



Immixon Law Group ^{PC}
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Crowdfunding & Raising Money on the Internet

Education by Immixon Law Group

About Immixon Law Group

Immixon Law Group specializes in matters of formation (startup, growth, and governance), fundraising, mergers, acquisitions, licensing, multi-party transactions, contract creation and enforcement, estate planning services, and litigation services.

Immixon Law Group is a **Certified B Corporation**.



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Outline – “So your client wants to raise money on the internet...”

Presented 3/26/14 – Leigh Gill and Robert Scott

1. What’s New in Fundraising
 - a. Almost everything you learned in Securities Regulation still applies
 - i. Companies seeking investment have long advertised for the opportunities
 - ii. Because of compliance costs, “General Solicitation” has been the privilege of well capitalized companies
 1. IPO Costs
 - iii. Smaller companies rely on friends and family and “check-the-box” accredited investors
 - b. The promise of crowdfunding is two-fold:
 - i. Smaller companies can reduce their compliance costs and use general solicitation
 1. Broadens the risk base and makes capital more available
 - ii. Traditional social networks have restrained the flow of capital to underserved communities
 1. Promise of social goods when entrepreneurship expands
 - c. Regulators (SEC and States) have responsibility to protect would be investors from themselves
 - i. Traditional method has been to require adequate disclosures by company, and
 - ii. Regulators prevent certain would-be investors from participating in offerings not overseen by regulators.
 - iii. Regulators have a dual role, to facilitate investment and to protect investors.
2. Evolution
 - a. Non-equity
 - i. Well suited for certain types of projects
 1. Not necessarily a viable way to start a company.
 2. About 50% of projects are never funded
 3. It can provide important brand or product validation
 - ii. Substantially exceeding fundraising goals can be disastrous
 1. No one will ask you for your business plan when you start a non-equity crowdfunding campaign.
 2. Platforms generally will not vet projects, and do not bear the risk of a failed project
 - iii. There are two false positives in managing a successful campaign:
 1. Funding a campaign does not result in delivering a product. There are many additional steps required (particularly for hardware / consumer goods).
 2. Substantially exceeding campaign goals may hinder, not help, success if the company is unable to scale.
 - iv. Non-equity fundraising operates on a “public radio model”

1. In exchange for your pledge, you get the social benefit, along with some membership premiums
2. Investors are also fans of the project
- v. Use cases:
 1. Elevation Dock: asked for \$75k, received \$1.5mm.
 - a. The company was able to use that initial project (product) as a starting point for the brand. They have since expanded to other products.
 2. Pebble Smartwatch: asked for \$100k, received \$10mm.
 - a. The Smartwatch is a category defining device that has garnered competition from HP, Samsung, Google and (it's rumored) Apple.
 3. Oculus: Asked for \$250k, received \$2.4 million.
 - a. On March 25th, Facebook announced the purchase of Oculus for \$2 billion. The original campaign on Kickstarter was August , 2012.
 - b. Fans (initial backers) of Oculus have posted multiple comments upon the announcement by Facebook, overwhelmingly negative.
- vi. IP Risks
 1. Crowdfunding is a public activity and seeking backers will disclose your ideas and potentially paint a target for your competitors
 - a. If you draw suit or threat of suit, the crowdfunding platform will takedown or suspend your campaign and refuse to release funds
 - b. Every campaign needs a video. Most companies are not well versed in rights clearance for videos.
 - c. A public campaign may be a patent-defeating disclosure
 - i. NDAs are not available
 - ii. International reach of campaigns
 2. Use Cases:
 - a. Formlabs raised nearly \$3 million (asked \$100k) for a 3D printer and drew suit by 3D Systems (Kickstarter was also named in the suit). Formlabs initially attempted to dismiss the suit on the basis that they had no products for sale
 - b. GameStick created an android-based video game platform and did not have rights for video presentation of one of the games. They were able to license the rights after their campaign was briefly suspended.
- b. Equity – Accredited Investor Networks
 - i. Commonly referred to as “Crowdfunding” websites have sprung up that rely on accredited investor status to facilitate investment.
 1. Examples include Angellist (angel.co), FundersClub (fundersclub.com).
 2. Well capitalized web portals, these are intentionally not general solicitation.
 - ii. Most often, these sites rely on 506(b) and are informed by no action letters issued by the SEC

