The Secrets of Wall Street

Raising Capital For Start-Up & Early Stage Companies

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Dedications

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Author: Timothy Daniel Hogan, Founder & CEO:
Commonwealth Capital Advisors, LLC & Commonwealth Capital, LLC

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1 Commonwealth Capital, LLC is a wholly owned subsidiary of Commonwealth Capital Advisors, LLC established April 2, 1998.
FOREWORD

By: Jeffrey H. Canfield, Esq.

I first became acquainted with Commonwealth Capital Advisors and their Financial Architect System™ in late 2003. At the time, I was a partner at a large general practice law firm (Bell, Boyd & Lloyd – Chicago) that had a substantial corporate practice. I was in the Intellectual Property Department. Inter-departmental cross selling was the watchword at the time, and I was often recruited by partners in our corporate department to develop intellectual property strategies for both newly formed start-up companies and established corporate clients.

Such was the case with Commonwealth Capital Advisors. One afternoon, I received an invitation to meet a new client who had developed some software for structuring deals for raising capital. I was to assess their technology and determine whether it might be patentable. The new client was Commonwealth Capital Advisors, and that day I met Tim Hogan. In short order, Tim launched into an enthusiastic description of Commonwealth Capital Advisors' new Financial Architect System™. As is often the case with new inventors, Tim was exuberant. It was clear that he was excited about Commonwealth Capital Advisors' new product, and he truly believed that Financial Architect® would revolutionize the way start-up companies and entrepreneurs raise capital.

Tim related how many small businesses and entrepreneurs are denied access to capital because they can’t pay the price of admission. Private offerings, debt issues, and other instruments for raising capital require the hands of professionals. The lawyer and accountant fees associated with preparing SEC filings, pro forma financial projections, and the like, can push the costs of obtaining funding well beyond the reach of many promising start-ups. The idea was to reduce the cost of raising capital by reducing the professional fees associated with developing a capitalization plan and preparing the supporting documentation to implement the plan by teaching entrepreneurs to do the heavy lifting themselves and providing them with tools to get the job done.

In the quintessential American spirit of self-help and do-it-yourself-ism, why not teach entrepreneurs basic strategies, capital-raising deal structures, and give them the
tools to start the process themselves? With a little effort and the right tools, there is no reason why ambitious hard-working entrepreneurs cannot put together their own capitalization plans complete with all the necessary financials and other supporting documentation. Taking care of these preliminaries on the entrepreneur’s time rather than the lawyer or accountant’s time could save thousands of dollars, even tens of thousands of dollars in attorney and accountant fees. Tim was not advocating bypassing the services of professionals all together, merely starting the billable clock much later in the process. By minimizing professional fees, start-ups and small businesses have a better opportunity to gain access to sources of capital from which their very lack of capital would otherwise exclude them.

All told, Tim’s presentation was impressive. The basic premise appeared sound; nonetheless, I was skeptical. I have worked with many, many inventors over the years. Most are enthusiastic about their ideas. Most are as enthusiastic as Tim was. Many inventors have very good ideas. Sometimes they have great ideas. Nevertheless, the task of turning a good idea into a tangible product or service that people will be willing to pay for is another thing entirely. Happily, my job does not require me to make judgments as to whether I think new inventions will sell or whether I think they are “a good idea.” My job is to assess whether an invention is patentable, and if so prepare a patent application and shepherd it through the Patent Office.

My initial assessment, with regard to Financial Architect®, was that various aspects of the system did appear to be appropriate subject matter for a patent. I committed to preparing an application. Shortly thereafter, I was supplied with all of the documentation and other resources that Commonwealth Capital Advisors had on hand to teach me about their invention. These included a draft copy of this book and the Securities-offering document Production Template Modules of Financial Architect®. They proved to be the only resources I would need.

At this point in the story, I should emphasize that I am not a finance person. I am a patent lawyer with an engineering background. Until I began working with Commonwealth Capital Advisors, my involvement with start-up companies had been limited to evaluating and protecting their intellectual property assets. Yet, to prepare a
patent application covering the novel aspects of Financial Architect® I had to become thoroughly acquainted with the ins and outs of capital formation and deal structuring as well as all of the supporting documentation necessary to put together and implement an effective capitalization plan. Not only that, I had to learn these things quickly and on a budget.

The Secrets of Wall Street: Raising Capital for Start-Up and Early stage Companies and the document-production-template modules of Financial Architect® were the perfect vehicles for bringing me up to speed. Within days I was acquainted with not only the various deal structures and financial arrangements that may be employed in developing a capitalization plan, I was running different scenarios, creating alternate deal structures and hybrid capitalization plans, changing deal structures, and evaluating which scenarios and capitalization plans would be best for my start-up business and my potential investors. I was able to view: how various deal structures played out over time; how they affected my bottom line; how they affected control of my company (I speak in the first person here because I literally felt as though I was setting up a capitalization plan for my own future business). In a very short time, I went from a clueless financing neophyte to a CEO with a plan. And not only did I have a plan, I had the pro forma financial projections compliant with GAAP (Generally Accepted Accounting Principles) standards to back it up!

Over the years I have worked with enough solo inventors and start-up companies to know that access to capital is the single greatest obstacle to bringing new ideas to market. Without adequate financial backing, even the most groundbreaking ideas will flounder. This book and Financial Architect® have the power to prevent that from happening. When entrepreneurs are aware of the options open to them, when they have the tools to put a realistic, well-thought-out capitalization plan together by themselves, the cost of accessing the capital markets is significantly reduced. Armed with the insights gained from this book and the tools provided by Financial Architect®, entrepreneurs can tap pools of capital that, heretofore, were beyond their means to even consider.

So if you have an idea, if you have a plan, if your business has everything it needs—except the financial resources necessary to put your plan into action—start
reading. In short order, you will possess the knowledge and tools necessary to raise the needed capital to put your dreams into effect.

Jeffrey H. Canfield, Esq.
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Chapter 1: An Introduction to Raising Capital in the United States

“The truth is like poetry. Everyone says they appreciate it, but no one wants to hear it”

~Anonymous

The following stories are typical and problematic. These are the challenges and successes this book addresses.

Trevor, a newly hired apprentice in John and Steve’s start-up company, made haste as he nervously packed up the audio-visual equipment—Steve was about to launch into John once again how this all had been a waste of time. Lately, the tensions between the two of them were becoming severe, palpable. John was clearly not in the mood to hear yet another lecture from Steve about the frustrations of “pounding the pavement,” seeking capital for their new company from venture capital and private-equity firms. Having spent his first twenty-three years as an US Air Force fighter pilot and hobby inventor, John had the discipline and tenacity (not to mention the intellectual prowess) to overcome almost any adversity. But he, too, was wearing thin. How many more false hopes and broken promises from these financial firms, which only sent “screeners” and never “decision makers” to these meetings, could he endure? After countless introductory and due-diligence meetings, they were exactly where they started five-and-a-half months ago—at square one. Having burnt through Steve’s inheritance and John’s savings, they were slowly going broke. Steve noticed something in John’s demeanor he was originally unaware of—a combination of fury with a much deeper pale of sadness (something was just not right). Was this slowly killing him? Steve decided to walk out of the room—the inevitable discussion could wait.2

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Darian and Kim’s social-media network had tens of thousands of followers and was growing daily. They just knew their first smart-phone application, would sell for ninety-nine cents to millions if they could only get it up and off the ground. They surmised they only needed $200,000 for launching their new company and releasing the application. Once this first app sold to the masses, they could create and sell more. They had tried the donation-based-crowdfunding platforms but only raised $11,454 in five months. Darian’s father, a CPA, suggested they speak with Ron, a good friend of his from college—a long-time SEC-enforcement attorney who now was running a private practice.

After their initial meeting with Ron, Kim and Darian were even more excited about the prospects of a successful venture, but realized just how much work was needed to prepare a business plan for Ron so he could produce the securities-offering documents. There’s lots of good news with Regulation Crowdfunding (aka Title III of the JOBS Act of 2012). An issuer of securities (the company seeking capital) simply fills out Form C before solicitation and sales can begin. The really good news is its being solicited to the general public. The bad news is an issuer of securities must use a

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2 This is a typical example of another heart-breaking scenario I’ve experienced over thirty years in corporate finance.
crowdfunding portal exclusively [no other method of solicitation may be used] to offer and sell the securities. Even worse, they can only engage one crowdfunding portal to do so. That’s a lot of risk placing the ability to raise capital with one solitary effort and source. Regulation Crowdfunding also has a strict, relatively low, investment dollar limit per investor, thereby compounding that risk. Although limited to a maximum offering amount of $5,000,000 per 12-month period, Regulation D - Rule 504 does not have a strict investment dollar limits per investor, so if one has friends, family, personal and professional contacts that would like to invest more than Regulation Crowdfunding allows, then they can simply invest using Regulation D - Rule 504 document.

Although Form C filed with the SEC doesn’t require a sophisticated securities-offering document, Ron though it wise to produce a securities-offering document under Regulation D - Rule 504 because it would enable Kim & Darian to retain two critical elements he recognized as very important. First, due to the higher level of disclosure, the securities-offering documents and elements of it in Form C would protect Kim and Darian against any claims of securities fraud. Second and more importantly, it would allow them to avoid the singular dependence on the performance of just a crowdfunding effort with only one crowdfunding portal, as they now could sell securities concurrently to their friends, family, personal and professional contacts (with no dollar limit per investor), as well. Yes, they would need these securities-offering documents to properly sell securities through a crowdfunding platform, under “Title III” or “Regulation Crowdfunding” by using the elements within the Regulation D - Rule 504 document to fill out Form C for the crowdfunding portal.

After researching successful securities offerings and the deal structures that made them so, they settled on a simple, three-year convertible-note structure to sell to investors. Ron suggested they move the size of the convertible-note offering to $1,000,000—just in case they needed more than originally thought. They could always close it early at a lesser amount, if necessary.

