

# FISHERBROYLES

A LIMITED LIABILITY PARTNERSHIP

## Early Stage Business, Securities Law and Arugula!

Many would say that an early stage business and securities law go together as well as arugula and hot fudge. While culinary compatibility is not our forte, all business people need to be aware of the implications of securities law.

It is important to understand that many things may be unexpectedly considered securities under state and/or federal law. In general, the standard of what is considered a security from the legal perspective is whether the interest signifies a right to actual or potential payment primarily as a result of the efforts of the issuer of the interest and without material involvement of the holder. Among other things that courts have found to be securities are participations in orange groves and herds of fur-bearing animals. Moreover, recent activity by the US Securities and Exchange Commission (the SEC) suggests that certain capital raising transactions involving virtual currencies and tokens such as bitcoin may be subject to securities laws as well.

If a security is present in a particular case, such as where a business seeks to raise equity capital from its founder and employees or outside investors, the business **must** either register the transaction with the SEC or qualify for a specific exemption from registration. Similarly, state securities laws require that securities transactions be registered unless they qualify for a specific exemption. It is also important to understand that securities law in general provides both for exempt transactions and exempt securities. While registration offers definite advantages, and at the behest of Congress the SEC has made a meaningful effort to streamline the process for small business, registration is still a cumbersome and expensive process. An exemption is usually preferable.

There are a number of exemptions from registration; for example, a private placement exemption, intrastate exemption and an exemption for compensatory issuances to employees, directors and consultants, the specifics of which have been or will be covered in other newsletters. However, various attributes of exemptions must be taken into account when determining which exemption is right for you and how to perfect your claim to it. Failure to observe applicable rules around each exemption results in many unhappy consequences, including purchasers who are dissatisfied having the ability to force the company to repurchase the securities (i.e., give the investor back their money!). It is also likely to prejudice your business position in the event that you seek to sell the company or pursue additional financing.

Several key areas which must be examined for each transaction are:

- Resale Restrictions. Securities sold pursuant to an exemption cannot be resold to just anyone on an exchange or otherwise. There may be limitations on the amount, timing and manner of resale. Where a public market is contemplated, parties often negotiate 'registration covenants' which dictate when registration is to be effected and who is to bear the cost.
- Offering Size. Some exemptions place a dollar limit on the amount of the capital raise.

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- Accurate disclosure. Depending on the exemption, written disclosure may or may not be required. To avoid potential fraud claims in the future, it is often best practice to provide **written** disclosure of all material attributes of the securities and the issuer, including use of proceeds, material risk factors and conflicts of interest of management other than in the case of an issuance to a very limited number of persons already intimately familiar with the company. While an exemption may allow greater flexibility in presenting information than does a public offering, **there is no right to deceive anyone through a misstatement or omission of material information**.
- Purchaser characteristics. There are often limitations on the number of purchasers, particularly those who do not meet prescribed standards for financial capacity and sophistication or purchase size. Also, the state of residence of each purchaser will in part dictate which state securities laws must be observed, and there is significant variation among states regarding the extent of available exemptions, the amount of filing fees, and other significant aspects.
- Manner of Offering. Even where all disclosures are accurate, issuers may not indiscriminately circulate them in any medium they choose – this is referred to as the ban on “general solicitation.” General solicitation is barred under most (but not all) private offering exemptions. As a result, it is essential to address the planned vehicle(s) for advising interested persons of the investment opportunity by reference to the specific requirements of the claimed exemption.
- Governmental filing. While no exemption requires anything close to a formal registration statement, in some cases there is a need for formal notice to the SEC and one or more state agencies.

When you are in or approaching capital raising mode, our corporate partners can work with you to determine the optimal strategy to suit your intentions and needs.

**If you would like additional information, please contact any of the following FisherBroyles partners:**

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