

**The NC Department of the Secretary of State**  
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**SECURITIES FOR NON-SECURITIES ATTORNEYS**

**Preface<sup>1</sup>**

The Department of the Secretary of State is grateful for this opportunity to share information with North Carolina attorneys and paralegals on Securities. We are proud of the work we do for the citizens of North Carolina and of our employees who do that work.

In putting together this manuscript, we have endeavored to provide you with:

1. An overview of the work of the Department of the Secretary of State as a principal department of North Carolina State government, including some “fast facts” about the Department and its work;
2. Information about the Securities laws we administer and enforce;
3. Practice tips to improve your experience in using our services and asking us for help;
4. Suggestions of ways you can help us to protect the citizens and businesses of North Carolina as well as foster its economy; and
5. Hyperlinks to additional information you and your clients may find helpful on various topics.

Immediately following this preface, you will find a table of contents to the manuscript.

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<sup>1</sup> This manuscript was prepared by Ann McNellis Elmore, Legal Specialist for Investor and Business Outreach, NC Department of the Secretary of State, with the able assistance of many of her colleagues.

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## The NC Department of the Secretary of State – Integral to Economic Dynamism

By Rodney S. Maddox, Chief Deputy Secretary of State

It is well recognized that economic growth is enhanced when there is a growth strategy underpinned by appropriate tactics. In this regard, a *Newsweek Magazine* article<sup>2</sup> pointed out that:

But if they [governments] really want to create jobs, raise incomes, and lift living standards, they should devote more energy to figuring out how to generate economic dynamism over the long term . . . countries must get the basics right. These include a solid rule of law, with patents and protections for intellectual property, enforceable contracts, and courts to resolve disputes; access to finance, particularly for startups; and an efficient physical and communications infrastructure.

The North Carolina Department of the Secretary of State has significant responsibilities which fall squarely within this description of “the basics” needed for economic dynamism. The Department has a substantial role in the following areas: promoting the rule of law, protections for intellectual property, enforceable contracts, and access to financial capital by the private business sector. These departmental roles are illustrated by the following examples:

- Creating “startups” is facilitated by the [Business Registration Division](#).
- Two distinct types of capital formation activities are promoted with the common result of making financial capital available to business management:
- Safe access to lending capital is promoted by the Certification and Filing Division’s UCC Article 9 lien filings and federal tax lien records.
- Safe access to equity investing capital is promoted by the Securities Division’s registration of investment products as well as securities brokers, dealers and investment advisers.
- Valuable capital in the form of real estate is more accessible, more quickly for financing purposes as the Land Records and Electronic Notary Public Units work together to facilitate the electronic filing of documents with Registers of Deeds and others.

In addition, the “solid rule of law” and “enforceable contracts” are promoted by the Department in several ways, centering around signature authentication for business documents. This is accomplished, for example, by:

- Commissioning [Notaries Public](#), who are crucial in preventing fraud in business documents.

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<sup>2</sup> “From the Ashes”, James Manyika, Susan Lund, Byron Auguste, *Newsweek*, August 16, 2010.

- [Authenticating](#) documents in compliance with the Hague Convention, thereby facilitating international commerce.
- Pursuing [business identity](#) thieves as they traverse the e-commerce pathway through official electronic databases in their quest for victims.
- Protecting intellectual property rights through registering State [trademarks](#) and enforcing criminal counterfeit trademarks law. In addition, the registering of Invention Development Services providers helps protect the patent development process.
- Registering [securities](#) brokers, dealers and investment advisers and investigating related fraudulent conduct leads to barring “bad actors” from various capital formation professions and related activities.
- Bringing transparency to activities of paid charitable solicitors by the [Charitable Solicitations Licensing Division](#) reduces the risk that fraud makes donations less available to benefit legitimate charities and society at large.

The Department has many other ancillary responsibilities as well, involving enforceable contracts and financial capital activities such as being the substitute agent for service of process, administering cable TV franchising, and maintaining an accessible database of over 33 million important governmental notices and business records. So when your thoughts turn to the basics of generating economic growth in NC, visit our Departmental website located at [www.sosnc.gov](http://www.sosnc.gov). While there, browse the free offerings when you have the opportunity to do so. Also see our practice tips at [https://www.sosnc.gov/divisions/general\\_counsel/practice\\_tips](https://www.sosnc.gov/divisions/general_counsel/practice_tips). We’ll make you welcome!

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# WHAT YOU NEED TO KNOW ABOUT THE SECRETARY OF STATE AND SECURITIES:

## AN OVERVIEW



North Carolina

## Department of the Secretary of State

Securities Division \* PO Box 29622 Raleigh, NC 27626-0622 \* (919) 814-5400

### **North Carolina Securities Division**

**Connect with Us!**

**Website: [www.sosnc.gov](http://www.sosnc.gov)**



@NCSecState



@NCSecState



NCSecState



North Carolina Department of the Secretary of State

**(800) 688-4507**

### **What does the North Carolina Securities Division do?**

The Securities Division is charged with regulating the offer and sale of securities in the state of North Carolina. Major responsibilities include:

- Administering and enforcing the North Carolina Securities Act, North Carolina Investment Advisers Act, and the North Carolina Commodities Act;
- Screening/registering securities offerings;
- Screening/licensing brokerage firms and representatives;
- Registering investment advisers and their representatives;
- Conducting on-site examinations of brokerage and investment adviser firms and their representatives;
- Reviewing consumer complaints;
- Protecting and educating consumers through the Division's Investor Education Program.

### **What does the Investor Education Program do?**

The program's goal is to promote the principles of sound investing and help investors recognize and avoid scams, frauds and investor abuses.

### **Where can I find further information about scams, fraud and abuse?**

Visit the Department of the Secretary of State Web site at [www.sosnc.gov](http://www.sosnc.gov), and "follow the links for the Securities Division." You will learn how to find out if your stockbroker or investment adviser is properly registered, the latest securities-related news, alerts and tips, and you can browse our investor education resources or order free copies of our brochures. If you need further information or would like to host an investor education workshop or seminar for your civic group or classroom, please contact the Securities Division at (800) 688-4507, or by email to [secdiv@sosnc.gov](mailto:secdiv@sosnc.gov). Please put "Speaker Request" in the subject line.

### **How can I investigate a seller of an investment product?**

By law, broker-dealers and investment advisers must be registered in North Carolina to do business here. Dealing with an unregistered seller or adviser greatly increases the risk of harm to you as an investor. Also, the investments they offer to you should be registered as well. To learn whether a specific investment professional is licensed in North Carolina or has any known history of violations or complaints, call us at (919) 814-5400, or toll-free (800) 688-4507.

## What do the titles and designations mean?

Financial services professionals often have impressive-sounding titles or include lots of initials after their names. While some of these titles or designations accurately reflect the person's experience, many are little more than marketing tools designed to convey the impression that the holder has more knowledge or experience than (s)he actually has. For instance, each of the following is either a generic term or job title, and could be used by people who may not possess any formal training in investments:

<b>Financial Analyst</b>	<b>Financial Consultant</b>	<b>Wealth Manager</b>
<b>Financial Adviser (or Advisor)</b>	<b>Financial Planner</b>	<b>Investment Consultant</b>

Some titles include terms like "Certified", "Professional", or "Registered", when, in fact, no official regulatory body has issued the designation. **Do not rely solely on a person's title or certification when making an investment decision.** Always contact the NC Securities Division (800-688-4507), the Financial Industry Regulatory Authority (FINRA, at 800-289-9999), or the Securities and Exchange Commission (SEC, at 800-732-0330) and check the registration status of both the person offering the investment and the investment itself **before** buying anything. If the person is selling insurance products, like annuities, contact the NC Department of Insurance (855-408-1212) to verify the person's insurance license. To learn what all the letters after a person's name mean, visit FINRA's Website ([www.finra.org](http://www.finra.org)). Search for "Professional Designations".

