WHITE PAPER

FEATURING

› START-UP FUNDRAISING
› FROM “FAMILY AND FRIENDS” THROUGH SERIES A
› LEGAL CONSIDERATIONS
Carpenter Wellington is a Seattle + Portland based full service corporate and commercial law firm, providing pragmatic, business-friendly legal advice and business solutions. Carpenter Wellington attorneys work exclusively with start-ups to middle market companies, partnering with executives, in-house counsel, investors, and entrepreneurs, including start-up and general counsel legal services.

We invite you to join our exclusive portfolio of exceptional clients and experience for yourself, the unique experience and value in working with Carpenter Wellington.

Disclaimer

This White Paper consists of an overview of the five fundraising rounds for start-ups, together with discussion of some of the legal issues that arise in the process.

Nothing in this White Paper is intended to be, or is, legal advice. By its very nature, legal advice can be given only after an attorney has delved into the facts of a specific case or project. If you decide to move forward with a start-up, you should consult with attorneys who have experience in that area of the law. We at Carpenter Wellington are ready to assist you with start-up legal issues and more.

Copyright © 2020 Carpenter Wellington PLLC

All rights reserved. No part of this publication may be reproduced, distributed, or transmitted in any form or by any means, including photocopying, recording, or other electronic or mechanical methods, without the prior written permission of the publisher, except in the case of brief quotations embodied in critical reviews and certain other noncommercial uses permitted by copyright law.
INTRODUCTION

Organizing a start-up is challenging. You have to learn as much as you can about the business you want to open. You need to know how to make a pitch if you want investors. You must establish accounting procedures. You must become familiar with all the organizational and reporting requirements of state and federal governments. It can be quite the learning curve.

Takeaways:

› First Three Start-Up Fundraising Rounds
› Federal and State Securities Laws

The Fundraising Rounds

One of the major challenges you face is raising funds for your startup. The start-up world organizes fundraising steps into “rounds.” There are commonly five rounds. They are:

› Round 1: The Pre-Seed, or Family and Friends Round
› Round 2: The Seed Funding Round
› Round 3: The Series A Round
› Round 4: The Series B Round
› Round 5: The Series C Round

Round B and C are for well-established, profitable companies. But we’re focusing on start-ups so will leave rounds B and C for another time. What we’ll do in this White Paper is delve into the first three rounds.

Registration, or Exemption, Under Securities Laws

An issue that accompanies fundraising is compliance with federal and state securities laws. Generally speaking, the federal Securities and Exchange Commission (SEC) oversees larger fundraising rounds, while state securities commissions oversee those that involve less than the floor value when the SEC requirements would kick in. If these laws apply to the fundraising round in question, then you just either register your offering with the SEC or with your state securities commission, unless an exemption from registration applies. Since registration is very expensive, exemptions are the best choice when they apply.

Rather than discuss SEC exemptions at every step of the first three start-up rounds, we reserve discussion to the final chapter of this White Paper.
Let's cut to the chase: Start-ups need money to fund the development of their ideas. But before seeking funds, the entrepreneur must become acquainted with the language of fundraising. That language is particular: There are more or less specific descriptions for each stage of fundraising.

Typically, fundraising begins with family and friends. If everything goes well, then start-up fundraising rounds end with a Series A round. As we mentioned, there are two additional rounds – rounds B and C – for mature companies. But we’re focusing on start-ups, so we cover only the first three rounds.

Takeaways:

› Round 1: The Pre-Seed, or Family and Friends Round
› Round 2: The Seed Funding Round
› Round 3: The Series A Round

Round 1: The Pre-Seed, or Family and Friends Round

Unless the entrepreneur is wealthy enough to self-fund, the entrepreneur typically will turn to family and friends to fund the start-up. This round can be called a “pre-seed” round, but it is more descriptive to call it a “family and friends” round because there is where most of the money will come from.

At this point, of course, the investment is risky because it is only an idea. Family and friends must realize that it is quite possible that they will lose their investments. There are ways to help protect both the entrepreneur and their family and friends from personal liability. But let’s assume that all has gone well so that the entrepreneur is ready for the next fundraising rounds.

