

Crowdfunding in the United States

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of Canada Equity Crowdfunding Workshop**

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What is a security?

- An expectation of profit from the efforts of others
- Cofounders vs. employees vs. others
 - Securities laws pertain to shares given or sold to employees and others
- What about startup loans?
 - Loans are securities if for general corporate purposes, widely distributed, investors expect them to be securities
 - Contrast commercial loans to acquire a particular asset, where lending laws suffice, and are not normally securities

What is a security?

- What about Kickstarter / Indiegogo?
 - Rewards are not securities under federal law
 - Federal Trade Commission jurisdiction
 - Some states *may* view putting capital at risk for a valuable reward as a security (CA, WA)

Who regulates securities?

- Overlapping jurisdiction of the SEC vs. the 50 states
 - SEC and the states always have concurrent jurisdiction to prosecute fraud
 - Some federal exemptions preempt state registration, but never anti-fraud rules
 - SEC regulates adequacy of disclosures, but some states also regulate the merit of the offering to be sold in the state even if adequately described
 - No SEC regulation of intrastate offerings to ppl. in state where issuer resides
 - 2,000 holders or 500 non-Accredited Investors ("AIs") and \$10mm in assets = public reporting
 - This cap contained in Exchange Act Sec. 12(g) applies to private Canadian entities with \geq 300 US resident shareholders
- What is regulated? Offers and sales, not companies
 - This includes resale of securities: one year holding period for private company shares

Who regulates securities?

- What is a broker and why does it matter?
 - Hallmarks of brokerage: receiving transaction compensation, holding funds or negotiating sales
 - Unlicensed brokerage activity is basis for rescission (an investor put option for buyer's remorse)
 - Broker-Dealer exemption for online platforms if no hallmarks of brokerage activity
 - Can make offers, co-invest, perform ancillary services such due diligence and distributing documents
 - Can charge for ancillary services and charge carried interest on profit at exit
 - Does not allow general solicitation, but achievable under the No Action Letters
- Consequences of violating the law
 - Jail, fines, injunction, bans on future access to capital markets ("bad actor" disqualification)

Securities offering basics

- Three types of offerings
 - Registered, exempt and illegal
- Crowdfunding via IPO?!
 - It's a crowd, but is expensive requires expertise of an underwriter that will only underwrite sizeable deals (e.g. \$30mm in revenue)
 - Multijurisdictional Disclosure System allows Canadian issuers to make registered public offerings in the U.S. using a prospectus mainly compliance only with Canadian law
- Exemptions for registration for crowdfunding:
 - Regulation D
 - •Regulation A+
 - Jobs Act Title III (anticipated to be adopted in October)
 - Intrastate offerings

Crowdfunding with Regulation D

- Accredited Investors status is the lynchpin
 - Traditional Reg. D — up to 35 non AI at most
 - Premise is all private approaches; including a single non-AI triggers disclosure requirements
 - Watch what you tweet or you will end up in new 506(c)
- Modern Reg. D on the Internet under 506(c)
 - Rolling your own
 - Advertise online and take reasonable steps verify AI status (bank, tax forms)
 - Use a third party AI verification service (e.g. SecondMarket)
 - Investment fund model
 - FundersClub and AngelList became SEC approved business models in 2013
 - Substitute for VC financing
 - They raise a funds from AIs under Regulation D roll them into an investment fund
 - Broker-dealer model
 - CircleUP (US entities), allows AI to invest directly in startups in a min/max round

Crowdfunding with Regulation D

- Peer-to-peer lending
 - LendingClub (US entities only) up to \$300k for business loans; Prosper.com
 - Series of notes are SEC registered in continuous process, so not limited to AIs
 - Significant state law restrictions on lending

Crowdfunding with Regulation A+

- Basics: SEC approved public disclosure + internet advertising
- Who can use Reg A+?
 - Formed and HQ in US or Canada; no investment, blank check, or mining / mineral interest issuers
- Tier 1: up to \$20mm in 12 months
 - Including \$6mm of resales, but capped at 30% in initial and second year offerings
 - No limit on number of AIs or amount they can purchase, but count toward 2,000/500 limit
 - Requires registration in each state of offering to comply with “blue sky” laws
 - New consolidated review program for blue sky: make one filing to registered in all offering states
 - No ongoing SEC compliance and no audit requirement for financial statements

Crowdfunding with Regulation A+

- Tier 2: up to \$50mm in 12 months
 - Including \$15mm of resales, but capped at 30% in initial and second year offerings
 - Non AIs limited to greater of 10% of yearly income or net worth (revenue or net assets for entities) per deal
 - Self certification of accredited status is okay in contrast to Reg D with advertising
 - Holders excluded from 2,000/500 limit if amount held by non-affiliates < \$75mm
 - No registration with the states, but states currently challenging this Tier 2 preemption
 - Financial statements must be audited, but auditor need not be PCAOB registered
 - On going annual, semi annual and current reporting similar to public companies

