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SEC Issues Proposal on Crowdfunding

On October 23, 2013, the Securities and Exchange Commission voted unanimously to propose rules under the JOBS Act to permit companies to offer and sell securities through crowdfunding.

SEC Chair Mary Jo White noted that the intent of the JOBS Act is to make it easier for startups and small businesses to raise capital from a wide range of potential investors and provide additional investment opportunities for investors.

“There is a great deal of excitement in the marketplace about the crowdfunding exemption, and I’m pleased that we’re in a position to seek public comment on a proposal to permit crowdfunding,” said Chair White. “We want this market to thrive in a safe manner for investors.”



Background

Crowdfunding is a term used to describe an evolving method of raising money through the Internet. For several years, this funding method has been used to generate financial support for such things as artistic endeavors like films and music recordings, typically through small individual contributions from a large number of people.

While crowdfunding can be used to raise funds for many things, it generally has not been used as a means to offer and sell securities. That is because offering a share of the financial returns or profits from business activities could trigger the application of federal and state securities laws, and an offer or sale of securities must be registered with the SEC or the NC Department of the Secretary of State Securities Division unless an exemption is available.

Congress created an exemption to permit securities-based crowdfunding when it passed the JOBS Act last year. Among other things, the JOBS Act was intended to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in relatively low dollar amounts.

Title III of the JOBS Act established the foundation for a regulatory structure that would permit these entities to use crowdfunding, and directed the SEC to write rules implementing the exemption. It also created a new entity – a funding portal – to allow Internet-based platforms or intermediaries to facilitate the offer and sale of securities without having to register with the SEC as brokers. Together these measures were intended to facilitate the raising of capital by small businesses while providing significant investor protections.

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Proposed Rules

Consistent with the JOBS Act, the proposed rules would among other things permit individuals to invest subject to certain thresholds, limit the amount of money a company can raise, require companies to disclose certain information about their offers, and create a regulatory framework for the intermediaries that would facilitate the crowdfunding transactions.

Under the proposed rules:

- A company would be able to raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period.
- Investors, over the course of a 12-month period, would be permitted to invest up to:
 - \$2,000 or 5 percent of their annual income or net worth, whichever is greater, if both their annual income and net worth are less than \$100,000.
 - 10 percent of their annual income or net worth, whichever is greater, if either their annual income or net worth is equal to or more than \$100,000. During the 12-month period, these investors would not be able to purchase more than \$100,000 of securities through crowdfunding.

Certain companies would not be eligible to use the crowdfunding exemption. Ineligible companies include non-U.S. companies, companies that already are SEC reporting companies, certain investment companies, companies that are disqualified under the proposed disqualification rules, companies that have failed to comply with the annual reporting requirements in the proposed rules, and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Investors Beware

As mandated by Title III of the JOBS Act, securities purchased in a crowdfunding transaction could not be resold for a period of one year. Holders of these securities would not count toward the threshold that requires a company to register with the SEC under Section 12(g) of the Exchange Act.

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INVESTORS BEWARE

By removing some regulatory requirements that have been in place since the 1930s, and allowing businesses to appeal directly to Main Street investors via the Internet, the federal JOBS Act makes it easier than ever for businesses to raise capital. The hope is these changes will promote business expansion and job growth. But these changes require investors to be more diligent than ever when making investment decisions. Here are things every crowdfunding investor should know:

1. You must not exceed the individual investment limits, which are based on your net worth or annual income.
2. You should expect to have limited rights and control in any new venture.
3. You should thoroughly check out all opportunities before investing and examine all financials and other documents provided by the issuer and Internet intermediary. Do not be afraid to ask for as much information as you need.
4. Investor questionnaires will be issued by intermediaries and are for your protection. Answer all questions honestly and be prepared to disclose personal financial information. You will be required to acknowledge the significant risks associated with crowdfunding.
5. Beware of overly optimistic projections, as there are no uniform standards for valuing startup or early stage companies.
6. There may be limited or no market for crowdfunding securities, so it may be difficult or impossible to sell your investment. Typically, shares may not be transferred within one year of purchase.
7. You should only invest money that you have no immediate use for, and that you can afford to lose.

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INVESTORS BEWARE

8. Crowdfunding investments are long-term investments and may not result in returns for a significant period of time, if at all.
9. Be aware that you may have limited rights against an intermediary or issuer in the event of a dispute.
10. Above all, take time to understand the process of crowdfunding. The NC Department of the Secretary of State Securities Division will be conducting investor education throughout the state on equity crowdfunding. For more information, visit www.sosnc.com or contact the Division at (919) 733-3924 or toll-free at (800) 688-4507.

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Disclosure by Companies

Consistent with Title III of the JOBS Act, the proposed rules would require companies conducting a crowdfunding offering to file certain information with the SEC, provide it to investors and the relevant intermediary facilitating the crowdfunding offering, and make it available to potential investors. In its offering documents, among the things the company would be required to disclose:

- Information about officers and directors as well as owners of 20 percent or more of the company.
- A description of the company's business and the use of proceeds from the offering.
- The price to the public of the securities being offered, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount.
- Certain related-party transactions.
- A description of the financial condition of the company.
- Financial statements of the company that, depending on the amount offered and sold during a 12-month period, would have to be accompanied by a copy of the company's tax returns or reviewed or audited by an independent public accountant or auditor.

