WHAT EVERY ENTREPENEUR SHOULD KNOW ABOUT GOING PUBLIC

YOUR INTRODUCTION TO BUSINESS SUCCESS THROUGH PUBLIC SECURITIES OFFERINGS

By Attorney David Grossack

Law Office of David Grossack, P.C.

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STARTING POINTS

If you are in business for yourself or thinking about it, there is a very good chance, in fact, an overwhelming likelihood, that having enough money to achieve your goals will be a problem.

This book is offered to discuss a possible way of overcoming this obstacle.

Going to a bank is an exercise in futility for many entrepreneurs. The old joke about banks only lending money when you can prove you do not need it is true. Banks do not invest. They insist on as safe a deal as they can find. Investing implies risk. Banks are averse to risk. That is why if you go to a bank to borrow, they insist you give then security interest in all of your property, stock portfolio, boats, cars or whatever you own as collateral even if you are trying to borrow money for a corporation and these assets are in your name personally. The only people who convince banks to lend their businesses money without the owners being personally liable are those corporate entrepreneurs who are so well capitalized that the bank feels so safe with them that they can probably do without the loan.

Interest on bank loans turns many small business owners into debt slaves to the bank. It's not an uncommon situation for the cost of borrowing money to force a business into ruin. It happens every day.

Searching for venture capital from private investors is a very difficult path to follow. The recognized venture capital community in the US, Asia and Europe is literally deluged with people seeking money. Their desks are piled up with proposals of varying qualities. They tend to be a club where introductions from their circle are often a key to being considered. Rarely do outsiders ever receive serious attention from a venture capital group.

When a venture capitalist is interested in your company, he drives a very hard bargain. Some of them offer a loan and they want it collateralized by both your personal property and stock in your company. The venture capitalist, like a bank lender, will have a law firm working for him who does nothing except draft agreements to give his clients the very best possible deal he can get. Other venture capitalists want a large stake in the company, control over the board of directors and a voting control of the stock.

This path has been the ruin of many a company founder.

THE ALTERNATIVE

What is the alternative?

Simply put, selling shares of your company to the public may well be the only real way you can obtain capital from the public without incurring tremendous personal exposure and losing control of the business. Of course, there is no pledging of personal assets. When a company sells stock there is no loan to be repaid. There are no interest payments. One can structure the sale of the stock so that control of the company is not surrendered. One can even issue a class of stock without voting rights.

The creation of publicly tradable stock has made more people millionaires than any other process.

Moreover, company founders have a significant amount of control over the events involved and when they become educated about the process, they realize that having the ability to issue stock is almost like printing up money in your own home or office.

Naturally there are some disadvantages to selling stock.

First, it is a complicated process with rules and regulations that are best understood by lawyers and accountants who have expertise in this field. Your average lawyer on the block is unlikely to know even the basics of securities law; it takes one with specialized experience and training.

Second, violation of the rules and regulations may lead to being the subject of extensive investigation, lawsuits and even criminal prosecution. That is why you need the guidance of lawyers and accountants every step of the way.

Third, it is a long, drawn out process. Preparation of disclosure statements, finding and working with the lawyers, accountants and investment bankers are all time consuming endeavors.

Fourth, it is expensive. Very expensive. The process makes best sense if you are trying to raise, (in my opinion), several million dollars, given the expense, vexation and numerous hassles you will face. In this process you need a law firm with securities experience. Similarly, one will need accountants with SEC experience, peer review credentials and liability insurance.

Before you return this book in disgust thinking “where will I ever get the money to hire the lawyers,” think over this possibility:

What if several small companies merged to share in the legal and accounting expenses? They would become one stronger company and more attractive to the investment community. Control would be exercised by a Board of Directors with representatives of each company. Is it too crazy an idea? You would be amazed how many egotists chose to flounder than cooperate with other people but I think it is the real way to go for thousands of emerging businesses.

As a Consultant to emerging public companies, the author has seen deals come and go. He has met inventors, promoters, deal makers, lawyers and accountants, regulators, brokers and tycoons. One thing has stuck in my mind: Nothing is so important as character. Honesty and integrity, caring for other people and doing the right thing by your fellow man and woman and being responsible in your relationships with the people around you, are of great importance.

THE REGULATORY FRAME WORK

If there was no regulation of the sale of securities your task would be easy. You could advertise on TV, in the newspapers, do mass mailings, perhaps walk door to door and even put up a Web page on the Internet and promote your company without ever filing a registration statement with the state and federal officials who regulate this process.

Unfortunately if you did this today you would most assuredly face severe legal action by the Securities and Exchange Commission and the Securities Division of the state government where you reside.

Therefore it is important that you have a good understanding of the legal environment in which “going public” occurs.

All public sales of securities must be registered unless they are exempt.

Securities include share of stock, debentures, limited partnerships and beneficial interests in a trust.

Securities can also take other forms if the regulators decide that what you really have is an “investment contract.” In the case of SEC vs. W.J. Howey Co., (328 US 293) the United States Supreme Court accepted a definition of an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common endeavor and is led to expect profits solely from the efforts of a third party... it being

immaterial whether the shares in the enterprise are evidenced by certificates or nominal interests in the physical asset employed in the enterprise.”