## Is there such a thing as a "free lunch"?

If you have ever received an invitation for a free meal at a nice restaurant in exchange for attending a financial seminar, you are not alone. A 2007 study by FINRA found that 78% of senior citizens received at least one such invitation, while 60% received six or more invitations during a three-year period. The study also found that one-third of the seminars reviewed contained misleading statements or outright fraud. Finally, despite assurances that "nothing would be sold" at the programs, the report found that every single program was a sales presentation, thus proving the old adage that "there is no such thing as a free lunch." While the offer of a free meal is legal, investors are warned not to buy anything or provide any personal information to anyone at such seminars until that person's registration status, credentials and business claims can be verified with the proper regulatory bodies. State securities regulators and AARP have teamed up to produce a worksheet called, "What to Listen for at Free Lunch Investment Seminars." For a free copy of the worksheet, contact the Securities Division at (800) 688-4507 or at [secdiv@sosnc.gov](mailto:secdiv@sosnc.gov). Please put "Free Lunch Worksheet" in the subject line.

## What are the warning signs of a potential investment fraud?

Financial criminals may be among the smartest people we will ever meet. The "successful" con artist is a marketing expert who understands human nature, and preys upon our fears or desires by unleashing a variety of psychological tactics against us, hoping to find the right combination that will get us to lower our natural defenses and give him what he wants – our money! The key, then, to avoid becoming an investment fraud victim is to recognize the pressure tactics and remember that **it is OK to say "NO"** to an unsolicited sales pitch! Although not complete, here are the most common psychological tactics con artists employ against their victims:

**Promises of Wealth** – The salesperson dangles the promise of wealth in a short period of time, often "guaranteed" with "little or no risk" involved. **Remember: All investments carry risk.**

**Trappings of Success** – The salesperson projects the image of success or offers testimonials, "proving" he and the offer are "legitimate." **Remember: Credibility can be faked.**

**The "Lemming" Effect** – The salesperson tells you that others are investing and that you should too or risk losing out on a good deal. **Remember: If everyone jumped off a cliff, would you?**

**Favors** – The salesperson gives you something (like a free meal or a discount) hoping you will feel obligated to give him something in return (like your money). **Remember: You have no obligation to return any business-related favor.**

**Act Now** – The salesperson pressures you to "act fast" because the offer will only be available "for a limited time." **Remember: Do not feel pressured to make a quick investment decision.**

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# What Is A “Security”?<sup>3</sup>

By Allan C. J. Russ, Senior Enforcement Counsel  
North Carolina Department of the Secretary of State, Securities Division

Businesses often need capital. One way to raise capital is by selling securities to investors. The definition of “security” is broader than many people may think. Determining whether you are working with a matter that involves a “security” is important because, if you are, compliance with the federal and state securities laws, including the registration and anti-fraud provisions, is required.

Generally speaking, when the product being sold is a “security,” it must be registered or be eligible to claim an exemption from registration. The persons who offer and sell securities in North Carolina must also be properly registered to engage in that business activity. Furthermore, the securities laws require full disclosure of all material facts regarding the issuer of the securities so that an investor has all the necessary information that he or she needs to make a fully informed investment decision.

Failure to comply with the North Carolina Securities Act (Chapter 78A of the North Carolina General Statutes, the “Securities Act”) can result in administrative, civil or criminal actions against noncompliant individuals and entities. This failure also results in a transaction that, for your client, is vulnerable to attack.

“Security” is defined in N.C.G.S. § 78A-2(11) and includes the following popular instruments:

any note; stock; bond; evidence of indebtedness; participation in any profit-sharing agreement; investment contract; participation in an oil, gas, or mining title or lease; and a viatical settlement contract.

This article is focused on one of the products mentioned above; the “investment contract.”

An “investment contract” is considered to be a “catch-all” for the definition of security. That is, if the product is not a note, stock, bond, evidence of indebtedness, etc., then one would need to look at the product and the way it is marketed and sold to determine if it meets the definition of an “investment contract.”

There are at least two recognized “tests” to determine whether a product is an “investment contract” under the Securities Act and those tests are found in the administrative rules. The first test is derived from the seminal case *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946) and it is known

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<sup>3</sup> This article first appeared in Notes Bearing Interest, the newsletter of the NC Bar Association’s Business Law Section.

simply as the “Howey” test. The second test is known as the ‘Hawaii Market Center” test as it is derived from the case *State v. Hawaii Market Center, Inc.*, 485 P.2d. 105 (1971).

Both tests are found in Title 18, Chapter 6A of the North Carolina Administrative Code, Rule .1104(8). The first test in Rule .1104(8), in keeping with the Howey test, provides that an “investment contract” includes (1) any investment in (2) a common enterprise (3) with the expectation of profit (4) to be derived through the essential managerial efforts of someone other than the investor.

The second alternative formula found in Rule .1104(8) (the “Hawaii Market Center” test) provides that an “investment contract” includes an investment by which (1) an offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risks of the enterprise, and (3) the furnishing of this initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind over and above the initial value will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

With respect to the Howey test found in Rule .1104(8), the first element of an “investment of money” has been defined by case law very broadly to include virtually every contribution of capital, services, or otherwise. Courts will look to whether the investor subjected herself to financial loss by committing assets to the enterprise.

With respect to the “common enterprise” element of the Howey test, “common enterprise” refers to the relationship between and among the promoter and the investors. Courts across the country are divided as to whether “horizontal commonality” or “vertical commonality” is required.

Horizontal commonality occurs when there is a pooling of money into a common fund that is then used to fund the enterprise. All people who have money in the “pool” are sharing the risk of loss and the hope of profits. These people are said to be involved in a common enterprise if they are in a jurisdiction that adopts the “horizontal commonality” position.

North Carolina is a jurisdiction that has adopted the “vertical commonality” version of a “common enterprise.” The “vertical commonality” test has at least two forms; the “broad” form and the “narrow or strict” form.

Under North Carolina’s Rule .1104(8)(a), "common enterprise" means an enterprise in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of a third party. This test for “common enterprise” is known as the “broad vertical commonality” test. For federal securities laws purposes, however, “strict vertical commonality” involving showing that investor’s profits are directly related to promoter’s profits



should be shown; “broad vertical commonality,” under which fortunes of investor need be linked only to efforts of promoter, is not sufficient. See *SEC v. Pinckney*, 923 F. Supp. 76 (1996).

The element of “expectation of profit” occurs when a person expects that their investment will produce a profit. For example, profits can come through capital appreciation or a participation in earnings.

The fourth element of the Howey test, “to be derived solely from the efforts of others,” requires an examination into the level of control retained by the investor. Courts will examine the investor’s involvement in the day-to-day operations or management decisions of the business enterprise to determine whether the investment depends solely on the efforts of others. Here, the courts are more interested in substance over form.

Essentially, one can easily condense the four elements of the Howey case into a neat rule of thumb. That is, if you have a “passive investment” made by an investor into some kind of enterprise, you are dealing with a matter that involves a “security.”

With respect to the Hawaii Market Center test for an “investment contract”, the Hawaii Market Center test is a combination of the Howey test with “risk capital” concepts added: if an investor puts his capital at risk of loss in order to finance an enterprise, with an expectation of a benefit, then the investment opportunity being offered is a “security.”

Again, these two tests for defining what is an “investment contract” under the Securities Act, and therefore a “security,” are critical because they help you determine whether a “security” is involved and whether the registration and anti-fraud provisions of the Securities Act apply to the particular transaction.

The Securities Division of the Department of the Secretary of State has seen a recent increase in people wishing to buy and sell distressed properties, either for the purpose of buying and managing the properties or simply “flipping” the properties after improving the property in some manner. Often, these persons seek capital contributions from investors to help them in purchasing or rehabilitating the properties in question.

These business activities could subject a client to find herself offering and selling securities in the form of an “investment contract.” Additionally, the client may also be offering and selling to investors other securities in the form of an LLC interest or a promissory note.

These business opportunities, if they satisfy the definition of an “investment contract” or a “security” would require your client to (1) comply with the registration provisions of the Securities Act and (2) ensure that they are providing all material information about the enterprise to investors.

If you should have any questions about whether or not you are involved in a transaction where a security is being offered or sold, please do not hesitate to contact the Securities Division to talk about compliance with the securities laws. The Securities Division’s telephone number is (919) 814-5400, Option 5-1 and our email address is [secdiv@sosnc.gov](mailto:secdiv@sosnc.gov).

