Client Memo

Crowdfunding – Clearing Away the Fog

Crowdfunding is a potentially paradigm-shifting revolution in corporate finance, but the JOBS Act restrictions on retail crowdfunding may hinder the development of that market in favor of accredited investor crowdfunding.

"Crowdfunding" is a capital-raising strategy by which groups of people, often composed of small individual contributors, pool their capital, usually via a website, Internet portal or other social media. The practice began by using crowdfunding to raise money for charitable and community projects, it then developed into a perk-based model where businesses solicited funds for artistic projects like films and books or new consumer products in exchange for a perk or commemorative memorabilia of some sort such as a first edition of the product or the author's signed photo, or a custom experience such as a back-stage pass. A further adaptation lead to B-to-B non-interest bearing loans crowdfunding. Investors were not able to legally receive a financial return, such as equity or interest on a loan, because financial returns are fundamentally derived from securities, and the Securities Act of 1933 (the "Securities Act") prohibits the sale of a security other than pursuant to an effective registration statement or an exemption from the registration requirement under the Securities Act. Thus, absent new legislation, selling a security through a crowdfunding site like Kickstarter or IndieGoGo would be an unregistered sale with no exemption, and consequently would have violated the Securities Act.

With the enactment of the Jumpstart our Business Startups Act[i] ("JOBS Act"), signed into law by President Obama on April 5, 2012, Title III thereof made it legally possible for certain businesses to raise money and sell securities to the general public through crowdfunding – let's call it "retail crowdfunding" -- without a registration statement under the Securities Act, subject to the limits set forth in the JOBS Act and rulemaking by the Securities and Exchange Commission ("SEC") to regulate the industry.

A separate provision in Title II of the JOBS Act, Section 201(c) created the ability for issuers to offer securities in a private placement pursuant to Regulation D[ii] , which primarily deals with offerings to accredited investors[iii], by means of a "platform or

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mechanism that permits the offer, sale, purchase, or negotiation of or with respect to securities, or permits general solicitations, general advertisements, or similar related activities by issuers of such securities, whether online, in person, or through any other means." Essentially, these provisions permit the existence of angel platforms, where issuers sell to accredited angel investors, and were effective immediately upon enactment of the JOBS Act, but the provisions dealing with lifting the prohibition on the use of general solicitation or general advertising in Reg D offerings were subject to SEC rulemaking prior to becoming effective.

Since the JOBS Act was enacted a few things occurred:

- First, the SEC missed the December 31, 2012 deadline to propose rules giving effect to the crowdfunding provisions of Title III governing retail crowdfunding, and still has not proposed rules;
- The marketplace, in reliance on Section 201(c) of the JOBS Act allowing the use of Internet portals (essentially a website designed to handle crowdfunding transactions), quickly witnessed the launch of Internet platforms run by angel groups and venture capital firms to bring together accredited investors and vetted issuers who were approved for the site, and to avoid running afoul of the still-effective ban on the use of general solicitation and general advertising they followed a convoluted jurisprudence set out in SEC no-action letters[iv] supporting the position that if a site is password protected and only accessible to registered accredited investors, and that there is a cooling off period between when the investor registered on the site and when the investor received information about an offering or invested, it creates the indicia of a pre-existing relationship and thus the bringing together of the investor and the issuer on the site was not deemed to have been done through general solicitation or general advertising. Thus, accredited investor crowdfunding portals were born but constrained by how they could attract investors due to the still-effective ban on the use of general solicitation and general advertising.
- The SEC adopted final rules amending Rule 506 of Regulation D (effective September 23, 2013), paving the way for the use of general solicitation and general advertising in connection with sales to accredited investors – thus marrying the abilities of an issuer to market generally to the public with an offering made through an Internet portal or otherwise but only sold to accredited investors, hence "accredited investor crowdfunding". For a complete discussion of the new rules lifting the ban on general solicitation and general advertising, please refer to our memorandum "A Seismic Shift In The Securities Laws: The Elimination Of The Ban On The Use Of General Solicitation Or General Advertising In Certain Private Placements, And What It Means For Issuers, Accredited Investors, And Crowdfunding".

