

Practical guidance at Lexis Practice Advisor®

Lexis Practice Advisor® offers beginning-to-end practical guidance to support attorneys' work in specific legal practice areas. Grounded in the real-world experience of expert practitioner-authors, our guidance ranges from practice notes and legal analysis to checklists and annotated forms. In addition, Lexis Practice Advisor provides everything you need to advise clients and draft your work product in 14 different practice areas.



Douglas S. Ellenoff

Market Trends: Crowdfunding

by Douglas S. Ellenoff, Ellenoff Grossman & Schole LLP (all market data by Sherwood Neiss and Jason Best, Crowdfund Capital Advisors)

Overview

Unlike other provisions of the Jumpstart Our Business Startups Act of 2012 (the JOBS Act), Regulation Crowdfunding securities-based crowdfunding, also known as Title III, had only slightly more than six months of results by the end of 2016, since this particular provision only went into effect May 16. Regulation Crowdfunding prescribes rules that permit securities-based crowdfunding by private companies without registering the offering with the Securities and Exchange Commission (SEC) pursuant to new Section 4(a)(6) (15 U.S.C.S. § 77d) of the Securities Act of 1933, as amended (the Securities Act). Consequently, pursuant to this provision, this statutorily permitted form of crowdfunding is only permissible in the United States, although there are versions of Regulation Crowdfunding in other jurisdictions. During the limited six-month initial period of Regulation Crowdfunding, there has been a slow but steady increase in all aspects of this emerging industry. On the day of implementation, there were fewer than 10 Financial Industry Regulatory Authority (FINRA) approved crowdfunding portals and nearly 25 entrepreneurial campaigns posted to those same sites for investor consideration. By the end of 2016, there were 21 FINRA approved portals operating in the market with 186 entrepreneurs seeking to raise capital pursuant to these new rules. Of these 186 entrepreneurial campaigns, 79 have raised sufficient funds to close on at least the minimum amount of their proposed funding requirements. In the aggregate, these campaigns will raise nearly \$17 million. While the aggregate amounts remain small, the initial metrics seem to be trending in an encouraging direction and well above any expectations for Regulation Crowdfunding's first six months. For a further discussion of Regulation Crowdfunding, see [An Overview of the SEC's Crowdfunding Regulations](#).

Notable Transactions

Of the 186 campaigns that sought to raise capital in 2016, three of such campaigns achieved the maximum permissible amount of \$1 million under Regulation Crowdfunding:

- **Beta Bionics (Biotech)** - July 28, 2016 - 954 Investors
- **Hops & Grain (Restaurant)** - August 15, 2016 - 535 Investors
- **Legion M (Hollywood Studio)** - August 9, 2016 - 2,882 Investors

Legion M raised its \$1 million on Wefunder and claims to be the first fan-owned entertainment company, working with top Hollywood creatives to make movies, TV, VR, and more. Beta Bionics, a Massachusetts-based diabetes medical device benefits corporation, also raised the maximum permissible through Wefunder, as did Hops & Grain as well.

Deal Structure and Process

Each CFP has their own approach to working with entrepreneurs, including the securities they ought to offer to potential investors and at what valuation. There are many factors that go into a successful campaign and determine how much that campaign may be able to raise. The most important component to a successful raise is a video explaining the product or service. Without one, an issuer has virtually no chance at raising any funds under Regulation Crowdfunding. More particularly, evidence seems to further suggest

that a campaign that uses a professionally produced video (as opposed to one shot on a smart device) gets an even better response from the crowd. Additionally, the best results are achieved when the founder is in the video and not only explains the product or service of the company but is able to simply explain the terms of the offering. While this may be common sense to a large degree, it seems to be clear from the data that it is even more pronounced in a Regulation Crowdfunding environment. Since May 16, the average investment by each participating investor has risen from \$750 at the beginning of the program to \$883 towards the end of the year. The average deal takes 45 days to achieve the minimum amount requested, and the average time to close on a financing is 97 days. Successful campaigns raise nearly 300% of their requested amounts. And for whatever the reason, funding increases on Tuesdays and Fridays. The average number of investors in a successfully completed financing is 331.

What is Regulation Crowdfunding?

