

**Request for Public Comment**  
**NASAA Corporation Finance Policy Project Group**  
**October 10, 2007**

PROPOSED AMENDMENT OF THE NASAA CR-EQUITY STATEMENTS OF  
POLICY

The Board of Directors of the North American Securities Administrators Association, Inc. (NASAA), has authorized release for public comment the attached proposal to update the following eleven NASAA CR-Equity statements of policy:

- *Statement of Policy Regarding Corporate Securities Definitions (1997/1999)*
- *Statement of Policy Regarding Preferred Stock (1997)*
- *Statement of Policy Regarding Loans and Other Material Transactions (1997)*
- *Statement of Policy Regarding Unequal Voting Rights (1991)*
- *Statement of Policy Regarding Specificity in Use of Proceeds (1997/1999)*
- *Statement of Policy Regarding Promoters Equity Investment (1997)*
- *Statement of Policy Regarding Promotional Shares (1997/1999)*
- *Statement of Policy Regarding Options and Warrants (1997/1999)*
- *Statement of Policy Regarding Unsound Financial Condition (1997/1999)*
- *Statement of Policy Regarding Underwriting Expenses, Underwriter's Warrants, Selling Expenses and Selling Security Holders (1997/1999)*
- *Statement of Policy Regarding Impoundment of Proceeds (1997/1999)*

The public comment period will remain open for 30 days. Comments on the proposal are invited, and written comments should be sent to Bill Beatty, Chair of the Corporation Finance Policy Project Group. To facilitate consideration of the comments, please send copies of your comments to each Project Group member and the NASAA Legal Department.

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## **BACKGROUND**

In an effort by NASAA to keep its library of statements of policy, guidelines, and other model rules current, the Corporation Finance Policy Project Group was charged with the task of reviewing NASAA's corporation finance-related SOPs, including those that are used in the CR-Equity program. The majority of the CR-Equity policies were adopted in 1997 and several were amended in 1999. Individual analyses of each policy are included below. They identify the specific substantive changes, if any, proposed to be made to each SOP. The reviews focused on the following areas:

- Each SOP has been amended to better conform to "Plain English" standards and to incorporate streamlined introductory language.
- Consistency with Uniform Securities Act of 2002
- Sarbanes-Oxley Act of 2002. The Project Group believes that each SOP, as proposed, is consistent with the Sarbanes-Oxley Act of 2002.
- Definitions have been removed from the substantive policies and incorporated in the *Definitions* SOP
- Updated references to federal statutes and rules.

## **ANALYSIS**

### **Statement of Policy Regarding Corporate Securities Definitions (1997/1999)**

The CCH Blue Sky Reporter indicates that 11 jurisdictions formally adopted the current version of this SOP.

Analysis: Noteworthy changes to the SOP included the following:

1. Definitions of "Administrator" and "Disclosure Document" were added in sections II.V and II.W, respectively.
2. The definition of "Independent Director" in section II.K was modified to align with section 301 of the Sarbanes-Oxley Act of 2002, which amended Section 10A of the Securities Exchange Act of 1934 to establish an independence standard for audit committees.<sup>1</sup>
3. "Unaffiliated Institutional Investor" in section II.T was greatly shortened by cross-referencing to the "institutional investor" definition in the Uniform Securities Act of 2002 (USA 2002).
4. "Qualified purchaser" was removed from the list of investors because "qualified purchaser" has not been defined by the U.S. Securities and Exchange Commission

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<sup>1</sup> Section 10A(m)(3)(B) of the Securities Exchange Act of 1934 provides: "CRITERIA. --In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee –

(i) accept any consulting, advisory, or other compensatory fee from the issuer; or  
(ii) be an affiliated person of the issuer or any subsidiary thereof."

- for purposes of section 18(b)(3) of the Securities Act of 1933.
5. Other definitions were modified by cross-referencing to the appropriate sections of USA 2002. See “Impound Agent” and “Person” at sections II.J and II.N, respectively.
  6. Section II.R.1 of the “Promotional Shares” definition was modified by incorporating a “look-back” of five years. This made the definition consistent with section 305(f) of USA 2002.<sup>2</sup> The project group also added Drafters’ Commentary concerning the need to modify this provision to align with statutory “look-back” provisions.
  7. “Promotional or Developmental Stage Company” in section II.Q is modified to reflect that NASDAQ’s National Market System is now , as of July 1, 2006, known as the Global Market.<sup>3</sup> In addition, this section is modified consistent with 2007 amendment that the SEC made to Rule 146(b)<sup>4</sup> which clarified that securities “authorized for listing,” as well as those listed, on exchanges recognized by the SEC in Rule 146 are “covered securities” pursuant to Section 18 of the Securities Act of 1933.
  8. Section II.X is added to define “Insolvent.” The term is currently defined in section II. of the *Unsound Financial Condition* policy. Moving the definition to the *Definitions* policy is consistent with the protocol established with the first round of CR-Equity revisions. The substance of the definition is retained.
  9. Sections II.Y and II.Z are added to define “Selling Expenses” and “Underwriting Expenses,” respectively. These terms are currently defined in the *Underwriting Expenses, Underwriters Warrants, Selling Expenses and Selling Security Holders* policy. Moving the definitions to the *Definitions* policy is consistent with the protocol established with the first round of CR-Equity revisions. The substance of the definitions is retained.

### **Statement of Policy Regarding Preferred Stock (1997)**

The *CCH Blue Sky Reporter* indicates that 23 jurisdictions formally adopted the current version of this SOP.

Analysis: The most noteworthy change appears in section III of the proposed SOP. Sections III and IV of the existing SOP permit an Administrator to deny registration to a preferred stock offering on the basis of either of two alternative grounds:

- The issuer has inadequate Adjusted Net Earnings (section III); or
- An analysis of the issuer’s statement of cash flows (section IV).

In the proposed SOP these two sections are collapsed into a single section III with two subparts; section III explains that the two subparts are disjunctive. Also, a note appears at the end of the SOP, stating that the Administrator may adopt the disjunctive section III as a whole or individually adopt either of the subsections.

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<sup>2</sup> USA 2002 Section 305(f) states: “A rule adopted or order issued under this Act may require as a condition of registration that a security issued within the previous five years or to be issued ...be deposited in escrow....”

<sup>3</sup> See Securities Exchange Act Release Nos. 53799 (May 12, 2006) and 54071 (July 10, 2006).

<sup>4</sup> See Securities Act Release No. 8791.

## **Statement of Policy Regarding Loans and Other Material Affiliated Transactions (1997)**

The *CCH Blue Sky Reporter* indicates that 19 jurisdictions formally adopted the current version of this SOP.

Analysis The proposed update to this SOP makes the following noteworthy changes:

1. In view of section 301 of Sarbanes-Oxley, the proposal centralizes provisions regarding independent directors in one section. *See* Section VI, “Independent Directors.”
2. The proposal amends the language of the SOP to conform to the National Securities Markets Improvement Act of 1996, by indicating that the SOP applies only to registrations by coordination or qualification.
3. The proposal incorporates “denial” and “registration” terminology typically used in securities statutes. For example, section III is entitled “Grounds for Denial of Securities Registrations.”
4. The substance of the end notes in the existing SOP has been incorporated into the body of the SOP.

## **Statement of Policy Regarding Unequal Voting Rights (1991)**

The *CCH Blue Sky Law Reporter* indicates that 22 jurisdictions formally adopted this SOP.

Analysis: This SOP contains significant updating, but does not change substantive standards. Noteworthy changes include:

1. The introductory language to Section III tracks the standard that appears in the USA 2002, section 606, for adopting rules and orders.
2. Consistent with the *NASAA Risk Disclosure Guidelines (2001)*, Part III.B is altered to remove details from the prospectus cover. Instead, we propose a cross reference to the risk factors.

