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For Attorneys Advising a New Tech Startup: Basic Securities Law Related to Convertible Note Offerings

By Brenton Twitchell

Basic Securities Law Related to Convertible Note Offerings

NOTE: For the purposes of these materials, it's assumed the issuer isn't going to engage in general solicitation and that this is a "traditional" offering of private securities. Securities laws are complex, so this covers the basics.

Full Disclosure

SEC Rule 10b-5 and (in Washington and for Washington companies) RCW 21.20.010 always apply. Rule 10b-5 was created under the Securities Exchange Act of 1934. In the context of a convertible note offering, this rule makes it illegal for an issuer (or anyone associated with it) to directly or indirectly do something to defraud, make false statements, omit relevant information or otherwise conduct its operations in a way that would deceive investors or potential investors. Most states have complementary and/or corresponding measures. In Washington, RCW 21.20.010 makes it illegal for:

> any person, in connection with the offer, sale or purchase of any security, directly or indirectly: (1) To employ any device, scheme or artifice to defraud; (2) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Practically, this means counsel to the issuer has to work in close coordination with the issuer to ensure that all material information is disclosed to any potential investor. Without going into too much detail, it's a good idea to develop a private placement memorandum (or "PPM") with something approaching prospectus-like disclosure to ensure that risks, the business plan, important financial information about the issuer, and other important information are all properly disclosed. Of course, the structure and complexity of the PPM are dependent on the type of deal. For example, if there is only going to be one institutional investor in the offering, and the institutional investor has already invested in the issuer in the past, the PPM can be much more streamlined or even eliminated so long as appropriate full disclosure is otherwise made.

Finder's Fees

A startup's founders often turn to their network of family, friends and associates in their search for investors and for leads to potential investors. Individuals who help locate sources of capital are commonly referred to as "finders," and startups often think it's a good idea to pay finders some form of transaction-based compensation for their referrals. It only makes sense to incentivize people to go out and help you find money, correct? Yes, such arrangements would make sense if they didn't also violate federal and state securities laws. You cannot give transaction-based compensation in connection with a securities transaction to a finder who isn't a registered broker dealer. Section 3(a)(4)(A) of the Securities Exchange Act of 1934 defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." This definition of broker includes entities as well as individuals. "Effecting transactions" means helping an issuer identify prospective investors, soliciting securities transactions, receiving transaction-based compensation in connection with a securities offering, helping an issuer structure a securities transactions, etc. Section 15(a)(1) of the Securities

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Exchange Act of 1934 requires brokers to be registered with the SEC. Failure to register can result in civil injunctions in federal court, civil money penalties, cease-and-desist orders, and criminal prosecution. Investors who have purchased securities in an offering involving an unregistered broker-dealer have the right to seek rescission from the company and probably its control persons as well. The exceptions, which allow unregistered persons to accept compensation for money-raising efforts are extremely limited, and both state and federal authorities are increasingly sensitive about this very real issue.

Requirements for Exemption from Registration

Accredited Investor

Generally, sales of securities entail registration obligations. Registration is very costly and typically unnecessary for small offerings; it's really mostly for "going public." Rule 506 of Regulation D of the Securities Act of 1933 provides the requirements that must be met in order for an offering to qualify as exempt from registration requirements. To run afoul of these laws and regulations is to risk fines, jail time and the destruction of the issuer's business (in addition to the loss of your law license). Rule 506 requires that those who purchase the securities in an exempt offering (i.e., a private placement) must be accredited or sophisticated. 17 § 230.506 (b)(2)(ii). In my experience, most issuers avoid selling to unaccredited parties because of the increased risk and due diligence requirements placed on the issuer to verify "sophisticated" status and instead sell to accredited investors only.

Rule 501 of Regulation D of the Securities Act of 1933 defines an "accredited investor" as a natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. 17 CFR § 230.501 (a)(6). Also, a natural person whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000 is considered accredited. *See* 17 CFR § 230.501 (a)(5). Directors, executive officers, and general partners of the issuer, or any director, executive officer, or general partner of a general partner of the issuer are accredited investors. 17 § 230.501 (a)(4). Entities of various types can also be accredited investors. For example, a 501(c)(3), a corporation, a Massachusetts or similar business trust, or a partnership, if not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000 is accredited. 17 CFR § 230.501 (a)(3).

Issuers are required to take "reasonable steps to verify that purchasers of securities sold" are accredited. 17 CFR § 230.506 (c)(2)(ii). The verification requirements are more onerous for accredited entities than for accredited natural persons. Long story short, a startup needs to make sure it is only offering and selling securities to accredited investors. This means that the startup needs to know in advance to whom it is offering securities and at the very least needs to include a part of the investment packet that explains what it means to be accredited and has the investor certify that he/she/it is accredited by signing on the dotted line.

Bad Actor Questionnaire

In 2013, the Securities and Exchange Commission ("SEC") amended Rule 506 to disqualify from the exemption any offering involving certain "felons and other 'bad actors.'" The new rule triggers disclosure of bad actors and bad acts that occurred on or prior to September 23, 2013, and provides that bad actors/bad acts occurring after September 23, 2013, cause the disqualification from reliance on Rule 506. This means that if any:

- director, executive officer, or other officer of the issuer participating in an offering,
- general partner or managing member of an issuer,
- beneficial owner of 20% or more of the issuer's outstanding voting equity securities,
- person that has been or will be paid (directly or indirectly) for solicitation of purchasers in connection with the sale of securities in the offering,
- general partner or managing member of any solicitor for the offering, or
- any director, executive officer, or other officer participating in the offering of any solicitor for the offering or general partner or managing member of any solicitor for the offering is a "bad actor," then the issuer can't rely on the Rule 506 exemption.

This means that prior to the commencement of an offering, counsel to the issuer should present the individuals listed above with a "Bad Actor Questionnaire" that parrots the language found in Rule 506. *See* 17 CFR § 230.506 (d). Typically, these are set up so the individual filling it out has to check the box for each type of bad actor, certifying that he or she or doesn't meet the description and then signing at the bottom of the form.

<u>Form D</u>
Form D is the form the issuer files with the SEC notifying the SEC that it is conducting an offering exempt from registration pursuant to Rule 504, 505, or 506 Regulation D or Section 4(5) of the Securities Act of 1933. The SEC requires that the notice be filed by an issuer within 15 days after the first sale of the securities in the offering. This is the first date on which the first investor, in the words of the SEC, "irrevocably contractually committed to invest." If the due date falls on a weekend or holiday, it's moved to the next business day. You file the Form D with the SEC online using the SEC's EDGAR (electronic gathering, analysis and retrieval) system.

<u>Blue Sky Filings</u>
Almost all states also require issuers to file Form D notices and amendments with their regulatory agencies when issuers have sold (or in the case of NY, and perhaps others, are going to sell) securities to their residents. Most states charge a filing fee. Each state has slightly different filing requirements, so it's important to go to the website of each state's securities regulatory agency to get the proper filing instructions. You can go to www.NASAA.org (North American Securities Administrators Association) to get links to the states' websites. Most states require paper filings. For example, in Washington an issuer can print out the SEC online Form D it filed on EDGAR and submit it together with $300 to the Washington State Department of Financial Institutions. WAC 460-44A-503.

Conclusion

The laws and regulations governing the issuance of securities are a minefield. Read and re-read the relevant statutes and regulations. When in doubt, pick up the phone and call a state regulator or a more experienced colleague.

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