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Using the New Equity Crowdfunding Rules to Raise Capital

Clients often ask us about “crowdfunding” and whether there is a way to raise capital online via crowdfunding. Below is a summary of the current state of equity crowdfunding, its limitations and other potential options.

What is “crowdfunding”?

The term “crowdfunding” is used in many contexts and has many meanings depending on the source. For example, many companies have raised money through crowdfunding sites like Kickstarter and Indiegogo. This type

of crowdfunding has been described as “cash for love” and the contributor typically receives something tangible in return for the donation. In 2015, watchmaker Pebble raised \$20.3 million from 78,471 backers for its new smart watch and in 2014 the Coolest Cooler raised a total of \$13.2 million from 62,642 backers for its high tech cooler. No equity or securities are issued to backers in this type of crowdfunding and such campaigns are generally not subject to federal and state securities laws.

However, companies that raise money online from investors in exchange for equity, securities or debt are subject to federal and state securities laws. Historically these laws have prohibited the type of activities that constitute equity crowdfunding.

Didn't Congress pass a crowdfunding law permitting equity crowdfunding?

To permit equity crowdfunding, Congress passed the CROWDFUND Act back in April 2012 as part of the Jumpstart our Business Startups (JOBS) Act.¹ The Act was designed to enable start-up companies to raise capital in small amounts from numerous investors through an online platform.

The Act wasn't effective immediately and directed the Securities and Exchange Commission (SEC) to adopt regulations implementing the Act within 270 days. Finally, in October 2015 – more than three years after Congress passed the Act – the SEC adopted Regulation CF implementing the crowdfunding rules.² The regulations will become effective on May 16, 2016.

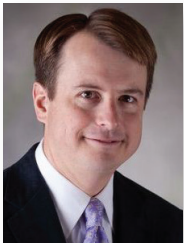
What are the advantages of equity crowdfunding?

The biggest advantage of equity crowdfunding is that it allows companies to raise capital from investors who are not “accredited” as defined by Rule 506 of Regulation D.³ Traditionally, except through a public offering, companies have been limited to raising capital from investors who had sufficient net worth or income to meet the accredited investor definition. This significantly lowers the number of potential investors. Under the new equity crowdfunding rules, any individual may invest subject to certain limitations on the total amount invested by such investor in all crowdfunding investments.⁴

Another advantage is the ability to publish and distribute notices containing basic information regarding the issuer and the offering across multiple online platforms. Although the company cannot engage in traditional advertising strategies to reach investors, the new rules provide a method to reach a large number of potential investors online.

What are the disadvantages of equity crowdfunding?

Unfortunately, there are many disadvantages. First “blank check” companies formed for unspecified purposes or to purchase another company cannot utilize the new crowdfunding exemption. In particular, this will prevent many real estate funds from using crowdfunding. Second, the total amount sold to investors in any 12 month period cannot exceed \$1 million. This small maximum offering amount will be insufficient for many offerings other



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than true start-ups. Third, issuers must provide Generally Accepted Accounting Principles (GAAP) financial statements for the two most recently completed fiscal years (or shorter period since inception).

For issuers that intend to raise more than \$100,000 by crowdfunding, the financial statements must be reviewed by a Certified Public Accountant (CPA). In some cases, issuers must provide audited financial statements. This is an added cost and administrative burden that doesn't exist in other exempt offerings. Fourth, issuers must file annual reports at the SEC for a period of time following the offering. Finally, we believe that many companies will be hesitant to admit a large number of unsophisticated investors as owners. Based on these disadvantages, we believe that Regulation CF will be unattractive to many companies seeking capital.

What other options are available?

We continue to believe that most companies seeking equity capital in excess of \$500,000 will be best served by utilizing the exemption provided by Rule 506 of Regulation D. Under this rule, companies can raise an unlimited amount of funds from an unlimited number of accredited investors.

In 2013, Rule 506 was amended to provide two different options for issuers. Under Rule 506(b), which has been used for decades, companies are prohibited from using advertising or general solicitation to seek investors. This means that an unrestricted website open to the public cannot be used to solicit investors. Recently, however, the SEC recognized an exception to this rule for online platforms


that prequalify potential investors and limit offers and sales to investors who meet the accredited investor requirements and other suitability requirements.⁵ This exception provides opportunities to companies who desire to seek investors online, but who don't wish to comply with the verification requirements described below.

Under new Rule 506(c), companies may utilize advertising and general solicitation – including unrestricted, open offerings online – if the company is willing to restrict all of its sales to accredited investors and is willing to comply with more burdensome requirements regarding the verification of each investor's status as an accredited investor.⁶ This exemption allows companies to reach a large number of potential investors without the burdens of the Regulation CF crowdfunding rules described above.

What are some examples of online platforms utilized by companies seeking capital?

Responding to these changes, a number of online platforms have sprung up to assist companies in raising capital online (again, as long as all investors are accredited). General equity crowdfunding platforms include Wealthforge, CircleUp, Crowdfunder, AngelList and Portfolia. In addition, a number of equity crowdfunding platforms focused on the real estate industry have emerged. Examples include Fundrise, RealtyShares, RealtyMogul, Prodigy Network and RealCrowd. Each of these platforms is different but each appears to require that investors be accredited and each appears to use a "cooling off period" after registration before investors

are permitted to make investments. Most of the platforms expressly state that the platform is not designed to comply with Regulation CF (also called Title III of the JOBS Act). Some of these sites act as a platform that matches issuers and potential investors. Others focus only on debt-like instruments such as senior secured loans, mezzanine loans and preferred equity. Finally, a number of the platforms pool funds from investors into a new LLC formed by the platform that in turn invests into a separate LLC or partnership that owns the property.

We expect to see the continued development and growth of online platforms that match investors with companies seeking equity capital. However, we believe that platforms structured to comply with Rule 506 (instead of Regulation CF) will be more useful to established companies. 

1 See www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf. As is customary, Congress came up with a tortured acronym for the Crowdfunding portion of the JOBS Act: "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012."

2 See www.sec.gov/rules/final/2015/33-9974.pdf

3 The definition of "accredited investor" can be found at 17 CFR §230.501.

4 For example, if both of an investor's annual income and net worth are equal to or more than \$100,000, the investor's total investment in all crowdfunding offerings over a 12 month period may not exceed 10 percent of the lesser of their annual income or net worth. For other investors, total investment may not exceed the greater of \$2,000 or 5 percent of the lesser of their annual income or net worth.

5 See CitizenVC No Action Letter, August 2015, www.sec.gov/divisions/corpfin/cf-noaction/2015/citizen-vc-inc-080615-502.htm

6 Of course, companies must be careful when advertising or publishing content online regarding offerings under Rule 506(c) to ensure that the content contains no misstatements, omissions or other information that could lead to a claim under the anti-fraud provisions of federal and state securities laws. Companies that utilize a broker-dealer must also comply with applicable FINRA advertising guidelines.