

Equity Crowdfunding for Texas Entrepreneurs and Small Businesses

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Speaker

Steve Litke is a partner and corporate practice group head at Blaies & Hightower, L.L.P., based in Fort Worth. His practice is focused on mergers and acquisitions, federal and state securities laws, entity formation, corporate finance, joint ventures, licensing, technology and other intellectual property transactions, commercial contracting, and general corporate matters. His diverse experiences gained over a twenty-year legal career have included advising public and private companies, private equity firms, medical practitioner groups, high net worth individuals, entrepreneurs, business owners and non-profit organizations in complex transactions as well as day-to-day business affairs.

Prior to joining Blaies & Hightower, L.L.P., Steve served five years as General Counsel of a privately-held, technology and education company based in Fort Worth. Prior to that, Steve was a partner in the corporate and securities section of a large Texas-based law firm, where he advised clients on corporate transactional matters for nearly 13 years. Steve began his career as a Staff Attorney with the Enforcement Division of the Securities and Exchange Commission. In addition to his legal practice, Steve served as an adjunct professor of Mergers and Acquisitions at Texas A&M University School of Law for three years.

Steve has been selected a Top Attorney in Fort Worth by *Fort Worth, Texas* magazine multiple years. Steve is an alumnus of Texas Christian University, where he obtained his B.B.A. (Accounting). He obtained his law degree, with honors, from the University of Tulsa College of Law.

Presentation Overview

- Evolution of Crowdfunding
- JOBS Act
- Intrastate Crowdfunding in Texas
- SEC'S Regulation Crowdfunding

Evolution of Crowdfunding

- Definition of Crowdfunding
- Mike Hayes
- Kickstarter
- Indiegogo
- GoFundMe
- Donorschoose.org

Definition of Crowdfunding

Crowdfunding is generally defined as the practice of funding a project or other business through contributions or donations from a large group of people.

Mike Hayes

- An example of utilizing the concept of crowdfunding prior to the age of the Internet
- Occurred in 1987
- University of Illinois freshman
- Method of dissemination and promotion: Newspapers (Bob Greene)
- Funds used for educational expenses

Kickstarter

- Limited to artists, musicians, filmmakers, designers and other creators
- Founded in 2009
- Mission is to help bring creative projects to life.
- Over 12 million people from every continent have backed a Kickstarter project
- \$2.7 billion has been raised
- 115,656 projects have been funded
- Funding goal is all-or-nothing

Kickstarter continued

- Backers of projects often receive unique rewards for contributing (copy of work being produced)
- Ownership of work remains with creator
- Kickstarter receives a 5% fee of the funds collected. Payment processors take an additional 3% to 5%.

Indiegogo

- Founded in 2008
- \$1 billion+ has been raised
- Over 11 million contributors
- Fixed and flexible funding options
- Offers pre-market and marketplace services in addition to the fundraising platform
- Users can raise funds for creative and entrepreneurial projects or personal and non-profit causes

Indiegogo continued

- Fee of 5% of funds raised (plus 3% + 30 cents for transaction processing) applies to projects

GoFundMe

- General crowdfunding site
- Broad range of categories (medical, education, memorials, charity, business, etc.)
- Education is fastest growing category (\$60 million raised in last 12 months)
- No penalty for missing goal
- Users can keep all money that is raised

Donorschoose.org

- Formed in 2000 by a former teacher
- Focused solely on education-related projects
- Raised more than \$100 million in last fiscal year
- Partners with corporations who donate to projects within their geographic area
- To ensure integrity of process, donorschoose.org vets all projects, purchases materials requested and ships materials directly to participating schools
- 501(c)(3) organization

Common Element of Initial Crowdfunding Sites

- Contributors did not receive ownership or equity in the project or the company promoting the project.
- The issuance of an ownership or equity interest in the project or company promoting project would involve the issuance of securities.
- Under Section 5 of the Securities Act of 1933, securities cannot be offered or sold unless they are registered or unless issued pursuant to a valid exemption.
- Existing Federal and Texas State Securities Laws did not provide for an exemption that would allow for the issuance of securities online through a crowdfunding site.

