OVERVIEW OF EXEMPTIONS USED FOR INVESTMENT "CROWDFUNDING"

The Securities Act of 1933 (the "**Securities Act**") provides that every offer and sale of securities in the U.S. is either registered with the Securities and Exchange Commission (the "**SEC**"), exempt from such registration, or is illegal. In addition, the various U.S. states and territories each have registration requirements for offers and sales of securities, which are generally referred to as "blue sky" laws. As such, issuers seeking to raise capital in the U.S. must be concerned with the application of both the Securities Act and blue sky laws.

Over the past five (5) years, direct online investment through offerings exempt from registration, which many refer to as "crowdfunding",[1] has blossomed in popularity. The following is a brief overview of the alternative exemptions from registration that issuers may avail themselves of in order to offer and sell securities without registering those transactions with the SEC. These "crowdfunding" alternatives include the following exemptions:

- Rule 506(b) promulgated under Section 4(a)(2) of the Securities Act;
- Rule 506(c) promulgated under Section 4(a)(2) of the Securities Act;
- Regulation A+ promulgated under Section 3(b)(2) of the Securities Act;
- Regulation Crowdfunding promulgated under Title III of the JOBS Act;

Rule 147 under Section 3(a)(11) of the Securities Act and Rule 504 under Section 3(b)(1) can also be used for crowdfunding, but are less popular and outside the scope of this paper. This overview provides a brief overview on these various alternatives and does not purport to be complete, nor does it constitute legal advice. Any issuer contemplating utilizing any of the below exemptions/safe harbors is highly encouraged to consult competent legal counsel before proceeding.

I. SECTION 4(a)(2) / RULE 506(b) OF REGULATION D – PRIVATE PLACEMENTS WITHOUT GENERAL SOLICITATION

Rule 506(b), which is by far the most common exemption from registration relied upon since its adoption (as well as by "crowdfunding" platforms), is a "safe harbor"[2] for the private placement offering exemption contained in Section 4(a)(2) of the Securities Act, meaning that Rule 506(b) provides specific requirements that, if followed, establish that a securities offering falls within the Section 4(a)(2) exemption. Rule 506(b) does not limit the

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[1] At the 31st Annual Securities and Exchange Commission Government-Business Forum on Small Business Capital Formation, then Director of Corporation Finance, Director Meredith Cross, made it clear that the term "crowdfunding" was not limited solely to Title III of the JOBS Act, but could encompass all of the exemptions discussed in this overview.

[2] A "safe harbor" means that if an issuer satisfies the requirements contained in the particular regulation, such issuer can take comfort that they safely satisfy the requirements of the applicable statutory exemption. However, it is not dispositive. Failing to satisfy the Rule 506(b) safe harbor (or other safe harbors discussed herein) does not, by itself, preclude an issuer from claiming to satisfy the underlying statutory exemption. Basically, relying on a statuary exemption and a safe harbor = less regulatory risk; but relying solely on a statutory exemption = more regulatory risk.

amount of money an issuer can raise or the number of "accredited investors"[3] it can sell securities to, but to qualify for the safe harbor, the offering must meet the following conditions:

- *No general solicitation or advertising to market the securities*. As a practical matter, most "crowdfunding" platforms that utilize Rule 506(b) rely on the SEC Staff's guidance provided in the *IPONet* (Jul. 26, 1996)[4] and *Lamp Technologies* (May 29, 1997)[5] no- action letters in order to comply with the prohibition on general solicitation;

- *Limit the number of non-accredited investors to 35*. As a practical matter, even though a limited number of non-accredited investors are permitted in a Rule 506(b) offering, almost no issuers allow non-accredited investors as a result of heightened disclosure standards, as well as fear of accidentally tripping over the 35-investor limit and thus blowing the safe-harbor;

- *Comply with Regulation D's information requirement*. For accredited investors, the issuer has no specific disclosure requirement; rather, it must decide what information to give to accredited investors that is consistent with the antifraud prohibitions of the federal securities laws. For non-accredited investors, the issuer is required to provide disclosure documents that are generally the same as those used in Regulation A offerings. If an issuer provides information to accredited investors, it must make this information available to non-accredited investors as well (as a practical matter, all investors should receive the same information); and

- *Form D Filing*. Issuers must file a Form D with the SEC and the state(s) in which sales of securities occur within 15 days of the first sale.

