# Five misconceptions of raising growth capital

## Investment laws still govern cannabis companies

By Neil M. Kaufman

Many cannabis companies seeking to raise capital appear to have some misunderstandings about how to do so. In order to clarify these prevailing misconceptions, here's a look at five common myths within the cannabis industry about raising capital.

**Myth:** ***Cannabis businesses cannot obtain financing.***

Unfortunately, many banks will not extend financing to companies within the cannabis industry because marijuana is prohibited by federal law. However, the availability of alternative financing, such as private equity and convertible notes, has increased as acceptance of cannabis in various U.S. jurisdictions has created new medical and recreational cannabis markets. Accordingly, cannabis companies can, and do, successfully raise various types of growth capital.

While the industry has its own set of uncertainties, investment in cannabis companies has been rapidly growing.

**Myth:** ***Companies can raise money without making substantive disclosures in offering documents, such as a private placement memorandum or term sheet with a business plan and risk factors.***

Although cannabis businesses may technically be in violation of federal controlled substances laws, they are still required to comply with federal and state securities laws.

Many types of offerings have specific disclosure requirements that must be made to prospective investors. While private placement offerings are exempt from federal registration, they are still required to provide fair disclosure to investors. For example, all offerings are subject to Securities Exchange Commission Rule 10b-5, which imposes on the issuer a duty to disclose all material information (i.e., that which would affect a reasonable investor's investment decision) and to not omit any information which, under the circumstances, would render the disclosed information misleading. If an issuer is found to have violated Rule 10b-5, the investors will have a right of rescission, which entitles them to a refund of their investment. Generally speaking, only offerings made exclusively to institutional or very highly sophisticated investors can safely be made without full disclosure.

Just because other companies have seemingly avoided a lawsuit or an indictment so far, that does not mean they are in compliance with the applicable legal requirements. A securities law violation can result in being required to return investor money, criminal prosecution, civil injunctive actions and considerable regulatory penalties and fines, in addition to very high legal fees. Furthermore, companies that are caught violating the securities laws may never again be able to be involved with a company raising capital.

> **U.S. SECURITIES LAWS APPLY TO BOTH EQUITY AND DEBT**

**Myth:** ***Raising capital does not require disclosures or offering documents for companies that are: (a) only raising a small amount; (b) only raising money from family and friends; or (c) only selling notes or convertible notes.***

U.S. securities laws apply to both equity and debt, regardless of how much is raised or the relationship with the investor, unless the investor actively participates in operating the business. Notes and convertible notes are "securities" that are subject to the same legal restrictions as stock and other equity.

**Myth:** ***Due diligence is not necessary.***

In order to prepare offering documents that contain appropriate disclosures, a reasonable due diligence investigation of the issuer will need to be conducted. With a proper due diligence review, issuers can avoid deficiencies in the offering documents that may give rise to liability. Any registered broker-dealer that raises capital for a company is required to complete a thorough due diligence investigation. In addition, legal counsel to the company is required to conduct a reasonable due diligence investigation; otherwise, they would be subject to the same level of liability to investors as the issuer (typically, the amount raised).

**Myth:** ***Cannabis companies do not need to worry about state securities laws or "blue sky" filings or registrations.***

State securities or "blue sky" laws are designed to protect investors against misleading or fraudulent practices within that state. While an exemption from federal registration may relieve an issuer from filing or registering with the Securities and Exchange Commission, issuers relying on such exemptions may still need to make certain filings to comply with state securities laws. Even offerings exempt from SEC registration (such as private placements) may be subject to state notice filing requirements, filing fees and antifraud liability. In many states, filing a copy of a federal Form D with the appropriate state agency is all that is required, but the laws of each state where the offering is conducted (the issuer's home state and all states where investors are located) must be examined.

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