Title III received the lion's share of media attention on the crowdfunding issue, but Title II has quietly lead to the crowdfunding revolution through the back door, albeit a contained revolution because sales to the general public are not allowed under its provisions. Currently in the US there is a high level of confusion exhibited in the market place about the JOBS Act, crowdfunding, and the new Rule 506(c) allowing general solicitation and general advertising in certain offerings. This may stem from the fact that issuers can now offer securities to the general public by any means, including a crowdfunding portal, but may only sell those securities to accredited investors. Additionally, the sloppy use of the terminology in the media and social networks, using the same term "crowdfunding" or "crowdsourcing" to refer to everything from donations made to charity for nothing in return, to donations make to businesses for a perk, to B-to-B lending, to advertising to accredited investors for equity investments via an Internet platform, does not help distinguish between the different kinds of financing. This memorandum analyzes the industry and the prospects for its development.

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Retail crowdfunding as envisioned under the JOBS Act

The Congressional battle over the final substance of Title III, with the competing interests of making access to capital easy and inexpensive and as unregulated as possible, versus safeguarding investor protections, lead to a law that seems at times schizophrenic -- because it allows sales to the general public but prohibits the use of general solicitation or advertising to reach the general public; because it imposes limits on the amount that can be raised by an issuer in a given year and even lower limits on the aggregate amount that any given investor can invest in all crowdfunding offerings in a given year (whether or not that investor would in fact qualify as an accredited investor able to invest an unlimited amount pursuant to Reg D); because it imposes documentation and disclosure requirements that will require legal and accounting guidance and thus add expense that may be particularly difficult to bear for cash-strapped early stage companies; and because it imposes substantial requirements on the Internet Portal to verify investor eligibility but prohibits the Portal from taking compensation related to the sale of a security thus creating a risk/reward imbalance.

The details of Title III

Title III of the JOBS Act amends, subject to the effectiveness of SEC final rulemaking, Section 4 of the Securities Act to exempt offerings that meet the following criteria:

- The issuer is a domestic company (organized under the laws of a US state or territory), not subject to the reporting obligations of the Exchange Act and is not an Investment Company as defined in the Investment Company Act, or excluded from the definition of investment company by Section 3(b) or Section 3(c) of the Investment Company Act.
- The aggregate amount of the securities sold by the issuer in the previous 12-month period does not exceed $1 million.
- The amount of securities sold to any one particular investor in reliance on the exemption within the previous 12-month period does not exceed:
  - the greater of $2,000 or 5% of the investor's annual income or net worth, if the investor's annual income or net worth is less than $100,000, and
  - 10% of the annual income or net worth of the investor, not to exceed a maximum aggregate amount sold of $100,000 to the investor, if either the investor's annual income or net worth is equal to or more than $100,000, with the requirement that the SEC adjust this amount at least once every 5 years.
- The securities are sold through a crowdfunding intermediary, a broker or funding portal registered with the SEC and the applicable self-regulatory organization. See more information on crowdfunding intermediaries below.

Issuer limits

Retail crowdfunding under Title III will only be available to US companies. The JOBS Act defines "issuer" to include any director, partner, principal executive officer, principal financial officer, controller or principal accounting officer of an issuer that offers or sells a security in a crowdfunding transaction, and any person who offers or sells the security in such offering." This definition causes some confusion and may be problematic when considered alongside certain other provisions related to crowdfunding, for instance the requirement that issuers provide income tax returns or financial

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statements to potential investors, or the requirement that issuers be organized under the laws of a US state or territory which is nonsensical when applied to a natural person.

Crowdfunding Intermediaries

Title III retail crowdfunding intermediaries are subject to an extensive set of rules. Intermediaries may not compensate promoters or finders, and officers and directors of an intermediary are prohibited from taking a financial interest in any issuer that uses their services. Brokers that choose to be a crowdfunding intermediary are subject to existing restrictions and regulations, and in subsequent guidance in the form of Frequently Asked Questions ("FAQs"), the SEC has indicated that it will require crowdfunding intermediaries to register with the SEC and a national securities association that is registered under Section 15A of the Exchange Act (currently the Financial Industry Regulatory Authority (FINRA) is the only such entity), even if such entity is already a registered broker-dealer. The SEC will adopt rules regarding the form and process of registration.

A funding portal may not offer investment advice, solicit transactions for securities offered through the portal, compensate employees, agents, promoters, finders or lead generators to solicit transactions, hold investor funds or securities, or engage in any other activity that the SEC prohibits in its rulemaking.

