

Crowdfunding: What It Is and What It Isn't



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THIS OUTLINE is intended to flag a number of things about Crowdfunding that counsel should consider and in guiding entrepreneurial clients and small issuers with this developing capital formation exemption from the registration provisions of the Securities Act. There are many articles, outlines, and summaries that will provide the how-to that practitioners seek, not the least important and useful of which will be the SEC's Release announcing Regulation Crowdfunding, when it is issued.

1. A Short Definition. Crowdfunding involves the use of the internet and social media to raise capital, typically from a large number of people and in relatively small amounts from each. Crowdfunding seeks to enable small startup businesses that may not have easy access to traditional capital markets and methods of venture capital fundraising to raise capital. (Practical Law).
2. Crowdfunding is Illegal. Congress passed the JOBS Act and Section 4(a)(6) of the Securities Act became law in April 2012. It provides for Crowdfunding subject to SEC Rulemaking. The SEC proposed Regulation Crowdfunding ("Regulation C/F") for comment in October 2013. The SEC staff is reviewing the many comments received. Until the SEC acts and adopts Regulation C/F it is illegal to engage in the sort of crowdfunding transactions contemplated by the JOBS Act. As noted below, other financing mechanisms widely referred to as crowdfunding are available and may yet crowd out capital-C Crowdfunding.

3. Crowdfunding is Internet and Online (Social Media) Based Only. As adopted in the JOBS Act, Crowdfunding must be conducted on the internet or an online platform (social media). There is no such thing as word-of-mouth Crowdfunding. There are other registration exemptions that allow companies to attract investors through word-of-mouth, advertising and general solicitation and do not require the internet or social media. (Regulation D, Rule 506(c)). Each has advantages and constraints.
4. Crowdfunding Isn't Simple or Easy. Some have said that Congress both gave and took away in Section 4(a)(6) ...and that's before the SEC steps in with specifics and details in Regulation C/F. Congress "gave" in allowing small businesses to raise capital on the Internet and online from potentially thousands of individual investors without SEC registration hoops. Presumably, direct Internet or social media access to investors willing to take a chance on small and start-up businesses that just might be the next great thing and would put America back to work. Congress, citing investor protection, "took away" in setting up limitations and conditions, including requiring "portals," that make it anything but simple and easy.
5. Quick Keys to Crowdfunding. For an overview, see the SEC's "Crowdfunding Fact Sheet" (October 23, 2013). To vastly oversimplify, Crowdfunding might be said to turn on these key provisions that are either required by the JOBS Act or anticipated in Regulation C/F.
 - a. *Issuers.* Public companies, foreign issuers, investment companies and hedge funds cannot use Crowdfunding. Nor can bad actors, shells and SPACs, and previously non-compliant Crowdfunders.
 - b. *Dollar Limitations.* The maximum Crowdfunding raise is \$1 million in a 12-month period; other financings do not count against the Crowdfunding cap. Issuers would generally be expected to set a target amount to be raised and a deadline.
 - c. *Intermediaries.* Crowdfunding raises must be conducted through a single broker-dealer or SEC registered funding portal and conducted only on the internet. Limited advertising, essentially notice, is permitted. The elaborate, and sometimes even video, presentations seen in community or donation-based crowdfunding are not contemplated for capital-C Crowdfunding.
 - d. *Investors.* While there is no sophistication test, there are maximum annual investment limitations. For investors whose income and net worth are below \$100,000, the maximum investment is the greater of (a) \$2,000 or (b) 5% of income or net worth. For investors whose income or net worth is \$100,000 or more, the annual limit is 10% of income or net worth, but not more than \$100,000. Unlike in Rule 506(c) offerings, Crowdfunding intermediaries may rely on an investor's representations concerning compliance with the investment limitation requirements.
 - e. *Information.* Crowdfunders must provide broad background and financial information to the intermediary, potential investors and investors, possibly the most important piece of which

