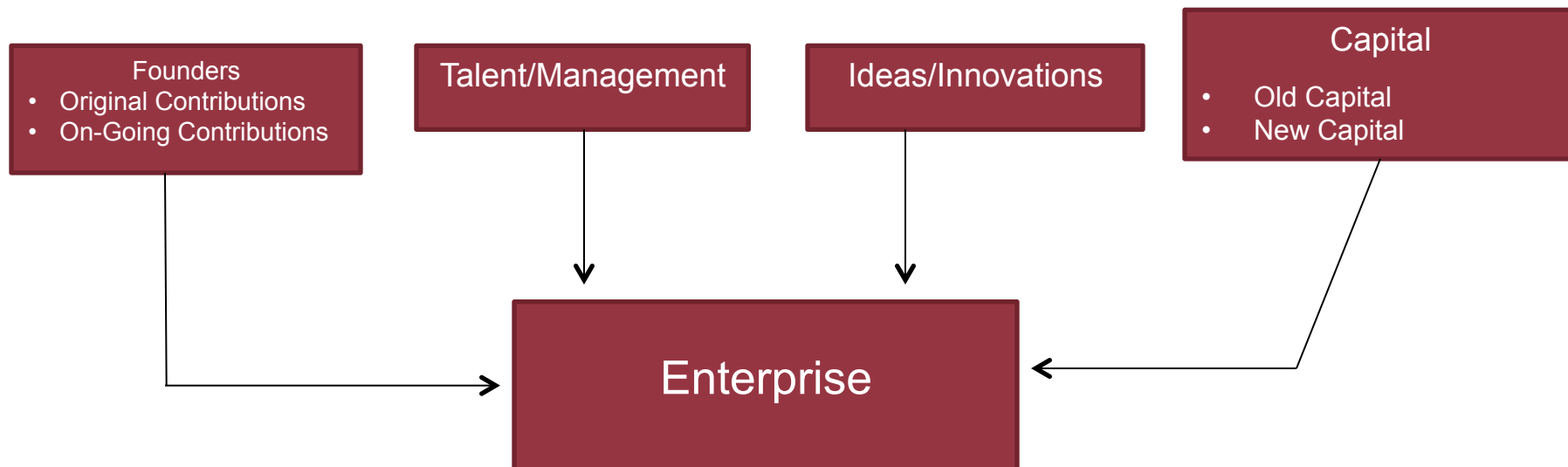


Agenda

- Introduction
- The Challenges
- Applicable Laws (Including the JOBS Act)
- The Security
- Commonly Discussed Terms
- Top 10 (or so) Pitfalls
- Questions and Answers (But Don't Wait)

The Challenge – Balance Competing Interests



Consider Alternative Sources of Capital

- Customers
- Bootstrap
- License Fees
- Public financing/grants
- Debt
- Crowdfunding

Funding Cycle

- Incubators (e.g., Project Olympus, Idea Foundry, Alpha Lab, Thrill Mill)
- Public or quasi-public funds (e.g., Innovation Works, Pittsburgh Life Sciences Greenhouse)
- **Friends and Family**
- Angels
 - **Early Stage**
 - Later Stage
- Venture Capital/Strategic Investors
 - **Early Stage**
 - Later Stage
- Public Markets

Securities Act of 1933

- Broad definition of Securities:
“Any note, stock, bond, debenture, evidence of indebtedness... investment contract...”
- Excludes short term note (typically less than 9 months)
- Securities Act – Registration

In general: Registration is required with the Securities and Exchange Commission for the sale of securities (e.g., an S-1)

- Registration is expensive and time-consuming
- **Objective: Avoid registration**

Exemptions from Registration

- Section 3(b) – Small Offering
- Section 4(a)(2) – Private Offering
- Effect of Exemption
 - Exemption from Registration Process
 - **No Exemption** from:
 - Notice Filing
 - Fraud provisions of the Securities Act

Safe Harbor: Regulation D

Rule 506(b) (under Section 4(a)(2)):

- Unlimited number of Accredited Investors
- Up to 35 Persons who are not Accredited Investors

For Unaccredited Investors, detailed information must be provided

- “Reasonable belief” regarding Accredited Investors

Rule 504 (under Section 3(b)):

- The aggregate offering price can not exceed \$1,000,000
- Unlimited Investors

Accredited Investors

- Natural person who, together with spouse, has a net worth of more than \$1,000,000 (excluding residence); or
- Natural person with individual income of at least \$200,000 (or joint income with spouse of \$300,000) in each of the two most recent years and has a reasonable expectation of the same income in the current year; or
- Corporation or partnership not formed for the specific purpose of investing with assets in excess of \$5,000,000; or
- Any director, executive officer or general partner of the issuer

Accredited Investors (cont.)