## **WHY DO NON-SECURITIES ATTORNEYS NEED TO KNOW ANYTHING ABOUT SECURITIES?**

So why do you care? It is often said that we must identify our “whys” and use them as our “guide star” to maximize chances of success. In this case, that means getting more out of this CLE.

Non-securities attorneys may find themselves facing securities related questions in a variety of settings. First, each of us is a potential consumer, or investor. Second, a family member, friend, or client may come to us with questions or concerns about an investment opportunity—or may mention things that should raise red flags. Hopefully, such inquiries arise before investments are made, and guidance given here can avoid problems. However, when the inquiry is triggered by problems, then remedy awareness improves the odds of a favorable outcome. Third, as counselors, we may be approached about helping a business raise money, including serving as escrow agent, or deal with problems related to raising capital. In each instance, a basic understanding of what and who is involved and where to turn for reliable information is key.

Certain general rules apply. North Carolina law declares it is “unlawful for any person to offer or sell any security...unless (i) it is registered under this Chapter; (ii) the security or transaction is exempted under G.S. 78A-16 or 78A-17....; or (iii) it is a security covered under federal law.”<sup>4</sup> Exempt securities are listed at NCGS § 78A-16. Securities are defined earlier in this manuscript. Exempt transactions are listed at NCGS § 78A-17. An exempt transaction that may be familiar is where the offer is made to not more than 25 persons, colloquially called the friends-and-family exemption.<sup>5</sup> Now, crowdfunding also is available.

## **CROWDFUNDING**

Crowdfunding began as a way for the public to donate small amounts of money, often through social networking websites, to help artists, musicians, filmmakers and other creative people finance their projects. Through the US JOBS Act, this concept was also promoted as a

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<sup>4</sup> NCGS § 78A-24.

<sup>5</sup> NCGS § 78A-17(9).

way to assist small businesses and startups looking for investment capital, typically using the internet. “This mode of capital raising originated overseas in the wake of the 2008 financial crisis because of the difficulty entrepreneurs and small businesses faced in raising funds,” according to a report by the SEC.<sup>6</sup> Feedback to the SEC’s Advocate for Small Business Capital Formation identifies two primary beneficiaries of crowdfunding. They are businesses

1. “in communities where smaller or community banks are less accessible; and”
2. “with meaningful growth potential but who lack ‘venture returns’ of 10X+, such as lifestyle, services, or retail businesses.”<sup>7</sup>

Crowdfunding comes in different forms. One is donation-based. Another is reward-based. A third involves raising money by selling securities—by whatever name—to investors. Each involves different expectations of the parties and different players.

**Donation-based fundraising** involves an “ask” for contributions where those funding the endeavor have no expectation of receiving a benefit. This appeals to those who believe in the cause. Donors neither obtain ownership or management rights nor become creditors of the endeavor. Kickstarter and Indiegogo are two examples of donation-based crowdfunding platforms.<sup>8</sup> “Donation-based crowdfunding platforms aimed at fundraising for charitable causes include GoFundMe and FirstGiving. Typically, these services take a 5%–10% fee of all donations.”<sup>9</sup> Current law does not bring these under regulation by the NC Department of the Secretary of State’s Charitable Solicitation Division. However, these undertakings can give rise to fraud and are subject to civil and criminal prosecution.

**Rewards-based fundraising** involves an “ask” tied to the offeror providing tangible rewards. They can be token awards or pre-sales of products to be produced with the money raised. An example of a token award is a tee shirt or restaurant menu items. Funders neither obtain ownership or management rights nor become creditors of the endeavor. Rewards-based platforms include CrowdfundingBum.<sup>10</sup>

At its core, investment crowdfunding is a method of raising capital from a large number of people who each invest relatively small amounts of money, or capital may be raised from a small number of accredited investors. Securities sold in this way rely on federal and state securities registration exemptions. With investment crowdfunding, investors buy a “security” issued by the company with the expectation of some type of financial return. These appeal to

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<sup>6</sup> Annual Report for Fiscal Year 2019 (US SEC Office of the Advocate for Small Business Capital Formation) at 46 (footnotes omitted).

<sup>7</sup> Id.

<sup>8</sup> These platforms are mentioned for illustrative purposes only and do not represent an endorsement.

<sup>9</sup> <https://www.investopedia.com/terms/d/donationbased-crowd-funding.asp> (Jan. 17, 2020). These platforms are mentioned for illustrative purposes only and do not represent an endorsement.

<sup>10</sup> See <https://crowdfundingbum.com/rewards-based-crowdfunding/>. Note: mention is for illustrative purposes only and does not represent an endorsement by the NC Department of the Secretary of State.

pure investors. Securities-based crowdfunding can be in the form of equity, or ownership rights. They also can be in the form of debt, conferring creditor rights. Either way, they can be subject to regulation.

## **CROWDFUNDING: Federal**

At the federal level, the [Jumpstart Our Business Startups \(JOBS\) Act](#), a series of legislative provisions designed to facilitate capital formation in the United States, was signed into law in 2012. Title III of the JOBS Act (also known as the CROWDFUND Act) allows entrepreneurs to raise capital by selling interests in their businesses over the internet through a third-party intermediary. Under the CROWDFUND Act, a business can raise up to \$1.07 million in a 12-month period by selling “securities” to investors without registering that offering with federal or state securities regulators.<sup>11</sup> Another option is through Rule 506(c). This is sometimes referred to as “accredited investor crowdfunding,” on account of its general solicitation offerings to verified accredited investors.<sup>12</sup> The JOBS Act limits how and to whom a business can sell its securities. Relief from the obligation to register does not eliminate all filing requirements. Even companies or individuals who are exempt from registration, must still comply with all of the anti-fraud provisions of federal and state law. The law became fully effective on May 16, 2016, when the Securities and Exchange Commission (SEC) issued rules—[Regulation Crowdfunding](#) (Regulation CF)—to implement this new exemption.

## **CROWDFUNDING: State**

While the SEC rules apply to crowdfunding on the national level, many states, including North Carolina, have enacted their own intrastate crowdfunding laws. Businesses in North Carolina have the option to use state-based crowdfunding exemptions to raise capital from investors within North Carolina’s borders. As of July 31, 2017, 34 states and the District of Columbia have laws on the books that allow businesses in their jurisdictions to raise money through state-based crowdfunding.<sup>13</sup>

State crowdfunding is available under the North Carolina Providing Access to Capital for Entrepreneurs and Small Business (NC PACES) Act. It was passed by the North Carolina General Assembly and approved by the Governor in 2016.<sup>14</sup> The NC PACES Act creates a new

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<sup>11</sup> Annual Report for Fiscal Year 2019 (US SEC Office of the Advocate for Small Business Capital Formation) at 46.

<sup>12</sup> Id.

<sup>13</sup> Links to specific intrastate crowdfunding exemptions adopted either through legislation, regulation or administrative orders in NASAA member jurisdictions may be found at <https://www.nasaa.org/industry-resources/securities-issuers/intrastate-crowdfunding-directory/>.

<sup>14</sup> 2015 Bill Text NC S.B. 481.

exemption from registration, also known as the “Invest NC Exemption,” for securities offered by local businesses seeking to raise money from local investors using “crowdfunding”. The law can be found on the Secretary of State’s website at <https://www.sosnc.gov/divisions/securities/crowdfunding> or on the General Assembly’s website at: [http://www.ncleg.net/EnactedLegislation/Statutes/PDF/BySection/Chapter\\_78A/GS\\_78A-17.1.pdf](http://www.ncleg.net/EnactedLegislation/Statutes/PDF/BySection/Chapter_78A/GS_78A-17.1.pdf). It also is addressed in the NC Administrative Code.<sup>15</sup>

## “A ROSE BY ANY OTHER NAME”

Securities-based fund raising can appear under many different names. As with the rose in the Shakespeare quotation in Romeo and Juliet, it matters not what it is called; it matters what it is. See discussion of what constitutes a security above.

## WHICH CROWDFUNDING MODEL?

Issuers must determine what crowdfunding model to use. There is debt-based crowdfunding. Besides a bond or banknote or debenture, variations also may include peer-to-peer lending, initial loan procurement and promissory notes. Another crowdfunding model is investment-, or equity-based crowdfunding, where the investor obtains a stake or interest in the business as through stock. Revenue sharing, entitling the investor to a share of the business earnings, is another option.