Round 2: The Seed Funding Round

Seed funding takes place prior to the time that the start-up plans to begin operations but also at the time when the start-up has a detailed business plan in place. “Seed” funding refers, then, to funding the start-up with enough money that it can grow to the point that it demonstrates the viability of the entrepreneur’s idea.

Generally speaking, there are two sources for seed fundraising rounds. One source lies in the venture capital world, where investment firms study and carefully pick among competing start-ups for funding. The firms, in turn, are funded by others who want to invest using the expertise of the venture capital firm.

An alternative source is the “angel” investor, who often is a wealthy person rather than part of a firm and who invests their own money in start-ups. For either source of funding, the investor will expect to receive some equity in the start-up as a condition of funding.
Round 3: The Series A Round

Now we’re ready to leave seeds behind and move to letters. The next step in fundraising rounds is Series A funding. The start-up seeks Series A funding when it has become apparent that the idea for the start-up is workable and has proved itself through the seed fundraising round.

At this point in the life of the start-up, the start-up focuses on how to monetize its business. The start-up must draw up detailed business plans about how to continue penetrating its targeted market but also creating revenue streams from it. A start-up with a powerful, well-thought-out strategy will succeed in obtaining Series A funding to begin growing into a mature company.

There are a couple of peculiarities with Series A funding. One is that by this time, it is more common that investments will come not from angel investors but from venture capital firms, such as Accel, Andreessen Horowitz, Benchmark, Greylock or Sequoia, among many others. Another peculiarity is a “follow-the-leader” effect, where if one venture capital firm invests in a start-up, others quickly take interest and are more likely to invest in it, too.

Fundraising Rounds Not Precise

Fundraising rounds are not scientifically defined. They can and do overlap, as do the investors who seek to inject capital into start-ups. Often, there is more than one of each type of round. But generally speaking, every start-up that has succeeded has gone through these three fundraising rounds. For that reason, it is incumbent on the entrepreneur to be familiar with their general definitions.
Entrepreneurs are full of ideas. After an entrepreneur comes up with an idea, the idea can turn into a start-up. During this time, unless the entrepreneur is independently wealthy, the entrepreneur needs to raise a certain amount of money, to pay for things like computers, software, outside technical help, modest office space, lawyers, accountants and so forth. These expenses will not be huge, but they are necessary to get the start-up off the ground. Often, the entrepreneur raises this money in the first round of fundraising, often called the “seed round” or the “family and friends round,” before moving on to the next.

Takeaways:

- Incorporate the start-up or organize it as an LLC to avoid personal liability.
- The start-up must always be treated as a separate entity from the entrepreneur.
- Family and friend investors should avoid becoming involved in the direction and management of the start-up.
- Loans should be evidenced by a note.

Unfortunately, Many Start-Ups Fail

According to the Small Business Administration, about a third of new businesses survive for two years but fully half are out of business within five years. The entrepreneur, as well as any investors, lose their money. The investors include family and friends of the entrepreneur.

Although most family and friends understand that one lends to a relative or friend with full understanding of the risk of nonpayment, others might want to try to recoup their investment if the start-up fails. Further, if the start-up is not successful, the entrepreneur will want to do what is possible to protect family and friends from outside creditors. In this chapter, we look at some of the things an entrepreneur can do to minimize risk to the entrepreneur as well as to family and friends.

Personal Liability

When a person incurs a debt, yet is unable to repay it, a creditor can go to court to obtain a judgment against the person. A judgment is like a hunting license: The creditor can attempt to seize the debtor’s property and sell it to satisfy the debt. There are limitations on what property the creditor may seize; some of it is said to be “exempt from execution.” But enough items of property are vulnerable to execution to make the entrepreneur want to avoid personal liability and potential liability for family and friends.