Once Ron was finished with their securities-offering documents he gave them the “thumbs-up.” He supplied them with a pdf copy of the Regulation D - Rule 504 document to send out to friends, family, personal and professional (pre-existing) investor contacts. Ron also gave them a MS Word copy to assist them in filling out (copy and pasting the elements in made easy) Form C with the SEC for the Crowdfunding effort. Darian and Kim used the business plan and disclosures in the Regulation D - Rule 504 document to fill out Form C with the SEC to qualify for Regulation Crowdfunding. Then they engaged a Crowdfunding portal to sell as much as it could, then went to work on selling the securities to friends, family, personal and professional (pre-existing) investor contacts under the exemption: Regulation D - Rule 504. Running with the “double-barreled shotgun” approach, they were able to further control the outcome and success of the capital-raising effort. Before engaging the crowdfunding portal and soliciting and selling securities under Regulation D - Rule 504 outside the crowdfunding portal, they obtained Ron’s blessing. (Early on in his college, business class, Darian learned an opinion of legal counsel is an affirmative defense in regulatory litigation.)
In addition, because they used Regulation D - Rule 504, Ron was easily and quickly able to file that document under their State’s Small Corporate Offering Registration (SCOR) allowing them to advertise the securities in their state and outside the crowdfunding portal. As some capital rolled in from friends and family, under SCOR they were able to advertise in the regional, financial publications. Although a little more expensive, that “triple-barreled shotgun” approach was highly effective. They learned quickly, when raising capital through public solicitation, using the general media, social media, and other means, you get what you pay for.

Ron oversaw all their regulatory requirements and was honored and excited to be a part of a real success story. Darian and Kim ended the offering early at $770,000; because they started to sell their app and unexpectedly received a significant, development contract from another company to design the app for them. Receiving outsourced app-design work was not part of their original business model; but after receiving support from their investor base, documented by Ron, they jumped at the opportunity. Funny how success breeds success!

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Since childhood, Sue and Margo had always known they would have a place in each other’s lives. Best friends and entrepreneurs since Girl Scouts—laughter and inventiveness fueled this friendship. Once again, the national economy forced them to strike out on their own—because working at a coffee shop was not their idea of full-time employment. Having received “good advice” from her brother, a doctor, Margo convinced Sue they should seek to raise $2,000,000 through a crowdfunding web portal—the Jobs Act enabled entrepreneurs to raise money through general solicitation. They went to a crowdfunding seminar, which was conducted by someone who claimed to be an “expert” in crowdfunding. Obviously, he must be—right?

Exhilarated to find investors, they signed up on one of the more popular, crowdfunding web portals, posting their company’s business plan. Things started off great. In five months, they raised an average of $117,000 per month and were very prudent on how they employed those funds. A few months later, they received news the web portal was seized by the SEC and seventeen state-securities administrators. Apparently, the regulators claimed the crowdfunding web portal Sue and Margo used was not properly registered. Further, because this portal enabled their client companies to simply post a business plan, the portal was charged with aiding and abetting fifty-seven companies in over 230 counts of various felonies—including securities fraud.

The SEC in turn seized the assets and forced liquidation of forty-three out of the fifty-seven companies, including Sue and Margo’s. Both women were banned from selling securities in the US for five years. Due to their lack of malice and intent, through plea-bargaining with the state and federal prosecutors, they survived any criminal convictions. Their investors, however, saw an open window to claim a breach of fiduciary duty on Sue and Margo’s part, citing lack of due diligence and proper legal counsel. This opened up their personal assets to attachment, voiding the limited-liability
Robert had met Kyle on the golf course at the invitation of his bother-in-law, Pete. Kyle, being a financial advisor for a large, New York, investment bank—one of the leading advisors in the firm—was bored and quite frankly unfulfilled with his position in life. He used to say, “I often feel like a high-paid babysitter who shuffles paper and contributes nothing of any real value to society. I wish I had the passion of my youth in business and my life was an example to my kids.”

Robert, a savvy real estate investor and developer, had grown his business to the degree he could handle it with little effort. Having been fortunate to accrue some past successes in his field, by sharing some of the profits with his employees through an ESOP (employee stock-ownership plan), he was able to build a real estate-development firm successfully. These employees were loyal and took care of the company as if they owned it, which they kind of did, when Robert simply needed time to himself. He trusted them, as they did him. Trust...a lost commodity of sorts, he thought. He had choices—sometimes too many. He could either sell the company, continue as he had been, or expand to varying degrees. At fifty-five years old, what would Robert do if he sold it—continue as is? Sure, but he, too, was a bit bored. High achievers tend to be.

After the round of golf and over a couple of cold ones, Robert asked Kyle if he knew anything about how one would go about building a REIT (Real Estate Investment Trust). Kyle explained he knew enough to get in trouble but certainly could put Robert in touch with some experts in the field.

That was a little over five and a half years ago. Because the REIT concept was a completely new business model for Robert, it was structured as a start-up. That one, friendly question led to a dream come true for both of them. Robert was able to build a formidable real-estate empire from scratch in a niche market overlooked by the giant REITs. Kyle came on as the new, management company’s CFO. He was the key in handling the securities-related aspects of building the firm. From individual investor contacts—through Kyle’s golden Rolodex, along with utilizing Title II of the JOBS Act of 2012 (aka Regulation D – Rule 506(c)) with broker-dealer engagements, as well as in-house securities sales effort and with continued, good investor relations—they had more investment capital than they could employ. The good news is, under Title II of the JOBS Act of 2012, they were able to solicit accredited investors (only) for an unlimited amount of capital and they didn’t need to use a crowdfunding portal exclusively, to do it. The only bad news is that they must obtain 3rd party verification of each investor’s accreditation prior to accepting an investment. To them, it seemed like an easy enough process to stay in compliance…and it was.

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3 This is a highly likely scenario in our current environment.
“It was simply the next level for both of us. The timing was perfect—two, successful fellas bored to death, needing the next level to grow personally, as well as professionally,” Kyle said.

Robert sought out the correct corporate and securities legal counsel, audit firm, and corporate financial-advisor firm and never looked back. Robert recently stated, “Once I knew how they did it on Wall Street, I wondered why none my old competitors did it. Today, I’m glad they didn’t because today they can’t compete with me…not even close.”

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Two of the previous examples are not all that empowering are they? They’re meant to be what they are, a warning. The money game is the biggest game in town, and it’s also the roughest. If you’re a serious entrepreneur, brace yourself in this armor of knowledge. It’s meant to protect you from those who would take advantage of your naïveté, to whatever degree they believe it is. The contents of this book will enable you to do this right the first time. This book is no substitute for proper legal counsel, accounting or corporate finance advice. It gives you the knowledge you need so that you can control the events and the players of this process. The information in this book is designed to increase the probability of successfully raising capital in the United States to the highest degree possible. How can we (my senior management members and I) make such a claim? We can because these are the secrets of Wall Street in relation to funding start-up and early stage companies. We have simply brought the “Wall Street process” to “Main Street companies.”

This book was written as the precedent to a revolutionary change in the ability, not necessarily the way, to successfully raise capital. The fundamentals of the way to raise capital rarely change—if at all—however, the ability to perform the necessary tasks to ensure success has. However, as a treatise, I will also introduce you to complex processes that have been substantially streamlined and simplified for the benefit of your understanding of the way to raise capital successfully. I will also divulge numerous secrets, strategies, and techniques used to raise capital. Most importantly, to further your ability to successfully raise capital for your start-up, early stage, or later-stage Company, I will introduce the practical applications used by Wall Street investment-banking firms. As it relates to raising capital for your company, my goal is to teach you how to deal from a relative position of strength throughout the life of your Company.

The most challenging part of writing this book was to take an enormously complex set of processes and simplify them as much as possible—without degrading them. The true value of what you are about to discover herein is your ability to make a qualified decision if these processes are right for you and your Company. Only you and your team can make the qualified decision if your Company is ready (or not) to take on this challenge. The process of selling securities to capitalize a company is not for everyone. This is not child’s play. I often humorously refer to this book as a tool we use...
to scare away the few entrepreneurs who simply are at the “dreamer stage” in their journey. From decades of experience, we know these processes will work for those who are ready. Many entrepreneurs come back to us within a few months—when reality sets in—and they are ready for the challenge and opportunity for long-term success. When the student is ready…the teacher appears.

To be clear, the activation of the processes outlined, discussed, and clarified in this book are for serious entrepreneurs only. This book is designed for those who need to raise substantial amounts of capital for start-up, early stage, or later-stage companies—or commercial projects—for which you want to maintain voting control and the vast majority of equity ownership. These processes are used by Wall Street investment banks to raise capital for their client companies. You can use them to capitalize your Company as well! Once you are able to successfully raise capital in the private markets, opportunities will abound. At that juncture, you may decide to take the Company public, sell it outright to a strategic acquirer, or remain private as your own personal, best investment. To raise capital, you do not have to take your Company public. These processes give you options, not restrictions.

When speaking of raising capital for developing companies, my primary focus lies in how to raise “passive” capital, as opposed to “active” capital.

“Passive” capital means attracting capital from investors who are not interested in any active management of a company but seek relative safety with a better-than-average rate of return on their investment. We refer to these investors as “True Angels.”

“Active” capital means attracting capital from professional investors who seek active management, strategic support, or both—i.e., actual control of the company. These investors will structure the deal (e.g., offer terms of financing on a term sheet) to achieve relative safety while seeking a substantial return on their investment. In most professional circles, this type of capital is referred to as “high octane” capital because of the high-pressure demand for speed and performance often put on the recipient company’s management team. These investors are commonly referred to as “institutional” or “professional” investors; and this type of funding is more typically known as “venture capital.” Most Angel Groups are considered professional investors. Throughout this book I will address both types of investors (re: True Angels and institutional/professional investors), as both sources of capital have their place. In the early stages, passive capital is generally better for most companies, especially for entrepreneurs who seek the freedom of control without having to answer to another type of boss (e.g., Angel Groups or the institutional/professional investors). In other words, too many proverbial cooks in the kitchen can distract the entrepreneur from realizing their dream.

In order to increase your Company’s chance of successfully raising capital, it will be to your advantage to know how other entrepreneurs are successfully raising capital in the marketplace. It is also important to know the current trends in the private, as well as the public capital markets, so that you are strategically positioned to take advantage of these trends and get ahead of them. More importantly, to increase your Company’s
chance of raising capital correctly and legally, you must understand the nature of the regulatory environment for issuing securities to capitalize your Company. More information on the current compliance rules and regulations will be highlighted throughout this book (see Chapter 20: Compliance with Federal and State Securities Laws).