Despite the burgeoning crowdfunding industry, few entrepreneurs and investment professionals and advisors are aware of the online capital formation and investing options. While many in the crowdfunding industry have been laboring for years to establish the foundation of this evolving market, in many ways the market has just begun to be recognized as a valuable and viable option for entrepreneurs to raise much needed funding to grow their businesses. By contrast entrepreneurs are quite familiar with the venture capital market and other more conventional means of raising funds. This isn't much of a surprise when you compare how established venture capital is versus Regulation Crowdfunding and that by recent estimates the venture market is slightly greater than \$20 billion dollars on average each year with investments funding approximately 4,000-5,000 deals. The angel market (i.e., where a high net worth individual invests in an early stage company) is of a similar size on average with funding going into more than 70,000 businesses. By certain estimates, although detailed information is scant, friends and families support their colleagues and family members to an amount that might actually be a multiple of each of those market amounts. Consequently, Regulation Crowdfunding may play an increasingly important role in the financing of what traditionally have been both angel and friends and family opportunities.

It is important to note that Regulation Crowdfunding is only one of the provisions enacted under the JOBS Act, which was signed into law after bi-partisan Congressional support April, 2012. It should not to be confused with other forms of securities crowdfunding, such as Accredited Investor Only/Title II Crowdfunding, Regulation A+/Title IV crowdfunding, or state only crowdfunding. For further information on some of these other provisions of the JOBS Act, see "[Regulation A-Plus](#)" [Limited Public Offerings under Securities Act Section 3\(b\)\(2\)](#); "[Regulation A-plus](#)" [Tier 1 and Tier 2 Offerings Summary Chart](#); [Rule 506\(c\) Third-Party Accredited Investor Verification Letter](#); and [Regulation D, Regulation A+, and Regulation Crowdfunding Requirements Chart](#). Rewards, donations or pre-order arrangements done on well-known sites, such as Kickstarter, Indiegogo, and GoFundMe, also should not be confused with Regulation Crowdfunding. While they may have certain vague similarities to securities crowdfunding, such sites are not offering any securities to the public; this may only be done pursuant to a qualified and compliant securities transaction. The other sites do, however, also match people and relevant ideas in an online environment. Any financing where the public is contributing funds in exchange for an ownership interest, profits participation, revenue sharing, or just loaning money should be presumed to be an offering of securities under both federal and state law. Please keep in mind that this article isn't seeking to address the evolving nature of the international crowdfunding markets.

Investment Amounts and CFPs

Regulation Crowdfunding enables any U.S. incorporated entity to raise up to \$1 million in any twelve-month rolling period, but it must post the campaign for investment consideration on a CFP. CFPs have discretion to determine which campaigns they elect to post through their portals. CFPs have numerous statutory duties and obligations, including performing background, anti-money laundering, and Office of Foreign Assets Control checks. See [Crowdfunding Intermediaries](#). A CFP must establish proper and thorough onboarding procedures for potential investors as well as provide education materials for their online community and potential investors. The education should encompass information about the crowdfunding industry and investing generally, risks associated with private illiquid securities, and the particulars of each campaign. All U.S. citizens may invest; however, there are investment caps on the amount that all investors may invest in Regulation Crowdfunding opportunities in each twelve-month rolling period as well. Although Regulation Crowdfunding financings are considered exempt from registration under the Securities Act, these campaigns may be marketed both offline and online, subject to very specific rules and SEC guidance.

So far, the most active CFP in Regulation Crowdfunding has been Wefunder, based in San Francisco, with over 68 campaigns posted, or 36% of the market. StartEngine, which is based in Los Angeles, has 28 campaigns and nearly 15% of the market. Each of the other CFPs have fewer than 10 campaigns. With the emergence of both Indiegogo (through its joint venture with Microventures) and AngelList (through Republic.co), 2017 should have very different relative participations, as well as many other new entrants following suit. Having both Indiegogo and AngelList enter this new industry, Regulation Crowdfunding will necessarily draw attention and attract new intermediaries, including smaller broker-dealers, who might have been waiting on the sidelines pending the final rules.

