Title III Crowdfunding: Primer for Issuers and Funding Portals

NYS Small Business Development Center

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Agenda

- What is Crowdfunding?
- Historical Impediments to Raising Capital
- Current equity “crowdfunding” alternatives
- Title III Crowdfunding
- Reform Efforts
What is Crowdfunding?

• Using internet/social media to raise funds from many people making small contributions.

• Originated w/ non-equity
  – Donation based
  – Rewards based
  – Pre-Order based
Help Farrah and family - CO theater tragedy

$171,525 of 200k
Raised by 6,088 people in 25 months

Donate Now

SHARE ON FACEBOOK
Carson Palmer Thrust Fund

$2,216 of $11.6k

Raised by 226 people in 2 days

Donate Now

SHARE ON FACEBOOK
Pebble: E-Paper Watch for iPhone and Android
by Pebble Technology

Funded! This project successfully raised its funding goal on May 18.

68,929 backers
$10,266,846 pledged of $100,000 goal
0 seconds to go
What is Equity Crowdfunding?

• Originated from two perceived needs:
  – start-ups lacked access to capital
  – non-accredited investors lacked access to early stage investment opportunities
• Non-accredited investors = 93% of U.S. population
• $30 trillion investable personal savings
• Internet coming to capital formation industry
Historical Impediments to Raising Capital

- Any offer of securities must either register w/ SEC, or satisfy exemption
- Registration is expensive, time consuming
- Private offering exemptions
  - Section 4(a)(2): “…not involving any public offering”
  - Rule 506: safe harbor
    - Unlimited accredited investors, plus up to 35 non-accredited/sophisticated
    - “accredited investors” = annual income of $200,000 or net worth of $1 million, not including primary residence
- Biggest impediments: prohibition on general solicitation, accredited investor bias
Title II: “accredited crowdfunding”
- Rule 506(c): allows general solicitation, so long as sell only to accredited investors and take reasonable steps to verify all purchasers are accredited

Title III: non-accredited, unregistered crowdfunding

Title IV/Reg A+: “registered crowdfunding” (Mini-IPO)
- Tier I: Up to $20 million in 12-mo. period
- Tier II: Up to $50 million in 12-month period
  - Enhanced investor protections; state preemption
Existing “Crowdfunding” Alternatives

- Accredited Crowdfunding
  - General solicitation? 506(b) vs. 506(c)
  - Broker-dealer vs. Investment fund model
- Registered crowdfunding: Title IV/Reg A+
- Intrastate Crowdfunding
- Foreign Crowdfunding
Elio Motors is in live offering mode and is currently only accepting investments from those who reserved shares.

$25,080,000
Funding Goal

183%
Reserved

$45,978,100
in non-binding indication received
Title III Crowdfunding

- Dollar Limits - during any rolling 12 month period:
  - Issuer Limit: $1 million
  - Investor Limit:
    - If investor’s annual income or net worth is less than $100,000, may invest the greater of:
      - $2,000; or
      - 5% of the lesser of annual income or net worth
    - If investor’s annual income and net worth are both at least $100,000, may invest the lesser of:
      - $100,000; or
      - 10% of the lesser of annual income or net worth
Issuer Qualification
- must be organized in the U.S.
- may not be public company, investment company, blind pool or “bad actor”

Must be conducted through one intermediary, either:
- broker/dealer registered with SEC and member of FINRA; or
- “funding portal” registered with SEC and member of FINRA
Offering Mechanics

- Investors may cancel up to 48 hours pre-closing
- All-or-Nothing
- If target reached before deadline, issuer may close early but five days’ notice
- If material change to offering, issuer must disclose
  - if investor does not reconfirm, investment cancelled and funds returned to investor
Title III Crowdfunding (cont.)

• Status of Securities
  – No transfers for one year, except to issuer, accredited investors, family
  – Holders not counted toward threshold triggering Section 12(g) registration provided current in annual reporting, retains registered transfer agent and has less than $25 million in total assets

• Rescission right for material misstatements or omissions
  – No need to prove intent to defraud or reckless disregard
  – Issuer burden proof: didn’t know, exercise of reasonable care could not have known
  – No intermediary exemption
Title III Crowdfunding (cont.)