- Definition likely to change
- SEC required to review accredited investor status every 4 years
- With inflation
 - Income: \$500,000/\$740,000
 - Net Worth: \$2.5 Million
- Balancing competing interests (chilling v. protection)

Common Requirements for Exemption:

- No general solicitation or general advertising (advertisement, article or media broadcast (hint: no website ads)) [other than New Rule 506(c)]
- Reasonable belief that the purchaser is purchasing for purposes of investment and not resale (hint: get a representation)
- File a Form D (no later than 15 days after the first sale)

Jumpstart On Business Startups Act (JOBS Act)

- Enacted on April 5, 2012
- Rule 506 Regulations – July, 2013
- Intent: Minimize Regulations of Private Offering of Securities

New Rule 506(c)

- Eliminates prohibition on General Solicitation
- 2 Key requirements
 - Purchasers must all be Accredited Investors
 - Issuers must take “reasonable steps” to verify accredited investor status
- Issuers must choose between Rule 506(b) and Rule 506(c)

New Rule 506(c) – Verification Obligations

- Factors:
 - Nature of Purchaser (e.g., individual or institution)
 - Amount and type of information that the issuer has about the investor
 - The terms of the offering (particularly a minimum investment)
- Check the box is insufficient
 - Burden is on issuers

New Rule 506(c) – Non-Exclusive and Non-Mandatory Methods of Verification

- Income Basis
 - IRS Forms for two most recent years
 - Written representation from investor for current year
- Net Worth Test
 - Assets – Bank statement, brokerage statement, statements of securities holding
 - Liabilities – Consumer report from at least 1 national consumer reporting agency

506(c) – Non-Exclusive and Non-Mandatory Methods of Verification (cont.)

- Third Party
 - Written confirmation from professional that the professional has taken reasonable steps to verify that the investor is an accredited investor within the prior 3 months
 - Registered broker-dealer
 - Registered investment advisor
 - Attorney
 - CPA

Blue Sky Laws (State Requirements)

- State-by-state regulation
- National Securities Markets Improvements Act of 1996
 - Preempts state regulation
 - 4(a)(2) exemption – Rule 506
 - Not Rule 504
 - Still requires notice and filing fees (concession to states)
- Check states – Example: NY

Bottom Line

- Rely on 506(b) or 506(c) and limit to Accredited Investors; or
- Rely on 504 (under \$1,000,000) and find state exemption
- Decide between 506(b) and 506(c) early
- Don't advertise until decision is made
- Note: Potential impact of future change in definition of Accredited Investor

Disclosure

- Requirements
- Private Placement Memorandum
 - Protection for “fraud” claims under Securities Act
 - Material misrepresentation
 - Omit to state a material fact necessary to make the statements made not misleading
 - Professionalism

Key Elements of Private Placement Memorandum (or short form)

- Description of Issuer
- Business plan
- **Risk factors**
- Subscription procedures
- **Conflicts of interest**
- Financial statements
- Capitalization
- Exhibits (e.g., organizational documents)
- In general – “Material” information

Reason for Compliance

- Purchaser remedies – rescission
- Future potential investors/purchaser
- Insurance Policy

Crowdfunding (e.g., Kickstarter)

- Origins
- Sidesteps securities laws – not a sale of a “Security”
- Example – Prevail Travail – Interactive Restaurant (raised \$75,000)
 - Rewards
 - Fast Pass
 - Cooking class
 - Tickets for dinner
 - Tickets to opening party
 - Sexy Chef Calendar

Other Examples

- Dobot Arm: High precision robot arm for residential use (e.g., soldering)
- \$339
- Basic version robot arm with clipper, sucker, laser head
- \$233,288 of \$36,000 goal



Other Examples (cont.)

- Schell Games: Puzzle Clubhouse – Crowd – designed games
 - \$1 – Founder clubhouse profile + desktop background
 - \$25 – 1 year membership
- \$11,403

Other Examples (cont.)

- Walter's Coffee Roastery – Breaking Bad inspired coffee lab opening in Brooklyn – combining science and coffee:
 - \$10 – Sample bag, postcard, stickers
 - \$20 – Plus Mug
 - \$30 – Tote Bag
- \$7,855 of \$65,000 (21 days to go)

Crowdfunding – Exemption 4(a)(6)

- A new exemption
- Regulations promulgated on October 30, 2015
- Effective Date: May 16, 2016
- Sale through registered intermediaries (brokers, portals)
- Limit on amount: \$1,000,000 during any 12 month period

Crowdfunding – Exemption 4(a)(6) (cont.)