1. Additional details below.
 2. The web portal is often a broker-dealer or affiliated with a broker-dealer.
- iii. Nearly all of these deals are seeking greater than \$1mm in investment
 1. Company must take on securities compliance activities for a private offering.
 2. The company bears the risk in the even of general solicitation.
- c. Equity – General Solicitation
 - i. Some international history
 1. Recently, Scottish company BrewDog closed a £4.25m investment round from investors / fans (£95/share). Raised £1 million in the first day.
 2. The Dutch have three years of experience with crowdfunding, and EU rules allow it (although some member states limit to incremental amounts).
 3. Although there have not been any frauds the evidence is sparse.
- d. Social impact
 - i. Historically, and on the basis of past regulation, investors have favored certain socio-economic classes of entrepreneurs.
 1. In part, these are network effects of those entrepreneurs who have an accredited investor angel network”
 2. Limited access to capital is one of the key reasons that early stage businesses fail
 - ii. When the crowdfunding portions of the JOBS act were announced, women-owned and minority-owned business were touted as beneficiaries.
3. Regulation of Securities – (at this point, feel free to order a beer and get comfortable)
 - a. What we will cover
 - i. High-level overview of the securities laws that may apply to fundraising on the internet, but not a deep dive
 - ii. There are many exemptions from registration that may apply to your client, but there are practical costs of identifying the right one(s) and complying
 1. In practice, the costs of ongoing compliance are critical to executing a compliance strategy.
 - b. Assumptions
 - i. All in the audience can do this, but will partner with someone as needed and do the research.
 - ii. High risk area for practice – *see, e.g., Prince v. Brydon.*
 - iii. You have some familiarity with Federal securities exemptions
 - c. Current & New Regs – Briefly Cover Whole Landscape – highlighting the new
 - i. Important point – much talk about Crowdfunding and whether anyone will use it – point is whether costs outweigh benefits
 - ii. All of these permit some form of internet solicitation
 1. Score (state)
 2. Reg A
 3. State Crowdfund
 4. Crowdfund exemption

5. Reg A+
6. Rule 506(c)
7. Rule 506(b)
- iii. Regulations reflect the dual purpose of regulators
 - a. Small investments in early stage companies are inherently risky.
 - i. Angel investors traditionally look for 10-to-1 return to cover failed investments. Sophisticated investors are aware of the risks of failure.
 2. SEC now anticipates that 2014+, private company financing will largely fall into 3 buckets: Reg A (now increased to \$50M); 506(c); and crowdfunding – underlying theme → all permit general solicitation!
- iv. Score & Rule 147
 1. No preemption
 2. 147 – codification of 3(a)(11); 80% assets in state; 80% revs in state; organized in state; ALL investors in state (what happens if 1 moves)
 3. Cost
- v. Reg A
 1. No preemption so 147, or ?
 2. Limited to \$5M
 3. Fundrise
 4. Cost
- vi. State Crowdfund (WA, ID)
 1. Much talk, but same issues with R147
 2. Cost
- vii. Crowdfund
 1. Preemption
 2. Cost – will circle back
- viii. Reg A+
 1. Improved; raise up to \$50M & preemption
 2. Sec thinks will be widely used
 3. Tombstone ad
 4. Cost
- ix. 506(c)
 1. General solicitation (internet) – better than Reg A?
 2. Still 10b-5 risks
 3. Verification; will circle back
- x. 506(b)
 1. Why on here?
 2. Can use on internet to reach investors + known and inexpensive
- xi. Public company
 1. Cost but \$85K Indian issuer
- d. 506(b) recap – please see slides
- e. 506(b) Evolution – please see slides
- f. 506(b) Evolution *IPOnet* – please see slides

