Notes Bearing Interest

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The Chair's Comments

Anna Mills

You should be receiving this newsletter in advance of our 2016 Business Law Institute and Annual Meeting program on Feb. 18 and 19 in Pinehurst. The Business Law Section is again partnering with the International Law & Practice Section, and we look forward to seeing you at this event. As is customary, we will present a wide choice of timely topics including a breakout session format to expand the offerings. Our sponsors for the event help fund the program and other section efforts, and I would like to recognize and thank them: Silver Sponsors, Davis Forensic Group LLC and Niki's Int'l Ltd. Abbie Baynes and David Broughton have done an outstanding job as the section's course planners, along with Stephen Later, our CLE chair and section vice chair, and the other members of the Planning Committee. At our Annual Meeting, we will be electing four new Council members, one replacement Council member, a new Secretary and a new Treasurer. Ken Carroll, who chairs our Nominating Committee, will be presenting an outstanding slate of candidates for your consideration and approval.

Since our last newsletter, the section presented its CLE program entitled Basics of Franchise Law in November. Our course planner for this event was Ritchie Taylor and we very much appreciate his time and effort.

We are about half way into our 2015-2016 fiscal year and your section has been busy on a variety of matters, including drafting and considering business law legislation, monitoring legislation proposed by others, producing CLE programs, preparing newsletters, supporting NC LEAP, and many more. These are the hallmarks of the section's activities, and we trust that these continue to be of value to you. We are always interested in exploring other ideas, so please feel free to contact me or others with any suggestions. We are always looking for volunteers, newsletter contributors, and other participants.

We remain very proud of our signature pro bono project, NC LEAP, which continues to provide a significant number of pro bono projects for transactional lawyers. Under the leadership of Laura Davenport, the current Chair, and the members of the Steering Committee, with outstanding staff support, we remain very bullish on the future of NC LEAP.

Thank you again for all that you do for our section. I look forward to seeing you in Pinehurst.

Anna Mills

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Five Myths of Investment Crowdfunding

By Benji Jones

Crowdfunding is hot. According to a report released by Massolution, the crowdfunding industry raised $16.2 billion worldwide in 2014, and that amount was expected to double during 2015. But what does it mean? How does it work? Is it easy to do?

This article provides a brief overview of the various paths to conduct an investment crowdfunding offering and shines light on some common investment crowdfunding "myths" and misconceptions.

What is "crowdfunding"?

Crowdfunding is a method of raising money to fund a project or venture using the Internet. An entity or individual raising funds through crowdfunding typically seeks small individual contributions from a large number of people. A crowdfunding campaign generally has a specified target amount of funds to be raised and an identified use of those funds.

Continued on page 2

Inside this Issue...

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Crowdfunding, continued from the front page

Rewards/Donation vs. Investment Crowdfunding.

With donation-based crowdfunding, a venture accepts monetary "donations" with no consideration returned (other than recognition). Similarly, in a rewards-based crowdfunding campaign, a venture accepts monetary "contributions" in exchange for some kind of incentive, recognition, or promotional gift. These types of campaigns have become popular through the use of Kickstarter, Indiegogo, GoFundMe, and other platforms.

Investment crowdfunding, however, is when a company offers investors a share of financial returns or profits generated from business activities being financed. Sometimes this is also referred to as "equity" crowdfunding, but that concept is too narrow. These types of offerings aren't limited to stock or ownership interests in a company. They can also cover debt and royalty streams as well as other kinds of securities and investment contracts.

Does the campaign involve the offer and sale of a "security"?

The key distinction is whether the campaign involves the offer and sale of a "security," which triggers regulation under federal and state law. An investment crowdfunding campaign is much more challenging from a regulatory perspective because it triggers a complex web of federal and state securities regulation. The Securities and Exchange Commission (the SEC) identifies eight separate federal statutes (plus related rules and regulations) that govern the securities industry. Each state (including jurisdictions like Washington, D.C. and Puerto Rico) also regulates the offer and sale of securities through local "blue sky" laws. On the federal level, the two primary regulatory schemes are established by the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. Section 5 of the Securities Act makes it unlawful to offer and sell securities without first registering them with the SEC, unless the offering falls within an exemption from those registration requirements. The Exchange Act (which is the principal source of reporting obligations for public companies and regulates the secondary trading of securities in the United States) also includes broad anti-fraud provisions, imposing liability for material misstatements and omissions made in connection with the offer or sale of securities. Generally, each state also requires registration, unless an exemption is available. The states also impose anti-fraud liability. More recent legislation like the Jumpstart Our Business Startups Act of 2012 (the JOBS Act) and certain provisions of the Fixing America's Surface Transportation Act of 2015 have created new pathways for conducting exempt offerings outside of the traditional private placement exemption. Federal and state laws also regulate broker-dealer activities, investment companies, and investment advisors, all of which can be implicated by investment crowdfunding.