For most readers and entrepreneurs, the wealth of information contained in this text is a lot to digest. As a learning tool, many concepts have been repeated throughout to help you understand the full magnitude of the process. When referring to “raising capital,” we mean raising substantial amounts of capital for the traditional working capital needs of “for-profit companies.” Substantial amounts of “seed” capital could mean anywhere from $100,000 to $1 million. Substantial amounts of “development” capital could mean anywhere from $1 to $10 million. Substantial amounts of “expansion” capital could mean anywhere from $5 to $50 million.

Although it is nice if you can get it, we also do not consider grant money from governmental or other organizations as a form of available, working capital for a start-up, early stage, or even seasoned companies. The availability of grant money is always shifting—the amounts are always too small—and the probability of attainment is generally very low. Grant money often comes with too many strings attached; nevertheless, we encourage pursuing such available funding (under the right circumstances) once a company is properly capitalized through the means illustrated in this book.

Although it generally lessens the amount of working capital needed (a very good thing), franchise sales, pre-construction price sales, or the sale of other rights are not considered raising capital; these are booked as sales and are finite in nature. We do consider any commercial lending activity as part of a capitalization plan or deal structure, which would include bank loans and lines of credit—US Small Business Administration (“SBA”) guaranteed or not—factoring of receivables, and purchase order financing. We embrace reasonable amounts of debt as part of the overall capitalization mix—once a company has sufficient revenues to support the principal payments and accrued interest—because debt is the least expensive form of financing if one assumes success in the foreseeable future. Thus, before the entrepreneur obtains reasonable amounts of debt financing from banks, they normally must have a substantial amount of equity capital saved, raised, retained earnings, and or a combination from a sustained operating history. This step often eliminates most start-up and early stage companies. It is important to keep in mind that financial structures need balance.

Unless you have really wealthy relatives who like you an awful lot, for all practical purposes, there are only two ways to legally raise capital in the United States. To legally raise capital in the United States, you must engage in one of the two activities listed below:
1. **Produce a business plan and submit it to institutional sources of capital.**

After you’ve produced your company’s business plan submit it *only* to institutional sources of capital. Institutional sources of equity and/or debt capital would include venture-capital firms, commercial banks, private-equity firms, family offices, broker-dealers, pension funds, angel-groups and other similar financial institutions. When soliciting financial institutions for capital, the definition is essentially defined as: “any entity regulated as a financial institution and or any un-regulated organization of professional investors, e.g. hedge funds and angel groups. Submitting business plans for substantial amounts of funding to financial institutions simply does not work for most start-up, early stage, or later-stage companies—those companies with under $10 million in annual revenues, rarely works. When it does work, only 0.77% of companies seeking seed capital receive it and they only receive 1% of all venture capital available and it often requires sacrificing too much equity ownership and control to make the funding worth it.

Although securities may be involved in the transaction with a financial institution, when these institutions make the “offering of terms” by issuing a term sheet to your Company, it is not considered a “securities-offering” because your Company did not making the offer. This is significant because in this scenario, you have no burden of regulatory compliance associated with a securities offering.

**IMPORTANT:** The business plan cannot offer ownership equity, debt or any other form of financing otherwise or it becomes an un-registered securities offering and exemptions from registration are most likely unavailable for any business plan. If you raise capital with a business plan from individual investors, without the proper disclosure as contained in a securities-offering document, the business plan could be used as a basis of securities fraud, a criminal offense punishable of up to 20 years in prison.6

In addition, Business plans are highly ineffective as documents used to raise capital, as they do not carry the “threat” of the “take away.” For instance, a business plan relies on any number of financial institutions to either accept or reject all of the financing. However, if you produce the required securities offering documents and advertise a securities offering in compliance with federal and state(s) laws, you can sell a little piece of your company to many individual investors, thereby eliminating the need to “beg” financial institutions to invest large amounts into your company. If you structure the deal where it’s extremely attractive to any investor, and your securities offering qualifies for general solicitation, and you have the advertising power to “by-pass” the financial institutions and go directly to passive investors, then you are dealing from a relative position of strength because you will have many opportunities to sell to many individual investors, and therefore you don’t need to “beg” and can pull it back or “take away” from any particular investor.

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4 This fairly well-known statistic in the investment-banking community is called a “venture-capital industry norm.” The National Venture Capital Association (NVCA) used to track this and similar statistics, but they now have either been restricted to members only or eliminated from public access. See Chapter 5 “The Secrets of Wall St…”for our calculations.  
Remember, there are only two investor fears: 1.) The fear of investment capital loss and, 2.) The fear of return on investment (or opportunity) lost. An investor might fear losing $10,000 of investment capital but may fear losing a $50,000 return on investment capital more. Through proper corporate engineering and deal structuring you easily can shift the fear of loss of money to loss of opportunity. It’s really not that hard once you know how.

**Conduct a securities offering in compliance with federal and state(s) securities laws, rules and regulations.**

What does raising capital for your Company through a securities offering entail? The following will explain in detail the exact nature of a securities offering, as well as cite examples. First, we need to define what constitutes a security. The courts have generally interpreted the statutory definition of a security to include both traditional and nontraditional forms of investment. In Section 2(1) of the Securities Act of 1933, as amended, the SEC defines the term “security” to mean “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 interests 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” (1–2)7 (also see SEC v. W. J. Howey & Co., 328 US 293 (1946)).

In *Landreth Timber Co. v. Landreth*, the US Supreme Court adopted a two-tier analysis that basically further elaborates as follows: “For purposes of securities laws, a security in an investment of money, property or other valuable consideration made in the expectation of receiving a financial return from the efforts of others.”8

To summarize, anything you trade an investor in exchange for an investment in your Company—where the investor expects a return on the investment—constitutes a security.

Now that we have made clear what constitutes a security, we need to define what constitutes an “offer” or “offering” of a security. Remember, presenting a business plan (without a specific deal structure or offer of terms) to a financial institution (i.e., venture-capital firm) to obtain capital will not constitute a securities offering—as long as the financial institution offers the terms of financing. The offer must come from the source of

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capital to avoid your Company inadvertently making an offering of securities. Even before the issuing entity is formed, the regulatory authorities may still consider the distribution of equity or debt before, at, or shortly after the original meeting of incorporators (in the case of a corporate entity being formed) or a meeting of organizers (in the case where an LLC or a Partnership is the entity to be formed) as an offering of securities.

When the regulatory authorities consider the distribution of equity or debt a securities offering (even before the issuing entity actually exists), simple intrastate exemptions from registration of those securities are available. This is the reason why most start-up companies do not necessarily violate securities laws. Some states allow for as little as six (and up to fifteen) entities—consisting of either individual’s organizations or combinations of both that reside in that state—to form the issuing entity and distribute securities to the founders, without the need to register the securities or qualify for the exemptions from registration.

Every state has its own uniform offering exemption(s), and you must comply with each state's stipulations to qualify for claiming those exemptions. However, you cannot rely on the intrastate exemption if one founder is from another state. In this case, the issuing entity must qualify for federal exemptions from registration under Regulation D or the Accredited Investor Exemption 4(a) (5)—if all founders are accredited—to rely on the Accredited Investor Exemption from registration.

The production of securities-offering documents normally takes a great deal of time, cost, and effort. No matter who produces the securities-offering document(s), it will take some time and effort for you and your management team to create an attractive business plan and to accurately respond to questions regarding disclosures and disclaimers included in the securities-offering document(s); however, Financial Architect® enables anyone to produce the required securities-offering documentation for a fraction of the time, cost, and effort otherwise typically involved.

Even when soliciting and selling exclusively to accredited investors, where technically no documentation is required to conduct a securities offering, according to the Accredited Investor Exemption—Section 4(a)(5) of the Securities Act of 1933, as amended—your offering may still be subject to the No General Solicitation rules and provide no protection from the anti-fraud provisions of the Securities Act of 1933 (and amendments thereto), irrespective of the degree of disclosure your documentation contains (or lack thereof).

To maintain the vast majority of equity interest and voting control in your company, you will need to construct a marketable deal structure and add the proper disclosures to create a securities-offering document and then offer it to investors.

**Currently, there are only three ways to legally conduct a securities offering in the United States:**
1. Register the securities on the federal and/or state level or Title IV (JOBS Act of 2012) Regulation A+ (a very expensive procedure).

2. Qualify for an exemption from registration, with the ability to advertise the offering with the use of the general media, e.g., Small Company Offering Registration (“SCOR”), California Corporation Code Section 25102(n). (A fairly expensive procedure.)

3. Claim an exemption from federal and/or state registration, with or without the ability to advertise the offering with the use of the general media, e.g., Title III - Regulation Crowdfunding, or Title II - Regulation D 506(c). (A relatively inexpensive procedure.)

NOTE: Title IV - Regulation A+ (Tier 1 or Tier 2) is highly inappropriate and impractical for most start-up or early stage companies. The initial burden of document production, registration and SEC approval, as well as ongoing filing and reporting is normally cost prohibitive for most start-up or early stage companies, as a general rule. See SEC Final Rules for Regulation A.⁹

Furthermore, there are only three ways to effectively sell securities:

1. Engage SEC-registered broker-dealers to sell your Company’s securities (note: they will not engage start-up or early stage companies).

2. Sell securities privately to your management team’s pre-existing relationships (personal and professional contacts).

3. Sell securities to investors, using public media sources under Title IV Regulation A+ for interstate offerings. Intrastate offerings would include SCOR Offerings or other intrastate registrations that allow for general solicitation (two fairly expensive propositions) or Title III - Regulation Crowdfunding; Title II - Regulation D, Rule 506(c) for accredited investors only; (two inexpensive propositions)

Please remember submitting business plans for substantial amounts of funding to institutions, simply does not work for most start-up, early stage, or later-stage companies (under $10 million in annual revenues). When it does work for the unique few, it often requires sacrificing too much equity ownership and control to make the funding worth it. Nonetheless, the following three basic problem issues arise when it comes to the alternative—raising capital through the solicitation, sale, and issuing of securities:

1. Affordability of the high cost of securities-offering-document production.
2. Deliverability of the securities offering, in compliance with federal and state(s) securities laws, to many investors.
3. Marketability of the proper deal structure to investors so they invest.

