

- 80% of the company's assets must be located within the state (Rule 147(c)(2)(ii)).

- The company must use at least 80% of net proceeds from the sale must be used within the state (Rule 147(c)(2)(iii)); and

- The principal office of the company must be located within the state (Rule 147(c)(2)(iv)).

In addition, offerees and purchasers must be residents of the same state as the company.

- Corporation and other entities are residents where its principal office is located (see Rule 147(d)(1)).

- Individuals are residents of state of principal residence (see Rule 147(d)(2)).

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

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

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

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

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

Two or more exempt offerings (one of which relies on Rule 147) may be integrated. If so, the Rule 147 exemption could be lost. See "**Regulation D** -- ***Integration***" above for a discussion of the factors considered by the SEC when considering whether to integrate two offerings.

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

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

Section 4(2)

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

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

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

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

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

Manner of Offering

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

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

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

Although Section 4(2) in theory allows **offers and sales** to a large number of investors, offers to a large number of prospective buyers may violate prohibitions against advertising and solicitation. The SEC prefers for companies to have a "nexus" to offerees.

Eligibility of Purchasers

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

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

Information

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

The company should also consider: (1) furnishing to each purchaser that is not an accredited investor a brief written description of any material written information provided to any accredited investor and, upon request, furnishing this information to the non-accredited investor; (2) advising each purchaser of the limitations on resale of the securities; and (3) making available to each purchaser the opportunity to ask questions and receive answers concerning the terms and conditions of the offering and obtain any additional information the company possesses, or can acquire without unreasonable effort or expense, that is necessary to verify the accuracy of the information furnished.

Resales

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

Integration

A company needs to be careful to insure that the Section 4(2) offering and another offering are not integrated. If a Section 4(2) offering and another offering are integrated, the company might lose the exemption. See "**Regulation D** -- ***Integration***" above for a discussion of the factors considered by the SEC when considering whether to integrate two offerings.

State Laws

Even if a federal exemption is available, a company must also comply with the securities laws of the state where the purchaser resides and obtain an exemption under the laws of that state.

Sales to Accredited Investors

Section 4(5) of the 1933 Act permits sales by a company to accredited investors where total sales do not exceed $5 million. Under this exemption:

- No advertising or public solicitation is allowed.
- The company must file a Form D with the SEC.
- Section 4(5) purchasers acquire "restricted securities" and the company must ensure that the purchasers are aware of these restrictions and take steps to enforce them as discussed above.

All sales under Section 4(5) are subject to anti-fraud rules. Even though the transaction may be exempt, the company is still subject to liability for securities fraud. Even if a federal exemption is available, a company must also comply with the securities laws of the state where the purchaser resides and obtain an exemption under the laws of that state.

Covered Securities

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

- Securities listed on the national stock exchanges and the Nasdaq.
- Securities exempted by the SEC under Section 4(2) of the 1933 Act.
- Securities sold pursuant to Rule 506 of Regulation D.

NSMIA preempts: (1) the application of state registration requirements with respect to covered securities; (2) state regulations relating to the content of any offering document used with respect thereto; and (3) state regulations relating to the merits of a sale of covered securities. Therefore, sales of securities under Rule 506 of Regulation D are exempt from state regulation.

States may require a company selling securities under Rule 506 to file with the state the documents filed with the SEC (Form D) and may require the payment of limited fees set out in NSMIA.

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

Illinois Exemptions

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

Under Illinois law, there are a variety of exemptions available from registration. These are set out in Section 4 of the Illinois Securities Law of 1953, as amended (the "Illinois Act"). These exemptions exempt the transaction (e.g., a sale to an existing shareholder) not the underlying security. Subsequent transactions may have to be registered if no exemption is available. Generally speaking, investors who resell their shares after holding them for a reasonable period of time should qualify for the private placement exemption available under Section 4(1) of the 1933 Act and Section 4(A) of the Illinois Act which exempt any sale of securities by a person other than the issuing company, underwriter or dealer.

Set forth below the most commonly used exemptions available under Illinois law.

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

Sales to Existing Shareholders

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

Sales to Corporations, Banks, etc.

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

Rule 506

Companies relying on Rule 506 of Regulation D (issuing covered securities) need only file a Form D with a $100 fee (Regulation 130.293(a)(1) of the Illinois Blue Sky Regulations).

Exchange Traded Securities

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

Rule 505

Rule 505 offerings are exempted under Regulation 130.420 of the Illinois Blue Sky Regulations if all criteria are satisfied.

- The Form D must be filed with Illinois (Regulation 130.420(b)(1)).
- A fee of $100 must be paid (Regulation 130.420(b)(3)).
- A company must agree to provide its disclosure statement to Illinois Securities Department if so requested but only with respect to information provided to non-accredited investors (Regulation 130.420(b)(2)).
- A company must comply with Rules 501-503 and 505.
- A company must be satisfied that a non-accredited investor (or his purchaser representative) is reasonably sophisticated (see Regulation 130.420(c)).