Required Filings and Disclosure

The entrepreneur/issuer has the responsibility to prepare and submit a disclosure document to the SEC, referred to as the Form C prior to posting the entrepreneur's campaign "live" on the CFP. The Form C, which doesn't have to be prepared by specialized securities counsel (although in our considered view, one ought to review the Form C to ensure compliance with the rules and reduce legal liability for potential securities law violations), is a relatively detailed offering statement that includes specified information, including:

- Name, legal status, physical address, and website of the issuer
- Certain information with respect to the issuer's directors, officers, and persons who are beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power
- Description of the business and anticipated business plan of the issuer
- Current number of employees of the issuer
- Risk factors, which should be tailored to the issuer's business and the offering
- Target offering amount and the deadline to reach such amount
- Whether the issuer will accept oversubscriptions and, if so, how they will be treated
- Use of proceeds
- Description of the process for completion of the transaction or cancellation of an investment commitment and the process for reconfirming investment commitments in the event of a material change of information
- Offering price of the securities (or the method for determining such price)
- Description of the ownership and capital structure of the issuer
- Certain information relating to the intermediary, including any financial interest in the transaction
- Description of the material terms of any indebtedness of the issuer
- Description of exempt securities offerings conducted within the prior three years
- Description of certain related-party transactions
- Discussion of the issuer's financial condition, including, to the extent material a discussion of the issuer's liquidity, capital resources, and historical results of operations (covering the period for which financial statements are provided, as discussed below)
- Certain disqualification events with respect to the issuer and other covered persons
- Location on the issuer's website, and time of availability of its ongoing annual reports under Regulation Crowdfunding, as well as any failure to comply with ongoing reporting requirements
- Any other material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading

Bad Actors

Regulation Crowdfunding disqualifies a bad actor from utilizing this exemption. The events which make a bad actor under Regulation Crowdfunding are similar to the disqualifying events with respect to Rule 506 (17 C.F.R. § 230.506) of Regulation D under the Securities Act, and include:

- Certain criminal convictions
- Court injunctions and restraining orders
- Regulatory agency orders

- SEC disciplinary, cease-and-desist, and stop orders
- Suspension or expulsion from membership in self-regulatory organizations.

For further information on Rule 506, see [Rule 506\(d\) Bad Actor Representations, Warranties, and Covenants](#) and [Knowing the Components of Regulation D](#).

Financial Statements

The extent of the financial statements required to be included in a Form C are based on the amount offered and sold in reliance on Regulation Crowdfunding within the preceding 12-month period:

- **Issuers offering \$100,000 or less:** Financial statements of the issuer and certain information from the issuer's federal income tax returns, both certified by the principal executive officer, are required. If, however, financial statements of the issuer are available that have either been reviewed or audited by an independent public accountant, the issuer must provide those financial statements instead and will not need to include the information reported on the federal income tax returns or the certification of the principal executive officer.
- **Issuers offering more than \$100,000 but not more than \$500,000:** Financial statements reviewed by an independent public accountant are required. If audited financial statements are available, however, the issuer must provide those financial statements instead and will not need to include the reviewed financial statements.
- **Issuers offering more than \$500,000:**
 - **For first-time Regulation Crowdfunding issuers:** Financial statements reviewed by an independent public accountant are required, unless financial statements of the issuer are available that have been audited by an independent auditor.
 - **Issuers that have previously sold securities in reliance on Regulation Crowdfunding:** Financial statements audited by an independent public accountant are required.

Notices

In accordance with the Title III statute, an entrepreneur conducting a Regulation Crowdfunding campaign may publicly disseminate a notice advising potential investors of the terms of its offering as described in the Form C. The notice may only include a limited number of permissible terms. An issuer may not advertise the terms of a Regulation Crowdfunding offering except in a notice that directs investors to the intermediary's platform and includes no more than the following information:

- A statement that the entrepreneur is conducting an offering pursuant to Section 4(a)(6) of the Securities Act, the name of the intermediary through which the offering is being conducted, and a link directing the potential investor to the intermediary's platform
- The terms of the offering, which mean the amount of securities offered, the nature of the securities, the price of the securities, and the closing date of the offering period
- Factual information about the legal identity and business location of the entrepreneur, limited to the name of the issuer, the address, phone number, and website of the issuer, the e-mail address of a representative of the issuer, and a brief description of the business of the issuer

