

Finance Your Business Plan With A Private Securities Offering

By Richard C. Engel

My practice area in law has provided me with the opportunity to review a large number of business plans for small businesses from the high-tech industry to real-estate ventures to manufacturing. Though these businesses and start-ups are diverse, in the beginning they all have one common characteristic — the need to raise capital.

Despite their presentation of impressive revenue projections, many small businesses are turned

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away by banks, because they do not yet generate revenue or have other hard collateral needed to secure a traditional bank loan. To be sure, commercial lenders are essential to the business after it's off the ground, but banks are not often inclined to be your investment partner in the early stages of your business development.

The alternative is to finance your business with a *private securities offering*, that is, to sell a piece of your business to passive investors. There are certain fundamental legal requirements that must be followed to raise any amount of capital from investors.

Many small companies are surprised to learn that raising start-up money, even from close friends and family members, is regulated on both the state and federal level.

In the years following the market and economic crash of 1929, the federal government created the Securities and

Exchange Commission (SEC) and delegated power to it under the Securities Act of 1933. The Securities Act requires registration with the SEC of all securities offerings, whether you are selling debt (a promise to repay) or equity (shares of stock in a corporation or an ownership interest in a limited-liability company).

Over time, certain exemptions and safe harbors were carved out of the 1933 Act to permit companies to avoid the high cost and complications of a public securities offering.

Chief among the safe harbors from SEC registration is Regulation D of the 1933 Act. Regulation D is a series of six rules, Rules 501-506, establishing three transactional exemptions (Rules 504, 505 and 506) from the registration requirements of the 1933 Act.

Since the National Securities Markets Improvement Act of 1996, the overwhelming majority of small businesses and other issuers have relied on Rule 506, because it permits companies to raise an unlimited amount of money from investors. Except for certain state form and filing fees, Rule 506 (unlike 504 and 505) preempts any state securities laws or regulations ("Blue Sky" laws) that would otherwise require registration of the securities on the state level.

Rule 506 is at its core a disclosure regulation. Issuers generally are required to disclose a variety of information to investors, in the form of a *private-placement memorandum*, regarding the nature, characteristics, and inherent risks of the investment. The rule requires disclosure

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of anything material that a reasonable investor would want to know in deciding whether to invest.

Compliance is essential. Rule 506 allows the issuer to raise an unlimited amount of money in a 12-month period from any number of high-net-worth or "accredited investors." These include individuals with net worth exceeding \$1 million, either alone or jointly with their spouse. Accredited investors can also be banks, brokerages, mutual funds, small-business investment companies, or non-profit organizations with total assets of more than \$5 million.

Rule 506 also allows up to 35 non-accredited investors who are considered to be "sophisticated investors." These are investors whom a company reasonably believes have adequate knowledge and experience in financial and business matters to evaluate the securities offered for sale.

A private offering must be just that,

private. Cold calling, seminars, or other general solicitations published in the newspaper or on the Internet are prohibited. In fact, the issuer is required to have a "pre-existing relationship" with the potential investor. In addition, any sale of securities (public or private) is governed by Rule 10b-5 of the 1934 Securities Exchange Act, an anti-fraud statute, which imposes liability on the issuer for any material misstatements or omissions to investors.

Obviously, many start-ups and small businesses will fail. If investors by means of a legally compliant private-securities offering financed the unsuccessful business, those investors accept the risk of losing their entire investment.

Any significant deviation from the rules, however, may result in you losing the exemption from registration, in which case, beyond other enforcement remedies available to the SEC, the issuer would at the very least have to offer to rescind the securities offering and return each investor's money.

Entrepreneurs in need of capital to finance their businesses need to consider the pros and cons of dealing with outside investors. A private securities offering when structured properly is one effective method that small businesses can use to get things off the ground. □

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