# Crowdfunding Right Now: Alternatives to Title III of the JOBS Act

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This Article summarizes some of the main for-profit crowdfunding methods currently being used in the US. It examines key criticisms of the pending crowdfunding exemption under Title III of the JOBS Act and describes alternative methods being used right now, before the Title III rulemaking is completed. These alternatives include rewards-based crowdfunding, accredited crowdfunding platforms, peer-to-peer lending platforms and intrastate crowdfunding.



Many companies are eager to stake a claim as one of the first crowdfunding portals authorized under Title III of the Jumpstart Our Business Startups Act (JOBS Act), hoping to become the Goldman Sachs or Morgan Stanley of the crowdfunding industry. Likewise, many small businesses, from sole proprietorships to more established companies, are eager to take advantage of the new capital-raising opportunities under Title III.

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 crowdfunding exemption remain unlawful under the Securities Act of 1933 (Securities Act). The December 31, 2012 statutory deadline for SEC rulemaking has already passed and guesses about the estimated timing for final rules continue to be pushed back.

Despite this delay, the crowdfunding industry is not standing still. A handful of creative companies are pioneering new business models that achieve the goals of crowdfunding in compliance with existing federal securities laws. Some of these business models pre-date the JOBS Act and others have grown up out of the frustration over the delayed rulemaking.

This Article briefly summarizes the pending JOBS Act crowdfunding exemption and examines some of the most visible for-profit crowdfunding platforms doing business right now, without waiting for Title III.

## THE TITLE III CROWDFUNDING EXEMPTION UNDER THE JOBS ACT

Title III crowdfunding will permit US issuers to raise up to $1 million per year from the general public, including investors that do not qualify as accredited investors, through publicly accessible websites called funding portals. In theory this opens up tremendous new financing opportunities for small businesses.

Many have expressed concerns, however, that Title III crowdfunding offerings may prove too time-consuming and costly for issuers. For example, an issuer raising funds under Title III must file with the SEC, and distribute to investors, disclosure including:

- Descriptions of its officers and directors, business, anticipated business plan and financial condition.
- A description of its ownership and capital structure, including:
  - the names and ownership levels of principal stockholders; and
  - an explanation of how the exercise of rights held by its principal stockholders could negatively affect those who purchase the securities being sold in the offering.
- Financial statements that have been:
  - reviewed by an independent public accountant if it intends to raise more than $100,000; or
  - audited if it intends to raise more than $500,000.

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 (see *Practice Note, Liability Provisions: Securities Offerings (http://us.practicallaw.com/6-381-1466)*). 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. In other words, 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 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. For a more detailed discussion of the requirements for issuers and funding portals under Title III of the JOBS Act, see *Practice Note, JOBS Act: Crowdfunding Summary (http://us.practicallaw.com/6-518-7396)*.

Even if the SEC and FINRA enact final rules for Title III in the near term, if the costs to issuers of complying with those rules outweigh the benefits, the Title III crowdfunding regime may be doomed from the start. In light of these issuer-side concerns and additional uncertainty about the regulatory burdens on Title III funding portals, the alternative crowdfunding platforms discussed below may continue to thrive and evolve even after Title III rulemaking is completed.

## REWARDS-BASED CROWDFUNDING PLATFORMS

Rewards-based crowdfunding is the model adopted by Kickstarter, Inc., Indiegogo, Inc. and 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 more than $590 million, successfully funding more than 40,000 different creative projects.

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.

When a project reaches the targeted funding amount, the platform takes a transaction fee based on a percentage of the amount raised. To avoid this transaction fee, some companies set up their own dedicated website to apply this crowdfunding model to a specific project. For example, Apigy Inc. launched a dedicated crowdfunding website to seek funding for its Lockitron keyless door lock system.

While couched in terms of donations and rewards, this business model is essentially the pre-sale of goods and services. There are pros and cons to this approach. By giving rewards instead of securities, the project sponsors can:

- Avoid diluting the equity of existing stockholders.
- Test the market demand for their goods and services before committing to produce them in large quantities.