- is a business plan. GAAP financial statements are required on a tiered basis, though they will likely not need to be independently audited in smaller offerings. SEC filing is required.
- f. Offering Updates.* Crowdfunders will have to file at least three updates with the SEC. One when the raise reaches 50% of the target, another at 100%, and a third at the deadline.
 - g. Annual Updates.* Each year until the Crowdfunded company goes public, is acquired or fails, it will have to post on its website and file with the SEC an annual report detailing the same sort of information initially required and current financial statements.
6. Crowdfunded Shares Aren't Likely to be Liquid in the Short Run. For one year after issuance, Crowdfunded shares may be resold only to accredited investors, back to the company or in an SEC-registered offering.
 7. There is Securities Act Liability Exposure for Crowdfunding Offerings. Though focused on small investments in small and startup companies all of the liability provisions of the federal securities laws apply to Crowdfunding offerings and the liability exposure for material misstatements and omissions extends to the issuer entity, its principals and directors promoters and, it appears, to intermediaries. Moreover, intermediaries are expected to undertake significant steps and efforts to avoid fraud similar to those imposed on broker-dealers in regular securities offerings.
 8. Crowdfunders have Continuing Corporate Maintenance Obligations. At the conclusion of a successful Crowdfunding offering there will be a small company with multiple, perhaps many, investors whose names and addresses and holdings must be maintained, who will expect communications, who will likely be entitled to vote on corporate matters at annual meetings and to elect directors, who will have expectations to be managed, all of which require management time and cost money. In addition, there will be legal and SEC filing obligations and accounting and auditing requirements, again a significant cost item. Securities sold under the Crowdfunding exemption, however, will not count toward the record holder threshold under Section 12(g) of the Exchange Act.
 9. Funding Portals are a New Kind of Entity with a Limited Role, but Significant Responsibilities. If not conducted through a regulated broker-dealer, a Crowdfunding offering must be conducted through a new form of entity called a "funding portal." While not broker-dealers, funding portals will be regulated by the SEC and FINRA. They are to be strictly portals, not marketing vehicles, and cannot offer investment advice, solicit investments, compensate employees or others for the sale of crowdfunding securities, or handle funds. Some have suggested that funding portals might not even be permitted to reject individual fundraising campaigns on the basis of their analysis suggesting that the venture is non-viable because that could be deemed to constitute providing "investment advice." But, funding portals do have affirmative investor education, disclosure, anti-money laundering and other responsibilities.
 10. State Crowdfunding Laws and the Intrastate Exemption. Several states and likely more to follow have adopted state versions of crowdfunding within the Section 3(a)(11), Rule 147 intrastate offering exemption from registration. A threshold problem is how to reach the crowd of potential investors without soliciting beyond the state's borders. SEC staff answered in a recent C&DI saying that internet crowdfunding would be permissible if all other elements of the interstate offering met the requirements of Section 3(a)(11) of the Securities Act. Note that Section 3(a)(11) and Rule 147 do not have a rubber clause that allows for "reasonable basis" to believe that all investors are local.

