



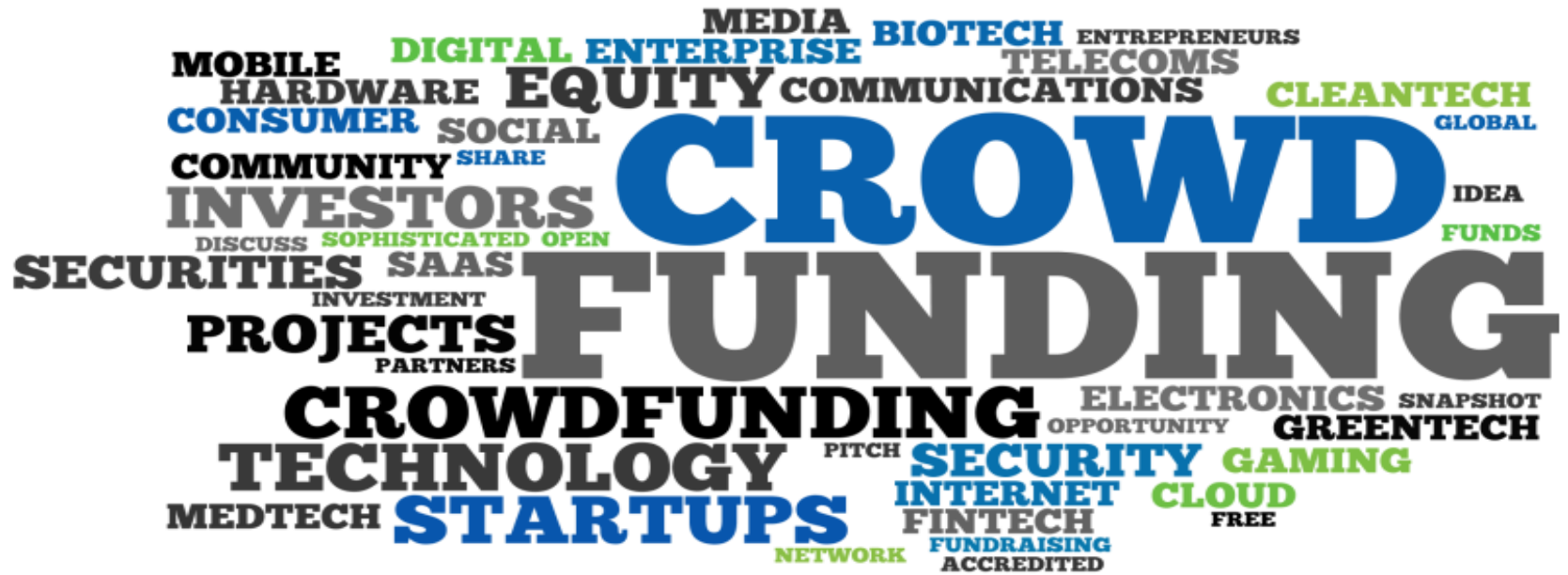
STARTUP ESSENTIALS: Crowdfunding

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Presenter:

Joe Green

Senior Legal Editor, Capital Markets & Corporate Governance Service, Practical Law



What is Crowdfunding?

What is Crowdfunding?

Definition:

The practice of financing a project, product or early-stage startup venture by raising modest amounts of capital...

- Through an online platform or intermediary
- From a large number of people who:
 - May have varying levels of financial resources and sophistication
 - Are largely unconnected with the party seeking funds
 - Contribute relatively small amounts individually



Rewards Crowdfunding

- Examples of platforms include Kickstarter and Indiegogo
- Inventors, artists and entrepreneurs seek funds to finance their projects, products or businesses
 - Typically used to finance consumer products and artistic projects
 - Generally no restrictions on who can participate
 - Contributors **DO NOT** get equity interests, but may receive:
 - Small gifts or rewards (such as branded T-shirts, tickets, etc.)
 - Initial products (pre-payment model)

Accredited Crowdfunding

- Examples of platforms include AngelList and CircleUp
- Startups raise seed capital from large groups of angels
 - Outgrowth of formal angel investing networks
 - Only open to “accredited investors” (**AIs**)
 - Net worth > \$1MM (excluding value of primary residence)
 - OR
 - Annual income > \$200K for last 2 years + reasonable expectation of earning at least that much this year
 - Investors receive equity in the companies



Federal Crowdfunding

Federal equity crowdfunding for non-accredited investors

- Congress created framework in Title III of the Jumpstart Our Business Startups (JOBS) Act enacted in 2012
- SEC proposed rules to implement Title III in Oct. 2013
- Final SEC rules (called Regulation Crowdfunding) adopted in Oct. 2015 **became effective** on May 16, 2016
- SEC has approved 9 “funding portals” so far
- 17 startups filed crowdfunding offering documents on Day 1



State “Blue Sky” Crowdfunding

- After Congress passed the JOBS Act, many states did not wait for SEC rulemaking process
- States created their own crowdfunding regulatory regimes for intrastate offerings exempt from federal registration
- Over half the U.S. states have adopted some form of “blue sky” crowdfunding regulation

Mini Public Offering

- Examples of platforms include StartEngine and SeedInvest
- Startups use “mini” public offering framework under amended Regulation A (or Reg. “A+”) to sell equity to the general public
 - Old Regulation A was little used because of \$5 million limit and lack of “blue sky” preemption
 - Congress ordered SEC to overhaul old Regulation A in Title IV of the JOBS Act; final rules went into effect in June 2015

