

Georgia Society of CPAs – September 19, 2013

# Crowdfunding and Other Capital Raising Issues

---

Presented by: Robert F. Dow Esq.  
robert.dow@agg.com

# Some Challenges in Raising Early Stage Capital

- Hard to find investors.
- Legal compliance is complex and costly.
- Time consuming; distracts from running the business.
- Hard to determine the proper valuation and price for the offering.
- Burdensome disclosure obligations.
- Liability for issuers and promoters.



# Securities Law 101

- All offerings of securities require state and federal registration, absent an exemption
- “Security” is broadly defined
- Registration is impractical and expensive for small offerings
- Exemption generally involves keeping the offering “private”
- Exemption does not shield the issuer from liability
- Regulation D currently is the primary federal exemption

# Some Challenges for Completing a Reg. D Offering

- Limitations on dollar amounts
- Limitations on types of offerees
- Information requirements
- Blue sky compliance
- Limitations on general solicitation
  - But these limitations are changing

# Do's and Don'ts for General Solicitation

## DO:



- Limit offerees
- Keep a list
- Control documents
- Follow a plan

## DON'T:



- Advertise
- Hold seminars
- Solicit large groups
- Mass mailings

# Capital Raising Alternatives Under the JOBS Act

The Jobs Act gives companies a menu of options:

- Enhanced private offerings under Regulation D
- Enhanced private offering to QIBs under Rule 144A
- New, enlarged private offerings under “Reg. A Plus”
- Crowdfunding – new type of offering to thousands of your closest friends
- IPO On-Ramp – easier to “go public”

Today we will focus on crowdfunding and Regulation D

# Title II of the JOBS Act: Access to Capital



# Title II - “Access to Capital”

Pursuant to specified rules by the Securities and Exchange Commission:

- In the private sale of securities to accredited investors pursuant to Rule 506 of Regulation D, general solicitation and advertising will be permitted.
- In Rule 144A offerings, offers to non-QIBs and general solicitation and advertising will be permitted as long as the issuer only sells to purchasers reasonably believed to be QIBs.



# Brave New World for Reg. D Offerings

Under the JOBS Act the prohibition against general solicitation under Regulation D is lifted, but:

- Only for specified Rule 506 offerings
- Only for offerings where all purchasers are accredited investors
  - What happens if we end up with an unaccredited investor?
  - What am I supposed to do to make sure they're all accredited?
- The antifraud rules still apply to all investor communications

# SEC Rule Amendments

## General Solicitation

On July 10, 2013, the SEC finally adopted amendments to permit general solicitation and advertising in Rule 506 and Rule 144A offerings. The new rules will become effective on September 23, 2013. A copy of the adopting release may be found on the SEC's web site at <http://www.sec.gov/rules/final/2013/33-9415.pdf>.



# SEC Rule Amendments

## General Solicitation

The rule amendments permit general solicitation and advertising. The adopted amendments:

- Create a new Rule 506(c) that permits general solicitation and advertising in Rule 506(c) offerings provided that (1) all purchasers are reasonably believed to be “accredited investors” as defined in Rule 501 of Regulation D and (2) the issuer takes *reasonable steps* (see discussion below) to verify that all purchasers are accredited investors.
- Revise Form D to require the issuer to check a box if it is relying on Rule 506(c).
- Have no effect on offerings under Rules 504 or 505 of Regulation D.
- Allow issuers to rely on Rule 506(b), without any general solicitation or advertising, if the issuer wants to sell to unaccredited investors and/or avoid the Rule 506(c) verification requirements.
- Allow securities to be offered pursuant to Rule 144A to persons other than “Qualified Institutional Buyers” as defined in Rule 144A (“QIBs”), including by means of general solicitation, provided that the securities are only sold to persons that the seller reasonably believes to be QIBs.

