RAISING CAPITAL FOR STARTUPS

As we all know, banks are not inclined to lend to startup companies, which is why you need investors. When seeking outside capital for startups or existing companies, it is important to be aware of a range of securities laws in terms of what they require or prohibit in this type of exercise. The backdrop of raising capital begins after you have successfully incorporated the startup company. As a general proposition, the legal issues involved when raising capital from outside investors arise from laws that regulate the offer and sale of securities. Such laws exist at both the federal and state level, which are designed to protect the investor from overselling an opportunity or fraud. The securities laws on the books require the registration and qualification of securities prior to an investor purchasing the security, which is a cumbersome and expensive process.

Fortunately, there exists a variety of exemptions to the qualification process on both the federal and state level that simplify how a startup may raise capital without having to register the security, making this process more efficient and far less costly. The two most prominent exemptions are found in Rule 504 and 506 of the securities laws and are referred to as “Reg D” exemptions in that they are part of Regulation D of the Securities Act enacted in 1933. There is a third type of exemption found in Rule 701 that relates to granting of stock to employees and consultants.

Reg D provides a number of exemptions from the registration requirements, allowing some companies to offer and sell their securities without having to register the offering with the SEC. If a company qualifies under Reg D, it does not have to register their offering of securities with the SEC; however, they must file a Form D electronically with the SEC after they first sell their securities. Form D is a brief notice that includes the names and addresses of the company’s promoters, executive officers and directors, and some details about the offering, but contains little other information about the company.

Even if a company takes advantage of an exemption from registration, it is important that it provides sufficient information to investors in order to avoid violating the antifraud provisions of the securities laws. This means that any information a company provides to investors must be free from false or misleading statements. Similarly, a company should not exclude any information if the omission makes what is provided to investors false or misleading.

Rule 504 permits the startup to raise capital from non-accredited investors when the criteria for the rule have been met; however, the level of funding that can be raised must not exceed five million ($5,000,000). Rule 504 requires the startup to comply with the state in which the investor resides, which could become prohibitively expensive if the raise is from a large number of investors across multiple states. Complying with Rule 504 requires detailed information and its preparation is costly and time consuming.

An offering under Rule 506(b), however, is subject to the following requirements: (i) no solicitation or advertising to market the securities and (ii) securities may not be sold to more than 35 non-accredited investors. All non-accredited investors, either alone or with a purchaser representative, must meet the legal standard of having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment.

If non-accredited investors are participating in the offering, the company conducting the offering (i) must give any non-accredited investors disclosure documents that generally contain the same type of information as provided in registered offerings (the company is not required to provide specified disclosure documents to accredited investors, but, if it does provide information to accredited investors, it must also make this information available to the non-accredited investors as well); (ii) must give any non-accredited investors financial statement information specified in Rule 506, and (iii) should be available to answer questions from prospective purchasers who are non-accredited investors.

Raising capital under a Rule 506 (b) exemption is the most popular and widely employed, which allows an unlimited amount of money to be raised in a private placement transaction without solicitation or advertising to market the securities, if certain requirements are met. In this scenario, the startup company is required to limit the sales of the securities to any number of accredited investors and to no more than 35 other purchasers who have sufficient knowledge and experience in financial and business matters, such that they have the ability to evaluate the risk of the investment. When raising capital under this exemption, the startup must provide the non-accredited investor disclosure documents that are very similar to those provided in a registered offering. The company is required to take reasonable steps to verify that the investors are accredited, which include tax returns, brokerage statements, credit reports and similar documentation that verifies that the investor qualifies as being accredited.

If you would like to learn more about raising capital for your business or have questions on other business matters, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

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