Peer-to-Peer (P2P) Lending

- Examples of platforms include Lending Club and Prosper Marketplace
- Not advertised as “crowdfunding” but has many similarities:
 - Online borrowing platforms
 - Large number of lenders
 - Each lender individually commits relatively small amounts to the principal of each borrower’s loan
- Not limited to accredited investors
- Investors receive debt, not equity

Types of Crowdfunding: Recap

Rewards crowdfunding



Accredited equity crowdfunding



Non-accredited equity crowdfunding

- Federal / State “blue sky” regimes



Mini public offering



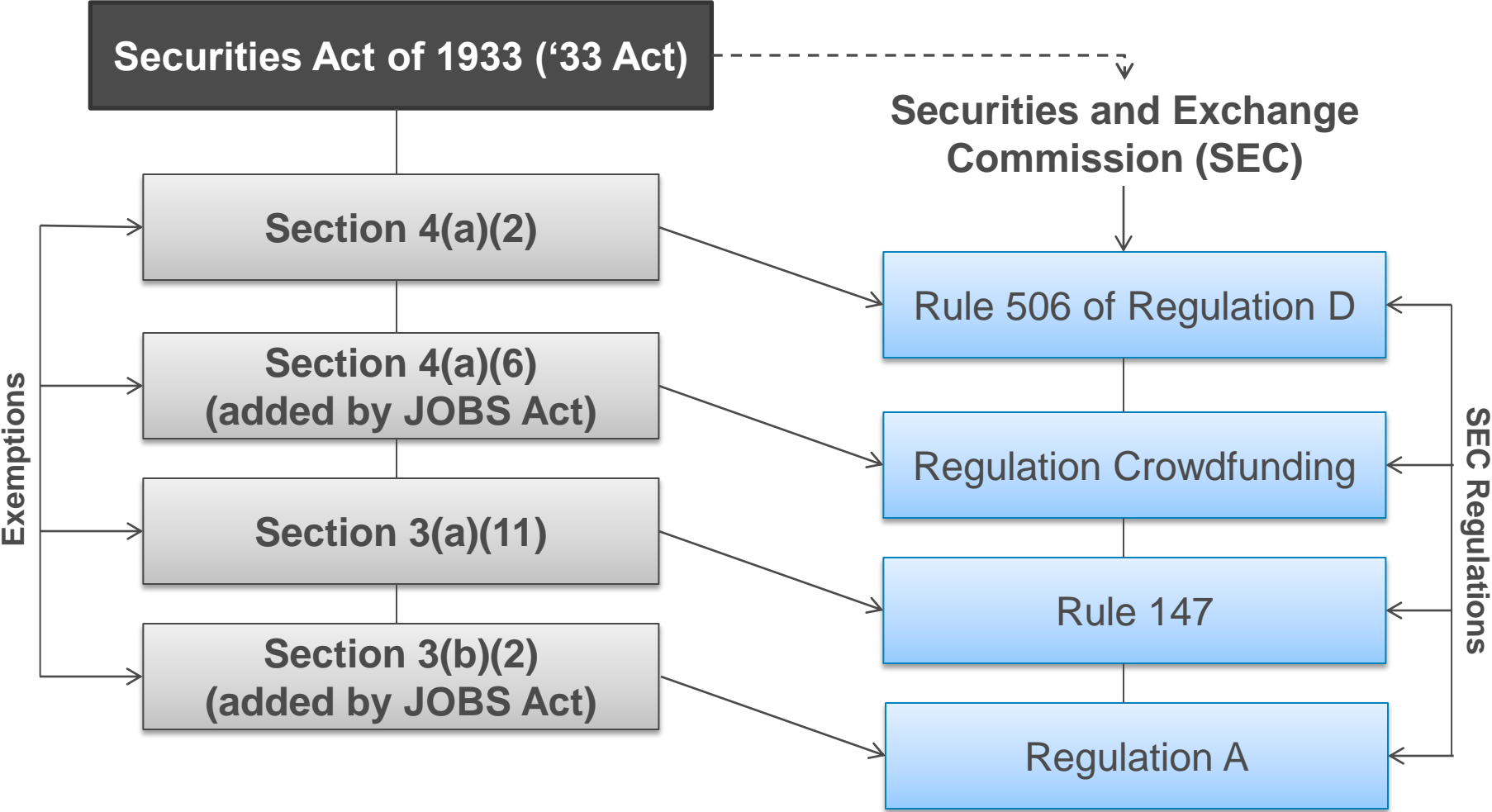
Peer-to-peer lending





Legal and Regulatory Framework

Relevant Federal Securities Law





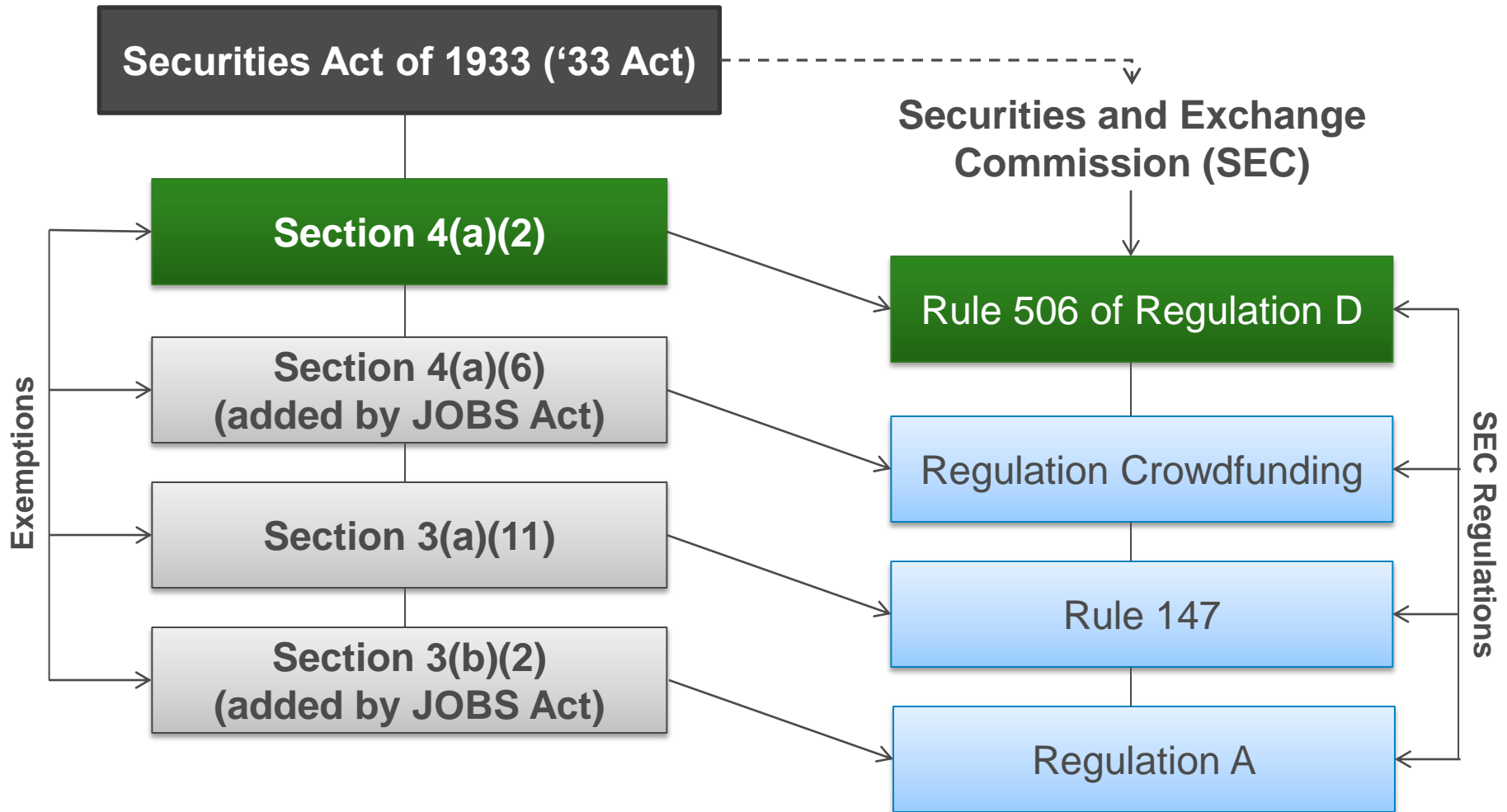
Rewards Crowdfunding Regulation

- Not covered by securities laws
 - Does not involve the offer or sale of securities
- Regulated by consumer protection laws
 - FTC and State AGs have brought fraud actions against fund seekers on these platforms for failing to follow through on promises made to contributors
 - Platforms' Terms of Service provide explicitly that any promises made regarding rewards are between fund seekers and contributors (not with platforms themselves)

Everything Else

- All other types of crowdfunding structures involve the offer and sale of securities
 - Fall within purview of federal and state securities laws
- However, each other type of crowdfunding structure is regulated differently under the securities laws
 - **Accredited crowdfunding:** Rule 506 (Regulation D)
 - **Federal crowdfunding:** Regulation Crowdfunding
 - **State “blue sky” crowdfunding:** Rule 147 / Blue sky laws
 - **Mini public offerings:** Regulation A
 - **Peer-to-peer lending:** Securities Act

Accredited Crowdfunding Regulation



Section 4(a)(2) and Rule 506

Rule 506 is the SEC's safe harbor for offerings to **accredited investors** under Section 4(a)(2) of the '33 Act

