Business Transactions Solutions § 151:124

Business Transactions Solutions
November 2016 Update
Alan S. Gutterman*
Part VI. Finance
Chapter 151. Securities Law Compliance
III. Master Forms and Clause Library
A. Securities Law Compliance Questionnaire
1. Complete Form with Practice Notes

§ 151:124. Securities law compliance questionnaire—Master form with practice notes

References

1. General Information on Securities Transactions

Provide the following:

- Schedule setting forth the capital stock structure of the company, including the number and type of authorized shares, the number of shares of each class issued and outstanding, the names of shareholders, and the percentage of the outstanding securities held by each shareholder.

- Schedule listing outstanding stock options or warrants with dates of expiration and exercise prices thereof and terms of any vesting.

- Schedule listing the shareholdings, and options and warrants, of directors and officers of the company, including dates of acquisition.

- Schedule listing all sales of securities by the company during the last three years, indicating the date of sale, identity of the purchaser, purchase price, and form of consideration received.

- Schedule listing all shareholders holding "legended" stock.

Provide copies of the articles or certificate of incorporation of the company (including the terms of any preferred stock), as amended to date, and the bylaws, as amended to date, of the company.

Provide copies of shareholder, buy-sell, voting trust or other agreements relating to the purchase of the company's stock.

Describe any oral or written commitments to issue stock to any parties, including informal conversations and correspondence.

Provide copies of irrevocable proxies, preemptive rights shareholder agreements, redemption agreements, or any other agreements affecting shareholder rights.

Provide copies of all indemnification contracts, insurance policies or other arrangements under which officers or directors may be indemnified against liabilities incurred in such capacity.

Provide copies of all stock certificates, warrants, options, debentures, calls, commitments, and any other outstanding securities.

Provide copies of all plans setting forth the terms and conditions upon which outstanding options, warrants or rights to purchase securities of the company or any of its affiliates have been or are proposed to be issued, together with specimen copies of such options, warrants, or rights; or, if not issued pursuant to such a plan, copies of each such option, warrant, or right.

Provide copies of any agreements with underwriters, investment bankers, and/or finders relating to the offer and sale of the company's securities.

Provide copies of all agreements containing registration rights relating to the company's securities or assigning such rights.

Provide copies of all agreements with transfer agents and registrars within the last five years.

Provide copies of all annual directors' and officers' questionnaires for the last three years.

Provide copies of all permits, qualifications, or notices relating to the company's securities that have been filed with the federal Securities and Exchange Commission ("SEC"), state securities law administrators, or other governmental agencies.

Provide copies of each proxy statement, annual report to shareholders, and other communication from the company to its shareholders during the last five years.

If the company is publicly traded, also provide:

- Each registration statement and prospectus filed by the company with the SEC, together with each exhibit thereto not otherwise furnished hereunder.
- List of stock exchange(s) where the company's stock is listed and any listing agreements within the last five years.
- All correspondence between the SEC and the company during the last five years.
- Each report (such as Forms 8-K, 10-Q, and 10-K) filed by the company during the last five years with the SEC.
- Schedules 13D, 13G, and 14D-1 filed by the company with respect to the securities of other issuers.
- Schedules 13D, 13G, 14D-1, and 14D-9 filed with respect to the securities of the company.

- Copies of Form 144 filed by company officers and directors.

- Copies of forms filed by company officers and directors relating to "insider trading" transactions.

Provide a list of the names and positions of all persons within the company who have knowledge of matters referred to in this questionnaire.

2. Business Information

Provide documents, reports, and other information describing the company's business, including:

- Sales and marketing arrangements.

- Customer base.

- Pricing and credit policies.

- Competition.

- Business reputation.

Provide copies of all contracts and agreements relating to the company which would need to be filed as exhibits to a registration statement under the Securities Act.

Provide copies of all contracts and agreements between the company and its employees, including employment agreements, assignment of inventions agreements, and non-competition agreements.

Provide copies of reports to management for the last five years by:

- Independent public accountants, including all letters and opinions accompanying financial statements, letters issued during the past three years regarding control systems, methods of accounting, etc., including any changes in such systems or methods.

- Internal auditors.

