



What happens if a startup does not comply with securities laws?

The federal securities laws exist to protect investors; ensure fair, orderly, and efficient markets; and to facilitate capital formation. When a startup or other company raises capital without complying with the federal securities laws, the company and its leadership may be subject to various types of liability and may face other adverse consequences. In addition, a company and its leadership must comply with any applicable state securities laws and regulations.

What penalties or other consequences could the company face?



Civil or Criminal Lawsuit

Companies and their leadership could face civil or criminal action brought by the federal or state government, depending on the nature of the violation, as well as civil liability from lawsuits brought by investors. This could include financial penalties or even incarceration, depending upon the type and severity of the offense.

Depending on the action, the company and certain individuals associated with the company may be subject to [“bad actor” disqualification](#), which would prohibit them from future capital raising using some of the most popular exemptions from registration, such as Rule 506(b) and Rule 506(c) of [Regulation D](#).



Rescission

If a company does not comply with the registration requirements of the Securities Act, investors may have a right of rescission, which forces the company to return to investors their investment plus interest. In addition, a company in these circumstances could decide to make a rescission offer to investors. This may be particularly challenging for companies that have put the capital raised to use in operating the company.



Future Investment Challenges

Failure to comply with the securities laws in earlier rounds of financing may cause potential investors to forgo investment to avoid involvement in a potential lawsuit or rescission offer, as highlighted above. Many sophisticated investors demand representations and warranties regarding past compliance with securities laws, an opinion letter from legal counsel, or other documentation of compliance as a condition of their investment.

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