Financial Position of Investor	Aggregate limits on all Crowdfunding Investments by Investor
Annual Income of net worth < \$100,000	Greater of: <ul style="list-style-type: none">• \$2,000 or• 5% of the lesser of the Investor's annual income or net worth
Annual Income and net worth > \$100,000	<ul style="list-style-type: none">• Lesser of:<ul style="list-style-type: none">• 10% of the investor's annual income• 10% of the Investor's net worth• \$100,000

Crowdfunding Exemption (cont.)

- Intermediary must be registered
 - Broker
 - Funding Portal
- Each Intermediary (funding portal) must:
 - Register with SEC
 - Ensure that each investor:
 - Confirms that it understands the risk
 - Answers questions confirming that it understands the risk
 - Takes measures to reduce risk of fraud
 - One Intermediary per Offering
 - Two Portals in line for registration

Crowdfunding Exemption (cont.)

- Disclosure
 - SEC
 - Investor
- Form C
 - Information on Issuer
 - Description of business
 - Number of employees
 - Risk factors, indebtedness and results
 - Related party transactions
 - Location of website
 - Information about the Offering
- Required To Update
 - Offering
 - Business

Crowdfunding Exemption (cont.)

Aggregate Amount of Securities Offered and Sold in Reliance on Section 4(a)(6) in the Preceding 12-Month Period	Financial Statement Requirements
< \$100,000	<p>If no reviewed or audited financial statements are available:</p> <ul style="list-style-type: none"> • Taxable income and total tax reflected on the issuer's federal income tax returns, <u>certified</u> by the principal executive officer • Financial statements <u>certified</u> by the principal executive officer
> \$100,000 but < \$500,000	<p>If no audited financial statements are available:</p> <ul style="list-style-type: none"> • <u>Reviewed</u> financial statements
> \$500,000	<p>If the issuer has previously sold securities in reliance on Section 4(a)(6):</p> <ul style="list-style-type: none"> • <u>Audited</u> financial statements <p>If the issuer has not previously sold securities in reliance on Section 4(a)(6) and no audited financial statements are available:</p> <ul style="list-style-type: none"> • <u>Reviewed</u> financial statements

Crowdfunding Exemption (cont.)

- Summary
 - Step in right direction
 - Preempts state laws
 - Almost in effect (May 16, 2016)
 - Public disclosure and financial statement requirements may be burdensome
 - The relationships with the Intermediaries are still to be determined and may be an issue

Type of Security

Secured Debt

Unsecured Debt

Convertible Debt

Preferred Equity

Common Equity

Debt

- Benefits
 - Simple
 - Non-dilutive
 - No valuation
- Downside
 - Must be paid
 - Interest
 - Balance sheet implications

Debt from Investor Perspective

- Preference in payment
- Potentially secured
- Fixed date for return of investment
- No upside
- Interest taxable as ordinary income

Collateral

- Personal Guarantees
- Security Interest
 - Pledged Assets
 - Remedies

Common Equity

- Benefits
 - Simple
 - Less expensive
 - Aligns interests
- Downside
 - Requires valuation
 - Likely lower price

Common Equity – Investor Perspective

- Simple – Aligns interest
- Investor gets “Upside”
- No preference
- Highest risk capital
- No typical preferred protections
 - Price protection
 - Dividends
 - Approvals

Factors In Valuation

- Availability of capital
- Amount of raise and dilution
- Type of investors
- Anticipated growth from investment
- Future plans for financing

Valuation

- Hard to value at this point
- Alpha Lab - \$25,000 for 5% common (\$500,000 post-money valuation)
- Alpha Gear - \$50,000 + incubator for 9% common (\$500,000 pre-money)
- Thrill Mill - 5% for incubator
- Cautious of giving up greater than 10% of the Company for an angel round (so, if you are raising \$100,000, post-money of \$1M)

(Light) Preferred

- Description
 - Liquidation Preference
 - Dividend (not your Disney-type dividend)
 - Fewer control features than typical preferred
- Benefits
 - Attracts investors
- Downside
 - Complexity
 - Separate class of stock (hidden rights)
 - Potential impact on future investors
 - Valuation
 - May not align interests

Liquidation Preferences – Downside Protection for Investors

- Definition of Liquidation
- **Participating Preferred:** Investor receives investment (plus accrued dividends) and participates on a pro rata basis
- **Non-Participating Preferred:** Investor receives the greater of (1) investment plus accrued dividends or (2) proceeds on a pro rata basis

Examples of Preferences

\$2M Investment

\$3M Pre-Money Valuation

Founders/Employees	60%		
Venture Capital		40%	

Participating

	<u>\$2M</u>	<u>\$5M</u>	<u>\$10M</u>
Founders/Employees	\$0M	\$1.8M	\$ 4.8
Venture Capital	\$2M	\$3.2M	\$ 5.2

Non-Participating

	<u>\$2M</u>	<u>\$5M</u>	<u>\$10M</u>
Founders/Employees	\$0M	\$3.0M	\$ 6.0
Venture Capital	\$2.0M	\$2.0M	\$ 4.0

Convertible Debt

- Description
 - Convertible to equity upon trigger events
 - Sometimes convertible into new security
 - Sometimes convertible into common stock
 - Mandatory vs. voluntary conversion
 - Discount to investment price (e.g., 20%)
 - Fancy conversion terms (avoid)
 - Base price in case of no additional investment
 - Cap on valuation/minimum valuation

Convertible Debt (cont.)