Companies would be required to amend the offering document to reflect material changes and provide updates on the company's progress toward reaching the target offering amount.

Companies relying on the crowdfunding exemption to offer and sell securities would be required to file an annual report with the SEC and provide it to investors.

Crowdfunding Platforms

One of the key investor protections Title III of the JOBS Act provides for crowdfunding is the requirement that crowdfunding transactions take place through an SEC-registered intermediary, either a broker-dealer or a funding portal. Under the proposed rules, the offerings would be conducted exclusively online through a platform operated by a registered broker or a funding portal, which is a new type of SEC registrant.

The proposed rules would require these intermediaries to:

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

The proposed rules would prohibit funding portals from:

- Offering investment advice or making recommendations.
- Soliciting purchases, sales or offers to buy securities offered or displayed on its website.
- Imposing certain restrictions on compensating people for solicitations.
- Holding, possessing, or handling investor funds or securities.

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The proposed rules would provide a safe harbor under which funding portals can engage in certain activities consistent with these restrictions.

What's Next?

The Commission will seek public comment on the proposed rules for 90 days. The Commission will then review the comments and determine whether to adopt the proposed rules.

Opinion:

Businesses: Should You Raise Equity Through Crowdfunding?

(The following is from "[Should You Raise Equity Through Crowdfunding](#)" by Scott Shane, the A. Malachi Mixon III, Professor of Entrepreneurial Studies at Case Western Reserve University. It is reprinted here with permission and was originally published December 9, 2013, by the daily online journal, [Small Business Trends](#). The views expressed are Professor Shane's and do not necessarily reflect those of the NC Department of the Secretary of State and should not be construed as providing legal advice. You should consult with a licensed securities attorney when deciding if equity crowdfunding is right for you and your business.)



Last October, the Securities and Exchange Commission (SEC) issued the rules that make equity crowdfunding possible. Now that you can, you may be wondering if you should sell shares to the crowd of unaccredited investors. The answer depends on how well equity crowdfunding fits your business opportunity.

First, you need to assess whether raising debt or equity is a better way to finance your business. Getting a loan – whether obtained through an online source like Prosper.com or from a bricks-and-mortar bank – makes more sense than selling shares if your business isn't likely to generate a huge return on investment. Investors buying equity demand greater returns than those lending money to compensate them for the greater risks involved in owning shares.

Borrowing money also makes more sense if you want to keep all of the future profits of your business because equity investors have a claim on future profits, while lenders don't.

If you want to maintain tight control over your business, you should borrow money, not sell shares. Buyers of equity have the right to participate in your company's decisions. At a minimum, you will have to discuss future plans with investors before you make them, and you might need their agreement if they own enough of your company. In fact, if the investors disagree with you, and they own a majority of the company, they can replace you as the chief executive.

If you raise equity, you probably need an exit plan. Most equity investors cash out of their investments in start-ups when the business goes public or gets acquired by another business. If you aren't planning one of those outcomes, equity crowd funding probably isn't right for your business.

If equity is more appropriate for your business than debt, then you need to evaluate whether tapping the crowd makes more sense than raising money from business angels or venture capitalists. If you need to raise a lot of money, equity crowd funding probably isn't the right way to go. Crowdfunding provides a way to tap the pool of unaccredited investors [whose incomes or net worth is less than \$100,000], but limits those financiers to no more than \$5,000 per year invested in any new business. Because you will need more investors to raise more money, and managing large groups of investors can be difficult, the equity crowdfunding model probably won't work well if you need millions of dollars.

Crowdfunding also makes more sense if your business needs to raise money just once rather than through multiple investment rounds. Multiple rounds will dilute your investors' stakes if you don't give first round investors "pro rata" rights to invest in a new round and make sure your investment rounds occur no more than once per year.

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If you plan to tap venture capitalists at some point, beginning with equity crowd funding might not be wise. Venture capitalists might shy away from businesses that have raised a lot of money from unaccredited investors because of the potential legal complications that such situations create.

If you need mentoring from people experienced in building companies or connections to suppliers, customers or management talent, then going the crowdfunding route also makes less sense. Unlike venture capitalists or successful business angels, the crowd isn't likely to offer much in the way of mentoring or connections.

Equity crowdfunding shouldn't be like the latest iPhone – something people pursue because everyone else they know has it. Rather, entrepreneurs should take a look at their business opportunities and figure out whether raising equity from the crowd is right for what they are doing.



The following [Investor Alert](#) was originally published by the Financial Industry Regulatory Authority (FINRA). It is reprinted here for educational purposes only.

Closed-End Fund Distributions: Where is the Money Coming From?

You may have considered investing in a closed-end fund as a way to generate income when other investments did not seem to offer what you may have been looking for. Closed-end funds have become popular products because some offer high distribution rates—as high as 6 percent or more. But be aware that a fund's distribution rate is not the same thing as its return—even if the numbers might look similar. And before you invest, be sure you understand where the closed-end fund is getting the money to pay distributions. In some cases, part of the distribution comes from the return of principal.



Image - copyright Daniel Baxter and reprinted with permission

FINRA is issuing this alert to explain what closed-end funds are, how they differ from traditional [mutual funds](#), what a distribution rate is and what to ask before investing.

Closed-End Funds Basics

A closed-end fund is a type of investment company that pools money from investors to buy securities. Closed-end funds are similar to mutual funds in that they professionally manage portfolios of stocks, bonds or other investments (including illiquid securities). Unlike mutual funds, which continuously sell newly issued shares and redeem outstanding shares, most closed-end funds offer a fixed number of shares in an initial public offering (IPO) that are then traded on an exchange.