# SEC Rule Amendments

## “Reasonable Steps” to Verify Accredited Investor Status

Whether the steps taken to verify accredited investor status are “reasonable” will require an objective determination by the issuer, based on the facts and circumstances. The issuer should consider a number of factors, including:

- The nature of the purchaser.
- The type of accredited investor the purchaser claims to be.
- The amount and type of information that the issuer has about the purchaser.
- The nature of the offering, such as the manner in which the purchaser was solicited.
- The terms of the offering, such as a minimum investment amount.

# SEC Rule Amendments

## “Reasonable Steps” *(cont’d)*

- The SEC noted that if the issuer has actual knowledge that the purchaser is an accredited investor, then the issuer will not need to take any additional steps at all.
- Because the issuer has the burden of proving eligibility for the exemption, the issuer should thoroughly document the steps taken to verify accredited investor status.
- Issuers may rely on a third party that has verified a person’s status, provided that the issuer has a reasonable basis to rely on such verification.
- Absent other indications, the issuer will not have taken reasonable steps to verify accredited investor status if it simply requires a purchaser to check a box in a questionnaire.

# SEC Rule Amendments

## Verification Methods

- The SEC provided issuers with a list of non-exclusive methods that issuers may use to satisfy the Rule 506(c) verification requirement as it applies to natural persons. The issuer will have satisfied the verification requirement if it uses any of the following four methods:
  - (1) In verifying whether a natural person (whether individually or jointly) is an accredited investor on the basis of income, the issuer
    - reviews copies of any IRS form that reports income for the two most recent years; and
    - obtains a written representation from the investor (and/or the spouse) that he, she, or they have a reasonable expectation of reaching the income level necessary to qualify as an accredited investor during the current year.

# SEC Rule Amendments

## Verification Methods *(cont'd)*

- (2) In verifying whether a natural person (whether individually or jointly) is an accredited investor on the basis of net worth, the issuer:
- reviews one or more of the following documents, dated within the previous three months:
    - For assets: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments and independent appraisal reports; and
    - For liabilities: a credit report, along with a written representation from the investor (and/or the spouse) that they have disclosed all liabilities necessary to make a net worth determination.

# SEC Rule Amendments

## Verification Methods *(cont'd)*

- (3) The issuer obtains a written confirmation from a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney, or a CPA that such person or entity has taken reasonable steps to verify within the prior three months, and has determined, that the purchaser is an accredited investor.
- (4) With respect to any natural person who invested in the issuer's Rule 506(b) offering as an accredited investor prior to Rule 506(c)'s effective date and remains an investor of the issuer: the same issuer, in a subsequent Rule 506(c) offering, obtains a certification by the person that he or she qualifies as an accredited investor.



# Disqualification of Felons and Other Bad Actors

The SEC also amended Rule 506 of Reg. D to disqualify issuers from using the exemption if the issuer or certain “covered persons” were subject to certain “disqualifying events.”

Covered Persons include:

- Directors and certain officers, general partners, and managing members of the issuer.
- 20 percent beneficial owners of the issuer.
- Promoters.
- Investment managers and principals of pooled investment funds.
- Persons compensated for soliciting investors and specified affiliates.

Disqualifying events include specified felony convictions, court orders and disciplinary actions relating to securities violations.

# Accredited Crowdfunding Platforms

- Title II also provides an exemption from broker-dealer registration for portals that:
  - Are limited to accredited investors.
  - Only facilitate limited offerings under Reg. D.
  - Limit their role to matchmaking.
  - May not handle investor funds.
  - Receive no commissions or similar transaction compensation.
- The SEC issued FAQ in Feb 2013 giving some interpretive guidance
  - Places emphasis on limiting compensation of the platform.
  - But allows the platform to receive profits from carried interest and certain consulting fees.
- Not to be confused with funding portal under Title III (are you confused yet?)

# Accredited Crowdfunding Platforms *(cont'd)*

- SEC recently issued two no-action letters: FundersClub and AngelList.
- Investors must be accredited and become members of the portal, after screening and verification.
- The letters appear to be based on the JOBS Act provision.