Jumpstart Our Business Startups (JOBS) Act

- Signed into law by President Obama on April 5, 2012
- Required SEC to write rules and issue studies on capital formation, disclosure and registration requirements.
- Title III of the JOBS Act created a new Securities Act Section 4(a)(6) that provides an exemption from the securities registration requirements for certain crowdfunding transactions.
- In 2015, the Commission adopted Regulation Crowdfunding to implement the requirements of Title III.
- Regulation Crowdfunding became effective May 16, 2016.

JOB S Act

- The crowdfunding provisions of the JOBS Act were intended to help provide startups and small businesses with capital by making relatively low dollar offerings of securities, featuring relatively low dollar investments by the 'crowd,' less costly.
- Congress included a number of provisions intended to protect investors who engage in these transactions, including investment limits, required disclosures by issuers, and a requirement to use regulated intermediaries.

Texas Crowdfunding

- In response to the JOBS Act, the Texas State Securities Board adopted its own Crowdfunding Exemption in 2014.
- The Texas Crowdfunding Exemption relies on the intrastate offering exemption set forth in Section 3(a)(11) of the Securities Act.
- All offers and sales of securities must be made to Texas residents who are age 18 or older. Issuers must have a reasonable basis for believing an investor is a Texas resident.

Requirements for a Company/Issuer to use Texas Crowdfunding Exemption

- Company must have been formed in Texas, having filed a Certificate of Formation with Secretary of State
- Company must be authorized to do business in Texas
- At least 80% of the issuer's gross revenues during its most recent fiscal year prior to offering are derived from the operation of a business in Texas
- At least 80% of the issuer's assets at the end of its most recent semiannual period prior to the offering are located in Texas
- The issuer will use at least 80% of the net proceeds of this offering in connection with the operation of its business within Texas
- The principle office of the issuer is located in Texas

Issuers/Companies may not be:

- ▶ A company that engaged in or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities.
- ▶ Subject to the reporting requirements of the Securities Exchange Act
- ▶ A company that has not yet defined its business operations, has no business plan, has no stated investment goal for the funds being raised, or that plans to engage in a merger or acquisition with an unspecified business entity.

Other requirements for Texas Crowdfunding Exemption

- Businesses may raise up to \$1 million annually
- Offering must be made exclusively through an Internet website
- Dollar amount of securities that a purchaser can buy from an issuer is capped at \$5,000, unless the purchaser is an accredited investor. No cap on the amount an accredited investor can purchase. Issuers must have a reasonable basis for believing an investor is an accredited investor.

Accredited Investors include:

- A natural person who earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior 2 years and reasonably expects the same for the current year
- A natural person who has a net worth over \$1 million, either alone or together with the person's spouse (excluding the value of the person's primary residence)
- Any entity in which all the equity owners are accredited investors

Disclosure Requirements

- A disclosure statement must be readily available and accessible to each prospective purchaser at the time the offer of securities is made to the prospective purchaser on the Internet website.
- Must be available on website for at least 21 days prior to any securities being sold.
- Must be filed with State Securities Commissioner prior to the offering appearing on the Internet website.

Disclosure Statement Contents:

- Material Information, Risk Factors and Financial Information
- Topics to address include the following:
 - General description of issuer's business
 - History of issuer's operations and organization
 - Management of the company and principal stockholders
 - How proceeds will be used
 - Financial information about the issuer
 - Description of securities being offered
 - Any litigation and legal proceedings

Disclosure Statement – Mandatory Disclosures/Disclaimers

- There is no ready market for the sale of the securities acquired from this offering; it may be difficult or impossible for an investor to sell or otherwise dispose of this investment. An investor may be required to hold and bear the financial risks of this investment indefinitely.
- The securities have not been registered under federal or state securities laws and therefore, cannot be resold unless the securities are registered or qualify for an exemption from the registration under federal and state law.
- In making an investment decision, investors must rely on their own examination of the issuer and the terms of the offering, including the merits and risks involved.
- No federal or state securities commission or regulatory authority has confirmed the accuracy or determined the adequacy of the disclosure statement of any other information on this Internet website.