Some debt-based crowdfunding endeavors merit mention here due to their relative novelty.

- **Peer-to-peer (P2P)** is a recent entry to the field. It is internet “matchmaking.” It consists of unsecured loans. Platform operators may be unseasoned businesses. The platform may not be authorized to conduct business in certain jurisdictions. Also, platform operators may issue securities and may, therefore be subject to federal and/or state registration requirements. Hence, careful attention to details are needed. NC rules expressly provide that such an issuer is not eligible to rely on the NC Exemption if it is peer-to-peer.<sup>16</sup>
- **Promissory notes** generally must be registered with SEC or qualify for an exemption. Check with the SEC’s EDGAR Database or SOSNC to confirm that the notes are registered or legally exempt.

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<sup>15</sup> 18 NCAC 06A .2001 through 18 NCAC 06A .2120.

<sup>16</sup> 18 NCAC 06A .2004.

- **Initial loan Procurement** is a crowdfunding method. Capital seekers and investors enter into loan agreements through legally-binding smart contracts stored on the blockchain. Instead of receiving tokens (as in an ICO), investors become creditors by lending money. These may be marketed worldwide. These are securities. As such, they generally must be registered or be exempt.
- **Initial Coin/Token Offerings (ICOs)** are a crowdfunding method. Promoters create a new virtual “coin” or “token.” Investors go online to an ICO exchange and get coins/tokens for fiat currency, e.g., U.S. Dollar. These can be securities. As such, they generally must be registered or be exempt. ICOs are not the same as Initial Public Offerings (IPOs), which involve rigorous filings and screenings by regulators.
- An **Initial Exchange Offering** is a crowdfunding method, too. Promoters offer digital assets, such as coins or tokens to raise capital. Initial Exchange Offerings are similar to Initial Coin Offerings but differ from Initial Public Offerings, which involve rigorous filings & screenings by regulators. Initial Exchange Offerings are offered directly by online trading platforms which may call themselves exchanges. Initial Exchange Offerings also can be securities. As such, they generally must be registered or be exempt.

## **TWO TYPES OF NC CROWDFUNDING**

There are two types of crowdfunding available under [NC PACES Act](#). One is an NC PACES Offering, or NCPO. The other is a “Local Public Offering,” or LPO. In general, businesses can raise money from local (i.e., North Carolina) investors<sup>17</sup>

- Directly or
- Through an intermediary such as
  - a broker-dealer or
  - a state-based online platform or portal
- Within a 12-month period.<sup>18</sup>

The amount a business can raise, and individual investment limits, are determined by North Carolina’s crowdfunding laws.

An **NC PACES Offering, or NCPO**, is a securities offering where a business is trying to raise up to \$2 million.<sup>19</sup> The business:

- Must use the Internet to communicate with investors,
- Can sell most types of securities, and
- Has limits on how it advertises the securities offering.

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<sup>17</sup> 18 NCAC 06A .2001(2).

<sup>18</sup> 18 NCAC 06A .2004(d); 18 NCAC 06A .2004(b).

<sup>19</sup> 18 NCAC 06A .2004(b): up to \$2M with audited or reviewed financial statements or up to \$1M without.

A **Local Public Offering, or LPO**, is a securities offering where a business is trying to raise a maximum of \$250,000. The business:

- Does not have to use the Internet to communicate with investors but it can,
- Can only sell one of these kinds of securities:
  - equity,
  - debt, or
  - revenue share agreements, and
- Has fewer limits on how it advertises the securities offering.<sup>20</sup>

### IN A NUTSHELL

Offering Type	NCPO	LPO
MAXIMUM raise with audited financials	2,000,000	250,000
MAXIMUM raise without audited financials	1,000,000	250,000
MINIMUM raise to secure release from escrow	20% of MAX	25% of MAX
Offering period/duration MAXIMUM	12 months	12 months
Can a NC <b>Funding Portal</b> (FP) host the offer?	YES	NO
Can a <b>broker dealer</b> host offering?	YES	NO
Can issuer create their own <b>internet platform</b> to host?	YES	YES
Can issuer conduct offering <b>without internet</b> hosting at all?	NO	YES

#### STATUS AS OF FEBRUARY 9, 2021

PORTALS	Currently accepting portal applications.
BROKERS	Any broker dealer can host an NC PACES offering; however, only LocalStake and Folla Capital, LLC, have expressed an interest in doing so.

\* 18 NCAC 06A .2120.

<sup>20</sup> 18 NCAC 06A .2104.

## WHO: Which Businesses?

Generally, businesses located in North Carolina<sup>21</sup> and registered and active with the NC Department of the Secretary of State's Business Registration Division can use the NC PACES exemption.<sup>22</sup> However, some businesses cannot use the NC PACES exemption. These exclusions can be found at:

- NCGS § 78A-17.1,
- 18 NCAC 06A .2004 (re: NCPOs), and
- 18 NCAC 06A .2117 but 18 NCAC 06A .2118 (re: LPOs).

Uncertainty may be resolved by calling the NC Department of the Secretary of State Securities Division at (919) 814-5400 or toll free at (800) 688-4507.

Before seeking additional stakeholders, would-be issuers should check to ensure that they are compliant with applicable rules and regulations. One place to start would be the database of registered business entities maintained by the NC Department of the Secretary of State's [Business Registration Division](#). It is important to check to ensure, for example, that annual reporting requirements have been met, and the business is in good standing.<sup>23</sup>

## WHO: Which Investors?

Investors participating in crowdfunding under NC PACES Act must meet certain requirements. To invest in a NC PACES offering (NC crowdfunding), an investor's principal residence must be in North Carolina.<sup>24</sup> However, investment crowdfunding is not limited to wealthy or financially sophisticated investors. An investor can invest up to \$5,000 in an NC PACES securities offering, or any amount if the person is an "accredited investor".<sup>25</sup>

An "**accredited investor**" is someone with significant assets available to invest. "Accredited investor" is defined by federal law which was amended in 2020.<sup>26</sup> NC PACES relies on the federal definition. "An accredited investor, in the context of a natural person, includes anyone who:

- "earned income that exceeded \$200,000 (or \$300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, OR

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<sup>21</sup> 18 NCAC 06A .2001(2).

<sup>22</sup> NCGS § 78A-17.1(a)(1); 18 NCAC 06A .2001 (1,2), 18 NCAC 06A .2003(19).

<sup>23</sup> See 18 NCAC 06A .2003(19)(b)(2).

<sup>24</sup> 18 NCAC 06A .2001 (2).

<sup>25</sup> 18 NCAC 06A .2004(c). The rule embraces the definition of accredited investor contained in 17 CFR 230.501.

<sup>26</sup> <https://www.sec.gov/corpfin/amendments-accredited-investor-definition-secg> and <https://www.sec.gov/rules/final/2020/33-10824.pdf>.



- “has a net worth over \$1 million, either alone or together with a spouse (excluding the value of the person’s primary residence).”

What are the implications of being an “accredited investor”? One implication is that less disclosure information is required of the issuer than for non-accredited investors and, hence, less information is provided to the investor. As a result, investors know much less about the investment and the people behind it. “The theory behind Rule 506 is that accredited investors are able to look after their own interests and do not need all the protections that non-accredited investors receive.”<sup>27</sup>

That does not prevent investors from getting information. If the offering involves both accredited and non-accredited investors, the same information must be available to both. Also, the accredited investor can ask for additional information. Even though federal and state securities laws do not mandate companies disclose information in a private placement offering, investors can and should still ask questions and request information. If the seller cannot or will not satisfactorily answer questions about the company, its business model, or its executives’ backgrounds, the investor can walk away. Investors have the power to control and withhold their investment dollars if they do not get the information requested.

If the investor him/herself is unable/unwilling to do that, the theory is that accredited investors have the means to protect themselves. They can afford accountants and lawyers. And they have sufficient means to be able to sustain the loss.

A telltale sign that the investor is being treated as an “accredited investor,” is that the investor is acted to sign a Subscription Agreement or Accredited Investor Questionnaire. Such documentation is required for all “accredited investors” in an offering. Any suggestion or request to falsify an investor’s financial information in order to qualify as an accredited investor is a red flag.