• Offering Disclosure: Form C
  – File with SEC (but no SEC approval needed)
  – Intermediary must post or provide a link to SEC filing
  – Similar to offering memorandum, must include:
    • Use of Proceeds;
    • Target and max offering size;
    • Offering Price;
    • Business;
    • Directors and officers;
    • Beneficial Ownership and Capital Structure;
    • Indebtedness;
    • Related party transactions;
    • Exempt offerings;
    • Risk factors;
    • Transfer restrictions; and
    • Management’s Discussion and Analysis
Financial information, depending on aggregate amount of offering together with all other Title III offerings within the last 12 months:

- **$100,000 or less**: income, taxable income and total tax for most recently completed year, certified by principal executive officer.

- **More than $100,000, up to $500,000**: financial statements reviewed by independent public accountant.

- **More than $500,000**: financial statements audited by independent public accountant, but first-time issuers only need reviewed financials
Progress Update: issuer required to file progress updates with SEC on Form C-U, five days after:

- commitments for 50% of the deal received
- commitments for full deal received
- subscriptions in excess of initial offering amount will be accepted, or issuer closes the offering.
Title III Crowdfunding - Issuer Requirements (cont.)

• Annual Report on Form C-AR
  – Issuer must file with SEC, post on website within 120 days after fiscal year end
  – Same information required in offering statement
  – Financial statements certified by principal executive officer
  – May terminate when issuer:
    • required to file reports under the Exchange Act
    • filed one annual report, fewer than 300 shareholders
    • filed three annual reports, assets not exceeding $10 million
    • repurchase all crowdfunded securities; or
    • liquidation or dissolution
Title III Crowdfunding - Issuer Requirements (cont.)

- Restrictions on Advertising and Promotion
  - Communicate with potential investors only through platform
    - Make clear communications being made by issuer or on issuer’s behalf
    - Take reasonable steps to ensure paid promoters disclose receipt of compensation
  - Exception for tombstone ads that include only:
    - statement that issuer conducting an offering
    - name of intermediary and link to offering page
    - amount, nature and price of securities offered
    - the closing date; and
    - brief factual description of issuer’s business
Title III Crowdfunding - Intermediary Requirements

• Financial Interest: Intermediaries (but not its directors, officers, partners) may receive financial interest in issuer, provided received for services in the offering and same securities as in offering

• Measures to Reduce Risk of Fraud
  – Reasonable basis for believing issuer in compliance with crowdfunding requirements and established means to keep accurate records of security holders
  – must deny access to an issuer if it has a reasonable belief that
    • issuer or offering would present a potential for fraud; or
    • issuer, or any of its directors, officers or 20% shareholders is subject to a “bad actor” disqualification
      – must conduct background check on each issuer and each officer, director and 20% shareholder
Title III Crowdfunding - Intermediary Requirements

• Opening Accounts
  – Obtain consent to electronic delivery of materials
  – Deliver educational materials, including information on process for buying securities on portal, types of securities and risks, investment caps, resale restrictions, limitations on right to cancel, annual information
  – obtain investor representation: reviewed educational materials, understands investment may be lost and can bear risk of loss
Title III Crowdfunding - Intermediary Requirements

• Issuer Information
  – offering information available to SEC and potential investors 21 days before any sale in offering
  – public access to offering information

• Investor Limits
  – make sure no investor exceeds investment cap
  – may reasonably rely on investor representation
Communications Channels

- allow investors to communicate with one another and issuer about offering
- public viewing, but only persons who have opened accounts may post
- intermediary may not participate unless registered B-D; may only set rules and remove offensive postings
- Representatives of the issuer, and anyone promoting the offering, must clearly identify
- Must keep records of all of all chats
Title III Crowdfunding - Intermediary Requirements

• Maintenance and Transmission of Funds
  – offering proceeds only provided to issuer when target reached, returned to investors if not
  – registered B-D must follow existing rules for maintenance and transmission of funds
  – funding portal may not handle funds; must direct investors to transmit to escrow agent
Title III Crowdfunding - Intermediary Requirements

• Additional Restrictions on Funding Portals
  – Streamlined registration process; Form Funding Portal
  – Effective on later of 30 days or FINRA membership
  – May not:
    • offer investment advice or recommendations
    • solicit offers
    • pay success fees to persons for solicitations; or
    • handle investor funds or securities

• But no net cap requirements, reps need not pass series exams
Title III Crowdfunding Reform Efforts

- Fix Crowdfunding Act
  - Issuer cap
  - Portal liability
  - Section 12(g) Registration Exemption
  - Special purpose vehicles
  - Testing the waters
Thank You.

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