Securities Law Issues

for Entities Doing Deals that Involve Accepting Money From Investors

Securities Trading Fund, Real Estate Fund

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***What is a Security?***

* **Issuing *any* equity interest in your business entity, in exchange for cash, property, or services, or in exchange for a supplier contract, is deemed to be the issuing of a security.** 
  + **Any share of stock, LLC interest, or LP interest, in a real estate LLC or LP, or in a securities trading fund, or any other type of company.**
  + **An “investor”** is any person who gives you money, property (or even free services), in exchange for equity, with expectation of making profits, or a return on their investment in your entity, through your efforts (or the efforts of others you engage) as opposed to their own efforts. Such a transaction is the issuance of a security.
* Even issuing, *or even giving*, **equity interests to employees**, board members, advisors, or consultants, in exchange for services, is a securities issuance.
  + **Debt can be a security**, if:
    - There is no fixed obligation of principal or interest payments, similar to those that would be on a mortgage loan, or
    - The payments to the lender are only due if the business makes money, and are not due if the business does not make money
    - The debt is convertible into equity.
  + A “Securities” issuance includes **shares, options, warrants**, any employee plan interest, (employees and advisers), even for services and no cash
* **Even selling stock to your mother is a securities sale.**
* **Pooling investor money in an entity, with an investment purpose = a security. The investment purpose can be either real estate investment, securities trading, other companies, or other, and the pooled money is deemed to be a “fund”. If the investor money is used to invest in securities of other issuers or into other real estate entities, it can be deemed to be an “investment company” under the 1940 Act.**

***If the Investment is A Security, then Registration or* exemption is required: Use Reg D or 4(2) exemptions.**

* **Key: Determine, and comply with, private offering exemptions from registration.**
* **However, there are *no exemptions from disclosure – the “Offering Memo” {covered in a later section below}***
* ***The Exemptions are from registration, and not from disclosure or notice filings. Still required to let the SEC & State Regulators know about the offering (through a notice filing.).***

**What Is an SEC Reg D 506 Offering?**

* **Compare to 4(2)**
* **Why Reg D 506 most preferable** Why Reg D 506 most preferable:
  + Consistency Among States, Uniform Notice Filing, Uniform Conditions of Exemption; Blue Sky.
  + But disclosure document required
* **Reg D 506 Limits on Method of Solicitation of Investors – No public Solicitation.** Issuer must know investors before solicitation of investment,   
  “pre-existing relationship of sufficient depth and duration in order to determine the suitability of the investment”

**[Handout – Private Offerings Turned Public by Solicitation]**

* **Reg D 506 Limits on # of investors: 35 nonaccredited, and unlimited accrediteds (you can accept up to 499 accredited investors).**

[Handout – Private Offering Exemption Q & A Chart]

* + **Investor Qualifications** - **What is an Accredited Investor?** 
    - **$1 million net worth, or $200K gross income, or $300K joint income with spouse**
    - **Why prohibit, or limit, sales to investors?**  Sophistication correlated to risk
    - **Audited Financials requirement for nonaccrediteds, none required for all accredited deal.**
    - **Full Disclosure Book for nonaccrediteds, more abbreviated disclosure permitted for all accredited deal.**
    - **Family members who are not accredited, still count as nonaccrediteds.**
* **No Dollar Limits on a Reg D 506 Deal**
* **Risk of non-compliance is rescission (give back the money to investors)**

***Funding Methods***

* **Self-Funding: Seed capital from founders’ personal savings & credit cards**
* **Family & very, very close friends**
* **Angels / friends/ business associates – larger group**
* **Professional investor or VC round**

***Notice Filings Required for EVERY deal and Every Sale to Investor***

* **Notice filing required with the SEC -** SEC Form D, if a Reg D offering
* **Blue Sky Law - Notice filings are required in each state in which investors reside:**
  + If the offering is a Reg D, either 506 or 504
  + Even if the offering is not a Reg D
  + For 4(2) offerings. Conditions and exemptions are not uniform for 4(2)
  + For sales or issuances to family, friends, employees, angels, VCs and sometimes institutions.
  + For Reg D 504 Offering of $1 million to nonaccrediteds (many states don’t have uniform exemptions, or any exemptions)
    - **Filings required in almost every state**
    - Advise company counsel & securities lawyer immediately when investor checks come in, because filings are required with in 15 days after sale.

[Hand out summarizing 50-state notice filing requirements.

