The Legal Intelligencer

From Lady Liberty to Startup Capital—Crowdfunding Today

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December 15, 2015

When invited to speak to entrepreneurs and developers about crowdfunding, I often open with a little-known story about a 130-year-old example: the Statue of Liberty. Construction of Lady Liberty was funded largely by contributions from French citizens. However, funding for the pedestal was left to New York. When the state came up short, newspaper publisher Joseph Pulitzer came to the rescue. Pulitzer placed a full-page ad in his newspaper, the New York World, in 1884, urging the public to contribute funds toward the pedestal.

"We must raise the money!" the ad read. "The World is the people's paper, and now it appeals to the people to come forward and raise the money. The $250,000 that the making of the statue cost was paid in by the masses of the French people—by the working men, the tradesmen, the shop girls, the artisans, by all, irrespective of class or condition. Let us respond in like manner. Let us not wait for the millionaires to give us this money. It is not a gift from the millionaires of France to the millionaires of America, but a gift of the whole people of France to the whole people of America."

The crowdfunding appeal was so popular that by Aug. 11, 1885, the New York World collected more than $100,000 in donations from approximately 160,000 people—well under a $1 on average—proving that when people join forces, they can achieve a desired result.

Flash forward 123 years to 2008 and the launch of the website Indiegogo revolutionized access to capital using the Internet. The three founders of Indiegogo had a simpler mission in mind: fund an off-Broadway play and charity event for myeloma cancer research. The following year, Indiegogo inspired another crowdfunding giant, Kickstarter, which had a mission to bring creative projects to life.

Despite their separation by more than a century, the common element in these examples is that crowdfunding was donative—donors expected nothing of significance in return except perhaps an acknowledgement in the credits of an Indie film or a thank you in the New York World (which, in fact, did occur and yielded an unintended benefit of increasing newspaper sales significantly).

The Great Recession Shake-up

Following the recession of 2008, the "donative" crowdfunding model experienced a subtle, but meaningful shake-up. By 2008 and 2009, many entrepreneurs and real estate developers experienced rejections when they sought banks loans, venture capital and private equity. Individuals who lost their jobs and could not find a new one often depleted their savings and 401(k) accounts. When both of these groups ran out of options, many of them turned to crowdfunding. Initially, they used the various crowdfunding websites available at the time with a "donative" appeal—a cupcake startup seeking $8,000 for an oven and initial rent for a storefront location, might have offered a free birthday cupcake for 10 years to contributors of more than $100.

Federal and state securities laws do not govern fundraising in such a donative manner where contributors are promised nothing or a nominal return. Over time, however, as traditional access to capital disappeared, some companies began to promise more than nominal consideration in return for crowdfunding contributions. To entice contributors, they began to offer a return on the investment, which means they were offering a "security," which is governed by securities laws, because a security is a contract or transaction whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, as in The Securities Act of 1933, as amended.

A long-standing federal law prohibited the company that offered its securities—the issuer—from using general solicitation to market them, meaning no ads in newspapers or magazines or on television and radio, and no seminars with invitation by general solicitation or general advertising. Using an unrestricted and therefore publicly available website constitutes general solicitation. Thus, the crowdfunding campaigns that promised more than nominal consideration violated securities laws, which did not go unnoticed by the Securities and Exchange Commission, state regulators and Congress. However, Congress also noticed that many issuers who raised relatively small amounts through crowdfunding succeeded in starting or growing companies and soon many were hiring others, thereby reducing unemployment.

The JOBS Act of 2012

Congress desired to continue this momentum so it enacted the Jumpstart Our Business Startups Act (JOBS Act) in 2012 to democratize investing to allow smaller companies access to capital and permit non-accredited investors to participate in the investment process. The JOBS Act required the SEC to adopt rules to expand registration exemptions under the Securities Act. Specifically, Title II of the JOBS Act directed the SEC to lift the ban on general solicitation, provided that all the investors in the offering are accredited; Title III required the SEC to bring non-accredited investors into the fold for equity crowdfunding.

On July 10, 2013, the SEC adopted amendments to Rule 506, creating Rule 506(c) of Regulation D and Rule 144A under the Securities Act to implement the requirements of Title II of the JOBS Act, which became effective on Sept. 23, 2013. Rule 506(c) allows issuers to raise funds using general solicitation or advertising to market their offerings, but only for sale to accredited investors. Rule 506(c) also requires the issuer to take "reasonable steps to verify" that investors are accredited. Recognizing the need for flexibility, the SEC declined to specify an exclusive list of verification methods; instead, Rule 506(c) lists suggested methods, including reviewing documentation such as W-2s, tax returns, bank and brokerage statements and credit reports.