Organize as a Corporation or LLC

One way to reduce liability on the part of the entrepreneur, as well as family and friends, is to organize as a corporation or a limited liability company early in the life of the start-up. The reason for organizing is that both corporations and LLCs provide protection against individual debt. If the entrepreneur’s start-up becomes a corporation or an LLC, and debts for services rendered or goods purchased are in the name of the corporation or LLC, then the individual entrepreneur cannot be held liable for them unless the entrepreneur treats the corporation or LLC as a personal bank account rather than an independent entity under the law.
As an example, suppose the start-up needs some furniture. The entrepreneur goes to an office supply store and opens an account in the name of the start-up as a corporation or LLC. Unless the entrepreneur personally guarantees the debt, then if the start-up suffers hard times and is unable to repay the debt, the entrepreneur will not be liable for it. The office supply store’s remedy is to repossess the furniture although it might not have even that remedy.

If you expect your startup to have only a few investors and you will not seek outside funding, the LLC is probably the better choice for you because there is less paperwork and formality. If you do want outside investors, you should incorporate instead. Investors love certainty; the law of corporations is far more developed than the law of LLCs because LLCs are a relatively recent legal entity while corporations have existed, in one form or another, for hundreds of years. The gold standard for a corporation is to be organized in Delaware because Delaware has the most highly developed corporate law of any state.

**Avoid Any Hint of Partnership with Family and Friends**

A partnership is the worst form of business entity for a start-up or, for that matter, any other kind of business. The reason is that under the law, each partner has the power to bind the partnership to a contract, even if the other partners know nothing about it. Partners can be held personally liable for partnership debts, including those incurred by their partners. Avoid partnerships at all costs.

By the same token, the entrepreneur should avoid any arrangement that might conceivably subject family and friends to liability as partners. For example, if an investor is merely a shareholder, the investor cannot be held liable for corporate debts. But if the investor takes an active but informal role in running the corporation, it’s possible that an imaginative attorney could figure out a way to hold the investor liable as a partner, especially if the corporation does not keep good books and records.

**Use Notes to Evidence Loans**

Sometimes entrepreneurs make handshake deals. This is a good thing so long as the entrepreneur and the investor consider the handshake only as a broad outline of their agreement and a good faith promise to negotiate a final deal. Some people think documenting a loan is contrary to the idea of working together in good faith. To the contrary, when the parties write up their respective obligations, they often find that they disagree on minor details or that there are issues they have not yet considered. Putting the deal in writing helps to clarify things and avoid confusion and mistrust.

A written document also can help family and friends who have invested in the start-up if the start-up does not succeed but nevertheless has some liquidation value. A promissory note is proof that there really was a loan. Further, if the note is secured by a lien on corporate property or stock, family and friends might have a preferred position in bankruptcy court as secured creditors.

---

**Recap for the Family and Friends Round**

If an entrepreneur accepts investments from family and friends, then family and friends must understand that the loan is speculative and that, despite the entrepreneur’s best efforts to succeed with the start-up, the loan might never be repaid. In addition, the parties should follow these rules:

- The entrepreneur should either incorporate the start-up or organize it as an LLC to avoid personal liability.
- The start-up should always do business as itself to make clear that it is a separate entity from the entrepreneur.
- Family and friends should avoid becoming involved in the direction and management of the start-up unless they formally take on such duties. Otherwise, there is potential liability as a partner.
- Loans should be evidenced by a note. The parties should consider securing the note with a lien on the start-up itself or its property.

Following these simple rules will avoid personal liability for the entrepreneur and family and friends if the start-up is not successful. If the start-up prospers, the rules will be no less important to how the start-up is run and to the distribution of the eventual profits.
A t this point in the life of a start-up, the business is up and running, but the founders need seed financing to raise enough money to operate for a year or two in order to prove the viability of their product. One way to raise the necessary funds is to sell stock in the company, which previously has been incorporated, preferably in Delaware.

But raising capital by selling common stock for seed financing is not typical. An investment in any start-up is risky. Investors therefore want more rights in the company than common stock provides. Further, if the company sells its stock, it has established a value for that stock. That value is usually much higher than the value at which the company would like to offer stock to its employees by way of option grants or restricted stock. For that reason, the start-up might not be able to attract the best talent if it sold common stock to raise funds.