Although advertising the terms of the offering outside of the CFP's platform is limited to a brief notice, an issuer may communicate with investors and potential investors about the terms of the offering through communication channels provided on the CFP's platform. An entrepreneur must identify itself as the issuer and persons acting on behalf of the issuer must identify their affiliation with the issuer in all communications on the intermediary's platform. An issuer is allowed to compensate others to promote its crowdfunding offerings through communication channels provided by a CFP, but only if the issuer takes reasonable steps to ensure that the promoter clearly discloses the compensation with each communication. The SEC's guidance on this point, through its published CD&Is (Compliance and Disclosure Interpretations), enables an entrepreneur to advertise on social media in a more meaningful manner arguably than the original statute might have contemplated. See Questions 204.01 – 205.01 of the SEC's Crowdfunding CD&Is (May 13, 2016), available at <https://www.sec.gov/divisions/corpfin/guidance/reg-crowdfunding-interps.htm>. Clarification on this point with the SEC staff has also facilitated greater communications with investors and additional financing in larger amounts. Keep in mind that any communication, marketing or otherwise, for an entrepreneur/issuer in the context of a securities transaction remains subject to the broad anti-fraud rules.

However, issuers need to realize that in order to conduct a successful campaign, they must already have social currency, meaning that

they must already have an affinity group of loyal followers. The data suggests that unless an issuer has a couple of thousand online contacts (Facebook friends and/or LinkedIn contacts) it will have difficulty raising even \$100,000. On the other hand, if the issuer has a social network closer to 10,000 contacts, then depending upon how actively engaged they are with the issuer’s opportunity, the offering may raise anywhere from a couple of hundred thousand dollars up to the Regulation Crowdfunding maximum. In addition to the entrepreneur’s social network, the use of a high-quality video to explain the offering and the business is equally critical to the financial success of the offering. So far, there have been an average of nearly 300 investors in each financing successfully closed.

So in essence, Regulation Crowdfunding allows an entrepreneur to make a semi-public solicitation to investors and have the transaction still be considered a private placement. For established securities lawyers, this will no doubt be difficult to reconcile. Call it the “publicification” of the private market, in a similar manner to Title II, which enables an issuer to conduct a general solicitation of investors, so long as only accredited investors participate in those financings and reasonable steps have been taken to verify their accredited status. While this is admittedly a new area of securities law and regulation, practitioners must familiarize themselves with the new exemptions which are now not only lawful for their clients but increasingly commonplace.

Deal Terms

In addition to the quality of the video and the simplicity of the founder’s explanation of the offering, the simplicity of the securities seems to correlate to the success of the offering as well. Common stock is easy to understand and a heavily structured convertible isn’t. Even though common stock is the security of choice so far, Regulation Crowdfunding accommodates whatever state law permits an issuer to offer to investors, including debt, equity, convertible securities, and even revenue sharing and royalties. The average amount of capital raised in a Regulation Crowdfunding campaign by an issuer has been \$226,578. The average compensation charged by a FINRA approved crowdfunding portal (CFP) is 5%. Based upon the data through December 31, 2016, the average pre-money valuation of each posted campaign is slightly less than \$9 million, although excluding a few extreme outliers the average drops to \$5.3 million.

Included below under Deal Terms is a Chart that provides greater detail of the types of offerings that have been successful in the early days of Regulation Crowdfunding.

The following chart summarizes the deal terms for crowdfunding offerings successfully completed in 2016:

Type of Corporation	Security Offered	# of Campaigns	Avg Commitments
Corporation	Common Stock	12	\$330,979
	Convertible Debt	6	\$209,747
	Debt	2	\$215,829
	Preferred Stock	5	\$216,025
	Revenue Share	1	\$251,686
	SAFE	24	\$150,131
Limited Liability Company	Common Stock	4	\$432,226
	Debt	7	\$120,991
	Membership Units	4	\$272,092
	Preferred Stock	1	\$870,638
	Revenue Share	9	\$322,358
	SAFE	3	\$65,919