***Securities Law Issues for Private Offerings***

* + - **Private vs. Public**
    - **Why It’s Illegal to Offer Your on the Internet**
    - **Limitations on Solicitations**
  + **Manner of Offering – No general Solicitation**
    - Private vs. Public Fund – Don’t want to be a public fund
    - Illegal to Offer Your Fund on the Internet,
      * IPO.Net and Lamp Technologies which allowed password protected websites giving access to offering memos on the websites, apply only to:
        + Website info provided to existing investors or existing clients of the issuer or broker
        + Funds sold by registered broker-dealers
    - Cold Calls, Advertising prohibited
    - Pre-exiting relationship or private introduction
    - Cold calls to Professional VCs are probably OK, but gray area

**Private Placement or Public Offering? A "General Solicitation” Turns a Private Offering into an Unregistered Public Offering**

An “Offering” is any instance of a company (an “Issuer”) selling its own stock in exchange for cash, services, property or stock. An Offering can be public or private.

Public Offerings must be registered with the SEC and the states. They require the preparation of a full blown prospectus, which must be cleared with the SEC and the states before use.

Private Offerings don’t need to be registered with the SEC and states, but they still require exemption notice filings with the SEC and states, and the preparation and distribution of a disclosure document (Private Offering Memo) and complying with all of the conditions of the exemption (including dollar limits, investor number limits, investors income or net worth requirements, limits on the manner of solicitation.)

**Private vs. Public Offering Distinction**:

***A Private Offering*** is one made to people who:

* Are your friends, family and business colleagues,
* With whom you have a pre-existing relationship,
* With your company (the issuer) has a pre-existing relationship,
* With whom your other officers or directors have a pre-existing relationship,
* Whom you already knew before the issuer’s offering them an investment in the company, or in advance of discussing the investment with them,
* To whom you have been privately introduced by a close contact such as a professional service provider like an accountant, lawyer, friend, close business colleague, or perhaps on a very limited basis, through a private introduction from one of your other investors,
* To whom you have been introduced by a registered broker-dealer, who have a pre-existing relationship with a registered broker, or
* Are professional venture capital investors, or professional institutional investors who, as their business invest in securities of other issuers.

The following contacts ***do not qualify as proper private placement contacts***, and could be deemed an unregistered public offering:

* Offers and sales made people to whom you have been introduced by a money finder, unregistered broker, financial consultant, investment banker, if those introducing people are not registered as a broker-dealer,
* Offers and sales from a “list of accredited investors” (purchased list, or confirmed list, or website list, all not permitted if you don’t know them in advance.)
* Offers made as a result of an email blast to a list of people you don’t know, or a list from someone else’s address book, or
* Contacts made through an “invest here” button on your own, or someone else’s, website.

***A Public Offering*** is one made:

* To people you don’t know by way of cold calling, or
* To your entire customer list, or
* By mass email, or otherwise on the Internet, to people you may or may not know, or
* On your website or someone else’s, or
* In a magazine, newspaper or newsletter, or
* By way of a press release,
* To all the X People in Y Group, even though you are a member of Y group or know someone from it: Each of the following would be, or has been deemed to be, an illegal public offering: “All the Doctors in Cincinnati”, or “all the realtors in Chicago”, “all the radiologists in townX”, to “all the partners in a large law firm”, “all the Executives in a trade association”, “all the attendees of a conference”.
* By one of the above done by someone acting on your behalf, such as a finder or a broker or a business broker.

In order to comply with the strict letter of the law, you must get to know the person in advance of offering them an investment in your company. Your relationship should be of “sufficient length and duration in order that the Issuer can determine the financial sophistication of the investor and suitability of the investment”.

There is a gray area between public and private offerings: If you offer to people you don’t know, but who are introduced to you by someone you do know, that’s probably fine, if it is a limited, calculated, private introduction. However, someone you know giving you their entire rolodex, would not be acceptable.

If the person you know who introduces you to someone they know, who introduces you to someone that they know, it’s probably to far removed.

**Regulation D Prohibition on Public Solicitation**

Under the federal securities laws (Regulation D, Rule 502(c)(1) and (2)) it is a violation of the private placement exemption under Reg D Rule 506, to obtain an investor through a seminar invitation or newspaper ad. (Most states’ securities laws are consistent with the federal rules.)

The SEC has followed that prohibition through to internet solicitations as well.

