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**Why An Offering Memo is Required To Raise Money
*from Friends, Business Associates, Acquaintances,
Angels or Venture Capitalists***

**And When “General Solicitation” Turns an Offering Into a
Public Offering**

Offering Memo Required When Raising Money

Full & Fair Disclosure Required Before Investments In Your Company

An Entrepreneur raising capital for a business has countless business and financial issues of which to be aware. However, raising capital for a business triggers important legal issues requiring attention by the entrepreneur: Whenever an investment is sought in a company (start-up, emerging growth, seasoned, or old-line company!), the securities laws impose an obligation to “full and fair” disclosure. Compliance with securities laws merits focus in any stage of money-raising, including the earliest stage, because compliance dictates the use of proper disclosure and filings in early stages, but has an effect on the company’s ability to raise money in later stages.

What is an Offering?

Raising money from investors to fund your company is referred to as an “Offering of Securities”. An “Offering” includes raising money from your family and friends, or from your officers, board members and employees. Selling any stock for money, services or property is an “Offering” even though it is small dollar amounts, privately sold and/or sold to a very limited number of people. Issuing stock to your fellow founding partners who will work in the company with you, is not an “Offering”. Generally, selling stock to board members and officers is exempt without further requirements, however selling stock to all others including employees, friends and family, is not exempt.

Private or Public? “General Solicitation” Turns Offering Public

An Offering can be private or public.

A Private Offering is one made to:

- Your friends, family and business colleagues,
- People you (or your officers or directors) know in advance of offering them an investment in your company, or in advance of discussing the investment with them, or

- People to whom you have been privately introduced by a close contact such as a professional service provider like an accountant or a lawyer, (private offering exemption does not apply to equity sales made people to whom you have been introduced by a finder, unregistered broker, financial consultant, investment banker if they are not registered as a broker-dealer),
- Professional venture capital investors, institutional investors,
- People to whom you have been introduced by a registered broker-dealer, who have a pre-existing relationship with a registered broker.

A Public Offering is one made:

- To people you don't know by way of cold calling, or
- To your entire customer list, or
- By mass email, or otherwise on the Internet, to people you may or may not know, or
- On your website or someone else's, or
- In a magazine, newspaper or newsletter, or
- By way of a press release,
- To all the X People in Y Group, even though you are a member of Y group or know someone from it: Such to all the Doctors in Chicago, to all the radiologists in a town, to all the partners in a law firm, to all the Executives in a trade association, all the Real Estate Agents in a suburb)
- By one of the above done by someone acting on your behalf, such as a finder or a broker.

There is a gray area between public and private offerings, if you offer to people you don't know, but who are introduced to you by someone you do know. In order to comply with the black letter of the law, you must get to know the person in advance of offering them an investment in your company. Your relationship should be of "sufficient length and duration in order that [company] can determine the financial sophistication of the investor and suitability of the investment".

When is an Offering Memo Required?

A securities Offering Memorandum (or "Disclosure Document" or "Offering Memo" or "Book") is required in both a Private Offering or in a Public Offering (in a Public Offering, it is called a Prospectus). An Offering Memo is required to raise money from investors outside of your immediate, trusted family. Immediate family means real family, such as blood relatives, or relatives by marriage, but does not include the family friend you affectionately call "Uncle Billy". Immediate family does not include distant relatives who are not in close contact with you.

In most cases, an Offering Memo is required to raise money from your friends, and from friends of the family. The exception would be for very intimate friends who would never consider suing you, and would completely forgive you for their loss, if your company loses their entire investment by burning through their money without becoming successful.

Suitable Investors

As exuberant as you are about the business being successful, you must be very careful whose money you take to fund your company. If it is not a "suitable" investment for

the person, if they can't afford to lose the money, or is too risky for them, don't take their money, even though tempting and needed by your company.

A Business Plan is not an Offering Memo

A business plan and a securities offering memo serve different functions. A business plan is a marketing document created to sell the company, from a marketing point of view. It necessarily contains optimistic information, forward-looking statements, hopes and dreams, anticipated revenues, potential markets, potential partners, potential directors and employees, and possibly financial projections of revenue and income.

A securities Offering Memo, on the other hand, is a full disclosure document, presented in a format that is more pessimistic, concrete, realistic, down-to-earth. It must contain all the bad news, risks, and potential downfalls of the company, the competition, the industry, the market, the management team. It must list and comment upon all possible scenarios involving the company that could go wrong. It must address the competition, regardless of how gloomy the prospects of that competition and how sophisticated the competition.

If you are seeking investments in your company, you are automatically subject to the securities laws, and the truth and accuracy that they require. The art of a disclosure document (Offering Memo) is to balance full disclosure, with selling the company, in written form. The goal is to sell the deal, while remaining in compliance with the truth and accuracy required under the securities laws.

