GETTING EQUITY INVESTMENT

Disclaimer: There are thousands of well researched books that talk about how to raise money from investors, and there are more investment structures, sources, laws and options than we can detail here. This document is meant to provide a very high level, very general, somewhat allegorical introduction to accepting equity investment. Seek well qualified professional and legal advice before approaching investors or accepting equity investment. All information in this document should be relied on only at your own risk.

WHEN TO SEEK EQUITY INVESTMENT

After using savings, donations, grants, and sometimes crowdfunding and startup loans, business owners turn to equity investors for money to grow their business.

Usually investors find new businesses an interesting investment when they can prove:

> **Demand:** Lots of customers are willing to pay well for the company's products or services
> **Ability to Deliver:** The business can deliver those products and services profitably

Most investors want a business to offer at least a 30% return on investment every year. This means that if they buy $100 worth of your shares, they want those shares to be worth $130 next year, and $169 the year after that. They need you to promise a high rate of return because only ⅓ of the investments they make pay off. If your business, if successful, doesn't even have the promise of paying off very well, they might as well invest in something more risky that promises better returns.

Most investors expect that they will recoup the money they have put into your company when you sell your business. If they purchase $100 worth of your stock, and keep it 5 years and, and when you sell your business they earn $370, they will feel they've made a very good return on their investment. This is why investors often ask you lots of questions about your exit strategy. They want to know how long they have to wait to get their money back.

Investors will consider other investment propositions including investments that pay dividends, and convertible notes, but they are almost always going to be looking for you to promise them a 30% or more year over year return, and they're going to want to see how you make good on that promise.

THE MECHANICS OF APPROACHING INVESTORS & ACCEPTING EQUITY INVESTMENT

In the United States, under the Securities Act of 1933, any offer to sell securities must either be registered with the United States Securities and Exchange Commission (SEC) or meet certain qualifications that exempt them from such registration. (http://www.sec.gov/answers/regd.htm)

Regulation D contains the rules providing exemptions from the SEC registration requirements, allowing some companies to offer and sell their securities without having to register the securities with the SEC.

There are 3 Regulation D exemptions, rules 504, 505, and 506.

Rule 504 (http://www.sec.gov/answers/rule504.htm) provides an exemption from the registration requirements of the federal securities laws for some companies when they offer and sell up to $1,000,000 of their securities in any 12-month period. A company can use this exemption so long as it is not a blank check company and does not have to file reports under the Securities Exchange Act of 1934. **Filing Requirements:** Prior to accepting investment under rule 504, if your company has its home in the State of California, you will need to file a 25120 (http://codes.lp.findlaw.com/cacode/CORP/1/4/d1/2/1/s25102) with the state. You will need to file Form D with the SEC as well (http://www.sec.gov/answers/formd.htm).

Rule 504 imposes no ceiling on the number of investors, permits the payment of commissions, and imposes no restrictions on the manner of offering or resale of securities. Further, Rule 504 does not prescribe specific disclosure requirements. Generally, the intent of Rule 504 is to shift the obligation of regulating very small offerings to state "Blue Sky" administrators, though the offerings continue to be subject to federal anti-fraud provisions and civil liability provisions of the Exchange Act.

Rule 505 (http://www.sec.gov/answers/rule505.htm) provides an exemption from the registration requirements of the federal securities laws for some companies when they offer and sell up to $5,000,000 of their securities in any 12-month period. A company can use this exemption so long as it is not a blank check company and does not have to file reports under the Securities Exchange Act of 1934. **Filing Requirements:** Prior to accepting investment under rule 504, if your company has its home in the State of California, you will need to file a 25120 (http://codes.lp.findlaw.com/cacode/CORP/1/4/d1/2/1/s25102) with the state. You will need to file Form D with the SEC as well (http://www.sec.gov/answers/formd.htm).

Sales to thirty-five "non-accredited" investors and to an unlimited number of accredited investors are permitted.

Rule 506:
(http://www.sec.gov/answers/rule506.htm) provides an exemption from the registration requirements of the federal securities laws for some companies selling an unlimited dollar amount of of their securities in any 12-month period. A company can use this exemption so long as it is not a blank check company and does not have to file reports under the Securities Exchange Act of 1934. **Filing Requirements:** Prior to accepting investment under rule 504, you need to file a Form D with the SEC. You do not need to file a 25102 with the state government. (http://codes.lp.findlaw.com/cacode/CORP/1/4/d1/2/1/s25102.1)

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Definition: General solicitation is the public advertisement of investment to the public at large.