## **Statement of Policy Regarding Specificity of Use of Proceeds**

The *CCH Blue Sky Reporter* indicates that 10 jurisdictions formally adopted the current version of this SOP.

Analysis: The update to this SOP proposes the following noteworthy changes:

1. Part IV adds a requirement that the issuer explain any contingencies relating to other sources of funds. This is consistent with the treatment of this issue in the SCOR Guide for Issuers.
2. Part V adds a requirement to disclose the terms of any indebtedness and how proceeds of recent indebtedness was used. Both additions are consistent with the treatment of similar issues in the SCOR Guide for Issuers.
3. The section dealing with impoundment of proceeds is deleted. This duplicated

- in part the Impoundment of Proceeds SOP. That SOP is the appropriate place to address how the issuer handles funds.
4. The SOP eliminates specific language concerning the power of an Administrator to deny a registration if the issuer does not comply with the SOP. The power to deny registration is found in state statutes.

### **Statement of Policy Regarding Promoters Equity Investment (1997)**

The CCH Blue Sky Reporter indicates that 14 jurisdictions formally adopted the current version of this SOP.

Analysis: The proposed update to this SOP does not change the substantive standards. The proposal:

1. Amends the language of the SOP to conform to the National Securities Markets Improvement Act of 1996, by indicating that the SOP applies only to registrations by coordination or qualification.
2. Amends section III to reflect a change in the heading.
3. Incorporates and list terms from the proposed updated *Statement of Policy Regarding Corporate Securities Definitions*, specifically the terms Administrator, Promoter, Promoters' Equity Investment, and Promotional Or Development Stage Company.

### **Statement of Policy Regarding Promotional Shares (1997/1999)**

The CCH Blue Sky Reporter indicates that 23 jurisdictions formally adopted the current version of this SOP.

Analysis: The proposed update to this SOP includes a few substantive changes and additions. Noteworthy changes to the SOP include the following:

1. The proposal amends the language of the SOP to conform to the National Securities Markets Improvement Act of 1996, by indicating that the SOP applies only to registrations by coordination or qualification.
2. The use of the formula for determining the amount of escrow of promotional shares is mandatory, and is fully described under Section III.
3. Provisions that dealt exclusively with the release of promotional shares are now under Section IV.
4. Section IV.A(a) and (b) has been changed to reflect what is released each year, rather than what is held each year, so as to conform with the lead-in of the section.

5. Provisions that dealt exclusively with the distribution of the Issuer's assets or securities are all under Section V. No substantive changes were made to these provisions.
6. Section VI, formally Section IV., has been amended to add provision D, which was previously a part of provision C of the former section.
7. Section VII has been amended to include the term 'Non-Exclusive' in the heading
8. Section VII, formally Section V, provisions A – B, and the sub-provisions therein, have been removed since these provisions are a part of the escrow and lock-in agreements.
9. Section VIII, formally Section VI, provisions A – C and E – H, have been removed since these provisions are a part of the escrow and lock-in agreements.
10. Section VIII has been modified to include the term Disclosure Document, but no substantive change has been made from the previous provision under the former section, Section VI, provision D.
11. Incorporates and lists terms from the proposed updated *Statement of Policy Regarding Corporate Securities Definitions*, specifically the terms Administrator, Affiliate, Aggregate Revenues, Associate, Disclosure Document, Escrow Agent, Equity Securities, Independent Directors, Issuer, Person, Promoter, and Promotional Shares.

### **Statement of Policy Regarding Options and Warrants (1997/1999)**

The CCH Blue Sky Reporter indicates that 25 jurisdictions formally adopted the current version of this SOP.

Analysis. The proposed update to this SOP required no substantive changes. Instead, the project group restructured the policy to enhance its readability and application. The project group also reworded the policy as necessary to accord with the Uniform Securities Act of 2002, the Internal Revenue Code, NSMIA, and the other proposed revisions to the CR-Equity SOPs. Finally, the project group revised the policy in accordance with plain English standards.

### **Statement of Policy Regarding Unsound Financial Condition (1997/1999)**

The CCH Blue Sky Reporter indicates that 13 jurisdictions formally adopted the current version of the SOP.

Analysis. The proposed update to this SOP includes a few substantive changes and additions. Noteworthy changes to the SOP include the following:

1. Definitions of “Administrator,” “Disclosure Document” and “Insolvent” have been added.
2. The proposal amends the language of the SOP to conform to the National Securities Markets Improvement Act of 1996, by indicating that the SOP applies only to registrations by coordination or qualification.
3. The suitability standards have been updated to reflect inflation since 1999.
4. The escrow of promotional shares provision was deleted, because the project group believes that issue is addressed by the Promotional Shares SOP.
5. The language in paragraph A of Section III was deleted as unnecessary and possibly inconsistent.

### **Statement of Policy Regarding Underwriting Expenses, Underwriter’s Warrants, Selling Expenses and Selling Security Holders (1997/1999)**

The CCH Blue Sky Reporter indicates that 13 jurisdictions formally adopted the current version of the SOP.

Analysis. The proposed update to this SOP includes a few substantive changes and additions. Noteworthy changes to the SOP include the following:

1. Definitions of “Administrator,” “Disclosure Document,” “Selling Expenses,” “Underwriter” and “Underwriting Expenses” have been added.
2. The proposal amends the language of the SOP to conform to the National Securities Markets Improvement Act of 1996, by indicating that the SOP applies only to registrations by coordination or qualification.
3. The Underwriter’s Warrants Sample Calculation of Value has been added.

### **Statement of Policy Regarding Impoundment of Proceeds (1997/1999)**

The CCH Blue Sky Reporter indicates that 34 jurisdictions formally adopted the current version of this SOP.

Analysis. The proposed update to this SOP includes several substantive changes. Noteworthy changes to the SOP include the following:

1. We added a provision to clarify that an Administrator may require an issuer to impound the proceeds of an offering that is not underwritten.
2. We clarified the list of those who could not act as impoundment agent and those who could not make a claim against the impounded proceeds.

## STATEMENTS OF POLICY

### STATEMENT OF POLICY REGARDING CORPORATE SECURITIES

#### DEFINITIONS

*Adopted April 27, 1997; Amended September 28, 1999 & \_\_\_\_\_*

#### I. INTRODUCTION

This Statement of Policy Regarding Definitions applies to definitions used in the following NASAA Statements of Policy:

Statement of Policy Regarding the Impoundment of Proceeds  
Statement of Policy Regarding Loans and Other Material Affiliated Transactions  
Statement of Policy Regarding Options and Warrants  
Statement of Policy Regarding Preferred Stock  
Statement of Policy Regarding Promoters' Equity Investment  
Statement of Policy Regarding Promotional Shares  
Statement of Policy Regarding Specificity in Use of Proceeds  
Statement of Policy Regarding Underwriting Expenses and Underwriter's  
Warrants  
Statement of Policy Regarding Unsound Financial Condition  
Statement of Policy Regarding Voting Rights

#### II. The following words and terms shall have the following meanings, unless the context clearly indicates otherwise.

- A. Adjusted Net Earnings means the issuer's Net Earnings after charges for interest and dividends, adjusted on a pro forma basis to reflect:
1. The elimination of any required charges for debt, debt securities, or preferred stock that are to be redeemed or retired from the proceeds derived from the public offering of preferred stock;
  2. The effect of any acquisitions or capital expenditures that the issuer made after its last fiscal year, or that it proposes or is required to make during the current fiscal year, which materially affect the issuer's Net Earnings;
  3. The effect of any charges or dividends on debt, debt securities or preferred stock issued after the issuer's last fiscal year;
  4. The effect of any charges or dividends on debt, debt securities or preferred stock issued during, but outstanding for only a portion of, the Issuer's last fiscal year, calculated as if the debt, debt securities or preferred stock had been outstanding for the entire fiscal year; and
  5. The effect of any other material changes to an issuer's future Net Earnings.

