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My Mother Wants to Invest in My Startup: Raising Funds With Non-Accredited Investors

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Emerging companies are filled with potential, and the entrepreneurs running them have countless great ideas that may one day change the world. These owners typically fund their startup companies with money from their own pockets at first. But eventually, as the company grows, the company needs more capital to fuel that growth. This is when entrepreneurs often turn to outside sources for funds. It may seem innocuous to ask family and friends to contribute to your growing, high-potential business. Of course, they want to support you and the work you are doing.

But don't be too quick to accept money from your biggest fans. The securities laws in the United States regulate capital raising, and entrepreneurs need to know how to raise funds within the boundaries of the securities laws *before* taking money from anyone, including family and friends, so as to avoid potential issues *after* taking that much-needed capital.

Under United States securities laws, and the securities laws of each individual state (or "blue sky" laws), offers and sales of securities have to be either registered or exempt from registration. Generally, registered offerings are too cost prohibitive for startup companies. This means a startup needs to issue securities pursuant to an exemption from registration. The most widely available and used exemptions depend entirely or mostly on limiting the offering to only "accredited" investors, but not every entrepreneur has a rich aunt or uncle in the family who qualifies as an accredited investor. Some exemptions permit offering to non-accredited investors, but depend on those investors still being "sophisticated." An investor can qualify as a non-accredited but "sophisticated" investor if the investor, either alone or with a "purchaser representative," (as defined by the SEC) has sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment. While your mother and best friend and second cousin may be very smart and may even run their own businesses, they may lack the sophistication the SEC requires to satisfy exemption requirements. Determining whether to include non-accredited investors, whether sophisticated or not, in the offering at the outset is important because it will affect which exemptions from registration are available for the offering and on what basis.

A brief description of some of the more typical exemptions that contemplate inclusion of non-accredited investors in the offering is below. Depending on which exemption is used, the cost and time it takes to get to the offering may vary dramatically.

Regulation Crowdfunding

Regulation Crowdfunding came about via the Jumpstart Our Business Startups Act of 2012, more commonly referred to as the “JOBS Act.” Regulation Crowdfunding is similar to the popular platform Kickstarter except, instead of giving out a t-shirt to investors, the entity raising capital can give out equity. A capital raise through Regulation Crowdfunding must meet the following requirements, among others:

1. all transactions must take place through a registered broker-dealer or an online, SEC-registered funding platform;

2. the company can raise a maximum aggregate amount of $5 million in a 12-month period;

3. non-accredited investors may invest in the offering, but the amounts in which they can invest are limited; and

4. the company must disclose certain information by filing a Form C with the SEC.

Generally, securities issued through Regulation Crowdfunding may not be resold for at least one year. An offering under Regulation Crowdfunding is not subject to state securities regulations.

Although non-accredited investors can invest in a Regulation Crowdfunding offering, the amount of securities that can be sold to a non-accredited investor is limited:

- If the investor’s annual income or net worth is less than $107,000, the investor can invest the greater of $2,200 or 5 percent of the greater of the investor’s annual income or net worth.

- If the investor’s annual income or net worth is equal to or greater than $107,000, the investor can invest 10 percent of the greater of the investor’s annual income or net worth, not to exceed an amount invested of $107,000.

Accredited investors may invest an unlimited amount in an offering under Regulation Crowdfunding (subject to the maximum amount a company can raise each year).

While the ability to raise a respectable amount of capital from any investor may seem appealing, there are some negatives to consider when thinking of conducting an offering pursuant to Regulation Crowdfunding. First, the Form C that is required to be filed at the outset of the offering requires the company to disclose a significant amount of information. A higher information requirement almost always leads to higher legal and other advisor costs. Second, the company must make annual filings, which include either audited financial statements or financial statements certified by the company’s principal executive officer. Finally, the company has no control over who actually invests. When it comes time to sell the company, the lack of relationship with a potentially large portion of investors may lead to challenges. And if the company is not as successful as planned, these investors could be prime plaintiffs in a securities action.

