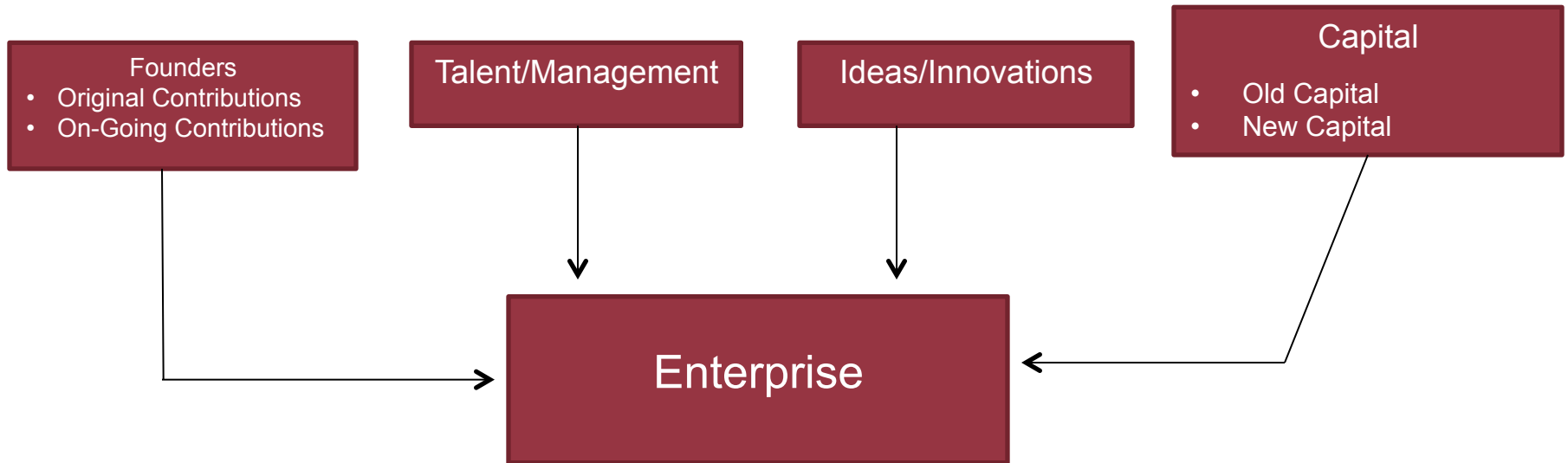


Agenda

- Introduction
- Some Challenges and Alternatives
- 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 (e.g., tests/pilots)
- Bootstrap
- License Fees
- Public financing/grants
- Debt
- Crowdfunding

Funding Cycle

- Incubators (e.g., Project Olympus, Idea Foundry, Alpha Lab, Ascender)
- 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**



Exemption – Private Offering

- Effect of Exemption
 - Exemption from Registration Process
 - **No Exemption** from:
 - Notice Filing
 - Fraud provisions of the Securities Act



Safe Harbor: Rule 506 of Regulation D

Rule 506(b)

- 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

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 Investor Definition May 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

(Relatively) New Rule 506(c)

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



Rule 506(c) – Heightened Verification

- Factors:
 - Nature of Purchaser (e.g., individual or institution)
 - Amount and type of information that the issuer has about the investor
- 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



Don't Forget about the States!

- State-by-state regulation
- National Securities Markets Improvements Act of 1996
 - Preempts state regulation
 - 4(a)(2) exemption – Rule 506
 - Requires notice and filing fees (concession to states)
- Check states – Example: NY

Bottom Line

- Rely on 506(b) or 506(c)
- Decide between 506(b) and 506(c) early
- Don't advertise until decision is made