Alert: At this point in your fundraising the securities laws will likely apply. See our final chapter, “Federal and State Regulation of Raising Capital for Start-Ups.”

The company must use an investment instrument that gives early investors more rights than they would have as common stockholders and avoids valuing the common stock. Start-ups and investors have created three widely used seed financing investment vehicles that meet these requirements. They are the convertible note, the simple agreement for future equity (SAFE) and the sale of preferred stock.

Takeaways:

› Convertible Notes for Seed Financing.
› Simple Agreements for Future Equity (SAFE Notes).
› Seed Financing Using Preferred Stock.

Convertible Notes for Seed Financing

Using a convertible note is the most common method for seed financing. It is a loan to the company that converts into equity upon the occurrence of a conversion event. The event usually is the issuance of a round of preferred stock although it could be the maturity date of the note. The conversion price is normally capped, either based on the value of the company upon conversion of the note or at a discounted price per share. The note usually carries little or no interest and is not secured although the noteholder does enjoy a preferential position should the company fail and be liquidated.

The lawyer’s job is to draft the convertible note. Ordinarily, the company and the investor will come to terms on the investment and write them up as a term sheet. After further communicating with the parties, the lawyer can memorialize their agreement in the note.

Simple Agreements for Future Equity (SAFE Notes)

The SAFE was developed by Y Combinator in 2013. With a SAFE, an investor gives money to the start-up in exchange for the right to convert that money into a proportion of equity. A SAFE investment itself is neither debt nor equity. No interest accrues, and there is no maturity date.

SAFEs vary depending on whether they contain a valuation cap and a discount. A valuation cap sets the maximum price at which the investment turns into equity. A discount entitles the investor to obtain equity at a discount.

Accordingly, there are four types of SAFE for seed financing:

› Valuation cap and discount
› Valuation cap but no discount
› No valuation cap but discount
› No valuation cap and no discount

The final SAFE – neither a valuation cap nor a discount – includes a “most favored nation” clause. What that means is that if the company issues a later SAFE containing terms better for the investor than the first SAFE, the investor is entitled to have the same terms as the second SAFE.

SAFEs are standalone legal instruments that are straightforward to prepare, although there are ancillary legal issues that the lawyer must address, such as the issue of taxation.
Seed Financing Using Preferred Stock

The third commonly used seed financing technique is to issue a round of preferred stock. Preferred stock can be attractive to investors because it gives investors more rights within the company than does common stock. Among these rights are:

- A preferential position should the company fail and liquidate
- Requiring preferred stockholder consent for important company decisions
- Preemptive rights
- Drag-along rights
- Possibly a seat on the company’s board of directors

Issuance of preferred stock for seed financing requires legal assistance not only for drafting the necessary legal documents but also to ensure compliance with the securities laws, as described in the final chapter of this White Paper.

Summary

There are three primary vehicles for seed financing: The convertible note, the SAFE and the issuance of preferred stock. Which technique would be best for a particular start-up is best determined after consulting with counsel.
A Series A round is appropriate when it is clear that the start-up has a successful product and the start-up has proved itself through seed funding. The start-up is now focused on creating revenue. It must have a business plan explaining how it will continue to promote its products to its intended market plus create revenue streams.

Series A round money commonly means an investment in preferred stock. Preferred stock is stock that typically gives the stockholder no voting rights in a corporation but guarantees a fixed stream of income. If the venture fails, preferred stockholders hold a priority position over common stockholders for distribution of assets upon liquidation, if there are any.

But how is the value of the preferred stock priced? This can be a complex question, especially if the start-up used SAFE notes in its seed round. SAFE notes do not grant any equity in the start-up to the note holder, but they are convertible to equity – in other words, shares of stock – upon completing a priced round, or in other words, a Series A round.

**Highlights:**
- Use of Preferred Stock
- Preparation of Capitalization Tables
- Converting SAFE Notes Into Equity

**Progression of the Capitalization Table Through Series A Round**

Capitalization tables are used to keep track of who owns what kinds of stock and at what value in a start-up. Let’s use an example to explain.