Funding portals will be required to implement extensive "know your investor" procedures to ensure that investors are qualified and knowledgeable enough to participate and have not exceeded the 12-month investing limits, including requirements to provide investor education material and ensure that each investor reviews the material and positively affirms that it understands that it is risking the loss of its entire investment, and answers questions to demonstrate that the investor understands the level of risk generally associated with investments in startups, emerging businesses, small issuers and illiquidity. Funding portals are required to take measures, as established by the SEC, to reduce the risk of fraud by, among other things, obtaining a background and securities enforcement regulatory history on each officer, director, and person that holds more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person.v

Offering proceeds may only be provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and investors are allowed to cancel their commitments to invest on such terms as the SEC may prescribe by rule.

SEC filing requirements

Even though Title III exempts issuers selling securities through a retail crowdfunding portal from the Exchange Act reporting requirements that kick in when an issuer has 2,000 or more shareholders or 500 or more non-accredited investor shareholders, Title III does require those issuers *and* the portal to provide certain information to the SEC when it initially offers securities, and in subsequent annual filings. The issuer, its officers, directors or partners, can be liable for any material misstatements or omissions. Note there are no analogous disclosure and filing requirements under Rule 506(c) for offerings to accredited investors, which are also permitted to make use of a crowdfunding portal; however, prudence and the need to avoid fraud liability will likely lead to the practice of providing adequate disclosure in offering documents in accredited investor crowdfunding transactions.

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Initial filing A retail crowdfunding issuer is required to provide a minimum threshold amount of information to the SEC about its business. The initial filing must include:

- The name, legal status, and addresses of the business, website, and names of directors, officers, and each shareholder holding more than 20 percent of the shares of the issuer.
- A business plan and description of the business.
- A description of the financial condition of the issuer which, depending on the size of the offering, may include income tax returns and officer-certified financial statements, unaudited financial statements or audited financial statements.[vi]
- A description of the purpose and intended use of the funds, the target offering amount, deadline to reach the amount, and regular progress reports regarding attaining the target.
- The price of the securities, provided that prior to the sale each investor must receive in writing the final price and be given the opportunity to rescind the commitment to purchase the securities.
- The ownership and capital structure of the business, including the terms of each class of the issuer's securities, risks of minority ownership and dilution, and methods of valuation for the current securities and potential future offerings, and
- Any other information required by the SEC.

Annual Information Requirements Retail crowdfunding issuers must provide the SEC and investors, through the crowdfunding intermediary, with annual reports on the results of the company's operations and financial statements for the prior year, in compliance with rules to be promulgated by the SEC.

Prohibition on advertising Retail crowdfunding issuers may not advertise the terms of the offering, except for notices that direct investors to the funding portal or broker. Conversely, issuers may use general solicitation and advertising to offer securities that are sold to accredited investors.

Liability for Material Misstatements and Omissions

Title III applies the same potential statutory liability in a crowdfunding context as if it were a public offering[vii], in addition to potential anti-fraud liability[viii]. Specifically, the Act provides that an "issuer" will be liable to purchasers if, in its oral or written communications, it misstated or omitted a material fact about which the issuer cannot prove that it did not know or could not have known if reasonable care had been exercised; however, "issuer" is defined as any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status), and any person who offers or sells the security – in other words, a crowdfunding portal that is, or is affiliated with, a registered broker-dealer who engages in solicitation of the offering – can potentially be statutorily liable for misstatements or omissions of a material fact[ix] made by the issuer.

Resale Restrictions

Securities sold in a crowdfunding transaction are subject to resale restrictions. Purchasers may not transfer the securities within one year of the date of purchase unless the securities are transferred to the issuer, to an accredited investor, as part

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of a registered public offering, to a family member or equivalent, or in the event of death or divorce in accordance with SEC rulemaking. The SEC has the statutory ability to establish other rules.

State Blue Sky laws and other state law issues

Title III crowdfunding offerings will be exempt from state blue sky registration requirements (they will be "covered securities" under Section 18 of the Securities Act), but the Act preserves state jurisdiction over fraud, deceit or the unlawful conduct of broker, dealers, funding portals and issuers. Additionally, states may not charge a fee with respect to a security offered in a crowdfunding transaction, except for state securities commissions in the state of the principal place of business of the issuer or the state in which 50% or more of the purchasers reside. States will also be prohibited from enforcing laws, rules or regulations against a registered funding portal unless the portal has its principal place of business in such state and the law, rule or regulation is not in addition to or in conflict with the SEC rules governing funding portals.