Reason for Compliance

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



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



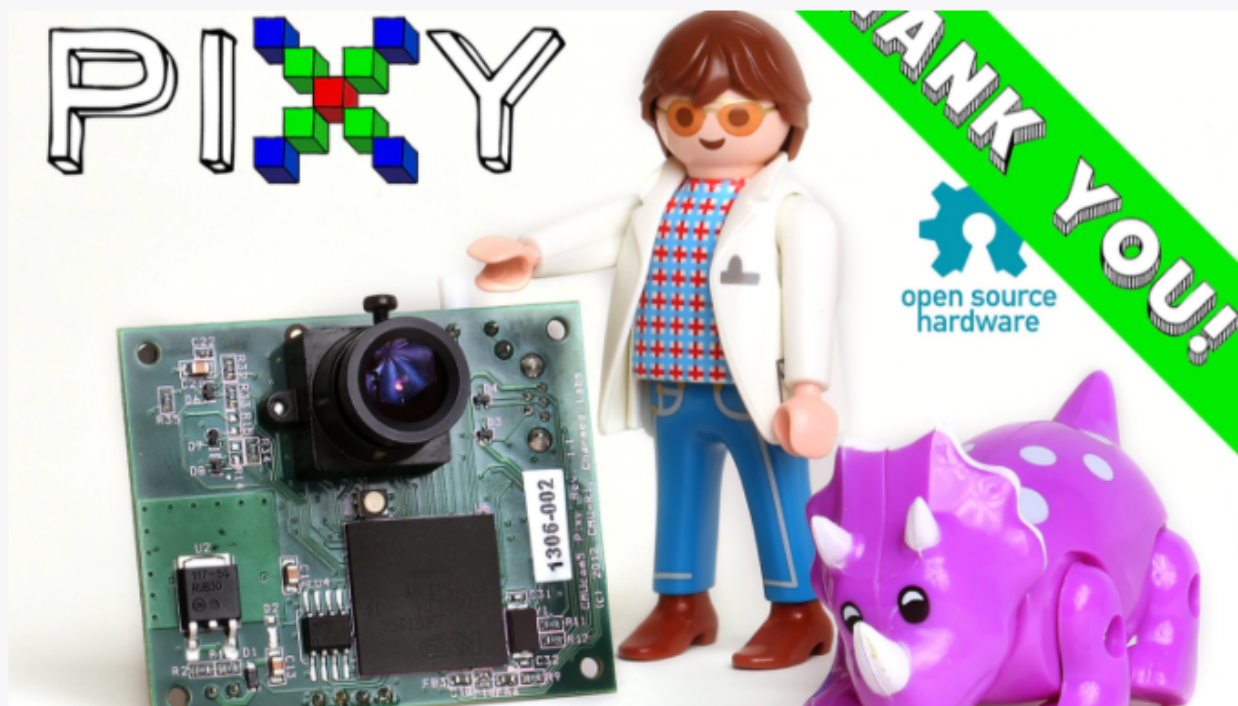
Key Elements of Private Placement Memorandum (or short form)

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

Crowdfunding (e.g., Kickstarter)

- Origins
- Sidesteps securities laws – not a sale of a “Security”
- Example – Preveil Travail – Interactive Restaurant (raised \$75,000)
 - Rewards
 - Fast Pass
 - Cooking class
 - Tickets for dinner
 - Tickets to opening party
 - 2014 Sexy Chef Calendar

Pixy (CMUcam5): a fast, easy-to-use vision sensor



Pixy is a fast vision sensor you can quickly “teach” to find objects, and it connects directly to Arduino and other controllers.

Created by

Charmed Labs and Carnegie Mellon

2,802 backers pledged \$274,352 to help bring this project to life.

[Campaign](#)

[FAQ ⁶](#)

[Updates ²¹](#)

[Comments ⁴⁸⁵](#)