From time to time one has a situation where there are exemptions from registration, or streamlined or “mini-registrations” that can be done or sales of stock that are exempt as private placements or isolated transactions.

Before these terms can be dealt with, it is important to understand a piece of legislation enacted around the time of the Roosevelt New Deal... the Securities Act of 1933.

The theoretical reasons for the Securities Act of 1933 were based on abolishing the principle of caveat emptor in the investment industry. Caveat emptor, of course, means “buyer beware.” There can be no secrets kept from investors anymore, the registration statement is designed to disclose every material fact about the investment that any reasonable investor would want to know. Selling securities which have not been registered according to the Securities Act of 1933 is a federal crime.

It is in the preparation of the registration statement that the major expense of the process of going public arises.

A few brave souls try to do these registration statements on their own without an attorney. They seek out copies of registration statements done by companies in a similar business, get the word processors going, and start rolling. This was especially common in the era were blind pools were popular. Blind pools were companies created for the purpose of raising money for a purpose to be decided later on! They were spun out like cookies from a mold and eventually nicknamed “deaf pools” because investors often never heard about them after they had parted with their money.

Regulators have targeted blind pool promoters for close scrutiny because of many losses and it would be unwise to go this route.

Get accustomed to seeing a different vocabulary

For example, dilution is a term in accounting that is frequently seen on a registration statement. Dilution refers to the change in the value of each share when new shares are sold and there are new assets added to the company.

Changes occur in the value of each share whenever new shares are issued by the company. Another item on every registration statement is the term “risk factor”. Whoever drafts a registration statement must list the risk factors which affect the possible performance of a company.

Risk factors often include some of the following items:

1. The fact, if applicable, that the key personnel have limited experience in the field.

2. The fact, if applicable that key personnel have other interests which affect their time commitment to the company.

3. The fact, if applicable, that competitor companies are better capitalized, have well established market shares, channels of distribution, and have more experience in the industry.

4. The dependence of the company, if applicable, upon key personnel.

5. The limited trading market for the securities.

6. The arbitrary determination of offering price.

Of course, this is only an abbreviated and partial list.

Omission of risk factors could be grounds by a suit by investors if the omission is material to any losses they suffer.

Biographical data concerning officers and directors is also required in a disclosure statement.

Compensation of officers and directors must be discussed, as well as their ownership of stock.

Detailed description of the business of the company, description of the securities to be sold and a detailed plan of how the securities are to be offered and sold, i.e.

underwriting arrangements, warrants (options) and everything else an investor would want to know must be disclosed in the registration statement, which will include a draft preliminary prospectus. When a stock is sold as an initial public offering, purchasers must be given a prospectus. Failure to do so is grounds to rescind the sale of the stock. The stock cannot be sold unless the SEC issued a clearing letter after the registration statement is filed with the Commission.

However, that is not the end of your regulatory hurdle.

State Blue Sky laws require registration at the state level of every offering of shares within the state unless an exemption is to be found in their labyrinth of rules and regulations.

The kind of information needed to satisfy state registration requirements usually includes a variation of the following:

1. Corporate name, state and date of incorporation.

2. A broad description of the business and its location.

3. A description of the business' assets and equipment.

4. A brief description of the business' competitive environment.

5. Identification of company officers and directors, the amount of compensation they will receive, their stock holdings in the company.

6. Contractual agreements between officers and directors and the company or its affiliates.

7. A list of all individuals owing ten (10%) percent or more of the company.

8. Compensation paid to promoters of the company.

9. Complete financial information about the company including:

    a. Assets and liabilities of the company, its affiliates and subsidiaries
    b. Capitalization and long term debt
    c. Current and long term assets and liabilities

d. Earnings history

10. A description of the kinds of securities being issued, the proposed offering price and the means by which the price was computed.

11. Underwriting commissions and finder's fees paid to agents, promoters, etc.

12. Experts' fees for preparing an offering, i.e. geologists if a mining company, legal expense, accounting fees, Consultants' fees.

13. Contract with underwriters.

14. Estimated cash proceeds to be received from the offering.

15. The purpose for which the proceeds are to be used; the amount to be used for each purpose; and the amounts to be raised from other sources.

16. Complete disclosure as to who holds stock options among officers, directors and promoters. Description of all stock options, warrants.

17. A description of all material litigation involving the company.

18. A description of contractual obligations of the company other than those made in the ordinary course of business.

19. A copy of all promotional literature intended to be used in the offering.

20. A specimen copy of the securities being used. Copies of the company articles of organization and by-laws.

21. Lawyer's opinion letter about the legality of the security being registered.

22. Expert opinions connected to the company's registration statement, i.e. the opinions of accountants, appraisers, engineers, geologists and scientists, if applicable.

23. Balance sheet of the issuer as of four (4) months prior to filing a registration statement, a profit and loss statement, and analysis of surplus for each of the three fiscal years preceding the date of the balance sheet if available.