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[3] Rule 501(a) contains a list of eight (8) different criteria for what constitutes an accredited investor; however, the most commonly relied upon are: Rule 501(a)(3) – a tax exempt charitable organization, corporation or partnership with assets in excess of $5 million (i.e., does your corporate entity have more than $5M in assets?); Rule 501(a)(4)
– a director, executive officer, or general partner of the company selling the securities (i.e., if you're an executive of an issuer, you can decide whether you should buy its securities); (v) Rule 501(a)(5) – an individual with a net worth, or joint net worth with spouse, of at least $1 million, not including the value of her/his primary residence (i.e., you have $1M in net worth regardless of whether you own a home, you can look out for yourself); (vi) Rule 501(a)(6) an individual with annual income exceeding $200,000 in each of the two most recent calendar years or joint annual income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year (not an example, but isn't it strange that annual income with a spouse is aggregated but net worth is not?); or (vii) Rule 501(a)(8) an enterprise in which all the equity owners are accredited investors (i.e., all the equity owners of the entity are wealthy enough to look out for themselves).

[4] Basic (incomplete) summary of *IPONet* – using a website to conduct a private placement will not necessarily result in impermissible general solicitation, so long as the offering is behind a password protected page that cannot be accessed by potential investors without such investors first signing up and going through an accreditation process, and such potential investors are only allowed to invest in offerings that launch subsequent to the date that the potential investor signed up for the website.

[5] Basic (incomplete) summary of *Lamp Technologies* – for issuers that conduct continuous offerings on a website, allowing potential investors to invest in offerings that have launched prior to the investor signing up for the website will not necessarily result in impermissible general solicitation so long as the investor is first put through a thirty (30) day cooling off period during which the investor cannot see or otherwise invest in such offering. Some of the various online platforms that rely on *Lamp Technologies* have shortened this cooling off period from 30 days to 21 days (or less).

As a result of Section 18(b)(4)(F) of the Securities Act, conducting an offering in a manner that complies with the Rule 506(b) safe-harbor significantly "pre-empts" the regulation of such offering under state blue-sky laws, meaning that the states may not directly or indirectly require the registration of the offering if it complies with the requirements of Rule 506(b). However, it is not all roses, as investors who purchase securities in a Rule 506(b) offering receive "restricted securities", and, may not resell without registering the transaction with the SEC or subject to the limitations of Rule 144 (or another exemption from registration).

The following table provides a brief overview of the benefits and drawbacks to utilizing Rule 506(b) to conduct an online securities offering:

Benefits of Rule 506(b) Offering

1. Unlimited offering amount.

2. Audited financial statements are not required.

3. No SEC review or registration requirements (however, issuers must file a Form D reporting the transaction).

4. No direct or indirect state registration requirements (only notice filing).

5. Unlimited number of accredited investors allowed, and up to 35 non-accredited, sophisticated investors.

Drawbacks of Rule 506(b) Offering

1. No general solicitation of potential investors.

2. May only sell to 35 unaccredited investors total; however, most issuers relying on Rule 506(b) do not allow any unaccredited investors as a result of the heightened disclosure requirements and fear of inadvertently admitting too many and blowing the safe harbor.

3. Investors receive "restricted securities" and may not resell without registering the transaction with the SEC or subject to the limitations of Rule 144 (or another exemption from registration).

II. SECTION 4(a)(2) / RULE 506(c) OF REGULATION D – PRIVATE PLACEMENTS WITH GENERAL SOLICITATION

On September 23, 2013, as mandated by Title II of the JOBS Act, Rule 506(c) became effective, which provides an exemption from registration for offerings that are conducted using general solicitation so long as such offerings adhere to the requirements of Rule 506(c).

Rule 506(c) of Regulation D provides that the prohibition against general solicitation and general advertising contained in Rule 502(c) of Regulation D does not apply to offers and sales of securities made pursuant to the safe harbor in Rule 506(c), so long as the issuer takes *reasonable steps to verify* that all purchasers of the securities are accredited investors and the issuer *reasonably believes* all of those purchasers to be accredited investors. Whether the steps taken are "*reasonable*" is an objective determination by the issuer (or those acting on its behalf) in the context of the particular facts and circumstances of each purchaser and transaction.

The issuer has the burden of demonstrating that its offering is entitled to rely on the safe harbor contained in Rule 506(c), and it is important for issuers to maintain adequate records regarding steps taken to verify that a purchaser was an accredited investor. Rule 506(c) contains a "non-exclusive" list of methods for verifying accredited investor status, including any of the following:

- Reviewing copies of any Internal Revenue Service form that reports income for the two most recent years, along with a written representation by the investor of similar projected income status for the upcoming year.