Definition: Portals promote investment opportunities to accredited investors. Such portals include sites like www.Fundable.com, www.Angelist.co and www.crowdfunder.com etc. Ideally you only want your offering only sold to accredited investors and these sites help you do that by asking those who register as investors to answer a number of qualifying questions.

Definition: A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person.

Definition: Form D is a online form at the SEC you complete that outlines the nature of your offering, the exemption you're claiming, and provide contact information for the company, and the names of those that run it. To file a Form D, you need to register with Edgar first.

Definition: Accredited Investors are those people who meet a certain set of criteria which the SEC has decided makes them capable of competently judging the risks and opportunities associated with making an investment in an enterprise. The requirements are listed here: http://www.sec.gov/answers/accred.htm

Definition: Sophisticated investor, which is a term relevant to investments made under the laws of the state of California, means an investor who is either personally or with the help of an independent investment advisor, able to make an intelligent decision about whether or not to invest in the offering.

Definition: Non-Accredited Investors are those people who do not meet the SEC's requirements for Accredited Investors. Specifically one who has a net worth of less than $1 million (including spouse) and who earned less than $200,000 annually ($300,000 with spouse) in the last two years. Non-accredited investors, like accredited investors, can sue a business for fraud and do need to see the PPM and other documents you make available to accredited investors.

Documents You Need to Create and Share with Investors

There are four documents you need to create as part of a Regulations D private placement. These documents inform investors about the opportunity you are pursuing and the risk they are taking. They specify how much money you are raising and when and how the money will be spent.

- Private Placement Memorandum (PPM)
- Subscription Agreement
- Investor Questionnaire
- Purchaser Representative Questionnaire

These are all documents that an entrepreneur can create and submit to their legal representation to review prior to filing a Form D and beginning to reach out to investors.

Creating these documents, rather than asking your attorney to do this, can save you both time and money. Furthermore it also, usually, more accurately reflects the opportunity you are offering to your investors and the risks they are taking which forestalls miscommunication later.

Private Placement Memorandum (PPM)

The PPM describes, in detail, the risks of investing in the company. The business plan, usually an appendix in the PPM, lays out the production plan, marketing plan, distribution plan, and anticipated revenue you expect the company to earn.

The PPM should furnish all information that is material to a reasonable person's investment decision.There's specific language that has to be in the PPM in order to protect both you and the investor before, during, and after investment.

Examples of omissions that would be material:

- Any use of investment money used to pay distributions to other investors
  (taking money from investors A, B and C to give a return on investment to investors X, Y, and Z)
- Any serious ongoing illness of a key person
  (if your lead actor has a serious drug addiction that you don't disclose to investors, you could be required to return all invested funds if the movie production fails because he can't perform)
- Any previous sanctions by the SEC or criminal prosecutions against anyone involved with the production.

(your production partners should not have been to jail for fraud, etc)
- material litigation your company is involved in (like your screenwriter suing you because you haven't paid for the script)

Generally speaking you should only let "qualified investors" see your PPM. Recent changes to the SEC, State, and Federal fundraising laws have created "portals" where business owners can describe their offering and only private investors can request and review their PPMs. You must be available to answer investor questions about your business after they've reviewed the PPM and before they give you money. You must be fully transparent and candid in your answers.

You can purchase templates for creating your PPM online that incorporate the language the SEC and state governments have indicated adequately warns investors about the risks they are taking. Note that the kind of company you own influences the PPM you need to create. Some sources for PPM templates include http://www.ppmfast.com, www.ppmlogix.net, and www.growthink.com.

Always remember, full disclosure is your friend when it comes to working with investors because any risk they are informed about prior to investing is a risk they've accepted. The more complete and accurate your PPM is the better.

Tip: Any business plan attached as an appendix to a PPM has to be quite factual. You may have to show financial documents, agreements with name talent to appear, etc. The business plan must explain, not sell, the opportunity to the investor.

Tip: If you use the rule 505 or 506, your PPM must include audited financials for your company which may be limited to an audited balance sheet for a new business or for a business that would otherwise find it difficult to create audited financial statements without unreasonable expense and effort.

The best way to write a good PPM is to read a few of them. You'll quickly see how important clear language, accurate information, and an intuitive structure is to ensuring people want to make an investment into what you're offering.

Once you've drafted a good PPM and a solid business plan, you can take them to an attorney with experience working with investors for review and you can ask them to spend a few hours reading it and giving you their opinion on what is missing or unclear.

