

Crowdfunding

in 2012 President Obama signed the JOBS Act, which introduced the concept of letting the wisdom of the crowd—instead of the regulator—determine the sale of securities. The crowdfunding movement (as expressed in the JOBS Act) is the result of technology, legislation and market acceptance of the idea of leveraged fundraising models. There are now several new ways to raise money and selecting the right approach—and avoiding the wrong one—is an important consideration for every startup entrepreneur.

What do the new developments mean for a startup seeking capital? The past few years have opened two main avenues for raising money: donation-based or rewards-based crowdfunding (think Kickstarter or Indiegogo) and equity crowdfunding. Equity crowdfunding can be broken down into public and private equity crowdfunding.

Donation-based Crowdfunding: Money for Nothing

Despite the debate about equity crowdfunding, the scene is still dominated by donation-based (or rewards-based) crowdfunding, which has exploded in the last five years. Businesses can now seek donations on websites like Kickstarter and Indiegogo and, while not typical, there are success stories of businesses raising millions of dollars within a few weeks.

Donation-based crowdfunding is best suited to young businesses that are still testing their model. Websites like Kickstarter and Indiegogo provide businesses a platform upon which to raise money for whatever purpose they see fit (within reason) without having to give away any ownership interest in the business.

In return for the donations, the business usually offers rewards linked to the product for which they are seeking funds. The rewards could be anything from a thank you email for a \$1 donation to a personal meeting with the business owner for a donation in the thousands of dollars. Many donors donate at a level

where the reward is the actual product or service for which funds are being raised. When used in this way, donation-based crowdfunding looks a lot like collecting pre-payments for goods and services.

Donation-based crowdfunding typically covers a broader array of businesses than equity crowdfunding. It's not uncommon to see musicians, authors, designers and other artists use donation-based crowdfunding to raise money to fund their latest project.

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One of the key benefits of the donation model is the lack of securities regulation. That said, those raising money should make sure they follow through on their commitments. Earlier this year, the Washington attorney general initiated a lawsuit against an individual for an alleged failure to deliver packs of playing cards to donors after collecting money through Kickstarter. As accusations of fraud become more common, we can expect to see more states take an interest in protecting those who “donate” through these websites.

Equity Crowdfunding

Raising money through the issuance of equity has been highly regulated since the introduction of the Securities Act in 1933.

Opportunities and Potential Roadblocks for Startups

The JOBS Act was supposed to cut down on the regulations impeding startups from accessing capital; however, the slow reaction from the SEC means that the future is still uncertain. The most significant regulatory changes in equity crowdfunding are happening under Title III of the JOBS Act and Rule 506 of the Securities Regulations.

Title III of the JOBS Act

Title III equity crowdfunding will allow companies to raise up to \$1 million from the public through a broker-dealer or registered funding portal. The issuer will be required to make disclosures to the SEC at least 21 days prior to the first sale, and audited financial statements will be required for issuances above \$500,000.

Neither the issuer, nor the broker-dealer/funding portal, will be able to solicit investments, and there will be caps on how much individual investors can invest in a year.

The JOBS Act instructed the SEC to draft regulations legalizing this form of equity crowdfunding by the end of 2012. The SEC released proposed regulations in October 2013, and the comment period expired Feb. 4, 2014. Nine months later the final regulations are still nowhere to be seen; however, based on the statute and the proposed regulations, Title III is unlikely to be very useful for the typical startup.

For starters, the transaction costs will be high after you add up fees for brokers, accountants, auditors, attorneys and insurance due to the requirements for (in some cases) audited financial statements, a business plan, registered broker-dealers and a heightened standard of liability for anyone who touches one of these offerings. In addition, many companies may be put off by the prospect of numerous small and unsophisticated shareholders. In conclusion, don't hold your breath for anything that represents true deregulation of equity crowdfunding.

Funding Portals Under Rule 506

While Title III received much of the attention

following the enactment of the JOBS Act, most of the action has occurred under Rule 506, which provides two main forms of exemptions.

Broadly, under Rule 506(b) an issuer can issue securities to up to 35 non-accredited investors, but cannot use general solicitation in doing so. Conversely, under Rule 506(c) an issuer may conduct general solicitation, but it cannot issue securities to any non-accredited investors.

Private Placements: In 2013, the SEC released two no-action letters that implied that issuers could use funding portals for Rule 506(b) issuances so long as access to the portal is restricted to accredited investors. Numerous “internet VCs” sprung up in the wake of these rulings (and, in fact, before the rulings).

Now, there is healthy competition for deal flow by investor groups that form “one off” funds consisting of relatively large groups of accredited investors to invest through highly automated internet-based funds.

This has been more of a technology development than a legal one, since the internet has simply streamlined an existing investment process and allowed it to be leveraged more efficiently. As a

practical matter, this development freed up billions of dollars of new angel capital that may not have otherwise found its way into the startup world.

Publicly Solicited Issuances: While Title III is hopeful, and 506(b) private placements are dominant, the future belongs to 506(c) publicly solicited transactions. Under 506(c), a company can advertise and publicly solicit the sale of its securities, provided that all eventual investors are verified as “accredited” with appropriate evidence such as tax returns, financial statements or a letter from the investor’s lawyer or accountant.