- Benefits
 - Common
 - Avoids the “valuation issue” (sort of...)
- Downside
 - Conversion price unknown (Risk of low valuation)
 - Usually accrues interest (can be additional dilution)
 - Debt holders can have interests that are not aligned with common

Example 1 (Priced Round) Initial

	<u>Shares</u>	<u>Percentage Ownership</u>
Founder	1,000,000	100%

Example 1 Employee Equity

	<u>Shares</u>	<u>Percentage</u>
Founder	1,000,000	85%
Employees	<u>176,471</u>	<u>15%</u>
Total	1,176,471	100%

Example 1 Friends and Family Round (Priced Round)

- \$250,000 Friends and Family
- \$1,000,000 Pre-Money Valuation

Founder	1,000,000	68%
Employees	176,471	12%
F&F (\$.85 per share)	<u>294,118</u>	<u>20%</u>
Total	1,470,589	100%

Example 1 Series A Round

- \$2M Investment
- \$3M Pre-Money Valuation

Founder	1,000,000	41%
Employees	176,471	7%
F&F	294,118	12%
VC (\$2.04 per share)	<u>979,608</u>	<u>40%</u>
Total	2,450,197	100%

Note: VC will want employees' amount increased
Note Control

Example 2 Initial

	<u>Shares</u>	<u>Percentage</u>
Founder	1,000,000	85%
Employees	<u>176,401</u>	<u>15%</u>
Total	1,176,471	100%

Example 2 (Convertible Debt)

- \$250,000 Friends and Family; convertible debt-20% discount
- Series A – \$2M investment at \$3M pre-money valuation

Founder	1,000,000	46%
Employees	176,401	8%
F&F (\$1.82 per share)	136,791	6%
Series A (\$2.28 per share)	<u>875,461</u>	<u>40%</u>
Total	2,188,653	100%

Comparison of Priced Round v. Convertible Debt

	Example 1 <u>(Priced Round)</u>	Example 2 <u>(Convertible Debt)</u>
Founder	41%	46%
Employees	7%	8%
F&F	12%	6%
Series A	<u>40%</u>	<u>40%</u>
Total	100%	100%

Example 3

Too Much Convertible Debt

- \$1,000,000 Friends and Family; convertible debt (20% discount)
- Series A – \$2M investment at \$3M pre-money valuation

Founder	1,000,000	30%
Employees	176,401	5%
F&F	840,286	25%
Series A	<u>1,344,458</u>	<u>40%</u>
Total	3,361,145	100%

Comparison

	Example 1 (\$250,000 Priced Round)	Example 2 (\$250,000 Convertible Debt)	Example 3 (\$1M Convertible Debt)
Founder	41%	46%	30%
Employees	7%	8%	5%
F&F	12%	6%	25%
Series A	<u>40%</u>	<u>40%</u>	<u>40%</u>
Total	100%	100%	100%

Control Issues

- Three Layers of “Influence”
- Approval Rights (Board or investor)
 - Day-to-day
 - Fundamental transactions (sale of the company)
 - Future financings
 - Employee equity
- Board Representation
 - Board seat
 - Board control
 - Observer

Commonly Discussed Terms

- Anti-Dilution Protection
- Information Rights
- Shareholder Arrangements
 - Agreement to execute a Shareholder Agreement (for note holders)
 - Drag-along rights
 - Restrictions on transfer of stock

Bottom Line

- Common or Convertible Debt
- Minimize the angel funding – it is likely to be expensive money
- Minimize control of investor
- Keep it simple

Top Ten (or so) Mistakes

- Over-Promise – Under-Deliver
- Waste Early Money
- Disrespect Capital
- Target Old Ladies, Pensions and Thanksgiving dinner companions
- Poison the Company
 - Not enough stock for management
 - Give away veto rights, rights of first refusal or exclusivity
- Severely underestimate the cost and time
- Leave the numbers to somebody else
- Give up control (legally or mentally)

Top Ten (or so) Mistakes (cont.)

- Over-capitalize
- Under-capitalize
- Ignore securities laws
- Don't align interests
- Engage a personal injury lawyer