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**Velocity Law, LLC**

*Law Firm for Business*

*Nancy Fallon-Houle*

*5449 Bending Oaks Place | Downers Grove, Illinois 60515-4456*

[nfallon@velocitylaw.com](mailto:nfallon@velocitylaw.com) *630-963-0439 x 22*

www.velocitylaw.com

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***Securities Law and Corporate Law Issues***

***for Companies Raising Capital From Investors***

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***Corporate Law Points & Business-Building Points as a Precursor to Raising Capital From Investors***

**Key issues for start-up or early stage companies:**

* **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, it’s 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.

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

[See - Filing Fees For Business Formation]

[See - Corporate Maintenance Checklist – “Legal Ducks in a Row During Operations”

*All info about rights to name and logos 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**
* **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.*

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

* **Business Contracts:**   **Use them.**
  + **Oral Relationships Must be Papered -** 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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**Raising Equity Capital**

***Built the entity foundation, have business plan, now ready to prepare to raise capital***

1. ***Funding Methods***

**Typical route -** The capital-raising process for early-stage business is comprised of a series of cash infusion events in several, or many, stages, **some or all of these:**

* Self-funding from founders’ personal pocket:
  + Personal Savings,
  + Credit cards,
  + Personal loans to founder from family
* Investment in equity in company by family & very close friends
* Seed capital from people in the industry
* Friends/ business associates
* Angel Investors – Single or a few known to founders
* Angel Investors – Professional Angels or Angel Group
* Reg D Rule 506(b) (private offering)
* Rule 506(c) public private offering to all accredited investors
* Professional investors or Venture capital investors
* More VC Rounds
* **Business self-funds by growing organically / businesses profits**
* **“Liquidity” event:**
  + **Acquisition**
  + **Merger**
  + **Business stays private and makes enough profits to pay returns to investors**
  + **Management buy-out of the early stage investors, or**
  + **IPO (the unusual case, and very costly).**
* Crowd Funding must be through an SEC qualified portal. Limits on dollars and number of investors. The SEC’s crowdfunding rules set parameters for exempt crowdfunding offerings to non-accredited investors, subject to a $1 million cap over a rolling 12-month period and dollar limits on an investor’s financial position.
* Crowd Funding in states: Some states allow narrow intra-state offering exemptions that allow small public offerings to public investors all in one state, and the same state that the issuer is located.
* JOBS Act Adopted it in 2012, SEC final adopting Regulations in October 2015, Finalized.

<https://www.sec.gov/news/pressrelease/2015-249.html>

FINRA and SEC need to create a regulatory system for the Crowdfunding portals.

* No such thing as immediate IPO, or even 1 year to IPO. It’s a myth that a company can “go public” on its first capital raise, or even within 5 years of start-up. Generally 5+ years to IPO, generally companies with 300+ employees and $1 million in net income.

1. ***What is a Security?***

Definition of a “Security” in SEC vs. Howey 328 US 293 (1946):

* Investment of money, property, or services,
* Into a common scheme or enterprise,
* With the expectation of profit,
* Through the efforts of others. (“others” meaning, you, the founders).

1. **Issuing *any* equity interest in your business entity, in exchange for cash, property, or services, or in exchange for a vendor contract, is deemed to be the issuing of a security.**

These are all Securities:

* Issuing *any* equity interest in your company, in exchange for cash, property, or services, or in exchange for a vendor/supplier contract.
* A share of stock, an LLC interest, an LP interest.
* Options, warrants, shares, stock bonus, convertible notes, convertible instruments, participating notes, or anything that contemplates a pay-back in the future.
* Issuing, or even giving, equity interests to employees, in exchange for services.
* Employee stock bonus plan, employee stock purchase plan, employee plan interest, even if in exchange for services and not for cash.
* Equity to board members, or advisory board members, advisors, or consultants, even if in exchange for advice or services and not for cash.
* Giving a security for services or property is a security sale!
* Loans can be securities (see next section).
* An “investor” is any person who gives you money, property, or free services), in exchange for equity, with expectation of making profits, or a return on their investment in your company, 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.
* An investment by more than one person, a common pool of money, into any entity, business or investment, is a security: A start-up, an operating company, a real estate investment, a trading fund, anything into which the investor expects to receive a return on the investment….is a security.
* Pooling investor money into an entity, with the purpose of making money, any type of investment pool, with any investment purpose, is a security. This includes a common pool of real estate investors.
* A real estate investment, or any venture or partnership, with more than one person investing, can be a security. (Exceptions, not a security if it’s a true loan. Not a security or a jointly managed partnership of actively, significantly, involved working partners).
* Investors who actively work in the venture as Managing Members or General Partners are not investors, and their interests are not securities. Investments by the founding partners, or the key management working in the company, are therefore not securities.
* Even selling stock to your mother is a securities sale (although an exempt one, not requiring documentation if it is to your mom).