Some attorneys will not work with clients this way, which is obviously their choice to make. Others really enjoy working with really proactive clients who actively engage in understanding the capital raising process and in creating the documents their business will depend on for years to come.

Subscription Agreement

A subscription agreement is the document Investors sign that indicates they are purchasing your stock at the price you've specified. In effect is an executive summary of all the information in the PPM and a review of the risks to the investor, including the risk of losing all their money. You can find quite a number of Subscription Agreements on the SEC website.
Most PPM templates you purchase will have a sample subscription agreement you can amend as well.

There are risks involved in allowing an investors to "self-certify" their status as "accredited". Third party verification of status offers protection against law suits alleging that unaccredited or unsophisticated investors were permitted to invest in the business.

Purchaser Representative Questionnaire

This document is used if the offering is made in reliance on Rule 506 and the prospective investor is not accredited or sophisticated investor.

It documents:

- Relationship of purchaser representative to the purchaser
- Relationship of purchaser representative to company raising money
- Prior investment experience of purchaser representative
- Existence and terms of material relationship between purchaser representative and the issuer (and their affiliates) during preceding two years
- Disclosure to purchaser of that material relationship

This document is generally not needed if you make your offering directly to accredited investors.

Soliciting and Advertising to Investors Now Legal: But Only the Accredited May Invest

On September 23, 2013 the SEC changed the rules by which businesses may solicit and advertise to investors. They published a general fact sheet in July 2013 that reviewed the new rules:

- You can now generally solicit, and advertise to, investors publicly which previously was very illegal.
- Only accredited investors can actually invest in generally solicited companies
- You must file Form D with the SEC before you begin soliciting, letting them know you will be advertising and soliciting investment.
- Disclose details about your general solicitation to the SEC within 15 days from first solicitation
- Strict verifications done by companies are required to confirm that each investor is accredited
- The penalty for not adequately meeting and following general solicitation requirements with the SEC is being banned from fundraising for a full year

Investors need to be aware:

- Only accredited investors can invest in companies who generally solicit

- Qualifying as accredited means having $1 million in net worth, or making over $200,000 a year for the past 3 years
- Investors will need to prove accredited investors status, which can be done through written confirmation by a CPA, attorney, investment advisor, or Broker-Dealer, or income-related IRS forms

Promoting your private placement through portals is a great way to find investors actively looking for good companies in which to invest money.

Equity Crowdfunding with Non-Accredited Investors

According to current regulations, businesses may not raise money with non-accredited investors. Title III will address ways that non-accredited investors may begin investing in companies, but the SEC has yet to finalize any rulings. Read this Forbes article for more information.

WHAT TO DO NEXT

Now that you understand the fundamentals of raising money under Regulation D you can:

- Evaluate your business opportunity to determine what rate of return you can promise investors and document how you plan to delivery that rate of return.
- Create your PPM, Subscription Agreement, Investor Questionnaire, Purchaser Representative Questionnaire if applicable. Show them to one or more attorneys who specialize in supporting business owners raising investment capital, and implement their reasonable notes, to confirm you've got documents that meet federal and state requirements.
- Get audited financial documents if required.
- Create your pitch video, slides and other documents you will use to pitch your investment to investors. You can look at portals to see what other companies seeking investment are doing.
- Investigate portals to decide which you want to work with. www.Fundable.com, www.MicroVentures.com, www.AngelList.com, are just a few of the many hundreds of crowdfunding portals now online. Spend time looking at these sites and really consider the business models and strategies each company seeking funding is using to appeal to investors.

- File your Form D with the SEC. Remember to file again when you receive your first investment. File Form D again after you've completed your fundraising.
- File the Form D and/or other state registration forms required. Example: California requires the following filings depending on which Reg D exemption you use.
- Make your investment available through your portal of choice.
- Once you get your funding, remember to follow through on your obligations. Keep investors informed as to the progress of your company over time, maintain all the accounting records, legal records, and tax documentation records required by you, your investors, those you partnered with and those you hired. These are requirements you should address with your attorney and tax advisor.

IN SUMMARY

Now that you've reviewed this document you have a fairly sound understanding of what documents you need to create, what forms you need to file, to begin raising money for your project through private placement.

Some Additional Resources to Look At

SEC Advice to Startups & Small Businesses: http://www.sec.gov/info/smallbus/qasbsec.htm
AIA ABA courseware on Regulation D Private Placements: http://www.ali-cle.org/index.cfm?fuseaction=courses.course&course_code=CS031&contenttype=1