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Securities 101: Raising Money Legally

Few things are as confusing as the federal and state securities laws.

What can you do legally — and what is illegal — if you want to raise money for your healthcare business or partnership? Here is a brief summary of what the law says.

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First, what is a "security"? If it's a security, it's regulated. If it's not, it's not. A security is, generally, stock in a company, a limited partnership interest, or debt that has an equity component like warrants. It could also be a range of other, more exotic financial instruments (like undivided interests in an oil well) but our focus here will be on financial instruments that healthcare companies are likely to employ.

Generally, if it's a financial instrument that passively places investors' money into the hands of a third party for management and involves risk of gain or loss, it's a security. Senior debt is, generally, not considered a security. Subordinated debt with warrants *is* a security.

Equity interests in joint ventures between hospital companies and physicians, especially if the members are not physicians practicing together, would generally be considered securities.

Second, you need to distinguish between an *Issuer* and the *Issue*.

Generally, Issuers can raise money for their own projects without being licensed as broker-dealers. But the amount you raise within a given period of time, the control you exercise over your employees who raise the money, and other factors determine if the Issuer is exempt from licensing requirements.

Even if the Issuer is exempt, the Issue itself may not be exempt. This is determined by a complex set of guidelines and exemptions. Generally, at the federal level, all Issues of securities must be registered unless they are "exempt." Registration is a complex process governed by the Securities and Exchange Commission. All sponsors of private placements (that is, not public offerings) will want to seek an exemption from registration.

To be exempt, your Issue must qualify for one of several exemptions like Regulation D. There are various sub-parts to Reg D but each of these limit either the amount of money you can raise to be exempt or the offerees to whom you may offer the security.

For example, you can raise up to $1 million in any 12-month period to an unlimited number of purchasers under Rule 504 but you can raise an unlimited amount under Rule 506 if you sell to 35 or fewer "unaccredited" investors and certain other tests are met.

An accredited investor is an individual who is appropriately suited for the investment by having financial sophistication and sufficient income or net worth to meet certain tests. These tests are consistent annual income of $200,000 per year or net worth of at least $1 million.

Even if your Issue is exempt at the federal level, however, it may not be exempt at the state level. Each state has its own securities regulations and regulatory authority. While the Uniform Securities Act makes it easier to raise money in multiple states, each Issuer and each Issue must be exempt in each state and, quite often, this means you have to deal with each state separately.

Crossing state lines to solicit investors in a new state triggers a whole range of requirements such as insuring that both the Issue and the Issuer meet the exemption tests for that new state *before any investors are solicited.*

Third party agents, like investment bankers, must be licensed to sell securities at both the federal level *and* in each state in which a security is offered. The firm by whom they are employed must also be licensed at both the federal and state levels as well as be a member of a Self Regulatory Organization like the NASD or New York Stock Exchange.

If all this sounds like the Full Employment Act for securities attorneys, it should, because it is. The laws that govern raising money are complex and complicated. The penalties for selling securities without an exemption or without proper licensing range from recission of the transaction to damages to prison.

If you noticed that the word "generally" has been used a lot, it's because for every rule there is (generally) an exception—or at least another interpretation. Many questions of law are open to interpretation even though they were designed to be—and are—very specific.

Two things are crystal clear however:

- If you sell a security, you must make full disclosure (and the burden is on the seller to disclose, not the buyer to ask.) Full disclosure means telling everything that is *material* to an investor's ability to judge the merits or lack of merits before he invests.
- Fraud is never exempt. And there is no statute of limitations on fraud.

Bottom line? Hire an experienced securities attorney before you seek to raise money or—excuse the commercial—hire an investment banker to raise it for you.

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