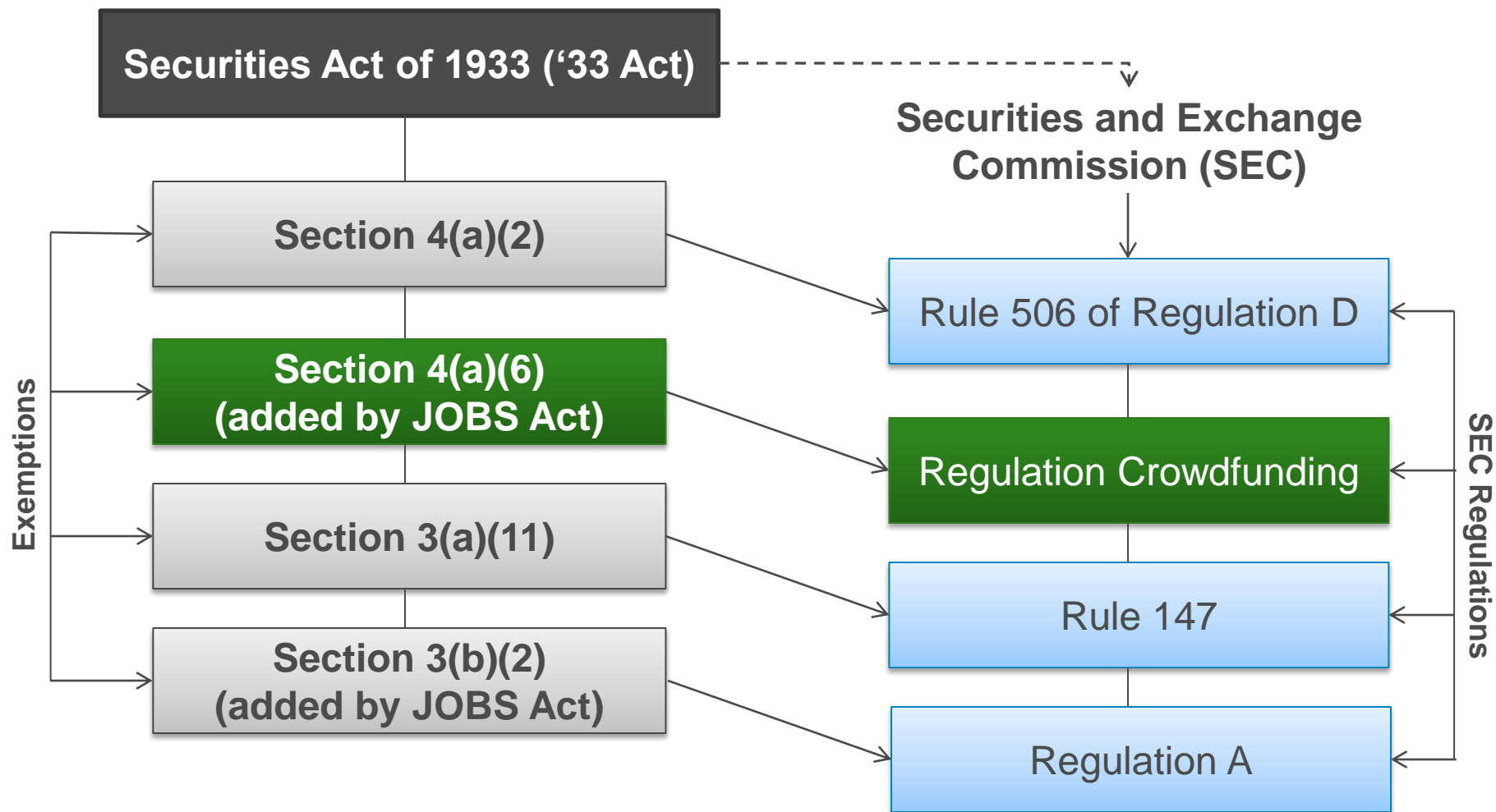
- Rule 506(b): No general solicitation
- Rule 506(c): Allows general solicitation in a securities offering when the securities are **only** sold to accredited investors
 - Company is required to take **reasonable steps to verify** that the buyers are accredited investors
- No limitations on number of accredited investors or size of investment

Accredited Crowdfunding Regulation

- Soliciting Investors
 - Rule 506(b) with “substantive pre-existing relationship”
 - SEC C&DIs and Citizen VC no-action letter (2015)
 - Rule 506(c) with accredited investor verification
- Platform Compensation
 - Online-VC fund model with carried interest compensation
 - FundersClub and AngelList no-action letters (2013)
 - Alternative: Platform partners with or becomes SEC-registered broker-dealer so it can charge transaction-based compensation (e.g., CircleUp)



Federal Crowdfunding Regulation



Federal Crowdfunding Regulations

Regulation Crowdfunding: Leans heavily toward investor protection at expense of promoting capital formation

- Limitations on issuers
- Limitations on investors
- Limitations on advertising
- Disclosure requirements
- Crowdfunding intermediaries

Federal Crowdfunding: Issuer Limitations

Companies cannot raise more than **\$1 million** in any rolling 12-month period

- Only securities sold under Section 4(a)(6) count towards the \$1 million cap
- **EXAMPLE:** In any 12-month period, a startup could raise:
 - \$1 million through Section 4(a)(6) crowdfunding offerings
 - Unlimited amounts through accredited crowdfunding platforms
 - Unlimited amounts through traditional angel or VC investment

Federal Crowdfunding: Investor Limitations

- Individuals with **either** an annual income **or** net worth that is less than \$100,000 can invest up to the **greater** of:
 - (i) \$2,000
 - (ii) 5% of the **lesser** of annual income and net worth
- Individuals with **both** annual income **and** net worth of at least \$100,000 can invest up to:
 - 10% of the **lesser** of annual income and net worth
- \$100,000 total individual investment limit per 12 months
- Measured for rolling 12 months across **all** 4(a)(6) issuers

Federal Crowdfunding: Advertising Limitations

Offering notices advertising the terms of the offering can include no more than the following:

- A statement that the issuer is conducting an offering
- The name of the intermediary (and a link to their platform)
- Limited info on the terms of the offering, including:
 - Amount, nature and price of securities offered
 - Closing date of the offering period
- Factual info about the legal identity and business location of the issuer, limited to:
 - Name and contact info of the issuer
 - Brief description of the issuer's business

Federal Crowdfunding: Disclosure Requirements

Issuers have to file Form C including following info (plus lots more):

- Directors and officers, including business experience for the past 3 years
- Business plan
- Company ownership and capital structure
 - Names of beneficial equityholders of $\geq 20\%$
 - Terms (such as voting rights and transfer restrictions) of the securities being offered and other outstanding securities
- Number of current employees
- Risk factors
- Certain related party transactions
- Any material information necessary in order to make the statements made in the Form C disclosure, in light of the circumstances under which they were made, not misleading

Federal Crowdfunding: Disclosure Requirements

- Issuers must provide GAAP financial statements
 - If raising over \$100,000, an independent public accountant must review the financial statements
 - If raising over \$500,000 (and if not the company's first 4(a)(6) offering), financial statements must be audited
- MD&A Lite: Issuers must also provide narrative discussion of their financial condition covering, among other things:
 - Historic results of operations
 - Liquidity and capital resources