1. ***When Are Loans Deemed to Be Securities? And When Not? Borrowing Debt vs. Raising Investor Equity***
2. **Debt can be a security**, if:
   * Payments to lender are made only out of profits, and not paid if the venture experiences losses.
   * Payments only due to lender if the business makes money, and are not due if the business does not make money.
   * There is no fixed obligation of principal or interest payments, similar to those that would be on a mortgage loan, or
   * The debt is convertible into equity.
3. **When Debt is a Security:**

* Shared equity ownership in the property or investment
* Investor owns a percentage or $ value of the LLC or LP or corp.
  + Note or Loan Convertible into stock or equity ownership.
  + Participating Note, or Loan, where borrower’s payments only due, or lender makes more $, if investment makes profits. No fixed Principal & Interest.

1. **When Debt is Not a Security:**

* Debt, Loans, Notes (generally), Borrowing a loan from lenders
* Fixed payments, payment dates & obligation amount
* Payment Not Based on Profits or Loss: Borrower’s payments due even if business becomes financially unsuccessful
* Lender has priority rights over investors in liquidation

1. ***Borrowing Debt vs. Raising Investor Equity – Pros & Cons***

* Lenders easier to find than investors, because lender’s debt has more security than investor’s equity.
* Debt faster to negotiate and close.
* Debt less costly than equity in a few ways.
  + Securities law compliance costs are very expensive. Equity (Investor money) more expensive than debt. Deal must be large to be worth securities law compliance cost.
  + Equity: Founders give up a piece of the company
* Investors share fully in profits & losses and only get paid if there are profits; while lenders get paid regardless of profits & losses.
* Lenders often prefer debt because of lender priority in liquidation or dissolution.

1. ***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!)

1. ***Securities Laws Apply if Investors Buying a Security: If the Investment is a Security, then Registration or* exemption is required.**

* **If a security is to be issued, then registration or exemption is required.**
* **Key to find, and comply with, exemptions from registration.** 4(2) or Regulation D 506(b) or 506(c).
* Registration exemptions typically require a notice filing, even in very small deal. Registration exemptions in states most always require notice filing or separate state registration.
* **However, there are *no exemptions from Disclosure***! Disclosure method required, either need PPM / Offering Memo, or abbreviated version of them in a securities law-compliance executive summary or securities law compliant business plan. ***The “Offering Memo”*** (See below.)

1. **No Exemptions from Disclosure Requirements.**

* The exemptions are from full blown registration, and not from disclosure or from the notice filings.
* **Even in an exempt private offering, there are *no exemptions from disclosure – Issuer still needs either an “Offering Memo” or something like it)***
* **SEC and State Notice Filings, or State Registrations:** The Issuer is still required to let the SEC & State Regulators know about the offering (through a notice filing.) Sometimes the notice process it time-consuming, lengthy and costly, and sometimes require preparing and filing the full disclosure document.
* Due Diligence on the principals of the Issuer is still required. 3rd party verification of no criminal, fraud, tax liens, bankruptcy of the founders or the issuer. Issuer pays the cost of Due Diligence back ground checks.
* Disclosure can be curtailed in a few circumstances, but not omitted. **See below** “Disclosure Curtailed”
* **Negotiated Deals with Sophisticated professional investors** can be exempt from complex disclosure. However, THOSE investors often require complex terms and investment documents before they will invest, which costs as much, or more, in legal fees as doing a full Offering Memo**.**
* **Use the safe harbor of a Regulation D Rule 506 deal, by using an Offering Memo.**

1. ***Why Disclosure?***

[See – Why Offering Memo Required]

