

## Current Crowdfunding Methods

PLC Corporate & Securities

The crowdfunding exemption in Title III of the Jumpstart Our Business Startups (JOBS) Act will permit US issuers to raise up to \$1 million per year from the general public, including non-accredited investors, through publicly accessible websites called funding portals. This exemption opens up exciting new financing opportunities for small businesses. However, until the SEC and the Financial Industry Regulatory Authority (FINRA) adopt final rules, offers and sales of securities purporting to rely on the Title III exemption are unlawful under the Securities Act of 1933 (Securities Act). Despite delays in the required rulemaking, the crowdfunding industry is not standing still. Practical Law Company asked Andrew Hecht to discuss Title III and provide a round-up of some of the most visible for-profit crowdfunding platforms doing business right now.



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Andrew is the firm's founder and is based in San Francisco. Previously he was a corporate and securities lawyer at Simpson Thacher & Bartlett LLP. Andrew has represented a wide variety of businesses, from startups to major investment banks, private equity firms and their portfolio companies. He co-founded and served as initial Chief Legal Officer of Wall & Main, Inc., one of the first companies to announce its intention to enter the post-JOBS Act crowdfunding industry.

### Some practitioners are concerned that Title III crowdfunding offerings may prove too costly and time-consuming for issuers. What are some of the anticipated problems?

Practitioners are worried that even if final rules for Title III are enacted in the near term, if the costs to issuers of complying with those rules outweigh the benefits then the Title III crowdfunding regime may be sidelined from the start.

Title III requires robust disclosure by issuers, including descriptions of their officers and directors, business, financial condition, ownership and capital structure, as well as financial statements (in some cases, audited). Issuers will be subject to liability for material misstatements or omissions in their oral and written statements as if liability were created under Section 12(a)(2) of the Securities Act, which does not require investors to prove fraudulent intent by the issuer. In other words, an issuer's disclosure will be held to a similar standard as disclosure in a full-fledged SEC-registered offering. Accordingly, the cost of accountants and lawyers needed to help prepare adequate and accurate disclosure is likely to consume a significant portion of the offering proceeds.

Another complication is that Title III crowdfunding offerings must be undertaken on an "all-or-nothing" basis. The issuer must set a target offering amount and unless it secures investor commitments equal to or greater than that target amount, no securities may be sold. This presents the risk that an issuer may incur considerable up-front offering expenses only to discover that the hoped-for investors fail to materialize, resulting in a failed offering.

If a Title III offering is successful, the issuer must then comply with periodic disclosure requirements. While the details remain subject to future SEC rulemaking, a crowdfunding issuer will be required to file with the SEC and provide to investors, at least once a year, its financial statements and reports of its results of operations.

In light of these issuer-side concerns and additional uncertainty about the regulatory burdens on Title III funding portals, alternative crowdfunding platforms may continue to thrive and evolve even after Title III rulemaking is completed.

>> For more detailed information on the requirements for issuers and funding portals under Title III of the JOBS Act, search [JOBS Act: Crowdfunding Summary](#) on our website.

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## What are some of the alternative crowdfunding platforms?

Rewards-based crowdfunding is the model adopted by Kickstarter, Inc., Indiegogo, Inc. and many others like them. This is the business model most people think of when they hear the word crowdfunding. Rewards-based crowdfunding has grown dramatically in recent years. According to Kickstarter, from its launch in 2009 until the end of April 2013, it has helped to raise over \$590 million, successfully funding more than 40,000 different creative projects.

While the rewards-based platform represents the most familiar form of crowdfunding, this business model does not require any exemption from the registration requirements of the Securities Act because it does not involve an offer or sale of securities, as that term is defined under the Securities Act and federal case law. Instead, an individual or company seeks funding for a project from individual donors in exchange for the promise to deliver a pre-determined reward resulting from the project. For example, an author seeking funds to complete research on a novel may agree to provide a free copy of the novel to each supporter who contributes to the project. As a result, a rewards-based platform in large part becomes a forum for the pre-sale of goods and services.

In contrast, crowdfunding models that facilitate offers and sales of securities include accredited crowdfunding platforms, intrastate crowdfunded offerings and peer-to-peer lending platforms. Recently, accredited crowdfunding received major attention when the SEC's Division of Trading and Markets issued no-action letters in March 2013 effectively blessing the business models proposed by FundersClub Inc. and AngelList LLC.

## How do accredited crowdfunding platforms work?

Accredited crowdfunding platforms (or Regulation D crowdfunding platforms) are only open to investors who meet the definition of accredited investor in Rule 501 of Regulation D under the Securities Act. Two key types of accredited crowdfunding platforms include the investment fund model and the broker-dealer model.

FundersClub and AngelList, which employ the investment fund model, are online platforms targeting the type of high-growth startup companies that might otherwise seek traditional venture capital financing. Each intends to form and advise investment funds that will make investments in startup companies. In turn, those investment funds will offer and sell their own equity securities to accredited investors in unregistered offerings under the Rule 506 safe harbor under Regulation D.

Both FundersClub and AngelList propose to operate as investment advisers. This means each will have to register under the Investment Advisers Act of 1940 or qualify for an

available exemption (for example, the exemption for venture capital fund advisers adopted under the Dodd-Frank Act). As an investment adviser, each will have the right to receive carried interest (a share of the eventual profits, if any, at the termination of an investment) from the investment funds they advise. Under the terms of the March 2013 no-action letters, each platform agrees that it will not accept any transaction-based compensation, permitting it to avoid broker-dealer registration and compliance requirements.

>> For more information on the FundersClub and AngelList no-action letters, search [JOBS Act: Regulation D and Rule 144A General Solicitation Summary](#) on our website.