11. Crowdfundings are High Risk. Although individual investments are limited and investor education and disclosure are required, the risks are high and probabilities of a successful return on any Crowdfunded investment are questionable. For starters most small businesses fail in a relatively short time; a Harvard study shows that about three-fourths of venture fund investments do not provide a return to investors and those are investments by sophisticated analysts with substantial information. (Courtesy: Hugh Makens). Moreover, many or even most Crowdfunding offerings will likely be made by inexperienced and understaffed entrepreneurs with little capability to manage and account for a business, little or no experience in addressing shareholder interests, competing demands, and continuing recordkeeping, legal and reporting obligations. Yet, crowdfunding is sexy and attracts huge interest; thousands and thousands of domain names with the word “crowdfunding” are filed, most still without content.
12. Crowdfunding Lookalikes. Inevitably, new and creative structures and mechanisms for capital formation will emerge and be tested against the realities of the market. A comprehensive catalog isn’t feasible, but here are some of the current models that generate both buzz and, apparently, meaningful financing alternatives to the traditional capital formation opportunities for the small and start-up businesses that the JOBS Act targeted.
 - a. *Regulation D, Rule 506(c) is the Real Crowdfunding.* Rule 506(c) private placements allow solicitation of investors to raise an unlimited amount of capital from an unlimited number of investors, without limit on the amount an individual may invest so long as all of the investors are accredited. There are few of the sorts of complexities mentioned about Crowdfunding and most of the advantages. Many of the existing online securities crowdfunding sources (e.g., EquityNet, CircleUp) are broker-dealers offering securities through a Crowdfunding look-a-like website that offers a capital formation tool based on Rule 506(c), but are not Crowdfunding as contemplated by the JOBS Act.

Rule 506(c) was and is hailed as a significant loosening of the rules and was expected to attract a massive following. Whatever the reason, there has not been a tectonic shift from the general-solicitation-prohibited Rule 506(b) offerings to liberalized solicitation-permitted Rule 506(c) financings. Perhaps this is attributable to the market’s comfort with established policies and procedures and a sense that Rule 506(c) imposes expanded investor verification requirements.

- b. *Community/Donation-Based Support.* Kickstarter and Indiegogo and the others like them are not Crowdfunding. By definition, Crowdfunding involves raising capital for an economic interest (usually shares or LP interests) in a business entity. These sites raise funds and often provide a recognition or gift (toys, tickets, or trinkets), but do not promise or provide a continuing economic interest in the success (or failure) of the venture. They are not part of the JOBS Act and are a great deal simpler.
- c. *Human/Income-Contingent Capital.* Upstart is another capital formation tool that isn’t Crowdfunding. On the theory that in a startup one really invests in the individual, Upstart and other human capital approaches provide for a return on an investment based on the earnings of the individual entrepreneur, not the particular venture or idea. For example, in exchange for \$X, the entrepreneur will pay the investor Y% of his/her earnings from whatever source for the next Z years. Income contingent arrangements are well-known in other contexts and may become part of the capital formation toolbox, but they are not Crowdfunding.

- d. Venture Fund Model.* Perhaps akin to investment clubs, venture capital funds offer issuers a way to have their opportunities vetted by professional advisers and recommended to investors in a somewhat diversified fund they have created for (usually) early stage companies. The question of whether advisers establishing and managing these funds were required to register as broker-dealers was resolved in the AngelList and FundersClub no-action letters (March 2013). In these letters, the SEC permitted venture capital fund advisors to use web-based platforms to facilitate investments and also permitted a registered investment adviser affiliated with the platform to receive incentive compensation and be reimbursed for documented expenses. Thus, in combination with the relaxation of the general solicitation rules, the AngelList and Funders Club no-action letters allow platform sponsors to be paid for placing investors into an investment vehicle, much as a broker-dealer would do, without requiring broker-dealer registration.

Investment Company Act ('40 Act) provisions, however, effectively limit the size or potential investor pool if the venture fund takes non-control equity positions in its investment targets. Under the '40 Act, a fund may not exceed 100 investors or must be limited to “qualified investors” (i.e., super-accredited investors) without '40 Act registration.

- e. Peer-to-Peer Lending.* Though sometimes labeled crowdfunding, peer-to-peer lending sites such as Lending Club and Prosper are not capital-C Crowdfunding. With variations, these sites offer investors an opportunity to choose among loan proposals from individuals and commercial entities. While a “Member Payment Dependent Note” is a security and may be offered in a registered offering, the peer-to-peer loan is subject to banking regulations and not SEC oversight. Whether Congress had peer-to-peer lending in mind in fashioning the JOBS Act or the SEC will seek additional regulatory involvement in this additional crowdfunding product is unclear ...and perhaps unlikely.

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