# COMMON FUNDRAISING PITFALLS FOR THE UNWARY ENTREPRENEUR

*Created by Elizabeth Resteghini from Morse for Scroobious*

This article was created by Elizabeth Resteghini from Morse for Scroobious founders.

Scroobious is increasing diversity in the startup ecosystem by providing the education, tools, and community founders need to create investor-compelling pitch material and a platform to help investors easily find them through data-driven curation. For startup founders who have a story to tell but need help telling it, The Pitch it Plan™, or PiP, is a virtual platform that helps you get your compelling story into an investor-ready format. Unlike googling for hours or paying thousands for a pitch coach, PiP is affordable and approachable through online education and personalized feedback from a human who understands the investor mindset. Our framework has been published, vetted by investors, and has helped founders score meetings, raise rounds, and get into prestigious accelerators. Founders can sign up here or book an intro call to chat.

Combining the best practices of traditional law firms with an inventive approach, Morse's founders created a solid basis for a more modern practice of law. We offer our clients responsive and reliable service, sound and insightful business advice, and reasonable fees. We're dedicated to developing real partnerships with our clients, addressing each client's specific challenges, and delivering effective results tailored to each client's needs. While we have long enjoyed a reputation for special competency in technology ventures, we represent clients of all sizes and industries in all stages of the business life cycle. Our clients include startups, emerging growth entities, established family businesses, and Fortune 1000 companies. Our exceptional business model affords clients access to highly experienced counsel in the areas of M&A, Venture Capital, IP, Employment, Taxation, Privacy, and Litigation.

Raising funds from investors can be an exciting time for entrepreneurs who have worked hard to grow their business. However, it is important to keep in mind that there are a number of regulations that govern the sale of securities, with harsh penalties for non-compliance. This article provides a brief overview of some key rules to comply with, as well as common pitfalls to avoid.

## An Overview of Key Regulatory Framework Governing the Sale of Securities

Private companies can raise capital in a number of different ways, including offering securities for sale. Securities are broadly defined by the U.S. Securities and Exchange Commission ("SEC") to include stock, membership interest, stock options, restricted stock, convertible instruments and debt. The sale of securities is regulated and enforced by the SEC (including sales by private companies) as well as by state securities divisions. The SEC is an independent federal agency with a mission, among other things, to protect investors and maintain fair markets. Under federal securities laws, including the Securities Act of 1933 (the "Act"), all sales of securities must either be registered with the SEC or have an exemption from registration. A registered offering is typically referred to as a public offering, whereas an exemption from registration should be sought with a private offering. There are a number of capital raising exemptions under the Act and companies should ensure compliance. Non-compliance could result in one or a combination of the following: civil or criminal lawsuits for companies and/or the leadership team, financial penalties, incarceration, rescission of the offering (in which companies are forced to return to the investors their investment plus interest), future investment challenges such as other investors not wanting to invest in the company, or the company being prohibited from future sales of securities.

## Common Exemptions and Pitfalls

Some common pitfalls when selling securities that can put companies in violation of the Act are general solicitation, using an unregistered broker or dealer, and violating the "bad actor" rules. A common exemption companies seek is selling securities to accredited investors. Companies should also remember to timely file any necessary securities filings with state and federal agencies after selling securities (for example, Form D and blue-sky securities filings).

## General Solicitation

General solicitation is marketing a capital raise to the public. Regulation 506(b) of Regulation D of the Act prohibits using general solicitation to market securities. Companies raising capital should not advertise the sale of securities in newspapers, magazines, websites, the radio, television, broadly over social media, or in company newsletters for which anyone can sign up. Instead, companies should offer securities to those that it has a pre-existing substantive relationship with. A pre-existing substantive relationship is typically one that has been formed before the start of the sale of securities and the issuing company has sufficient information to evaluate such investor's status as an accredited investor.

## Accredited Investors

A common exemption that companies seek when selling securities is limiting participation to only accredited investors. The SEC has established rules for who qualifies as an accredited investor. There are a number of ways for an individual investor to qualify as an accredited investor, including some of the following common ways: an individual who has a net worth over $1,000,000 (excluding their primary place of residence) or an income over $200,000 (individually) or $300,000 (with a spouse or partner) in each of the prior two years and reasonably expects to earn at least that amount in the current year. There are also a number of ways entity investors can qualify as an accredited investor, including, but not limited to, all of the individual owners of an entity being accredited investors, or assets of certain types of entities that exceed $5,000,000. If non-accredited investors are participating, the private placement rules are strict and should be followed closely.

## Unregistered Brokers or Dealers

Companies selling securities might turn to an intermediary, such as a broker or dealer, to help with fundraising. However, companies should use caution because using an unregistered broker or dealer is prohibited. Using an unregistered broker or dealer can be as simple as a company using an intermediary such as another company or individual to sell securities on behalf of the company or to make connections to potential investors, with such intermediary receiving a small profit or fee for doing so, while not being registered to sell securities as a broker or dealer with the SEC. Companies considering fundraising with an intermediary should closely follow the SEC guidelines prior to engaging an intermediary because the repercussions for non-compliance can be quite severe. To learn more, see my article *Using An Unregistered Broker Is A Perilous Trap For The Unwary.*

## The "Bad Actor" Rules

Under Rule 506 of Regulation D of the Act, issuers of securities are required to conduct a factual inquiry of those investors who would be considered a "covered person" under the Act (such as stockholders holding 20% or more of the securities/membership interest of a company, executive officers, directors and partners of the issuer, etc.) to determine whether there has been a disqualifying event (including, but not limited to, certain criminal convictions relating to the purchase or sale of securities, certain SEC disciplinary actions or orders against them, etc.) It is important to understand the rules, ask questions and keep records that appropriate diligence was conducted.

*For more information, please contact Elizabeth Resteghini.*