An alternate version of the accredited crowdfunding platform is the broker-dealer model. This is the model adopted by CircleUp Network, Inc., which has partnered with WR Hambrecht + Co., a registered broker-dealer. CircleUp's partnership with a broker-dealer permits WR Hambrecht to receive transaction-based compensation (a percentage of the amount raised in each offering), making this business model similar to a virtual storefront for a traditional broker-dealer. In the CircleUp model, securities of the startup company itself, not an intermediary investment fund, are sold directly to accredited investors under Rule 506 of Regulation D.

While CircleUp primarily targets retail and consumer products companies, the broker-dealer model may also be used to raise funds for other types of companies. Some expect this type of platform to become more popular once final rules lifting the ban on general solicitation under Rule 506 become effective under Title II of the JOBS Act, making it easier to market these offerings to accredited investors.

## What are some of the advantages and disadvantages of accredited crowdfunding platforms?

Compared to rewards-based platforms, accredited crowdfunding platforms may be more attractive to business-to-business oriented companies that are not in a position to offer in-kind rewards of consumer goods and services.

One of the practical advantages for a company using the investment fund model is the ability to raise funds from a single new shareholder of record (the investment fund) instead of from multiple new shareholders (as in the broker-dealer business model).

A drawback to the investment fund model is that, because these platforms only receive carried interest at the termination of an investment, a company operating one of these platforms is likely to need other sources of revenue to fund its early-stage operations. For example, AngelList is expected to generate revenue from its existing online job-matching service.

One of the practical challenges of the broker-dealer model is the need to identify and partner with a registered broker-dealer that can legally accept transaction-based compensation. In addition, it may be difficult to compete with established broker-dealers to originate and close a sufficient number of offerings to make the platform profitable.

Obviously, one of the main disadvantages to accredited crowdfunding platforms is that they are limited to accredited investors. In contrast, the pool of potential investors is larger for prospective Title III crowdfunding, rewards-based crowdfunding and intrastate crowdfunded offerings.

### How can intrastate offerings be used to conduct crowdfunding-like public offerings?

An intrastate offering is a securities offering that is:

- Registered with a US state securities regulator.
- Exempt from SEC registration requirements under Section 3(a)(11) of the Securities Act.

While the state-level registration and offering requirements for intrastate offerings vary from state to state, for the securities to qualify for the Section 3(a)(11) Securities Act registration exemption, they may only be offered and sold to residents of the state in which the offering is registered.

For example, in April 2013, Solar Mosaic, Inc., a California-based solar finance company, launched a \$100 million intrastate debt offering in California. Mosaic registered its offering with the Commissioner of the California Department of Corporations.

From a crowdfunding perspective, the advantage of an intrastate offering over an offering under Rule 506 of Regulation D is that it can generally be marketed and sold to a broad base of retail investors, subject to any state law investor qualification requirements (which are typically looser than the accredited investor definition under Rule 501). The appeal of Mosaic's intrastate offering for retail investors is illustrated by the minimum investment amount for the offered notes, at just \$25.

### Although you mentioned peer-to-peer lending as an alternative crowdfunding method, peer-to-peer lenders typically do not advertise themselves as crowdfunding platforms. How is this business model like crowdfunding?

The business model adopted by peer-to-peer lenders, such as LendingClub Corporation and Prosper Marketplace, Inc., has many of the hallmarks of crowdfunding. Each business serves as a platform for online borrowing from a large number of lenders who individually commit relatively small principal amounts.

These two platforms facilitate interest-bearing loans to individual borrowers in amounts up to \$35,000. While the loans are unsecured personal loans, borrowers may use the

proceeds to fund small business initiatives. Each platform has a registration statement on Form S-1 on file with the SEC that permits it to engage in a continuous offering to the public under Rule 415 under the Securities Act. Prospectus supplements offering multiple series of notes are filed on an almost daily basis. The platform receives a transaction-based fee at the time each loan is funded and receives additional servicing fees as payments are made on the loan. According to their websites, to date LendingClub has funded more than \$1.6 billion in loans and Prosper Marketplace has funded more than \$500 million.

Investors are members of the general public seeking the comparatively high yields offered by personal loans. Investors typically diversify their investment across many different series. The minimum investment amount per note is \$25.

Peer-to-peer lending platforms have several notable limitations, including personal liability for the borrower, small loan sizes and prohibitive state law restrictions in some jurisdictions. In addition, the notes issued by these two peer-to-peer lenders are only transferable through a designated trading platform operated by FOLIO<sup>fn</sup> Investments, Inc., a registered broker-dealer. The trading platform is not available to residents of all states and some investors have complained of low liquidity. Despite these limitations and the significant costs involved in setting up and maintaining this type of platform, many expect this business model to remain viable even after the Title III crowdfunding rules are adopted.

### Besides the pending Title III exemption, are there any other statutory crowdfunding developments practitioners should know about?

Adding to the ongoing experimentation around crowdfunding, two states recently enacted state securities law exemptions for intrastate crowdfunding offerings:

- Kansas adopted the Invest Kansas Exemption in 2011 (*Kan. Admin. Regs. § 81-5-21*).
- Georgia adopted the Invest Georgia Exemption in 2012 (*Ga. Code Ann. § 590-4-2-.08*).

Notably, in early April 2013, two more state legislatures introduced similar bills to create their own intrastate crowdfunding exemptions:

- House Bill 2023 in Washington.
- House Bill 680 in North Carolina.

While intrastate crowdfunding is currently more of a curiosity than a mainstream business model, it may gain momentum as more and more states adopt similar exemptions.

>> For a more in-depth discussion of current crowdfunding methods, search [Crowdfunding Right Now: Alternatives to Title III of the JOBS Act](#) on our website.