We will review the practical applications and processes that solve all three basic problem issues and enable your Company to compete directly with qualified institutions for individual-investor capital through an offering of securities that is affordable and effective. Once you build your Company in the style proposed throughout this book, you will be able to negotiate with any and all sources of capital from a “relative position of strength,” which allows you to dictate the terms of future rounds of financing using a [suggested] series of securities offerings.

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LEGAL PERSPECTIVE - by Russell C. Weigel, III, Esq.: 

What does this have to do with a business or real estate entrepreneur seeking investors? Legally, everything. Unless you are the United States of America and you are offering United States treasury or savings bonds, or you fit into one of ten other federal, special, statutory exemptions, all securities offers must be registered. The first registered offer of an issuer of securities is often referred to as its initial public offering (IPO).

Because there are statutory exemptions for specific offering situations, most investment offerings are conducted as private offerings (also known as private placements) and are not registered. Generally speaking, private offerings are less expensive for companies to undertake because they do not undergo federal government review before being made available to prospective investors. Depending on the nature of the offering and the statutory exemption travelled under by the issuer, state-securities commission- registration may still be required for certain offerings. The primary distinction between a public offering and a private offering is public offerings are offered to the general public without regard for the knowledge level or sophistication of the prospective investors because they are receiving a disclosure document filed with the government. Whereas, until recently, federal law prohibited private (unregistered) offerings from being solicited or advertised because no disclosure document would have been filed or reviewed by the appropriate securities regulator—unless an applicable state statute authorized a local advertising. The failure of an issuer to comply with the exemption requirements always has meant that it conducted an illegal, unregistered offering. People have been jailed for such violations because the solicitation to sell an unregistered, non-exempt, security is punishable as a felony at the state and federal levels.

Small companies face the possibility that their solicitations for investment funds must be registered at both the federal level and in each state: (i) where they propose to offer an investment, and (ii) where the offer originated. The exemptions are tricky; but in certain circumstances and in a few states, it is possible to advertise an investment solicitation if the offer is limited to the residents of a single state, and the solicitation is conducted in compliance with that state’s law. However, state-offering registration may be a requirement before in-state advertising is permissible. (See Chapter 18.)

Here is a typical small-company example:
Mary is the owner of a successful nail-care business. She believes she can expand her business to a couple of new locations but also may be able to acquire one or two of her competitors for the right amount of cash. However, Mary does not have the cash in her business to expand this quickly. Mary has seen some businesses that have advertised in local classifieds for investors. That gives her an idea. She knows many of her customers seem to be wealthy, so she puts a small flier by the cash register that states: “We are growing. Wouldn’t you like to be part of our future? Contact Mary for more information.”

Can she legally seek capital this way? The answer is no, unless she is prepared to file the required government notices, pay required state fees, and verify that her “wealthy” customers are in fact sufficiently wealthy to meet the definition of “accredited investor.” Prior to September 23rd 2013, Mary’s method of seeking capital could have been perceived as a general solicitation or advertising – and therefore illegal -- because anyone walking into her store could see the flyer, not just those persons that already knew her. When Title II of the Jumpstart Our Business Startups Act of 2012 was implemented by the SEC (new Regulation D Rule 506(c) in September 2013, Mary’s method of general solicitation became legal, provided she complies with Rule 506(c)’s investor accreditation proof requirements and accepts only accredited investors. To be compliant with existing law (Regulation D Rule 506(b)), she could communicate with existing customers if she knew them well enough to know whether they were sophisticated about business matters - but not before they are personally known to her. Now that Titles III and IV of the Jumpstart Our Business Startups Act of 2012 are implemented by the SEC, Mary is able to raise capital in the manner she was using the crowdfunding exemption under Title III (regulation crowdfunding), provided that her advertising is limited to directing investors to contact only her investor portal or licensed securities broker dealer that has been engaged to sell her securities. Also, she will be able to raise capital under Title IV (Regulation A+), if she is conducting an offering in her state in compliance with Regulation A+’s requirements, which allow her to publicly offer and sell her securities, provided that her financial statements are annually audited, among other requirements. Hopefully, Mary seeks competent securities counsel before she makes a legal mistake that hurts her and her business. Ultimately, on the part of many people, it seems natural there would be an assumption that if everyone is doing it, it must be legal. Of course, without following the requirements of each registration exemption, general solicitation for investment capital is illegal. And although it’s a numbers game of getting caught by regulators or getting sued by one’s investors, the consequences of getting sued by a government, financial regulator or of having in the public record a private investor’s judgment for fraud against you can be destructive or fatal to one’s business and personal reputation.

All of this is longhand for saying a prudent person should think hard about the risks of something going wrong in their offering, including the risks of bringing strangers into their company. The best time to think about these issues is before accepting their money. Assuming you are willing to move forward, let’s start to plan a capital raise with a view to keeping you and your company out of trouble.
The term, “crowd funding,” has been thrown around a bit too loosely. The original term was properly used for donation-based crowd funding. Then the term was used to define the exemption from registration under **Title II (2)** of the JOBS Act of 2012, more specifically Regulation D - Rule 506(c) and then **Title IV (4)** of the JOBS Act of 2012 more specifically Regulation A+. Regulation D, Rule 506(c), enables one (an issuer) to advertise a securities offering, using the general media, but to accredited investors only—their accreditation verification is mandated. But that’s not a “crowd” as defined under **Title III (3)** of the JOBS Act of 2012. Under **Title III (3)** of the JOBS Act of 2012, crowd funding is officially termed “Regulation Crowdfunding.” This means the originally intended term, “crowd funding,” **in reference to raising capital**, is meant to enable one to raise up to $1,000,000 per year from many investors (accredited or not)—aka “the crowd.” **Title IV (4)** of the JOBS Act of 2012 more specifically Regulation A+ is meant to enable one to raise up to $20,000,000 (Tier 1) or $50,000,000 (Tier 2) per year from many investors (accredited or not)—aka “the crowd.”

**I. Donation-Based Crowdfunding**

Donation-fueled crowd funding really isn’t considered raising capital—certainly not substantial amounts—because that model is weak and fading. In addition, do you realize crowd-funded proceeds are considered revenue and therefore subject to federal and state income tax? That’s right…if you were even remotely lucky enough to raise $500,000 through a crowd-funding donation-based model for your “C” corporation, under the tax code for 2016 and assuming a flat 7.5% state-tax corporate rate with little or no cost of goods sold (the cost of the little thank-you gifts), you can expect to pay 40% or $200,000 to the federal, state and local governments. You’d be left with only $300,000 in working capital—ouch! Even LLCs are subject to this extreme tax treatment. Due to the pass through of average, individual, tax brackets and factoring in FICA & Medicare withholdings (aka self-employment tax matched by the LLC) make the effective tax-rate percentage essentially the same. It is our understanding that some of the crowdfunding portals do send out 1099-MISC tax-reporting forms to recipients of funds from a donation-fueled crowdfunding campaign. They do so to shift that tax liability off their backs and onto yours.

If you’ve been in a professional or business capacity in the US for any length of time, you know by now that the federal and state taxing authorities rarely miss an opportunity to tax, if they can. It’s pure speculation when internet-based-publication authors claim that conducting a corporately structured crowd-funding campaign may dodge taxation issues. Officially, the IRS has not ruled on this issue. The current position is they examine on a case-by-case basis. Therefore, if the internet-based-publication authors are wrong, you may be in violation of federal and state tax laws. If they’re right, it’s because you’ve booked it as a capital contribution on your accounting records, which means you’re most likely in violation of federal and state securities laws, unless of

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course, you have produced and distributed the required securities-offering documents in compliance with federal and state securities laws, rules, and regulations. Remember, there is no tax on the capital raised for your company, through a securities offering, bank loan, venture capital term-sheet, and so forth.

II. Capital-Based, Regulation Crowdfunding

Issuers of Securities

The following includes excerpts from the 685 page document known as the SEC Final Rules regarding crowdfunding with comments from us to clarify, warn, praise, or most importantly make one aware of the practicality of various tactics behind the process to ensure success.

Title III of the JOBS Act (“Title III”) added new Securities Act Section 4(a)(6), 14 which provides an exemption from the registration requirements of Securities Act Section 5 for certain crowdfunding transactions.

Not to get too complicated, there are only a handful of items you and your company, as the issuer of securities, will need to be aware of.

Qualification

Regulation Crowdfunding is the new term used to identify the exemption for registering securities under the Title III regulations. Very much like the Regulation D exemptions, certain companies are not eligible to use the Regulation Crowdfunding exemption. Ineligible companies include non-U.S. companies, companies that already are Exchange Act reporting companies (aka SEC Reporting 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 two years immediately preceding the filing of the offering statement, and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Limitation on Investment Amounts

To qualify for the exemption under Section 4(a)(6), crowdfunding transactions by an issuer (including all entities controlled by or under common control with the issuer) must meet specified requirements, including the following:

- An issuer is permitted to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period;
- Individual investors, over the course of a 12-month period, are permitted to invest in the aggregate across all crowdfunding offerings up to:

(1) the greater of: $2,000 or 5 percent of the lesser of the investor’s annual income or net worth if either annual income or net worth is less than $100,000; or (2) 10 percent of the lesser of the investor’s annual income or net worth, not to exceed an amount sold of $100,000, if both annual income and net worth are $100,000 or more and

- During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed $100,000.

Under this approach, an investor with annual income of $50,000 a year and $105,000 in net worth would be subject to an investment limit of $2,500.

For further clarification see Chart below:

<table>
<thead>
<tr>
<th>Investor Annual Income</th>
<th>Investor Net Worth</th>
<th>Calculation</th>
<th>Investment Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$30,000</td>
<td>$105,000</td>
<td>Greater of $2,000 or 5% of $30,000 ($1,500)</td>
<td>$2,000</td>
</tr>
<tr>
<td>$150,000</td>
<td>$80,000</td>
<td>Greater of $2,000 or 5% of $80,000 ($4,000)</td>
<td>$4,000</td>
</tr>
<tr>
<td>$150,000</td>
<td>$100,000</td>
<td>10% of $100,000 ($10,000)</td>
<td>$10,000</td>
</tr>
<tr>
<td>$200,000</td>
<td>$900,000</td>
<td>10% of $200,000 ($20,000)</td>
<td>$20,000</td>
</tr>
<tr>
<td>$1,200,000</td>
<td>$2,000,000</td>
<td>10% of $1,200,000 ($120,000), subject to $100,000 cap</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

The rules allow an investor’s annual income and net worth to be calculated as those values are calculated for purposes of determining accredited investor status under Regulation D. The rules allow spouses to calculate their net worth or annual income jointly, and when such a joint calculation is used, the aggregate investment of the spouses may not exceed the limit that would apply to an individual investor at that income and net worth level.