For a private offering:

* **No general solicitation** permitted; no mass mailing or cold calling to people you don’t know, no newspaper ads, no **planted news** articles.
* **No Internet** solicitation permitted, unless you already know the investor.
* Pre-existing relationship required with investors; of “sufficient length and duration” that you can evaluate their financial position and suitability for investment.

SEC No Action Letters on General Solicitation:

* Lamp Technologies (5/97 and 5/98), IPO.Net (7/96) and ACE.Net , No Action Letters; Internet Solicitations allowed to a **password-protected list of pre-qualified accredited investor subscribers** to listing service. ***SEC announced at the ABA Meeting in July, 2000 in New York, that IPO.Net and Lamp ONLY apply to issuers or hedge fund operators who are a registered broker-dealer firm, or who have a subsidiary registered broker- dealer firm, and that those No Action Letters do not apply to issuers who are not affiliated with a registered broker-dealer firm. ACE.Net only applies to Rule 504 offerings of <$1,000,000.***
* Mobile Biopsy, LLC No Action Letter (8/99): SEC **prohibits** issuer solicitation to list of persons that it thinks **might be accredited** (“all doctors in North Carolina”), and after indication of interest, requiring certification of accredited status after solicitation.

Wilmer Cutler No Action Letter (10/98) No Action: Offshore funs performing “Ten Commandments”.

***Integration of Offerings***

* 6 month window between offerings
* Required to avoid the offerings being “integrated” or lumped together as one offering.
* Integration is only an issue or problem if you have two offerings with nonaccrediteds that total more than 35 for both, or if you have two offerings and one used prohibited solicitation or inadequate offering disclosure.

***Business Issues and Deal Structure***

* **Determine in advance, the Liquidity Event or how investors will be paid back**
  + **Selling the Properties**
  + **Quarterly/Annual Profit splits**
  + **Management buy out of investors.**
  + **Acquisition/Merger with another entity**
* **Fees for “real estate fund”, often Management fee if the property is income generating, or instead a “back end fee” or “participation fee”, or a portin of the profits on sale of property**

***Disclosure Document / Offering Memo***

* **Even in an exempt private offering are *no exemptions from disclosure – the “Offering Memo”***
  + ***Exemptions are from registration, and not from disclosure*** or notice filings.
  + ***Disclosure is the SOLE requirement of the 4(2) and Reg D exemptions in most cases, if all investors are accredited.***
  + ***Disclosure is the CYA, the insulation (not 100% protection, but insulation) against a lawsuit if deal crashes. Investors can sue, but they likely will not win if you have provided full and complete disclosure doc.***
* Even **disclosure can be curtailed,** but not omitted, in a few instances of
  + ***Seed capital, first small money in after founder’s money***, and
    - Only in cases where all investors would ***never*** sue you even if you lost all of their money (I call it the “folks who would never sue you exemption”
    - Very limited in number, like 1 to 3 investors
    - Immediate family (parents siblings), small number, providing start-up seed money (perhaps up to 5 immediate family members)
    - “Single, Sophisticated” investor providing single shot of start up seed money, someone well-known to the company and principals.
    - Other very limited situations by judgment of the attorney after discussion with attorney about the facts of the investors
    - Even without a traditional disclosure document, you still need to provide disclosure some how, and comply with the requirements. Don’t do this at home without professional advice and help
    - Land mine of errors that, in the worst case:
      * Have to give back the money (rescission), and/or
      * Can forever bar you from raising additional money
  + Other methods of accomplishing disclosure under 10b-5: Providing everything investors need, or ask for, all material information, in the form of a “document stack and financials”. Include full disclosure of all due diligence info.
  + 4(2) – exemption, very small group
* **Exempt from complex disclosure, but investors often require complex terms and investment documents before they will invest**
* **Or Use the safe harbor of a Reg D 506 with Offering Memo**
* **Offering Memo is the “CYA” Document**

[Hand Out – Why Offering Memo Required]

* + - * Securities law rules require Disclosure of all info material to investment decision
      * Not promising to make money, not promising a fair deal, just telling facts of people, industry, strategy
      * If you are uncomfortable disclosing it, its probably material
      * Protect, not insulate, from liability
      * Cost: Is a $25,000 insurance policy
      * Initial Cost is high, but the first private placement memo can be recycled and enhanced with each successive deal, more complex deal, and even act at the foundation for the IPO prospectus or the M & A Disclosure Document.
      * **Saves you time as a business tool, so that you are covering much of your presentation first in writing, presentation is consistent.**
      * No need to repeat same info to multiple parties over and over.
      * CYA so that you are saying the same thing to each investor – no deviation

*[Hand Out – Why Offering Memo Required]*

***Disclosure Doc Highlights***

**Bios, Background Check, Use of Proceeds, Property Description; Cap table, Industry Analysis, Risks**, Corporate and Personal Due Diligence, Summary of all material agreements.