In approximately twelve or thirteen states, filing this information accurately is enough to qualify a company to be in compliance with that state's blue sky laws.

These states are called FULL DISCLOSURE STATES. The other thirty-eight or so states are called MERIT REVIEW STATES. For the securities regulators in these states full disclosure of the information described above is not enough to obtain clearance to sell your stock. They have to be certain your offering is economically viable. Such states are more difficult and sometimes impossible to obtain permission to sell stock in if you are a new company.

Going public then is not a bed of roses. Obviously, the paperwork, time, and expense is a drawback.

Some states exempt certain companies from registration if the company is listed in highly regarded securities manuals. Fitch's Individual Stock Bulletin, Moody's Industrial Manual and Standard & Poors' manuals and so forth already contain so much information about a stock that it is the policy of some states to rely on them as a means of disclosure. The catch in the manual exemption is only good for secondary trading, i.e. n__-issuer sales, or sales by private parties.

The regulatory hurdles having been overcome, the entrepreneur's company, which from now on will be referred to as the “issuer” (because it is issuing stock) can begin to trade.

An important prerequisite to trading is to have a market maker. A market maker is a registered securities dealer who provides and publishes competitive “bid” prices (price he will buy at) and “ask” (price will sell at) quotations for a particular stock. The securities industry relies on market makers to buy for their own account, to keep the market orderly on an ongoing basis.

It is likely that your company will be begin as an “over the counter” or OTC stock, which will be traded directly between brokerage houses and individuals. Price will be reported in the “pink sheets” a daily publication of the National Stock Quotation Bureau, a private company which prints on pink paper a list of the over the counter stocks, their market makers and the market makers' bid and ask quotations.

Some companies now trade on an electronic bulletin board, which was established in the Spring 1990 to automate by computer a list of OTC stocks and to provide bid ask prices.

If you go public with an underwriter (a company which arranges the sale of your stock for you through a network of brokers for a commission) your underwriter will arrange market makers and listings on the OTC or one of the exchanges.

Underwriters often work in one of two ways in how they structure their agreements with you.

One method is the “best efforts underwriting”. This is when the underwriter does not contract to sell a specific dollar amounts worth of stock. Instead, the underwriter is agreeing to use its best efforts to sell as much stock as it can... without any guarantees.

The other method is called “a firm commitment underwriting.” This is when the underwriter promises to sell a specific amount of stock and guarantees that the issuer will receive a specific amount of proceeds of the sale of the stock.

In some underwriting agreements the underwriter agrees to buy stock from the issuer and then either hold it for a period of time or sell it, or some other combination of terms.

If an underwriter violates any securities laws, either willfully or through negligence, it is possible for the issuer to also be liable, at least in terms of civil liability (i.e. a lawsuit for monetary damages), and vice versa.

QUARTERLY REPORTING OBLIGATION

Securities and Exchange Commission (SEC) rules include tremendous obligations for detailed record keeping and compliance with a plethora of ongoing disclosure requirements. The SEC requires quarterly reporting of financial condition and an extremely detailed annual report due after the end of the fiscal year. The annual report is known as the 10K; the quarterly report is referred to as a 10Q.

These disclosures should be prepared by an accounting firm with extensive SEC experience. If errors in accounting practice are discovered and publicized and the stock dips, there is a potential series of civil and criminal legal problems. The reader must understand the concept of living in a fish bowl and the consequences of every action.

Every significant event which occurs in a company, such as a merger or acquisition or a substantial private placement, a new invention or other event which could have a material effect upwards or downwards on a stock's price must also be disclosed on Form 8K within 15 days of the event. Form 8K is filed with the SEC.

During this time company founders and “insiders”, such as officers, directors, accountants and lawyers, are barred from profiting on undisclosed information obtained by their insider status.

Moreover, the shares they hold are usually subject to what is known as a restrictive legend. It is a part of the labyrinth of exemptions, restrictions and legal barriers that await shareholders of companies with publicly trading stock.

Simply put, all stock held by insiders when a company does an initial public offering remains subject to the restriction of Rule 144. This generally places a two year waiting period on the shareholder and the limited sales of stock can take place subject to a fixed percentage of trading volume set forth by the rules the SEC currently has in effect.

The rule applies to sales into the open market. The SEC does not apply to Rule 144 to sales to private parties or to foreign citizens residing outside of the United States.

The question then arises as to whether these buyers can then sell their shares into the open market.

The answer appears to be a qualified “sometimes.” Possible exemptions to the registration requirement may exist under Section 4.1 of the securities Act of 1933.

Section 4.1 of the 1933 Act exempts from registration the transactions by persons other than an issuer, underwriter or dealer.

Unfortunately, SEC law has evolved to the point whereby one can be declared a “statutory underwriter.” This makes the exemption void, and subjects the seller to penalties. Statutory underwriters are persons who may not technically be brokers or dealers or underwriters, but if they purchase enough stock and make enough transactions with large amounts of stock or otherwise engage in conduct which could make it seem as if they are behaving like an underwriter, then they are no longer entitled to the exemption, as confusing as it may sound.

