Finding Investors 101: Understanding Securities Law and Legal Compliance Structures

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In my work with impact-focused entrepreneurs who are ready to raise capital to take their businesses to the next level, I find that phrases like *securities law* and *legal compliance* can be intimidating. But, while these concepts can admittedly be complex, they shouldn’t dissuade you from getting your business funded.

Instead, with some education, you can understand enough about legal compliance structures to work with your attorney to make the right decisions. Then you will be equipped with a strategy that will enable you to seek and secure investors in a legally compliant way.

What is securities law?

Securities law is a somewhat arcane area of law that’s been around since the early 1900s. The first securities law was adopted in Kansas in 1911. The story goes that some people were in Kansas from out of state trying to offer investment opportunities, and the Kansas legislature got wind of it. Believing it was better if Kansans kept their money in the state and wanting to protect people from being tricked into investing in out-of-state schemes, the Kansas legislature adopted the first securities law in the nation.

Several other states followed suit and adopted their own versions of securities law. After the stock market crash of 1929, the federal government adopted securities laws as well, but by then, there were already many state laws. Because of this history, we now have to be mindful of complying with both state and federal securities laws.

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What is a "security"?

When you're raising money from investors, you're offering them a security. Basically, a security means anything you offer another person to invest in, from which they expect to derive profit.

The definition is very broad. People often try to set up offers and claim they're not securities – this is happening a lot right now in the crypto space – but if people are putting in money with the expectation of getting a financial return, it's a security.

If you're looking for investors, chances are you're offering a security, and you have to comply with securities law.

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The basic rule of securities law

A securities offering also is defined very broadly – even just saying to someone, "Hey, I'm looking for investors for my business," can be considered a securities offering. Any time you have any communication that tells another person you're offering an investment opportunity is going to be considered a securities offering.

Unless an exemption applies to your situation (more on that later), a securities offering must be registered under federal securities law and the securities laws of any states where the offering is made. A federal offering registration is the process companies go through when they "go public" (aka do an IPO). A federal securities offering registration is very onerous and expensive, so if possible, we want to offer an investment opportunity without having to register.

If you're offering securities and trying to avoid federal registration, you must identify a federal exemption. You also have to figure out how you will comply with the state laws of any state where you plan to offer securities. Some state-level registrations are not as onerous as federal registrations. But ideally, you're going to identify both a federal exemption and a state exemption in every state where you're offering the investment opportunity.

To do this, we consider all of the possible exemptions from the registration requirement, both at the state and federal level and look for one or more exemptions that may fit the situation.

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Understanding securities regulations

To help you understand the thinking behind securities regulations, I want to share the thinking of securities regulators so you can understand why certain types of offerings require you to jump through more legal hoops than others.

- **Public advertising of a securities offering**: Let's say

you go on a radio program and say, “Hey, these securities are for sale; check out this investment. It’s really great.” Security regulators are concerned that this creates a greater risk than a private offering, where you’re having one-on-one conversations with fewer people. They are scared that if you publicly advertise an investment offering, a whole bunch of people could jump into it and end up losing all of their money.

- **Offerings to unaccredited investors**: An accredited investor is defined under federal law. Generally, accredited investors are people with at least a million dollars in net worth, not including their primary residence, or $200,000 or more in annual income, or an entity with $5 million in net assets. They’re a relatively small percentage of the population. Securities regulators believe that if only accredited investors are offered an investment opportunity, there’s less chance of significant damage happening because these people have more money and, therefore, can afford to lose their investment.
- **Large offerings**: The larger a securities offering, the more damage it could do if things don’t work out. If you’re raising $100,000, the potential for widespread economic devastation is minimal. But if you’re raising $100 million, that can impact many people if they all lose their money.

These are the principles behind securities regulations: Private offerings to accredited investors and small offerings are subject to fewer rules than public offerings open to everyone for larger amounts.

This doesn’t mean we need to be afraid of public advertising, unaccredited investors or large offerings. It just means we need to be aware that these factors must be considered when we choose our legal compliance strategy.