***Selling the deal –***

* + **Determine the “liquidity event”, explain, don’t promise. How will investors get paid back?**
  + **Full disclosure,** whole truth and nothing but the truth.
    - **No superlatives.**
    - **No BS**
  + **Separate selling your product** and the virtues of you company from selling the stock in the company, Turn off the marketing press.
  + You’re **not selling a used car or real estate** – Taking the approach of “if you don’t buy into the opportunity to day, it will be gone” is not appropriate.
  + Will be **partners with your investors** for a long time, and want to develop and maintain a good relationship with them, don’t BS them.
  + **Investors can file Lawsuits for misstatements or even misleading statements**

***Avoid Use of Money Finders to sell the Deal – Unless they Are Registered BDs*:**

* + **Illegal if they are not registered** securities brokers under 1934 Act. Ask for their CRD number and run it through [www.nasdr.com](http://www.nasdr.com).
  + **Be careful**, as the finder pool contains a high percentage of **disbarred** stock brokers and lawyers, de-licensed insurance brokers and real estate brokers, and convicted felons.
  + **Check references** and experience level
  + Make sure they have **good book of investor** business
  + Red Flag if they are advertising in the paper or on Internet “money available”.

***Common Mistakes:***

* Salaries to Founders, or paying back founder loans, early in the game. Don’t expect to get paid back the money you invested until after the investors have cashed out. Don’t expect to receive salary as a founder out of early stage seed money, perhaps an option after a year or two after funding by investors.
* Pie-in-the-sky projections, or
  + Only one set of projections (use 3, min, mid, max) or
  + No substance as back-up for the projections
  + Excel sheet that does not add up
* Unrealistic expectations about % of equity give-up for the funding you so desperately need. Professional investors will expect to take 40% or 50% or 70% or even higher, if the company is not yet well developed.
* Ignoring Due Diligence Issues in backgrounds of principals, officers and directors. Run a background check on yourself, and also Google yourself, before you contact any investors. Do a credit check on yourself as well. Investors will do all of the above.
* Dispensing stock loosely, to everyone including the cleaning lady. Don’t make promises of “I’ll take care of you” to people you can’t keep, or will not keep. You will need to account for all of the “pieces” of equity you have doled out along the way. It dilutes your ownership and/or investors, and they don’t like that.
* Waiting too long to start preparation for a capital raise, creating an emergency out of it.
  + Desperate will be written all over your face and your financials
  + Intention is to overlap between the next capital raise and the end of the current money.
  + Allow 12 to 18 months to do the preparation, find the money and close the deal.
* Wrong Motivation for doing capital raise – to Cash you out
  + Examine your motivation
  + Not a get rich quick scheme based on exit quick strategy – expect to be in it for the long haul
* Believing that your lawyer or accountant will find your investors for you
  + Definition of private placement means that the issuer knows the investors. The main group of investors you bring in, should be people you know first hand.
* Believing that your lawyer, accountant and other professionals can be paid out of proceeds of offering.
* Thinking that a Business plan works as an Offering Memo.
* Not realizing that Sophisticated Investors will negotiate terms: You can raise larger $$ from professional investors, but they will hold you hostage to their own terms. Friends and family will not negotiate terms, but you can’t raise much $$ from them
* Using AOL or hot mail or as your business email account,
  + looks unprofessional and
  + emails of any size will bounce,
  + can’t store emails to keep as business records
  + emails are deleted after 30 days
  + Spend some money on technology so you look like a professional playing in the tech field (or any other field.)