The Role of Crowdfunding in the Corporate Finance Landscape

What kind of issuer is best suited for crowdfunding?

Title III retail crowdfunding is limited to US private companies that are not Exchange Act reporting companies or investment companies (thus hedge funds are excluded), whereas accredited investor crowdfunding has no limit on the kind of issuer other than it cannot be a "bad actor" as defined in Rule 506(d) as discussed in our memo "A Seismic Shift in the Securities Laws".

The economic downturn that began in 2007 caused traditional funding sources for start-up and early stage companies to dry up. In today's market it is almost impossible for pre-revenue companies to borrow money from a bank or pique the interest of angel and venture capital firms, and if the entrepreneur is unable to raise money through friends or family then they are typically out of luck. The passage of the JOBS Act was intended to help bridge this small business capital cap and consequently help capitalize small businesses which, as a sector, have historically been responsible for the largest number of jobs in the US.

With its limits on the dollar amount that an issuer can raise in a given year, and the limit on the type of company that can take advantage of the Title III retail crowdfunding regime – namely, US-based private companies and excluding mutual funds, private investment funds and bad actors – retail crowdfunding market may add value in certain niches and not others. Three potential market categories may be:

- the local business, such as a restaurant or boutique, or non-high-tech consumer product developer that needs, for instance, to finance a prototype or a volume-scale production run for their first large customer, and has the potential to be profitable but is not sexy enough to attract angel or VC investors;
- entertainment financing for the very sexy, very risky and possibly hugely lucrative one-off project, such as a film or theater production or sizzler for reality TV show; and

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- the early-stage pre-revenue company in a higher worth category, such as high-tech, bio-tech, clean tech or life sciences or the next trendy luxury, or food or beverage product for national distribution, that needs to raise small amounts of capital in order to finance the development of a prototype or early-stage research and development.

Crowdfuding for the first business model could take the place of friends and family or bank financing, and in fact may be all the funding that the enterprise ever needs, but on the flip side may be the sector that attracts the least amount of interest due to its limited scale or mundane character.

As for the entertainment industry, perk-based non-equity crowdfunding has already proven to be very successful. Accredited investor crowdfunding where the investors have deeper pockets and there are no limits on the amounts that can be raised, can offer a new vehicle for financing larger productions, while retail crowdfunding offers the potential for smaller or lesser-known artists to access capital; however, non-equity perk-based crowdfunding through Kickstarter or Indiegogo, for example, would still offer the same potential without having to relinquish any financial upside, so artists will likely ask themselves why they should give up the equity if they don't have to. Both the first and second business model can create long term jobs or create job project opportunities in an industry where project-based jobs are the norm due to the nature of the product, thus furthering the policy intent of the JOBS Act.

Crowdfunding for the third business model, however, has its pitfalls, the concern being that start-ups in industries that require large amounts of capital but raise small sums may be too naïve or too unprepared for their real capital needs to be able to succeed. Some of these businesses may find themselves reactionary and chronic small-raise issuers, never really getting the big infusion of cash needed to make a bold step forward, and years later may find that they have missed the opportunity window in a market that has moved on to a different opportunity, or that someone else has beaten them to market in a bigger and better way. Providing a means to finance a business against all odds does not facilitate long term job creation.

Will an efficient market be created?

The focus of attention on the development of crowdfunding as a financing tool has been primarily on the inbound side of the equation, providing a means for businesses to access capital, and defining who can invest and how much. Not enough attention has been paid to how those investors will get out of an investment. Liquidity in retail crowdfunding under Title III is prescribed by a one-year holding period unless the security is sold to an accredited investor, family members or the issuer buys it back. Although accredited investor sales are typically also subject to a one-year holding period for non-reporting companies as set forth in Rule 144, in practice immediate resales are allowed using the "Section 4(1-1/2)" procedures.[x]

Without the creation of a secondary market, or a security with a natural exit like a debt instrument with a due date or equity with a put or a right to tag-along if the company has a subsequent funding round, or the ability for retail and accredited investors to participate together in the same offering (successfully done recently on WiSeed in France, discussed below), it may be difficult to attract investors in the first place. It will be easier for accredited investor crowdfunding portals to adapt to accommodating secondary market sales – the site SecondMarket, for instance, operates a secondary market for accredited investors. Adding the complication of liquidity provisions to an equity security will add to the issuer's legal costs and may be prohibitive for a retail crowdfunding issuer.

