Securities Regulation – Crowdfunding and Investor Rights

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Outline

• Example of securities transaction
• What is a security and court tests
• Register or find an exemption
• Investment Crowdfunding
• Common transactions involving securities
• Avoiding securities fraud

Sources of capital

• Banks, SBA, credit unions
• Donation/rewards-based crowdfunding on Kickstarter etc.
• Friends and family
• Angel investors: eg. Shark Tank
• Venture capital firms

Amy starts a cupcake shop...

Crowds outside Amy’s Cupcake Shop

Amy turns to friends and family...

Cupcake Amy turns to friends and family...
What is a security?
Federal definition

• (1) The term “security” means any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

• Section 2(a) (1) of the 1933 Securities Act

What is a security?

• N.C. G.S. 78A-2 defines Security as “any note; stock; treasury stock; bond;…..investment contract…”

An investment contract* for Securities Act purposes is one where a person:
• (1) Invests his money
• (2) in a common enterprise
• (3) is led to expect profits
• (4) solely from efforts of promoter or 3rd party

• *SEC v. W.J. Howey Co., 328 U.S. 293 (1946)

Courts have found these to be securities

• Scotch whiskey1 warehouse receipts
• Self improvement courses2 (right to sell plans)
• Commissions on recruiting cosmetics salespersons3
• Coin operated telephone lease plan4

1. SEC v. Glen-Arden Commodities Inc. (EDNY 1973)
2. SEC v. Glenn W. Turner Enterprises (9th Circ. 1973)
3. SEC v. Koscot Interplanetary Inc. 497 F.2d 473 (5th Circ. 1974)

Risk Capital test

• Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811 (1961) (California Supreme Court)
• Marin County club sold membership interests to finance improvements
• California Corporations statute “defines a security broadly to protect the public against spurious schemes, however ingeniously devised, to attract risk capital.”
• Here “petitioners are soliciting the risk capital with which to develop a business for profit.”
• Act’s objective is to “afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital.”

Hawaii test

• State by Commissioner of Sec. v. Hawaii Mkt. Ctr., Supreme Court of Hawaii (1971)
• ‘solely’ in Howey should not be taken literally
• Focus on economic realities of transactions
• Test fulfill remedial purposes of Securities Act
• “It is irrelevant to the remedial purposes of the Securities Act that an investor participates in a minor way in the operations of the enterprise.”

Investment contract in N.C.

• “any investment in a common enterprise with the expectation of profit to be derived through the essential managerial efforts of someone other than the investor”
• AND
• Hawaii Test: “any investment by which ...
• (1) an offeree furnishes initial value to an offeror, and
• (2) a portion of initial value is subjected to the risks of the enterprise, and
• (3) the furnishing of this initial value is induced by the offeror’s promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind over and above the initial value will accrue to the offeree as a result of the operation of the enterprise, and
• (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.”

• 18 NCAC 06.1104
Basic general rule

- G.S. 78A-24: “unlawful for any person to offer or sell any security...unless (i) it is registered under this Chapter, (ii) the security or transaction is exempted under G.S. 78A-16 or 78A-17,...or (iii) it is a security covered under federal law.”

Exemptions...exemptions

- G.S. 78A-16: list of exempt securities
- G.S. 78A-17: list of exempt transactions

Popular ones:
- 17 (9) – offer to not more than 25 persons
- 16 (9) – security by not for private profit entities including religious, educational, athletic charities

Exemptions - Rule 506

- 99% of Reg D securities sold nationally - this is the exemption used*
- Nearly $1 trillion annually raised nationally
- Beware of ‘bad actors’ disqualification
- Federal exemption still requires Notice filing Form D to state regulator within 15 days of sale in N.C.

Some exemptions require that you satisfy additional legal requirements as found in Title 18, Chapter 6A of the NC Administrative Code.

506 filings* in N.C.

- Total no. of 506 transactions: 1,882
- No. of 506 transactions with indefinite offering amount: 502
- Total offering amount of 506 transactions: $99.89 billion

Federal Reg D exemption

Rule 506 (b) – ban on general solicitation and general advertising, unlimited accredited investors and 35 non-accredited investors

Rule 506 (c) – eliminates ban on general solicitation/advertising as long as all participating investors are verified to be accredited.

* Source: July 2013-June 2014 N.C. Secretary of State Securities Division
Amended Reg A Rules (adopted March 25, 2015)

- Tier 1 – Up to $20M in 12-month period— review by SEC and states
- Tier 2 – Up to $50M in 12-month period– full review by SEC; states are preempted
- Unlike 506 (b) exemption, shares can be sold to unlimited non-accredited investors; not “restricted shares”

Amended Reg A: Practice tip

If making a Reg A filing with the Securities Exchange Commission, N.C. issuers/attorneys are requested to send...
- Cover letter
- Form U-2 Uniform Consent to Service of Process form to the N.C. Securities Division.

Regulation A

- Coordinated review for small offerings
- Program of North American Securities Administrators Association (NASAA)
- N.C. is part of the program
- All review and comment timeframe is 21 business days from start to finish (where no deficiencies)
- http://www.nasaa.org/industry-resources/corporation-finance/coordinated-review/regulation-a-offerings/

Crowdfunding

- Donation or rewards based model: Kickstarter, IndieGogo
- Investment based model: AngelList, WeFunder, etc. (previously only available to accredited investors)

Regulation Crowdfunding – How it fits within federal law

Regulation Crowdfunding created under new Section 4(a)(6) of the Securities Act of 1933.