Suppose Anaya has an idea for a start-up. Anaya has noticed that a lot of edible produce is discarded because it isn’t “pretty.” A tomato, for example, might be lopsided instead of round, so the grocers and the restaurants don’t want to buy it. It gets thrown out.

But the misshapen tomato is still a nutritious vegetable. Suppose Anaya could start an “ugly produce” business by offering boxes of otherwise rejected produce for delivery to customers? Like the best business ideas, it is a win-win. The farmers can sell more of their produce, the consumer can pay less for good food, and Anaya can make money facilitating the process.

Anaya runs the idea past her friend Liam. He likes the idea and says he’s in. Anaya is the idea and people person, while Liam is the techie. Anaya will run the operations side of the business while Liam will build the website and the ordering and delivery software.

**Initial Organization as Delaware Corporation**

Anaya and Liam organized their business as a Delaware corporation because they followed the advice of their lawyer. The lawyer told them that the Delaware corporation is the gold standard if they eventually plan on outside investors.

Anaya and Liam name their corporation “Quirky Produce Inc.” The lawyer suggests capitalization of Quirky Produce by issuing each of them 4,500,000 shares, holding 1,000,000 shares in reserve for employee options, for a total of 10,000,000 shares. Anaya and Liam authorize issuance of the 10,000,000 shares at par value of 0.0001 per share. Each of them contributes $450 to Quirky Produce in exchange for their 4,500,000 shares.
At this point, the capitalization table of Quirky Produce looks like this:

### Capitalization Table of Quirky Produce Inc. at Founding:

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Percent</th>
<th>Number of Shares</th>
<th>Price</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anaya</td>
<td>45%</td>
<td>4,500,000</td>
<td>$0.0001</td>
<td>$450</td>
</tr>
<tr>
<td>Liam</td>
<td>45%</td>
<td>4,500,000</td>
<td>$0.0001</td>
<td>$450</td>
</tr>
<tr>
<td>Options Pool</td>
<td>10%</td>
<td>1,000,000</td>
<td>$0.0001</td>
<td>$100</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td>10,000,000</td>
<td>$0.0001</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

### SAFE Notes at the Seed Round

Anaya and Liam decided they needed to raise $100,000 in their seed round. They convinced two venture funds to invest in Quirky Produce:

1. Vegetable Capital invested $30,000 via SAFE note providing for a 25% discount on stock.
2. Vitamin D Partners kicked in $70,000, also via SAFE note, but its note has a $1,000,000 valuation cap.

At this point, the SAFE notes are not reflected on the capitalization table for the anticipated Series A round because they grant their holders only a potential equity interest – i.e., preferred stock – in Quirky Produce.

### Capitalization After the Series A Round

Quirky Produce’s business has grown dramatically. It’s now time for a Series A round. Anaya and Liam estimate they need $2,500,000 to reach the next goal for Quirky Produce. Let’s say that they convince First Round Capital to invest $1,500,000, Plug & Play Ventures Group LLC to invest $500,000 and Vegetable Capital (which holds one of the SAFE notes) to invest the other $500,000. How many shares do the various stockholders own now?

### Converting the Discounted SAFE Note to Equity

First Round Capital conducts an analysis of Quirky Produce’s value prior to the Series A investment. It concludes that the company is worth $5,000,000 prior to the Series A investment. This is Quirky Produce’s “pre-money” value.

Vegetable Capital’s SAFE note granted Vegetable Capital a 25% discount when purchasing stock. The value of the Series A round shares equals $5,000,000 pre-money value divided by 10,000,000 shares issued, which is $0.50 per share. At a discount of 25%, the convertible price of each share under the discounted SAFE note becomes $0.375. Vegetable Capital’s $30,000 investment becomes 80,000 shares, calculated by dividing the $30,000 invested by the discounted share price of $0.375.

### Converting the Valuation Cap SAFE Note to Equity

Vitamin D Partners invested $70,000 with a valuation cap of $1,000,000. Each share is thus valued at $1,000,000 divided by 10,000,000 outstanding shares, or $0.10 per share, in this Series A round. As a result of the $70,000 investment, Vitamin D Partners can purchase 700,000 shares from its original investment. As noted, Vitamin D Partners will also invest $500,000 as a straight stock investment at $0.50 per share, or 1,000,000 shares.