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The Comparative Roles of Accredited Investor Crowdfunding and Retail Crowdfunding, and Choosing Which to Use for a Particular Issuer

Size of the Offering. Issuers using retail crowdfunding are limited to raising no more than $1 million in any 12-month period, whereas issuers can raise an unlimited amount of funds through accredited investor crowdfunding under Title II and Rule 506(c).

Costs of Mandatory Disclosure. Due to the financial and non-financial disclosure (including income tax returns) and SEC filing requirements that apply to both issuers and portals in retail crowdfunding under Title III of the JOBS Act, which do not apply to accredited investor crowdfunding in reliance on Title II and Rule 506(c), retail crowdfunding will be more costly for an issuer; however, we will not know the full extent of the potential cost until the SEC and FINRA propose their rules, or whether any relevant body takes the step of developing standard documentation templates to help contain costs. Of course, issuers taking part in accredited investor crowdfunding rounds still face anti-fraud liability risk and therefore will likely voluntarily provide a level of disclosure necessary to avoid violation of the anti-fraud provisions of the securities laws. Additionally, the more regulatory requirements that apply, the less lean and agile an issuer can be. Issuers can raise more money, and reach more potential investors using general solicitation or advertising, with less regulatory hurdles by using accredited investor crowdfunding.

Corporate governance management. Retail crowdfunding anticipates the potential for a very large number of small equity holders, and state law corporate governance requirements can become quite onerous when there is a large volume of shareholders entitled to notices for annual meetings, or who must be counted for quorum requirements and so forth, or be even more complicated from a tax reporting perspective if the issuer is a limited liability company, a typical business form for small businesses. Accredited investors typically invest more money per transaction, so a typical funding round will have fewer total investors.

Liability exposure. The liability exposure to issuers and others engaged in a retail crowdfunding offering is greater than in accredited investor crowdfunding because, in addition to fraud liability and the application of the anti-fraud provisions of section 10(b) and Rule 10b-5 under the Securities Exchange Act which apply to both retail and accredited investor crowdfunding situations, Title III of the JOBS Act specifies that an action brought under Title III will also be subject to the statutory liability provisions under Section 12 of the Securities Act[xi], and it is easier for a plaintiff to prove statutory liability than fraud.[xii] This potential statutory liability applies not only to Title III retail crowdfunding issuers but also to various directors and executives and even the crowdfunding portal.

In addition to the risk of lawsuits for statutory liability or fraud claims, insurers may rate Title III retail crowdfunding issuers in the same category as public issuers due to the exposure to the same kind of liability risk as a public company, consequently the cost of Director's and Officer's insurance and broker's fees may be higher. The potential portal liability just adds another factor to the risk/reward imbalance that retail crowdfunding portals will face thus impacting the feasibility of operating a portal for low-value transactions in the first place.

Portal third party fees. Portals are required for Title III retail crowdfunding activities, but not Rule 506(c) accredited investor sales, and portals will need to make money. If the portal is a registered broker-dealer and participates in the offering then it can charge transaction-based fees, or if it is not so affiliated or offers a tier of service that allows issuers to list their securities and documentation on the site without providing the services of a broker-dealer, then they will still need to pass on fees of a clearing broker and also charge the issuer either a flat fee or have some other fee arrangement

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that cannot be construed to be transaction-based for listing on the site; however, this second model is really only feasible for accredited investor crowdfunding because Title III requires retail crowdfunding portals to take on certain issuer and investor verification responsibilities. Paradoxically, it is therefore reasonable to expect that these fees may be greater on retail crowdfunding portal sites which are statutorily prescribed to conduct investor verification and are exposed to statutory and fraud liability related to the content of the offering documents, whereas accredited investor crowdfunding sites (which, as a reminder, are not required for issuers to sell to accredited investors) have no such duties or exposure under Title II and new Rule 506(c). Even if accredited investor crowdfunding portals opt to offer the accredited investor verification service for a fee for those issuers who do not want to take on the burden themselves, it will likely be optional, and the matters to be verified for accredited investor status are more narrow and delineated in scope than those to be verified for individual retail crowdfunding investors.

