

SECURITIES-BASED CROWDFUNDING SCORECARD

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In 2014, proponents of broad-based, crowdfunded securities offerings were excited by the adoption of Title III of the JOBS Act. Title III allows businesses to raise up to \$1 million in a 12-month period through the sale of securities to an unlimited number of non-accredited, small investors. However, actually conducting any of these offerings was subject to the SEC adopting rules to implement Title III. After an agonizing two years, the SEC finally adopted its Title III crowdfunding rules (Reg CF), effective on May 16, 2016. The SEC also adopted issuer guidance which gives a good overview of Reg CF.¹

As client interest in conducting federal crowdfunding offerings increases, I thought it would be useful to take a brief look at state crowdfunding offerings, and then to look at what has occurred in this new federal marketplace during the first three months of Reg CF's existence.

State Crowdfunding Rules

While waiting on the SEC rules, over half of the states adopted rules permitting securities-based crowdfunding offerings to small investors residing solely within the issuer's state, in reliance on the federal "intrastate" exemption from registration.² These state crowdfunding rules vary widely in their requirements and have met with varying degrees of success in permitting securities-based crowdfunding offerings to get to market. According to the North American Securities Administrators Association (NASAA), as of June 20, 2016, a total of 179 state crowdfunding offerings had been filed, and 166 had been cleared/approved by state regulators.³ Unfortunately, Washington's crowdfunding rules⁴ are among the most restrictive in the country. As of June 2016, only one Washington crowdfunding offering had been approved after a two-year approval process.⁵

For federal Title III crowdfunded offerings, NASAA has issued a proposed model rule and draft uniform notice form to the states. In July 2016, Washington substantially adopted those rules and notice form.⁶

Reg CF Offering Activity

Through August 24, 2016, approximately 86 offerings had been filed with the SEC under Reg CF on the new Form C. WeFunder Portal (the most active Title III funding portal) reports that 24 of those offerings had met their minimum funding targets required to release the funds from escrow.⁷ Those funding targets ranged from a low of \$27,612 to three offerings achieving the maximum \$1 million. If you don't count those three largest offerings, the average fully funded offering size was approximately \$163,000.

The types of companies that have successfully funded include a number of brewery/spirits/coffee companies, several indie film companies, several hospitality companies, and a number of health/medical device companies. Of the fully funded offerings, 18 of the 24 were conducted through WeFunder.

Offering Platforms

One unique feature of Reg CF is its requirement that all offerings must be exclusively conducted through one online platform operated by a broker-dealer or one of the new "funding portals" authorized by the JOBS Act. Currently 16 funding portals have registered with the SEC and FINRA. These platforms charge fees based on a percentage of the offering amount, ranging from 3% - 10%, and several also receive 2%-5% of the securities

¹ SEC issuer guidance: <https://www.sec.gov/info/smallbus/secg/rcomplianceguide-051316.htm>

² Rule 147 under the federal Securities Act of 1933.

³ <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2014/12/Intrastate-Crowdfunding-Slides-7-18-16.pdf>

⁴ WAC 460.99C

⁵ <http://www.bizjournals.com/seattle/blog/techflash/2016/06/first-washington-startup-gets-through-crowdfunding.html>

⁶ WAC 460-18A-210 - Notice filing requirements for federal crowdfunding offerings.

⁷ See <https://wefunder.com/stats> for continuously updated funding statistics.

issued. These commissions add significant cost to conducting a federal crowdfunded offering. A review of filed Form Cs, through August 24, 2016, estimates funding portal activity and commission rates as follows:

Platform	Filing #	Fee %
WeFunder (Portal)	33	3%
StartEngine (Portal)	13	7%
UFundingPortal (Portal)	9	5%
FlashFunders (Portal)	6	5%
Venture Co Brokerage (B/D)	4	7%
TruCrowd (Portal)	4	7%
SeedInvest (Portal)	4	5%

Platform	Filing #	Fee %
OpenDeal (Portal)	4	5%
NextSeed (Portal)	3	5-10%
Jumpstart Micro (Portal)	3	6%
Crowdfunder (Portal)	2	7%
Bankers Direct (B/D)	2	10%
LocalStake Marketplace (B/D)	1	5%

As shown above, most of the registered crowdfunded offerings through August 24, 2016 were done through the new funding portals, with only seven being done through platforms operated by three registered broker-dealers.

Types of Securities Offered

Federal crowdfunded offerings include both equity and debt securities. A review of filed Form Cs, through August 24, 2016, estimates the types of securities being offered as follows:

Security Offered:	#
Common Stock	32
“SAFES”	24
Debt	14
LLC interests/units	8
Preferred Stock	8

The high number of SAFE offerings as a percentage of the total crowdfunded offerings to date is a significant concern from an investor protection perspective. SAFES (Simple Agreements for Future Equity) were developed in 2013 for startups as an alternative to issuing convertible notes before their first venture capital round. SAFES are a contract granting the investor the right to purchase equity at a future date when the startup sells its first round of priced stock. If no equity round is issued, they will never convert into stock. But, since they are not debt, the company generally is not obligated to repay the invested amount unless there is a liquidity event, and, in the repayment hierarchy of a bankruptcy or dissolution the investors will fall behind creditors.

Also of concern is that five of the debt offerings were “revenue sharing” or “revenue participation” agreements, rather than traditional convertible notes. These arrangements are basically promissory notes repaid based on a percentage of the issuer’s revenues, rather than an amortized basis. If the issuer has no profits, no payments are required until maturity, and the investor has no right to exchange the amount due for equity.

A sampling of the Form Cs for several of revenue sharing and SAFE offerings showed a lack of adequate disclosure of the significant risks these alternative securities pose to investors as compared to traditional equity and debt securities.

Offering Materials

A sampling of the filed Form Cs reflects a wide range of disclosure quality, ranging from materials clearly prepared by securities counsel, to fluffy materials that read like the company’s website and which contain little real risk disclosure.

The funding portals provide the issuers with on-line interface for the completing the SEC’s Form C filing. They also offer forms of common and preferred stock subscription agreements and convertible promissory notes, plus forms of revenue sharing agreements and SAFES, all complex securities instruments. The funding portals

generally advise the issuers to work with qualified legal counsel. However, the volume of legal advice and legal forms provided on these funding portals, when combined with their high commissions and the do-it-yourself paradigm inherited from the non-equity crowdfunding world, would appear to create a strong disincentive for cash-strapped issuers to engage adequate legal advice on their federal crowdfunded securities offerings.

We may well have to wait until the failure of one of the companies with the largest crowdfunding raised in order to see how the SEC and FINRA will respond to the funding portals' current practices.