However, because of its consumer focus, rewards-based crowdfunding platforms implicate several consumer protection concerns, including:

- Who is responsible if the project fails to deliver the reward?
- What happens if the project fails to conform to the description provided by the sponsor?
- How are refunds and credit card charge-backs handled?

Project sponsors should also carefully consider the tax consequences of raising funds through a rewards-based platform. The funds received from donors are likely to be treated as income to the recipient.

Practitioners have also pointed out that rewards-based crowdfunding platforms may run afoul of the securities laws of states that apply a risk capital definition of a security. Under a risk capital definition, state regulators and courts may view donations through a rewards-based platform as investments in securities. Specifically, donors may be viewed as putting capital at risk in an enterprise over which they exercise no control with the expectation of receiving a valuable reward that is dependent on the successful conduct of a business with the capital raised from donors.

States that apply a risk capital definition of security include:

- California (see, for example, *Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811 (1961)*).
- Washington (*Wash. Rev. Code § 21.20.005(17)(a)*).

## ACCREDITED CROWDFUNDING PLATFORMS

### Investment Fund Model

FundersClub Inc. and AngelList LLC recently received major attention in the crowdfunding sphere after the SEC's Division of Trading and Markets issued no-action letters in March 2013 effectively blessing their proposed business models.

FundersClub and AngelList 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 of the Securities Act (see *Practice Note, Section 4(a)(2) and Regulation D Private Placements (http://us.practicallaw.com/8-382-6259)*).

 

These platforms are commonly referred to as accredited crowdfunding platforms or Regulation D crowdfunding platforms because they are only open to investors who meet the definition of accredited investor in Rule 501 of 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 on the FundersClub and AngelList no-action letters, see *Practice Note, JOBS Act: Regulation D and Rule 144A General Solicitation Summary: Funding Platform No-Action Letters (http://us.practicallaw.com/1-518-7172#a1026283)*.

Because accredited crowdfunding platforms only receive carried interest at the termination of an investment, an entity 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 advantages for a company using an accredited crowdfunding platform 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 described below. 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.

However, because these platforms are limited to accredited investors, the pool of potential investors is smaller than the pool of investors accessible through:

- Prospective JOBS Act crowdfunding under Title III.
- Rewards-based crowdfunding.
- Intrastate offerings.

### Broker-dealer Model

An alternate version of the accredited crowdfunding platform 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.

Some expect this type of direct-investment accredited crowdfunding platform to become more popular once final rules lifting the ban on general solicitation under Rule 506 are adopted under Title II of the JOBS Act, making it easier to market these offerings to accredited investors (see *Practice Note, JOBS Act: Regulation D and Rule 144A General Solicitation Summary (http://us.practicallaw.com/1-518-7172)*).

While CircleUp primarily targets retail and consumer products companies, this crowdfunding model may also be used to raise funds for other types of companies.

Practical challenges to launching this type of platform include:

- The need to identify and partner with a registered broker-dealer that can legally accept transaction-based compensation.
- Competing with established broker-dealers to originate and close a sufficient number of offerings to make the platform profitable.

## PEER-TO-PEER LENDING PLATFORMS

This is the business model adopted by peer-to-peer lenders LendingClub Corporation and Prosper Marketplace, Inc. While these companies do not advertise themselves as crowdfunding platforms, their business model has many of the same hallmarks. Each serves as a platform for online borrowing from a large number of lenders who each individually commit relatively small principal amounts. 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.

Each platform facilitates 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 (see *Practice Note, Shelf Registrations: Overview (http://us.practicallaw.com/5-381-0962)*). 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.

Each series of notes offered corresponds to a single consumer loan originated through the peer-to-peer platform. Notes have a maturity of three or five years. Because payments on an individual series of notes depend entirely on monthly payments to be made by the borrower on the underlying loan, the notes are referred to as "borrower payment dependent notes."

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.

