



# Crowdfunding and Creative Finance

Jeff O'Brien, Lommen Abdo  
Ryan Schildkraut, Freeland Briese

# Securities Laws - Generally

- Other than rewards or donation-based crowdfunding, almost all means by which a company raises capital online will involve securities laws. *See §2(a)(1) of Securities Act of 1933 for the definition of a security.*
- Securities laws regulate:



HOW YOU SELL  
THE SECURITIES



HOW MUCH  
MONEY YOU CAN  
RAISE



WHO YOU CAN  
TALK TO ABOUT  
YOUR OFFERING



HOW YOU TARGET  
POTENTIAL  
INVESTORS



RIGHTS OF  
INVESTORS TO  
GET THEIR MONEY  
BACK

# Current Regulatory Framework

- As a general rule, in order to comply with Federal securities laws, an issuer offering or selling a security must either (a) “register” such offer or sale with the SEC or (b) identify a specific exemption that allows such offer or sale to be conducted without registration.
  - In most circumstances, registration is time consuming and expensive.
  - Most small businesses are not able to easily comply with registration requirements.
- In addition, an issuer offering or selling securities must also adhere to **blue sky laws** in each state where the securities are being offered or sold, all of which vary from each other.

# Private Placement Offerings

- The most common federal exemption entrepreneurs rely on is Section 4(2) of the Securities Act, which exempts “transactions by an issuer not involving any public offering” – i.e., a **private placement**.
- The SEC has provided a clear set of “safe harbor” rules that issuers can follow to ensure that they are conducting a valid private placement under Section 4(2).
- In Regulation D, the SEC provides a clear set of “safe harbor” rules that issuers can follow to ensure that they are conducting a valid private placement under Section 4(2). The most common safe harbors that small companies have customarily relied upon in conducting private placements are Rule 504 and Rule 506 (*now called Rule 506(b)*).

# Common Private Placement Exemptions

	Rule 504	Rule 506 [now Rule 506(b)]
How much money can I raise?	Up to \$1M	Unlimited
Can I advertise the sale of my securities?	No, unless coupled with a state exemption or registration that allows advertising.	No.
To whom can I sell securities?	Anyone  However, counterpart state exemptions or registrations may impose additional restrictions on number of non-accredited investors.	Unlimited number of accredited investors  Up to 35 non-accredited investors if you believe they are “sophisticated”
Do I have to comply with the SEC’s formal information delivery requirements?	No, but counterpart state exemption or registration may impose additional requirements.	No, if only accredited investors are included  Yes, if any non-accredited investors are included
Do I have to verify that any accredited investors are truly accredited?	No, accredited investors can “self-certify.”	No, accredited investors can “self-certify.”

# No General Solicitation

- In order to keep an offering “private” under Rule 504 or Rule 506(b), companies cannot engage in “general solicitation.” This means:



# Congress Responds – JOBS Act

- As part of the JOBS Act of 2012, Congress directed the SEC to develop new rules that would make it easier for companies to raise capital from investors.



# JOBs Act: Key Components

## Advertising in Connection with Sales to Accredited Investors

### Title II

- ❖ Also called Rule 506(c).
- ❖ Became effective in October 2013.
- ❖ Growing in popularity.

## Crowdfunding for All

### Title III

- ❖ SEC released proposed rules in October 2013.
- ❖ The proposed rules have been almost universally criticized.
- ❖ Revised rules released in October 2015.

## Reg A+ | “Mini-IPOs”

### Title IV

- ❖ SEC released final rules in March 2015.
- ❖ Became effective in June 2015.
- ❖ Not very useful for startups.