The new rule led to an interesting result. While many awaited the SEC's release of Title III rules bringing non-accredited investors into the crowdfunding fold, other private placement issuers began to raise money from accredited investors on new crowdfunding websites operating under Rule 506(c). According to 2014 SEC data, issuers raised more than $14 billion under Rule 506(c) in the first 18 months after its release. And that amount is expected to double by the end of 2015.

Title III Equity Crowdfunding

On Oct. 30, the SEC adopted the eagerly awaited final rules under Title III of the JOBS Act, allowing non-accredited investors to participate in private company, securities-based crowdfunding for the first time in eight decades—truly a historical day. The SEC proposed rules under Title III follow the 2013 crowdfunding proposed rules in most significant respects and represent a major shift in how small U.S. companies can raise money. The rules allow an issuer to raise up to $1 million through crowdfunding in a 12-month period and require certain information to be provided to the SEC, investors and the relevant intermediary, and be made available to potential investors. The new rules and accompanying forms are expected to be effective 180 days after they are published, except that forms for funding portals to register with the SEC would be effective Jan. 29, 2016.

Issuer Eligibility

Certain categories of issuers may not use the crowdfunding exemption:

• Non-U.S. companies, blank check companies and companies reporting under the Exchange Act of 1934;

• Investment companies and companies that are excluded from the investment company definition of the Investment Company Act;

• Companies that are disqualified under Title III crowdfunding's disqualification provisions ("bad actor" disqualification); and

• Companies that have failed to comply with the annual reporting requirements under Title III crowdfunding during the two preceding years).

Annual Investor Limitations

The Title III rules include annual investor limitations, as follows:

• Individual investors (including non-accredited investors) aggregate crowdfunding investing in a 12-month period may not exceed:

• if either annual income or net worth is less than $100,000, the greater of $2,000 or 5% of the lesser of their annual income or net worth; or

• if both their annual income and net worth are equal to or greater than $100,000, 10 percent of the lesser of their annual income or net worth and subject to an investment cap of $100,000

Crowdfunding Portals/Intermediary Regulation

Crowdfunding transactions by definition occur online and henceforth on portals operated by an SEC-registered intermediary, either a broker-dealer or a new type of SEC registrant called a "funding portal." An issuer relying on the crowdfunding exemption is required to conduct its offering exclusively through one intermediary platform at a time to create the "crowd" and to facilitate the issuer's compliance with the $1 million aggregate offering limitation.

Title III regulates crowdfunding portals that act as an intermediary to nonaccredited investors. Portals must register with the SEC and become a member of the Financial Industry Regulatory Authority. Portals may earn compensation with a financial stake in the issuer companies, including earning a carried interest rather than a commission. This modification in the traditional crowdfunding structure should appeal to investors because the platforms earn profits at the back end, when investors do. The carried interest compensation regime also relieves the issuer from parting with a portion of the proceeds and leaves more for its business plan.

The Title III rules require the portals to provide investors with educational materials that explain, among other things, the process for investing on the platform, the types of securities being offered and the information an investor can expect from the issuer company.

In addition, the portals also must make information an issuer is required to disclose available to the public on its platform throughout the offering period and for a minimum of 21 days before any security may be sold.

The "Issuer Disclosure Requirements" are below:

• Provide communication channels to permit discussions about offerings on the platform;

• Provide disclosure to investors about the intermediary's compensation;

• Accept an investment commitment only after an investor has opened an account;

• Have a reasonable basis for believing an investor complies with the investment limitations;

• Provide investors notice of investment commitments and confirmation at or before completion of a transaction;

• Comply with requirements for maintenance and transmission of funds; and

• Comply with completion, cancellation and reconfirmation of offerings requirements.

Issuers must provide disclosure materials to the SEC (filed via the EDGAR system on new Form C), investors and the relevant brokers or funding portals. The disclosure documents should include a description of the company's business and financial condition, and contain a complete set of financial statements covering the shorter of the two most recently completed fiscal years or the period since the inception of the business.

Advertising Restrictions

The Title III rules prohibit an issuer from advertising the terms of the crowdfunding offering except for limited notices of the offering itself (comparable to "tombstone ads" permitted under Securities Act Rule 134) that direct investors to the intermediary's platform. For example, the issuer may provide the name of the intermediary through which the offering is being conducted and a link to the intermediary's platform, the amount and price of the securities and limited factual information about the issuer: the name, address, phone number and website of the issuer; the email address of a representative of the issuer; and a brief description of the issuer's business. There are no limits on how the issuer distributes the advertising notices such as through social media.

Conclusion

Time will tell how Title III crowdfunding plays out and whether Title II platforms will enter into the Title III crowdfunding market. One thing has already been clear since accredited-crowdfunding offerings exploded under Title II of the JOBS Act: crowdfunding has come a long way since Joseph Pulitzer's newspaper ad.