This article will not discuss all of the technical requirements imposed by these regulations. Of course, these details are of critical importance, and anyone who intends to advise clients on investment crowdfunding will need to carefully read and study the related statutes and regulations. But it would be too difficult to cover everything in this article. Instead, in an effort to shine some light on some common misconceptions and "myths" about investment crowdfunding, this article will focus on the big picture and practical realities involved.

Myth No. 1: All crowdfunding is the same.

Beyond the distinction between a rewards/donation campaign and investment crowdfunding, it is important to understand that there are different ways to conduct an investment crowdfunding offering. Companies must strictly adhere to a particular set of rules in order to claim an exemption and to avoid registration requirements. In many instances, the availability of a particular exemption turns, in large part, upon:

- the **amount of money** an issuer wants to raise,
- the **nature of the investor** (i.e., whether or not they satisfy certain residency, sophistication, or wealth standards),
- the **manner** by which the offering is conducted (i.e., many exemptions prohibit the use of general solicitation and general advertising to market the securities) and
- the **types of disclosures** that may be required.

In addition, in some instances, certain types of issuers are prohibited from relying on an exemption. For instance, companies that that file reports under the Exchange Act and certain investment companies cannot use Regulation A or Regulation Crowdfunding.

However, when considering how an investment crowdfunding offering might fit within a particular exemption, the most critical factors will be the amount of money to be raised, the degree to which all of the members of the "crowd" (not just the super-wealthy) can participate, and whether, and how, companies can communicate with potential investors. Many exemptions prohibit the use of general solicitation to market an offering and/or restrict investments to only accredited investors (entities and individuals who meet certain financial standards), both of which are incompatible with the idea of sourcing capital from the "crowd."

Fundamentally there are four different paths to investment crowdfunding:

Accredited Investor Crowdfunding – These types of offerings rely primarily on the "private placement" exemption found in Rule 506(c) and, in specific situations, Rule 506(b) of Regulation D. There is no limit on the amount of money a company can raise, but only "accredited investors" can participate. Typically, there are no mandated disclosures although issuers usually provide investors some information about the issuer, its operations, and the offering.

New Regulation A (as amended by Title IV of the JOBS Act and commonly known as "Regulation A+") – While there are limits on the amount a company can raise in a 12-month period under new Regulation A ($20 million under tier 1 and $50 million under tier 2), generally anyone can invest (sometimes subject to caps). Issuers submit a detailed disclosure document (including audited financial statements for tier 2 offerings) to the SEC (and, with tier 2 offerings, applicable state regulatory agencies) for review and comment, and issuers engaged in tier 2 offerings typically will be required to comply with on going reporting requirements. But companies can advertise the offerings and, in some instances, will be able to "test the waters" before making any formal filings with the SEC.

Regulation Crowdfunding – Under the new Section 4(a)(6) exemption established by Title III of the JOBS Act, companies can utilize the Internet to conduct investment crowdfunding campaigns to raise up to $1 million in a 12-month period. Generally, anyone can invest, irrespective of their sophistication or net worth (subject to caps); however, issuers are extremely limited in the manner in which this offering can be conducted. Issuers must use either a SEC registered "funding portal" or registered broker-dealer to conduct the offering and must prepare (and file with the SEC) specific disclosure materials (including audited financial statements, in some circumstances) and must comply with on going reporting requirements once the offering is complete. Funding portals and broker-dealers operating under Regulation Crowdfunding are subject to numerous regulations dictating activities they are required to undertake, as well as those that they are prohibited from undertaking, in connection with an investment crowdfunding offering.