# Title III of the JOBS Act: Crowdfunding



# What is Crowdfunding?

## Some uses of the term

- Non-securities crowdfunding – using social media to raise contributions or presell products for start-ups
- Accredited investor portals – using the internet to conduct Reg. D offerings
- JOBS Act Crowdfunding – selling securities through a portal authorized under the JOBS Act – NOT EFFECTIVE YET
- Invest Georgia Exemption – a special exemption for offerings limited to Georgia investors

# Examples of Non-Securities Crowdfunding

- Kickstarter
- Veronica Mars
- Amanda Palmer
- Righteous Cheese

Caution: Must not offer an investment return



# Examples of Non-Securities Crowdfunding

**KICKSTARTER**



indiegogo

***givengain***

ONE WORLD. ZERO BARRIERS

**give**   
234give.com



Crowdfunding Healthcare Projects

AFRICANS  
IN THE  
DIASPORA



probueno

**PUBSLUSH** Press  
the people's publisher 



globalgiving

# Regulation D “Accredited Investor Crowdfunding”

EquityNet, an online Reg. D portal claims that its offerings from 2007-2012:

- Involved over 1,000 companies.
- Raised over \$202 million.
- Provided access to over 12,000 investors.



# Title III - “Crowdfunding”

Following SEC rulemaking, will provide an exemption to allow private companies to raise capital through the use of “funding portals” (on the internet) and registered brokers and allows sales to nonaccredited investors.

- Limited advertising, solely directed potential investors to portal sites is allowed.
- Offerings may be up to \$1 million in a 12 month period to an unlimited number of investors.
- Maximum investment by individual investors ranges from \$2,000 to \$100,000 depending on the wealth and income level of such individual investors.

# Title III - “Crowdfunding” *(cont’d)*

- Requires specified disclosures, including risk factors, to investors. SEC rulemaking will determine SEC filing and reporting obligations.
- Preemption of state securities laws by making securities sold through crowdfunding “covered securities.”

# Warning: Will Crowdfunding Lead to More Fraud?

Regulators and commentators are concerned that this model will create more opportunity for fraud

- Many small unaccredited investors
- Lack of oversight
- Lack of audit (if under \$500k)

# Warning: Will Crowdfunding Lead to More Fraud? *(cont'd)*

To address concerns, some (limited) protections were built into the final JOBS Act:

- Stricter \$ limits than originally proposed
- Audits for offerings over \$500k
- Some (limited) disclosure requirements
- Requirements placed on brokers handling crowdfunding offerings
- Tough anti-fraud liability provisions
- Requires issuer to file annual reports with the SEC

# Investor Limits

Each investor is limited to investing no more than the following amount in the aggregate for all crowdfunding investments (including the current offering) for any 12-month period:

- Investors with an annual income or net worth of less than \$100,000 will only be permitted to invest the greater of \$2,000 or 5% of their annual income or net worth.
- Investors with an annual income or net worth greater than \$100,000 will be permitted to invest 10% of their annual income or net worth, up to a maximum of \$100,000.

# Disclosure Requirements

The issuer must file with the SEC and provide to investors the following disclosure:

- Basic information about itself, including name, address and names of officers and directors.
- Description of its business and anticipated business plan.
- Financial information based on the amount of the offering:
  - Under \$100k, most recent tax return, and financial statements certified by an officer
  - Between \$100k and \$500k, financial statements reviewed by CPAs
  - Over \$500k, audited financial statements.

# Disclosure Requirements *(cont'd)*

- The target amount of the offering and deadline to reach the target.
- The price of the securities and method for determining the price.
- A description of its capital structure, including the impact of other shareholders' rights on the investor.