The rule appears designed to prevent private parties from acting as conduits for holders of restricted stocks trying to circumvent Rule 144.

SUPERCURRENCY

Even if your stock is restricted, there are things you can do with it.

For example, the stock can still be used to trade for things you want. The author has heard of restricted stock being used to acquire everything from private or public companies and ranches to paintings and big screen television sets... and office buildings.

Some banks will allow you to use it as collateral for a loan. Often a good use of restricted stock is to fuel mergers and acquisitions. It is possible to structure proposals to acquire controlling interests in much larger companies using restricted stock as a down payment and adding debentures (promissory notes) and other consideration to the package. This is done by companies seeking to acquire other companies, or a specific asset of another company, such as real estate, equipment or a patent or trade secret.

The classified advertisement sections of the Wall Street Journal and World Wide Business Exchange often feature ads from people searching for restricted stock to use in barter, buying real estate or raising collateral.

Tender offers are offers made by people seeking to acquire a controlling interest in a corporation by means of obtaining shares held by groups of shareholders. Very often tender offers include stock in one company to be used as a payment or partial payment for the target shares of another company.

The Securities and Exchange Commission has complex rules and regulations for the acquisition of stock in a public company by means of a tender offer. The tender offer must be disclosed in a detailed form subject to comments by the SEC.

STOCK SWAPS

Stock swaps are a very valuable tool for building a company, diversifying investments and increasing the balance sheets of a company.

Companies can swap stock even if it is restricted. This is a great way of building business alliances and a corporate investment portfolio.

Valuations of the stock acquired for disclosure purposes is a sensitive issue. The valuations must be done by a firm of certified public accountants with a great deal of experience in performing these kinds of valuations. There are specific formulas used to value restricted stock, stock in private companies and so forth that only a qualified accounting firm should be entrusted to work with.

Although the accounting expenses will seem high, the best strategy is to pay the bill for the best qualified help and not risk a major hassle with federal regulators over your financial statements.

A risk in doing too many stock swaps is that the SEC may consider your cooperation a holding company and require a new registration statement from it. Generally, if a company has one ongoing concern, i.e. operating company, it is exempt from being treated as a holding company.

SHELL MERGERS

From time to time a company will go public by acquiring a “shell company” which is already publicly trading and conducting a reorganization or so-called “reverse shell merger” for the purpose of obtaining the ability to create a trading vehicle instantaneously.

There are tremendous advantages to this, as well as disadvantages.

The positive side is that the shells offer a company to have control over a publicly trading stock and all of the benefits thereof instantaneously. For secondary trading purposes, this offers a lot of opportunities for investors and speculators, as well as the entrepreneurs who can do a secondary offering with their new vehicle, and have tremendous avenues open a public company with the ability to acquire assets, raise money and settle liabilities with restricted stock.

Disadvantages also exist with shell mergers. Whenever a shell deal is put together, a lot of events take place that are particularly problematic if the wrong circumstances all happen to fit together.

Remember that when a shell is acquired the new controlling persons are acquiring somebody else's company. They're stepping into existing shareholder lists, possible debts or contingent liabilities and the reality of having large blocks of stock sitting out there in investor land waiting for a high stock price to unload their holdings.

At such a point in time the stock price will fall unless a trading volume has emerged to balance purchases with sales and vice versa.

Thus total chaos can unfold with a company's share price.

Experienced public company executives frequently use a “reverse split” to ward off some of the damage done by theses lurking Damocles' swords.

The reverse split forces a shareholder to surrender his stock for a small fraction of the number of shares he formerly held and, to compensate him, the price of the stock is increased proportionately.

If the stock held by potentially problematic shareholders is restricted at the time of the reverse split, the potential for damage will be curtailed. Shell mergers attract speculators and promoters who have been known to use sharp practices and wreak havoc on share prices, the last thing you need in building a company.

Even if you dot all I's and cross all your T's, and spend $150,000 on lawyers, accountants, promoters and financial public relations, there is no guarantee that you will sell a dime's worth of stock.

This is truly scary.

Many a fortune has been spend on a SEC filing without any stock being sold!

Many a fortune has been paid for publicly trading OTC shells for naught.

All kinds of money can be spent putting deals together and then nothing is left to show for it.

This is why a number of factors must be considered before one goes through the time and effort and expense of trying to do a public offering.

Do you have a company or concept that will attract investors?

What is there about your business plan (make sure you have a business plan!) that will attract investors?

Can you add any glamour or sizzle to the company?

The use of press kits, cassettes, videos, seminars, tours of a factory, what it takes, should be utilized to make an impression on brokers who you want to promote stock, and investors who you want to put their hard earned money into your company.

Think... if you were an investor would you want to invest in your company? If not, what could you do to change their perception?

By the way, be sure you clear all promotional materials with legal counsel.