- Reviewing one of the following forms along with a written representation by the investor that all liabilities relevant to net worth have been disclosed:

    - *Assets*: bank statements or statements of securities holdings, certificates of deposit, tax assessments, and satisfactory independent appraisal reports; or

    - *Liabilities*: consumer report from national consumer reporting agencies.

- Obtaining written confirmation that one of the following persons has taken reasonable steps to verify accredited investor status within the prior three months: a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant.

As with Rule 506(b), undertaking an offering in a manner that complies with the Rule 506(c) safe harbor significantly "pre-empts" the regulation of that offering under blue sky laws, greatly reducing the application of blue sky laws. In addition, purchasers receive "restricted securities" in Rule 506(c) offerings, and may not resell without registering the transaction with the SEC or subject to the limitations of Rule 144 (or another exemption from registration).

The following table provides a brief overview of the benefits and drawbacks to utilizing Rule 506(c) to conduct a securities offering beginning on September 23, 2013:

<u>Benefits of Rule 506(c) Offering</u>

1. Unlimited offering amount.

2. General solicitation is permitted.

3. Audited financial statements are not required.

4. No SEC review or registration requirements (however, issuers must file a Form D reporting the transaction).

5. No direct or indirect state registration requirements (only notice filing).

6. Unlimited number of accredited investors allowed.

Drawbacks of Rule 506(c) Offering

1. Once general solicitation has occurred, can't switch over to Rule 506(b).

2. No non-accredited investors allowed.

3. Issuer must take reasonable steps to verify accredited status of each investor, but investors, or their representatives, may be reluctant to provide the necessary information.

4. Issuers receive "restricted securities" and may not resell without registering the transaction with the SEC or subject to the limitations of Rule 144 (or another exemption from registration).

III. Regulation A+

Revisions to Regulation A (commonly referred to as "**Regulation A+**"), were adopted by the SEC on March 25, 2015, and became effective on June 19, 2015. Regulation A+ provides an exemption from registration for non-Exchange Act reporting companies for public offerings of up to $50 million in securities in any 12-month period. This exemption does not restrict the types of investors that may purchase securities in the offering, meaning that offers and sales may be made to both accredited and unaccredited investors.[6] In addition, because the securities are not restricted, they are eligible to be traded, immediately after the offering, freely between two parties in a private transaction or in the over-the-counter market.

Issuers that intend to offer securities under Regulation A+ must qualify an offering circular on Form 1-A with the SEC, which includes certain disclosure and exhibit requirements. Issuers are allowed to file these items with the SEC confidentially, but must make their filings public for a period of at least 21 days prior to the SEC declaring the offering "qualified."

Regulation A+ contains two different tiers of exemptions, with their own requirements:

- **Tier 1 –** basically old Regulation A but with a bump up in the maximum offering amount, requires state-level registration of the offering in each state in which the offering is to be made, but increases the maximum offering amount in any 12-month period from $5 million (under old Regulation A) to $20 million (including up to $6 million on behalf of selling securityholders); and

- **Tier 2 –** allows for offerings up to $50 million in any 12-month period (including up to $15 million on behalf of selling securityholders), subject to ongoing reporting

[6] However, unaccredited investors are limited in the amount they are allowed to invest, with the limits being the greater of 10% of such investor's gross annual income or net worth. Issuers are allowed to rely on representations from investors at the time of the investment that this is true, without any further obligation to verify, so long as they do not have any reason to believe that the representation was given falsely.

requirements with the SEC.[7] Securities offered and sold in a Tier 2 offering are deemed "covered securities" under Section 18(b)(3) of the Securities Act, and are thus not subject to direct or indirect state-level registration requirements.[8]

For offerings of up to $20 million, an issuer may choose whether to conduct the offering pursuant to Tier 1 or Tier 2.

For Tier 1 offerings, a number of states coordinate their review and registration processes. To take advantage of the coordinated review process, an issuer must submit a Form CR-3(b) together with its Form 1-A and exhibits to the securities regulator of the State of Washington, which is the lead state for the review process. Utilizing the coordinated review program should reduce the regulatory burden of registering a Tier 1 offering in more than one state.[9]

The following table provides a brief overview of the benefits and drawbacks to utilizing Regulation A to conduct a securities offering:

Benefits of Regulation A Offering

1. Offering may be up to $50 million dollars in any 12-month period.

2. May generally solicit all potential investors (i) resident in the state(s) in which the offering has been registered (Tier 1); or (ii) resident in the United States (Tier 2).