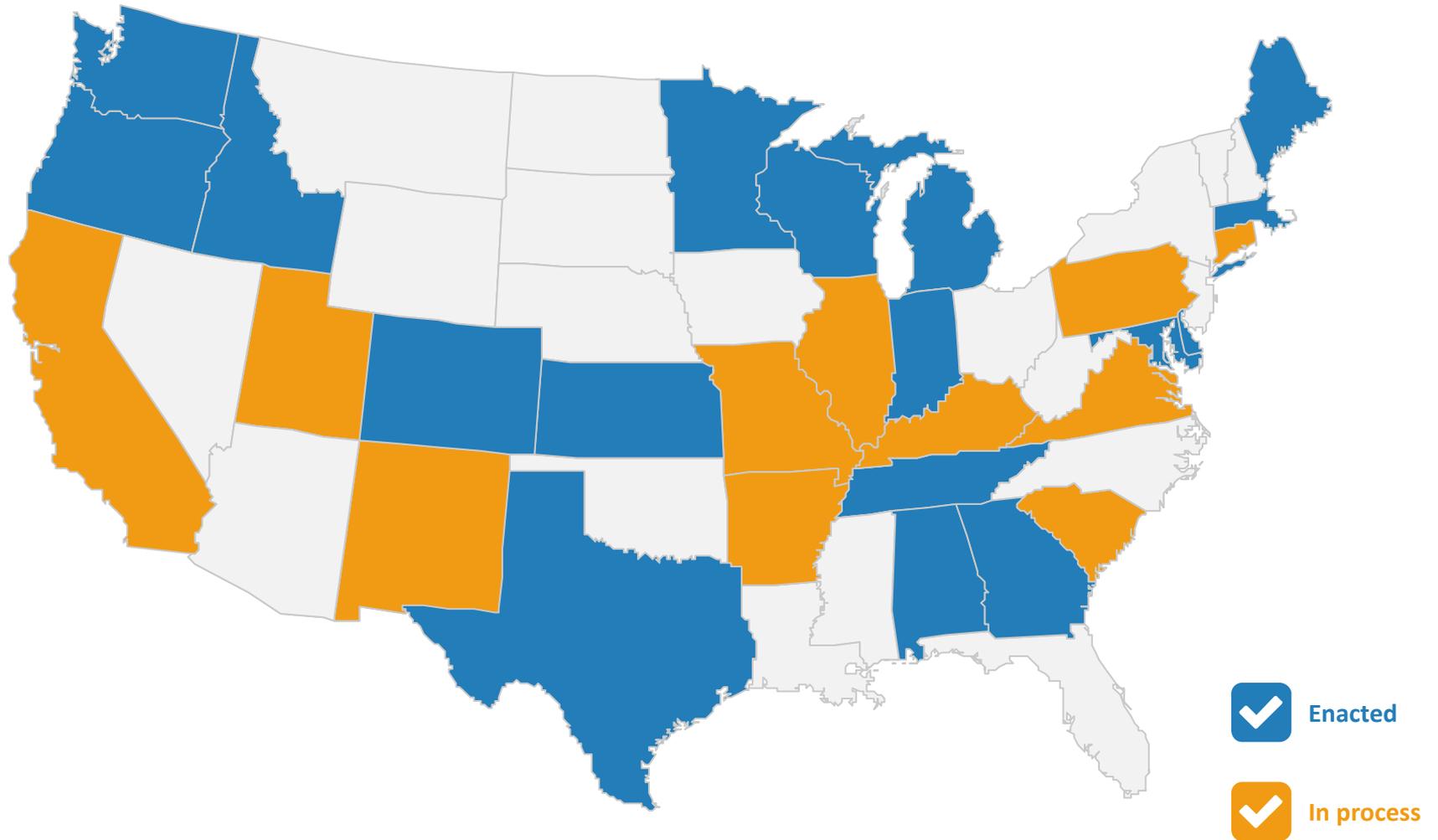
# Title II and Rule 506(c)

	Rule 504	Rule 506(b)	Rule 506(c)
How much money can I raise?	Up to \$1M	Unlimited	<b>Unlimited</b>
Can I advertise the sale of my securities?	No, unless coupled with a state exemption or registration that allows advertising.	No.	<b>Yes.</b>
To whom can I sell securities?	Anyone  However, counterpart state exemptions or registrations may impose additional restrictions on number of non-accredited investors.	Unlimited number of accredited investors  Up to 35 non-accredited investors if you believe they are “sophisticated”	<b>Unlimited number of accredited investors</b>
Do I have to comply with the SEC’s formal information delivery requirements?	No, but counterpart state exemption or registration may impose additional requirements.	No, if only accredited investors are included  Yes, if any non-accredited investors are included	<b>No.</b>
Do I have to verify that any accredited investors are truly accredited?	No, accredited investors can “self-certify.”	No, accredited investors can “self-certify.”	<b>Yes, you must take “reasonable steps” to verify that the investors are, in fact, accredited.</b>