## **WHO? Funding Portal and Broker Selection**

A funding portal is a website, also called a “platform,” through which investors may invest in crowdfunding offerings. Funding portals must be registered.<sup>28</sup> Companies using NCPO crowdfunding may not make investment opportunities directly to individual investors. Issuers conducting a Local Public Offering may use the internet to sell their securities but is not required

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<sup>27</sup> Bower, Matthew W., “Reasons to Include Only Accredited Investors in Your rule 506(b) Private Offering,” Startup Blog Post (Sept. 6, 2019), <https://www.varnumlaw.com/newsroom-publications-reasons-to-include-only-accredited-investors-in-your-rule-506b-private-offering>.

<sup>28</sup> 18 NCAC 06A .2030(a).

to use a platform.<sup>29</sup> The funding portal or platform facilitates the investment including the payment from the investor to the issuer. Some portals may list a variety of investment opportunities on one website, allowing investors to select one or more projects. Investment-based platforms that have used the investment-based model include AngelList, WeFunder, StartEngine and others. By law, “funding portals” are not allowed to provide investment advice and must be registered with the SEC and/or file notice with the North Carolina Department of the Secretary of State.

A broker or funding portal should be chosen with care. Federal crowdfunding requires an issuer to work through an intermediary, and some state crowdfunding laws similarly require an intermediary. NC is such a state when it comes to NCPOs, but not LPOs.<sup>30</sup> When an issuer selects an intermediary, be sure that the broker or funding portal complies with the requirements of the CROWDFUND Act and Regulation Crowdfunding (or similar state statutes and rules). The issuer is obliged to ensure that the broker or funding portal is compliant with applicable laws and regulations. For example, since small businesses under the Regulation Crowdfunding are liable for any misrepresentations to investors or failures to disclose important information by the crowdfunding platforms they choose; issuers should be wary of crowdfunding platforms that seem careless about the importance of providing adequate disclosures to investors. Careful screening by the issuing business is essential to avoid unscrupulous persons offering to take fees to help raise capital over the Internet. If a broker or funding portal does not comply with the SEC, or applicable State rules, the exemption may be voided, subjecting the issuer to liability for an unregistered offering.

Whether an issuer uses a registered funding portal or their own web site to conduct the offering, several requirements apply. First, the portal/website must have a communication channel or message board where all questions and answers are preserved and available for all would-be investors to review. Second, the Disclosure Document(s) must be posted.

### **WHO: Escrow Agent and Role**

An issuer must establish and maintain an escrow account.<sup>31</sup> An escrow agent is required.<sup>32</sup> Any of the following may serve as an escrow agent:

- A lawyer,
- Bank or depository institution, or
- A registered stock broker-dealer.<sup>33</sup>

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<sup>29</sup> 18 NCAC 06A .2110(a).

<sup>30</sup> Compare 18 NCAC 06A .2045 and 18 NCAC 06A .2103(a)(b).

<sup>31</sup> 18 NCAC 06A .2017(a), 18 NCAC 06A .2109.

<sup>32</sup> 18 NCAC 06A .2017(b)(1).

<sup>33</sup> 18 NCAC 06A .2003(10).

A **lawyer** acting as an escrow agent is obliged to meet certain criteria.<sup>34</sup> Lawyers are not exempt from the collection and disclosure requirements.<sup>35</sup> State law deems **bank or depository institution** information “confidential and trade secrets while in the possession of the Administrator.”<sup>36</sup> In order to act as an escrow agent, a **registered dealer** must comply with special requirements.<sup>37</sup>

The **escrow agent’s role** extends beyond collecting, segregating, and insuring investor money.<sup>38</sup> The agent is required to collect at least investor names, investor residences, the aggregate number of securities sold during the offering in numbers of units of securities sold and dollars raised.<sup>39</sup> The agent is obliged to attend to “any conflicts of interest that may arise or exist.”<sup>40</sup> The agent must provide various notices to the NC Department of the Secretary of State Securities Division. That includes notice of “any material changes to the escrow agreement.”<sup>41</sup> The escrow agent also must notify the Administrator in writing upon reaching the minimum offering amount and termination of the escrow agreement.<sup>42</sup> The agent must make documents available to the Administrator upon request.<sup>43</sup> The agent’s obligations extend “for six years after the filing of the Form NCE....”<sup>44</sup>

## **WEIGHING RISKS AND BENEFITS: From the Business Perspective**

The state crowdfunding exemption is meant to lower capital-raising costs by exempting capital formation efforts of \$2 million or less from registration. However, exemption does not eliminate the need for filings. Consequently, a small business using this exemption can benefit from legal guidance as to how to comply with federal and state securities laws.

**Consider the obligations.** Issuers (i.e. businesses seeking capital) must meet filing requirements.<sup>45</sup> Disclosure documents must list all material risks investors need to know to make informed investment decisions, and the rules require legends (i.e. standardized cautionary language for investors, typically appearing on the first page of the offering document) to highlight risks of investing in the securities.<sup>46</sup> If it is an LPO, there is a mandatory conference

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<sup>34</sup> 18 NCAC 06A .2017(c).

<sup>35</sup> See 18 NCAC 06A .2027.

<sup>36</sup> 18 NCAC 06A .2028 referencing NCGS § 78A-17.1(a)(10).

<sup>37</sup> 18 NCAC 06A .2026.

<sup>38</sup> 18 NCAC 06A .2023, 18 NCAC 06A .2017(b).

<sup>39</sup> 18 NCAC 06A .2027 (1).

<sup>40</sup> 18 NCAC 06A .2023(2).

<sup>41</sup> 18 NCAC 06A .2023(4).

<sup>42</sup> 18 NCAC 06A .2024 (a).

<sup>43</sup> 18 NCAC 06A .2023(3), 18 NCAC 06A .2027(2).

<sup>44</sup> 18 NCAC 06A .2023(3).

<sup>45</sup> 18 NCAC 06A .2007 et seq. for NC PACES; 18 NCAC 06A .2106 et seq. for LPOs.

<sup>46</sup> 18 NCAC 06A .2010 & 18 NCAC 06A .2011; 18 NCAC 06A .2106 – 18 NCAC 06A .2108.

with NC Secretary of State staff.<sup>47</sup> Rules for advertising and other materials to be used in connection with the offer or sale of a security are detailed, and materials must be submitted for review.<sup>48</sup> The definition of what constitutes an offer is a “term of art in securities law,”<sup>49</sup> and wording should be carefully crafted to conform to securities law. LPOs can host events, use a website, publish ads, use email, etc. upon prior review by the Securities Division. However, NCPOs are limited to notices (i.e., tombstone ads) including on Facebook, but those, too, must be submitted for review prior to posting. Record keeping obligations also apply.<sup>50</sup>

**Consider the distractions.** Issuers of securities must provide notices and reports. For example, an issuer must give the Administrator written notice after reaching the minimum offering amount, after initial release of funds from escrow, and after escrow agreement termination.<sup>51</sup> Additionally, the issuer must provide quarterly reports to investors until no securities are outstanding.<sup>52</sup> Crowdfunding is built around the premise of having a large number of owners of the company. However, having hundreds of owners may distract the company’s management from devoting the time and energy that is necessary to run a successful business. Venture capital companies or private equity funds may be less inclined to invest in a company that already has a large crowd of small investors. Some issuers minimize this by limiting the offer to accredited investors.

**Consider the financial risks.** The business will not get any of the money until it raises at least its minimum.<sup>53</sup> For NCPOs, that is at least 20 percent of its goal.<sup>54</sup> For Local Public Offerings, that is 25 percent of the target.<sup>55</sup> Until that time, the money will be kept in an escrow account. Put another way: If the minimum is not raised, the money is returned to the investors.<sup>56</sup> Investors have the option of cancelling for any reason before the minimum offering amount is reached.<sup>57</sup> Failure to raise the minimum results in the issuer absorbing all costs attendant to the endeavor without any offsetting income. Regardless of whether the issuer goes it alone or uses a lawyer, broker/dealer, or funding portal, the issuer must ascertain and consider, exactly:

- What each will do (e.g., prepare initial filings so an offering can be made? Market and process the offering?),
- What each is not going to do, and
- How much it’s going to cost.