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15 See Instruction 1 to paragraph (a)(2) of Rule 100 of Regulation Crowdfunding.
16 17 CFR 230.501. Thus, for example, a natural person’s primary residence shall not be included as an asset in the calculation of net worth. 17 CFR 230.501(a)(5)(i)(A).
17 For example, if each spouse’s annual income is $30,000, the spouses jointly may invest up to an aggregate of 5% of their joint income of $60,000. If one spouse’s annual income is $120,000 and the other’s is $30,000, the spouses jointly may invest up to an aggregate of 10% of their joint income of $150,000, the same investment limit that would apply for an individual investor with income of $150,000. See Instruction 2 to paragraph (a)(2) of Rule 100 of Regulation Crowdfunding.
The rules allow an issuer to rely on efforts that an intermediary is required to undertake in order to determine that the aggregate amount of securities purchased by an investor does not cause the investor to exceed the investment limits, provided that the issuer does not have knowledge that the investor had exceeded, or would exceed, the investment limits as a result of purchasing securities in the issuer’s offering.¹⁸ This is good news as the portal would need to provide some mechanism for investors to calculate and determine the maximum allowable investment, thereby relieving you, the issuer, from such determination and burden of proof.

**Disclosure Requirements**

Securities Act Section 4A(b)(1) sets forth specific disclosures that an issuer offering or selling securities in reliance on Section 4(a)(6) must “file with the SEC and provide to investors and the relevant broker or funding portal, and make available to potential investors.” These disclosures include:

1. the name, legal status, physical address and website address of the issuer;
2. the names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer;
3. a description of the business of the issuer and the anticipated business plan of the issuer;
4. a description of the financial condition of the issuer (for offers of more than $100,000, up to 2-years of past financial statements {balance sheets, statements of comprehensive income, statements of cash flows and statement of changes in stockholders’ equity} produced under U.S. GAAP rules);
5. a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
6. the target offering amount, the deadline to reach the target offering amount and regular updates about the progress of the issuer in meeting the target offering amount [over-subscription amounts and limitations];
7. the price to the public of the securities or the method for determining the price; and
8. a description of the ownership and capital structure of the issuer.

By filing Form C with the SEC and providing it to the relevant intermediary, issuers will satisfy the requirement of Securities Act Section 4A(b) that issuers relying on Section 4(a)(6) must “file with the SEC and provide to investors and the relevant broker of funding portal, and make available to potential investors” certain information. In a clarifying change from the proposal, we have moved the definition of “investor” from proposed Rule 300(c)(4) to Rule 100(d) to clarify that for purposes of all of Regulation Crowdfunding, “investor” includes any investor or any potential investor, as the context requires.

¹⁸ See Instruction 3 to paragraph (a)(2) of Rule 100 of Regulation Crowdfunding.
Surprisingly, the SEC did not adopt an exclusive but held to a non-exclusive list of items that must be contained within the business plan. Although a business plan must be part of the disclosure, the SEC states: We anticipate that issuers engaging in crowdfunding transactions may have businesses at various stages of development in different industries, and therefore, we believe that the rules should provide flexibility for these issuers regarding what information they disclose about their businesses. This flexible approach is consistent with the suggestion of one commenter that the business plan requirements be scaled to match the size of the offering. We [SEC] also are concerned that a non-exclusive list of the types of information an issuer should consider providing would be viewed as a de facto disclosure requirement that all issuers would feel compelled to meet and would, therefore, undermine the intended flexibility of the final rules.

The final rules will amend Regulation S-T to permit an issuer to submit exhibits to Form C in Portable Document Format (“PDF”) as official filings. Form C allows for pdf exhibits to accommodate for charts, graphs, pro forma financial projections, transcripts of video presentations, etc. The beauty in all of this is that you can add attachments to Form C. This is important for actually getting investors to invest. Every investor knows what the downside risk is to his or her investment… 100% loss. However, rarely is an investor supplied with the potential upside return on investment and timing of that return. That’s where U.S. GAAP compliant pro forma financial projections come in.

We commend the SEC for providing this degree or flexibility, as it’s our experience that to effectively sell securities to investors your disclosures should be embedded within a story that excites and motivates investors to invest, but also includes the necessary disclosures for compliance. Form C also provides for an “answer and question” format for filling out Form C. As professional investors, we can tell you that the Q&A format is elementary and smacks of naiveté.

The flexibility of business plan submission may seem like a great way for issuers to keep confidential matters…confidential, however, we caution issuers to not take this course too lightly. It is our opinion that lack of certain disclosures, such as; material breach of contracts (by either party), regulatory proceedings, pending litigation, current litigation or any outstanding court order or judgment affecting the issuer or its property, in the business plan could be a basis for claiming securities fraud, a criminal offense. It’s simply wise, on many levels, to tell the truth and disclose to investors everything you would want to know if you were making the investment in a company you didn’t control.

To avoid serious problems that could arise with the lack of disclosure on Form C for Crowdfunding, we suggest creating a securities-offering document constructed under Regulation D – Rule 506, because it has a comprehensive list of disclosure items (Regulation D – Rule 502) and it is an old body of law. The degree of disclosure required under Regulation D – Rule 502 will help the issuer avoid claims of securities fraud. Once completed, you simply “copy and paste” areas within your securities-offering document under Regulation D – Rule 506 to properly fill out Form C with the SEC for
Crowdfunding. It’s important that you have the exact same disclosures in your Form C as you do in your Regulation D – Rule 506 document to strengthen your defense against any claims against you for securities fraud.

More importantly, creating a securities-offering document Regulation D – Rule 506 will easily allow you to run two concurrent offerings simultaneously thereby increasing the probability of success exponentially. When you create securities-offering documents under Regulation D – Rule 506(b) or (c), or 504, disclosures for Rule 502 are covered.

Shameless Plug

All of the Financial Architect® programs produce securities-offering documents under Regulation D – Rule 506 (which covers Rule 504) for legal counsel review. In addition, the “Use of Proceeds” Statement as required by item 5 above; prices the securities with the method of determination as required by item 7 above. More importantly, Financial Architect® produces a marketable deal-structure based on GAAP-compliant pro forma financial projections with an illustration of Internal Rate of Return (IRR) and a projected timing of that return. When using the Convertible Note deal structure contained in Seed Capital Producer™ or the Convertible Preferred Equity deal structure within Development Capital Producer™ you do not need to worry about properly valuing the company or its common equity, because your securities will be arbitrarily priced at $1,000 per Note or $100 per Preferred Share. By adding these critical elements as attachments to your Form C, you will be able to show prospective investors potential IRRs under various scenarios with a 5-year time period. This accomplishes two critical elements to a successful capital raising effort through a securities offering. This process: 1.) assures that you will not be selling too much of your company too early, for too little; and 2.) sets your securities offering head and shoulders above the crowd (rest of the issuers looking for capital) thereby increasing the probability of getting funded.

Financial Architect® will enable an issuer of securities to run a Crowdfunding effort within a registered crowdfunding portal, as well as a private or public offering outside the portal, thereby maximizing the probability of a successful capital raising campaign. Financial Architect® is available, exclusively, to all Sprocket Network™ Companies.

Intermediaries – Crowdfunding Portals

It’s not for us to educate you on all the crowdfunding portal regulations in detail, but you and your company as an issuer of securities, should be aware what their responsibilities are so you can be sure you’re engaging a crowdfunding portal that is in compliance. The burden of securities offering compliance ultimately falls on the issuer of securities, i.e. your company.
Due to these new changes in securities laws, there are many new opportunities in servicing young companies, in the process of raising capital. Many businesses have taken the route of establishing crowdfunding portals and selling those services to entrepreneurs to capitalize on these changes. The business models that are engaged in establishing crowdfunding portals as a means of attracting investors for their various customers (young companies) may not understand the complexity and compliance issues involving the securities industry...nor the impending litigation risk that comes with the turf. Although there are some fairly simple rules for registered portals to follow, many may act, inadvertently, as un-registered broker dealers, which is a violation of federal and state(s) securities laws. We doubt many broker-dealers will engage and compete in this arena for some time, due to the lack of being able to accurately ascertain risks of the function of “broker.” When companies fail, and start-ups fail a lot, brokers are the only entity left to sue. If a broker dealer chooses to engage in this area they most likely will set up a separate corporation, as a wholly-owned subsidiary, to act as a registered portal. Therefore, the following discussion will focus on registered crowdfunding portals only.

One of the key investor protections of Title III of the JOBS Act is the requirement that Regulation Crowdfunding transactions take place through an SEC-registered intermediary, either a broker-dealer or a funding portal.

Under Regulation Crowdfunding, offerings must be conducted \textit{exclusively} through a platform operated by a registered broker-dealer or a funding portal, which is a new type of SEC registrant.

\textbf{The rules require these intermediaries to:}
\begin{itemize}
  \item Provide investors with educational materials;
  \item Take measures to reduce the risk of fraud;
  \item Make available information about the issuer and the offering;
  \item Provide communication channels to permit discussions about offerings on the platform; and
  \item Facilitate the offer and sale of crowdfunded securities.
\end{itemize}

\textbf{The rules prohibit funding portals from:}
\begin{itemize}
  \item Offering investment advice or making recommendations;
  \item Soliciting purchases, sales or offers to buy securities offered or displayed on its platform;
  \item Compensating promoters and others for solicitations based on the sale of securities; and
  \item Holding, possessing, or handling investor funds or securities.
\end{itemize}

\textbf{Transaction Conducted Through an Intermediary (Broker Dealer or Registered Portal) – Final Rule:}
Section 4(a)(6)(C) requires that a transaction in reliance on Section 4(a)(6) be conducted through a broker or funding portal that complies with the requirements of Securities Act Section 4A(a).