# Funding Portals

The Act provides for the creation of Funding Portals. They are not allowed to:

- Give investment advice
- Hold investor funds
- Compensate employees or agents for finding investors
- Solicit sales

Alternatively, the issuer may use a registered broker-dealer, which would not be subject to these restrictions.



# Broker-dealer and Funding Portal Requirements

Broker-dealers and funding portals are subject to the following requirements:

- Must be registered with the SEC and any applicable self-regulatory organization.
- Provide disclosures and questionnaires to investors as required by SEC rules.
- Ensure investors review the disclosure materials and have answered questionnaires confirming their understanding.
- Provide information to investors and the SEC at least 21 days before sale of the securities.

# Broker-dealer and Funding Portal Requirements *(cont'd)*

- Ensure that offering proceeds are provided to the issuer only when the target offering amount has been achieved.
- Perform background checks on issuer's officers, directors and significant shareholders.
- Protect the privacy of investor information.
- Ensure that no investor has exceeded the aggregate investment limits.

# Some Proposed Funding Portals

- EarlyShares
- Crowdnetic
- Cayzo
- InitialCrowdOffering
- WeFunder
- Crowd Tilt

# Restricted Securities

The shares received in a crowdfunding offering will be treated as restricted securities. As such they cannot be transferred during the first 12 months after purchase except to:

- The issuer,
- Purchasers in a registered offering,
- Accredited investors, or
- Family members in the case of death, divorce or similar circumstances.



# Some Interpretive Issues Raised by the ABA

- Should the crowdfunding \$ limits be combined with other transaction limits? (ABA: no)
- The operation of the investor limits should be clarified.
- Should the issuer be allowed to conduct a CF offering concurrently or in proximity with other exempt offerings? (ABA: yes)
- Should issuers and intermediaries be allowed to rely investor representations about net worth and annual income? (ABA: yes)
- Should the SEC permit issuers to raise funds in excess of the targets specified in the JOBS Act? (ABA: yes)
- There should be additional clarification of the requirements for intermediaries, including compensation, which FINRA rules apply, what constitutes investment advice.

# Crowdfunding Pitfalls

## Problem: Information Overload

### ***Diagnosis:***

The issuer is required to provide extensive information to be provided to the investors and filed with the SEC.

### ***Prescription:***

Careful planning and drafting. Select good counsel and CPAs.



# Crowdfunding Pitfalls

## Problem: Paperwork Overload

### ***Diagnosis:***

The Act requires ongoing SEC reporting; expensive and burdensome.

### ***Prescription:***

Efficient accounting dept. to churn out reports. Exit strategies.



# Crowdfunding Pitfalls

## Problem: Shareholder Overload

### ***Diagnosis:***

Because of the individual investment limits, issuer will end up with many small investors.

### ***Prescription:***

Get organized. Think about shareholder communication. Select and use a shareholder management system. Use shareholder agreements or voting trusts to manage voting.





# Crowdfunding Pitfalls

## Problem: Liability Overload

### ***Diagnosis:***

Promoters and management will be liable to many shareholders for misleading disclosure and fiduciary duties.

### ***Prescription:***

Awareness that it's not really "your company" any more. See above regarding information. Consider using an LLC.



# Crowdfunding Pitfalls

## Problem: The Trading Dead Zone

### ***Diagnosis:***

No after-market for shares.

### ***Prescription:***

Promote awareness that investors are in it for the long haul. Avoid get rich quick expectations. Think about exit strategies.



# Crowdfunding Pitfalls

## Problem: The Fund-Raising Dead Zone

### ***Diagnosis:***

The presence of many small shareholders is toxic to private equity funds and other money sources.

### ***Prescription:***

Careful shareholder management.  
Consider stock redemption or buyback provisions.



# Invest Georgia Exemption



# Invest Georgia Exemption Overview

The Georgia Securities Commissioner amended section 590-4-2-.08 of the Georgia rules to provide for an intrastate crowdfunding offering exemption.