Local Crowdfunding Exemptions – Many states have established procedures where local companies can conduct exempt investment crowdfunding offerings. These exemptions are established by statute or rule on a state-by-state basis and are typically structured to rely on the intrastate offering exemption (Section 3(a)(11) and/or Rule 147 of the Securities Act) or the limited offering exemption under Rule 504 of Regulation D. North Carolina has yet to pass such legislation, although a bill structured in reliance upon the intrastate offering exemption may be taken up in the short session this spring[1]. Typically, there are limits on the amounts an issuer can raise. It varies between $1 million and $2 million, and there is a push to raise these thresholds to $5 million. Typically, anyone can participate, subject to investment caps. Issuers prepare specific disclosure documents (including audited financials in certain circumstances) to be filed with local regulators and may be subject to on going reporting requirements once the offering is concluded.

But wait . . . Can't companies use Kickstarter or Indiegogo to sell securities?

At last check, no. Neither of these platforms has adopted programs to enable investment crowdfunding campaigns on their platforms . . . but they might do so in the future.

What this issuer is offering isn't a "security."

Don't be fooled. The Securities Act has a broad definition of what it deems to be a security: stock, ownership interests, units, partnership interests, promissory notes, bonds, options, warrants, royalty streams, investment contracts . . . if it involves giving money to someone else to manage with the expectation of profits, you've usually got a security.

Some companies are too small to be regulated.

This is just plain not true. Every issuer – irrespective of its size, age or value – must comply with federal and state securities laws.

Some offerings are too small to be regulated.

Again, not true. An offering of any amount is subject to regulation. There are no de-minimis exceptions.

Myth No. 2: Now that we have the JOBS Act, . . . anyone can invest in offerings (not just the "super wealthy").

Conceptually yes, this is true. But, in practice, it depends on how the offering is structured and which exemption a company wants to use. The JOBS Act aims to reduce capital raising restrictions currently faced by many companies, both by loosening regulations governing private securities offerings and by easing the road to public securities offerings for so-called "emerging growth companies." However, it achieved these goals in highly complicated regulatory fashion. Some parts of the JOBS Act make it easier for people who are not "accredited investors" to invest in offerings; for instance, Title IV created new Regulation A, which increased the amount of money an issuer can raise in a "mini-public offering" (which can include "retail" investors, sometimes subject to a cap) to up to $50 million. Title III of the JOBS Act created "Regu-

Continued on page 4

Continued from page 3

lation Crowdfunding," which established the structure for true "investment crowdfunding" offerings similar to campaigns we see on Kickstarter and Indiegogo where anyone in the "crowd" can participate (subject to caps). But Title II of the JOBS Act, which eliminated the ban on general solicitation in Rule 506 and Rule 144 offerings, only permits accredited investors to participate.

And . . . companies can freely advertise offerings.

No. They cannot. Just because aspects of the JOBS Act permit the use of general solicitation and advertising, or the use of the Internet, to reach investors does not mean there are no rules to follow. And the rules surrounding what issuers can say, and when, are complex. For instance, under new Regulation Crowdfunding an issuer cannot advertise its offering over the Internet or really make any other kind of public announcement about its offering (other than through a very short press release). The issuer must use a registered funding portal or registered broker-dealer to conduct the offering. Although an issuer can advertise much more freely under the Rule 506(c) exemption, it must be prepared to verify that all of the purchasers are accredited investors. In any event, an issuer should not just go off and advertise an offering without careful planning. It needs to determine which rules apply and then follow them – or the company risks busting its exemption and having to scrap or delay an offering (or even worse, needing to conduct a recession offering to try to "clean up" the problem).

. . . they can even "test the waters" without risk.

Testing the waters is the idea that, before making a lot of costly and time-consuming regulatory filings, an issuer can preview the terms of a specific offer to assess market reaction. If there is positive reaction, then the issuer moves forward with the more complicated aspects of the offering, but, if there isn't market acceptance, the issuer can stop and reassess its options. In the investment crowdfunding world, the test the waters concept can clearly be used in new Regulation A offerings and, conceptually, in Rule 506(c) offerings. But it is not risk free and it is definitely complicated. There are two primary things to keep in mind. First, there is no clear path to testing the waters under state regulations. Some states do not permit a company to test the waters at all while others require companies to file the materials before first use. So, if state regulation isn't preempted, it can be hard to navigate the process in an offering that might be conducted in multiple states (which seems hard to avoid when utilizing the "world wide web" to test the waters). Next, companies will have anti-fraud liability on the materials used to test the waters and typically would need to file the materials used to test the waters with regulators. This can impact the content of the materials used to test the waters and requires careful planning and control of the process.