Critical Issue: Full Disclosure

The securities laws dictate the use of an Offering Memo. The disclosure process during the early money-raising stages affects not only the securities law compliance for the current offering, but also has a permanent effect on the company's ability to legally conduct future offerings, private or public. Therefore, when a company is raising capital, the use of a disclosure document (if required) and the proper manner of offering are critical.

Full Disclosure: Offering Memo – What is it and Why Is It Important?

- ***Disclosure Obligation Under 10b-5:***

“Antifraud” Laws, “Securities Fraud” Laws, or “Securities laws” Require Full and Fair Disclosure.

Issuers (companies issuing stock) are required to comply with Rule 10b-5 under the Securities Act of 1934, and provide full and fair disclosure:

- Even in an exempt offering made to all accredited investors;
- Even where a “no filing” exemption applies to the offering, the 1934 Act does not apply a disclosure exemption. Federal and state “antifraud” laws (securities laws, or securities fraud laws) apply regardless of whether a federal or state filing is required; and
- Under Reg D 506, the absence of specific disclosure requirements for accredited investors, does not mean that NO disclosure is required. It merely means that specific statutory disclosure and audited financial statements are not required.

- **Securities Fraud Liability to Directors and Officers and Promoters**
 - You as officers and directors of a company issuing stock, as well as anyone promoting or selling the stock for you, have legal liability under Section 10b and Rule 10b-5 under the 1934 Act, for everything that is written, or not written, or said or not said, about the offering, the company, the parties. You can have personal liability.
 - Your liability can be for the entire amount of the stock sold, plus attorney's fees. If you have received \$ 1 million from investors, and the company fails, you can be personally liable for the full \$1 million to investors, plus their attorney's fees and costs if the lawsuit is brought under certain statutes.
 - In addition, federal and state securities regulators can bring criminal actions against companies selling stock. Feds look for fraudulent deals; states however, have a lower standard and look only for lost money and failures to file in the state.
 - You must take this very seriously and tread carefully in your disclosure.

- **Veracity Obligation under 10b-5:**
"Anti-fraud" securities laws require truth in statements and no material omissions.
 - Be **excruciatingly correct about the statements** in the Offering Memo. Ditto with statements you make orally outside of the Offering Memo. If you don't know for sure that a statement is true, don't say it at all.
 - **Check your facts**, statistics, studies, surveys, websites you are quoting, up to the minute, before publication of the Offering Memo. (Imperative from a professional impression standpoint also.) Don't quote sources that may not be true, and don't misquote, or quote out of context.
 - **Don't recite partnerships with customers or suppliers that are not yet signed.**

 - **Don't ever promise, or even allude to:**
 - **A specific rate of return,**
 - **Future price per share,**
 - **Future company valuation, or**
 - **Specific exit strategy.**

That approach is the fastest, most direct, route to a securities fraud lawsuit. Don't promise IPO or merger. Multiple rounds of financing will be required before you can IPO or be acquired or merged, and you will need to build the company, before investors can exit.
 - **Any statements** you make (**oral or written**), that don't come true, can (and will be) be the basis of a securities fraud lawsuit under 10b-5. The simplicity and allure of making unverified, or exaggerated, statements in order to sell the stock now, are not worth the pain of having to return the money to investors later, after a lawsuit or securities regulatory action. (Rescission offer as a result of misstatements requires return of investor money, plus interest and attorney's fees.)
 - Important to **control investor expectations**. If you mis-set investor expectations, and things don't go well, you can guarantee investor lawsuits.

- **Oral Disclosure - Issues**

Oral disclosure is inconsistent, time consuming and not memorialized.

- When talking to your family, you have been telling them about your idea already. They know everything about you and have made a judgment about whether they can trust you with their money.
- When talking to your very close 2 or 3 friends, you can say it all in a meeting. They also know much about you and have made a judgment about whether they can trust you with their money.
- However, as the offeree list grows outside of your family a couple very close friends, it is impossible to orally describe all material information. That is why the offering book is 40 to 80 pages long.
- It is impossible to say everything, consistently, to all people to whom you offer. If you tell one person one thing, and put a different spin on it for another person, then you may have given them different impressions.
- Must be in writing to make sure you have covered it all, and covered consistently.
- OK to summarize the writing in an oral presentation.

- **Don't say Anything outside of the Offering Book**

If you must say something that is not in the book (because an investor asks a good question that you did not anticipate, or because facts have changed):

- Do it in writing or an email (which is a writing), or immediately follow up your oral statement with a writing confirming the oral statement.
- Have the book revised immediately to add the change. Easy and efficient to change an offering document with technology.
- Do not *ever* say anything outside of the book that is an exaggeration, or untrue, or possibly untrue, or could be misinterpreted as varying from the book.