- B. An Affiliate means a Person who, directly or indirectly, Controls, is Controlled by, or is under common Control with the Person referred to in this Definitions Policy.
- C. Aggregate Revenues means the total revenues, excluding interest and extraordinary items a Person has received during:
1. the last three consecutive fiscal years immediately before the public offering, and
  2. the period in the current fiscal year for which interim period financial information is included in the prospectus.
- D. An Associate, when used to indicate a relationship with a Person, includes:
1. Corporations or legal entities, other than the issuer or majority-owned subsidiaries of the issuer, of which a Person is an officer, director, partner, or a direct or indirect, legal or beneficial owner of five percent (5%) or more of any class of Equity Securities;
  2. Trusts or other estates in which a Person has a substantial beneficial interest or for which a Person serves as a trustee or in a similar capacity; and
  3. A Person's spouse and relatives, by blood or by marriage, if the Person is a Promoter of the issuer, its subsidiaries, its Affiliates, or its parent.
- E. Average Promotional Price means the average per share price paid for Promotional Shares and other shares issued prior to the public offering that are of the same class of shares being offered in the public offering as determined by reference to the audited financial statements of the issuer included in the prospectus.
- F. Cash Analysis is the issuer's "Net Cash Provided By Operating Activities" as reflected on the Statement of Cash Flows and determined in accordance with generally accepted accounting principles. If the issuer will use the proceeds of the public offering to redeem or retire debt securities, the issuer must adjust, on a pro forma basis, for the elimination of the related interest charges, net of applicable income taxes.
- G. Control means the power to direct or influence the direction of the management or policies of a Person, directly or indirectly, through the ownership of voting securities, by contract or otherwise.
- H. Equity Securities include shares of common stock or similar securities, convertible securities, and warrants, options or rights that may be converted into or exercised to purchase, shares of common stock or similar

securities.

- I. An Escrow Agent means:
1. a financial institution whose principal place of business and domicile is in the United States or Canada and that is not affiliated with the Issuer, its Promoters, or Associates. A financial institution may act as an Escrow Agent even if the issuer, its Promoters or Associates are its customers.
  2. an attorney or certified public accountant, provided that the attorney or certified public accountant:
    - (i) is not affiliated with the issuer, its Promoters, or their Associates;
    - (ii) is licensed to do business in the state in which the attorney or certified public accountant practices; and
    - (iii) can demonstrate adequate insurance or can provide a fidelity bond.
- J. An Impoundment Agent means a depository institution as defined in Section 102(5) of the Uniform Securities Act of 2002 that is domiciled and whose principal place of business is located in the United States or Canada.
- K. An Independent Director means a member of issuer's board of directors who:
1. Does not receive, other than in his or her capacity as a member of the board of directors or a board committee, any consulting, advisory or other compensatory fee from the issuer, its subsidiaries, or their Affiliates or Associates;
  2. Has not received, other than in his or her capacity as a member of the board of directors or a board committee, any consulting, advisory or other compensatory fee from the issuer, its subsidiaries, or their Affiliates or Associates within the last two years
  3. Other than serving as a director of the issuer, is not a Promoter as defined below; and
  4. Does not have a material business or professional relationship with the issuer or any of its Affiliates or Associates. For purposes of determining whether or not a business or professional relationship is material, the gross revenue that the Independent Director derives from the issuer, its Affiliates and Associates is deemed material if it exceeds 5% of the Independent Director's:

- (i) annual gross revenue, derived from all sources, during either of the last two years; or
  - (ii) net worth, on a fair market value basis
- L. Lock-In Agreement means an agreement entered into between an issuer and a Person as a condition of registration in which the Person agrees not to dispose of or otherwise transfer Equity Securities the Person received from the issuer or that the issuer granted to the Person.
- M. Net Earnings means the issuer's after-tax earnings, excluding extraordinary and nonrecurring items, determined in accordance with generally accepted accounting principles.
- N. Person has the same meaning as set forth in Section 102(20) of the Uniform Securities Act of 2002.
- O. Promoter:
  - 1. Includes a Person who:
    - (i) Alone or in conjunction with one or more Persons, directly or indirectly, took the initiative in founding or organizing the issuer or Controls the issuer,
    - (ii) Directly or indirectly, receives, as consideration for property or for services rendered, five percent (5%) or more of any class of the issuer's Equity Securities or five percent (5%) or more of the proceeds from the sale of any class of the issuer's Equity Securities;
    - (iii) Is an officer or director for the issuer;
    - (iv) Legally or beneficially owns, directly or indirectly, five percent (5%) or more of any class of the issuer's Equity Securities; or
    - (v) Is an Affiliate or an Associate of a Person specified in paragraphs i through iv, above.
  - 2. Does not include:
    - (i) A Person who receives securities or proceeds solely as underwriting compensation unless that Person otherwise comes within the term.
    - (ii) An Unaffiliated Institutional Investor, who purchased the issuer's Equity Securities more than one year prior to the filing date of the Issuer's registration statement.
    - (iii) At the Administrator's discretion, an Unaffiliated

Institutional investor, who purchased the issuer's Equity Securities on an arm's-length basis within one year prior to the filing date of the issuer's registration statement.

- P. Promoters' Equity Investment means the total of cash and tangible assets Promoters contributed to the issuer, provided that the Administrator accepts the value of the tangible or intangible assets. The Administrator may require the issuer to adjust Promoters' Equity Investment by the issuer's earned surplus immediately prior to the public offering.
- Q. Promotional Or Development Stage Company means an Issuer:
1. That is not listed, or authorized for listing, on the New York Stock Exchange, the American Stock Exchange, the NASDAQ Global Market, or a securities exchange that the Securities and Exchange Commission determines under Section 18(b)(1) of the Securities Act of 1933 has substantially similar listing standards;
  2. That has had annual Net Earnings for each of the last two (2) consecutive fiscal years before the public offering that have been less than five percent (5%) of the aggregate public offering; or
  3. That has had average, annual Net Earnings for the last five (5) fiscal years before the public offering that have been less than five percent (5%) of the aggregate public offering.
- R. Promotional Shares mean Equity Securities that:
1. A Promotional Or Development Stage Company has issued within five (5) years before the filing of the registration statement or will issue to its Promoters for cash or other consideration, including services rendered, patents, copyrights, and other intangibles; or
  2. An issuer that is not a Promotional Or Developmental Stage Company has issued within three (3) years before the filing of the registration statement or will issue to Promoters for cash or other consideration, including services rendered, patents, copyrights and other intangibles.
- S. Public Offering Price means the per share price at which a Promotional Or Development Stage Company proposes to offer Equity Securities to the public.
- T. Unaffiliated Institutional Investor means the following investors if not Affiliated with the issuer:
1. An institutional investor as defined in Section 102(11) of the Uniform Securities Act of 2002; and
  2. An business development Company as defined in Section 2(a)(48)

of the Investment Company Act of 1940.