* **Disclosure required even if an exemption applies that permits “no filing”, no notice filing, and no registration.**
* Securities laws require “**full and fair disclosure**”, of all information material to investment decision. Before the investment is made. (§ 10b-5, the Anti-fraud laws).
* Disclosure is the ***sole*** federal (SEC) requirement of the 4(2) exemption in most cases, and is 1 of only 3 requirements of the federal Reg D Rule 506 (if all investors are accredited.) Even though not stated as a requirement in the 4(2) or Reg D exemptions.
* **Disclosure doc is the CYA document!** It’s the insulation (not protection, but insulation) against a lawsuit (investor suing issuer) if deal crashes. Investors can sue, but they likely will not win if you have provided full and complete disclosure in written format.
* CYA so that you are saying the same thing to every investor:
  + No deviation that can be the source of litigation (you told one investor one thing and another investor another).
  + Oral disclosure is inconsistent, time-consuming and not memorialized to protect you the Issuer, from an investor saying that you didn’t tell the investor a material fact.
* Saves you time as a business tool:
  + Forces Issuer to crystalize thoughts in writing. Create much of your presentation first, in writing narrative document, and then in power point,
  + Presentation is consistent
  + Presentation is polished, rather than oral and giving the appearance of “winging it”.
  + **Time Saver** for your sales pitches. No need to repeat same info to multiple parties over and over.
* Not promising to make money, just telling the facts of the deal, the people, the industry, the strategy, offering terms, principals, risks, investor repayment plan, exit strategy.
* **Legal Protection** (to Issuer), from investors if unsuccessful investment, and exaggerating brokers. Investors may sue, but they are far less likely to win if you have everything written up in the “book”.
  + Don’t say anything orally outside of the book, and
  + Don’t say anything untrue, misleading or “puffing”, even if you are trying to sell the deal.
* **Investor Perception**: Improved with professional book; Increases investor confidence that other legal compliance is done correctly.
* **Anticipates & answers investor questions, and answers them in advance, making the investor meeting and due diligence process more streamlined and efficient.**
* Can and should be a **marketing document**: Touting the virtues of investment strategy, your background, and your team.
* Balances Sales Pitch with Full Disclosure
* Puts your **money where your mouth is**: You have invested personal assets in start-up costs (legal, accounting, printing.)

1. ***Disclosure Document / Offering Memo – What is It?***

* **Material information** for investment decision, “full and fair disclosure” about deal and principals, industry and risks.
* **Disclosure Doc Highlights:**
  + **Biography** and 20-year historical background of principals and 5% owners.
  + “**Bad boy”** history on all principals: Criminal, Fraud, Regulatory/licensing history, court actions, bankruptcy, tax liens.
    - If you are uncomfortable disclosing an item that is unfavorable, it’s probably material, and must be disclosed.
    - Background check required on Issuer and Principals
    - Corporate and Personal Due Diligence Summaries
  + Intellectual property description, and assurance statement it is protected
  + Investment Strategy / Property Types, Geographic Scope
  + Industry Analysis
  + Industry Risk Factors
  + Prior Performance / Track record
  + Use of Proceeds Table
  + Capitalization Table (who owns what equity in the issuer, and who are lenders and how much lent)
  + Financial condition including debt.
  + Any brokers or Finders? Compensation to whom and how much?
  + **Fees** charged to investors; fees & expenses to fund, clear & concise.
  + Material **Agreements,** including debt, summarized.
  + **Risk Factors**: Strategy Risks, Market Risks, Your Competition, experience level.
  + Any other affiliated entities, persons, investment funds? Who owns what of the affiliates?
* **Cost High**: Initial Cost of Disclosure Doc is high, multiple 10s of thousands of dollars. But:
  + It is an insulation, of sorts, to defend in an investor lawsuit, and
  + The first private placement memo is the foundation and template for all later capital raises. It will be built upon, 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.