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When you buy shares in a closed-end fund IPO, you'll pay a premium because the fees and expenses paid for the offering come from the capital raised. In other words, if you pay \$10 for a share, the actual amount invested for you will be less than \$10. After a closed-end fund goes public, you can buy shares in the secondary market on an exchange, such as the NYSE or NASDAQ, paying the fees that your broker charges for this type of transaction.

Because closed-end funds trade like stocks, the supply and demand for the shares determines their market price. Both closed-end funds and mutual funds have an inherent net asset value (NAV) that reflects the value of the funds' underlying assets (less liabilities) divided by the number of shares outstanding. Closed-end funds also have a market price that fluctuates throughout the trading day, and that price may be higher or lower than its NAV. You may get information on a closed-end fund's current price and NAV on the fund's website or that of the exchange where it trades. Information on a fund's portfolio holdings is usually available on the fund's website and company filings submitted to the Securities and Exchange Commission.

Closed-end funds have historically traded at a discount to NAV—that is, at a market price lower than the fund's NAV. Some closed-end funds, however, may trade at a premium to NAV—that is, at a market price higher than the fund's NAV. One reason may be that investors looking for a high distribution rate may be willing to pay that higher market price to get the distributions. In contrast, shares of a mutual fund are always priced based on the NAV, which is set daily at the close of trading.

Closed-end funds and mutual funds share some other features. For instance, both closed-end funds and mutual funds charge investors annual fees and expenses. Both fund types might use leverage to enhance their returns, which can magnify a fund's gains as well as its losses. But while closed-end funds and mutual funds can invest in illiquid securities, closed-end funds are not impacted by redemptions as mutual funds are and they are allowed to hold a greater percentage of illiquid securities in their investment portfolios.

Distribution Rates: Understand Where the Money Comes From

Closed-end funds typically pay distributions to investors on a monthly or quarterly basis, and may increase or decrease the distribution rate from one distribution period to the next. Depending on a closed-end fund's underlying holdings, its distributions can include interest income, dividends, capital gains or a combination of these types of payments. In some cases, distributions also include a return of principal, sometimes referred to as a return of capital. That means the monies used to pay the distribution come from the fund's assets rather than from any income generated by the investments in the fund's portfolio.

Closed-end funds that return capital can carry a higher level of risk because the fund is eroding the asset base it has to generate income to pay distributions. Some closed-end funds set a specific distribution rate to pay regardless of the income generated by the fund. In that case, it is more likely that a fund may return capital to investors along the way. Before you invest in a fund, find out if the closed-end fund follows this approach—also known as a managed distribution policy.

Distribution Rate, Total Return or Yield: What is the Difference?

Take care not to confuse a closed-end fund's distribution rate with the fund's total return. In general, a distribution rate is calculated by annualizing the most recent amount paid to investors and dividing the resulting amount by

either the market price or the fund's NAV. The total return from a closed-end fund will take into account the change in share price from a specific point in time and the income the fund paid. Total return figures for closed-end funds usually assume all distributions were reinvested in the fund.

When looking at closed-end funds and traditional mutual funds, keep in mind that distribution rates and yields are different measures. A mutual fund's yield shows its interest and dividend income expressed as a percentage of the fund's current share price. With a closed-end fund, the distribution rate might also include a return of principal.

You can get information about a closed-end fund's distribution rate from the fund's website, its annual report and company announcements. Every time a fund pays a distribution, it must also provide a written statement about the sources it is tapping to pay the distribution. In addition, closed-end funds notify investors of the sources once a year in IRS Form 1099-DIV. You need to pay attention to the sources and amounts reported because a return of capital has different tax consequences than a distribution of interest income, dividends or capital gains.

Six Questions to Ask Before Investing in a Closed-End Fund

1. **Does a closed-end fund fit into my investment objectives?** If unclear, you may want to consult with someone who understands your investment objectives, time horizon and risk tolerance to see how closed-end funds fit with your investment objectives. An investment professional should understand these complex products and be able to explain how they may fit with those objectives.
2. **What is the closed-end fund's investment strategy?** The fund's prospectus or most recent annual or quarterly reports will have details about the fund's investment strategies, risks, proposed sources of distributions, intended use of leverage and management costs. If the fund invests in bonds, look at how its net asset value has fluctuated as interest rates have changed over time. Be clear on whether the fund's strategy involves volatile or illiquid investments that may carry more risk. You should also understand the fund's distribution policy. Remember that past performance does not indicate or guarantee future performance. You can obtain the prospectus and other company reports on the SEC's [EDGAR database](#), the fund's website or through your broker.
3. **How much of what I pay per share in an IPO will actually be invested?** Typically, the IPO price may include a "built-in" sales charge of up to 5 percent of the price that goes to the broker who sells you the shares, plus a separate amount for the offering expenses. Read the fund's prospectus and talk to your broker to understand how much of the price you pay will actually be invested to work for you.
4. **What are the tax implications?** Like mutual funds, closed-end funds do not directly pay taxes but instead "pass through" tax obligations to investors. So you need to understand how any closed-end fund distributions you receive will impact the taxes you owe. Remember that you have no control over the timing of the distributions you might receive, the sources that the closed-end fund will tap to pay them or the tax treatment that will apply.
5. **How is the distribution rate set?** A fund's prospectus or distribution announcements should provide you with an understanding of the sources used to make distribution payments or if the closed-end fund follows a managed distribution policy. If you see frequent returns of capital, ask why the fund is not generating enough income to fund distributions. Also, keep in mind that a fund's current distribution rate is not indicative of the future distribution rates you can expect.