Image is the most important thing you have going after substance. Some people say it is more important than substance. The way company personnel are dressed, how organized the company seems to be. The diction and erudition of key employees, the neatness and tidiness of the premises of the business; these are all factors that might be important to people who will unquestionably visit your place of business and decide that the company should or should not be within the scope of their attention.

The company you're promoting should have the potential to grow into a large company that will be sizable enough to deserve the attention you are trying to get for it.

The rewards are certainly there, but they have to be earned and deserved.

Building a strong public company is not a simple task. It requires a team of competent people who know their strengths and know their limits; and know when to get outside assistance when it is needed.

PART TWO
MERGE YOUR WAY TO BECOMING A PUBLIC COMPANY

It is possible to take your existing company and make it a part of, or the controlling force, in an existing public company, i.e. one that has 500 or more shareholders and which is trading on an exchange or the bulletin board, or which is qualified for that purpose.

There are a fair number of promoters and "dealmakers" who have the knowledge of where shells can be or obtained or they have the staff and professional support team of lawyers and accountants to create IPO's off of a word processor.

One can also look over the listings of the various public companies throughout the country and abroad and very often find one willing to acquire your company or assets for stock or willing to even allow you to acquire effective control of the company exchange for stock or cash or a mixture in trade.

Advertisements for these kinds of deals are found all day long in the Wall Street Journal, Barrons and similar publications.

The important considerations are as follows:

1. Make sure the legal and accounting professionals who you use are well trained in this kind of work. Have them review the work of the shell company's predecessors accountants and lawyers.

2. When you acquire a public shell make certain the company's corporate record book includes details of meetings, elections of officers, properly ratified actions, and necessary disclosures to regulators.

3. If there are defects make sure they are corrected.

4. Review the history of the company with a fine tooth comb. Review the commercial transactions and accounts of the company. Obtain extensive reports concerning all of the debts of the company, liens, lawsuits, possible lawsuits, loans, bad deals, deals that may turn sour, disgruntled former employees or what have you.

The reason for these steps should be obvious. If you take over a corporation run by others and they mismanaged it, you can be in for their headaches. If they promise to indemnify you for any problems that arise, they simply might not be able to afford to do so thus you must insist upon a clean shell, verify that it is clean, and still make yourself personally judgment proof just in case. Given the common occurrence of shareholder liability suits, no matter what you do with a public company, it is necessary to own nothing in your own name, not a bank account, not a property, and no luxury cars, planes or boats.

Using another family member who has nothing to do with the public company is one way of judgement proofing, but a lawyer who is specialized in asset protection can tell you more about this.

In any case, a public shell has no real purpose unless it helps you raise money.

When the shell becomes no longer a shell, and has your company inside of it, a series of steps must be taken to make it legally capable, and otherwise capable of trading, of obtaining a quote and being used as a vehicle to fund your needs.

This process is not necessarily simple.

As pointed out earlier, the regulatory maze is intricate, expensive and time-consuming. Finding a honest, diligent market-maker, an underwriter, experienced securities and lawyers who will all work well together is a significant project.

A company with a bright future is clearly more likely to attract a strong and effective team than one that looks like an ego trip or smoke and mirrors.

IS YOUR COMPANY A CANDIDATE?

The glitter and sizzle of an emerging company is reflected in its arithmetic and its potential for attractive numbers in the future.

Further, the glitter and sizzle can be enhanced by any number of factors:

1. The track record of management, in other companies.

2. The stability of the company. Does the company have cash reserves to meet expenses and withstand a crisis?

3. The company's market share of an industry.

4. The strength of the competition.

5. The potential for growth. Can this business be franchised?

6. Does the company have a toll-booth, i.e. a service or product that people cannot get elsewhere and therefore are under pressure to buy from your company?

7. Is there a patent, trade secret or copyrighted software?

8. How solid are the channels of distribution?

9. Did the founders put up any of their own money? Did they pay a reasonable price for the stock they obtained?

10. Are there experts in necessary fields affiliated with the company?

11. How solid is the concept? How vital and important is the service or product?

12. Is it unique? Would you feel comfortable telling a close friend or relative to put his or her own money (or putting your own money in to this venture if it were run by somebody else)?

13. Do you convey the sense that you are trying to build a company or trying just to get money from investors? This is a problem among start ups. The start up venture has a credibility problem. Can you overcome it?

14. What can be done to overcome the obstacles presented by adverse answers to any of the above questions?

To attract investment bankers and promoters to the company, you must be certain that you have something that they will feel excited about because investors will feel excited about it. It's that simple.

A merger and acquisition strategy before the offering might create a synergistic impact that could make a dull company look more interesting if it is properly structured and well thought out.

OPPORTUNITIES FOR FINDERS

The opportunity to earn a finder's fee in the six or even seven figure range is not impossible in the world of securities. Mergers and acquisitions offer the chance to help companies obtain assets far greater than themselves, often using cash in the most sparing way.

Stocks, warrants (options) and debentures (IOU's) are used as substitutes for cash, Companies can almost always issue a promissory note or more stock to pay for an asset if another company will accept it. A finder brings together two or more persons or companies with mutual needs and allows them to work out the transaction themselves. His fee is paid when a transaction is consummated unless other arrangements are made.