Federal Crowdfunding: Disclosure Requirements

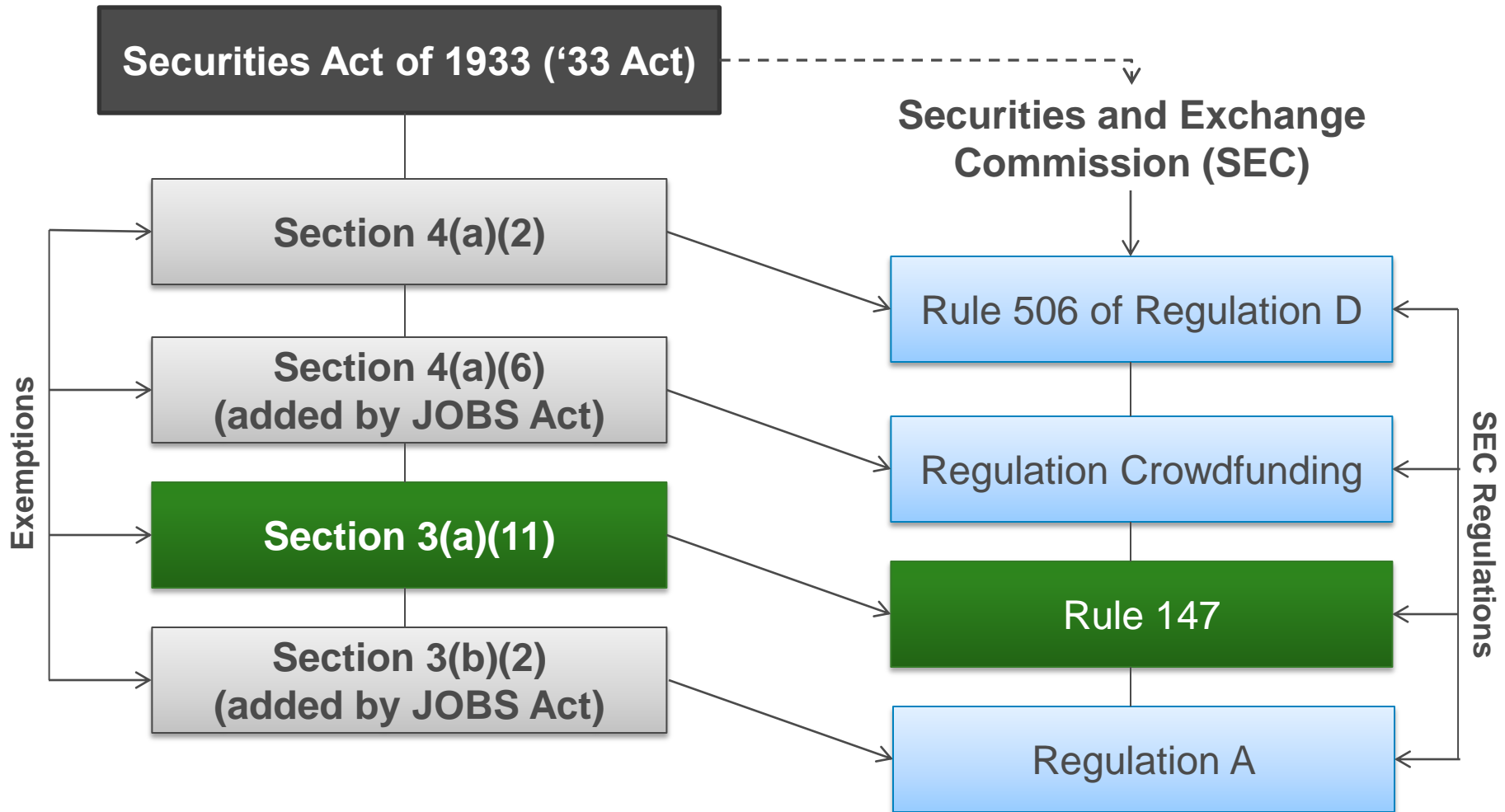
- Issuer must publicly file a report annually with the SEC within 120 days of the end of each fiscal year
- This report must include non-offering-specific info from Form C, including:
 - Financial statements certified by CEO
 - Narrative disclosures of its financial condition
- Annual reporting requirement continues until one of the following:
 - Issuer files at least 1 report and has < 300 stockholders
 - Issuer files at least 3 reports and has total assets < \$10 million
 - All issuer's securities sold under 4(a)(6) are purchased by a third party or repurchased by issuer
 - Issuer becomes a '34 Act reporting company

Federal Crowdfunding: Intermediaries

- All Section 4(a)(6) offerings must be made through **either** a registered broker-dealer **or** a new registered “funding portal”
 - Issuers can pay portals in equity (but must be same terms and price as issued to investors)
- Crowdfunding intermediaries are required to:
 - Provide investors with educational materials
 - Police 12-month investor limits
 - Take steps to reduce risk of fraud
- Crowdfunding intermediaries provide communication channels for discussions among investors, and between investors and issuers, about offerings on the platform