TIP: Closed-end funds aren't the only investment that offers distribution rates to attract investors. When considering an investment in non-traded real estate investment trusts (REITs), business development companies (BDCs) or master limited partnerships (MLPs), you should ask the same question about distributions.

6. **Are the shares trading at a premium or discount to NAV?** While you may not be able to determine why a closed-end fund's shares are trading at a premium or discount to NAV, be sure to find out—from the closed-end fund's website or exchange where it is listed—how the price you are paying compares to the fund's inherent value. This fact is important to know because it will affect your total return. In either case, be sure to find out whether the fund's distributions include a return of principal. If so, consider whether you want to make an investment just to get your money back.



Operator of Multi-Million-Dollar Ponzi Scheme Indicted on Federal Charges

The operator of a \$44 million Ponzi scheme that defrauded more than 200 investors was indicted December 19, in Charlotte on federal charges, announced Anne M. Tompkins, U.S. Attorney for the Western District of North Carolina. A federal grand jury sitting in Charlotte returned the criminal indictment on Wednesday, December 18, 2013, charging Daniel H. Williford, 55, of Statesville, North Carolina, with one count of securities fraud, one count of wire fraud, and five counts of money laundering. The indictment also includes a forfeiture allegation seeking a money judgment in the amount of \$44,000,000.

U.S. Attorney Tompkins was joined in making this announcement by John A. Strong, Special Agent in Charge of the Federal Bureau of Investigation (FBI) in North Carolina.

"For those fraudsters who have not gotten the message yet, I am committed to prosecuting financial crimes and going after those who take money from victims with fake promises. Let me make it simple: you rip people off, you get indicted," said U.S. Attorney Tompkins.

"For years, Daniel Williford swindled hundreds of people, including his own co-workers, out of their hard-earned money. While most people struggle to afford college, he paid those expenses using cash from his investors. Now he will be held accountable for his actions because of the agents and prosecutors who worked so diligently to bring him to justice," said Special Agent Strong.

According to allegations contained in the indictment, from January 2007 through July 2013, Williford induced more than 200 investors in Charlotte and elsewhere to invest more than \$44 million, by promising his victims their money would be invested in wireless Internet equipment, Internet towers, and other facilities and companies. Instead of investing the money, the indictment alleges, Williford used it to run a Ponzi-style scheme and to fund his personal lifestyle. According to the indictment, during the course of the fraud, Williford invested only \$7.7 million of the victims' money as promised. The indictment alleges that Williford used approximately \$32 million of the investor's money to cover personal expenses and to pay some of his victims supposed "profits" on their investments. However, these payouts came from funds contributed by new investors, known as Ponzi payments.

Williford has been ordered by the U.S. District Court to appear on a summons for his initial appearance, which will be scheduled by the court. If convicted, Williford faces a maximum of 20 years in prison for each of the securities fraud and wire fraud counts and a maximum of 10 years imprisonment for each of the money laundering counts. The securities fraud count carries a maximum fine of \$5,000,000, the wire fraud count a maximum fine of \$250,000, and each of the money laundering counts carries a maximum fine of \$250,000 or twice the amount of criminally derived proceeds.

The details contained in this indictment are allegations. The defendant is presumed innocent unless and until proven guilty beyond a reasonable doubt in a court of law.

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SEC Charges Woman and Stepson for Involvement in ZeekRewards Ponzi and Pyramid Scheme

On December 20, 2013, the Securities and Exchange Commission [announced charges](#) against a woman and her stepson for their involvement in a North Carolina-based Ponzi and pyramid scheme that the agency [shut down last year](#).

The SEC alleges that Dawn Wright-Olivares and Daniel Olivares, who each now live in Arkansas, provided operational support, marketing, and computer expertise to sustain ZeekRewards.com, which offered and sold securities in the form of “premium subscriptions” and “VIP bids” for penny auctions. While the website conveyed the impression that the significant payouts to investors meant the company was extremely profitable, the payouts actually bore no relation to the company’s net profits. Approximately 98 percent of total revenues for ZeekRewards – and correspondingly the share of purported net profits paid to investors – were comprised of funds received from new investors rather than legitimate retail sales.

Wright-Olivares and Olivares have agreed to settle the SEC’s charges. In a parallel action, the U.S. Attorney’s Office for the Western District of North Carolina today announced criminal charges against the pair.

“Wright-Olivares was a marketing and operational mastermind behind the scheme and Olivares was the chief architect of the computer databases they used,” said Stephen Cohen, an associate director in the SEC’s Division of Enforcement. “After they learned ZeekRewards was under investigation by law enforcement, they accepted substantial sums of money from the scheme while keeping investors in the dark about its imminent collapse.”

[Pyramid schemes](#) are a type of investment scam often pitched as a legitimate business opportunity in the form of multi-level marketing programs. According to the SEC’s complaint filed in federal court in Charlotte, N.C., the ZeekRewards scheme raised more than \$850 million from approximately one million investors worldwide.