- g. 506(b) Evolution *Angellist* – please see slides – we’re picking on Angellist and FundersClub because they are large early entrants into space
 - h. 506(b) Evolution *FundersClub* – please see slides
 - i. FundersClub and Angellist appear to have receded back into *IPOnet/Lamp* land.
 - 1. Did regulators “suggest” a more conservative approach?
 - ii. A September 2013 FundersClub investor letter – blasts 506(c) as risky.
 - 1. “Failure to properly verify could force a startup into bankruptcy for blowing the securities exemption . . . it is irresponsible to pull startups in a direction that taints them with such risk”
 - i. Future of 506(b) on the internet – please see slides
 - i. Seems like low priority for SEC
 - ii. One enforcement action could shift to compliance with 506(c)
 - j. 506(c) – please see slides
 - k. 506(c) Method – please see slides
 - i. 3rd party verification – growth of services – Fundable
 - ii. Principles based – i.e. publication of income
 - iii. Proposed rules – pre-file, post-file; submission of offering materials - can do now voluntarily; legend
 - l. Crowdfund – please see slides – still in rulemaking – comment period closed in February – proposed rules 585 pages
 - a. FINRA has proposed rules for funding portals, which if adopted would be self-regulated as well as subject to SEC oversight
 - ii. Can be debt or equity – not rigid on Form
 - iii. All such securities must be held for at least one year from purchase
 - iv. Form C – hybrid between SCORE and Form D or (like 1A + some)
 - a. Price per share, total amount of offering, deadline for acceptance of investments, and whether oversubscription will be permitted
 - b. Disclose all owners (greater than 20%), officers and directors
 - c. Proposed use of proceeds – officer income
 - v. Must use intermediary - Funding portal
 - 1. Registered with SEC; background checks; potentially liable with issuer
 - 2. Can only use one
 - 3. No endorsement
 - 4. No equity
 - vi. Discussion and proposed rules
 - 1. Can be voting or non; potential issues with numbers
 - 2. Annual financial statements to investors as long as securities outstanding
 - 3. Proposed – lead investor and other protections
 - a. Ratchet down of annual financials requirements
4. Crowdfund investor limits – please see slides

Evolution

- › Non-Equity
- › Accredited Investor Networks
- › Social Based Loans
- › Crowdfunding (Equity Based)

Evolution

- › Non-Equity = A project to produce goods, events and artistic works
 - › Kickstarter
 - › Indigogo
 - › Crowdsupply

Public Radio model (schwag for money)
Non-Equity = Donation?
Contract relationship between sponsor and donor.

Evolution: Non-Equity

- › Provides important brand validation:
 - › Elevation Dock – asked for \$75k, received \$1.5mm
 - › Pebble – asked for \$100k, raised \$10mm for a category defining “smart watch”
 - › Facebook purchases Oculus for \$2 Billion

Two false positives:

- › Funding a campaign ≠ delivering product
- › Substantially exceeding goal can be disastrous

Evolution: Non-Equity

Crowdfunding relies upon publicity. **There are important IP risks.**

- › The crowdfunding site will take down your campaign and refuse to distribute funds.
- › Formlabs raised nearly \$3mm for a 3D Printer. 3D Systems sued both Kickstarter and Formlabs.
- › GameStick campaigned an android-based game platform but did not have rights for video presentation of one of the games shown. Able to license the rights after short suspension.
- › Campaign may be patent-defeating disclosure (no NDAs).

Evolution: Accredited Investor Networks

Commonly referred to as “Crowdfunding” these are intentionally not general solicitation. Sites like AngelList (angel.co) and FundersClub (fundersclub.com)

- › Nearly all deals on these platforms are seeking greater than \$1mm in investor funding.
- › Appeal is primarily to investors seeking greater returns available from angel investments.
- › Some deals facilitated via these platforms are offline and recorded online (e.g. Foundry Group investment in OnTheGo Platforms).
- › The company bears the risk if they generally solicit