The SEC believes that requiring an issuer to use only one intermediary to conduct an offering or concurrent offerings in reliance on Section 4(a)(6) would help foster the creation of a “crowd” and better accomplish the purpose of the statute. In order for a crowd to effectively share information, the SEC believes it would be most beneficial to have one meeting place for the crowd to obtain and share information, thus avoiding dilution or disbursement of the “crowd.” The SEC also believes that limiting a crowdfunding transaction to a single intermediary’s online platform helps to minimize the risk that issuers and intermediaries would circumvent the requirements of Regulation Crowdfunding.

In essence, an issuer can only use one Crowdfunding portal to solicit and attract investors. This is probably best for both issuers and investors but limits competition among portals and requires an issuer to choose a portal based on claims by the portal. We suggest you use other methods to conduct portal due diligence, such as; researching through third parties, to determine if any or all claims a portal makes are valid. Just because a portal may be owned or operated by a broker-dealer, doesn’t mean the claims are valid.

Securities Act Section 4A(a)(1) requires that a person acting as an intermediary in a crowdfunding transaction register with the Commission as a broker or as a funding portal. Proposed Rule 300(a)(1) of Regulation Crowdfunding would implement this requirement by providing that a person acting as an intermediary in a transaction involving the offer or sale of securities made in reliance on Section 4(a)(6) must be registered with the Commission as a broker under Exchange Act Section 15(b), or as a funding portal pursuant to Section 4A(a)(1) and proposed Rule 400 of Regulation Crowdfunding. Securities Act Section 4A(a)(2) requires an intermediary to register with any applicable self-regulatory organization (“SRO”), as defined in Exchange Act Section 3(a)(26). Act Section 3(h)(1)(B) separately requires, as a condition of the exemption from broker registration, that a funding portal be a member of a national securities association that is registered with the Commission under Exchange Act Section 15A. Proposed Rule 300(a)(2) would implement these provisions by requiring an intermediary in a transaction involving the offer or sale of securities made in reliance on Section 4(a)(6) to be a member of FINRA or any other national securities association registered under Exchange Act Section 15A. Currently, FINRA is the only registered national securities association. Hence, be sure the portal you choose is both registered with the SEC and FINRA.

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19 As the SEC noted in the Proposing Release, facilitating crowd-funded transactions (which involve the offer or sale of securities by an issuer and not secondary market activity) alone would not require an intermediary to register as an exchange or as an alternative trading system (i.e., registration as a broker-dealer subject to Regulation ATS). See Proposing Release at 78 FR 66459 (discussing secondary market activity and exchange or ATS registration).
20 15 U.S.C. 78c(a)(26). Exchange Act Section 3(a)(26) defines an “SRO” to include, among other things, a “registered securities association.” Id.
Being a former director of compliance for a broker-dealer, I am intimately familiar with the NASD / FINRA regulations. For the most part, FINRA establishes and maintains a code of ethical conduct for its members, which isn’t too difficult to understand or follow. If a portal is duly registered and is a member-in-good-standing with FINRA, it can be assumed, but not guaranteed, that the portal is in compliance thereby relieving you and your firm of some of that burden.

Intermediaries are generally prohibited under the rule as adopted from having such a financial interest, as discussed below, in response to comments, the SEC has amended the rule to permit an intermediary to have a financial interest in an issuer that is offering or selling securities in reliance on Section 4(a)(6) through the intermediary’s platform, provided that: (1) the intermediary receives the financial interest from the issuer as compensation for the services provided to, or for the benefit of, the issuer in connection with the offer or sale of such securities being offered or sold in reliance on Section 4(a)(6) through the intermediary’s platform; and (2) the financial interest consists of securities of the same class and having the same terms, conditions and rights as the securities being offered or sold in reliance on Section 4(a)(6) through the intermediary’s platform. Among other things, Rule 302(d) requires an intermediary to clearly disclose the manner in which it will be compensated in connection with offerings and sales of securities made in reliance on Section 4(a)(6) at account opening and Rule 303(f) requires disclosure of remuneration received by an intermediary (including securities received as remuneration) on confirmations. In addition, the intermediary must comply with all other applicable requirements of Regulation Crowdfunding, including the statutory limitations on a funding portal’s activities.

In other words, the Crowdfunding portal cannot invest directly or indirectly in an issuer using its portal, but can be compensated, for its services as a portal directly related to selling the securities, with the same type and price of securities being offered. We doubt many portals will be able to afford the lack of cash flow in their business model by accepting illiquid securities as compensation for services rendered. Think about it if your company was a portal, you’d soon be in a severe cash crunch, because every issuer would

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22 See Sections II.C.4.d and II.C.5.f. See also Rule 302(c) of Regulation Crowdfunding (requiring intermediaries to inform investors, at the time of account opening, that promoters must clearly disclose in all communications on the platform the receipt of compensation and the fact that he or she is engaging in promotional activities on behalf of the issuer).
23 See Exchange Act Section 3(a)(80) (defining “funding portal” and establishing certain limitations on their activities consistent with the statute, such as prohibiting a funding portal from offering investment advice or recommendation; soliciting purchases, sales or offers to buy securities offered or displayed on its website or portal; or holding, managing, possessing, or otherwise handling investor funds or securities). In this regard, compliance with disclosures required by Regulation Crowdfunding generally would not cause a funding portal to provide investment advice or recommendations. Nonetheless, a funding portal should seek to ensure that disclosure of its financial interest(s) in an issuer is not inconsistent with the statutory prohibition on providing investment advice or recommendations. For example, a funding portal must not present its financial interest in an issuer as a recommendation or endorsement of that issuer. See Section II.D.3. We also note that if a funding portal holds, owns or proposes to acquire securities issued by an issuer, or multiple issuers, that individually or in aggregate exceed more than 40% of the value of the funding portal’s total assets (excluding government securities and cash items) on an unconsolidated basis, the funding portal may fall within the definition of investment company under Section 3(a)(1)(C) of the Investment Company Act. We generally would expect, however, that such funding portal would seek to rely on the exclusion from the definition of investment company in Section 3(c)(2) of the Investment Company.
just as soon pay for your services with “paper” (their securities) as opposed to cash, because small companies are often starved for cash… hence the reason for raising capital in the first place.

The reason you need to know this, is because the burden of securities compliance ultimately falls upon you and your company as the issuer of securities, in the absence of a broker-dealer. Broker-dealers may share in that burden but never totally relieve that burden from the issuer. Therefore, if and when using the Regulation-Crowdfunding exemption, you will need to engage only one Crowdfunding Portal and it must be SEC registered and a FINRA Member. Remember, it’s up to you and or your legal counsel to ensure you’re using a portal that is in compliance and more importantly that your disclosures limit the possibility of claims against you for securities fraud—a criminal offense.

Record Keeping - Stock / Securities Record

The recordkeeping functions can be extensive and could include, for example, the ability to (1) monitor the issuance of the securities the issuer offers and sells through the intermediary’s platform, (2) maintain a master security holder list reflecting the owners of those securities, (3) maintain a transfer journal or other such log recording any transfer of ownership, (4) effect the exchange or conversion of any applicable securities, (5) maintain a control book demonstrating the historical registration of those securities, and (6) countersign or legend physical certificates of those securities.

Although the SEC allows the issuer to either choose a third party, such as; a registered transfer agent, to keep the securities transactions records or conduct and record those transactions “in-house,” we believe it wise to hire a transfer agent (if not too costly) as the SEC is providing a safe harbor for compliance with Rule 301(b) for those issuers that use a registered transfer agent. The safe harbor is a nice provision regarding this ongoing compliance issue. Some FINRA Member Crowdfunding Portals may offer this as a valuable service.

Denying Access.

Rule 301(c)(1) requires an intermediary to deny access to its platform if the intermediary has a reasonable basis for believing that an issuer, or any of its officers, directors (or any person occupying a similar status or performing a similar function), or any 20 Percent Beneficial Owner is subject to a disqualification under Rule 503 of Regulation Crowdfunding. The SEC believes that a “reasonable basis” standard for denying access is an appropriate standard for Rule 301(c)(1), in part because this requirement on an intermediary is buttressed by the fact that an issuer independently is subject to the disqualification provisions under Rule 503. In addition, Rule 301(c)(1) implements the requirement of Section 4A(a)(5) that an intermediary conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered by the intermediary, as well as on each of its officers, directors (or any person occupying a similar status or performing a similar function) and 20
percent of beneficial owners. **This is an interesting and potentially disturbing proviso**n. The ongoing burden of qualification is shouldered by the Portal, and we wonder what actions the Portal can take if the issuer simply cannot provide or find it cost prohibitive to produce the type of information required by any given portal and any given time, as the portals have latitude in how the determine that compliance protocol. One may conclude that level of discernment is unchecked regulatory power in the hands of a single portal. It’ll be interesting to see how this plays out over time.

In addition, we’ve been observing that most Registered Crowd-Funding Portals are requiring that issuer candidates have a large, social-media following or they’re denied access to the Portal. Although not part of the preceding provision, it makes good business sense to further assure that capital is raised for these issuing companies and by requiring large, social-media followings, which inherently attracts more potential investors, the Portals are simply protecting their business model. Don’t be surprised if this trend not only continues, but becomes a competitive edge for issuing companies competing with one another for acceptance into a Portal.

**Compensation**

The SEC requires intermediaries to provide information to investors about the manner in which they will be compensated at account opening, rather than at a subsequent time, will provide investors with notice of how the intermediary is being compensated at a threshold stage in the relationship (i.e., account opening), which, in turn, will help investors make better-informed decisions.

The final rules allow intermediaries to receive a financial interest in the issuer as compensation, subject to certain limitations. An intermediary that receives or may receive a financial interest in an issuer in the future as compensation for its services is required to disclose that compensation at account opening. We also note that Rule 201(o), which is discussed in Section II.B.1 and separately requires an issuer to disclose in its offering materials a description of the intermediary’s interests in the issuer’s transaction, including the amount of compensation paid or to be paid to the intermediary for conducting a particular offering, the amount of referral and any other fees associated with the offering.