Crowdfunding with Regulation A+

- Disclosure requirements
 - Form A-1 consists of Part I Summary, II Offering Circular, III Exhibits, F/S
 - Two years of F/S with US GAAP or IFRS for Canadians
 - Level of disclosure similar to an IPO; can be satisfied using IPO forms (S-1)
- Advertising and liability
 - Only limited “testing the waters” communications prior to filing publicly Form A-1
 - Requires disclaimers, no commitments, subject to anti-fraud, state law if Tier 1
 - After public Form A-1 filing, can make binding offers, subject to SEC qualification
 - After SEC qualification of Form A-1 (6-9 months anticipated), can make sales
 - Issuer, D&Os, selling shareholders liability for written and oral statements, without intent

Crowdfunding Under JOBS Act Title III

- Section 4(a)(6) enacted but Regulation Crowdfunding is not yet the law (targeted for October)
- Per issuer and per investor limits
 - \$1mm on a rolling 12 month basis for company and affiliates; 4(a)(6) \$ raised not "integrated" with other securities issuances
 - Investors with 12 month income and NW < \$100k can invest the greater of \$2k, 5% of income and 5% NW
 - Investors with 12 month income or NW > \$100k, can invest the greater of 10% of income or NW, up to \$100k
 - Must offer through single online broker or portal; portal tracks investor limits
 - Securities do not count toward Section 12(g) 2,000/500 person limit

Crowdfunding Under JOBS Act Title III

- General disclosure obligations (File new Form C on EDGAR 21 days before 1st sale)
 - Identity of the issuer, D&O and 20% stockholder info
 - Business plan info (detail unspecified, but SEC raised question of scope in proposal)
 - Offering price; use of proceeds; description of securities incl. voting, transfer restrictions
 - Risk factors, description of debt, # employees, insider transactions, fees to intermediary

Crowdfunding Under JOBS Act Title III

- Financial disclosure obligations (based amount sold last 12 months plus current amount targeted)
 - ≤ \$100k, US GAAP FS for 2 years plus last year's tax return, certified by PEO
 - \$100k to \$500k, US GAAP FS for 2 years reviewed by independent public accountant
 - > \$500k, US GAAP FS for 2 years audited by independent public accountant
 - Discussion of financial condition: results of operations, liquidity, capital resources

Crowdfunding Under JOBS Act Title III

- Significant limitations

- Must be US issuers, but forming a US subsidiary is easy
- Must be an operating co., not blank check or investment company (no real estate investment companies)
- Ads ok, but content limited to issuer, \$ amount, security type, closing date, link to portal
- Ad rules bind employees, other promoters; both must disclose their comp in each ad
- Liability to D&Os, sellers, portals, for written oral misstatements (rescission or damages)
- Update Form C yearly w/in 120 days of year end until all securities resold or IPO
- No resale for one year unless to issuer or AIs, registered or to family upon death/divorce

Crowdfunding Under JOBS Act Title III

- Requirements for all intermediaries (none apply to current AI crowdfunding portals)
 - Registration with FINRA, and as a broker or funding portal with the SEC
 - Intermediaries and their principals may not have a financial interest in the issuers
 - Act as gatekeepers, with reasonable belief the transaction complies with laws
 - Must perform background checks on D&Os and 20% owners
 - Required to educate investors on offering road rules and risks
 - Must enforce annual per investor limits across all portals (but may rely on investor's word)

Crowdfunding Under JOBS Act Title III

- Additional requirements for funding portals (not registered as brokers):
 - May not provide investment advice or recommendations
 - May not solicit purchases or sale of the securities offered on the portal
 - May not handle funds or pay compensation based on sales

Intrastate Crowdfunding

- Rules enacted in about half of the 50 states; not much data but NYT cited 95 intrastate offerings to date
- Federal exemption premised on a local offering by a local business (Securities Act Sec. 3(a)(11) + Rule 147)
 - Principal office, plus 80% of gross revenues, assets and proceeds all in the state
 - No resales out of state for 9 months after last issuer sale
 - No concurrent intrastate offerings in 2+ states due to "integration" of offerings
 - Integration if one plan of financing, same class, time, consideration and purpose
 - Obvious advantage for high population states, but no rules yet in CA or NY

Intrastate Crowdfunding

- Offering basics

- Maximum offering generally \$1-2mm; typical cap of \$10k per investor unless AI
- Audited financial statements required for higher offering amounts
- Issuers required to be either formed or qualified in the state
- Issuers either required or encouraged to use portals
- All internet advertising allowed if properly geo-fenced / limited to the offering state, but this impractical with social media
- Issuers may use state law compliant portals with disclaimers and self certification by investors of their state of residency

Analysis and recommendations

- No sale of securities is a good option if feasible (Kickstarter)
- Pitfalls of having a large investor base
 - Exceeding 500 non-AI limit, more plaintiffs, less professional potential plaintiffs
 - Burdensome logistics for voting, notices, and related shareholder governance
 - May limit options for or be less attractive to future sources of financing
- Liability may be greater if issuers free form ads instead of disclosure documents vetted with counsel
- Private Reg. D preferable to advertising if feasible
- If advertising required to raise capital, use a structured Reg. D portal with carefully vetted advertising instead of a DIY solution with free form ads

Thank you

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