- Appraisers relating to valuation of the company's assets and business.

- Other consultants or outside experts, including without limitation environmental experts and management consultants, hired with respect to business operations.

Provide copies of the company's financial statements (audited, if available) for the past five years.

Provide copies of news releases relating to the Company's products, management changes, etc. within the past five years.

Provide a list indicating each state or jurisdiction in which the company is qualified to do business, or owns, leases, or licenses real property.

3. Securities Law Compliance Issues

Provide copies of any prospectuses, private placement memoranda, business plans, or other materials regarding the company provided to investors during the last five years.

Describe the procedures followed by the company and its employees to verify that the information included in any offering documents was accurate and complete.

Describe the degree to which experts (e.g., lawyers, accountants, underwriters, etc.) have been involved in the preparation of offering documents used in prior offerings of the company's securities.

Describe the circumstances under which any director, officer, major shareholder, or other individuals acting on behalf of the company may have made representations to prospective purchasers during the course of any prior offering of the company's securities.

With regard to any prior offering of the company's securities, has any offeree or purchaser asserted (or threatened to assert) a claim relating to statements made or information omitted in discussions or written communications in connection with the offering? If so, describe the assertions and provide information regarding:

(1) Any facts tending to show the complaining party knew the truth or had knowledge of the omitted information;

(2) Whether or not the complaining party would have entered into the transaction even if the party knew the truth;

(3) Whether the complaining party had access to information or other resources so that the party should have known the truth or that facts were withheld, or

(4) Whether a reasonable investor would have considered the information allegedly misstated or withheld to be important in deciding whether to complete the transaction.

With regard to any prior offering of the company's securities, has any offeree or purchaser asserted (or threatened to asset) a claim regarding some act or practice alleged to be deceptive or unfairly advantageous to the company? If so, describe the assertions.

Has the company failed, in any material respect, to meet any projections regarding the company's financial or business performance included in any prior offering documents. If so, provide further information and a copy of the relevant portions of the prior offering documents.

Regardless of the circumstances, are any prior purchasers of the company's securities antagonistic or have any of them

indicated displeasure with their investment?

Has the company failed to make a timely public announcement of material favorable or unfavorable information?

Have officers, directors, or key employees bought or sold securities recently, while aware of material favorable or unfavorable information about the company not publicly available?

4. Exemptions from Registration

Is the company planning to, or has the company recently offered or sold securities, without registration under federal or state securities laws? If so, what exemptions from registration is the company intending to rely upon in making such offers or sales (or, in the case of past transactions, what exemptions from registration has the company relied upon in making any offers or sales of its securities)?

Has any director, officer, or major shareholders recently offered or sold all or a portion of their holdings of the company's securities without registration under federal or state securities laws?

With regard to each prior unregistered offering of the company's securities, provide information regarding the amount raised in the offering, the date(s) on which the securities were purchased and sold, and the names and places of residence of each of the purchasers.

Provide copies of all correspondence with securities regulators (Securities and Exchange Commission and all appropriate state securities regulators) regarding exemptions from registration (which should be retained throughout the life of the security).

Has the company advertised or publicly promoted its securities in the course of any prior offering of its securities? If so, please describe the circumstances.

With regard to any contemplated offering, provide answers for the following:

- Does the company propose to raise in excess of $1,000,000 through an unregistered sale of securities?
- Will the securities be offered only to residents of the state in which your principal business office is located? If yes:
- Is your company organized in the state in which your principal office is located?
- Is most of your business done in the state in which your principal office is located?
- Will the proceeds of the sale of your securities be used in connection with your business in the state in which your principal office is located?

• Have you identified persons who will be likely to purchase the securities offered? If yes:

• Are such persons generally wealthy with substantial business expertise?

• Are the potential purchasers directors and officers of your company or institutional investors such as banks, insurance companies, pension trust funds and the like?

• Have you determined the number of persons to whom you intend to offer securities?

• With respect to potential purchasers thought to be "accredited investors" as defined in Regulation D promulgated by the Securities and Exchange Commission, have you requested, received and reviewed documentation necessary to confirm accredited investor status?

5. Public Offerings

Are you considering a registered public offering of securities?