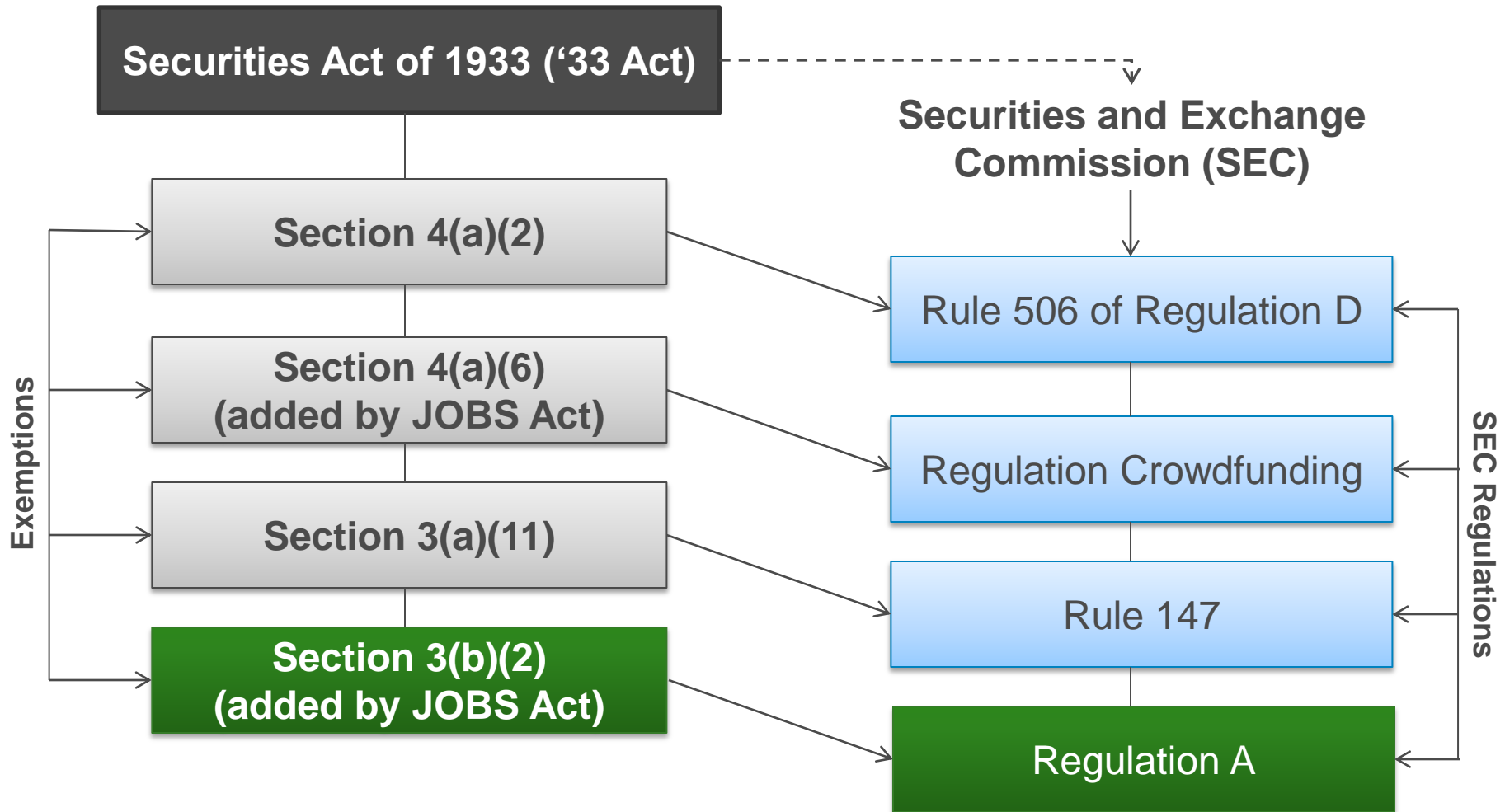
State “Blue Sky” Crowdfunding Regulations



State “Blue Sky” Crowdfunding Regulations

- Currently, most state crowdfunding regimes rely on Rule 147, the federal safe harbor for intrastate offerings
 - Rule 147: Issuer must be organized **AND** doing business in state where securities are **offered and sold**
- SEC proposed amendments to Rule 147 in Oct. 2015 to facilitate intrastate crowdfunding
 - Issuer can be organized elsewhere if all sales are made in state where issuer has its principal place of business
 - Issuer can make offers out-of-state if sales are only in-state
 - Liberalizes test for demonstrating intrastate nature of an issuer’s business

Mini Public Offering (Reg. "A+")



Regulation “A+”: Highlights

- Issuers elect either **Tier 1** or **Tier 2** regime
- General solicitation and advertising permitted
- Securities issued are **not** restricted securities
- Blue sky preemption (Tier 2 only)
- Issuer and investor limitations apply
- Offering Circular with substantial disclosure requirements
- SEC/FINRA review and comment process
- Ongoing reporting requirements similar to SRCs (Tier 2 only)

Regulation “A+”: Issuer Limitations

- **Limitation on the size of offering depends on tier:**
 - **TIER 1:**
 - Up to \$20MM in any 12-month period
 - May include secondary sales by affiliates up to \$6MM
 - **TIER 2:**
 - Up to \$50MM in any 12-month period
 - May include secondary sales by affiliates up to \$15MM
- **Secondary sales capped at 30% of any Reg. A offering in 12-months following first Reg. A offering**
- **“Bad actor” disqualification (like Reg. D)**

Regulation “A+”: Investor Limitations (Tier 2)

- **Accredited investors** can invest unlimited amounts
- **Non-accredited natural persons** can invest up to:
 - 10% of the greater of annual income or net worth
 - (as defined in Rule 501 of Reg. D)*
- Issuers must inform investors of limitation, but can rely on reps in good faith (no requirement to verify)
- Limitations do not apply if securities will be listed on national securities exchange