Industry Insights

Maybe not so surprisingly, given the natural focus of crowdfunding on each entrepreneur’s community of followers and affinity

groups, the largest issuer categories benefitting from raising funding under Regulation Crowdfunding are wine and spirits, food and beverage, and entertainment. Retail investors know what they like, can taste and/or touch with these products and services and want to provide their financial support when offered the investment opportunity. The only somewhat surprising category may be technology hardware, but this may be explained by gaming technology and devices, although it remains to be seen whether this will hold up in 2017. Unlike with other forms of crowdfunding, the real estate industry has not been actively using Regulation Crowdfunding. This is probably due to the statute which restricts the ability of issuers under the same common control of ownership to the same \$1 million cap as other issuers.

By last count, there were issuers conducting crowdfunding offerings in more than half of the states in the United States. Although much of the overall activity so far is in California (58), New York (14), Texas (12), and Florida (18), there are meaningful contributions from Massachusetts (8), Illinois (9), Colorado (8), and Michigan (5). Given the limited number of posted campaigns during this period of time since the inception of the new exemption, as the market size increases, the percentage of deals from the states identified above as the early leaders should decrease. As new CFPs begin to operate in some of the missing states, their percentages ought to inversely increase. Overall, entrepreneurs from each state are expected to have campaigns posted. There should be no geographic location excluded from participation, since there are entrepreneurs everywhere and crowdfunding can make a meaningful difference through its ability to better and more efficiently allocate capital and facilitate investor participation from affinity audiences wherever they might reside. Crowdfunding in general, which is increasing in acceptance throughout most capital markets, and U.S. style Regulation Crowdfunding in particular, is not in competition with venture capital and larger more well-established capital formation programs. Most venture-backed opportunities require larger investment amounts than are achievable in Regulation Crowdfunding, and are seeking larger market opportunities. 39% of the campaigns so far have been in business for less than one year.

While most of the existing 21 operating CFPs in business currently focus on campaigns offering equity in start-ups and early-stage companies (also referred to as general opportunity CFPs), NextSeed has thus far concentrated on having its issuers offer debt to its community. NextSeed, which also participates in the Texas Intrastate Crowdfunding initiative, currently has 9 debt campaigns posted on its site. Their CFP specializes in small businesses (not necessarily start-ups or early-stage companies) that have operations and are prepared to offer debt securities with current returns. There are more debt CFPs in the works that will enter the market next year. In addition to what NextSeed is doing, there are debt campaigns on other general opportunity CFPs as well. These businesses are unlikely to ever go public, tend to be local in nature, and may not ever be sold. In addition, their audience of potential investors uses the issuer's services or consume their products, know the local business or entrepreneur, and desire to support them and see them succeed. Given these practical realities, issuing debt makes more sense and provides investors with a more defined way of obtaining a financial return, as well as possibly a discount on products and/or services. Supporting the local economy and other intangibles may also play a role in the investor's interest. Over time, small business lending should achieve a greater acceptance in Regulation Crowdfunding than has been apparent in the first sixth months.

Legal and Regulatory Trends

Notwithstanding years of anticipation of Regulation Crowdfunding going into effect, the industry seems to be off to a comparatively slow start based upon the aggregate amount of funding that has been raised in 2016 versus other pathways to raising private placement capital. While \$17 million can easily be argued to be "much ado about nothing," a better perspective might be that the new rules have enabled 79 entrepreneurs (that might not otherwise have been able to raise necessary funding) to actually get the start that they had hoped. This was always the argument for crowdfunding and still remains. Even if crowdfunding is never a billion-dollar industry, which it still may prove otherwise, those entrepreneurs that were given the means to explore another way to raise capital and pursue their dreams have benefited from the regulation. Just as importantly, the 21 CFPs conducting crowdfunding activity seem to be complying substantially with the rules and undertaking both their regulatory and commercial responsibilities seriously, other than one start-up CFP that was shut down quickly by the regulators. With the exception of that one platform, the regulators seem to be reasonably comfortable with the collective conduct to date and are cooperating with the industry to make sure that entrepreneurs understand that this opportunity exists for them. Through the end of the year, there have been no enforcement actions announced with respect to the Regulation Crowdfunding activity.