These existing platforms have several notable limitations, including:

- *Personal liability for the borrower.* Because corporate loans are not available, amounts borrowed to fund a small business are personal obligations of the borrower. The borrower is therefore personally liable if the business does not generate sufficient income to repay the loan.
- *Small loan sizes.* The maximum borrowing amount is only $35,000, making the existing platforms useful to only the smallest of small businesses.
- *State law restrictions.* Because of restrictions under certain state borrower protection and lending laws, there are some states in which the notes are not currently offered.
- *Liquidity.* The notes sold through the existing platforms are only transferable through a designated trading platform operated and maintained by FOLIO*fn* 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. Prospectuses warn investors that they should be prepared to hold their notes until maturity. However, as compared to securities purchased in a Title III crowdfunding offering (where resales will be significantly restricted for one year from the purchase date), the relative liquidity of peer-to-peer notes may be seen as a positive.

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. For entrepreneurs and small businesses seeking small loans, the business loan application process for a peer-to-peer lender is much simpler than the disclosure and other requirements under the prospective Title III crowdfunding framework.

## INTRASTATE OFFERINGS AND CROWDFUNDING

A recent transaction by Solar Mosaic, Inc., a California-based solar finance company, illustrates how intrastate offerings may be used to conduct crowdfunding-like public offerings that are open to individual retail investors.

In early 2013, Mosaic completed a string of multi-state unregistered offerings under Rule 504 and Rule 506 of Regulation D, raising amounts between $25,000 and $350,000. The proceeds of Mosaic's offerings were used to underwrite loans to solar power projects. Like the notes issued through peer-to-peer lending platforms, each series of notes offered and sold by Mosaic corresponds to an underlying solar project loan. Payments on a note are tied to payments on a specific loan, and the loan is secured by the assets of the solar project. Mosaic receives a management fee from each investor based on the overall value of the investor's account.

Following these smaller-scale offerings, in April 2013 Mosaic launched a $100 million intrastate debt offering in California for similar solar project notes. 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 (see *Section 3 Registration Exemptions: Chart (http://us.practicallaw.com/8-383-4155)*).

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. Mosaic registered its April 2013 offering with the Commissioner of the California Department of Corporations.

From a crowdfunding perspective, the advantage of an intrastate offering over a Rule 506 offering 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). In contrast, a Rule 506 offering:

- Currently permits sales to no more than 35 non-accredited investors.
- Using general solicitation, after future rule changes are adopted under Title II of the JOBS Act, will not permit sales to any non-accredited investors.

The appeal of Mosaic's intrastate offering for retail investors is illustrated by the minimum investment amount for the offered notes, at just $25.

The drawbacks of intrastate offerings include:

- The offering may only be made to the residents of a single state, greatly narrowing the size of the potential investor base.
- While investor resales to in-state residents are permitted, resales to out-of-state residents are only permitted beginning nine months after the last sale of the securities by the issuer, in each case subject to any state law restrictions on resales (which may be more strict) (see *Practice Note, Road Map for Undertaking a Private Offering: Rule 147: The Intrastate Offering Exemption (http://us.practicallaw.com/4-501-6353#a613920)*).
- In some states, the securities regulator reviews the merits of the offering, meaning that some offerings may fail regulatory review and never reach the market.

 

## New State Securities Law Crowdfunding Exemptions

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*).

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.

An online version of this article is available at:
http://us.practicallaw.com/6-527-2460

For more information, search for the following resources on our website.

Practice Notes:

- JOBS Act: Crowdfunding Summary (http://us.practicallaw.com/6-518-7396)
- JOBS Act: Regulation D and Rule 144A General Solicitation Summary (http://us.practicallaw.com/1-518-7172)
- Road Map for Undertaking a Private Offering (http://us.practicallaw.com/4-501-6353)
- Section 4(a)(2) and Regulation D Private Placements (http://us.practicallaw.com/8-382-6259)

Checklist:

- Section 3 Registration Exemptions: Chart (http://us.practicallaw.com/8-383-4155)



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