Regulation “A+”: Solicitation and Advertising

- **General solicitation and advertising is permitted**
- **Rule 255: “Testing the Waters” communications**
 - Allowed **before and after** filing Form 1-A with SEC
 - All written communications **must be filed** with Form 1-A
 - Must contain legends that offers to purchase and consideration can’t be accepted until after SEC qualification
 - Issuers may solicit **non-binding** indications of interest
 - Can’t be used for Tier 1 offerings unless “blue sky” compliant (since no preemption for Tier 1)

Regulation “A+”: Disclosure Requirements

Issuers must file **Form 1-A** with the SEC, including an Offering Circular containing the following info (plus more):

- Offering details
- Description of securities being offered (and existing securities)
- Risk factors
- Business description (covering last 3 fiscal years)
- MD&A
- Related party transactions
- Compensation for three highest paid D&O
- Beneficial ownership (D&O and >10% owners)
- 2 years of financial statements (audited, for Tier 2 only)
- Plan of distribution

Regulation “A+”: Ongoing Disclosure

- Tier 2 issuers have ongoing reporting obligations similar to Exchange Act reporting companies:
 - Annual reports on Form 1-K (including audited financials)
 - Semiannual reports on Form 1-SA
 - Current reports on Form 1-U
- Reporting requirement continues until one of the following:
 - Issuer completes reporting for fiscal year in which Form 1-A was filed, files a Form 1-Z exit report **AND**:
 - Issuer has filed all required ongoing reports in last 3 years timely
 - Issuer has < 300 record holders of class of securities offered under Reg. A
 - Issuer has no ongoing Reg. A offering
 - Issuer becomes an Exchange Act reporting company

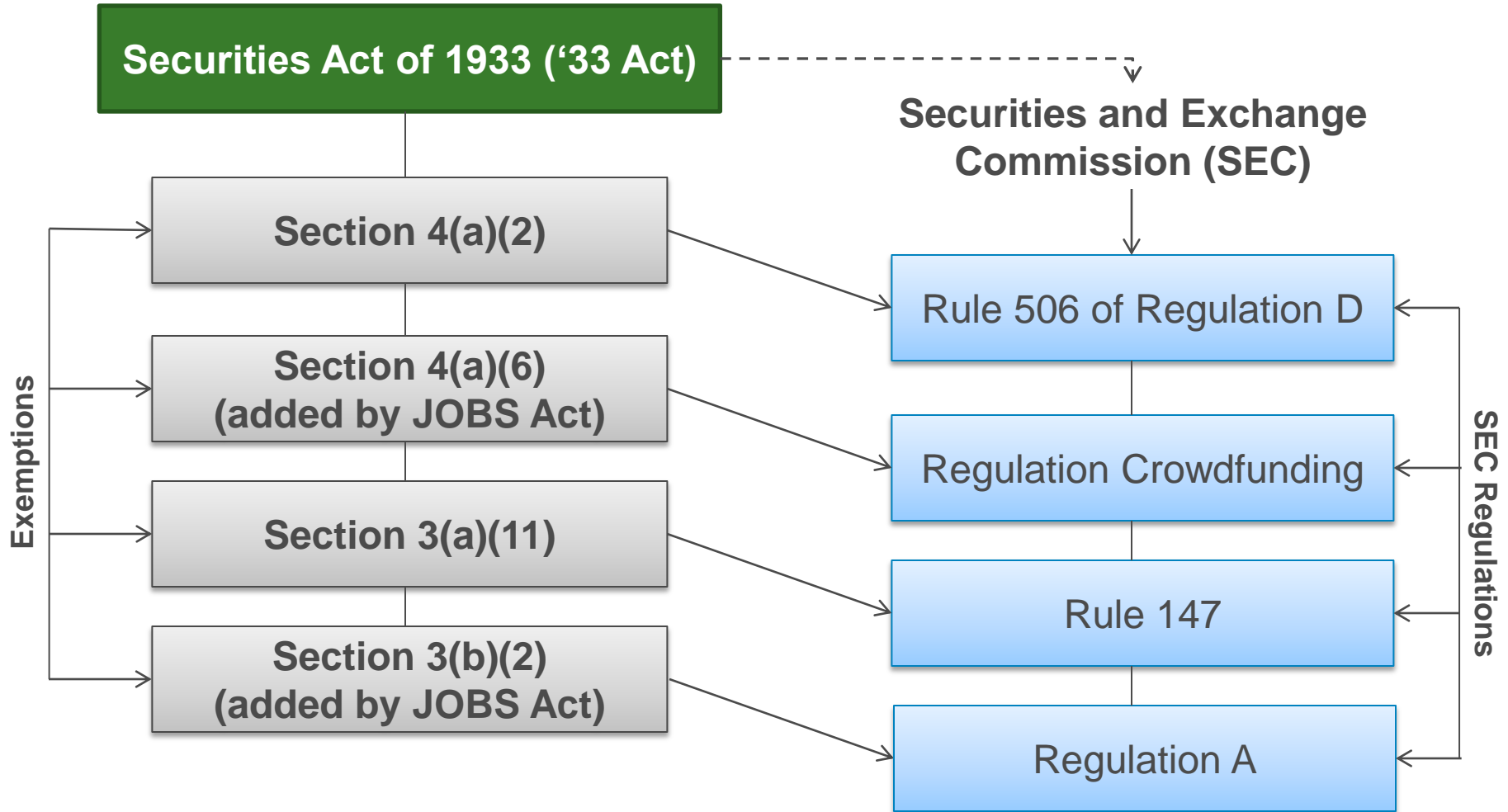


Regulation “A+”: Case Study

Elio Motors was first to close a Tier 2 offering under new Reg. A

- June 19, 2015: First “testing the waters” communications
- August 28, 2015: Filed Form 1-A with SEC for \$25MM offering
- November 20, 2015: Elio receives SEC qualification of Form 1-A
- February 1, 2016: Elio closes “best efforts” sale of \$17MM of common stock from 6,000+ investors on StartEngine’s platform
 - Form 1-A estimate of legal fees (incl. blue sky): \$110K
- February 22, 2016: Elio starts trading on OTC market (OTCQX:ELIO)
 - 52wk range: \$13 - \$75