And, with the JOBS Act, we can ignore state "Blue Sky" regulation.

Again – absolutely not. The degree to which the states can regulate an offering depends upon what path a company is pursuing. Some exemptions (like intrastate offerings or Rule 504 offerings) depend on local rules and regulations. In addition, not all federal exemptions preempt blue sky regulation. Preemption generally applies to (1) Rule 506 offerings, (2) Regulation Crowdfunding offerings and (3) tier 2 Regulation A offerings (although there is an ongoing lawsuit that challenges federal preemption of tier 2 offerings). Even with preemption, the states typically can require notice filings and the payment of fees. They also impose anti-fraud liability on offerings. Companies will also need to be cognizant of any state broker-dealer and sales person regulation that may apply to preempted offerings.

Myth No. 3: Regulation Crowdfunding will make all other paths redundant.

No. There is no one-size-fits-all exemption. Issuers may have many different objectives that impact which path is best. Just look at the offering caps – companies can only raise $1 million per year under Regulation Crowdfunding. That might be too low. So companies may need to consider alternate paths to raise a larger amount of capital. Local crowdfunding exemptions may provide access to a larger amount. Currently, SB418 (NC PACES) would permit companies with reviewed or audited financials to raise up to $2 million in a 12-month period. Regulation A increases those caps to as much as $50 million in a 12-month period; Rule 506 has no cap. Despite the lower offering thresholds, some issuers may be drawn to the Regulation Crowdfunding or local crowdfunding statutes for the marketing bonus – harnessing the "crowd" to promote an enterprise can be an extremely powerful tool and added bonus for some issuers. Alternatively, other companies will require more sophisticated investors, preferring to target only accredited investors through Rule 506 or structure a hybrid offering under Regulation A. Regulation Crowdfunding simply opened up another avenue for companies to pursue capital, but it is unlikely to become a roadblock for pursuing other options.

Myth No. 4: All investors are created equal.
Know your audience.

Understand the costs and benefits associated with accepting money from investors who may lack experience in making investments in private companies (where securities have to be held for an indefinite period of time and there is no public market for secondary sales). Their tolerance for risk or their expectation of how long they should have to wait before they are able to get a return on their investment may be different. The value they may add to a business enterprise may not be the same as the "super wealthy" experienced investor. Will your investors be easy to manage and communicate with or will they require extensive hand-holding? It's important to understand the pros and cons of taking an investment from anyone – before making the offer.

Note also --- you may need to verify who is an Accredited Investor.

Rule 501 of Regulation D currently defines "accredited investor" to generally include: (1) banks and other large entities; (2) executive officers and directors of the issuer; and (3) high net worth individuals who have earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, or who have a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence and any loans secured by the residence (up to the value of the residence)).

You cannot always check the box to confirm this status. This is of particular importance in Rule 506(c) offerings (which involve general solicitation), when an issuer needs to "verify" that each purchaser is accredited. There are services issuers can hire to do this, and there are principled approaches to undertaking the verification independently, but the SEC has indicated that just getting an investor to "check the box" isn't one of them.

You will also need to stay abreast of changes in the accredited investor definition. The SEC has been actively examining this definition (as required every four years pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act). In December 2015, the Staff released a detailed report analyzing the current definition and making certain recommendations for modifying it. The Staff's recommendations touched on ways to adjust the financial threshold requirements (such as keeping the current thresholds but applying investment limits or creating new inflation-adjusted thresholds) and adding categories of accredited investors based on measures of sophistication not currently contemplated (such as a minimum investment threshold, professional credentials, etc.). It will be important to monitor these changes and to be prepared to explain to clients how these changes might impact their choices.

Myth No. 5: Companies can "go it alone."