Evolution: Social Impact – the Promise Land

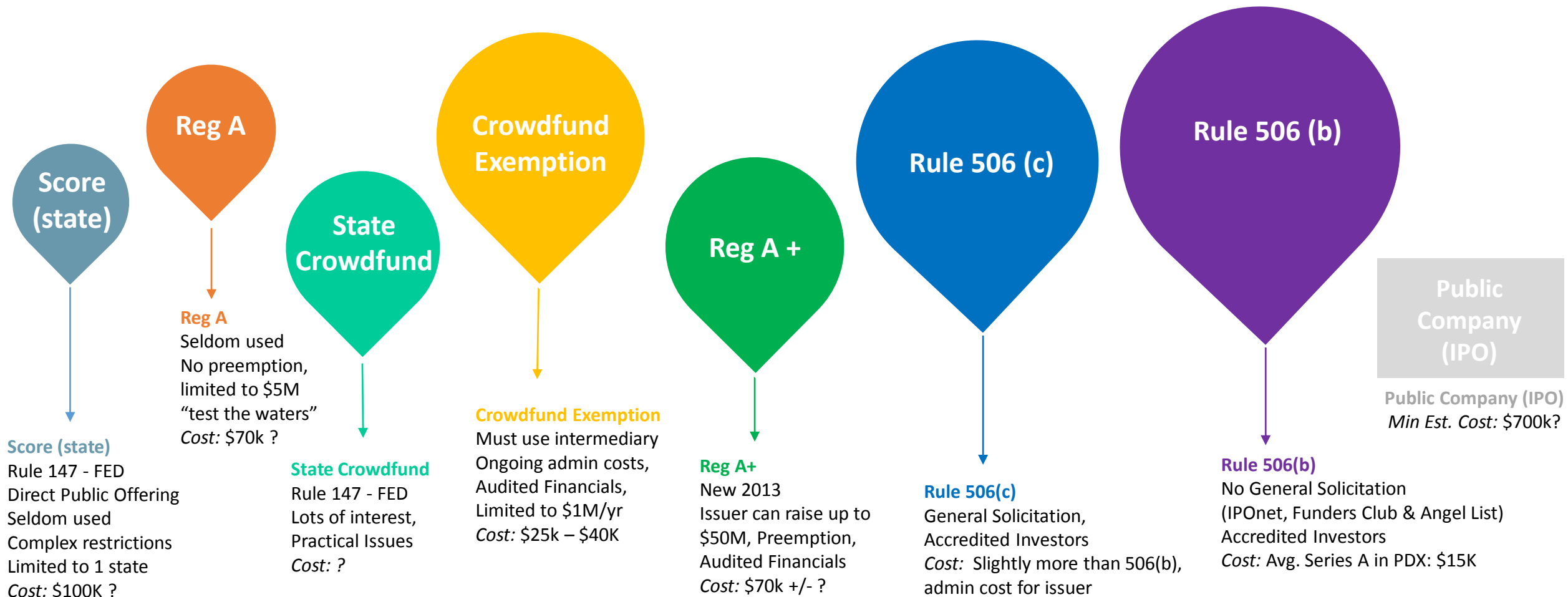
When crowdfunding was announced with the JOBS act, women and minority-owned businesses were touted as beneficiaries.

“We think big, take risks and believe that anyone with a solid plan and a willingness to work hard can take even the most improbable idea and turn it into a solid business.”

– President Obama (announcing the JOBS Act)

The promise of funding via internet means a “marketplace of ideas” where people without a wealthy “friends and family” network can start successful companies

Securities: Regulations that permit some form of Internet Fundraising



Securities: Rule 506(b) (A Recap of Everyone's Favorite)

- › No maximum offering amount; no maximum number of investors
- › Federal preemption means states can only require notice filings (i.e. filing the Form D and payment of a fee)*
- › Accredited investors only, but you can have up to 35 non-accredited, “sophisticated” investors (few do this because of next point)
- › As long as all investors are accredited - no minimum disclosures (just materiality requirement); no review/audit of financials
- › “Private Offering” under Reg D means no general solicitation, **but** . . .