Other Key Market Trends

SAFEs

Another form of security offering becoming increasingly popular in Regulation Crowdfunding is what is referred to as a SAFE (simple agreement for future equity), which is offered on several of the CFPs, including Wefunder, Microventures (the joint venture partner of Indiegogo in the crowdfunding space), and AngelList's affiliated CFP, Republic.co. A SAFE is intended to replace the convertible notes (i.e., convertible into equity) often used to finance start-ups and early-stage businesses. A SAFE seeks to address perceived issues with convertible notes, such as the term and interest. Having indebtedness on the balance sheet isn't good for a start-up or early-stage

company, and neither is having to pay interest. Features of a SAFE include:

- Unlike a convertible note, a SAFE is not a debt instrument for corporate law or accounting purposes. Debt instruments have maturity dates, are typically subject to certain regulations, create the threat of insolvency, and can include security interests.
- Since the money invested in a start-up/early-stage company via a SAFE is not a loan, it will not accrue interest. This is particularly beneficial for the issuer since in most cases it better embodies the intention of investors, who never expected to receive interest or be paid back due to the specular nature of the investment.
- An investor in a SAFE is not an actual shareholder of stock, unless the company elects to convert the SAFE into company stock.
- There is a fixed conversion price, and an investor will always receive the same economic outcome (regardless of whether the company elects to convert) if and when there is a liquidity event.
- An investor will not receive cash or stock unless one of the events specified in the SAFE offering documents occurs (e.g., the company either goes public or gets acquired by another company).

While there were discussions with the SEC staff in 2012 about limiting the type of securities being offered in a Regulation Crowdfunding campaign to simply common stock, since the Title III statute was silent on the issue, the final rules recognize that state law of formation is controlling. Notwithstanding what the rules permit, simplicity does facilitate interest. Offering common stock from a standard corporation receives greater investor interest than other complex financial instruments and revenue sharing arrangements being offered by an LLP or LLC.

2017 Outlook

Improving Regulation Crowdfunding

Two of the recurring issues raised by the crowdfunding industry are (i) the \$1 million limitation on the amount that an issuer may raise under Regulation Crowdfunding, and (ii) investors being prevented from pooling their capital into a special purpose vehicle (SPVs). The original proposal for the Regulation Crowdfunding statute had been \$5 million. While this makes sense commercially, it should be noted that the Regulation Crowdfunding rules do permit, under certain circumstances, simultaneous offerings so that an issuer can raise more than the \$1 million in a Regulation Crowdfunding campaign, so long as it follows the rules and avoids integration. For further information on integration, see [Identifying Integration Issues for Private Offerings](#) and [Integration Safe Harbors Checklist](#). Amending the rules to permit the use of SPVs would be good for the industry because it should facilitate more capital being available to be invested in crowdfunding campaigns, but equally importantly, the funds could then be managed by investment professionals who would be in a better position to protect investor's interests. Congress is already debating certain amendments to the Title III statute along these lines, so 2017 ought to be beneficial for crowdfunding overall.

By the end of 2017, there are projected to be closer to 50 FINRA approved portals with 1,000 entrepreneurs seeking to raise capital pursuant to these new rules. Of these 1,000 entrepreneurial campaigns, 400-500 of these campaigns are expected to have sufficient funds to close on at least the minimum amount of their proposed funding requirements, and it is expected that in the aggregate, these campaigns will have collected more than \$100 million of investor proceeds. CFPs and issuers believe that if certain of the provisions mentioned above are amended during the upcoming year then those provisions which they believe are otherwise restraining growth in Regulation Crowdfunding would potentially permit growth to accelerate at an even greater rate.

This excerpt from Lexis Practice Advisor®, a comprehensive practical guidance resource providing insight from leading practitioners, is reproduced with the permission of LexisNexis. Lexis Practice Advisor includes coverage of the topics critical to attorneys who handle legal matters. For more information or to sign up for a free trial visit www.lexisnexis.com/practice-advisor. Reproduction of this material, in any form, is specifically prohibited without written consent from LexisNexis.

Learn more at: lexisnexis.com/practice-advisor



LexisNexis, Lexis Practice Advisor and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license.
© 2017 LexisNexis. All rights reserved.