Conditionally exempts securities pursuant to Section 4(a)(6) from registration requirements of Section 12(g) of the Securities Exchange Act of 1934.

Crowdfunding updates

- SEC’s rules went effective May 16, 2016.
- Form Funding Portal and amendments to Form ID effective Jan. 29, 2016.
- Nearly 35 jurisdictions/states have allowed crowdfunding
- Most under Section 3(a)(11) of 1933 Securities Act exemption for intrastate offerings.
Federal crowdfunding rules*

Issuer parameters:
- Raise up to $1M
- Accounting: <100K – certified financials by executive
- 100K-500K: reviewed by accountant
- 500K-$1M: audited by accountant, but for 1st time issuers allowed if only reviewed by accountant
- Form C, Q&A optional format for disclosures
- Internet funding portal/Broker-dealer required

* effective May 16, 2016

Crowdfunding - Investor limits

- Can target unaccredited investors
- $2,000 or 5% of lesser of annual income or net worth for income or net worth <$100K
- 10% of lesser of income or net worth (capped at $100,000) if income and net worth ≥100K

2016 Federal crowdfunding

- 21 Crowdfunding portals
- 186 companies in 36 states began offerings
- 105 of them closed by year-end
- 50% hit their minimum and raised $13M
- 50% did not, returned $950K to investors
- Altogether $14M committed to 105 campaigns
- Source: Crowdfund Capital Advisors

“Invest N.C. exemption”

- Part of N.C. PACES Act of July 2016
- Up to $2M if reviewed or audited financials
- Up to $1M if no reviewed or audited financials
- Investors must be N.C. residents
- Up to $5,000 from non-accredited investors
- File disclosures with N.C. Securities Division
- Ongoing quarterly reporting obligation
- Registered Web sites may be used

Intrastate Crowdfunding

- Source: NASAA

Common transactions that may involve securities, i.e. investment contracts

- Seeking investors for real-estate rehab/rent-to-own/flippping
- N.C. Gen. Stat. 78A-17(5) exempt if:
  “any transaction in a bond or ...lien or security interest in real or personal property...if the entire security interest or agreement, together with all the bonds or other evidences of indebtedness secured thereby, is offered and sold as a unit.”
Common transactions that may involve securities, i.e. investment contracts

• Sale of LLC interests
• 18 NCAC 06A.1510
  LLC interests presumed securities if either:
  • A) Articles of Organization provide all members not managers OR
  • B) all members managers +>15 members

Why all this matters...

If one fails to satisfy all requirements, will be considered to have made an:
1. Unregistered offering as an
2. Unregistered agent

Which Means...

Both of which may be felonies.
And ...

And...

You have exposed yourself AND your business/clients to all the penalties provided by the securities laws.

Including....

Possible fine, jail time, suit from angry investors, Loss of Law license

Because....

• Securities laws are primarily for the protection of investors (and protects issuers in disputes with investors).
• Those who seek capital are required to provide complete and accurate information about the investment so investors can make informed decisions.
• A violation can occur without intent.
Things You Must Disclose

You must disclose all material information about the investment opportunity, including:

– Names/histories of the business’s management
– What the money will be used for
– All possible risks posed by competitors
– Details of the company’s business/marketing plans and financial health and history

This is only a partial list.

For more details, download a copy of the Small Company Offering Registration (SCOR) Form U7, available from the North American Securities Administrators Association (NASAA) at http://www.nasaa.org/industry-resources/corporation-finance/

Securities Fraud

• N.C.G.S. Section 78A-8(2) and G.S. Section 78A-56(a)(2) impose civil liability upon any person who:
  • "Offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading (the purchaser not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of the untruth or omission..."*


By contrast actual fraud requires intent....

• The essential elements of actual fraud are:
  “(1) False representation or concealment of a material fact, (2) reasonably calculated to deceive, (3) made with intent to deceive, (4) which does in fact deceive, (5) resulting in damage to the injured party.” Ragsdale v. Kennedy, 286 N.C. 130, 138, 209 S.E.2d 494, 500 (1974).*


Practice tip:
Ordering brochures for your office

• http://www.sosnc.com/sec/brochures.aspx

• Topics: Cybersecurity, Making Sense of Financial Professional titles, Private Placements, Crowdfunding, Elder investment fraud, Peer-to-Peer lending
• 40-plus topics
• Download free for your office today!

Acknowledgements

• N.C. Securities Division staff
• What constitutes an “investment contract” within the meaning of state blue sky laws. 47 A.L.R.3d 1375
• Following the Wisdom of the Crowd? Nov. 2, 2015, Morrison Foerster Law
• The Role of Counsel in Intrastate Securities Crowdfunding by Sara Hanks, Andrew Stephenson, Business Law Today, Dec. 2015
• The Law of Securities Regulation, Revised Fifth Edition, Thomas Lee Hazen, Thomson West
• North American Securities Administrators Association
• U.S. Securities and Exchange Commission