The SEC alleges that Wright-Olivares served as the chief operating officer for much of the existence of ZeekRewards. She helped develop the program and its key features, marketed it to investors, and managed some of its operations. She also helped design and implement features that concealed the fraud. Olivares managed the electronic operations that tracked all investments and managed payouts to investors. Together, Wright-Olivares and Olivares helped perpetuate the illusion of a successful retail business.

The SEC’s complaint charges Wright-Olivares with violating the registration and antifraud provisions of Sections 5 and 17 of the Securities Act, and Section 10 of the Exchange Act and Rule 10b-5. The complaint charges Olivares with violating Section 17 of the Securities Act and Section 10 of the Exchange Act and Rule 10b-5. To settle the SEC’s charges, Wright-Olivares agreed to pay at least \$8,184,064.94 and Olivares agreed to pay at least \$3,272,934.58 – amounts that represent the entirety of their ill-gotten gains plus prejudgment interest. Payments will be made as part of the parallel criminal proceeding in which additional financial penalties could be imposed in a restitution order.

The SEC’s investigation, which is continuing, has been conducted by Brian Privor, Alfred Tierney, and John Bowers. The SEC appreciates the assistance of the U.S. Attorney’s Office of the Western District of North Carolina and the U.S. Secret Service.

The SEC's Office of Investor Education and Advocacy and Office of Credit Ratings are issuing this [Investor Bulletin](#) as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law. It is reprinted here for informational purposes.



SEC

OFFICE of INVESTOR
EDUCATION and ADVOCACY

Investor Bulletin:

The ABCs of Credit Ratings

If you invest in bonds, notes, or other debt instruments, you have probably come across credit ratings. These credit ratings usually appear in the form of alphabetical letter grades (for example, 'AAA' and 'BBB') and are intended to give you an estimation of the relative level of credit risk of a bond or a company or government as a whole.

Credit ratings can be a useful item of information to consider when evaluating an investment along with other information. But if you use credit ratings, you should understand their limitations. You should not base your investment decision solely on a credit rating or treat a credit rating as if it were investment advice.

What is a credit rating?

A credit rating is an assessment of an entity's ability to pay its financial obligations. The ability to pay financial obligations is referred to as "creditworthiness." Credit ratings apply to *debt* securities like bonds, notes, and other debt instruments (such as certain asset-backed securities) and do not apply to *equity* securities like common stock. Credit ratings also are assigned to companies and governments.

The entity whose creditworthiness is being assessed typically is referred to as an obligor or issuer. Obligors include entities such as corporations, financial institutions, insurance companies, or municipalities that have been rated by a credit rating agency. For purposes of this Investor Bulletin, issuers, in this context, are obligors that issue rated debt securities.

Credit ratings generally reflect a relative ranking of credit risk. For example, an obligor or debt security with a high credit rating is assessed by the credit rating agency to have a lower likelihood of default than an issuer or debt security with a lower credit rating.

Credit rating scales, symbols, and definitions may vary among credit rating agencies. Credit ratings typically are expressed on a scale of alpha and/or numeric symbols, and these symbols are defined by the particular credit rating agency issuing those ratings. A typical credit rating scale, as shown in the table below, has a top rating of 'AAA' and may have a lowest rating of 'D' (indicating default). Some credit rating agencies' scales distinguish between investment grade and non-investment grade (*i.e.*, "speculative" or "high yield") ratings and they draw this distinction between the 'BBB' and 'BB' rating categories (in other words, a rating that is 'BBB-minus' or higher is investment grade and a rating that is lower than 'BBB-minus' is non-investment grade).

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Typical Credit Rating Scale
AAA
AA
A
BBB
BB
B
CCC
CC
C
D (default)
<i>For further refinement, some of the ratings above may be modified with a "+", "-", or a number.</i>

What a credit rating is not

A credit rating does not reflect other types of risk, such as market or liquidity risks, which may also affect the value of a security. nor does a credit rating consider the price at which an investor purchased a security, or the price at which the security may be sold. You should not interpret a credit rating as investment advice and should not view it as a recommendation to buy, sell, or hold securities.

A credit rating is not a guarantee that a financial obligation will be repaid. For example, an 'AAA' credit rating on a debt instrument does not mean the investor will always be paid with absolute certainty—instruments rated at this level sometimes default.

Important Considerations

A credit rating is an assessment of the creditworthiness of a debt instrument or obligor, based on a credit rating agency's analytical models, assumptions, and expectations. A credit rating may reflect a credit rating agency's subjective judgment of an issuer's business and management. While historical financial and operating experience and collateral performance may factor into the analysis of an obligor, credit ratings are

simply a prediction of how an obligor may behave in the future. Predictions are based on the views of the credit rating agency, which may differ from your view and those of other industry participants.

Credit rating changes can happen at any time, without warning, and at any rating level. Even debt rated 'AAA' can default. Some credit rating agencies provide rating "outlooks" and rating "watches" to formally alert investors about potential revisions to those ratings. Even still, these alerts may not precede every rating action.

You should understand the information that credit ratings are intended to convey and any limitations to the ratings. While institutional investors have the resources to perform their own credit assessment as part of their due diligence procedures, you may not have access to those resources on your own. If you are unable to perform a credit assessment on your own (including a careful examination of a bond's prospectus or other documents that provide issue- or issuer-specific financial information and an analysis of related industry news and reports), you should consider seeking professional advice. You should also evaluate non-credit-related factors to determine whether an investment is suitable for you.