Have you considered other forms of financing, such as a conventional bank loan, in lieu of a public offering?

Do the circumstances of the proposed offering preclude the use of an exemption from the registration requirements of the securities laws?

Do you have the funds available for legal, accounting, and other expenses in connection with a public offering?

Will officers and directors of your company have the time and effort necessary to prepare a registration statement?

Have you considered the restrictions on the way your company does business and manages its affairs which may result from a substantially increased number of shareholders?

Following the offering, will your company register its securities on any national securities exchange?

Have you considered the time and expense involved in complying with the financial and other filing requirements imposed on companies with registered securities?

Have you considered the additional potential liabilities, both civil and criminal, confronting directors and officers of companies with registered securities?

Will the offering be underwritten?

Notes

Notes On Use

Federal and state securities laws are an important part of many common business transactions. Obviously, securities laws must be considered whenever a company seeks to raise capital through sales of securities to outside investors. However, securities laws must also be considered in designing incentive and benefit programs for employees and in matters of corporate governance.

This questionnaire touches on a variety of areas, from collecting information on securities-related transactions and the company itself to situations where the company might be "at-risk" for violations of the securities laws. Information collected through responses to the questionnaire can be used to design and operate a securities law compliance program for the company. However, it is important to remember that the information gathering process must be continuous. For this reason, consideration should be given to scheduling an annual "due diligence" meeting involving the company's outside counsel, accountants, and key executives. Such meetings are often held by large, publicly-held corporations and include the company's underwriters, but even the smallest of companies can benefit from sitting down and focusing on the documents which may become important in preparing (and defending) the company's disclosures to shareholders and prospective investors. The meeting can:

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- Provide an opportunity to update the company's files;
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- Furnish a forum for outside counsel to ask questions to be sure that material misrepresentations and omissions do not occur at the time a disclosure document is prepared;
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- Serve as a means for educating company officials on the importance of record-keeping; and
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- Permit the company to teach outside counsel and the accountants about its business and specific risks and uncertainties that may need to be addressed in drafting disclosure materials.

This questionnaire should be used in conjunction with other practice tools that can be used to inform clients about some of the general principles associated with compliance with federal and state securities laws. For example, clients can be provided with a memorandum regarding compliance with the securities laws that outline the registration requirements and the most often used exemptions from the registration and provides the client with a sense of the steps that need to be taken in order to ensure that the requirements for an exemption have been satisfied. See Specialty Form at § 151:154.

1. General Information on Securities Transactions

One of the most important steps in any securities law compliance program is collecting all available information relating to the company's past and pending securities transactions. This section of the questionnaire lists various schedules, contracts, and lists which can be used to develop and maintain the compliance program.

A specific person or group of persons within the company should be designated as the repository of the company's securities-related records. In many cases, the secretary of the company will manage the files, perhaps with copies of all records also being retained by outside counsel. Don't forget that state law requirements regarding the availability of records must be obeyed, which means that copies of certain documents may need to be deposited at locations different from the location of the corporate secretary. In all cases, the person(s) responsible for record keeping should be trained about the content and importance of the documents and should always be informed of any changes to applicable policies.

Clearly, the responsible party should receive schedules describing the current composition of the company's shareholders, as well as the persons who may acquire securities in the future through the exercise of options, warrants, and other types of conversion or purchase rights. More detailed information is required regarding transactions which have occurred within the last three years, since the statute of limitations for securities law claims generally extends that far back. Information included in the schedules can be verified, if necessary, by reviewing copies of share certificates, warrants, options, and other evidences of securities.

Collection of the other documents listed in this section provides the responsible party with a better idea of the actual rights, preferences, and privileges of the holders of the company's securities. For example, shareholders may be granted registration rights, which allow the shareholders to have their securities registered for resale to the public under the procedures included in Section 5 of the Securities Act of 1933 (15 U.S.C.A. § 77e). Registration rights can be divided into "demand" and "piggyback" rights.

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• Shareholders with "demand rights" can require the company to register their securities, even at times when the company itself is not engaged in a primary offering of its own securities for capital-raising purposes.