3. Audited financial statements are not required by the SEC for Tier 1 (but still may be required by the states).

4. Coordinated review of offering among states is permitted for Tier 1 offerings.

5. May "test-the-waters" for a Tier 2 offering before the commencement of an offering to determine if there is a market.

6. May confidentially submit Form 1-A to the SEC for review.

7. Investors do not receive "restricted securities," and may freely resell such securities without registering the transaction or relying upon Rule 144 (or another exemption from registration); however, resale of such securities may be subject to state-level regulation.

Drawbacks of Regulation A Offering

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[7] Ongoing reporting requirements for Regulation A Tier 2 issuers include Annual Reports on Form 1-K, Semi-Annual Reports on Form 1-SA, and Current Reports on Form 1-U.

[8] Technically, the way it works is that Section 18(b)(4)(D) deems any security offered or sold to a "qualified purchaser" to be a "covered security", thus preempting state law. Rule 256 of Regulation A+ defines a "qualified purchaser" to be "*any person to whom securities are offered or sold pursuant to a Tier 2 offering of this Regulation A*." In other words, everyone offered and sold a security pursuant to Tier 2 of Regulation A is deemed a "qualified purchaser", and thus state blue sky laws are preempted. MA and MT sued the SEC over this preemption and lost.

[9] A fuller description of the coordinated review process may be found at http://www.coordinatedreview.org/regulation-a/.

1. Offering exemption is currently limited to $50 million dollars in any 12-month period.

2. For Tier 1 offerings, registration must occur in each state in which it will be conducted.

3. The permissibility of "testing-the-waters" for Tier 1 offerings is determined on a state-by- state basis.

4. Ongoing reporting requirements with the SEC for Tier 2 offerings; potential ongoing reporting requirements with the states for Tier 1 offerings depending on each state's registration requirements.

IV. TITLE III OF THE JOBS ACT - REGULATION CROWDFUNDING

On April 5, 2012, President Obama signed into law the JOBS Act, Title III of which (titled the "CROWDFUND Act") mandated the SEC to adopt rules to permits an issuer to raise up to $1,000,000 within a 1-year period from both accredited and non-accredited investors, without registering the offering with the SEC. On October 23, 2013, the SEC proposed, in a 585 page proposing release,[10] Regulation Crowdfunding, and almost exactly two years later (October 30, 2015), the SEC adopted Regulation Crowdfunding (with a 685 page adopting release),[11] with Regulation Crowdfunding finally going effective on May 16, 2016.[12]

The aggregate amount of securities an issuer may sell pursuant to Regulation Crowdfunding during any 12-month period may not exceed $1,000,000 (including affiliates).[13] In addition, the amount of securities that may be purchased by any individual investor during a 12-month period across all Regulation Crowdfunding offerings is capped:

- for an investor with <u>*either*</u> annual income <u>*or*</u> net worth of less than $100,000 - the greater of $2,000 or 5% of the lesser of such investor's annual income or net worth;[14] or

- for an investor with <u>*both*</u> annual income <u>*and*</u> net worth of more than $100,000 - 10% of the lesser of such investor's annual income or net worth, not to exceed $100,000.

Although Regulation Crowdfunding allows issuers to avoid pre-clearing offerings with the SEC, issuers are still required to provide certain information publicly. Specifically, issuers must:

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[10] Securities Act Release No. 33-9470 (Oct. 23, 2013).

[11] Securities Act Release No. 33-9974 (Oct. 30, 2015).

[12] Although Title III has only been effective for a few months, there were over $5 million in total Title III offerings in the first month alone. A more detailed description of the first month of Title III can be found at http://www.crowdfundinsider.com/2016/06/87201-progress-report-data-30-days-title-iii-equity-crowdfunding/.

[13] Unlike some of the exemptions/safe harbors discussed in this overview, Regulation Crowdfunding prevents affiliated issuers from raising an aggregate of more than $1 million in any 12-month period. So, for example, if you are a home flipper, even though each of your home flips are in a separate entity (for liability purposes, obviously), all of your various entities would only be allowed to raise $1 million, in the aggregate, over any 12-month period.

[14] Interestingly, this results in the strange situation where it is possible to have an individual that qualifies as an accredited investor through their annual income (*e.g.*, a fifth year big-law associate) having a $5,000 investment limit *per year in aggregate* unless such investor also has a net worth of over $100,000.