Many companies will employ finders to locate assets they can buy with stock.

Written contracts are necessary for finders, because may unscrupulous people look for an opportunity to avoid paying the finder. It might be wise to charge a modest advance fee in addition to a contingent fee so that no money is lost on the transaction.

The Cambridge Sterling Society will work with finders who want to help build companies. We will include finders in projects and see to it that their interests are protected. Any interested person can simply contact the author and indicate the areas of their interest. Perhaps you know of a company that would like to merge with a public company. Or a company that will be interested in acquiring a supplier or a distributor. Or perhaps you have an idea for a company.

In any event, we want to hear from you!

THE SEC AND SECURITIES REGULATION OVERSEAS

With the apparent triumph of the market system over the planned economies in Russia, Eastern Europe and People's Republic of China, the need for capital formation and the financing of private enterprise is of obvious importance to the stability of these changing social systems, throughout the planet.

These factors contribute to the development of a great interest in the former socialist countries and throughout the Third World in the techniques of debt and equity financing to the extent that there are now stock exchanges emerging in almost every corner of the world.

More than ever before, the market for capital and financial instruments is international.

Yet this market is frequently hamstrung due to regulation by individual nations rather than by an international body which could offer standardization by means of a uniform international code of securities regulations.

Each country's legal system governs the offer and sale of securities in its respective jurisdiction, and in the instances of the United States and Canada the subdivisions of states and provinces further regulate sales.

The Congress of the United States delegates the authority for securities regulation to the Securities and Exchange Commission (SEC), a body politic of the Executive Branch.

The majority of the SEC's time is expended in implementing the Securities Act of 1933 and the Securities and Exchange Act of 1934 which respectively govern the registration of securities and the marketing of securities.

The theoretical rationale of securities registration is investor protection through disclosure of facts about a company's activities, financial data and risk factors.

U.S. Securities registration laws require exhaustive (and expensive) disclosure of many items pertaining to every detail of the company, its officers, and the book value and dilution of its shares and similar information. Registration expenses often exceed $100,000 (U.S.), creating substantial expense to capital formation for small companies.

Restrictions exist on shares which are not registered or which do not fall into any category of exemptions (See Section 5, Securities Act of 1933)

Recognizing the development of the growing internationalization of securities trading and the need for finance capital and instruments to be able to move across national boundaries, the SEC, on April 24, 1990, issued a new policy for releasing restriction on securities intended for the offshore market.

Known as Regulation S, this could be the beginning of a flexibility on the part of the SEC to enable active involvement of offshore investors in the U.S. enterprises and to stimulate economic growth consequently.

Under SEC Rule 902 of Regulation S, the shares of publicity held reporting companies, (companies that file quarterly reports of their financial conditions to the Securities and Exchange Commission) can be sold offshore and, although restricted in the United States, can be free trading forty (40) days after coming to rest outside the United States. This has in fact promoted an increased interest among U.S. holders of restricted securities in publicly traded companies in the offshore market.

Rule 902 of Regulation S requires that offshore sales be made subject to “offering restrictions” in the 40 day period until the offer (from the U.S. to a foreign purchaser) is presumed to come to rest.

These restrictions can be summarized as follows:

a. Full disclosure that the securities being offered are restricted.

b. Full disclosure that the securities cannot be sold to U.S. residents unless they become exempt.

c. None of the shares are sold to U.S. citizens or residents in the one year period.

d. No marketing activities are conducted in the United States in the one year period for the shares.

Nevertheless, once the securities fall into the hands of bona fide investors who are not underwriters, broker-dealers, issuers or affiliates, the securities are exempt under Section 4.1 of the Securities Act of 1933 which reads as follows:

"The provisions of Section 5 shall not apply to... transactions by any person other than an issuer, underwriter or dealer." (Section 5 is the registration requirement). Hence, offshore investors can acquire shares of restricted securities in the hands of issuers or American stockholders who desire liquidity.

There is left unresolved the question of compliance with the securities registration laws with the 192 other countries in which U.S. securities can conceivably be sold.

The Securities and Exchange Commission has already entered into Memoranda of Understanding (MOUS) with several countries, including Brazil, the United Kingdom, Japan and others providing for reciprocal enforcement of securities laws.

The United States has also entered into treaties with the Bahamas, Belgium, Columbia, Mexico, Morocco, Canada, Thailand and the Cayman Islands to provide mutual assistance in enforcing U.S. securities laws.

Hence, any American who sells or trades U.S. securities in another country in violation of local laws can, in theory, be prosecuted in the U.S. or extradited for prosecution to the aggrieved jurisdiction.

Moreover, through treaties, the SEC can cause foreign nationals residing in other countries to be required to comply with requests for answers to interrogatories, and other tools of discovery leading to resolution of criminal, civil and administrative cases.

Frequently the SEC has failed to secure foreign cooperation in the enforcement of its discovery requests for a variety of reasons related to local law or custom.