Now, the capitalization table after the Series A round looks like this:

### Capitalization Table of Quirky Produce Inc. After Series A

<table>
<thead>
<tr>
<th>Shareholder</th>
<th>Class</th>
<th>Percent</th>
<th>Number of Shares</th>
<th>Price</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anaya</td>
<td>Common</td>
<td>28.52%</td>
<td>4,500,000</td>
<td>$0.50</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>Liam</td>
<td>Common</td>
<td>28.52%</td>
<td>4,500,000</td>
<td>$0.50</td>
<td>$2,250,000</td>
</tr>
<tr>
<td>Options Pool</td>
<td>Common</td>
<td>6.34%</td>
<td>1,000,000</td>
<td>$0.50</td>
<td>$500,000</td>
</tr>
<tr>
<td>Vegetable Capital</td>
<td>Seed Preferred</td>
<td>0.51%</td>
<td>80,000</td>
<td>$0.50</td>
<td>$40,000</td>
</tr>
<tr>
<td>Vitamin D Partners</td>
<td>Seed Preferred</td>
<td>4.45%</td>
<td>700,000</td>
<td>$0.50</td>
<td>$350,000</td>
</tr>
<tr>
<td>First Round Capital</td>
<td>Series A Preferred</td>
<td>19.01%</td>
<td>3,000,000</td>
<td>$0.50</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Plug &amp; Play Ventures Group LLC</td>
<td>Series A Preferred</td>
<td>6.34%</td>
<td>1,000,000</td>
<td>$0.50</td>
<td>$500,000</td>
</tr>
<tr>
<td>Vegetable Capital</td>
<td>Series A Preferred</td>
<td>6.34%</td>
<td>1,000,000</td>
<td>$0.50</td>
<td>$500,000</td>
</tr>
<tr>
<td>100%</td>
<td></td>
<td></td>
<td>15,220,000</td>
<td></td>
<td>7,690,000</td>
</tr>
</tbody>
</table>

Thus, after the Series A round, the shareholders own the specified types of stock in the number of shares indicated. The post-money valuation of Quirky Produce equals $7,610,000.

This capitalization table is essential so that after the Series A round, every investor knows where it stands, in type, percentage, number and value of shares held. Moreover, it will be critical moving forward to the next rounds of financing if Quirky Produce continues to prosper.
After the family and friends round, and certainly in the seed round, the start-up will seek outside investment for seed capital. Any solicitation will require compliance with the federal securities laws or state securities laws or an exemption from their application. The primary regulator is the federal government, so we begin with Regulation D of the Securities Exchange Commission.

Highlights:

- Securities Registration Under Securities Act of 1933
- Regulation D Exemptions from Registration
- Rule 504 Exemption
- Rule 506(b) Exemption
- Rule 506(c) Exemption

Securities Registration

Unless an exemption applies, the federal Securities Act of 1933 requires a business that wants to offer stock for sale to raise capital to register the offering with the SEC. The registration forms require four categories of information:

- The company must describe its properties and business.
- The securities to be sold must be described, in detail.
- The business must provide information about its management.
- Financial statements must be provided. Independent accountants must certify the financial statements.

The registration materials, together with prospectuses, are made available for public inspection on the SEC’s EDGAR database.

Regulation D Exemptions from Registration

Securities registration is an expensive and cumbersome process. To ease the burdens of registration on both start-ups and established businesses, the SEC promulgated Regulation D. This regulation allows a business to avoid registration if it complies with one of the exemptions from registration set out in the regulation.

There are three exemptions from registration, contained in two rules, Rule 504 and Rule 506. There used to be a Rule 505, but in 2016 the SEC repealed it, folded its provisions into Rule 504 and amended that rule.
The Rule 504 Exemption

Under Rule 504 of Regulation D, a security offering is exempt from registration with the SEC if the business raises no more than $5,000,000 over any twelve-month period. The securities offered must be restricted, meaning that the purchasers may not sell them for six months or one year, depending on the circumstances. In lieu of registration, this exemption requires the issuer to file a Form D with the SEC. Form D lists the names and addresses of the issuer’s promoters, executive officers and directors, but it includes little other information.