- U. Underwriter means any Person that has agreed with the Issuer or with another Person on whose behalf a distribution is to be made:
1. To purchase securities for distribution;
  2. To distribute securities on behalf of the issuer or other Person; or
  3. To manage or supervise a distribution of securities on behalf of the issuer or other Person.
- V. Administrator means the agency that regulates the securities industry.
- W. Disclosure Document means a prospectus, information statement, offering circular or other offering document.
- X. A Person is Insolvent if it:
1. Has an accumulated deficit;
  2. Has negative shareholder equity;
  3. Is unable to satisfy current obligations as they come due;
  4. Has negative cash flow; or
  5. Has financial statements that include a footnote or explanatory paragraph in the auditor's report regarding the issuer's ability to continue as a going concern.
- Y. The term Selling Expenses means the expenses directly or indirectly incurred in the sale of the registered securities, including, but not limited to, the following:
1. Commissions to Underwriters or broker-dealers,
  2. Non-accountable fees or expenses to be paid to the Underwriters or broker-dealers,
  3. Auditor's and accountant's fees,
  4. Legal fees,
  5. The cost of printing Disclosure Documents required to comply with securities laws and regulations,
  6. Charges of transfer agents, registrars, indenture trustees, escrow holders, depositories, engineers, appraisers, and other experts,

7. The cost of authorizing and preparing the securities, including issue taxes and stamps,
8. Financial consulting and financial advisory agreements with an Underwriter or any similar type agreement or fees, however designated, which shall be valued at actual cost, excluding financial and consulting agreements that are entered into at least twelve months before the issuer files a registration statement with the Securities and Exchange Commission,
9. Payments made either six months prior to or required to be made six months following the public offering to investor relations firms that the Underwriter designated .
10. Other cash expenses incurred in connection with the public offering of securities that the Administrator determines, and
11. Expenses incurred in connection with bridge financing in the twelve month period preceding a public offering of securities, including, but not limited to:
  - a. Direct expenses attributable to the financing, including interest charges, underwriting and selling expenses.
  - b. The value of warrants and options.
  - c. Expenses attributable to the issuance of the securities that are not options, warrants, or convertible securities valued by the following formula:

$$\frac{(\text{Public Offering Price per share} - \text{Cost per share}) \times \text{Number of Securities Issued} \times 100}{\text{Aggregate Public Offering Proceeds}}$$

Z. The term Underwriting Expenses includes, but is not limited to,

1. Commissions to Underwriters or broker dealers;
2. Non-accountable fees or expenses paid to Underwriters or broker dealers;
3. The value of Underwriter's warrants;
4. Rights of first refusal, to be valued at 1% of the public offering or the amount payable to the underwriter if the issuer terminates the right of first refusal;

5. Solicitation fees payable to the underwriter, to be valued at the lesser of actual cost or 1% of the public offering if the fees are payable within one year of the offering;
6. Financial consulting or financial advisory agreements with an underwriter or any other similar type of agreement or fees, however designated, to be valued at actual cost;
7. Underwriter's due diligence expenses;
8. Payments made either six months prior to or required to be made six months following the offering to investor relations firms that the Underwriter designated ; and
9. Other underwriting expenses incurred in connection with the public offering of securities that the Administrator determines.

*Drafters' Commentary: Section II.R.1 has been revised to be consistent with section 305(f) of the Uniform Securities Act of 2002 (USA), which allows a state to require as a condition of registration the escrow of shares issued within the previous five years for consideration that is substantially less than the public offering price. A state that has a statutory 'look-back' that differs from the USA should modify the look-back provision of Section II.R to comply with that statute.*

## **STATEMENT OF POLICY REGARDING PREFERRED STOCK**

*Adopted April 27, 1997 and Amended \_\_\_\_\_*

### **I. INTRODUCTION**

This statement of policy applies to all applications to register by coordination or by qualification.

### **II. DEFINITIONS**

This statement of policy uses the following terms defined in the North American Administrators Association, Inc., *Statement of Policy Regarding Corporate Securities Definitions*:

- Adjusted Net Earnings
- Administrator
- Cash Analysis
- Disclosure Document
- Equity Securities
- Independent Director
- Promoter

### **III. GROUNDS FOR DENIAL OF SECURITIES REGISTRATION RELATING TO PAYMENT ABILITY**

The Administrator may deny the offer or sale of preferred stock based on the issuer's Adjusted Net Earnings or a Cash Analysis. In either case, the issuer must have enough cash to pay the dividend, if any, on the preferred stock being offered whether or not declared.

- A. The Administrator may deny the offer and sale of preferred stock if either the issuer's Adjusted Net Earnings for its last fiscal year or the issuer's Adjusted Net Earnings for its last three fiscal years were insufficient to pay the issuer's:
  - 1. Fixed charges;
  - 2. Preferred stock dividends, whether or not accrued; and
  - 3. The redemption requirements, if any, of the preferred stock being offered to investors.
  
- B. The Administrator may deny the offer or sale of preferred stock unless the issuer's Statement of Cash Flows shows that "Net Cash Provided by Operating Activities" was positive for the issuer's last fiscal year. The Administrator may require the issuer to submit a financial statement that is presented in conformity with generally accepted accounting principles and demonstrates that the issuer had an average positive "Net Cash Provided by Operating Activities" for the last three fiscal years. [*See editor's Note at end regarding the Administrator's use of sections III.A or III.B.*]

#### **IV. EXEMPTION FROM DENIAL OF SECURITIES REGISTRATION RELATING TO PAYMENT ABILITY**

Section III does not apply to public offerings of:

- A. Convertible preferred stock that ranks ahead of any convertible debt relating to payment of dividends, interest, and liquidation proceeds; or
- B. Preferred stock that is or may be legally or beneficially, directly or indirectly, owned by Promoters.

#### **V. GROUNDS FOR DENIAL OF SECURITIES REGISTRATION RELATING TO SHAREHOLDER APPROVAL**

The Administrator may deny the offer or sale of Equity Securities if the issuer's articles of incorporation authorize the board of directors to issue preferred stock without a vote by the common shareholders.

#### **VI. EXEMPTION FROM DENIAL OF SECURITIES REGISTRATION RELATING TO SHAREHOLDER APPROVAL**

Section V does not apply if:

- A. The Disclosure Document states that the issuer will not offer preferred stock to Promoters except on the same terms as it is offered to all other existing or new shareholders; or

- B. A majority of the issuer’s Independent Directors that do not have an interest in the transaction:
  - 1. Approve any offering of preferred stock; and
  - 2. Have access, at the issuer’s expense, to issuer’s counsel or independent counsel.

## **VII. DISCLOSURE REQUIREMENTS**

The issuer’s Disclosure Document relating to an offering of preferred stock must disclose:

- A. Whether dividends on the preferred stock are cumulative;
- B. The risks of failure to declare or pay dividends on the preferred stock; and
- C. The equity characteristics of any convertible preferred stock being offered to investors.

*Note: The Administrator may adopt section III in its entirety. Alternatively, the Administrator may adopt either section III.A or section III.B.*

## **STATEMENT OF POLICY REGARDING LOANS AND OTHER MATERIAL TRANSACTIONS**

*Adopted April 27, 1997 and Amended \_\_\_\_\_*

### **I. INTRODUCTION**

This statement of policy applies to all applications to register by coordination or by qualification.

### **II. DEFINITIONS**

This statement of policy uses the following definitions adopted by the North American Securities Administrators Association, Inc. (“NASAA”) in the NASAA Statement of Policy Regarding Corporate Securities Definitions.

Administrator  
Affiliate  
Disclosure Document  
Independent Director  
Promoter

### **III. GROUNDS FOR DENIAL OF SECURITIES REGISTRATIONS**

The Administrator may deny the offer or sale of securities if:

- A. The issuer or its Affiliates have loans outstanding after the offering that are not permitted by this Statement of Policy;

- B. The issuer or its Affiliates have engaged in material transactions with Promoters that are not permitted by this Statement of Policy; or
- C. Required representations and statements are not included in the Disclosure Document.