Who provides credit ratings?

Credit rating agencies, some of which are registered with the SEC, provide credit ratings. Credit rating agencies registered with the SEC are referred to as nationally recognized statistical rating organizations ("NRSROs"). The larger credit rating agencies issue credit ratings across industry sectors and around the world, while some smaller credit rating agencies focus on specific types of ratings. You can find out whether a credit rating agency is registered with the SEC by visiting the SEC's website at www.sec.gov/about/offices/ocr.shtml.

The SEC has oversight and examination authority over NRSROs. By law, however, the SEC is not permitted to regulate the substance of credit ratings or the procedures and methodologies by which any NRSRO determines credit ratings. Methodologies include, among other things, the quantitative and qualitative models used to determine credit ratings.

Potential conflicts of interest in credit ratings

Many credit rating agencies—including the largest agencies—are paid by the obligors they rate or by the issuers of the securities they rate. This creates a potential conflict of interest in that the credit rating agency may be influenced to determine more favorable (i.e., higher) ratings than warranted to retain the obligors or issuers as clients and to obtain new obligor or issuer clients. Alternatively, some credit rating agencies are paid by subscribers to their ratings services, which are usually investors. Investors' desire for low or high credit ratings, depending on their holdings and trading positions, may also present a conflict of interest. NRSROs are subject to laws and regulations that require them to disclose these conflicts of interest. NRSROs are also required to establish, maintain, and enforce written policies and procedures to address and manage these conflicts of interest.

Where can you find credit ratings and related information?

Many credit rating agencies make their ratings available to the public via their websites and market data providers, while others require subscriptions to access their credit ratings. Your financial adviser may also have access to this information. All NRSROs are required to provide on their public websites a description of their credit rating scales and definitions and the methodologies they use to determine their ratings. Credit rating agencies may require subscriptions or fees to obtain narrative reports they issue containing credit analysis, although some credit rating agencies make these reports freely available to investors.

Why do investors use credit ratings?

When making investment decisions, credit ratings and any related rating and industry trend reports can be helpful tools, provided you use them appropriately. Credit ratings may offer an alternative point of view to your own financial analysis or that of your financial adviser.

Credit ratings may enable you to compare risks among investments in your portfolio. Considering the credit ratings of multiple credit rating agencies may be useful because they may offer diverse views on the creditworthiness of an investment.

In general, if you use credit ratings, they should be a supplement to, and not a replacement for, your own research, analysis, and judgment to determine whether an investment best satisfies your needs. Remember that credit ratings address credit risk only; they do not address other risks such as liquidity risk, interest rate or market risk, or prepayment risk. The bottom line is that you should know what you are buying and only invest in what you understand.

Credit ratings are subjective

There are no standard or agreed-upon methods to measure the accuracy of credit ratings. This is partly because of the subjective nature of credit ratings. Also, the performance of credit ratings may not be comparable across different industry sectors, meaning that defaults and rating changes (or "transitions" of an issuer's or debt instrument's rating from one rating to another) may not be consistent for each rating category across the sectors. For example, default rates for corporate bonds historically have been greater than default rates for municipal bonds with the same credit ratings.

Even within an industry sector, transition and default rates may differ over time and in different geographic regions. Inconsistencies in performance can be attributable to changes in business cycles and economic environments that do not impact all obligors equally and at the same time.

In terms of comparing credit ratings performance across credit rating agencies, you should know that definitions for what their credit ratings mean differ among credit rating agencies. Credit rating agencies also use different analytical approaches and levels of subjectivity when determining credit ratings.

Credit rating agencies may differ in the time horizon that their ratings address. For example, some credit rating agencies aim for stability in ratings so they assume a longer term horizon in their analysis. Other credit rating agencies prefer to address short-term risks and events, which can lead to more variability in their ratings. Additionally, some credit rating agencies' ratings only reflect the likelihood that an obligor will default, while others' ratings also consider the expected loss that may result from a default.

Each NRSRO is registered with the SEC in up to five possible credit rating classes. These credit rating classes are: (1) financial institutions; (2) insurance

companies; (3) corporate issuers; (4) asset-backed securities; and (5) government securities. NRSROs are required each year to post on their websites performance statistics and the history of their credit ratings for their registered rating classes. The

performance statistics show transition and default rates for the classes of ratings. Investors can also use these statistics to assess the stability, or volatility, of credit ratings within and among fixed income sectors.

SEC office of Credit ratings (www.sec.gov/about/offices/ocr.shtml)

SEC Investor Bulletin: Municipal Bonds: Understanding Credit risk (www.sec.gov/investor/alerts/municipalbondsbulletin.pdf)

SEC Investor Bulletin: What Are Corporate Bonds? (www.sec.gov/investor/alerts/ib_corporatebonds.pdf)

SEC Investor Bulletin: What Are High-yield Corporate Bonds? (www.sec.gov/investor/alerts/ib_high-yield.pdf)

SEC Investor Bulletin: Focus on Municipal Bonds (www.sec.gov/investor/alerts/municipal.htm)

Investor.gov (<http://investor.gov>)

Calendar of Upcoming Events



A representative from the Securities Division will be giving an anti-fraud presentation on the following dates and locations. Dates and times are subject to cancellation (although cancellations are rare), so please call the contact number listed to confirm the event is still on before leaving for it. All presentations are free and open to the public unless otherwise indicated. If you would like to schedule a speaker for your church, business, group or organization, please contact [John Maron](mailto:John.Maron@sosnc.com) or [Barbara Bennett](mailto:Barbara.Bennett@sosnc.com) at (800) 688-4507.

