



## 5 Rules of the Road For Private Company Financings

by StartUpAdmin

August 11, 2011



There's nothing more relaxing than a long drive right? The stereo's bumping, you've got your bouncing baby startup strapped tightly in the car seat in the back, and you're looking for ice cream, because your startup is about to startup some major crying without ice cream. If you speed, you'll get to it faster. If you jump the curb and cut through someone's lawn you might get to it even faster. But all of that is illegal and dangerous. Do it even once and there's a chance you could suffer a calamitous outcome, and above all, you'd be putting your precious baby startup in jeopardy. The same applies to private company financings. You've GOT to know and adhere to the "rules of the road" or all of the work you've done up to this point could be for not.

The rules for most private company financings are found under the [Securities Exchange Commission's \(SEC\)](#) "Rule 506," which dictates how individuals and startups must conduct themselves when seeking investment funds by selling securities (a share of stock, a convertible note, etc.). Running afoul of these rules can not only prevent you from raising the funds that you need, it could subject your personal assets to exposure (no corporate liability shield will be there to protect you), and in the worst case scenario, subject you to civil and criminal penalties. So, these rules can't be taken lightly.

### The 5 Rules of the Road for [Private Company Financings](#) under Rule 506

Before you start your securities offering, you have to identify an applicable securities law exemption from registration. What does this mean? Each time your company issues



a security, the company must register the securities offering with the SEC and state securities divisions with jurisdiction unless there is an applicable exemption from registration under the securities laws. Meaning, you **have** to identify a specific provision under both state and federal law that says that either for the type of transaction you are involved with or the type of securities you are selling, you do not have to go through a registration process with the SEC or with the particular state. Registration is a very expensive process. Thus, exemptions are key.

In general, for most private companies, the exemption most frequently relied upon in the fund raising context is Rule 506 under federal Regulation D. Under Rule 506, companies can raise an unlimited amount of money, as long as they abide by the following five “rules of the road”:

1) **No general solicitation** – A condition of Rule 506 is not soliciting the sale of the securities through public channels. Specifically the rule states that *“neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising.”* Advertising seems like a great way to find these people, but that’s a no-no. No matter how tempting it is to post to Twitter or LinkedIn that you are raising money, don’t do it.

2) **Accredited investors only** – One of the keys in raising money in Rule 506 offerings is to only accept funds from persons that you have a reasonable basis to believe are accredited investors. If you accept funds from only accredited investors, there is no specific information that you need to provide investors (no audited financials, for example). Note: that doesn’t mean you don’t have to provide information; it just means that there is no specific format for the types of information you have to provide. You’re still subject to the anti-fraud requirements of federal and state law. Here’s another important note: The rule does say that, in a Rule 506 offering, you can raise money from up to 35 non-accredited investors as well—but don’t be misled. Keep on reading the rule. If you do, you will see that, if you accept money from any non-accredited investors, you will have to provide the potential investors a voluminous amount of information. You probably don’t want to do this. So, accept money from accredited investors only.

### **Accredited investors generally are:**

- **High net worth individuals** – The SEC defines this individual as “a natural person” (a human being as opposed to a “legal person” such as a corporation) who has individual net worth (meaning, net of debt), or joint net worth with the person’s spouse, in excess of \$1 million at the time of the purchase, not including the value of their primary residence (vacation homes can count).



# Startup Law Blog

Insights for founders of and investors in emerging and startup companies

- **High income person** – This is a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year.
- **Entities In Which All Owners Are Accredited** – This can be a business in which all of the equity owners are accredited investors.
- **Director or Executive Officers of the Company** – These individuals can be a director, executive officer, or general partner of the company selling the securities.
- **Certain Other Entities** – Entities with assets in excess of \$5 million not specifically created in order to acquire the securities offered can qualify.

3) **File Forms D** – In a Rule 506 offering, you are supposed to file a Form D with the SEC and with most states in which investors are resident within 15 days of first raising money.

4) **Be careful with finders** – Be careful with folks who want to charge you a fee to help you raise money. First, any such fees will have to be disclosed to investors as part of the offering. Second, the SEC and state securities regulators take a dim view of finders, especially finders who are not registered as broker/dealers. The SEC will want you to disclose on your Form D who you used as a finder in your financing. And certain states give investors the right to rescind investments in which unregistered finders were involved (e.g., see California’s law on finders).

5) **Beware of “integration” with other offerings** – In Rule 506 offerings, you have to be careful, because all sales that are part of the same offering must meet all of the terms and conditions of Regulation D. So, if you sold stock to friends and family who were not accredited three months ago—and now you want to sell stock to investors in an all accredited investor offering—your prior stock sales to your friends and family may be “integrated” into, and disrupt, your planned all accredited offering and not allow you to rely on Rule 506.

**Not a rule of the road yet—but beware of bad actors** – If you are a regular reader of this blog then you may have heard the term bad actors mentioned. For a full detailed description of bad actors see the article [Willful Blindness: The Rule 506 Securities Law Exemption and the New “Bad Actor” Rules](#). The SEC is in the process of adopting final rules which will prohibit companies from using Rule 506 if bad actors are involved with the company. The new rules will have “look back” provisions. These rules are not yet



# Startup Law Blog

Insights for founders of and investors in emerging and startup companies

effective, but if you are planning on raising money in the months ahead, you should keep yourself apprised of developments on this front and get ready to comply with this incoming regulatory onslaught.

## **Be Careful**

So lets recap: don't advertise for funds, file your Forms D with the SEC and state securities regulators, choose only accredited investors, be wary of finders, look out for integration, and keep your eye out for bad actors. It seems like a lot, but nobody said that there weren't going to be potholes in the road to your dreams. We just know that swerving around them is a heck of a lot less damaging than plowing into them. Now drive safely...somebody needs some ice cream.

This advisory is a publication of Davis Wright Tremaine LLP. Our purpose in publishing this advisory is to inform our clients and friends of recent legal developments. It is not intended, nor should it be used, as a substitute for specific legal advice as legal counsel may only be given in response to inquiries regarding particular situations.