Chilling effect on subsequent angel and VC rounds, and other potential liquidity risks. There is arguably a risk that venture capitalists or institutional investors may disfavor companies exposed to the type of liability that issuers face if they engage in retail crowdfunding rounds under Title III, thereby limiting the issuer's subsequent access to capital. Also, venture capitalists may discount the value of a company that has a large number of really small investors, which may require that special attention be paid to anti-dilution protections in governing state law.

Will an Issuer actually have a choice?

The manner in which the existing accredited investor sites operate involves a rigorous beauty contest which is highly selective and leads to a curated stable of issuers, not every company that wants to list on the site is accepted. The case may be different for crowdfunding portals that merely offer the tools for issuers to enroll and use the tools on the site, but that is more likely to be a viable portal model for accredited investor crowdfunding where the portal is not legally mandated to do any verification of the issuer or the AI status of investors (the legal responsibility of the issuer) and does not have any statutory liability related to the disclosure documents as it would in retail crowdfunding where, arguably, issuer screening is even more important than in accredited investor crowdfunding due to the heightened liability risk. It remains to be seen whether retail crowdfunding sites will develop some sort of screening algorithm in an attempt to identify issuers with a lower risk profile.

Why use crowdfunding at all? Even for issuers who decide to forego retail crowdfunding in favor of accredited investor crowdfunding, if the issuer runs afoul of meeting all the requirements of a Rule 506(c) offering using accredited investor crowdfunding, the issuer does not have the fall-back exemption under Section 4(a)(2) for offerings "not involving a public offering" and may be in violation of the Securities Act. For those issuers able to cross the line of being generally attractive to angel groups, venture capitalists, or accredited investors who can be accessed without using methods that would be deemed to be general solicitation or general advertising, and who are raising a significant amount of capital in one transaction, the traditional model of relying on Regulation D Rule 506(b), and foregoing the use of general solicitation or advertising, may remain the most attractive option.

State Law implications.

The Kansas Securities Commission adopted the Invest Kansas[xiii] retail crowdfunding exemption in March 2011, for offers of up to $1 million in a 12-month period by businesses formed under the laws of Kansas and sold exclusively to Kansas residents who can invest no more than $1,000, with the proceeds being deposited into a Kansas banking institution. The

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law lays out transaction reporting requirements and criteria for collecting a commission. Georgia followed suit with a similar law but a higher $10,000 cap per investor.[xiv] Neither state has had much activity, but it is conceivable that state-specific crowdfunding sites will develop to service the local business market.

Lessons we can learn from existing crowdfunding markets overseas

Securities-based crowdfunding platforms are already operating across the world, and the different models being developed are worthy of note. Crowdfunding sites operate across Europe, the most robust market being in Britain with other notable European markets in The Netherlands and France. Further afield, crowdfunding markets operate in Australia and South and Central America, notably Brazil where currently it is limited to perk-based non-equity crowdfunding similar to Kickstarter but also regional sites that operate in Argentina, Chile and Mexico, and handful in China, Japan and Korea. The platforms tend to carry a selection of vetted issuers.

Debt offerings are quite prevalent in Britain (Crowdcube and Funding Circle for example), debt being an attractive security in a retail crowdfunding context because it does not burgeon the number of equity holders that could impact corporate governance management, or complicate the equity structure in a manner that would make the issuer less attractive to subsequent angel or VC funding rounds, and offers a scheduled cash payment and exit to investors. The debt offerings in Britain tend to be for issuers who have cash flow and are coupled with the platform's ability to provide credit ratings which may not be possible in the US because portals under Title III are not allowed to give investment advice. The default rate on Funding Circle is quite low, only 3.4 percent, well below the 11.6 percent default rate on loans issued by the Small Business Administration, which indicates that the selection process lets the cream float to the top and results in a selection of issuers that are more credit-worthy .

Equity offerings on some overseas platforms allow accredited and non-accredited investors to participate together. For example on WiSeed this past year a two-round offering was structured that allowed the accredited investor to conduct due diligence and the crowdfunding investors to invest in the first round, followed by a second round where the accredited investor invests, and at a later date the accredited investor offers to buy the crowdfunding equity, the result being that the accredited investor shared the early stage risk and the crowdfunding investors got the benefit of the more experienced investor's judgment on due diligence and the ability to liquidate at a profit. The segregation of accredited and retail crowdfunding investors in the US could adversely impact the creation an efficient market that includes retail crowdfunding.