Date	City	Details
1/11/14	Reidsville	50+ Informational Meeting, Mt. Carmel United Methodist Church , 361 Mt. Carmel Church Road. Time: 11:00 AM – Noon. For more information, contact Karen Tucker at (336) 383-8358.
1/14/14	Southern Pines	Southern Pines Graciously Retirement Living , 205 SE Service Road. Time: 2:00 PM – 3:00 PM. For more information, contact Susan Rodgers at (910) 692-3367.
1/29/14	Louisburg	“Raising Business Capital: FAQ’s for Entrepreneurs and Small Businesspersons,” Vance-Granville Community College, Room F131, 8100 NC 56 Hwy. Time: 9:00 AM – 11:00 AM. Free, but to pre-register call (919) 496-1567 or contact Tanya Weary at (252) 738-3240.
2/10/14	Wilmington	Scam Jam hosted by Cape Fear Elder Abuse Prevention Network , at Scott's Hill Baptist Church Crosspointe Center, 185 Scotts Hill Loop Road. Time 9:00 AM – 2:00 PM. For more information, contact Jane Jones at (910) 395-4553, Ext. 209.
2/19/14	Fayetteville	“Marriage Money Matters,” ACS, Building 4-2843, 3rd Floor, Soldier Support Center , 2843 Normandy Drive. Open to military personnel and their families only. Time: 1:30 PM -- 4:30 PM. For more information, contact Lynn Olavarria at (910) 907-3670.
2/26/14	Fayetteville	“Introduction to Securities for Entrepreneurs Seeking to Raise Business Capital,” Center for Business & Industry , 2723 Fort Bragg Road. Time: 10:00 AM -- Noon. Free, but registration required. For more information, contact Tamara Bryant at (910) 678-8462.
2/27/14	New Bern	“Introduction to Securities for Entrepreneurs Seeking to Raise Business Capital,” The Entrepreneur Academy , Craven Community College, 800 College Ct., Room 125 Brock. Time: 6:00 PM – 9:00 PM. Free, but registration is required. For more information, contact Rebecca Moorer at (252) 638-1191.

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On The Docket

The following cases are ones in which the Securities Division has had some involvement, either as the lead investigative agency or in a supporting role.

Walter Ray Reinhardt, of Durham, NC, was served with 62 felony arrest warrants for securities violations on November 17, 2010. He is alleged to have defrauded 16 victims in Durham County out of more than \$1 million. Reinhardt had his first appearance in Durham County District Court on November 18, 2010 on 38 felony counts of securities fraud, 12 felony counts of common law forgery, and 12 felony counts of common law uttering. He is currently being held in the Durham County Jail under a \$4 million bond.

Darren Joseph Capote, of Patterson, NY, was indicted on July 11, 2011, in Ashe County Superior Court on three Class C felony counts of securities fraud. He is alleged to have defrauded an elderly victim in Ashe County. He was released from custody on a \$100,000 secured bond. His next court appearance in Ashe County has not been scheduled.

Michael Anthony Jenkins, of Raleigh, NC, was served on August 17, 2012, with three felony arrest warrants for securities fraud. Investigators with the Secretary of State Securities Division allege that Jenkins told investors he would use their funds to trade commodities futures or "E-mini futures" through his company, Harbor Light Asset Management, LLC. Investigators allege Jenkins instead converted funds to his personal use and used money from later investors to pay earlier investors in what is commonly referred to as a Ponzi scheme. Jenkins is in the Wake County Jail under \$500,000 secured bond. During his first hearing on August 20, 2012, the prosecutor told the court that there are 377 known victims of Jenkins' approximately \$1.79 million Ponzi scheme. The Securities Division's investigation is continuing. Anyone who has made investments with Harbor Light Asset Management, LLC is asked to contact the Securities Division at (800) 688-4507 or (919) 733-3924.

Recent Enforcement Actions

(For prior administrative and criminal actions, click on the badge to the right.)

On **October 22, 2013**, the Securities Division of the North Carolina Department of the Secretary of State issued a **Temporary Order to Cease and Desist to Vasquez Global Investments, LLC and Edwin A. Vasquez**. Vasquez Global Investments, LLC and Edwin A. Vasquez were ordered to cease and desist from offering for sale, soliciting offers to purchase or selling, in or from North Carolina, any securities unless and until such securities have been registered and Vasquez Global Investments, LLC and Edwin A. Vasquez become registered as a dealer or salesman of securities. The Temporary Order to Cease and Desist found that Vasquez Global Investments, LLC and Edwin A. Vasquez offered and sold debt instruments in transactions involving an investment enterprise that alleged to trade in futures contracts and commodities, which violated the North Carolina Securities Act. The Temporary Order to Cease and Desist gives Respondents 30 days in which to request a hearing. If no such request is made during that time, the Temporary Order to Cease and Desist shall become final. Click [here](#) to view the Temporary Order.



News from the Regulators

(The following are selected public notices issued by one or more securities regulator. Click the links to view the full notices. These are offered for informational purposes only.)