Two Rule 506 Regulation D Exemptions

Rule 506 of Regulation D encompasses two exemptions from registration with the SEC. Unlike Rule 504 offerings, there is no limit to the amount of money that can be raised under Rule 506. Registrations exempt under Rule 506 also include the requirement of filing a Form D with the SEC.

Exemption Under Rule 506(b)
The Rule 506(b) exemption has several requirements for exemption under Regulation D. They are:

- General solicitation or advertising of the securities is forbidden.
- There is no limit on the number of "accredited investors" who may buy the securities.
- The term "accredited investor" is defined in Rule 501(a). There are many definitions. Generally speaking, accredited investors consist of certain institutions and wealthy or high-income individuals.
- The issuer may sell to no more than thirty-five unaccredited investors, but they must be "sophisticated" investors, able to evaluate the proposed investment.
- The business must not give investors false or misleading information about the investment or exclude any information the investors should know.

Exemption Under Rule 506(c)
The Rule 506(c) exemption from registration under Regulation D applies only to accredited investors. It has a major advantage over Rule 506(b). General advertising of the investment is permitted. But that advantage comes with a disadvantage. When a business uses Rule 506(c) to raise money, the business has the burden of taking reasonable steps to make sure that the investors are, in fact, accredited investors. This may be done by reviewing financial documents such as W-2s, tax returns, bank and brokerage statements and credit reports.

Oregon and Washington Securities Laws

Securities laws exist to protect the public from fraudulent investment schemes. Typically, state securities laws kick in when the amount of money sought does not rise to the floor of the federal levels under Regulation D. State securities law are called "blue sky" laws. The term was coined in the early 1900s with the observation that some speculative investment schemes "have no more basis than so many feet of blue sky." Like the federal Securities Act, Oregon and Washington both require registration of securities and provide for exemptions from registration.

Choices for Regulation D Exemption

Depending on how far along a start-up is in its development, the entrepreneur is in the position of choosing which of Regulation D’s exemptions would be best to raise money for the start-up. If less than $5,000,000 is needed over a twelve-month period, and the investors do not object to their securities being restricted from sale for six months to one year, the Rule 504 exemption is superior.

The other two exemptions allow raising unlimited amounts. But under Rule 506(b), which can include unaccredited investors, there can be no advertising and accountant-certified financials are required. Rule 506(c) allows advertising, but all the investors must be accredited. Thus the Rule 506 exemptions from registration under Regulation D will be more expensive to use than the Rule 504 exemption.

Information Required by the SEC for Exemption

When a company offers securities exempt from registration with the SEC, it must file an SEC Form D with the SEC that provides some basic information about the prospective investment. The form asks for some background information such as the name of the company, the state in which organized, the type of entity, the company’s principal place of business, and so forth. But then we get to the heart of the form:

- One of the sections is called "related persons." These are the officers and directors of the corporation and any person who has been a promoter of the issuer over the prior five years. This information is important for a potential investor because investors want to know who they are dealing with in any round, no matter the series.
- The particular exemption the company will claim.
- Whether the offering is intended to last more than one year.
- The types of securities that will be offered. These securities can include equity, debt, warrant, pooled funds, and so forth.
- Whether there is a minimum investment.
- The number of unaccredited investors who already have invested, along with the total number of all prior investors.

All this information is intended to help prevent the types of widespread securities fraud and insider trading that resulted in the passage of the Securities Exchange Act of 1933, following Wall Street’s 1929 collapse.

The entrepreneur should consult with experienced counsel to make, and properly implement, the best choice of exemption.
We hope you have enjoyed our brief introduction into the first three rounds of start-up fundraising. For more information, please visit our website carpenterwellington.com. You might also wish to subscribe to our blog where we often post articles relating to our core practices, including start-up law.

~ Carpenter Wellington PLLC