**Highlighting Offerings**

Getting your offering noticed with hybrid securities. Rule 402(b)(2) allows a funding portal to highlight particular issuers or offerings of securities made in reliance on Section 4(a)(6) on its platform based on objective criteria where the criteria are reasonably designed to highlight a broad selection of issuers offering securities through the funding portal’s platform, are applied consistently to all issuers and offerings and are clearly displayed on the funding portal’s platform. Consistent with the proposal, the final rule specifies in subparagraph (b)(2)(ii) that objective criteria may include, for example: the type of securities being offered (e.g., common stock, preferred stock or debt securities); the geographic location of the issuer; the industry or business segment of the issuer; the number or amount of investment commitments made; the progress in meeting
the target offering amount or, if applicable, the maximum offering amount; and the 
minimum or maximum investment amount. It is important to note that the criteria must 
be reasonably designed to highlight a broad selection of issuers and offerings, so as not to 
suggest or implicitly endorse one issuer or offering over another, and must be applied 
consistently to all potential issuers and offerings.

Proposed Rule 402(b)(3) would permit a funding portal to provide search 
functions or other tools that investors can use to search, sort, or categorize the offerings 
available through the funding portal’s platform according to objective criteria where: (i) 
the objective criteria may include, among other things, the type of securities being 
offered (for example, common stock, preferred stock or debt securities); the geographic 
location of the issuer; the industry or business segment of the issuer; the number or 
amount of investment commitments made, progress in meeting the issuer’s target offering 
amount or, if applicable, the maximum offering amount; and the minimum or maximum 
investment amount; and (ii) the objective criteria may not include, among other things, 
the advisability of investing in the issuer or its offering, or an assessment of any 
characteristic of the issuer, its business plan, its key management or risks associated with 
an investment.

What this essentially means is the portal can delineate each offering into sub-
categories of industry, geography, etc., as well as types of securities making it easier for 
investors to be productive during their search for investments. We believe most portals 
will segregate offerings by industry sector, regions, etc., as well as by security type. We 
believe most offerings will be in the nature of offering small amounts common stock, 
with serious dilution of value for investors.

Think about it. You need a million dollars. You have a start-up that is difficult to 
value because it has no operating history or any meaningful amount of tangible assets, 
which is needed for the basis of pricing the common stock. Your offering would need to 
be structured to either give up a substantial amount (80 to 90%) of common stock (your 
most precious asset) and voting control or give up a minimal amount (10 to 20%) of 
common stock but disclose that investors will experience a 80 to 90% dilution of the net 
value of their investment immediately. If you were an investor and someone wanted your 
million dollars for essentially an idea and you were to immediately lose 80 to 90% of 
your investment through equity dilution would you invest? Without that disclosure, it 
could lead to securities fraud—a criminal offense. So you either give up a too much of 
your company too early for too little, or risk not attracting any investors. Sure there are 
fools who may invest at that level of dilution, but is that who you want as your investors?

A start-up or early stage company’s only reasonable alternative is to offer hybrid 
securities, such as convertible bridge notes or convertible participating preferred equity.

**Disqualifying Issuers**

Under the final disqualification rules, covered persons include the issuer and any 
predecessor of the issuer or affiliated issuer; directors, officers, general partners or
managing members of the issuer; beneficial owners of 20% or more of the issuer’s outstanding voting equity securities (which we believe should be calculated based on the present right to vote for the election of directors, irrespective of the existence of control or significant influence); any promoter connected with the issuer in any capacity at the time of such sale; compensated solicitors of investors; and general partners, directors, officers or managing members of any such solicitor.

**The disqualifying events include:**
- Felony and misdemeanor convictions within the last five years in the case of issuers, their predecessors and affiliated issuers, and 10 years in the case of other covered persons in connection with the purchase or sale of a security, involving the making of a false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, funding portal or paid solicitor of purchasers of securities;
- Injunctions and court orders within the last five years against engaging in or continuing conduct or practices in connection with the purchase or sale of securities; involving the making of any false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, funding portal or paid solicitor of purchasers of securities;
- Certain final orders and bars of certain state and other federal regulators;
- Commission cease-and-desist orders relating to violations of scienter-based anti-fraud provisions of the federal securities laws or Section 5 of the Securities Act;
- Filing, or being named as an underwriter in, a registration statement or Regulation A offering statement that is the subject of a proceeding to determine whether a stop order or suspension should be issued, or as to which a stop order or suspension was issued within the last five years;
- United States Postal Service false representation orders within the last five years; and
- for covered persons other than the issuer, being subject to a Commission order:
  - revoking or suspending their registration as a broker, dealer, municipal securities dealer,
  - investment adviser or funding portal;
  - placing limitations on their activities as such;
  - barring them from association with any entity; or
  - barring them from participating in an offering of penny stock; or being suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or national securities association for conduct inconsistent with just and equitable principles of trade.

**Current Crowdfunding Practices**

A recent crowdfunding industry report\(^2\) defines the current crowdfunding activity in the United States generally as “lending-based,” “reward-based,” “donation-based,” “royalty-based,” “equity-based,” and “hybrid.”

\(^2\) See Massolution 2015.
The industry report indicates that, in 2014, crowdfunding platforms raised approximately $16.2 billion globally, which represented a 167% increase over the amount raised in 2013. These amounts include various types of crowdfunding: lending-based crowdfunding accounted for the largest share of volume (approximately $11.08 billion) followed by equity-based crowdfunding (approximately $1.11 billion), reward-based crowdfunding (approximately $1.33 billion), donation-based crowdfunding (approximately $1.94 billion), royalty-based crowdfunding (approximately $273 million), and hybrid crowdfunding (approximately $487 million).

These statistics back-up our own experience. We continue to believe the lending based, coupled with a hybrid based, e.g. convertible notes is, by far, the most effective deal structure to raise substantial amounts of seed capital. Equity coupled with a hybrid based deal structure, e.g. convertible preferred equity, is a close second to the lending based model and the most effective deal structure to raise substantial amounts of seed and development capital.

It is unclear what types of investors will participate in offerings made in reliance on Section 4(a)(6), but given the investment limitations in the final rules, we [the SEC] believe that many investors affected by the final rules will likely be individual retail investors who currently do not have broad access to investment opportunities in early-stage ventures. Offerings made in reliance on Section 4(a)(6) may provide retail investors with additional investment opportunities, although the extent to which they invest in such offerings will likely depend on their view of the potential return on investment as well as the risk for fraud.

In contrast, larger, more sophisticated or well-funded investors may be less likely to invest in offerings made in reliance on Section 4(a)(6). The relatively low investment limits set by the statute for crowdfunding investors may make these offerings less attractive for professional investors, including VCs and angel investors. While an offering made in reliance on Section 4(a)(6) can bring an issuer to the attention of these investors, it is possible that professional investors will prefer, instead, to invest in offerings in reliance on Rule 506, which are not subject to the investment limitations applicable to offerings made in reliance on Section 4(a)(6).

The industry report further indicates that, in 2014 the worldwide average size of a funded campaign was less than $4,000 for consumer lending-based, reward-based, and donation-based crowdfunding types. Crowdfunded business loans and equity-based campaigns, however, were substantially higher. In 2014, the global average size of a funded peer-to-business lending-based crowdfunding campaign was $103,618. In 2014, a typical equity-based campaign was larger, with the global average size of $275,461. These figures suggest that the types of ventures financed through equity-based crowdfunding could be different than those financed through other crowdfunding


26 An observer suggests that, unlike angels, VCs may be less interested in crowdfunding because, if VCs rely on crowdfunding sites for their deal flow, it would be difficult to justify charging a 2% management fee and 20% carried interest to their limited partners. See Ryan Caldbeck, Crowdfunding – Why Angels, Venture Capitalists And Private Equity Investors All May Benefit, FORBES, Aug. 7, 2013.
methods. In 2014, the average size of a funded equity-based campaign in North America was $175,000. These amounts are anemic at best.

Non-Integration with Concurrent Offerings

Offerings made in reliance on Section 4(a)(6) will not be integrated\(^\text{27}\) with other exempt offerings made by the issuer, provided that each offering complies with the requirements of the applicable exemption that is being relied upon for the particular offering. **This is excellent news** in that one can immediately move to another offering exempt from registration within the 12-month period, such as; Regulation D - Rules 504, 506(b) or 506(c) or Securities Act Section 4(a)(5) - the Accredited Investor Exemption - and continue the capital raise under the same deal structure. Technically, one could conduct *concurrent* offerings with the same deal structure under various exemptions and stay in compliance. From a practical standpoint, this would make a lot of sense in that one would not be reliant on only one method of solicitation (Regulation Crowdfunding) with only one portal. An issuer could “double down” by soliciting inside as well as outside the portal under various other exemptions from registration, such as; Regulation D, SCOR or Regulation A. This would require legal review and oversight but should prove cost-effective given the increased probability of a successful capital raising effort.

Under Section 4(a)(6), the amount of securities sold in reliance on Section 4(a)(6) by entities controlled by or under common control with the issuer must be aggregated with the amount to be sold by the issuer in the current offering to determine the aggregate amount sold in reliance on Section 4(a)(6) during the preceding 12-month period. Under the proposed rules, for purposes of determining whether an entity is “controlled by or under common control with” the issuer, an issuer would be required to consider whether it has “control” based on the definition in Securities Act Rule 405. \(^\text{19}\) As proposed, the amount of securities sold in reliance on Section 4(a)(6) also would include securities sold by any predecessor of the issuer in reliance on Section 4(a)(6) during the preceding 12-month period.

We [the SEC] provide guidance that an offering made in reliance on Section 4(a)(6) is not required to be integrated with another exempt offering made by the issuer to the extent that each offering complies with the requirements of the applicable exemption that is being relied upon for that particular offering. As mentioned earlier, an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Section 4(a)(6). Alternatively, an issuer conducting a concurrent exempt offering for which general solicitation is permitted, for example, under Rule 506(c), cannot include in any such general solicitation an advertisement of the terms of an offering made in reliance on Section 4(a)(6), unless that advertisement otherwise complies with Section 4(a)(6) and the final rules.

\(^\text{27}\) The integration doctrine seeks to prevent an issuer from improperly avoiding registration by artificially dividing a single offering into multiple offerings such that Securities Act exemptions would apply to multiple offerings that would not be available for the combined offering. See, e.g., Final Rule: Nonpublic Offering Exemption, Release No. 33-4552 (Nov. 6, 1962).
In our opinion, the non-integration with other exemptions provision is the most important position the SEC has taken on crowdfunding. The reasoning is the SEC takes notice that crowdfunding, due to its limitation on the size any particular investor can make, will dissuade professional and true angel investors from participating in a crowdfunding campaign. The ability to continue (simultaneously) the capital raising effort through another exemption outside Regulated Crowdfunding may prove invaluable to young companies seeking seed or development capital.

