Basics of Selling Securities to Finance your Venture

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Since You want Money, at Some Point, You'll Sell "Securities"

- All business at some point want to raise $$
- All businesses will at some time sell pieces of the company to "investors" to get that $$
- Hence many businesses will sell "securities" at some point
  - In Plain English a Security is:
    - Some instrument for sale by a company (shares, units, notes, etc.)
    - That Instrument offers $$ "upside" if the company does well
    - And that instrument rarely offers "downside" protection or refund if the company does badly, or worse, goes under
    - Finally, the instrument gives the purchaser little to no control over the management of the company
- The entire process of selling securities is ***heavily*** regulated under State & Federal Securities law
- Knowing the very basics of securities for startups and private companies can save your reputation, your brand, and in the best case, *jail time*

Selling Securities w/o Heeding Rules can Lead to Severe Consequences

- Many startups + mature companies simply sell pieces of their co. without heeding securities laws
- As a result, the principals are potentially exposed to personal liability for "fraud"
- So if the company goes under, even if investor monies were legitimately spent, an investor could latch on to the company's failure to follow securities laws and get the state and federal governments to:
  - 1) Get the $$ back from the principals personally (i.e., ignore the entity)
  - 2) Blacklist the principals so they can't raise investor money in the future
  - 3) Impose criminal sanctions

No to IPO: a Private Process to Sell Securities

- Not all companies can/want to go the route of Google and go through an IPO (time, expense (thousands if not millions of dollars), regulatory overview)
- What can smaller companies and startups do instead?
- Follow the securities law framework for so called "private offerings" of securities

Private Offerings

- For startups and private companies, instead of "going ***public***", they can offer a "***private*** placement" of securities
- Again, just selling securities "willy nilly" can lead in the worst case, to jail
- A "Private Placement" (aka "Private Offering") can enable the company to sell securities, so long as the company plays by the securities laws rules
- Those rules are laid out by the securities laws under so-called Regulation D

Regulation D

- Startups and private companies that don't want to go "public" can still sell securities
- They will have to abide by Regulation D **exemption** from registration under the Securities Act of 1933
- This federal regulation lays out a framework that if followed can insulate the company and its principals from violating the law and accusations of "fraud" if things go "bad"

The FIVE Features of a Regulation D Offering

- There are five major features to a regulation D private placement offering
- Those features are:
  1. Private
  2. Disclosure
  3. Restricted
  4. Blue Sky Notices
  5. Accredited investors (i.e., *rich people*)

Five Features–Private

- **Private**:
  - this basically means you don't take out ads in the newspaper and you don't sell the security to just anybody off the street (generally this means you are selling securities to people with whom you have a substantially pre-existing relationship);
  - this is essentially the opposite of a public offering where, for example, Google can selling securities on an exchange to basically anyone who wants to buy them

Five Features—Disclosure (anti-fraud)

- **Disclosure**:
  - If you're going to do a private placement simply "telling" an investor your basic idea is insufficient
  - You generally have to provide a prospectus: a detailed document that lays out in detail all of the risks, the potential downside, description of the industry, the people involved, and a variety other data that an investor would reasonably need to make an investment
  - In the private offering, that prospectus is generally called "Private Placement Memorandum"
  - Failure to have a PPM can lead to accusations of "fraud", even though you may not have told a "lie"
  - Under securities laws, "fraud" can be tantamount to omitting facts an investor needs to understand, (i.e., risk factors)

Five Features—Restricted Securities

- **Restricted**:
  - simply, when you sell securities under a private placement, you have to let the investor know he or she can't just resell it to anybody as they see fit
  - This is fundamentally different from a share in a public company, like Google, which can be sold to another party the minute you bought it
  - So generally speaking, when securities are sold through a private offering they are "illiquid"
  - Hence, an investor buys securities in a private offering for the "long run", they are not buying it for the opportunity to resell but for the overall growth opportunity

Five Features—Blue Sky

- **Blue Sky Notices**:
  - you generally have to advise various states in which the investors reside that you are engaged in a private placement offering so that you are "on their radar"
  - Failure to do so can result in blowing all of the hard work that you put in to create a private placement to avoid being ensnared by the securities laws
  - For example, if you are trying to raise $500K from investors who live in New York and New Jersey, you likely will have to file so-called blue sky notice filings in both states advising those states that you're trying to raise $500K from residents who live there
  - Note: there are fees that accompany Blue Sky filings

Five Features—Accredited Investors

- **Accredited Investors**:
  - Generally, it is best to sell private securities to investors who are relatively "wealthy"
  - Under the law there is a technical definition for who is "wealthy", that definition is referred to as "accredited investor"
    - individuals who earned $200,000 or more in the past two years, with a reasonable expectation of earning the same amount of money or more in the year in which the investment is made
  - A secondary definition: the individual investor has $1 million or more in assets, not including their primary residence (take note those with New York apartments that have skyrocketed in value)
  - It is possible to take money from non-accredited investors but law protects them with higher degree of scrutiny, make sure to take care of other four pillars, in particular disclosure, because failure could have higher consequences
  - Also, numerical limitations on the number of unaccredited investors that you can take in (generally the highest number being 35)
  - There are other/related accredited investor definitions for institutions, etc.

Some Best Practices; Timing

- There is a timing to how the private placement process should play out
- You generally can't/shouldn't talk to investors about investment propositions (i.e., soliciting them to invest in your securities) before you have taken care of the five pillars)
- Companies going the private placement route should spend time money and effort in gathering the materials necessary to satisfy the five pillars before they pull the trigger and solicit investors
- Planning ahead is the key

Complexity Beyond Presentation

- The previous slides were very a basic intro to private placements
- Some other factors that should be considered when engaging in a private placement are: the amount of money being raised, the type of securities being offered (debt, equity, hybrid, etc.)
- There are many more complexities that can impact the various parameters discussed
- Any company looking to do a private placement really needs to leverage competent counsel who knows this area of the law

Crowdfunding

- Crowdfunding is of course of interest to any company looking to raise money
- Under the law now (but not for long due to JOBS Act), crowdfunding enables all sorts of people from all over the world to basically give but not "invest" money to a venture so that the company can do great things
- Currently crowdfunding does not allow companies to sell "upside" to these third-party donors
- Instead, the company that relies on “Kickstarter", is basically selling the product or certain other favors to the donor instead the revenue stream of the company or upside if the company were ever to be sold
- People who give money to third-party companies via crowdfunding are generally not "investors" in the traditional sense and therefore lack many of the incentives that come with being an "investor"
- Under the JOBS ACT that will change but how exactly that will change is still up in the air
- In any event, the basics of private offerings will still apply even in the crowdfunding context so it's good to become familiar the previous slides