#### **IV. LOANS AND LOAN GUARANTEES**

The following types of loans or loan guarantees on behalf of Promoters of the issuer are permitted:

- A. Advances to officers, directors, and employees for travel, business expense, and similar ordinary operating expenditures.
- B. Loans or loan guarantees to allow the issuer's officers, directors, and employees to purchase the issuer's securities, and loans for relocation of officers, directors, and employees, if the loan is approved under Section VI.
- C. Loans the issuer or its Affiliates make to its Promoters if an issuer or its Affiliates are in the primary business of making loans and if:
  - 1. The loans are evidenced by promissory notes naming the lender as payee;
  - 2. The loans bear interest at rates comparable to those that other commercial lenders normally charge for similar loans made in the lender's locale;
  - 3. The loans require Promoters to repay the loans under appropriate amortization schedules;
  - 4. The loans are supported by credit reports and financial statements that show the issuer or its Affiliates can collect the loans and that the borrowers are satisfactory credit risks, in light of the nature and terms of the loans and other circumstances;
  - 5. The loans meet loan policies that other commercial lenders normally use for similar loans made in the lender's locale;
  - 6. The issuer will review the purposes of the loans and monitor the disbursements of proceeds in a manner that other commercial lenders normally use for similar loans made in the lender's locale;
  - 7. The loans will not violate the requirements of any banking or other financial institutions regulatory authority; and
  - 8. The loans contain default provisions comparable to those other commercial lenders normally use for similar loans made in the lender's locale.

#### **V. REPAYMENT OF LOANS**

Loans to Promoters that exist at the time of the application for registration must be repaid by Promoters in full:

- A. From proceeds of the offering, if a portion of the offering is made on behalf of

- a Promoter;
- B. Before the offering; or
- C. After the offering using appropriate amortization schedules, if the Administrator permits.

## **VI. INDEPENDENT DIRECTORS**

- A. If there have been or will be loans and other material affiliated transactions, the Disclosure Document must represent that the issuer will maintain at least two Independent Directors on its board of directors.
- B. The issuer must provide Independent Directors with access, at the issuer's expense, to legal counsel for the issuer or independent legal counsel.
- C. A majority of the issuer's Independent Directors that do not have an interest in the transaction must approve any loan or other material affiliated transaction involving its Promoters.
- D. If the issuer has only two Independent Directors on its board of directors, both Independent Directors must be disinterested in and approve loans and other material affiliated transactions.

## **VII. DISCLOSURE REQUIREMENTS**

- A. Loans. The issuer must disclose in the Disclosure Document whether or not it or its Affiliates have made or will make loans to or have made or will make loan guarantees on behalf of Promoters and the relevant terms and conditions.
- B. Affiliated Transactions. The issuer shall disclose in the Disclosure Document whether or not it or its Affiliates have engaged or will engage in material transactions with Promoters and the relevant terms and conditions.
- C. Representations. The Administrator may require the following statements and representations to appear in the Disclosure Document.
  - 1. A statement that the issuer or its Affiliates will make all future material affiliated transactions and enter into all future loans on terms that are no less favorable to the issuer than those that can be obtained from unaffiliated third parties.
  - 2. A statement that a majority of the issuer's Independent Directors will approve all future material transactions and loans, and any forgiveness of loans, in accordance with Section VI.
  - 3. A statement that the issuer's officers, directors, and counsel will:
    - a. Consider their due diligence and assure that there is a reasonable basis

- for these representations, and
- b. Consider whether to embody the representations in the issuer's charter or bylaws.

## **VIII. MATERIAL TRANSACTIONS WITH PROMOTERS**

The following types of affiliated transactions are allowed:

- A. A transaction approved in accordance with Section VI, if the Disclosure Document discloses the terms of the transactions and indicates whether the terms are as favorable to the issuer or its Affiliates as those generally available from unaffiliated third parties.
- B. A transaction entered into when the issuer had less than two disinterested Independent Directors, if the Disclosure Document:
  1. Discloses the terms of the transactions;
  2. Indicates whether the terms are as favorable to the issuer or its Affiliates as those generally available from unaffiliated third parties; and
  3. Discloses that the issuer lacked sufficient disinterested Independent Directors to approve the transactions at the time of the transactions were initiated.

The Administrator expects the issuer and its officers and directors to consider their due diligence and other obligations to demonstrate a reasonable basis for these representations.

## **STATEMENT OF POLICY REGARDING UNEQUAL VOTING RIGHTS**

*Adopted 1991 and Amended \_\_\_\_\_*

### **I. INTRODUCTION**

This statement of policy applies to applications to register by coordination or by qualification Equity Securities with voting rights less than equal to the voting rights of authorized or outstanding Equity Securities of the same issuer.

### **II. DEFINITIONS**

This statement of policy uses the following terms defined in the North American Securities Administrators Association, Inc., *Statement of Policy Regarding Corporate Securities Definitions*:

Administrator  
Equity Securities  
Disclosure Document

### **III. STANDARD**

Offerings described in this statement of policy are inconsistent with the protection of investors and not in the public interest, unless:

- A. The offered Equity Securities have preferential treatment as to dividends and liquidation, or the issuer justifies the unequal voting rights to the satisfaction of the Administrator; and
- B. The cover of the Disclosure Document includes a specific warning and a cross reference to an appropriate risk factor.

### **STATEMENT OF POLICY REGARDING SPECIFICITY IN USE OF PROCEEDS**

*Amended 1997, 1999, and \_\_\_\_\_*

#### **I. INTRODUCTION**

This statement of policy applies to all applications to register by coordination or by qualification.

#### **II. DEFINITIONS**

This statement of policy uses the following definitions adopted by the North American Securities Administrators Association, Inc. (“NASAA”) in the NASAA Statement of Policy Regarding Corporate Securities Definitions:

Disclosure Document.  
Promoter

#### **III. PROCEEDS DISCLOSURE**

The issuer must disclose in the Disclosure Document for both the minimum and maximum amounts proposed, if applicable, the percentages and dollar amounts of the following, in a tabular form:

- A. The proceeds the issuer expects to receive from the offering;
- B. The purposes for which the issuer will use the proceeds;
- C. The estimated amount to be used for each purpose; and
- D. The order or priority in which the issuer will use the proceeds for the purposes stated.

#### **IV. DISCLOSURE OF OTHER SOURCES OF FUNDS**

The issuer must disclose in the Disclosure Document:

- A. The amounts of any funds to be raised from other sources to achieve the purposes stated;
- B. The sources of any additional funds; and
- C. Whether the sources are firm or contingent and, if contingent, an explanation of the contingency.

## **V. DISCLOSURE OF PROPERTY ACQUISITION**

- A. If the issuer will use any part of the proceeds to acquire any property (including goodwill) otherwise than in the ordinary course of business, the issuer must disclose in the Disclosure Document:
  - 1. the names and addresses of the vendors;
  - 2. the purchase price;
  - 3. the names of any persons who have received commissions in connection with the acquisition; and
  - 4. the amounts of any commissions and any other expense in connection with the acquisition (including the cost of borrowing money to finance the acquisition).
- B. If any part of the proceeds will be used to acquire property or a business that is not yet identified, the issuer must disclose in the Disclosure Document:
  - 1. the type of property or business the issuer is seeking;
  - 2. how it will impact the issuer's core business; and
  - 3. the issuer's acquisition criteria.

## **VI. DISCLOSURE OF DEBT REPAYMENT**

If the issuer plans to use any material part of the proceeds to discharge indebtedness, the Issuer must disclose in the Disclosure Document:

- A. The terms of the indebtedness, including interest rate;
- B. Whether the indebtedness includes unpaid salaries to Promoters; and
- C. If the indebtedness was incurred during the current or previous fiscal year, how the issuer used the proceeds of the indebtedness.

## **VII. FLEXIBILITY IN USE OF PROCEEDS**

The issuer must not reserve more than 15% of the proceeds for working capital or

general corporate purposes (or for any other unspecified use). If the issuer's business plans require flexibility in the use of unspecified proceeds, the issuer must:

- A. Disclose all potential uses of the proceeds with qualifying language that the uses may be subject to change; and
- B. Indicate the circumstances that may lead to reallocation and the potential areas of reallocation.