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<sup>47</sup> 18 NCAC 06A .2105.

<sup>48</sup> 18 NCAC 06A .2111-18 NCAC 06A .2115; also 18 NCAC 06A .1308; 18 NCAC 06A .2111-18 NCAC 06A .2116.

<sup>49</sup> 18 NCAC 06A .2103(3).

<sup>50</sup> 18 NCAC 06A .2060.

<sup>51</sup> 18 NCAC 06A .20204(b).

<sup>52</sup> NCGS § 78A-17.1(c), 18 NCAC 06A .2057.

<sup>53</sup> 18 NCAC 06A .2055.

<sup>54</sup> 18 NCAC 06A .2004(b)(3).

<sup>55</sup> 18 NCAC 06A .2104(b).

<sup>56</sup> 18 NCAC 06A .2010 (10), 18 NCAC 06A .2010(13)(b).

<sup>57</sup> 18 NCAC 06A .2010(13)(a), 18 NCAC 06A .2020(11), 18 NCAC 06A .2054.

**Consider the legal risks.** Securities have to be registered unless there is an exemption. The NC PACES Act does provide an exemption from registration. However, that does not eliminate the need to file with the NC Department of the Secretary of State and take other actions before using the exemption.<sup>58</sup> While North Carolina does have provision which has been called a “friends-and-family” exemption, it does not relieve an offeror of all filing requirements.<sup>59</sup> Despite the registration exemptions, issuers must still comply with all of the anti-fraud provisions of federal and state law. Exemptions give no relief from anti-fraud provisions. Failure to satisfy these other requirements may be viewed as an:

- Unregistered offering made by an
- Unregistered agent.

Such conduct exposes the company raising capital to administrative, civil, and criminal liability. A violation of the securities law can occur without intent. Securities laws are primarily for the protection of investors. Consequently, those who seek capital are required to provide complete and accurate information about the investment so investors can make informed decisions. Issuers must disclose all important information about the investment opportunity, including:

- Names/histories of the business’ management,
- What the money will be used for
- All possible risks posed by competitors
- Details of the company’s business/marketing plans and financial health and history.

The foregoing is a partial list. How much information must be disclosed depends upon the offering type and the investors participating. The same information must be made available to all investors. If any investors are non-accredited, then the greater disclosure requirements apply. While not required for NC Crowdfunding<sup>60</sup>, the Small Company Offering Registration (SCOR) Form U7 is a useful tool. It is available from the North American Securities Administrators Association (NASAA) at:

<https://www.nasaa.org/industry-resources/uniform-forms/>.

Administrative remedies for violation of law and rules may include having to make a rescission offer<sup>61</sup>:

- Informing investors about the securities law violations,
- Offering to remedy the violation by

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<sup>58</sup> See 18 NCAC 6A.

<sup>59</sup> NCGS § 78A-17(9).

<sup>60</sup> See 18 NCAC 06A .2010 & 18 NCAC 06A .2011.

<sup>61</sup> 18 NCAC 06A .1501

- Buying back all securities sold at the purchase price and
- Paying 8 percent.
- Filing documentation with the regulator (the NC Department of the Secretary of State) that the rescission offer has been made.

Consider **funding alternatives**. Crowdfunding may be less expensive than doing a public offering of securities, but it may be more expensive than other alternatives. Federal and state laws provide other ways for a company to raise money from a limited number of investors with little or no cost. The Small Business Administration reports: “The most common source of capital to finance business expansion is personal and family savings (21.9% of small firms), followed by business profits and assets (5.7%), business loans from financial institutions (4.5%), and business credit cards from banks (3.3%).”<sup>62</sup>

### **WEIGHING RISKS AND BENEFITS: From the Investor Perspective**

All investments have risk, but small business investments are particularly risky. Small businesses have high failure rates and there is very little information publicly available about the businesses.<sup>63</sup> Disclosures should be collected, carefully reviewed, and claims therein verified to the extent possible. Particular attention should be given to the issuer’s track record. Crowdfunding portals or other online intermediaries claiming an accreditation or “seal of approval” from a standards program or board may not be legitimate and should be verified. Assistance with offerings made on the Internet—whether on a funding portal, in an online newsletter, message board or chat room—can be had from the North Carolina Department of the Secretary of State, Securities Division at (800) 688-4507 or (919) 814-5400, Option 5-1, or visit <https://www.sosnc.gov/divisions/securities/crowdfunding>. Crowdfunding investments are mostly illiquid and investors must be prepared to hold their investments indefinitely. It may be difficult or impossible to resell these securities due to the lack of a secondary market. In short, investors should be prepared to withstand the loss of their entire investment.

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<sup>62</sup> Frequently Asked Questions about Small Business, US Small Business Administration Office of Advocacy (August 2018) § 18 at 4, <https://www.sba.gov/sites/default/files/advocacy/Frequently-Asked-Questions-Small-Business-2018.pdf>.

<sup>63</sup> Id. at 2 § 6: “Four out of five establishments that started in 2016 survived until 2017 (79.8%). From 2005 to 2017, an average of 78.6% of new establishments survived one year.

- About half of all establishments survive five years or longer. In the past decade, this ranged from a low of 45.4% for establishments started in 2006, and a high of 51.0% for those started in 2011.
- About one-third of establishments survive 10 years or longer.”

“Accredited investors” face increased risks.<sup>64</sup> NC incorporates the federal definition of accredited investors.<sup>65</sup> Such investors are presumed to be “financially sophisticated and able to fend for themselves or sustain the risk of loss, thus rendering unnecessary the protections that come from a registered offering.” The disclosures required for accredited investors are fewer than those for non-accredited investors. However, if an issuer is offering securities to both accredited and non-accredited investors, the same information must be available to both. Accredited investor risks are above and beyond the risks that must be disclosed to all would-be investors including:

These securities are subject to restrictions on transferability and resale and may not be transferred or resold except as permitted under the Securities Act of 1933, as amended, and the applicable state securities laws, pursuant to registration or exemption therefrom. Investors should be aware that they will be required to bear the financial risks of this investment for an indefinite period of time.<sup>66</sup>

Any investor who is being treated as an accredited investor must submit a signed and dated certification of accredited investor status.<sup>67</sup> This may be in the form of a Subscription Agreement or Accredited Investor Questionnaire, for example.

### **WHEN: Time Limitations**

There are two types of time limitations presently applicable to NC Crowdfunding. The first is that each fund-raise is limited to 12 months from the date of notice of compliance.<sup>68</sup> The second is that no Local Public Offerings can be accepted after April 1, 2020.<sup>69</sup> Moreover, the rules presently applicable to Local Public Offerings expire April 1, 2021.<sup>70</sup> No sunset rule applies to NCPOs. Third, an issuer may use only one exemption at a time.<sup>71</sup>

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<sup>64</sup> Updated Investor Bulletin: Accredited Investors, US SEC (Jan. 31, 2019), <https://www.investor.gov/additional-resources/news-alerts/alerts-bulletins/updated-investor-bulletin-accredited-investors>.

<sup>65</sup> 18 NCAC 06A .2004© incorporating 17 CFR 230.501. NOTE: The SEC is considering a rule change to modify the definition of accredited investors to include more potential investors. <https://www.sec.gov/news/press-release/2019-265> (Dec. 18, 2019); see also Cheryl Winokur Munk, “Is the Definition of Accredited Investor Ripe for Change?” Debanked.com (Oct. 26, 2019).

<sup>66</sup> 18 NCAC 06A .2011(b)(2).

<sup>67</sup> 18 NCAC 06A .2053(a)(2).

<sup>68</sup> 18 NCAC 06A .2004(d).

<sup>69</sup> 18 NCAC 06A .2120(a).

<sup>70</sup> 18 NCAC 06A .2120(b).

<sup>71</sup> 18 NCAC 06A .2064(a).

## WHERE TO TURN FOR HELP

NC Rule of Professional Conduct 1.1 prohibits a lawyer from handling “a legal matter that the lawyer knows or should know he or she is not competent to handle without associating with a lawyer who is competent to handle the matter...” Even if a lawyer cannot handle the legal matter directly or is disinclined to associate with another, lawyers can provide substantial assistance by helping clients connecting with needed legal expertise.