Maybe. In many instances an issuer is not allowed to conduct an offering without the use of a portal or intermediary. Practically speaking, it also might not be prudent to try to conduct the offering without using one. It just depends on what path or exemption will be used. In a nutshell: an issuer must use a crowdfunding intermediary (either a registered funding portal or a registered broker-dealer) under Regulation Crowdfunding. The same may be the case for local crowdfunding exemptions, but it will depend on the rules that apply to a particular jurisdiction. Although companies are not required to use an intermediary for Regulation A offerings, they may want to engage some kind of listing platform or broker-dealer to help market the deal if they want to raise a significant amount of money (say over $10 million). Accredited Investor offerings are kind of a hybrid. Theoretically, companies could advertise their offerings independently under Rule 506(c), but many larger deals are conducted through platforms (AngelList, Equity Shares, Funders Club, CircleUp, etc.) that structure direct investments and syndicated investments in companies and facilitate verification when general solicitation is involved.

But remember . . . not all portals are created equal.

Companies (and their advisors) need to carefully diligence who to use to help with the offering. Offering portals are potentially regulated as investment advisors and as broker-dealers. They may also be structuring transactions in a way that implicates the Investment Company Act of 1940. Portals will need to comply with specific regulations imposed upon their activities (like under Regulation Crowdfunding). The overlapping nature of these regulations is complex, and it is important to find an operator that understands how these regulations impact what it can and cannot do as well as what it must do. We are just now finding out who is registered as a funding portal – take a hard look at them. Understand how platforms charge fees, whether they conduct diligence on offerings and whether they structure transactions or provide form documents. Do they have experience in other forms of online offerings? What is their track record? Can they provide verification of accredited investors or are they simply a bulletin board service? Are they a registered broker-dealer or working with one? Read the fine print and the FAQs on the portal's website. Look for the regulatory disclosures to assess how they operate (or if they even know that there are compliance issues to address). Use the Internet to assess the reputation and success of different portals. See what bloggers are saying about the landscape.

Do the diligence before engaging a partner or commencing an offering and then work with your client to determine what best serves its needs.

Benji Jones practices in Raleigh with Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, LLP. She has extensive experience in representing companies in exempt and non-exempt securities offerings. Feel free to reach out to the author with questions or comments.

(Endnotes)

1 See SB418 "Providing Access to Entrepreneurs and Small Business Act" (NC PACES).

Annual Reports Practice Tip from the North Carolina Secretary of State

E-filing a client Corporation's or LLC's North Carolina tax returns? Remember, annual reports **must** be filed at the N.C. Secretary of State's office!

The N.C. Department of Revenue (DOR) has a new e-file capability for business corporation tax returns. However, DOR's system **does not** permit or accommodate the e-filing of annual reports. Therefore, it is **critical** that you e-file your clients' annual reports directly with the Secretary of State. You can do that by going to: http://www.sosnc.com/Corporations/arentry.aspx.

The process is simple, easy, **and** it costs your clients less than filing it in paper form ($20 for e-filing with the SOS instead of $25 for mailing a paper annual report to DOR).

If you have any questions about filing an annual report online, please see the instructions for online annual report filing which may be found at the link above.

Thank you for helping the Secretary of State's Office keep business records accurate and up-to-date.

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2016 Business Law Institute

Thursday, February 18, 2016 | Pinehurst Resort | CLE Credit: 3.75 Hours

Typically attended in conjunction with the 2016 North Carolina Business Law and International Law and Practice Sections Joint Annual Meeting, the Business Law Institute is the kick-off to this day and a half of hearing from the state's top business lawyers and international law practitioners at this annual CLE event.

Register online today: tinyurl.com/478BLI

2016 Business Law and International Law & Practice Sections Joint Annual Meeting

Friday, February 19, 2016 | Pinehurst Resort | CLE Credit: 7.5 Hours, includes 1.0 Hour of Ethics/Professional Responsibility and 1.0 Hour of Substance Abuse/Mental Health

This annual CLE—with over 10 sessions, breakout sessions and networking events —has something for everyone. Topics on the agenda for this year's program include: Annual Business Law Update, Lessons Learned from the Famous Security Breach, Emerging Ethics: Regulating the 2.0 Frontier, the 2015 ABA Private Target Mark M&A Deal Points Study and more!

Register online today: tinyurl.com/479BLM