## **VIII. SUFFICIENCY OF FUNDS**

The issuer must demonstrate that the offering proceeds, together with all other sources of financing currently available to the issuer, are sufficient to sustain the issuer's proposed activities. If the proceeds are insufficient to sustain the issuer's activities for at least 12 months following the offering, include in the Disclosure Document the appropriate risk disclosure.

### **STATEMENT OF POLICY REGARDING PROMOTERS' EQUITY INVESTMENT**

Amended by the North American Securities Administrators Association, Inc. ("NASAA") on April 27, 1997 and \_\_\_\_\_, 2007.

#### **I. INTRODUCTION**

This statement of policy applies to all applications to register by coordination or by qualification.

#### **II. DEFINITIONS**

This statement of policy uses the following terms defined in the NASAA *Statement of Policy Regarding Corporate Securities Definitions*:

Administrator  
Promoter  
Promoters' Equity Investment  
Promotional Or Development Stage Company

#### **III. DENIAL OF SECURITIES REGISTRATION**

The Administrator may deny registration for a public offering by a Promotional Or Development Stage Company if the Promoters' Equity Investment is less than:

- A. Ten percent (10%) of the first \$1,000,000 of the aggregate public offering, and
- B. Seven percent (7%) of the next \$500,000 of the aggregate public offering, and
- C. Five percent (5%) of the next \$500,000 of the aggregate public offering, and
- D. Two and one-half percent (2 ½%) of the balance over \$2,000,000. The Promoter may include items to meet this requirement if the Administrator has accepted their value.

### **STATEMENT OF POLICY REGARDING PROMOTIONAL SHARES**

Amended by the North American Securities Administrators Association, Inc. (“NASAA”) on November 17, 1997; September 28, 1999 and \_\_\_\_\_ 2007.

#### **I. INTRODUCTION**

This statement of policy applies to all applications to register by coordination or by qualification.

#### **II. DEFINITIONS**

This statement of policy uses the following terms defined in the NASAA *Statement of Policy Regarding Corporate Securities Definitions*:

Administrator  
Affiliate  
Aggregate Revenues  
Associate  
Disclosure Document  
Escrow Agent  
Equity Securities  
Independent Directors  
Issuer  
Person  
Promoter  
Promotional Shares

#### **III. ESCROW OF PROMOTIONAL SHARES**

As a condition to registering a public offering of Equity Securities, the Administrator may require that some or all of the Promoters deposit Promotional Shares into an escrow account (“escrow”) with an Escrow Agent, as provided by an escrow agreement. Promoters who deposit Promotional Shares into escrow will be collectively referred to as “depositors”.

- A. Use the following formula to determine the number of Promotional Shares for deposit in escrow, except in situations where a Promoter must comply with paragraph B below:

$$A - B$$

where

**A** equals total number of shares that the Promoters hold

**B** equals the number of fully paid shares, calculated as follows:

$$\frac{C}{D \times 0.85}$$

**C** equals the total that the Promoters paid for the shares, and

**D** equals the public offering price per share

Sample Calculation of Value.

	Shares	Total Price	Per Share
Shares Held by Promoters	100		\$1.00
Public Offering Price per Share			\$10.00
<u>Total Paid by Promoter*</u>		<u>\$100</u>	= 11.77
Public Offering Price Per Share x .85	\$10 x .85		Fully Paid Shares
Shares held by Promoters			100
Fully paid shares (rounded)			12
Number of Promotional Shares to be escrowed			88

\*The promoters cannot use consideration other than cash unless the Administrator accepts the value of the consideration.

- B. If the issuer’s latest audited financial statements contain an auditor’s report or footnote that contains an opinion or statement regarding the ability of the issuer to continue as a going concern, the Promoters must deposit all Promotional Shares in escrow.

- C. The Administrator may require each Promoter to deposit Promotional Shares into escrow on a pro rata basis.

#### **IV. RELEASE OF PROMOTIONAL SHARES**

- A. The Escrow Agent must release the Promotional Shares held in escrow in the manner set out in the table below:

If the issuer's Aggregate Revenues are:

- a. \$500,000 or more (class A offering), and neither the auditor's opinion nor any footnote to the issuer's latest audited financial statements contain an opinion or statement regarding the ability of the issuer to continue as a going concern, then the required release of escrow or lock-in shares are as follows:
    - i. Year 1 – none
    - ii. Year 2 – 2 ½% pro rata per quarter
    - iii. Year 3 – all
  - b. Less than \$500,000 (class B offering), then the required release of escrow or lock-in shares are as follows:
    - i. Year 1 – none
    - ii. Year 2 – none
    - iii. Year 3 – 2 ½% pro rata per quarter
    - iv. Year 4 – 2 ½% pro rata per quarter
    - v. Year 5 – all
- B. In the event securities in the escrow become “Covered Securities,” as defined in Section 18(b)(1) of the Securities Act of 1933, the Escrow Agent must release all securities in escrow.
  - C. If the public offering is terminated, and no securities were sold, the Escrow Agent must release all securities in escrow.
  - D. If the public offering is terminated, and all of the gross proceeds of the offering have been returned to the public investors, the Escrow Agent must release all securities in escrow.

#### **V. DISTRIBUTION OF THE ISSUER'S ASSETS OR SECURITIES**

The depositors agree that if any transaction or proceeding results in a distribution of the issuer's assets or securities (“distribution”), while the agreement remains in effect, one of the following happens:

- A. If the transaction is with a person that is not a Promoter, :
1. Holders of the issuer's Equity Securities initially share in the distribution on a pro rata basis, depending on the price the holders paid per share. This continues until the public shareholders are paid out in full. For the purpose of this Statement of Policy, the public shareholders are paid out in full when they have received, or have had irrevocably set aside for them, an amount equal to
 
$$A \times B \times 100\%$$
 where *A* equals price per share in the public offering, and where *B* equals the number of shares they purchased under the public offering and still hold at the time of the distribution.
  2. Once the public shareholders are paid out under paragraph 1, holders of the issuer's Equity Securities participate on a pro rata basis, depending on the the number of shares of Equity Securities they hold at the time of the distribution,
  3. A distribution may proceed on lesser terms and conditions than those stated in paragraphs 1 and 2, if the holders of a majority of the Equity Securities, not including related party securities, approve the lesser terms and conditions at a special meeting called for that specific purpose. For the purpose of this subparagraph, "related party securities" mean those Promoters or their Associates or Affiliates.
  4. The number of shares calculated for distribution under paragraph 1 and 2 may be adjusted if there is a stock split, stock dividend, recapitalization or similar transaction.
- B. If the transaction is with a Promoter, the depositors' Promotional Shares must remain in escrow subject to the terms of the agreement.

**VI. DOCUMENTATION REGARDING THE TERMINATION OF THE ESCROW AGREEMENT AND/OR THE RELEASE OF PROMOTIONAL SHARES**

- A. A request for the release of any of the Promotional Shares from escrow must be in writing and forwarded to the Escrow Agent.
- B. The issuer must provide the documentation, showing that the requirements of paragraph IV, above, have been met to the Escrow Agent.

- C. The Escrow Agent must terminate the agreement and/or release some or all of the Promotional Shares from escrow if all the applicable provisions of the agreement have been satisfied. The Escrow Agent must maintain all records relating to the agreement for a period of three (3) years following the termination of the agreement.
- D. The Escrow Agent must forward copies of all retained records to the Administrator promptly upon written request.