# Invest Georgia Exemption

## Overview *(cont'd)*

- Limited to \$1 million total offered in one year.
- Can offer to both accredited and non-accredited investors
  - Non-accredited investors are limited to \$10,000 per investor
- Limited to Georgia investors only.
- Strict prohibition against paid intermediaries.
  - May not compensate employees, officers, or anyone else for finding money.
- Must escrow the offering proceeds in a bank.
- Notice to be filed with the state.
- Relies on the Federal intrastate offering exemption (Rule 147)
  - Securities may not be resold outside Georgia for 9 months.

# Invest Georgia Exemption

## Reliance on Federal Rule 147

- IGE only exempts the offering from Georgia law.
- For Federal exemption the issuer must use Rule 147 (intrastate offerings).
- May only sell to Georgia residents.
- Internet portal must be designed to screen for state of residence.
- Securities must include a nine-month limitation on resales outside of Georgia.

# Invest Georgia Exemption Limitation on Total Offering

The sum of all cash and other consideration to be received for all sales of the security in reliance upon this exemption shall not exceed \$1,000,000, less the aggregate amount received for all sales of securities by the issuer within 12 months before the first offer or sale made in reliance upon this exemption.



# Invest Georgia Exemption Funding Portals

- Spark Market
- Sterling Funder
- Others?

# Title IV of the JOBS Act: Small Company Capital Formation



# Title IV - “Small Company Capital Formation:

Creates a new exemption similar to Regulation A (“Reg A Plus”). Subject to SEC rulemaking:

- The exemption has an offering cap of \$50 million (compared to \$5 million for the existing Reg A)
- Exempts the offerings from state securities laws, so long as the securities are (1) offered or sold over a national securities exchange or (2) sold to a “qualified purchaser” (a term that will need to be defined by SEC rulemaking)
- Specified disclosures to be provided to investors
- Will require issuers to file audited financial statements annually with the SEC

# New Small Public Offering Exemption

- Securities will be offered and sold publicly.
  - Securities will not be “restricted” (*i.e.*, more liquid, and thereby more attractive to investors and underwriters than the same shares acquired in a private offering).
  - Allows general solicitation or general advertising for the offering.
- Will permit pre-filing solicitations of interest, subject to SEC rulemaking.
- Does not automatically subject the issuer to periodic reporting under Exchange Act Section 15(d).
- No federal limitation on types of investors (but be mindful of the bifurcated Exchange Act triggers under Section 12(g)).
- The securities will be “covered securities” for NSMIA purposes (and not subject to state securities review) if they are:
  - Offered and sold on a national securities exchange; or
  - Offered or sold to a “qualified purchaser,” as defined by the SEC.

# NOTICE

This presentation was prepared for educational purposes only. It may not be relied upon as the legal or tax advice of the author or Arnall Golden Gregory LLP with respect to any specific transaction.

**IRS CIRCULAR 230 NOTICE:** To comply with requirements imposed by the IRS, we inform you that any information contained in this communication (including any attachment) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this communication.

# AGG's Securities and Corporate Governance Practice

Arnall Golden Gregory LLP counsels public and private companies, as well as officers, directors, investors, and underwriters, in matters regarding transactions, compliance and corporate governance. Our clients include entrepreneurial private companies, as well as companies listed on NYSE, NASDAQ, AMEX and OTC Bulletin Board. We work together with those clients to provide solutions that make sense given their goals and resources.

We regularly counsel companies and underwriters in a variety of complex securities transactions, including initial and follow-on public offerings, “going private” and “roll-up” transactions, mergers, PIPES offerings, and private offerings.

**Arnall  
Golden  
Gregory** LLP

Attorneys at Law

**For more information, please contact:**

**Robert F. Dow, Partner**

171 17<sup>th</sup> Street NW, Suite 2100

Atlanta, GA 30363

Robert.dow@agg.com

404.873.8706

[www.agg.com](http://www.agg.com)