### **HELP: For Investors**

Investors who have lost money and suspect fraud or other misconduct have resources to turn to. The NC Department of the Secretary of State has administrative, civil, and criminal authority. Inquiries may be submitted to the **Investor Hotline at 1-800-688-4507**. Complaints may be filed online or submitted by fax or mail.<sup>72</sup> Any action taken by the NC Department of the Secretary of State to regulate and enforce the state securities and investment adviser laws must be on behalf of all North Carolinians, not individual investors. Consequently, investors also may want to contact an attorney in private practice to pursue additional remedies including individually bringing a lawsuit seeking restitution. NC and federal securities laws do permit investors to bring a civil lawsuit to recover money or the amount of damages suffered because of someone’s violation of those laws. The [Public Investors Advocate Bar Association](#)<sup>73</sup> states that it is “an international bar association whose members represent investors in disputes with the securities industry.” Nine attorneys licensed in North Carolina are listed among its membership.<sup>74</sup> Also, the North Carolina Bar Association’s Lawyer Referral Service (LRS) can serve as a resource. The call center can be reached at 800-662-7660 or at [www.NCFindALawyer.org](http://www.NCFindALawyer.org).

### **HELP: For Businesses**

Issuers are urged to contact the NC Department of the Secretary of State to inquire about brokers and platforms, and to ensure that all obligations have been met and a notice of

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<sup>72</sup> [https://www.sosnc.gov/divisions/securities/file\\_a\\_complaint](https://www.sosnc.gov/divisions/securities/file_a_complaint).

<sup>73</sup> PIABA.org or 888.621.7484. This is offered for information only and is not an endorsement

<sup>74</sup> See [https://piaba.org/find-attorney?search\\_type=state&field\\_willing\\_to\\_take\\_cases\\_target\\_id=All&state=NC&field\\_firm\\_geofield\\_proximity%5Bvalue%5D=&field\\_firm\\_geofield\\_proximity%5Bsource\\_configuration%5D%5Borigin\\_address%5D=](https://piaba.org/find-attorney?search_type=state&field_willing_to_take_cases_target_id=All&state=NC&field_firm_geofield_proximity%5Bvalue%5D=&field_firm_geofield_proximity%5Bsource_configuration%5D%5Borigin_address%5D=)



compliance has issued before advertising or offering securities by whatever name.<sup>75</sup> For more information:

NC Department of the Secretary of State  
Securities Division  
P.O. Box 29622  
Raleigh, NC 27626-0622  
Telephone: (919) 814-5400, Option 5-1 or toll-free: (800) 688-4507  
Fax: (919) 807-2183 or Email: [secdiv@sosnc.gov](mailto:secdiv@sosnc.gov)  
Crowdfunding page of our website:  
<https://www.sosnc.gov/divisions/securities/crowdfunding>

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<sup>75</sup> 18 NCAC 06A .2004(g).

# INVESTORS TAKE HEED

## Check Before You Invest: Ten Do's And Don'ts for Investors

**If you want to avoid being suckered in an investment scam, the smart approach is to ask questions before you part with your money!**

Smart investing requires good information. The Securities Division of the North Carolina Department of the Secretary of State offers the following advice for prospective investors.

1. Be suspicious when strangers offering get-rich-quick schemes contact you with "cold" phone calls, emails, or unannounced visits to your home. The phone calls could be "boiler room" scams, in which the operators rent offices with impressive addresses and hire unlicensed sales people to work banks of phones calling individuals from lists they buy. The e-mails may be totally bogus attempts to fleece you of your money.
2. Be skeptical of fantastic promises of extraordinary returns on your investments. Too-good-to-be-true offers are, in reality, too good to be true.
3. Resist high-pressure sales techniques requiring you to turn over your investment money over immediately. Scam artists sometimes send messengers to investors' homes to pick up their checks almost as soon as they end a phone call, so that the investor won't have time for second thoughts or time to inquire with the authorities.
4. Avoid investments in which the seller has little or no written information about the company or its past performance. If the opportunity is legitimate, details about the investment should be given to you in writing. But remember, even printed materials, no matter how slickly presented, can be fakes. Crooks are very skilled at producing impressive-looking (but fake) prospectuses. Read all materials carefully, ask questions, and check with expert advisers.
5. Stay away from investments sold on the basis of rumors, tips or supposedly "inside information." Inside information is usually just lies, or information obtained illegally.
6. Demand that the seller give you written information about the investment, including the prospectus (also called an offering circular) and financial statements. Such information is required for many types of investments, including stock offerings, limited offerings, limited partnerships, franchise offerings and mutual funds. Read the material or get an expert adviser to read them before you sign a purchase order to pay for an investment.
7. Consult with a registered stockbroker or investment adviser about investment "opportunities" that are pitched to you. Check out the company with the Financial Industry Regulatory Authority, Inc. (FINRA) **BrokerCheck Hotline at 1-800-289-9999**.

8. Contact the Securities Division of the NC Department of the Secretary of State at 1-800-688-4507 to find out if a company or individual is properly licensed to sell investments or has any history of violating the law. A person or company who has failed to properly register or has had a history of trouble with authorities should be a “red flag” to any prospective investor.
9. Deal with established investment professionals whose reputations are known in the community.
10. When in doubt, wait! If something seems fishy, if your questions are not answered, don’t commit your money. There will always be another investment opportunity coming along. Remember, even legitimate investments present the risk of the loss of your investment money.

## **Top Investor Traps**

To help educate investors, securities regulators of the [North America Securities Administrators Association’s \(NASAA\)](#) Enforcement Section have identified the following financial products and practices as potential traps for the unwary. Additional information about these and other investor traps can be found on the Secretary of State’s website at [https://www.sosnc.gov/online\\_services/securities/investor\\_education\\_booklets](https://www.sosnc.gov/online_services/securities/investor_education_booklets).

### **PROMISSORY NOTES**

In an environment of low interest rates, the promise of high interest promissory notes may tempt investors, especially seniors and others living on a fixed income.

A promissory note is a written promise to pay (or repay) a specified sum of money at a stated time in the future or upon demand. Promissory notes generally pay interest, either periodically before maturity of the note or at the time of maturity. Companies may sell promissory notes to raise capital, and usually offer them only to sophisticated or institutional investors. But not all promissory notes are sold in this way.

Promissory notes may be offered and sold to retail investors. Such notes must be registered with the Securities and Exchange Commission and/or the state(s) in which they are sold or qualify for an exemption from securities registration. Most promissory notes sold to the general public also must be sold by securities salespeople who have the appropriate securities license or registration from their state securities agency.

Promissory notes from legitimate issuers can provide reasonable investment returns at an acceptable level of risk, although state securities regulators have identified an unfortunately high number of promissory note frauds. Individuals considering investing in a promissory note should thoroughly research the investment – and the people promoting it. Investors should be cautious about promissory notes with durations of nine months or less, as these notes generally do not require federal or state securities registration.

Such short-term notes have been the source of most (though not all) of the fraudulent activity involving promissory notes identified by state securities regulators. These short-term debt instruments may be offered by little-known (or perhaps even nonexistent) companies and extend promises of high returns – perhaps over 15 percent monthly – at little to no risk. But if an investment sounds too good to be true, it probably is.

### **PONZI/PYRAMID SCHEMES**

A Ponzi scheme (named after 1920's swindler Charles Ponzi) is a ploy wherein earlier investors are repaid through the funds deposited by subsequent investors.

Charles Ponzi took investors for \$10 million by promising 40 percent returns from arbitrage profits on International Postal Reply Coupons.

In a **Ponzi scheme**, the underlying investment claims are usually entirely fictional; very few, if any, actual physical assets or investments generally exist. As the number of total investors grows and the supply of potential new investors dwindles, there is not enough money to pay off promised returns and cover investors who try to cash out.

A Ponzi bubble will burst when the con artist simply cannot keep up with the payments investors are expecting to receive.

When the scheme collapses (as it always does), investors may lose their entire investment in the fraud. In many cases, the perpetrator will have spent investment money on personal expenses, depleting funds and accelerating the bursting of the bubble.