## **VII. NON-EXCLUSIVE RESTRICTIONS ON THE TRANSFER, SALE OR DISPOSAL OF PROMOTIONAL SHARES**

- A. A depositor must not transfer any Promotional Shares held in escrow or any interest in the Promotional Shares in escrow.
- B. Despite subsection A, a depositor may transfer Promotional Shares held in escrow by gift to the depositor's family members, if the depositor's family member agrees that the Promotional Shares remain subject to the terms of the escrow agreement.
- C. For a self-underwritten offering, Promoters must not sell any of their Promotional Shares during the time that the issuer is offering its securities to the public, even if the Promotional Shares are not subject to escrow or would otherwise be released from escrow.

## **VIII. TERMS OF THE ESCROW**

A summary of the agreement must be included in the Disclosure Document annual reports to shareholders, proxy statements and other disclosure materials used to make investment decisions until the public offering ends.

### **STATEMENT OF POLICY REGARDING OPTIONS AND WARRANTS**

Adopted by the North American Securities Administrators Association, Inc. ("NASAA") on Amended November 17, 1997, September 28, 1999, and \_\_\_\_\_, 2007

#### **I. INTRODUCTION**

This statement of policy applies to all applications to register by coordination or by qualification.

#### **II. DEFINITIONS**

This statement of policy uses the following terms defined in the NASAA *Statement of Policy Regarding Corporate Securities Definitions*.

Administrator  
Disclosure Document  
Lock-In Agreement  
Person  
Promoter  
Unaffiliated Institutional Investors  
Underwriters

### **III. PERMISSIBLE GRANTS OF OPTIONS OR WARRANTS**

An issuer may issue options or warrants:

- A. To Unaffiliated Institutional Investors in connection with a loan if:
  - 1. the options or warrants are issued at the same time as the loan;
  - 2. the options or warrants are issued as the result of negotiations between the issuer and the Unaffiliated Institutional Investor;
  - 3. the exercise price of the options or warrants is not less than the fair market value of the issuer's common stock or similar securities underlying the options or warrants on the date the loan was approved; and
  - 4. the number of shares that can be issued on exercise of the options or warrants multiplied by the options or warrants' exercise price does not exceed the face amount of the loan.
  
- B. To Underwriters as compensation in connection with a public offering if those options or warrants comply with the requirements of the *NASAA Statement of Policy Regarding Underwriting Expenses, Underwriter's Warrants, Selling Expenses, and Selling Security Holders*.
  
- C. In connection with acquisitions, reorganizations, consolidations, or mergers, if:
  - 1. the options or warrants are issued to Persons that are unaffiliated with the issuer; and
  - 2. exercising the options or warrants will not materially dilute the issuer's earnings:
    - a. at the time of grant, and
    - b. after giving effect to the acquisition, reorganization, consolidation or merger.

### **IV. GENERAL PROHIBITIONS**

- A. ***Limitation on Exercise Price.*** An issuer may not grant options or warrants at an exercise price that is less than 85% of the fair market value of the issuer's underlying shares of common stock or similar securities on the date of grant. The issuer must demonstrate the underlying shares' fair market value to the

Administrator's satisfaction. The Administrator may require the issuer to provide a concurrent appraisal of the shares' fair market value from a qualified independent appraiser .

**B. *Limitations on the Total Number of Options or Warrants.***

1. ***Fifteen Percent Limitation.*** For one year following the effective date of the offering, the total number of options and warrants that the issuer may issue or reserve for issuance may not exceed 15% of the sum of the issuer's common stock outstanding at the date of the public offering plus;
  - a. the number of firmly underwritten shares being offered, or
  - b. the number of shares required to meet the minimum offering amount, if not firmly underwritten.
  
2. ***Exclusions.*** The calculation in paragraph 1 excludes options and warrants that:
  - a. the issuer issued or reserved for issuance under section III. above;
  - b. the issuer issued or reserved for issuance to employees or consultants who are not Promoters under an incentive stock option plan under Section 422 of the Internal Revenue Code; or
  - c. a person may exercise at or above the offering price for public investors.
  
3. ***Excess Options.*** If any options or warrants exceed the 15% limit established in paragraph 1 ("Excess Options"), then the Administrator may require the issuer to:
  - a. cancel the Excess Options, or
  - b. subject the Excess Options to a Lock-in Agreement consistent with the terms specified in section VI of the *Statement of Policy Regarding Promotional Shares.*

**V. DISCLOSURE REQUIREMENTS**

If the number of options and warrants that

- the issuer has issued and that remain outstanding or
- that the issuer has reserved for issuance

is material, the issuer's Disclosure Document must disclose the potential dilution of the options and warrants. The issuer's Disclosure Document must present this disclosure in accordance with Item 506 of Regulation S-K.

**STATEMENT OF POLICY REGARDING UNSOUND FINANCIAL CONDITION**

**Adopted by the North American Securities Administrators Association, Inc. ("NASAA") on April 27, 1997 and amended on September 28, 1999 and \_\_\_\_\_**

**I. INTRODUCTION.**

This statement of policy applies to all applications to register by coordination

or by qualification.

## **II. DEFINITIONS**

This statement of policy uses the following terms defined in the NASAA *Statement of Policy Regarding Corporate Securities Definitions*.

Administrator  
Disclosure Document  
Insolvent

## **III. DENIAL OF SECURITIES REGISTRATION**

- A. The Administrator may deny the registration if the issuer is Insolvent.
- B. The Administrator may permit an Insolvent issuer to sell securities if the issuer demonstrates that the offering proceeds and the issuer's long-term business plan will improve the issuer's financial condition. The Administrator may require pro forma financial statements acceptable to the Administrator. The pro forma financial statements must include a description and documentation of any material assumptions and demonstrate when the issuer expects to be profitable.

## **IV. DISCLOSURE REQUIREMENTS**

If the issuer is Insolvent, the Disclosure Document must disclose the following prominently:

- A. Persons should not invest unless they can afford to lose their entire investment; and
- B. The following risk factors, if applicable:
  - 1. The presence of an explanatory paragraph in the independent auditor's report;
  - 2. The issuer's lack of revenue from operations and an indication of how the issuer has been financing operations;
  - 3. The presence and amount of any accumulated deficit;
  - 4. The presence and amount of any negative shareholder's equity; or
  - 5. The need for future financing.

## V. SUITABILITY STANDARDS

- A. If the issuer is Insolvent, the Administrator may impose net worth standards or limit the sale of securities to accredited investors instead of, or in addition to, the requirements in Sections IV and V. The imposition of these minimal net worth standards does not relieve a dealer from the responsibility to make an independent determination of suitability required under industry standards.
- B. Unless the Administrator determines that the risk associated with the offering would require lower standards, public investors must have the following:
  - 1. A minimum annual gross income of \$70,000 and a minimum net worth of \$70,000, exclusive of automobile, home and home furnishings, or
  - 2. A minimum net worth of \$250,000, exclusive of automobile, home and home furnishings.

### **STATEMENT OF POLICY REGARDING UNDERWRITING EXPENSES, UNDERWRITER'S WARRANTS, SELLING EXPENSES AND SELLING SECURITY HOLDERS**

Adopted by the North American Securities Administrators Association, Inc. ("NASAA") on April 27, 1997 and amended on September 28, 1999 and \_\_\_\_\_.

#### I. INTRODUCTION

This statement of policy applies to all applications to register by coordination and or by qualification.

#### II. DEFINITIONS

This statement of policy uses the following terms defined in the NASAA *Statement of Policy Regarding Corporate Securities Definitions*.

Administrator  
Disclosure Document  
Selling Expenses  
Underwriter  
Underwriting Expenses

### III. **GROUNDS FOR DENIAL OF SECURITIES REGISTRATIONS**

The Administrator may deny the registration of securities if:

- A. The underwriting expenses exceed seventeen percent (17%) of the gross proceeds from the public offering,
- B. The selling expenses of the offering exceed twenty percent (20%) of the gross proceeds from the public offering, or
- C. Selling security holders are offering more than ten percent (10%) of the securities for sale in the public offering.