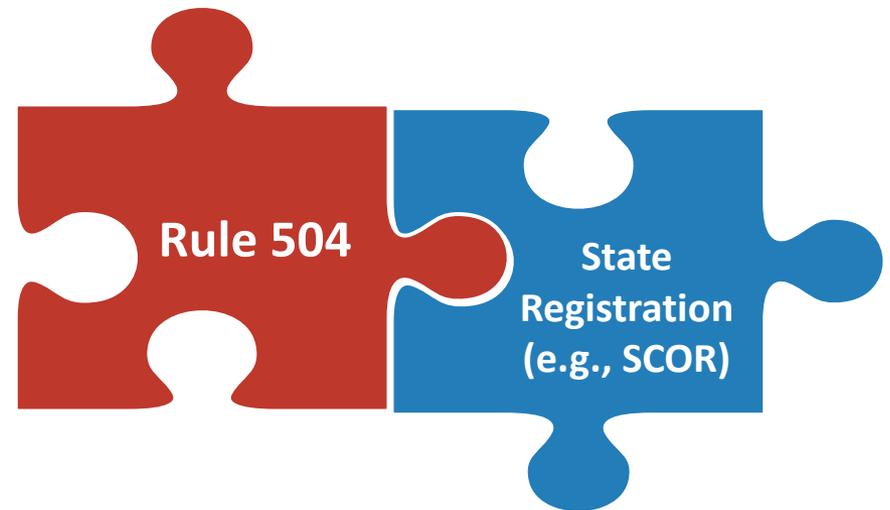
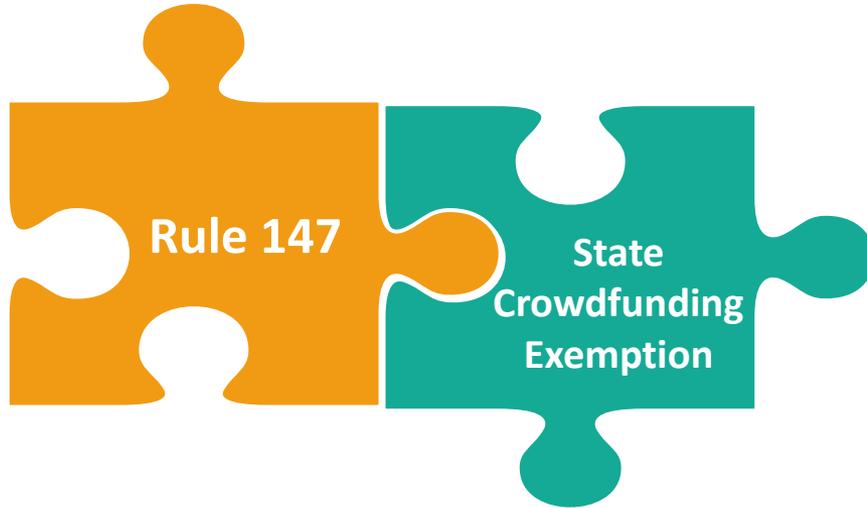
# Intrastate Crowdfunding

- Frustrated by the SEC's inability to design a useable system, individual states have adopted their own Crowdfunding laws.
- These state Crowdfunding laws permit **intrastate crowdfunded offerings** between an issuer and residents residing within the same state.
  - **Intrastate offerings** are exempt from registration under Federal law [See Section 3(a)(11) of the Securities Act or Rule 147 promulgated thereunder].

# State Crowdfunding Laws (September 2016)



# Intrastate Crowdfunding: Two Models



# Problems with Most Intrastate Crowdfunding Models

- Most intrastate crowdfunding laws require issuers to use Rule 147 for their Federal exemption. Rule 147 have potentially onerous requirements, such as:
  - The issuer must be incorporated in the state in which it is offering the securities;
  - The issuer must only sell the securities to individuals residing in that state;
  - 80% of the issuer's consolidated gross revenues must be derived from the state in which the offering is conducted;
  - 80% of the issuer's consolidated assets must be located within the state in which the offering is conducted;
  - 80% of the issuer's net proceeds must be intended to be used, and actually used, in connection with the operation of a business or real property, the purchase of real property located in, or the rendering of services, within the state in which the offering is conducted; and
  - **Advertising cannot result in offers to non-residents.**
    - **Most use reasonable measures to make sure that advertisements do not reach out-of-state residents.**

# MNvest – The Minnesota Solution

- Became law in June 2015 → Final rules issued in June 2016.
- Only available to Minnesota-based companies.
- All investors must be Minnesota residents and all Minnesota residents can be investors.
- Offerings must be made online through a “MNvest Portal” registered with the Minnesota Department of Commerce.
  - Issuers may create their own MNvest portal or work with a third-party host platform.
- MNvest Portals do not need to be registered broker-dealers.
  - However, only registered BDs can charge “transaction based” fees; Non-BDs can only charge flat fees.