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• A "piggyback right" simply permits shareholders to include securities as part of a registration statement that the company is otherwise preparing for a primary offering and/or securities held by another party with demand registration rights.

Among the other agreements effecting shareholders' rights included on the list are the following:

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• Voting and voting trust agreements;

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• Proxies;

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• Redemption agreements; and

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• Shareholders agreements.

All these agreements can be material for potential investors and should be disclosed and described as part of any disclosure documents used in connection with an offering of the company's securities.

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• Prospective investors need to know the effect of a voting agreement which calls for pooling of shares held by a small group of existing shareholders. The existence of such an agreement may adversely affect the ability of new shareholders to attain representation on the company's board of directors.

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• Buy-sell agreements between shareholders are also important to the extent that they may ultimately change the balance of control within the shareholder group without the participation of all the shareholders.

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• Investors need to be aware of any obligation that the company might have to redeem or repurchase shares held by any existing shareholder.

The items listed in this section, when collected, should give the responsible party a complete view of all prior securities-related transactions in which the company has been involved. The representations and warranties provided by the company in any stock purchase agreement should be reviewed, since they may become the basis for an adverse claim by a prior investor in the event that the information included in the agreement turns out to have been incorrect or materially misleading. Schedules to the agreement should also be reviewed, since they often contain important information about matters such as:

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• Material contracts;

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• Share ownership; and

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• Pending litigation.

The information listed in this section should be supplemented by other information regarding the company's activities, including copies of the minutes of meetings of the board of directors and all board committees (and all actions taken by the board or a committee by written consent); and minutes of shareholders' meetings (and all actions taken by the shareholders by written consent).

Most of the information listed in the text should be collected from every company, regardless of whether the company has securities which are publicly traded. The liabilities associated with failure to comply with securities laws generally do not distinguish between public and private status although public companies certain have additional obligations well beyond private companies. The background information on shareholders' rights and similar matters is important when a company is contemplating a public offering. Once a public offering has been completed, a thorough due diligence investigation must include all the of the additional items at the end of the section including registration statements, correspondence with the SEC, period filings under the Exchange Act and special filings required under provisions of the Exchange Act that regulate tender offers and other large acquisitions of securities of publicly traded companies.

2. Business Information

In order to understand the scope of the company's disclosure obligations under the securities laws, the responsible party needs to have an idea of the type of business conducted by the company, the company's financial conditions, and the company's relationships with business partners (e.g., vendors, customers, employees, distributors, etc.). Hopefully, much of this information has been included in disclosure documents used in the company's prior offerings. However, it makes good sense to collect copies of all the company's important, or "material," contracts, and place them in a central file. Other important sources of information include:

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• Financial statements and related reports;

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• Reports prepared by outside consultants and experts regarding some aspect of the company's business; and

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• The company's own internal reports about sales, marketing, manufacturing, distribution, and competition.

All the information collected under this section can be used in preparing the company's securities offering disclosure documents. For example, it is common for business plans, private placement memoranda, and registration statements to have extensive discussions of the following areas:

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- Products;
- Research and development;
- Technology;
- Manufacturing;
- Sales and distribution;
- Strategic alliances;
- Competition;
- Properties and facilities;
- Laws and regulations; and
- Human resources.

The financial statements will often be included in their entirety as part of the disclosure documents. In addition, a narrative description of the company's financial condition will be prepared for prospective investors and current shareholders and will outline the company's balance sheet and income statement position. Of course, financial information can also be used as the basis for projections of future performance, an area which must be carefully reviewed by senior managers and securities counsel before disclosures are made to the investment community.

This section also calls for collection of information regarding the relationship between the company and its executives and employees. Executive compensation and employment agreements are always an important disclosure item and the information that must be included in a registration statement and/or Form 10-Ks and annual reports prepared pursuant to the Securities Exchange Act of 1934 (15 U.S.C.A. § 78a et seq.) is quite detailed. Employment agreements should also be reviewed to identify employees obligations to the company (e.g., assignment of inventions, non-competition and non-solicitation), as well as any liabilities that the company may have to employees with respect to compensation, bonuses, and benefits.