- **Provides YOU with Legal Protection**

- If company unsuccessful or market or industry crashes, and lawsuit ensues:
 - It substantiates your representations, proves your full and fair disclosure to investors; Protects you from “he said, she said”.
- If a broker or finder is selling your deal, the offering book protects **you** from the **broker or finder**, in the event broker makes **exaggerations** or misstatements. It also protects the company from miscreant officers or directors who overstep their bounds in promises to investors.

- **Investor Perception Improved**

- Providing professional written disclosure document gives your investors confidence that you take the time to do important things correctly.
- Puts your money where your mouth is, because you will have invested personal assets in start up costs (legal, accounting, state filing fees).

- **Time Saver**

- Shortens the depth and breadth of your sales pitches; Meetings shorter, to the point.
- Investor can read before or after.

- Disinterested investors can read book and say “no” before you waste your time with them.
 - You can concentrate on running the business, rather than 150% full time money raising.
 - Oral disclosure is inconsistent, “what did I say to whom?” you must keep notes of conversations, which takes more time.
- **Answers Investor Questions**
 - Basics are in the Offering Memo, if a clear concise one. Investors can ask more complex questions.

- **Marketing Document**

Offering Memo can and should be a **marketing document** touting the virtues of you, your background and your company, with the proper temperament under the securities laws.

No Disclosure Exemptions (Even if a “no filing” registration exemption applies.)

Disclosure Book Required by 10b-5. Even though an offering may be exempt from filing under the securities laws, (“Exempt Offering”), disclosure is still required. The Reg D Rule 502 exception from disclosure to accredited investors applies only to the means and magnitude of providing disclosure, but does not eliminate disclosure requirement of Rule 10b-5. You are still obligated to provide investors with all material information that is relevant to their investment decision.

Unique Methods of Disclosure In Lieu of an Offering Memo

- **Family and Intimate Friends - Oral Disclosure.**

- Family and very, very close friends can acquire much of required disclosure by way of their relationship with you. They are investing in you, rather than in the company in any event. You may have another disclosure format option if the investors:
 - Know you extremely well as a close family member or a very, very close friend, and trust you,
 - Have been hearing you talk about this business venture for an extended period,
 - Know all about the business,
 - Know all of your partners well and trust them,
 - Understand the risks in the industry
 - Are aware of, and have discussed with you and your partners, thoroughly and in person, full background of you and your partners, work history, college, and any disclosure items in your, or your partners, backgrounds (bankruptcy, financial insolvency, regulatory actions, tax liens, fraud allegations, frequent litigation).
- You can give them a collection of all relevant documents (business and financial), coupled with oral disclosure from you, that may satisfy your disclosure obligation under the securities laws.
- You must give them a full description of what they are missing, for example if you have regulatory history or financial problems of which they are not aware.
- Only use this “oral disclosure” method for people who would **forgive you if you lost all of their money** (i.e, they would not sue you). If they would sue you,

they **will** sue you if you lose their money, and you **will** be liable under securities fraud statutes for failing to provide them with even the smallest piece of material information.

- ***Institutional Investors - Only if they Conduct Thorough Due Diligence.***
 - Professional Venture Capital Investors and highly sophisticated institutions may not need an Offering Memo. If they invest securities as their principal business, and have substantial net worth, then they likely have their own means of collecting due diligence information on you, the company, the industry, the deal. Their due diligence process will likely produce proper disclosure. Because they can fend for themselves, you may be able to get by without providing a disclosure document, in some cases.
 - Again, you are obligated to tell them anything that they are missing.
 - However, they will be asking you for all of the things in the offering memo:
 - It will be more efficient and productive to have one prepared for them in advance.
 - You may spend as much in legal fees responding to due diligence requests, as you would in preparing an offering memo.

Reg D 506: Other Disclosure Conditions

An Accredited Investor is a person who has either \$1 million net worth, or \$200,000 per year income or \$300,000 per year income jointly with spouse. (Other definitions not included here, as they apply to entities, and to specific situations.)

Nonaccredited investors change nature of disclosure compliance, and cause an increase in legal and accounting expense, because:

- Specific statutory disclosure is required (longer offering book),
- Suitability Representations are required in the Subscription Agreement, and
- Audited financial statements are required.

Blue Sky (State Securities Law) Issues

50 states each have own securities laws; law of state of residence of investor applies. Most states have individual disclosure document laws, but all are similar to the federal. Most have criminal penalties for disclosure violations.