

SEEKING FUNDING FROM PRIVATE INVESTORS??

Make Sure You Consider Regulation D.

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If you are seeking private investors to help fund your venture, you need to consider following the guidelines provided by Regulation D of the Securities Act of 1933. Why? Some of the many reasons are:

(i) Potential investors will receive the kind of professional investment package from you that they are accustomed to receiving from others seeking their investment dollars.

(ii) If you comply with certain rules of Regulation D you will not be subject to a ceiling on the amount of investment you can seek.

(iii) Because your investment is structured as a Regulation D transaction, you are better able to retain your desired equity or other deal terms in the face of investors who will be seeking better terms or concessions.

(iv) You will get the kind of protection from lawsuits and liability that you would never get using only a business plan (even a well-crafted one) or a similar generic investment document.

I have often begun seminars on venture financing with a simple maxim: If an investment is involved, it almost always involves an “issuance of securities” – in exchange for dollars, the company issues securities to the investor representing an interest in the company (in ownership, rights to payments or otherwise). It doesn’t much matter whether you call the interests issued to the investor shares of stock, LLC units, options, participating interests or otherwise – if someone invests money with the hope of receiving a profit mainly from the activities of the company or venture, you are dealing with a securities offering (you offered the securities, the investor gave something of value, you issued the securities.)

There are a lot of factors involved but its best to just assume you are involved in a securities offering (this is true even if it is a minimal dollar amount). As I learned as a young intern at the Securities and Exchange Commission, before you offer and issue any securities, they must be registered with the SEC (i.e. public registration subject to SEC review of prospectus and comments) or there must be an exemption from this type of registration.

The key is making sure you have an exemption from registration that you can “hang your hat” on. Companies taking in investor funds without regard to complying with an applicable exemption are taking on a significant risk because any company involved in a securities offering might be required in the future to affirmatively prove that there was an exemption that applied to them at the time securities were sold. For example, let’s say one of your investors has a problem with you or your company two years after investing and decides to sue (the thing about investors is that also have the money to hire

lawyers...) You should assume one of the claims will be that the company offered and sold “unregistered” securities in exchange for his investment. The inability to refute this claim could spell disaster for your company and its other investors (your situation just became more precarious). While there are a few exemptions other than Regulation D that may apply, there is no “slam dunk” because you still have to prove you complied which can be tricky.

Like many other practitioners, I will often rely on the exemption from registration provided by Regulation D because, when complied with, it provides the client with a “safe harbor” from the general registration requirements enforced by the SEC. This is key so I will repeat it - when the various rules and provisions of Regulation D are complied with, you can rely on this “safe harbor” exemption from registration while seeking your funding. Many issues (relating to numbers of investors, specific information disclosed, limitations on soliciting interest and so forth) are involved in complying with Regulation D but, if you do comply, you can breathe a bit easier.

Yes, it takes some additional legal and accounting fees in the initial stages to complete a Regulation D offering document and to conduct the offering in the required manner (changes to specific provisions of Regulation D occur occasionally with a number of revisions under way right now at the SEC). At the end of the day, rely on your professional advisors and their input to help guide you in your decision regarding funding strategy and future risk assessment.

A great number of issues touched on briefly here are beyond the scope of this article but I will get into these in more detail in future articles. If you have questions or comments, send an email – perhaps I can address something of particular interest to you in the future.

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This article should not be construed as legal advice. Due to the complexities of Regulation D, the specific facts and circumstances and the current status of the law must be carefully considered when seeking to benefit from the Regulation D safe harbor exemption.

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