- file with the SEC, provide to investors and the relevant broker or funding portal, and make available to potential investors a detailed disclosure document on Form C that includes many of the disclosure requirements of Regulation A;[15] however, the financial statements of the issuer must be:

  - for offerings of $100,000 or less: issuer's tax returns from the most recent year and financial statements certified by the principal executive officer;
  - for offerings of more than $100,000, but not more than $500,000: financial statements reviewed by an independent public accountant;
  - for offerings of more than $500,000: audited financial statements; ***provided, however***, first time issuers seeking to raise more than $500,000 pursuant to Regulation Crowdfunding may provide financial statements reviewed by an independent public accountant.

- provide regular progress updates on the offering under cover of Form C-U;
- annually, within 120 days of the end of its fiscal year, annual reports on Form C-AR, including all of the information required by Form C (described above).

Several industry advocates have criticized the final Regulation Crowdfunding rules, stating that the regulations are far too burdensome for issuers raising one million dollars or less.[16] Regulation Crowdfunding also has a number of restrictions, which include:

- Not available to investment companies (or companies that are excluded from the definition of an "investment company" under Section 3(b) or 3(c) of the Investment Company Act), companies that are currently registered under the Exchange Act, or issuers that are not organized under the laws of one of the 50 states, D.C., or a federal territory;
- Offerings must be conducted through a FINRA-registered broker-dealer or funding portal;
- Advertising of offerings outside of funding portals must be limited solely to notices that direct investors to a broker or funding portal; and
- Issuers may not compensate any person to promote an offering through a crowdfunding intermediary unless each form of promotional communication discloses the receipt of compensation.

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[15] Business, Management's Discussion and Analysis, Risk Factors, Use of Proceeds, Directors and Officers, Related Party Transactions, Beneficial Ownership and Capital Structure, etc.

[16] There have been several proposals to fix Title III to make Regulation Crowdfunding easier. For example, raising the funding cap to $5 million, removing future public registration requirements, and allowing investments through special purpose vehicles (SPVs). A more detailed breakdown of the barriers facing Title III and proposed amendments can be found at http://www.crowdfundinsider.com/2016/05/85696-title-iii-crowdfunding-became-legal-on-may-16-what-it-does-whats-still-lacking/.

Undertaking an offering in a manner that complies with the Regulation Crowdfunding significantly "pre-empts" the regulation of that offering under blue sky laws, greatly reducing the application of blue sky laws.[17] However, the securities received by purchasers are subject to transfer restrictions, including not being able to resell such securities for one year (other than to certain parties, such as the issuer and accredited investors).

The following table provides a brief overview of the benefits and drawbacks to utilizing the Regulation Crowdfunding to conduct a securities offering:

Benefits of a Regulation Crowdfunding Offering

1. Exemption crafted specifically for crowdfunding.

2. No SEC review or registration requirements.

3. No state registration requirements.

4. Investors do not need to be accredited investors.

5. Unlimited number of investors allowed.

Drawbacks of Regulation Crowdfunding Offering

1. Extremely complex regulatory burden.

2. Residual reporting obligation to file annual reports.

3. Audited or reviewed financial statements for offerings with maximum raises between $200,000 and $1 million.

4. The overall amount an issuer may raise is capped at $1 million (including affiliates) during any 12-month period.

5. The amount that each investor may invest in a year (across all Regulation Crowdfunding offerings) is capped.

6. Securities received by investors are subject to extensive transfer restrictions during the first year after purchase.

It is important to note the relationship between "crowdfunding" and the traditional funding structure of syndication. Syndication focuses on funding relationships and structure between the funder and funded, whereas crowdfunding is a method of finding investors. A more detailed discussion can be found at http://www.crowdfundinsider.com/2016/08/88621-syndication-is-the-what-crowdfunding-is-the-how/

[1] Looking back on the approximately 105 publicly-filed Regulation A+ filings to date, with approximately 44 of those filings qualified by the SEC, the average legal fees were around $107,000 per filing, exclusive of blue sky and auditing fees. At least two issuers spent approximately $500,000 on legal fees—one with a large law firm and another with a

[17] Except for the state of the issuer's principal place of business or any state in which purchasers of 50% or greater of the aggregate amount of the issue are residents, states may not require a filing or fee for relevant securities.

smaller law firm. For the most part, the legal fees are about what one would expect, with national and big law firms charging in the $150,000 – $300,000 range for representation, and smaller law firms generally charging less. A more detailed reflection on Regulation A+ since it became effective can be found at http://www.crowdfundinsider.com/2016/07/87745-looking-regulation-one-year-later/.