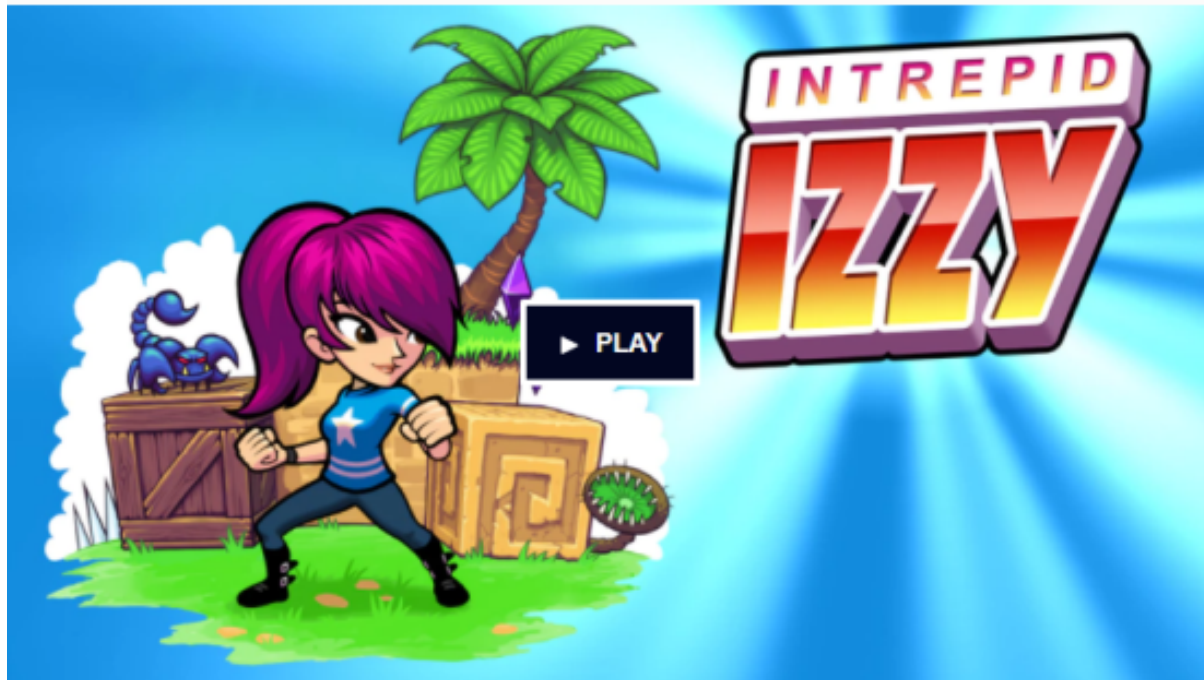
[Community](#)



Intrepid Izzy - PC / Dreamcast / PS4

By Senile Team
First created

Explore a colorful and imaginative world. Jump, fight and puzzle your way past its many dangers and mysteries.



\$33,939

pledged of \$41,145 goal

354

backers

35

hours to go

Back this project

Save



All or nothing. This project will only be funded if it reaches its goal by Fri, October 27 2017 4:00 AM EDT.



Project We Love



Video Games



Dordrecht, Netherlands

Puzzle Clubhouse: Crowd Designed Episodic Game Dev



Ready to be a Game Designer? At Puzzle Clubhouse, people who PLAY games help MAKE games! Design, Submit, Vote and Play!

Created by

Schell Games



214 backers pledged \$11,403 to help bring this project to life.



London, UK

Restaurants

Project We Love

An authentic Jewish delicatessen open seven days a week, where traditional recipes are made expertly in house with great love and care.

Crowdfunding – the internet exemption

- A relatively 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**

Limitations on Investment

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

Intermediary Required

- 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

Significant Disclosure Requirements

- 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

Financial Statement Requirements

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
 - Public disclosure and financial statement requirements may be burdensome
 - The relationships with the Intermediaries are still to be determined and may be an issue
 - Has not taken off (\$18M offered in the last 9 months of 2016)

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
 - 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

(Light) Preferred

- Description
 - Liquidation Preference
 - Dividend (not your Disney-type dividend)
 - Fewer control features than typical preferred
- Benefits
 - Attracts investors
- Downside
 - Complexity
 - Potential impact on future investors
 - Requires a valuation
 - May not align interests

Liquidation Preferences

- 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

Example of Participating Preference

\$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%)
 - Avoid fancy conversion terms
 - Base price in case of no additional investment
 - Cap on 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

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)
- Ascender - 5% for incubator
- Caution of giving up over 10% of the Company for an angel round (so, if you are raising \$100,000, post-money of \$1M)

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 (\$0.85 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.)

- Under-capitalize
- Ignore securities laws
- Engage a personal injury lawyer