# Additional MNvest Requirements

- Non-accredited investors can invest up to \$10,000 per deal.
- Companies subject to annual caps on amount of funds raised via MNvest.
  - \$2M with audited or review financial statements
  - \$1M with internally prepared financial statements
- Companies must provide detailed disclosure documents that comply with statutory requirements.
- Investor funds must be held in escrow until minimum funding target is reached.
- MNvest Portals subject to stringent recordkeeping requirements and general oversight by the Minnesota Department of Commerce.



# Title IV and Reg A+ | The “Mini-IPO”

- SEC released rules in March 2015 under JOBS Act Title IV
- Reg A+ become effective in June
- Companies able to raise up to \$50M from general public
- Pros:
  - General solicitation allowed; non-accredited investors can participate
  - State preemption (under Tier 2)
- Cons:
  - Raises under \$20M (Tier 1) subject to state review
  - Likely cost prohibitive for startups and earlier stage companies (filing offering circular, financial audit, and ongoing reporting under Tier 2)
  - Tier 2 offerings could take up to 6 months to receive SEC approval

# Comparison of Fundraising Models

Method	\$ Limit	Advertising?	Non-Accredited Investors?	Detailed Prospectus?
Rule 504 + state exemption	\$1M	✘	✓	✘
Rule 504 + state registration (SCOR)	\$1M	✓	✓	✓
Rule 506(b)	Unlimited	✘	✓	✓ *
Rule 506(c) / Title II	Unlimited	✓	✘	✘
Reg A+ / Title IV	Tier 1: \$20M Tier 2: \$50M	✓	✓	✓

*\*Assuming non-accredited investor participation*

# Title III and Regulation CF

- Final rules released in October 2015.
  - Issuer limits: \$1,000,000 in a 12-month period.
  - Investor limits: If annual income or net worth < \$100,000, then they can only invest the greater of \$2,000 or 5% of their annual income or net worth (whichever is less) on an annual basis in crowdfunding investments. If income and net worth > \$100,000 or more, then they can invest 10% of their income or net worth (whichever is less) up to a maximum \$100,000 in crowdfunding investments on an annual basis.
- On October 23, 2013 the SEC issued proposed rules, which have been criticized by most commentators as onerous and impractical.
  - The nearly 600-page rules set out a very difficult and expensive process for any business that wished to raise funds through crowdfunding.

## Practical Considerations

- Investors have rights as owners in the company.
- Corporations: unless otherwise provided in the Articles of Incorporation, shareholders have equal rights to vote, rights to profits, rights to certain information and, in some instances, dissenters rights (M.S. 302A.471).
- LLCs: Unless otherwise provided in the Operating Agreement, members have voting rights, rights to profits, rights to certain information and rights of action as to “oppressive conduct” (M.S. 322C.0701).
- **PRACTICE TIP:** be sure that the entity’s governing documents are clear in what rights minority owners have in the entity BEFORE commencing a private offering.

# Alternative Financing Sources

- Before commencing a private offering, it is a good practice for businesses to exhaust other options for financing that do not require the issuance of ownership interests in the business.
- Debt Financing (SBA)
- “Gap” Financing – Minnesota DEED, local incentives, TIF financing
- Kickstarter/Rewards-based crowdfunding

## Structuring a Private Offering

- In order to maintain control of the entity, it may be necessary to offer “sweeteners” to investors (preferred distributions, preferential/accelerated distributions)
- In addition, a built-in exit strategy may be desirable as well (put rights, call rights)
- These provisions should be included in the entity’s governing documents and disclosed in the offering document.



# Questions?



Jeff O'Brien ([jobrien@lommen.com](mailto:jobrien@lommen.com))