Securities: Rule 506(b) - The Evolution of “General Solicitation”

Rule 502

- › Explicit: no general solicitation means no ads or publications “in any newspaper, magazine, or similar media or broadcast over television or radio”

Then came the Internet

- › Print, television, and radio ads require an affirmative commitment to reach a large audience, but internet and email solicitations can be active or passive, and targeted to small or large audiences.
- › The lines between private fundraising and general solicitation are blurred . . .

Securities: Rule 506(b)- The Evolution of “General Solicitation”

The SEC weighs in – the No-Action letters:

- › “friends of friends” and the pre-existing relationship

IPOnet (1996) and *Lamp* (1997)

- › Time-stamping the “pre-existing, substantive relationship”
- › Key = password protected and no access to deals until cleared (*IPOnet*) or 30 days (*Lamp*)
- › *Lamp*: broker-dealer registration not required in some contexts
- › *Progressive Technology* (2000): B-D license required if soliciting investors or giving issuers advice about preparing offering materials

Securities: Rule 506(b)- The Evolution of “General Solicitation”

AngelList

- › Sought and received no-action letter confirming that investment and advisory structure would not trigger broker-dealer registration obligations, but . . .
- › Neither no-action letter nor K&L Gates opinion letter addressed fact that website showed offering info and did not require password and accredited investor questionnaire (previously home page showed fundraising details like Kickstarter; now just basic issuer info)
- › Silent on general solicitation = tacit endorsement?
- › Why did AngelList shift gears?

Securities: Rule 506(b)- The Evolution of “General Solicitation”

FundersClub

- › Sought and received no-action letter confirming that investment and advisory structure would not trigger investment adviser registration obligations (exempt VC adviser), but . . .
- › The no-action letter did not address the fact that website showed offering info and did not require password and accredited investor questionnaire (previously home page showed fundraising details like Kickstarter; now just basic issuer info)
- › Silent on general solicitation = tacit endorsement?
- › Why did FundersClub shift gears?

Securities: Rule 506(b) – Speculation about tomorrow

The Peanut Gallery weighs in

- › With the introduction of 506(c) and equity crowdfunding, many speculate that the SEC will begin enforcing general solicitation under 506(b).

One enforcement action would disrupt an entire industry and rattle the startup community as a whole.

Securities: Rule 506(c)

General Solicitation Permitted

- › The Rule 506(c) exemption is identical to 506(b) (still a “private offering” under § 4(a)(2)), except general solicitation is permitted, all investors must be accredited, **and** the issuer must **verify** that all investors are accredited.

Verification

- › Impetus on process, not accuracy – good faith carve-out

Securities: Rule 506(c) – 4 approved methods of verification

- › Income – issuer review tax returns for prior 2 years + rep from investor
- › Net Worth – issuer reviews statements issued within past 3 months, plus checks credit report to confirm liabilities do not exceed assets, plus rep from investor that all liabilities have been disclosed
- › 3rd Party Verification – professional verification (B-D, RIA, **attorney**, CPA) issued within the past 3 months
- › Principles-Based Framework – based on context of purchaser and accredited status, amount and type of information issuer has about investor, and the nature of the offering, solicitation method, and terms of the offering

Securities: Crowdfund Exemption

Issuer Highlights

- › Must file “Form C” through EDGAR – disclosure of all investors > 20%, officer compensation, etc.
- › Must offer through an intermediary (registered broker or “funding portal”)
- › Maximum of \$1M per year
- › For offerings >\$250K, financials must be reviewed by independent accountant
- › For offerings >\$500K, financials must be audited
- › Annual financial statement obligations for life of securities
- › Crowdfunded investors do not count towards private company max (now 2K)

Securities: Crowdfund Exemption

Investor Highlights

- › Must complete questionnaire showing understanding of risk of angel investing
- › Investor Limits (<\$100K annual income or net worth):
The greater of \$2K or 5% of annual income (per investor per company per year)
- › Investor Limits (>\$100K annual income or net worth):
The lesser of 10% of annual income or 10% of net worth
(per investor per company per year)

Thank you

Public Service Announcement

- › Every note (promissory note, convertible note, etc.) is a security!

Copies of Slides and Outlines

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