[FINRA Releases 2014 Regulatory and Exam Priorities](#)

Jan. 2, 2014 -- The Financial Industry Regulatory Authority (FINRA) released its 2014 Regulatory and Examination Priorities letter which highlights significant risks and issues that could adversely affect investors and market integrity this year. FINRA addresses topics related to business conduct, fraud, financial and operational concerns, and market regulation priorities in the letter, and will update its view on risks throughout the year, adjusting its regulatory programs and allocation of resources to address changes in those perceived risks.

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[SEC Proposes Rules to Increase Access to Capital for Smaller Companies](#)

Dec. 18, 2013 -- The Securities and Exchange Commission has voted to [propose rules](#) intended to increase access to capital for smaller companies. The SEC's proposal would build upon Regulation A, which is an existing exemption from registration for small offerings of securities up to \$5 million within a 12-month period. The updated exemption would enable companies to offer and sell up to \$50 million of securities within a 12-month period. The rules are mandated by Title IV of the Jumpstart Our Business Startup (JOBS) Act. For more information, click any of the links above. Click [here](#) to comment on the proposed rules.

[NASAA Statement on SEC's Regulation A+ Proposed Rule](#)

Dec. 18, 2013 – The North American Securities Administrators Association (NASAA) issued a statement in response to the SEC's proposed rules on Regulation A (see item above). NASAA's statement reads, in part, "The Commission's proposed rule ignores Congress' recent judgment and defies Congress' clear intent. As a policy matter, it is not clear why the Commission would remove state oversight in a high-risk area where both federal and state resources should be fully leveraged to provide sufficient, regular review. State securities regulators want offerings under the new Regulation A+ to be an attractive alternative for small business filers, but are weary of expending state resources to combat frauds that they are preempted from preventing on the front end through the state review and registration process. It is not reasonable for the Commission to expect the states to continue to clean up all of the mess left behind in the wake of preemptive measures like this." To read the full statement, click the link above.

[SEC Announces Enforcement Results for FY 2013](#)

Dec. 17, 2013 -- The Securities and Exchange Commission announced that the agency's enforcement actions in fiscal year 2013 resulted in a record \$3.4 billion in monetary sanctions ordered against wrongdoers. The SEC filed 686 enforcement actions in the fiscal year that ended in September. The \$3.4 billion in disgorgement and penalties resulting from those actions is 10 percent higher than FY 2012 and 22 percent higher than FY 2011, when the SEC filed the most actions in agency history. For full details about the report, click the link above.

[SEC Charges Charlotte Investment Managers for Misconduct in CDO Collateral Selection Process](#)

Dec. 12, 2013 — The Securities and Exchange Commission announced that it had charged the managing partners of a Charlotte, N.C.-based investment advisory firm for compromising their independent judgment and allowing a third party with its own interests to influence the portfolio selection process of a collateralized debt obligation (CDO) being offered to investors. The investment managers have agreed to collectively pay more than \$472,000 and exit the securities industry to settle the SEC's charges. According to the SEC's order instituting settled administrative proceedings, disclosures to investors indicated that NIR Capital Management LLC was solely selecting the assets for Norma CDO I Ltd. as the designated collateral manager. However, NIR's **Scott H. Shannon** accepted assets chosen by hedge fund firm Magnetar Capital LLC for the Norma CDO's portfolio, and **Joseph G. Parish III** allowed Magnetar to influence the selection of some other assets. Shannon himself called at least one of the residential mortgage-backed securities (RMBS) ultimately included in the portfolio a "real stinker." Magnetar bought the equity in the CDO but also placed short bets on collateral in the CDO and therefore had an interest not necessarily aligned with potential long-term debt investors that relied on the CDO and its collateral to perform well. The SEC also [announced charges against Merrill Lynch](#), which structured and marketed the Norma CDO.

[SEC Issues Proposal on Crowdfunding](#)

Nov. 5, 2013 -- The Securities and Exchange Commission is proposing for comment new Regulation Crowdfunding under the Securities Act of 1933 and the Securities Exchange Act of 1934 to implement the requirements of Title III of the Jumpstart Our Business Startups Act. Regulation Crowdfunding would prescribe rules governing the offer and sale of securities under new Section 4(a)(6) of the Securities Act of 1933. The proposal also would provide a framework for the regulation of registered funding portals and brokers that issuers are required to use as intermediaries in the offer and sale of securities in reliance on Section 4(a)(6). In addition, the proposal would exempt securities sold pursuant to Section 4(a)(6) from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934. **Comments should be received by the SEC on or before February 3, 2014.** For information on how to submit comments, click the link above.

All investors are strongly encouraged to contact the Securities Division at (919) 733-3924 or toll-free at (800) 688-4507 to check that their investment professional is properly registered ***before*** transferring any assets to that person's control. One five-minute telephone call to the Securities Division could protect your entire life's savings from being stolen from you. For a wealth of investor education information, please visit our Web site, www.sosnc.com. Click on the yellow box entitled "Investment Securities".

This newsletter is produced by the Investor Education Program of the Securities Division of the North Carolina Department of the Secretary of State. If you have questions or comments about this publication, or would like to schedule an investor education presentation with your group or organization, please email [John Maron](mailto:John.Maron@sosnc.com), Director of the Investor Education Program, or call (919) 807-2106.

Please help us publicize the educational information in this mailing by forwarding it to your contacts around the state. If you no longer wish to receive mailings from the Securities Division, please send an email to: jmaron@sosnc.com with "Remove from mailing list" in the subject line.

Remember that if an investment sounds too good to be true, it ***probably*** is!