Summary of Offering

- A Summary of the Issuer's Offering must also be made available on the Internet website for a minimum of 21 days before any securities can be sold in the offering.
- Summary of the Offering includes:
 - A description of the issuer – type of entity, form of business, principal office, history, business plan, and intended use of offering proceeds, including compensation paid to any owner, executive officer, director or manager.
 - The identity of the executive officers, directors, and managers, including their titles and their prior experience and the identity of all persons owning more than 20% of the ownership interest of any class of securities of the company.
 - A description of the securities being offered and of any outstanding securities of the company, amount of the offering, and percentage of ownership represented by offered securities.

Marketing/Advertising

- The issuer is allowed to distribute a limited notice.
- Notice must be restricted to Texas.
- Content of notice is limited to a statement that the issuer is conducting an offering, the name of the registered dealer or TCP through which the offering is being conducted, and a link directing potential investors to the dealer or TCP's Internet website.

Communications

- All communications between the issuer, prospective purchasers, or investors taking place during the offer of securities must occur through the Internet website of the registered general dealer or Texas crowdfunding portal.
- During the time the offering appears on the Internet website, the website must provide channels through which potential purchasers and investors can communicate with one another and with representatives of the issuer about the offering. These communications must be visible to all those with access to the offering materials on the Internet website.

Internet Website

- The Internet website operated by the general dealer or the Texas crowdfunding portal must meet the following requirements:
 - Must contain a disclaimer that reflects access to securities offerings on the website is limited to Texas residents and offers and sales of the securities appearing on the website are limited to Texas residents
 - An affirmative representation by a site visitor that such visitor is a resident of Texas is required before visitor can view securities-related offering materials on website
 - Evidence of Texas residency is required before a sale can be made to a prospective purchaser (Texas DL, Texas voter ID, or general property tax records)

Restrictions on Resale

- Purchasers of securities issued pursuant to the Texas Crowdfunding exemption are subject to restrictions on the resale of those securities.
- Issuer must place a legend on the certificate or other document evidencing the security stating that the securities have not been registered and that any resale of the securities for a period of 9 months after the date of the last sale by the issuer in the offering, can only be made to Texas residents.
- Issuing stop transfer instructions to the issuer's transfer agent with respect to the securities, or, if the issuer transfers its own securities make a notation in the appropriate records of the issuer.
- Obtaining a written representation from each purchaser as to his residence.

Escrow or Segregated Account

- All payments must be held in an escrow or segregated account until the aggregate capital raised from all purchasers is equal to or greater than the minimum target offering amount necessary to implement the business plan.
- Investors will receive a return of all their subscription funds if the target offering amount is not raised by the time stated in the disclosure statement.
- A segregated account may be used in lieu of an escrow account if the maximum offering amount is \$100,000 or less.

Registered Texas Crowdfunding Portals

- Subject to their own set of rules and regulations issued by the Texas Securities Board
- Currently 11 portals offering Texas Crowdfunding exempt offerings
- Each portal has the flexibility to operate differently in how it raises and disperses investments (consistent with state regulations)
- Some focus on different types of investments (i.e. real estate, oil and gas, debt only, etc.).

Registered Texas Crowdfunding Portals

Business Funding LLC
2100 Wychwood Drive
Austin, Texas 78746

Crudefunders Portal Texas, LLC
4550 Post Oak Place Drive, Suite 119
Houston, TX 77027

Fiabus, LLC
4403 Eli Street
Houston, Texas 77007

Registered Texas Crowdfunding Portals continued

Mass Venture Inc.
110 E. Houston Street, 7th Floor
Houston Texas 77098

Nextseed TX LLC
4101 Greenbriar Drive, Suite 122K
Houston, Texas 77098

Rehabdaddy, LLC
11822 Key Biscayne Ct
Houston, Texas 77065

Texas Crowdfunding Exemption Success Story

- Jenna's Asian Kitchen, Austin, Texas-based restaurant
 - Raised \$75,000 that was funded on March 30, 2016
 - Utilized the Nextseed Texas Crowdfunding portal
 - A total of 41 investors participated in the offering
 - Securities offered were term loan agreements (no equity ownership)
 - Loans provided for a 30-month term with 16% interest per year

SEC's Regulation Crowdfunding

- Adopted by the SEC in 2015 in response to JOBS Act
- Became effective on May 16, 2016
- Unlike the Texas Crowdfunding Exemption, this exemption is national in scope
- Allows eligible companies to raise an aggregate amount of \$1 million in a 12-month period.