3. Securities Law Compliance Issues

While the preceding sections of the questionnaire focused on collecting information about the company and its business in order to identify potential securities-related transactions and prepare disclosure documents, this section goes directly to the issue of whether or not actions taken by the company might expose it and its managers (i.e., officers and directors) to liability under federal and state securities laws.

To some extent, the person(s) responsible for executing the securities law compliance program must play "devil's advocate" as they try and determine whether a violation of law may have occurred during the course of a prior offering. In order to

effectively discharge this role, the responsible person(s) must be well versed on the extensive case law that has developed around those sections of the federal securities laws that include liability provisions. The provisions which cause the greatest concerns for private companies (i.e., companies which have not registered a class of securities under the Securities Exchange Act of 1934) include Sections 3 to 5 (registration requirements and exemptions therefrom) (15 U.S.C.A. § 77c, 15 U.S.C.A. § 77e) and 12 (misstatements) (15 U.S.C.A. § 77
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) of the Securities Act of 1933 and Section 10(b) and Rule 10b-5 (misstatements) under the Securities Exchange Act. Section 11 of the Securities Act (15 U.S.C.A. § 77k) relates to misstatements and omissions in Securities Act registration statements and will apply to a private company's initial public offering and any subsequent registered offering.

The first step in this area is to be sure that copies of all prior offering documents have been collected. The information included in these materials will, of course, overlap with much of the information collected under the preceding sections. Nonetheless, it is crucial for the responsible person(s) to be able to review all public written communications which have been made to prospective investors. Communications to existing shareholders must also be reviewed, since information provided to shareholders by the company may be relevant to shareholders in determining whether to hold their shares and continue as an investor in the company or to seek a purchaser for the shares (including possible redemption by the company).

If available, the responsible party should also attempt to review copies of early drafts of shareholders' reports, proxy materials, and other disclosure documents (including registration statements once the company is ready to make a public offering). There are two schools of thought regarding the policy that should be followed with respect to retaining draft copies.

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1. Some argue that drafts should not be retained because they are almost never referred to by the company and can be used against the company in situations where a claim is later made that material in the document was vague, false, or misleading.

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2. Others argue for retaining drafts for some period of time as a means for determining the thought process behind particular disclosures. They also claim that drafts can be used as support for the statements that eventually appear in the final version of the document.

In any event, the company should establish a policy and stick with it, since exceptions may be given undue weight in the event that litigation erupts regarding the document.

The next step is to identify any actual or potential causes of action against the company with respect to the securities laws. Areas of concern include failure to comply with the registration requirements of the Securities Act and misstatements or omissions in disclosure documents or other communications to prospective investors. The next two sections deal with exemption issues and the factors that should be considered before undertaking a registered offering. The focus in this section is whether or not all of the requirements for an exemption from registration have been satisfied with respect to prior unregistered offerings. The analysis must take into account a number of things, including:

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• The number of offerees and purchasers;

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• The states in which offering activities took place;

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• The size of the offering; and

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• The sophistication of the investor group.

Once the responsible party has a preliminary idea about the type of exemption that may have been relied on for a specific offering, the facts and circumstances surrounding the offering should be evaluated in light of the factors listed in the next section.

Potential liabilities for defects in the disclosure documents should always be reviewed. Of course, if an actual complaint has been filed by one or more persons, the investigation should focus on the merits of the particular claim. However, even if no complaint has been filed, the responsible party should poll company managers to determine if there is any unhappiness among the company s investor group which might lead to a future claim. And, the actual performance of the company should be compared to any projections included in prior documents to see if a basis for a claim is developing. For example, the company's failure to achieve anticipated performance milestones may be a "red flag" for trouble, even if the failure stemmed from causes that couldn't reasonably have been anticipated at the time the disclosure documents were originally prepared.