There are other requirements, such as increased Form D reporting, but all in all, the ability to advertise the sale of securities has huge potential. Many sites have been successfully marketing the sale of securities under this exemption and we can expect many more to figure it out going forward.


Conclusions and Thoughts

So what is a startup to make of this array of options? Here are some general guidelines:

- If your company is newly formed, un-established and you have not yet gotten traction (i.e. revenues or customer

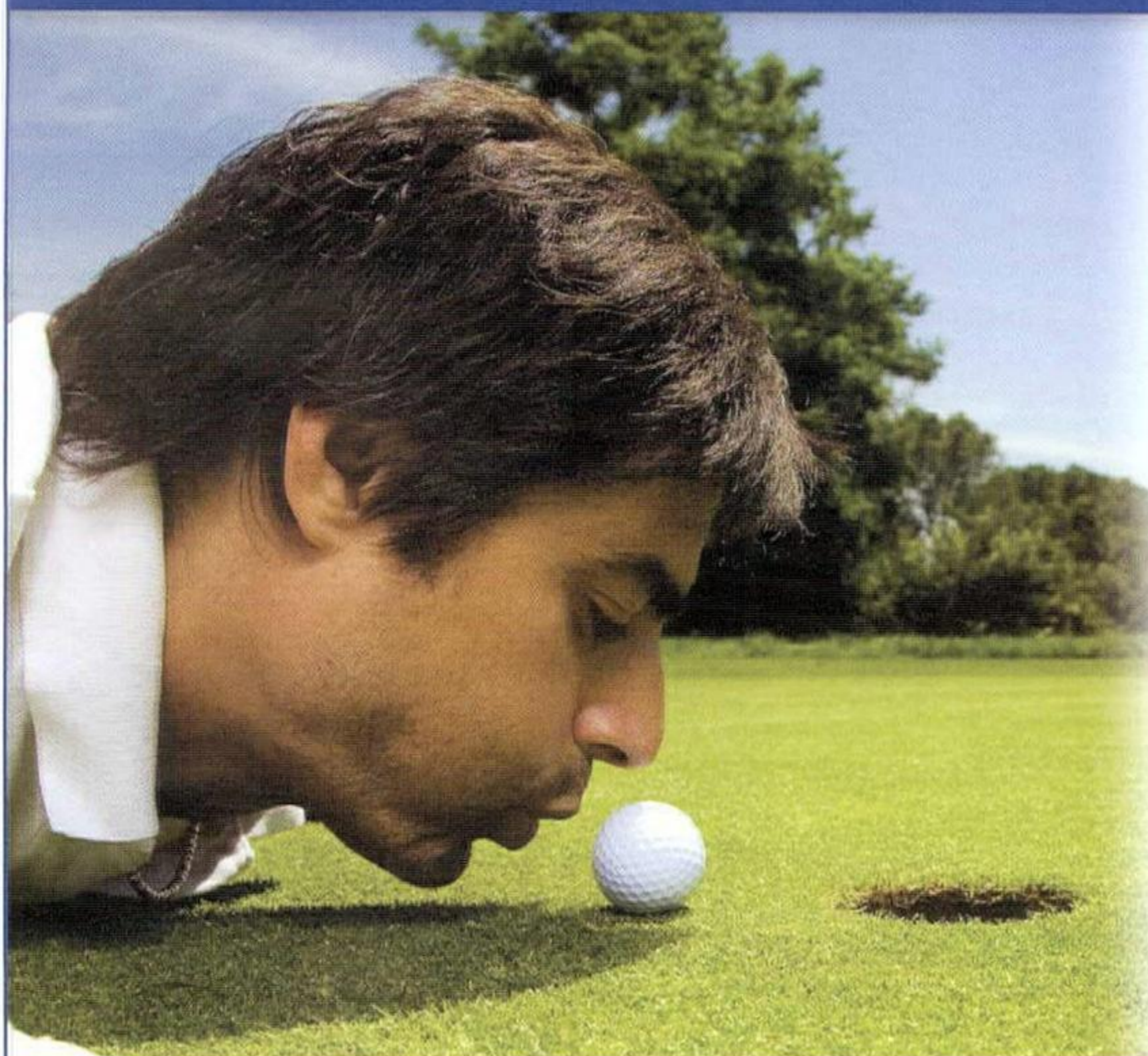
validation), consider donation-based or rewards-based crowdfunding. Equity investment will be a hard sell without any sales metrics, and pre-sales or donations may be your best bet to raise money and prove the concept.

- If the startup has traction, a 506(b) offering has a lower hassle factor as a regulatory matter, whether you seek funding on a private portal or the old fashioned way (with people with whom you have a pre-existing relationship). If the startup has good fundamentals (team, traction, technology) and is in an affinity business (one that is cool, easy to understand or otherwise hot), 506(c) publicly solicited fundraising may allow you to access (potentially) billions of dollars of new capital and may be worth doing.

In any case, strategy is key, as you will want to take your best shot and target the most likely vehicle for raising money. 

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