Eligibility

- Certain companies are not eligible to use the Regulation Crowdfunding Exemption:
 - Non-U.S. Companies
 - Companies that are already Exchange Act companies
 - Certain investment companies
 - Companies that are disqualified under Regulation Crowdfunding's disqualification rules
 - Companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the 2-years immediately preceding the filing of an offering statement
 - Companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unspecified company

Disclosure

- Issuers must file a Form C through the SEC's EDGAR system and with the intermediary facilitating the offering
- Issuer must disclose:
 - Information about officers and directors as well as owners of 20 percent or more of the issuer;
 - A description of the issuer's business and the use of proceeds from the offering;
 - The price to the public of the securities or the method for determining the price, the target offering amount, the deadline to reach the target offering amount;
 - whether the issuer will accept investments in excess of the target offering amount;
 - Certain related-party transactions;
 - A discussion of the issuer's financial condition and financial statements

Financial Statements Disclosure

- Level of Financial Disclosure depends on offering size
- \$107,000 or less: Financial statements from issuer and certain information from federal tax returns, both certified by CEO
- \$107,001 to \$535,000: Financial statements that have been reviewed by independent public accountant
- \$535,000 or more: First time issuers may provide financial statements reviewed by independent public accountant. Previous crowdfunding issuers must provided audited financials.

Regulation Crowdfunding Platforms

The JOBS Act required that crowdfunding transactions take place through an SEC-registered intermediary, either a broker-dealer or a funding portal. Under Regulation Crowdfunding, offerings must be conducted exclusively through a platform operated by a registered broker or a funding portal, which is a new type of SEC registrant.

Crowdfunding Platforms

The rules require the crowdfunding intermediaries to:

- Provide investors with educational materials;
- Take measures to reduce the risk of fraud;
- Make available information about the issuer and the offering;
- Provide communication channels to permit discussions about offerings on the platform; and
- Facilitate the offering and sale of crowdfunded securities.

Issuer Reporting Requirements

After completing a crowdfunding offering, a company must file an annual report with SEC which includes financial statements. If the company had its financial statements reviewed or audited by CPA, it must file those reviewed or audited financial statements.

Resale Restrictions

Securities purchased in a crowdfunding offering generally cannot be resold for a period of 12 months following the purchase.

Bad Actor Disqualifications

A company is generally not permitted to utilize the crowdfunding exemption if the company or any of its officers, directors, substantial shareholders, promoters, or affiliates have been involved in any disqualifying events, such as regulatory bans from participating in the securities or banking industries, or felony convictions relating to past securities industry activities.

Annual Investor Limit

The aggregate amount of crowdfunding investments that any one investor may make in any 12-month period across all companies conducting crowdfunding offerings is limited as follows:

- If the investor has either an annual income or net worth of less than \$107,000, then the investor's annual investment limit is equal to the greater of (i) \$2,200, or (ii) 5% of the lesser of the investor's annual income or the investor's net worth.
- If the investor has both an annual income and net worth of \$107,000 or more, then the investor's annual investment limit is equal to 10% of the lesser of the investor's annual income or the investor's net worth.

Regulation Crowdfunding Success Story

- Hops and Grain Production, LLC
 - Has raised the full \$1 million annual limit from a total of 307 investors
 - Proceeds will be used to build a second production facility in San Marcos to produce more of its craft beer
 - Conducted its offering through www.wefunder.com

Thoughts on Texas Intrastate Crowdfunding and Regulation Crowdfunding

- Would typically not be an entrepreneur or small company's first option for capital or financing
- \$1 million annual cap limits potential uses
- Company's with access to capital from private equity, angel investors, friends and family or other sources would likely choose these other sources rather than crowdfunding
- These exemptions do provide a financing/capital raising option to those that do not have other options
- These options can also generate buzz or publicity in the products and services offered by the issuer