1. ***Disclosure Document – Limited Version - Possibilities.***

**Disclosure can be curtailed,** but not omitted, in a few limited circumstances where the Issuer is less at risk when not using a full disclosure doc, and where one is not required, if the disclosure obligations are met in some other fashion. Examples:

* + ***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, approx. 1 to 3 investors
    - Immediate family (parents or siblings), small number, providing start-up seed money (perhaps up to 5 immediate family members) a couple of close friends OK. Like 2 or 3.
    - **Institutional Investors**
    - A sole, or 1 to 3, “Sophisticated” investor providing single shot of startup 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 somehow, 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: the “Stack of Documents” approach:
    - 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 of family or small group of professional investors, or just a group of 1 or 2 other investors.
* **Negotiated Transaction with sophisticated, experienced, often institutional, investor. Exempts the issuer from complex disclosure document, however, those investors often require complex terms and investment documents before they will invest.**
* **Or Use the safe harbor of a Reg D 506(b) or (c) with Offering Memo**

1. **Registration Exemptions - Use Regulation D 504 or 506(b) or 4(a)(2) exemptions.**

* **What Is a 4(a)(2) and a SEC Reg D 506(b) or 506(c) [See chart]**
* **Risk of non-compliance is rescission (give back the money to investors)**
* **Compare to 4(a)(2)** (Self-executing, but hard to prove, no safe harbors)
* **Why Reg D 506(b) most preferable** Why Reg D 506(b) most preferable:
  + Consistency Among States, Uniform Notice Filing, Uniform Conditions of Exemption; Blue Sky.
  + But disclosure document required
* **Reg D 506(b) 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”.

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

* **Reg D 506 (c) New Law 4/01/2012 and 9/23/13 that allows public solicitation of private offering, as long as sales are made only to accredited investors. However, written 3rd party certification or proof of accredited status required for 506(c) offering.**

1. **Regulation D Rule 506(b) Conditions**

* Private offering
* No public solicitation, no ads, no website solicitation, no social media, no mass emails to lists of unknown investors, no seminars.
* Pre-existing relationship between issuer and investor required.
* Unlimited dollar amount on offers & sales.
* Unlimited time for offering.
* Accredited and Nonaccredited Investors Permitted.
* Limit on number of investors:
  + 35 Nonaccredited Investors permitted.
  + 499 accredited Investors permitted
    - Commercial Issuers subject to ‘34 Act Reporting Requirements if over 499 investors, or
    - Hedge Fund, Futures Fund and Real Estate Fund Issuers Subject to ‘40 Act’s 99 investor limit, or 499 if QEP Investors.

[See – Private Offering Exemption Q & A Chart]

* No 3rd party verification of accredited status is required as long as investors meet the pre-existing relationship test under Reg D Rule 506(c).
* Issuer’s principals subject to “Bad Actor Disqualifications”, and active confirmation by questionnaire required.
* Filing Form D is a condition of the exemption, with severe penalties for failure to file.
* Finder Fee disclosure required on Form D.
* 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.

[See – Private Offering Exemption Q & A Chart]

1. ***Regulation D Rule 506(c) Conditions***

* Private offering with public solicitation permitted.
* General Solicitation permitted to all investors, but can only accept accredited investors.
* No pre-existing relationship required, unknown investors may invest.
* Unlimited dollar amount on offers & sales.
* Unlimited time for offering
* **Accredited Investors ONLY. No nonaccrediteds**.
* Issuer must actively confirm with 3rd party verification, or by objective 3rd party proof, that each investor is accredited.
* Limit on number of investors:
  + 0 nonaccrediteds permitted.
  + 499 accredited Investors permitted
    - Commercial Issuers subject to ‘34 Act Reporting Requirements if over 499 investors, or
    - Hedge Fund, Futures Fund and Real Estate Fund Issuers Subject to ‘40 Act’s 99 investor limit, or 499 if QEP Investors.

[See – Private Offering Exemption Q & A Chart]

* Issuer’s principals subject to “Bad Actor Disqualifications”, and active confirmation by questionnaire required.
* Filing Form D is a condition of the exemption, with severe penalties for failure to file.
* Finder Fee disclosure required on Form D.
* Unlimited dollar amount on offers & sales.
* Unlimited time frame for offering.
* Limit on # of accredited investors: Up to 499 accredited investors.
  + Commercial Issuers subject to ‘34 Act Reporting Requirements if over 500 investors, or
  + Hedge Fund, Futures Fund and Real Estate Fund Issuers Subject to ‘40 Act 100 investor limit or 500 if QEP Investors.
* Audited Financials not required, because no nonaccrediteds permitted, though financials may be required if issuer has operating history.
* Abbreviated disclosure book permitted for all accredited deal, though must still comply with 10b-5 anti-fraud, including all material information given to investors.
* Family members, who are not accredited, still count as nonaccrediteds and may not invest (unless the issuer expends additional time and money on the disclosure docs.)