***Corporate Law Points & Intellecutal Property Points as a Precursor to Raising Capital From Investors***

* **Who owns IP?** 
  + **Developed** Where? While employed somewhere else? Might they have a claim to it?
  + **Co-developed** with another party? If so, legal rights assigned to you? If not, its not yours to develop.
  + **IP Ownership –** IPMust be owned by the company that is raising the capital from investors, so that investors can own the asset into which it is investing.
  + **Protection of Intellectual Property**
    - Is protection of your IP Possible? Patented? Business Process Patent option? Have you blown that protection by putting your ides in the public domain
    - NDAs for Employees and Partners
    - Name and trademark (see 2nd from next item)
    - Balance how much to disclose in O. Memo vs. Proprietary Info
  + *All info about the intellectual property, and who owns it must be in the disclosure document / offering memo*
* **Noncompete with current or former Employer**
  + Does your current, or former, employer’s Non-Compete Agreement or Employment Agreement **impede your starting your business**? To what degree? Applicable after you leave? How Long?
  + Employer **perhaps may negotiable on a supplement** to the agreement that would allow you to start your business, compete in their space,
    - but not steal their customers, or employees?
* **Name Check:** Critical **before business formation** or growth, importance of global name check, given the global use (and surveillance) of business names through Internet.

[Hand out – Incorporation / LLC Formation Checklist, including search vehicles & techniques for “knock out” name search]

[Hand out - Filing Fees For Business Formation]

[Hand out - Corporate Maintenance Checklist – “Legal Ducks in a Row”

*All info about rights to name and logs must be in the offering memo*

* **Corporate Formalities –**
  + **Keep corporate records straight, *especially stock records.***
    - **Stock ledger is you corporate check book for you company’s bank account of shares**
    - **Botched Do-It-Yourself Incorporation**
  + **Separate finances, actions, contracts:**
    - **From personal and**
    - **From other businesses**
  + **Diligent accounting records**
  + **Follow Corporate Formalities**
  + Investor due diligence on these
  + *All material info about the Company must be in the offering memo or disclosure document*
* **Use Technology to Operate Your Business – or you’ll be left in the dust**
* **Business Ducks in a Row –** 
  + **Research and Know your industry,** 
    - **No such thing as “no competitors”, what are the current substitutes**
  + **Daily Internet searches to keep your info current**
  + **Suppliers in place, as close to letter of intent or contract as possible.**
  + **Customers in place, if appropriate or possible, even one or two customers**
  + **Industry Compliance – hire experts, such as Telco**
  + **Due Diligence on Company you Keep – business reputation sometimes affected by those you partner with**
  + *All material info about the business and industry must be in the offering memo, describe industry, market place, competitors, other players who are not direct competitors, risk factors.*

[Hand out – Article “Is Your Business Investor Ready”? and [“20 Questions VCs Will Ask”] and “Due Diligence Questionnaire”?]

* **Business Contracts:**   **Use them.**
  + **Oral Relationships -** Investors will **not invest on deal built on them**, not matter how solid. Make the deal, but eventually paper it
  + Expensive to paper all agreements at once and retroactively.
  + Shareholder agreement between you and **your business partners –founding partners, alliance partners** [Hand out available by email, Checklist of discussion items among partners in corp]
  + *Must Summarize all material contracts in the Disclosure Document / Offering Memo. Have to have the deal papered in order for securities lawyer to summarize it.*
* **Due Diligence - Clean Background is Key** 
  + **Due Diligence that Investors will conduct on Principals**
  + **Background checks**, criminal, regulatory, tax liens, bankruptcy
  + Principals (D’s & O’s, Control Shareholders), the entity itself, and prior business and legal history) – All of above, plus business reputation
  + *All material info about the principals must be in the offering memo*

[Hand out – Due Diligence Questionnaire for Private Placements]

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***Equity advantages over Debt:***

* If equity deal crashes, you are **not personally liable** (However, you ***are personally*** liable in equity raise, if you have in any way, mislead investors or misstated any fact, or even a shade of meaning in the disclosure, and they sue you in a securities fraud lawsuit)
* Equity Broadens the company’s horizons because decisions will now be made by “committee” of investors and larger board, rather than narrower decision factors determined by bank loan officer and you and your small, closely held board.
* Access to capital not based on loan-to-value, or personal collateral available for security, especially attractive for early stage companies who don’t qualify for equity.
* Investors share fully in your losses (and profits!)
* **Realistic Expectations as to Cost, Timing, Involvement –** 
  + **Months** not weeks
  + Cash from your pocket – Money where your mouth is
  + Not free or cheap, no payments out of proceeds
  + **Operational Documents Needed**: **[NFH]** Founders Agreement; Offering Memo; Shareholder Agreement; Subscription Agreement. No detail required here.
  + **Full time job while its in process**