Similarly, a **pyramid scheme** is a fraudulent multi-level marketing strategy whereby investors earn potential returns by recruiting more and more other investors. Multi-level marketing strategies are not intrinsically fraudulent, and there are many legitimate multi-level marketing companies offering various consumer products and services.

What makes a multi-level marketing strategy into a fraudulent pyramid scheme is the lack of a genuine underlying investment enterprise or product upon which the strategy can hope to be sustained.

### **REAL ESTATE INVESTMENTS**

The promise of earning quick money through investments related to real estate continues to lure investors. Real estate investment scams are a perennial investor trap.

State securities regulators caution investors about real estate investment seminars, especially those marketed aggressively as an alternative to more traditional retirement planning

strategies involving stocks, bonds and mutual funds. Attendees at these seminars may hear testimonials from people claiming to have doubled or tripled their income through seemingly simple real estate investments. But these claims may be nothing more than hot air.

Two of the most popular investment pitches involve so-called “hard-money lending” and “property flipping.” Hard-money lending is a term used to refer to real estate investments financed through means other than traditional bank borrowing. (This type of loan gets its name from the fact that it would be “hard to get” from a traditional lending source.)

Some firms or wealthy individuals specialize in making hard-money loans, as these loans can command comparatively high interest rates. But borrowers may seek to obtain such loans from retail investors as well. Investors may be tempted by the opportunity to earn greater rates of return by participating on a hard-money loan and may (or may not) appreciate the potential risks, including as to the borrower’s credit, the expected stability of income from the investment, or time constraints.

There are three players in a hard-money transaction: the investor, the lender and the borrower. Private lenders raise money from investors to lend to borrowers. If funds from different investors are combined, the investment vehicle used to purchase the property is a “pooled investment,” which is a security and, as such, is subject to the protections and disclosure requirements of securities laws and regulations.

While traditional loans are based on the ability of the borrower to repay using indicators such as credit scores and income, hard-money loans are based primarily on the value of the property with which they are secured, which the borrower already owns or is acquiring with the loan.

If the borrower defaults, the lender may be able to seize the asset and try to sell it; however, it may be harder for the investor to recoup the loan depending on how it is structured.

Property flipping is the practice of purchasing distressed real estate, refurbishing it, and then immediately re-selling it in hopes of earning a profit. A property flipper can use its own money to finance the flip or can seek financing from others. Property flipping financed through borrowed funds or outside investments can be done entirely lawfully, but it can also be a source for fraud.

A scammer may, for example, defraud potential investors in the flip by misrepresenting the value of the underlying property or the expected profit potential on the flip. Scammers may also misappropriate borrowed or invested funds or seek to use unwitting investors as “straw

buyers” with outside banks or mortgage lenders, leveraging investors’ names and credit scores to facilitate their scams.

## **CRYPTOCURRENCY-RELATED INVESTMENTS**

Cryptocurrencies burst into the investing mainstream in 2017 as the values of some virtual coins and tokens skyrocketed, led by Bitcoin. Shortly after, the news featured coverage of new cryptocurrencies, coin exchanges, and related investment products. Stories of “crypto millionaires” attracted some investors to try their hand at investing in cryptocurrencies or crypto-related investments. But stories of those who bet big and lost also began appearing and continue to appear.

Before you jump into the crypto craze, be mindful that cryptocurrencies and related financial products may be nothing more than public facing fronts for Ponzi schemes and other frauds. And because these products do not fall neatly into the existing federal/state regulatory framework, it may be easier for the promoters of these products to fleece you. Investing in cryptocurrencies and related financial products accordingly should be seen for what it is: extremely risky speculation with a high risk of loss.

## **SOCIAL MEDIA/INTERNET INVESTMENT FRAUD**

Social networking through the internet allows people to connect to one another more quickly and easily than ever before. Investment promoters increasingly are logging on to find investors ... and their money.

A social network is a group of individuals (or organizations) who are connected through common interests, hobbies, lifestyles, relationships, faith or other beliefs. Platforms such as Facebook, Twitter, LinkedIn, eHarmony and other online social networks and communities have made it faster and easier for users to meet, interact and establish connections with other users anywhere in the world.

While social networking helps connect people with others who share similar interests or views, con artists infiltrate these social networks looking for victims. By joining and actively participating in a social network or community, the con artist builds credibility and gains the trust of other members of the group.

In online social networks, a con artist can establish this trust and credibility more quickly. The scammer has immediate access to potential victims through their online profiles, which may contain sensitive personal information such as their dates or places of birth, phone numbers, home addresses, religious and political views, employment histories, and even personal photographs.

The con artist takes advantage of how easily people share background and personal information online and uses it to make a skillful and highly targeted pitch. The scam can spread rapidly through a social network as the con artist gains access to the friends and colleagues of the initial target.

Online investment fraud has many of the same characteristics as offline investment fraud. Learn to recognize these **red flags**:

- **Promises of high returns with no risk.** Many online scams promise unreasonably high short-term profits. Guarantees of returns around 2 percent a day, 14 percent a week or 40 percent a month are too good to be true. Remember that risk and reward go hand-in-hand.
- **Offshore operations.** Many scams are headquartered offshore, making it more difficult for regulators to shut down the scam and recover investors' funds.
- **E-Currency sites.** If you have to open an e-currency account to transfer money, use caution. These sites may not be regulated, and the con artists use them to cover up the money trail.
- **Recruit your friends.** Most cons will offer bonuses if you recruit your friends into the scheme.
- **Professional websites with little to no information.** These days anyone can put up a website. Scam sites may look professional, but they offer little to no information about the company's management, location or details about the investment.
- **No written information.** Online scam promoters often fail to provide a prospectus or other form of written information detailing the risks of the investment and procedures to get your money out.

## Want to be kept in the know?

Read about the latest scams and fraud prevention tips by subscribing to the Securities Division's monthly e-newsletter. To subscribe or read archived editions, please visit: <https://www.sosnc.gov/divisions/securities/newsletter>.

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# Cybersecurity

The Department of the Secretary of State has identified the cybersecurity of state registered investment advisers, their business records and client funds to be a critically important issue. Cyberattacks are a real danger, with impacts on both the advisers and their clients. Consequently, the Department is undertaking a special emphasis initiative to help North Carolina's registered investment advisers become more "cybersecure."

All state-registered investment advisers are fiduciaries. Consequentially, they have a legal obligation to keep their clients' personal and financial data safe and secure. As part of their books and records obligations, all state registered investment advisers must also keep and maintain policies and procedures that are meaningful and specific to their businesses. This includes having specific cybersecurity policies.

**Our cybersecurity consultative services are completely free and voluntary for any North Carolina-registered investment adviser.**

The initiative is being run through our Investor Protection and Education Services Program. The program is not being coordinated with the audit unit, nor will information gathered through this consultative initiative be shared with the audit unit.

**Please note:** Participation in this initiative will **not** guarantee that an investment adviser will not have compliance issues. However, active participation in the initiative will put the adviser in much better shape to pass an examination on these elements than it likely would be if it did not participate. Participation in every stage of this initiative should significantly reduce the chances that an investment adviser will experience related compliance issues in the future.

Our initiative is based on the Framework for Improving Critical Infrastructure Cybersecurity (the "Cybersecurity Framework") developed by the National Institute of Standards and Technology (NIST). The Cybersecurity Framework is a voluntary, risk-based framework of industry standards and best practices designed to help organizations manage cybersecurity risks. (For more information about the Cybersecurity Framework, please see their website at <https://www.nist.gov/cyberframework>.) Our initiative also draws from materials produced by the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the North American Securities Administrators Association (NASAA), and the International Organization of Securities Commissions (IOSCO).

The NIST Cybersecurity Framework identifies five core functions: Identify, Protect, Detect, Respond, and Recover. We will help the volunteer participants in this initiative work through these five core functions in stages. Throughout this process, we are going to utilize



portions of FINRA’s “Checklist for a Small Firm's Cybersecurity Program” which may be downloaded at <https://www.finra.org/industry/cybersecurity#checklist>. For more information about this on-going initiative, please visit [https://www.sosnc.gov/divisions/securities/cyber\\_security](https://www.sosnc.gov/divisions/securities/cyber_security).