1. **Accredited Investor Qualifications** - **What is an Accredited Investor?** 
   * $1 million net worth, or $200K gross income, or $300K joint income with spouse. Exclude personal residence from net worth calculation.
   * SEC views sophistication as being correlated to risk to investors
   * 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(c) Deal amount offered, only limits on how you connect with the investors, and on the qualification of the investors.
2. ***Nonaccredited Investors Change the Nature / Cost of Compliance***

* Audited Financial Statements Required if even 1 nonaccredited is in the deal.
* Lengthier Offering Book Required under Reg D 506 and 502 for Nonaccrediteds
* Detailed Investor Suitability Questionnaire Required for Nonaccrediteds
* If nonaccrediteds permitted as investors, compliance often becomes prohibitively expensive (legal & accounting costs).
* Nonaccrediteds do not qualify as ‘40 Act QEP investors for > 100 investor fund.

1. ***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.
* Multiple Offerings must have 6 month window between each offering, or
* Start a separate fund with completely different trading strategy (gray area).
* Consequence of failure to comply = all funds lumped together as 1, by the SEC.
* Not a problem if total of all nonaccredited investors in all funds < 35.

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

* **Notice filing required with the SEC - SEC Form D** Filed for a Reg D offering
* SEC Form D 10 page disclosure notice filed online on EDGAR.
* Disclosure of principals and deal terms
* Disclosure of brokers & finders, names & fees, offering amount, $ sold, # investors.
* File with SEC 15 days after 1st sale in any state. Plus in states file 15 days after 1st sale in each state.

1. **Blue Sky Law for Reg D 506(b) or 506(c) or 504 or 4(a)(2): Notice filings are required in each state in which investors reside:**
   * 50 states each have own securities laws.
   * State of residence of investor is key.
   * State review and comment on Reg D 506 pre-empted by federal law (National Securities Market Improvement Act 1996)
   * Filings still required in each state, whether it’s a Reg D offering or not:
     + Form D, Notice Letter & Fee
     + 15 days after sale in each state (except PA & NY, pre offer)
     + New York attempt to require pre-offer filing.
     + If the offering is a Reg D, either 506 or 504
   * Even if the offering is not a Reg D
   * For 4(a)(2) offerings. Conditions and exemptions are not uniform for 4(a)(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 within 15 days after sale.

[Chart: 50-state notice filing requirements.

1. ***Private vs. Public Offering Distinction***

* Private Offering = No Public Solicitation, no internet solicitation, no cold-calls, no mass email or mail to unknown recipients, no newspaper or magazine ads, no planted articles, no websites selling, No Internet Solicitation, no LinkedIn Hunt for Investors, No Facebook Publicity on the hunt for investors, but OK to publicize the product or service.
* Pre-existing Relationship with your Investors Required = Must know your investor, even if not long,
* Or selling broker-dealer must have pre-existing relationship with his /her investors.
* New Law 4/9/2012 JOBS Act – Public Solicitation permitted in Reg D Rule 506(c) public private Offering, if only selling to accredited investors, but cannot use yet until the SEC adopts Regulations with conditions
* **What Contact Allowed?**
* **Jobs Act 4/5/2012 (Eff. 7/5/12):** Nonaccrediteds: Must know Nonaccredited Investors in advance of offering. *“Pre-existing Relationship of sufficient length and duration to determine suitability of investment”.*
* Accrediteds: May solicit unknown investors, but may sell only to confirmed Accredited investors. Must verify Accredited status.
* **SEC No Action Letters**: Issuer may solicit Accredited Investors from pre-qualified list of prior accredited subscribers to password-protected list. Lamp, IPO.Net

1. **Why It’s Illegal to Offer Your Investment on the Internet in a 506(b) or 4(a)(2)**
   * + **Limitations on Solicitations in 506(b) and 4(a)(2)**
   * **Manner of Offering – No general Solicitation**
     + Private vs. Public Offering – Don’t want to be a public offering
     + 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
2. ***What Is an SEC Reg D 506(b) or (c) Offering?*** 
   * + - **Compare to 4(2)**
       - **Why Reg D 506(b) most preferable** Why Reg D 506(b) most preferable – Blue Sky – But disclosure required
       - **Limits on # of investors 35**
       - **Limits on # of investors 499 for Commercial Issuers, 99 for Securities or Futures Funds**