4. Exemptions from Registration

The questions in this section focus on the basic requirements for the more common exemptions from the Securities Act registration requirements which may be relied on by private companies, and by public companies wishing to sell their securities without going to the expense of preparing and filing a registration statement. These exemptions include the private placement, or limited offering, exemptions under Section 4(a)(2) (15 U.S.C.A. § 77d(a)(2)) and/or Regulation D of the Securities Act (17 C.F.R. §§ 230.501 et seq.) and the intrastate offering exemption for offerings limited to persons resident in the state where the company's principal business activities are located (i.e., Securities Act Rule 147). Note that the questionnaire also solicits information about what other exemptions from registration the company may have relied upon in making offers and sales of securities and in those instances where an exemption other than Section 4(a)(2) (15 U.S.C.A. § 77d(a)(2)) and/or Regulation D (17 C.F.R. §§ 230.501 et seq.) was used counsel should plan on conducting further interviews to determine whether the requirements of such exemptions have been satisfied. For example, the exemption from registration under Section 4(a)(6) of the Securities Act (15 U.S.C.A. § 77d(a)(6)) allows issuers to raise up to $1,000,000 from potentially large numbers of small investors in so-called "crowd funding" offerings; however, reliance on that exemption requires satisfaction of extensive disclosure and reporting obligations (see § 151:78).

In any event, information should be collected about the following:

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• The dollar amount which the company seeks to raise in the offering;

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• Whether a portion of the offering includes securities which have already been issued to existing shareholders (i.e., a secondary offering);

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• Whether the current offering is so close in time to a prior offering that there is a risk that the two offerings will be "integrated" for securities law purposes;

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• The manner in which the company intends to promote the securities to prospective investors;

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• The geographic scope of the offering (e.g., within a single state or across state lines); and

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• The number of offers and the relative level of experience and sophistication of the offeree group.

The dollar amount of the offering is relevant to the amount of regulation that the company may confront in completing the financing.

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• Offerings of up to $1 million in securities can be accomplished with few restrictions under Rule 504 of Regulation D (although compliance with state securities law is still required).

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• Offerings of up to $5 million may be made under Regulation A (17 C.F.R. §§ 230.251 et seq.) and a procedure similar to Regulation A can be used to facilitate offerings up to as much as $50 million (see § 151:87).

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• In cases where the offering is limited to persons or entities meeting the conditions for "accredited investor" status under Regulation D, the dollar amount of the offering is irrelevant and it may also be possible to conduct the offering without needing to comply with the restrictions on general advertising and solicitation that generally apply to exempt private offerings. This is one of the main reasons for collecting information about the experience and sophistication of the offeree group including the specific documentation suggested by the SEC in Rule 506(c) (see § 151:77).

Timing of the offering, and the possibility of "integrating" two or more offerings that fall close in time, is important because integration may deprive the company of an exemption and cause all the offerings to violate the registration requirements of the Securities Act. For example, Rules 505 and 506 of Regulation D permit the sale of securities to up to 35 "non-accredited investors" (and an unlimited number of accredited investors) provided that certain other conditions are satisfied, including manner of offering and disclosure requirements. If a company sells securities in a Rule 506 (17 C.F.R. § 230.506) offering to 30 non-accredited investors in January and then sell securities to another 20 non-accredited investors in March in an offering which is "integrated" with the January sales, the Rule 506 (17 C.F.R. § 230.506) exemption may not be available and all the sales may have violated the registration requirements.

5. Public Offerings

The questions in this section are appropriate in situations where the company is considering its first registering offering, an event which generally leads to public company status and the need to comply with the periodic reporting requirements and insider trading rules of the Exchange Act. "Going public" is a big step, and managers need to carefully consider the costs involved, not only in preparing the registration statement and completing the offering, but also in dealing with a large shareholder group and the formalities associated with corporate governance of a public company. In many cases, public company status is an attractive way to raise new capital and provide liquidity to the company's existing investors. The ability of the company to successfully bring its stock to market will be determined with the advice of investment bankers, and the company will be required to enter into an underwriting agreement with extensive representations and warranties and operational covenants. For further discussion, see Registered Public Offerings (§§ 288:1 et seq.) and Reporting Companies (§§ 290:1 et seq.).

Footnotes

* Alan S. Gutterman is the founder and director of the Business Counselor Institute (www.businesscounselorinstitute.org) and the Growth-Oriented Entrepreneurship Project (www.growthentrepreneurship.org). He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University and a Ph.D. in Law from the University of Cambridge in the United Kingdom. For more information about Alan, see https://www.linkedin.com/in/alangutterman and/or contact him at agutterman@alangutterman.com.

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