As a means of enhancing its ability to work with local enforcement authorities, the SEC has been participating in the IOSCO, The International Organization of Securities Commission, which was established fifteen years ago as the Inter-American Association of Securities Commissions and similar organizations.

In November, 1980, the Executive Committee of the IOSCO adopted an SEC proposal relating to cooperation among securities commissions calling upon all members to provide assistance on a reciprocal basis for obtaining information related to market oversight and protection of each nations markets against fraudulent transactions; and to designate a contact person who will insure the timely processing of all request for assistance. Twenty-two members in addition to the SEC signed the resolution including Argentina, Bolivia, Brazil, Chile, Taiwan, Columbia, Costa Rica, Ecuador, France, Great Britain, Hong Kong, Italy, Mexico, New Zealand, Nigeria, Norway, Ontario, Panama, Peru, Quebec, Trinidad and Tobago, and Uruguay.

Hence, the tools for international enforcement and regulation are beginning to take a solid form.

As an inhibitor to fraud on investors, there is clearly a strong public policy argument for a global strategy for securities law enforcement.

However, with the exception of Regulation S, there is no similar stampede to breakdown international barriers to capital formation, multinational securities trading and the encouragement of a deregulation of the costly and stringent securities registration process which acts as a barrier to enterprise development in the United States and many other countries.

Virtually every major industrial nation, (and many others) have enacted their own form of the Securities Act of 1933.

Further, the various stock exchanges have enacted their own listing requirements, trading rules and regulations governing the behavior of brokers.

The various stock exchanges of member nations should be persuaded to allow trading in companies that would list their securities through the reciprocity, perhaps according to standards agreed upon by nations through an international treaty.

Clearly, United States policy has been to strengthen the role of international law in solving international problems.

Securities law on one hand supports the challenges of law enforcement, but on the other hand can be structured to promote economic development.

From both perspectives, uniform reciprocity could be an effective policy to encourage fair market practices and an adequate, but hopefully not excessive, system of regulation through disclosure and reporting.

The federal courts of the United States have made no secret of the fact that they recognize the Securities and Exchange Commission's claim of global jurisdiction to regulate and enforce U.S. securities trading laws, at least as far as insider trading and fraud are concerned.

In the case of SEC vs. Collier, No. 88 Civ. 4505 (C.D. Call. July 26, 1988) the Securities and Exchange Commission brought suit against one Geoffrey Collier who already used the services of an American broker-dealer to trade with inside information.

The case was unusual because Collier misappropriated the information from a British investment concern where he was employed, and made his trades on the London Stock Exchange, ostensibly outside of the SEC's scope of authority.

Collier had apparently used the American broker in an unsuccessful attempt to evade detection in the United Kingdom. Therefore, jurisdiction was exercised by the U.S. District Court for Central California and the British defendant consented to injunctive relief.

The U.S. broker was made a co-defendant in the action, which was brought under Section 10(b) of the Exchange Act and Rule 10b-5.

In SEC vs. Wang and Lee, No. 88-4461 (RO) (SDNY, July 9, 1988) a New York federal court issued a restraining order against defendant Fred C. Lee, a Taiwan national residing in Hong Kong enjoining him from removing assets from banks in Hong Kong, as he was under investigation for insider trading.

After the district court granted the order, Lee sought declaratory relief from a Hong Kong court nullifying the effort of the New York court order freezing his bank accounts.

The U.S. District Court issued an “anti-suit” injunction against Lee prohibiting him from bringing an action against the Hong Kong bank to unravel the SEC's asset freeze.

The Hong Kong Court eventually decided that the local bank was in fact holding the Defendant's funds as a constructive trust for aggrieved investors and ultimately substantial restitution resulted.

Other SEC actions have included successful attempts to order Swiss banks to violate their own regulation by waiving customer confidentiality SEC vs. Banca Della Svizzera Italiana, 81 Civ. 1836 (MP) (SDNY).

In summary, the Securities and Exchange Commission has achieved tremendous power in acting as a global police of economic activity. While the lofty purpose of investor protection may be an objective worthy of praise, such an omnipotent and ubiquitous concentration of authority could be abused if there are no checks and balances.

To the extent that an international organization could possibly assist in developing and enforcing a uniform securities laws, this option should be considered as a means of promoting world economic growth, and allowing all nations to participate in developing and enforcing these laws.

THE SCOR PROGRAM

The agencies which regulate the sale of investments to the public such as the Securities Division of the various states and the Securities and Exchange Commission are confronted with conflicting missions. On one hand they wish to protect investors by requiring extensive disclosures from entrepreneurs who wish to raise money, yet on the other hand they want to avoid hamstringing the economy by making the process so costly and cumbersome businesses give up on financing.

Most states have adopted a program promoted by the North American Securities Administration Association known as SCOR (Small Corporate Offering Registration)

The SCOR program allows a simplified securities registration process which allows small businesses to go public by selling up to one million dollars worth of securities every twelve months. The program allows an entrepreneur to begin his or her company from ground zero using investor's capital contributions or permits an existing company to raise money for expansion, research or other purposes, so long as the uses of the money are disclosed fully.