Conclusion

Crowdfunding is potentially a paradigm-shifting revolution in corporate finance; however, in light of the layers of regulation imposed on Title III retail crowdfunding portals, the restraints on the manner in which they operate and can be compensated, and the exposure to potential statutory and fraud liability for issuer misstatements or omissions, one wonders whether the JOBS Act itself effectively sounds a death knell to the prospects of retail crowdfunding developing in the US in the first place. The more optimistic prospects for growth are in the accredited investor crowdfunding arena, but by its nature that market will be open to a more limited issuer base and its growth may be affected by whether a robust secondary market develops.

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Endnotes

[i] Pub. L. No. 112-106, 126 Stat. 306.

[ii] Securities Act Rule 501-508, 17 CFR §230.501-508. *et seq*.

[iii] An accredited investor is defined in Rule 501 of Regulation D, and includes public and private for-profit and not-for-profit corporations, general and limited partnerships, business and other types of trusts, funds and other types of collective investment vehicles, and natural persons who meet certain financial tests. Pursuant to the definition (as amended by the The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")), a natural person qualifies as an accredited investor if he or she has individual net worth – or joint net worth with a spouse – that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person, or, if he or she has income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year.

[iv] SEC No-Action letter dated March 28, 2013 to K&L Gates re: AngelList LLC and AngelList Advisors LLC.

[v] JOBS Act, Title III, Section 4A(a)(5).

[vi] For an issuer whose aggregate total offering target amount within the preceding 12-month period is (x) $100,000 or less, the issuer must provide current year income tax returns (if any) and financial statements certified by the principal executive officer to be true and complete in all material respects; (y) more than $100,000 but not more than $500,000, the issuer must provide financial statements reviewed by an independent public accountant, using professional standards and procedures as may be set by the SEC; and (z) more than $500,000, the issuer must provide audited financial statements. JOBS Act, Title III, Section 4A(b).

[vii] *See* the JOBS Act, § 302(b), codified in Section 4A(c)(1)(B) of the Securities Act, 15 USC 77d-1(c)(1)(B) ("An action brought under this paragraph shall be subject to the provisions of section 12(b) and section 13 [of the Securities Act of 1933], as if the liability were created under section 12(a)(2).").

[viii] *See, e.g.*, Rule 10b-5 of the Exchange Act, 17 C.F.R. § 240.10b-5.

[ix] JOBS Act Title III, Sections 4A(c)(1)and 4A(c)(3).

[x] "Section 4(1-1/2)" is the colloquial reference to the practice, to which the SEC does not object, of a purchaser of restricted securities from an issuer in a private placement pursuant to the Section 4(a)(2) statutory exemption for offers "not involving any public offering", immediately reselling those securities in a transaction in which the selling purchaser follows the strict requirements for a transaction that would not involve a public offering by an issuer under Section 4(a)(2).

[xi] *See* the JOBS Act, § 302(b), codified in Section 4A(c)(1)(B) of the Securities Act, 15 USC 77d-1(c)(1)(B) ("An action brought under this paragraph shall be subject to the provisions of section 12(b) and section 13 [of the Securities Act of 1933], as if the liability were created under section 12(a)(2).")

[xii] What this effectively means is that, Under Title III retail crowdfunding, the plaintiff merely has to prove that s/he did not know the truth or was unaware of the omission which puts the burden on the issuer to prove that it did not know, and in the exercise of reasonable care could not have known, of the material misstatement or omission ("due diligence" defense). Fraud is more difficult to prove because a plaintiff must prove the issuer had "scienter" – that the statement was intentional or reckless and not merely negligent – and also prove actual reliance by the plaintiff, so for a private company with no active secondary trding market for its shares, it will be nearly impossible to certify a class for a class-action lawsuit because each individual plaintiff will need to prove reliance. Courts can get around this issue by applying the doctrine of "fraud on the market" in the case of securities that trade in an efficient secondary market, but if there is no trading market, as may be the case with a private company in the crowdfunding context, then courts may find it difficult to apply the doctrine.

[xiii] K.A.R. 81-5-21 as modified by Special Order dated June 21, 2013.

[xiv] Ga. Code Ann. § 590-4-2-.08.

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