### IV. **SELLING SECURITY HOLDERS.**

The Administrator may permit a public offering or sale of securities that includes selling security holders offering more than ten percent (10%) of the securities for sale in the public offering if either of the following apply:

- A. The Disclosure Document discloses the amount of selling expenses that the selling security holders will pay.
  - 1. Selling security holders offering at least ten percent (10%) but not more than fifty percent (50%) of the registered securities pay a pro rata share of all selling expenses of the public offering, excluding the legal and accounting expenses of the public offering, and
  - 2. Selling security holders offering more than fifty percent (50%) of the registered securities pay a pro rata share of all selling expenses of the public offering.
- B. With the exception of Underwriter's or broker-dealer's compensation, the selling security holders have a written agreement with the issuer that was entered into in an arm's-length transaction, under which the issuer agreed to pay all of the selling security holder's selling expenses.

### V. **RESTRICTIONS ON WARRANTS GRANTED TO UNDERWRITERS**

Warrants granted to Underwriters are subject to the following restrictions:

- A. The Underwriter must be a managing Underwriter.
- B. The public offering must be either a firmly underwritten offering or a "minimum-maximum" offering. Options or warrants may be

issued in a “minimum-maximum” public offering only if:

1. The options or warrants are issued on a pro rata basis, and
  2. The “minimum” amount of securities has been sold.
- C. The exercise price of the warrants must be at least equal to the public offering price.
- D. The number of shares covered by the Underwriter’s options or warrants must not exceed ten percent (10%) of the shares of common stock actually sold in the public offering.
- E. The options or warrants must not be exercisable more than five (5) years after the public offering is completed.
- F. The options or warrants must not be exercisable during the first year after the public offering is completed.
- G. Option or warrants may not be transferred, except:
1. To partners of the Underwriter, if the Underwriter is a partnership.
  2. To officers and employees of the Underwriter, who are also shareholders of the Underwriter, if the Underwriter is a corporation, or
  3. By will, under the laws of descent and distribution, or by operation of law.
- H. The warrant agreement may not allow for a reduction in the exercise price of the options or warrants resulting from the issuer subsequently issuing shares except if the issuer issues shares under :
1. a stock dividend or stock split, or
  2. a merger, consolidation, reclassification, reorganization, recapitalization, or sale of assets.

## VI. **PROHIBITED UNDERWRITING EXPENSES**

Underwriting expenses must not include financial consulting or financial advisory agreements with the underwriter payable at the time the services are rendered, provided that the issuer entered into the agreement at least twelve months before the issuer filed the registration statement with the Securities

and Exchange Commission.

## VII. VALUATION OF UNDERWRITER'S WARRANTS

Formula. The following formula must be used to value Underwriter's warrants:

$$\frac{[165\% \times \text{Aggregate Offering Price}] - (\text{Exercise Price} \times \# \text{ of shares offered to public}) \times \# \text{ shares underlying warrants}}{2} \times \# \text{ shares offered to the public}$$

$$\frac{A - B \times C}{2 \quad D}$$

where

**A** equals 165% of the aggregate offering price

**B** equals the exercise price multiplied by the number of shares offered to the public

**C** equals the number of shares underlying the warrants, and

**D** equals the number of shares offered to the public

### A. Sample Calculation of Value.

1. Assumptions: Public offering of 1,000,000 shares at \$5.00 per share and an Underwriter's warrant of 100,000 shares (10%) at 120% of a \$6.00 public offering price, exercisable starting one year after completion of the public offering.
2. Dollar value of Underwriter's warrant is \$112,500 (\$1,125,000 x .10) = \$112,500 (See below).
3. Percentage value is 2.25% (\$112,500 divided by \$5,000,000).

### Calculation of warrant value:

$$\frac{[165\% \times \text{Aggregate Offering Price}] - (\text{Exercise Price} \times \# \text{ of shares offered to public}) \times \# \text{ shares underlying warrants}}{2} \times \# \text{ shares offered to public}$$

$$\frac{[165\% \times (1,000,000 \text{ shares} \times \$5.00)] - (1,000,000 \times \$6.00)}{2} \times \frac{100,000}{1,000,000}$$

$$\frac{[165\% \times \$5,000,000] - \$6,000,000}{2} \times .10$$

$$\frac{\$8,250,000 - \$6,000,000}{2} \times .10$$

$$\frac{\$2,250,000}{2} \times .10$$

**STATEMENT OF POLICY REGARDING  
THE IMPOUNDMENT OF PROCEEDS**

Amended by the North American Administrators Association, Inc.  
("NASAA") on April 27, 1997; September 28, 1999 and \_\_\_\_\_ 2007

**I. INTRODUCTION.**

This statement of policy applies to all applications to register by coordination or by qualification.

**II. DEFINITIONS**

This statement of policy uses the following terms defined in the NASAA *Statement of Policy Regarding Corporate Securities Definitions*:

Administrator  
Affiliate  
Associate  
Disclosure Document  
Impoundment Agent  
Person  
Promoter  
Underwriter

**III. DENIAL OF SECURITIES REGISTRATION**

If an Underwriter has not firmly underwritten the offering, the Administrator may deny the registration unless the issuer has impounded the proceeds.

**IV. DEPOSIT OF PROCEEDS**

A. If an Administrator has denied the registration under Section III, the issuer or other person that receives the proceeds from the sale of the securities must deposit the proceeds in an interest bearing escrow or trust account with an Impoundment Agent.

B. The following are not eligible to act as an Impoundment Agent:

1. the issuer,

2. the issuer's officers or directors,
3. the Underwriter,
4. any Promoter, or
5. an Affiliate of any of the above.

**V. The Impoundment Agreement**

- A. An Impoundment Agreement must provide that, until the Impoundment Agent releases the proceeds to the issuer under the terms of the Agreement, the following persons do not have any claims to the impounded proceeds
1. creditors of the issuer,
  2. Affiliates,
  3. Associates, or
  4. Underwriters.
- B. The Agreement must provide that
1. the Impoundment Agent must notify the Administrator in writing when the Agent releases the proceeds to the issuer or other person entitled to the proceeds;
  2. if the proceeds do not meet the minimum requirements within the time set out in the Agreement, the Impoundment Agent
    - a. must release and return the proceeds directly to the investors,
    - b. when returning proceeds to investors, must also pay to the investors, on a pro rata basis, all interest earned on the proceeds, and
    - c. must not deduct any expenses, including fees of the Impoundment Agent.
- C. The Agreement must provide that the Administrator may
1. inspect the records of the Impoundment Agent at any reasonable time and where the records are located, and
  2. copy any record that is inspected.

- D. An officer from each of the issuer, Underwriter (if applicable) and Impoundment Agent must sign the Impoundment Agreement on behalf of the entity they represent.
- E. The Disclosure Document must include a summary of the principal terms of the Impoundment Agreement.
- F. The issuer or other person offering securities under the Disclosure Document must file a signed copy of the Impoundment Agreement with the Administrator. On filing, the Agreement becomes part of the Disclosure Document.

**VI. PURCHASES BY UNDERWRITERS AND PERSONS CONNECTED TO THE ISSUER**

If the issuer receives proceeds of the public offering sold under a Disclosure Statement from an Underwriter or an officer, director, Promoter, Affiliate, or Associate of the Issuer

- A. The Underwriter or other Person must purchase the securities on the same terms as unaffiliated public investors; and
- B. The Disclosure Document must disclose that a Person referred to in this section may purchase securities of the Issuer for purposes of completing the impoundment requirements imposed under this Statement of Policy.