Registration of stock through a SCOR offering is through a question and answer format; there are 57 questions asking about every conceivable matter which an investor would want to know, ranging from the job experience of the Board of Directors to the time period it will take for company operations to become profitable.

Audited financial statements to the extent available must be produced as part of the entrepreneur's disclosure package. Each time a SCOR offering is filed, the issuer (the company selling the stock) must file a 4 page Form D with the regional office of the Securities Exchange Commission which merely puts the SEC on notice that the offering is being made. No formal SEC registration is required even if you decide to sell shares outside of Massachusetts. However, you must send copies of your SCOR registration filing to the state securities administrators of each state in which you plan to sell shares.

So far, thirty-seven states permit sales of stock under this program. The program also sets a minimum price of $5.00 per share for each share of common stock sold in a SCOR offering.

No stockbrokers are required to sell the shares. The Company may do so itself using the mails or periodical advertising.

The entrepreneur who decides to use this program to raise money should use capable lawyers and accountants to prepare the disclosure package (called a U-7).

The risks of a mistake in the disclosure could precipitate suits by disgruntled investors or even criminal prosecution if the disclosures are misleading.

Despite the expense and risk of offering securities, the “going public” alternative is the only way many businesses will ever have of getting off the ground. Most people, of course, do not have access to a million dollars as risk capital. However, laws such as those that permit a SCOR offering make it possible to build a company accessing investors' funds with the hope that everybody will win.

BARTERING WITH REAL ESTATE AND SECURITIES THE LEGAL WAY

There is a right way and a wrong way to utilize your contacts and knowledge of barter techniques when you are trading for real estate or securities.

If you are not a licensed stock broker or real estate agent, there are traps you can fall into if you are not prepared.

For example, one trap would be getting cheated out of a finder s fee. A barter broker trying to recover a finder s fee might face a defense claiming that an unlicensed finder does not deserve such a fee. Fortunately, there are cases which protect a finder in such an instance.

The courts are careful to distinguish between brokers and finders.

Finders introduce parties who subsequently negotiate a transaction with each other.

Finders receive fees solely for introductory services. Of course, these fees may be contingent.

Brokers actually participate in the negotiations. Freeman vs. Hergins, 271 p.2 210 (1954) From the time of the earliest legislation (referring to the State of California) of real estate and securities brokers, the legislature has refrained from extending the regulations to those who do no more than arrange an introduction between an owner and a prospective purchaser. Freeman, ibid.

This point of view was echoed repeatedly in McKenna vs. Edwards, 19 CAL App. 2d. 327:

> One who merely introduces an owner of securities and a prospective purchaser is not engaged in the business of selling,

> offering for sale, negotiating for the sale of or otherwise dealing in any security issued by others...

The word “sell” is of course broadly construed to encompass each of the “exchanges” a finder facilitates.

In Schaller vs. Litton Industries the Plaintiff held himself out as a “corporate broker” engaged in the business of interesting “corporate partners” in each other and then utilizing contacts to place parties in a situation conducive to merger. Plaintiff was not required to have a license as a securities dealer in order to recover his fee based on two relevant theories cited by a Wisconsin federal court:

1. The Wisconsin Blue Sky Laws exempted mergers.

2. Plaintiff was a matchmaker. The Court characterized his actions a “corporate catalytic agent.” Said the Court... (Plaintiff) had information and contacts for sale, and Litton bought them.”

The Court held that the Plaintiff reserved to be compensated for merely offering information and contacts, and arranging meetings and that this was not broker-dealer activity. 307 F.Supp at 126 (1969).

An important point to remember is that the ultimate deal must be negotiated by the parties, not the finder.

In drafting a contract for finder s or barter broker services, it is important to include a clause reading something like this:

> “Customer acknowledges that finder is not representing himself as a licensed dealer in real estate or securities. Finder is solely providing introductory services, contacts and meetings. Customer agrees to refrain from raising a defense finder s lack of license in any action to recover fees for his services.”

LAW OFFICES OF DAVID GROSSACK, P.C.

Dear Reader:

If you want to raise money for your company by selling stock to the public, this booklet is the way to learn the basics about what is involved.

“Take Your Company Public” need not only be for the big companies.

There is no reason why small companies and start up ventures cannot do it also.

Meaningful access to the economy is only available when there is capital needed to build and nurture a business from start.

For most people, going into business means going in on a shoestring and struggling to stay afloat. This is not the way to prosperity.

For this reason, I am offering the reader an introduction to the only real way most business ideas have a chance of ever getting financed... going to the capital markets, the general public that invests, and pitching your idea!

This business also offers many opportunities for people who want to be part of the process, as promoters, intermediaries and finders. Mergers and acquisitions candidates and the use of stock as a “supercurrency” to acquire assets are also an integral part of the world of corporate securities, and there’s lots of room for people who want to participate.

I have tried to make this complex subject as simple as possible. I know I have done less than a perfect job. Should you have any questions, I am only a telephone call away.

Thank you,

David C. Grossack
Founder