[Handout – Private Offering Exemption Q & A Chart]

* + - * + **Investor Qualifications** –
        + **What is an Accredited Investor?**
      * **Why prohibit, or limit, sales to them?** Lack of Sophistication
      * **Audited Financials requirement for nonaccrediteds**
      * **What about family who are not accredited?**
    - **Risk of non-compliance is rescission (give back the money) and since 9/23/13 penalties and prohibition on using Reg D in future.**
    - **506(c) allows public solicitation, but sales only to accredited investors permitted.**

1. ***Regulation D Rule 504; Regulation A; Regulation CF (Crowdfunding)***

**Reg D Rule 504:**

* Blue Sky for Reg D 504 (Small Public Offering of $1 million) requires full registration in at least one state.
* 504 is limited to $1 million in investor sales,
* 504 Must be registered in at least one state, many states require full-blown registration; though Illinois requires only a notice filing on Form D.
* CPA reviewed (or audited) Financials required.
* 504 allows public solicitation.

**Crowdfunding Reg CF**

* Crowdfunding – New Law adopted October 2015, allows public or social media offering up to $1,000,000, but limit of $500 per investor, and must be sold through a registered intermediary.
* Crowdfunding does not work for investment fund.
* If you do Crowdfunding right, it is still cost prohibitive, given cost of audits and disclosure documents, given the small amount you can raise.

**Regulation A**

* Regulation A, for up to $20,000,000 for Tier 1 and up to $50,000,000 for Tier 2. Semi-registration with the SEC, full registration with states; but not registered with the SEC, not underwritten by broker, not listed on an exchange and shares are illiquid.

**Do not use Reg D Rule 505 (obsolete):**

* 505 is limited to $ 5 million in sales
* State 505 exemptions are a landmine, so 505 is obsolete

DO USE and Rely on Reg D 506(b) or 506(c) **as the only practical and cost-effective exemption.**

1. ***1934 Act: Broker-Dealer Issues (Person Selling)***

* Person selling your investment must be registered as a broker-dealer in US and in states. No commissions.
* Issuer-Dealer Exemptions for you, the fund operator, and your partners: Rule 3a4-1 and comparable state exemptions:
  + Officer or Director status required,
  + No commissions, and
  + No other concurrent deals.
* Hire a broker to help you sell?

1. **Money Finders - *Avoid Use of Money Finders to Sell the Deal – Unless they Are Registered BDs*:**

* Must be disclosed on SEC Form D that the issuer company files.
* Beware: Unregulated industry, no licensing of finders.
  + **Illegal if they are not registered** securities brokers under 1934 Act. Ask for their CRD number and run it through [www.finra.com](http://www.finra.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 on Internet or in the newspaper “money available”.
* Some are expelled brokers; or people with criminal records.
* Quality & ethics run the gamut.
* Disclosure on Form D brings finder before SEC & states, may cause regulatory trouble for unregistered finder.
  + Will increase your legal fees to use one.
* M&A Broker dealer allowed to receive commissions, but only on M&A Deal

1. **Business Issues, Deal Structure, Investor Expectations**

**[See, “Deal Structure and Term considerations”]**

* **Determine in advance, the Liquidity Event or how investors will be paid back.**
  + **Selling the Properties**
  + **Quarterly/Annual Profit splits**
  + **Management buyout 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 portion of the profits on sale of property**

1. **Selling the Deal** 
   * Full disclosure, whole truth and nothing but the truth in the PPM.

No superlatives; no omissions; No BS, don’t enhance the written disclosure.

* + Don’t supplement the written disclosure orally, unless your supplement is in writing.
  + **Separate selling your product** and the virtues of you company from selling the **stock** in the company, Turn off the marketing press when selling the stock.
  + You’re **not selling a used car or real estate** – Don’t take 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**

1. ***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.
* **Unrealistic Expectations as to Cost, Timing, Involvement of Raising Capital –** 
  + **Months** not weeks to raise capital
  + Cash from your pocket – must spend money to be in compliance to bring in investors
  + Investors expect you to have some cash skin in the game (Your own “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 for founders while it is in process**
* 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
  + Spend some money on technology so you look like a professional playing in the tech field (or any other field.)