The failure to comply with all requirements of Regulation 130.420 might not cause loss of exemption (Regulation 130.420(d)).

Section 4G-Limited Offering

Section 4G exempts offers, sales or issuance to residents (or non-residents) as follows:

- All sales to Illinois residents during the preceding 12 months have been made to fewer than 35 persons or all sales to Illinois residents in the last 12 months totaled less than $1 million (regardless of how many people in Illinois purchased shares) (Section 4G).
- When counting the 35 people or the amount of the sales, the company may exclude sales exempted under other subsections of Section 4.
    - A sale to joint tenants with right of survivorship is one sale (Regulation 130.441(a) of the Illinois Blue Sky Regulations).
    - Purchases by relatives or spouses who share same residence shall not be a sale to an additional purchaser (Regulation 130.441(b)).
- No general advertising or solicitation is permitted.
- Commissions may not exceed 20% of the sale price.
- A report on Form 4G must be filed (alternatively a company may file a Form D (Regulation 130.440(a)).
    - A $100 fee must be paid.

- The report is due within 12 months of first sale.
- The company need only report 4G sales (it does not need to report sales exempted under other subsections of Section 4).
- Failure to file report or filing of an inaccurate report does not give right of rescission.
- By filing, the company agrees to deliver disclosure materials to the Illinois Securities Department if so requested.

Accredited Investors

Section 4H exempts sales to accredited investors who meet income and net worth tests discussed above or sales to an entity where 90% of the equity interests are owned by accredited investors (see "**Regulation D -- *Accredited Investors***," above). Securities may not be sold by means of general advertising or solicitation.

Shareholder Approval

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

Preincorporation Sales

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

- Limited to 25 people.
  - A sale to joint tenants with right of survivorship is one sale (Regulation 130.441(a) of the Illinois Blue Sky Regulations).
  - Purchases by relatives or spouses who share same residence shall not be a sale to an additional purchaser (Regulation 130.441(b)).
- No commission can be paid, except as indicated below.
- If commissions are paid, the securities may not be sold by way of general advertising or solicitation.

Minimum Purchase

Any offer, sale or issuance to anyone who purchases more than $150,000 provided that the purchase does not exceed 20% of buyer's net worth provided no advertising is undertaken (Section 4R).

Sales to Executive Officers and Directors

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

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

Exempt Securities

Both federal law (Section 3(a) of the 1933 Act) and the Illinois Act (Section 3 of the Illinois Act) designate certain types of securities that are deemed to be "exempt" from the registration requirements. These securities may be issued without the company having to secure an exemption or registering them under federal or Illinois law.

One of the more common type of exempt security is bank stock. It should be noted, however, that if a bank has more than 500 shareholders of record it becomes subject to the SEC's rules which rules will be administered by the appropriate federal bank regulator.

Even though these securities are exempt from the registration requirements, they are still governed by the anti-fraud rules.

Appendix A -- Accredited Investors

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

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

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

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

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

5. Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000 **(exclusive of the net value of the person’s primary residence but including as a liability the amount of any indebtedness on the residence that exceeds its fair market value)**;

6. Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

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

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

Appendix B -- Information Requirements for Rule 505 and 506 Offerings Where Securities Are To Be Sold To Non-Accredited Investors

If sales are being made under Rule 505 or Rule 506 to any purchaser that is not an accredited investor, the company must furnish the information described below to such purchaser a reasonable time prior to the sale (Rule 502(b)(1)).

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

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

Non-SEC Reporting Companies

Non-financial statement information

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

If the company is not eligible to use Regulation A, the same kind of information as required in Part I of a registration statement filed under the 1933 Act on the form that the company would be entitled to use.

Financial statement information

Offerings up to $2,000,000

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

Offerings up to $7,500,000

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

Offerings over $7,500,000

The financial statement as would be required in a registration statement filed under the 1933 Act on the form that the company would be entitled to use. If a company, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or

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

Public Companies

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

Information; Communications

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

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

For business combinations or exchange offers, in addition to information required by Form S-4, the company must provide to each purchaser at the time the plan is submitted to security holders, or, with an exchange, during the course of the transaction and prior to sale, written information about any terms or arrangements of the proposed transactions that are materially different from those for all other security holders. For purposes of this subsection, a company which is not subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act may satisfy the requirements of Part I.B. or C. of Form S-4 by compliance with paragraph (b)(2)(i) of this §230.502.

At a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction, the company shall advise the purchaser of the limitations on resale as provided _____.

Appendix C -- Information Requirements for Rule 701

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

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

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

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

If the sale involves a stock option or other derivative security, the company must deliver the disclosure a reasonable period of time before the date of exercise or conversion.

For deferred compensation or similar plans, the company must deliver disclosure to investors a reasonable period of time before the date the irrevocable election to defer is made.