Peer-to-Peer Lending Regulation



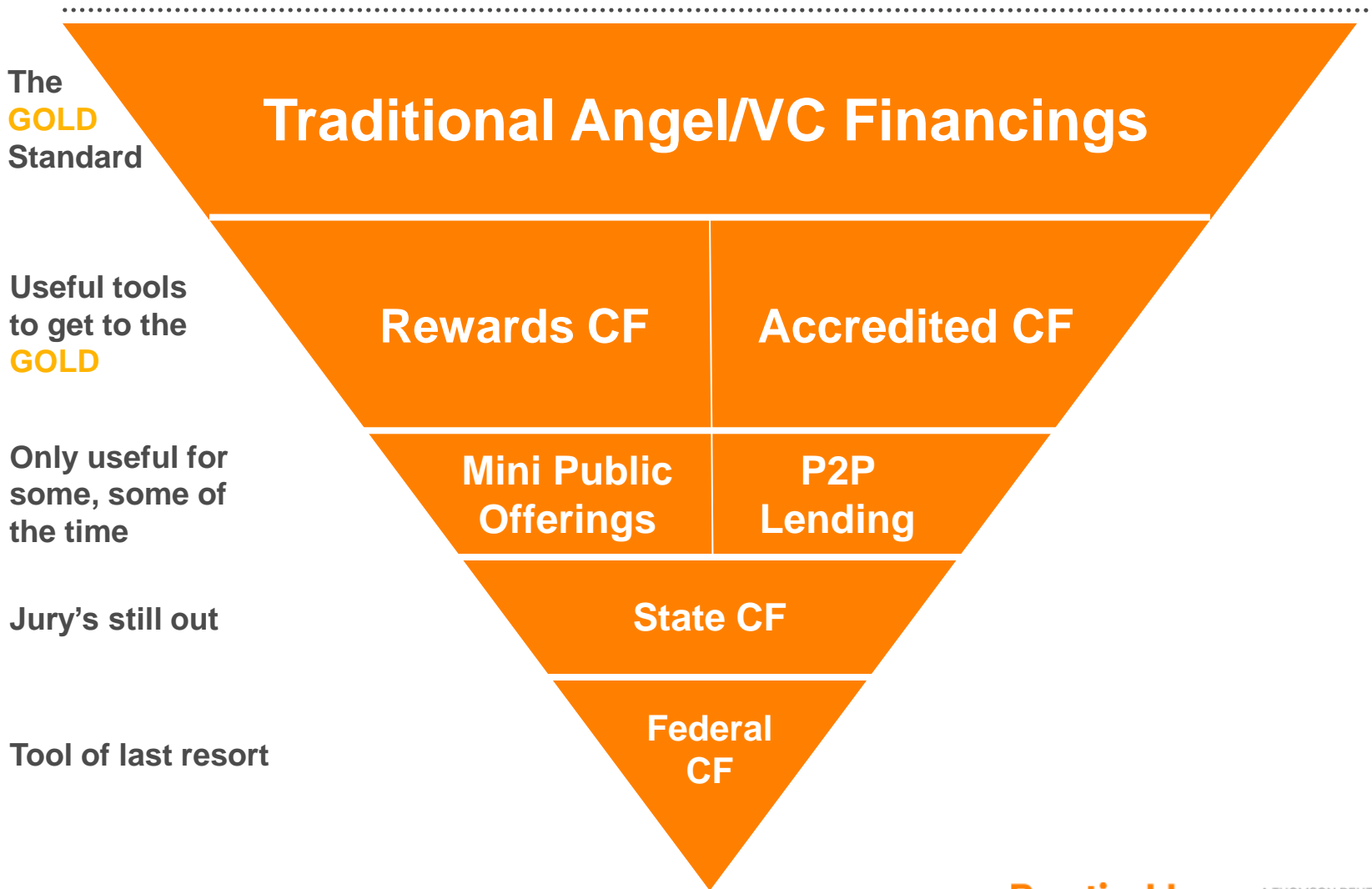
Peer-to-Peer Lending Regulation

- Personal and bank loans traditionally not considered “securities” for purposes of securities laws
 - P2P Lending Platforms initially took this position
- In 2008, SEC took note that the loans were marketed as investments
 - Took action against main players to require them to register these “investment contracts” with the SEC
 - Now these platforms file shelf registration statements for a continuous offering under Rule 415
 - The registration statements are regularly supplemented with information on each loan that is made through the platform



What's a Startup to Do?

Advising Startups on Crowdfunding (CF) Options



Relevant Practical Law Resources

- [Crowdfunding Offerings Under Section 4\(a\)\(6\)](#)
- [Crowdfunding Intermediaries: Funding Portals and Brokers](#)
- [Comparative Chart: Regulation D, Amended Regulation A and Regulation Crowdfunding](#)
- [Expert Q&A on Equity Crowdfunding](#)
- [Expert Q&A on Accredited Crowdfunding](#)
- [Startup Crowdfunding Toolkit](#)

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