Regulation D

Regulation D of the Securities Act of 1933, as amended (the “Securities Act”) sets forth safe harbors providing for exemption from registration under Section 4(a)(2) of the Securities Act. Some of these safe harbors are available even if offering to non-accredited investors, including Rule 504 and Rule 506(b) of Regulation D.

Rule 504

Under Rule 504, a company can offer to sell up to $10,000,000 of securities in a 12-month period. A company utilizing this exemption may not be a reporting company, an investment company, or a blank check company. The company may use general solicitation so long as certain state securities disclosure conditions are met, and securities generally may be sold to non-accredited investors, depending on state law. Because Rule 504 does not pre-empt state law, a company issuing securities pursuant to Rule 504 must comply with state securities laws, in addition to the federal securities laws, which requires the issuer to qualify or register the offering in every state in which the company plans to offer the securities, or requires the issuance to be subject to an exemption. Compliance with state securities laws is time-consuming and costly, especially if the company is issuing securities in multiple states.

Rule 506(b)

Under Rule 506(b), a company can raise an unlimited amount of capital and can sell securities to an unlimited number of accredited investors. A company also can sell securities to up to 35 non-accredited but sophisticated investors. However, selling to non-accredited investors, no matter how sophisticated they are, requires the company to provide substantially more disclosure, including financial statements, to such non-accredited investors. A higher information requirement almost always leads to higher legal and other advisor costs. The company also must make itself available to answer questions from non-accredited investors. Rule 506(b) also prohibits the use of general solicitation in an offering.

Regulation A

Another product of the JOBS Act, the amended version of Regulation A (referred to herein as simply “Regulation A”) is sometimes referred to as a “mini public offering.” Companies may sell securities to investors under two tiers, each of which has different requirements. Under either tier, the company must file with the SEC an offering statement on Form 1-A, which must be qualified by the SEC before the company may take any funds from investors. Before the SEC qualifies the offering, the SEC will review and provide comments to the company’s Form 1-A, and the company will have to amend the Form 1-A based on the SEC’s comments to the SEC’s satisfaction.

Tier 1

- A company can raise up to $20 million in a 12-month period.
- The company must include in its disclosure documents financial statements that have been reviewed by an independent accounting firm.
- There is no individual investment limit.
- The company must file a Form 1-Z exit report.

Tier 2

- A company can raise up to $75 million in a 12-month period.
- The company must include in its disclosure documents financial statements that have been audited by an independent accounting firm.
- Investors in a Tier 2 Regulation A offering that are not accredited investors are subject to an investment limit equal to 10 percent of the greater of the investor's annual income or net worth if the investor is a natural person or 10 percent of the greater of the investor's annual revenue or net assets if the investor is not a natural person.
- The company is required to file with the SEC annual reports on Form 1-K, with audited financial statements, semiannual reports on Form 1-SA, current reports on Form 1-U, and an exit report on Form 1-Z.

A company selling securities under Regulation A may use general solicitation, though any general solicitation before the Form 1-A has been filed must comply with the requirements for "test the waters" communications. An offering conducted under Tier 1 is subject to state blue sky laws, but an offering under Tier 2 is not. Securities sold in reliance on Regulation A are not restricted securities, meaning they generally can be freely resold, subject to applicable state blue sky laws. As mentioned above, complying with state blue sky laws is time-consuming and costly.

Other registration exemptions may be available in specific situations that allow offering to non-accredited investors, but the above are the most readily available. As the process and requirements for qualifying for any of these exemptions makes clear, raising money from your mother is not as simple as accepting a check. Always have a plan on how and to whom you are offering securities before you start taking money. Meeting the requirements of an exemption that allows offering securities to a non-accredited investor is typically time-consuming, complicated, and costly because of the disclosure requirements.

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