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Choosing your compliance strategy and exemptions

When choosing your compliance strategy and the proper exemptions to use, you will want to work with a securities lawyer who can help ensure you meet the necessary legal requirements. Below is some of the basic information you will need to know to have an informed conversation about the choices with your legal counsel.

If your lawyer doesn't know about all of the options available or tries to push you into just one option because that is what they are most familiar with, I recommend looking for a different lawyer.

What are the primary federal exemptions?

When offering securities to potential investors, you need to identify the right federal exemption to fit your goals (e.g., do you want to be able to advertise publicly, do you want to include everyone or limit yourself to accredited investors, how much do you want to raise, etc.). Here is a brief overview of the most commonly used federal exemptions.

- **Rule 506(b):** This is the exemption most commonly used by securities lawyers working with clients that are high-growth startups looking to raise funding in the venture capital world. Under this exemption,
    - There is no cap on the amount you can raise
    - No public advertising is allowed
    - You can include up to 35 unaccredited investors, but this increases the disclosure requirements
    - Unless you complete the extra disclosure requirements for unaccredited investors, you need to make sure that everyone you talk to about

investing is accredited – this is typically accomplished by requiring potential investors to complete a questionnaire before talking to them
    - There is preemption of substantive state law requirements, but you must file state notice filings and fees in any state where you have investors
    - You must file a federal Form D
- **Rule 504:** Under this exemption,
    - You can raise up to $10 million in any 12-month period
    - You can include an unlimited number of unaccredited investors under federal law, but this will usually be limited under state law because there is no federal preemption of state regulations under Rule 504
    - No public advertising is allowed unless you comply with state-level registration requirements
    - There may be state filings and fees required depending on the states where you make your offering
    - You must file a federal Form D
- **Rule 506(c):** This is a relatively new rule that was part of the JOBS Act of 2012. Under this exemption,
    - There is no cap on the amount you can raise
    - You can publicly advertise your offering
    - You must ensure that all of your investors are accredited
    - There is preemption of substantive state law requirements, but you must file state notice filings and fees in any state where you have investors
    - You must file a federal Form D
- **Regulation Crowdfunding:** This was authorized under the JOBS Act of 2012 and went into effect in 2016. Under this exemption,
    - You can raise up to $5 million

    - If you are raising more than $124,000, you must have financial statements professionally prepared by an independent CPA
    - You can raise from the whole country without doing any state-level filings (although there may be a state filing required for the state where you are located and/or raise the majority of your funding from)
    - Anyone can invest, although there are caps on the amounts unaccredited folks can invest
    - Extensive disclosures must be filed the with the Securities and Exchange Commission
    - You must use a third-party platform registered with the Securities and Exchange Commission, and you want to choose carefully as there is a wide range in the quality and service the platforms provide.
- **Intrastate Exemption**
    - This exemption applies if you are offering securities only to residents of the state where your business is located
    - You must comply with state securities regulations
    - State crowdfunding options are available, and some of them are pretty easy to comply with
- **Nonprofit Exemption**
    - Nonprofits can raise funding from investors under this exemption but must comply with state securities regulations
    - Some states have exemptions for nonprofit securities offerings

Final points for consideration

One last point to be aware of is the issue of integration. This somewhat complicated topic boils down to one crucial point: You can’t do two separate offerings that have different requirements as a way to get around the rules.

I’ll give you an example. Let’s say you did a public offering under regulation crowdfunding, did a ton of advertising and collected the emails of everyone who expressed interest. Then the public offering ended, and you decided to do a private offering under Rule 504. Now you want to send an email about the private offering to this huge list of people who said they were interested in the public offering. That is essentially doing an end run around the rules, saying you can’t find private investors through public advertising. So make sure you comply with the integration rules.

That’s it for now. This article has barely scratched the surface of all the complexities of state and federal securities law. But if you’ve taken the time to read it, you now know more than 99.9% of entrepreneurs about the rules governing how you can raise money from investors! Be sure to find a skilled security law expert who can coach you on the best compliance strategy for you and help you stay compliant throughout the fundraising process.

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