Advertising the Offering

The statute and the final rules prohibit an issuer from advertising the terms of the offering, except for notices that direct investors to an intermediary’s platform. The terms of the offering include the amount offered, the nature of the securities, price of the securities and length of the offering period. The final rules allow an issuer to publish a notice about the terms of the offering made in reliance on Section 4(a)(6), subject to certain limitations on the content of the notice. The notices are similar to the “tombstone ads” permitted under Securities Act Rule 134, except that the final rules require the notices to direct investors to the intermediary’s platform, through which the offering made in reliance on Section 4(a)(6) is being conducted.

Under the final rules, an advertising notice that includes the terms of the offering can include no more than: (1) a statement that the issuer is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the investor to the intermediary’s platform; (2) the terms of the offering; and (3) factual information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and website of the issuer, the e-mail address of a representative of the issuer and a brief description of the business of the issuer. Consistent with the proposal, the final rules define “terms of the offering” to include: (1) the amount of securities offered; (2) the nature of the securities; (3) the price of the securities; and (4) the closing date of the offering period. The permitted notices will be similar to “tombstone ads” under Securities Act Rule 134, except that the notices will be required to direct an investor to the intermediary’s platform through which the offering is being conducted, such as through a link directing the investor to the platform. The final rules do not impose limitations on how the issuer distributes the notices. For example, an issuer could place notices in newspapers or post notices on social media sites or the issuer’s own website. We believe the final rules will allow issuers to leverage social media to attract investors, while at the same time protecting investors by limiting the ability of issuers to advertise the terms of the offering without directing them to the required disclosure.

In our opinion, this provision has sufficient latitude and is an efficient use of costs. As in other exemptions, a tombstone advertisement, done correctly, will motivate a

28 See Instruction to Rule 204 of Regulation Crowdfunding.
29 See Rule 204(b) of Regulation Crowdfunding. See also Section II.B.4.
31 See Instruction to Rule 204 of Regulation Crowdfunding.
prospective investor to investigate further by going to your company’s offering page on
the portal.

**Oversubscription and Offering Price**

The final rules permit an issuer to accept investments in excess of the target
offering amount, subject to the $1 million limitation, but require the issuer to disclose the
maximum amount the issuer will accept and how shares in oversubscribed offerings will
be allocated. We [the SEC] continue to believe that permitting oversubscriptions will
provide flexibility to issuers so that they can raise the amount of capital they deem
necessary to finance their businesses. Given the uncertainty on the part of the issuer about
potential market demand for the issuer’s securities, we believe it is valuable for issuers to
have the option to permit oversubscriptions. For example, permitting oversubscriptions
will allow an issuer to raise more funds, while lowering compliance costs as a proportion
of the amount raised, if the issuer discovers during the offering process that there is
greater investor interest in the offering than initially anticipated or if the cost of capital is
lower than initially anticipated.

This is another pleasantly surprising form of leniency on the part of the SEC. We
encourage all our customers to go for the maximum $1,000,000 allowable amount under
Regulation Crowdfunding, but design a greater amount in your deal structure, then
simply provide for disclosure on Form C that you can go for more. It was called a “green-
shoe” option back in the day on Wall Street. We have yet to meet an entrepreneur that
could use less capital than originally planned for.

**Restrictions on Resales**

The statute and the final rules include restrictions on the transfer of securities for
one year, subject to limited exceptions (e.g., for transfers to the issuer of the securities, in
a registered offering, to an accredited investor or to certain family members). Under the
statute and the final rules, the securities will be freely tradable after one year. This too is
more lenient than most other exemptions from registration, opening the door to an exit
strategy for investors. This may also enable an issuer to liquidate previous investor
holdings during subsequent private offerings, with full disclosure, thereby enabling one
to “clean-up” the investor base. Sometimes an issuer can have “problem” investors and
this is a good way to get them out of your hair without costly registration of securities.

**Relationship with State Law**

Section 305 of the JOBS Act amended Securities Act Section 18(b)(4) to
preempt the ability of states to regulate certain aspects of crowdfunding conducted
pursuant to Section 4(a)(6). The requirement in the final rules that issuers file information
on EDGAR also helps to ensure that information about issuers is available to individual
state regulators, which retain the authority to bring enforcement actions for fraud.

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33 See Section 4A(c). See also Rule 501(a) of Regulation Crowdfunding.
This is another lenient provision provided by the title of the JOBS Act of 2012 itself. It was always intended that the Act be national and hence only federal regulators, barring fraud, have jurisdiction on regulation and enforcement.

**Exemption from Section 12(g) - Becoming an SEC Reporting Co.**

Rule 12g-6 provides that securities issued pursuant to an offering made under Section 4(a)(6) are exempted from the record holder count under Section 12(g) provided the issuer is current in its ongoing annual reports required pursuant to Rule 202 of Regulation Crowdfunding, has total assets as of the end of its last fiscal year not in excess of $25 million, and has engaged the services of a transfer agent registered with the Commission pursuant to Section 17A of the Exchange Act. An issuer that exceeds the $25 million total asset threshold in addition to exceeding the thresholds in Section 12(g) will be granted a two-year transition period before it is required to register its class of securities pursuant to Section 12(g), provided it timely files all its ongoing reports due pursuant to Rule 202 of Regulation Crowdfunding during such period. Section 12(g) registration will be required only if, on the last day of the fiscal year in which the company exceeded the $25 million total asset threshold, the company has total assets of more than $10 million and the class of equity securities is held by more than 2,000 persons or 500 persons who are not accredited investors.\(^{35}\) In such circumstances, an issuer that exceeds the thresholds in Section 12(g) and has total assets of $25 million or more is required to begin reporting under the Exchange Act the fiscal year immediately following the end of the two-year transition period. An issuer entering Exchange Act reporting will be considered an “emerging growth company” to the extent the issuer otherwise qualifies for such status.

The conditional 12(g) exemption will defer the more extensive Exchange Act reporting requirements until the issuer either sells securities in a registered transaction or registers a class of securities under the Exchange Act. Consequently, smaller issuers will not be required to become an Exchange Act reporting company as a result of a Section 4(a)(6) offering.

Therefore, before Title III, if your small company had over 2,000 investors you became an SEC Reporting company whether your company’s securities were publicly traded or not. This is still the case, but the amount investors you obtain during a crowdfunding campaign will not be counted toward that 2,000 number. We applaud this thoughtful and lenient policy of the SEC.

In conclusion, done correctly, Regulation Crowdfunding conducted under Title II of the JOBS Act of 2012, in conjunction and offered concurrently with other exemptions from registration, such as; Regulation D 506(c), with a marketable deal structure will enable serious entrepreneurs to raise substantial amounts of capital like never before. Unlike the previous eight decades prior to May 16\(^{th}\) 2016, it’s now relatively easy to raise capital the right way—in compliance with federal and state securities and tax laws, rules, and regulations.

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\(^{35}\) 15 U.S.C. 78l(g).
The balance of this book focuses on how the world of capital works; creating a marketable deal structure that attracts investors; exemptions from registration to enable concurrent offerings with Regulation Crowdfunding (and regulatory compliance) to increase the probability of raising substantial amounts of capital to the highest degree possible without giving up too much of your company too early for too little.

The Expert Edition of “The Secrets of Wall Street- Raising Capital for Start-Up and Early Stage Companies” is included with every Financial Architect® Program. The following is a continuation of the Table of Contents included in the Expert Edition.

Chapter 3: Capitalizing On the Winds of Change
Chapter 4: The Perfect Storm: Are you Ready?
Chapter 5: Rules of the Game: The Power-Play
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Capital for Keeps: Limit Litigation While Raising Capital, By Russell C. Weigel, III.
2013-2014. His law firm does business as InvestmentAttorneys.com
About the Authors:

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Mr. Hogan has been in the Investment Banking and Securities Industry, since May 5th, 1985. His securities industry training started with a few large securities brokerage and investment banking firms, such as; Merrill Lynch, E. F. Hutton and Shearson Lehman Brothers, now known as, Salomon/Smith Barney a Member of Citigroup. He’s held Six (6) NASD/FINRA securities licenses and registrations primarily of “Principal” status. Mr. Hogan is a former Director of Compliance and Senior Trading Principal for North American Financial Group, Inc. a SEC Registered Investment Bank and Securities Broker. Chairman of the Investment Policy Committee for North American Capital Advisors, Inc. a SEC Registered Investment Advisory firm.

Mr. Hogan has been a Founding Principal of seven entrepreneurial endeavors, including an eighteen-hole championship golf course and real estate development, a software-development firm and other Internet related businesses, as well as, an investment-banking company. He has held board and executive committee seats on various firms. Mr. Hogan holds a double major (Marketing & Finance) Bachelors of Business Administration from Grand Valley State University’s Seidman College of Business.

**Russell C. Weigel III, Esq.**
Mr. Weigel is a securities lawyer that started his legal career in 1989. Between 1989 and 1990, Mr. Weigel served the state of Florida as a criminal prosecutor. Between 1990 and 2001, Mr. Weigel worked for the Securities and Exchange Commission as an enforcement attorney. He supervised and conducted numerous investigations and litigated many civil injunctive and administrative proceedings nationwide. Most of his cases involved allegations of fraud, sales of unregistered non-exempt securities or regulatory compliance violations. Mr. Weigel also supervised investigations and litigated cases involving securities issuers’ Ponzi schemes and false financial reporting. The targets of Mr. Weigel’s cases typically were stock promoters, public companies, broker dealers, investment advisers, and stock transfer agents.

Mr. Weigel currently has a private practice, specializing in securities law. He handles both securities transactional and securities litigation matters. His focus includes advising public and private company clients on capital raising transactions and mergers, preparing their SEC reports and registration statement filings, regulatory compliance matters for securities-industry participants, and defending clients involved in arbitrations and FINRA, SEC, and state securities enforcement matters. Mr. Weigel is an AV-rated securities attorney.

Mr. Weigel joined Commonwealth Capital Advisors as a Managing Director and Chief Legal Counsel in April of 2014. He joined Commonwealth Capital in the same capacity.

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