

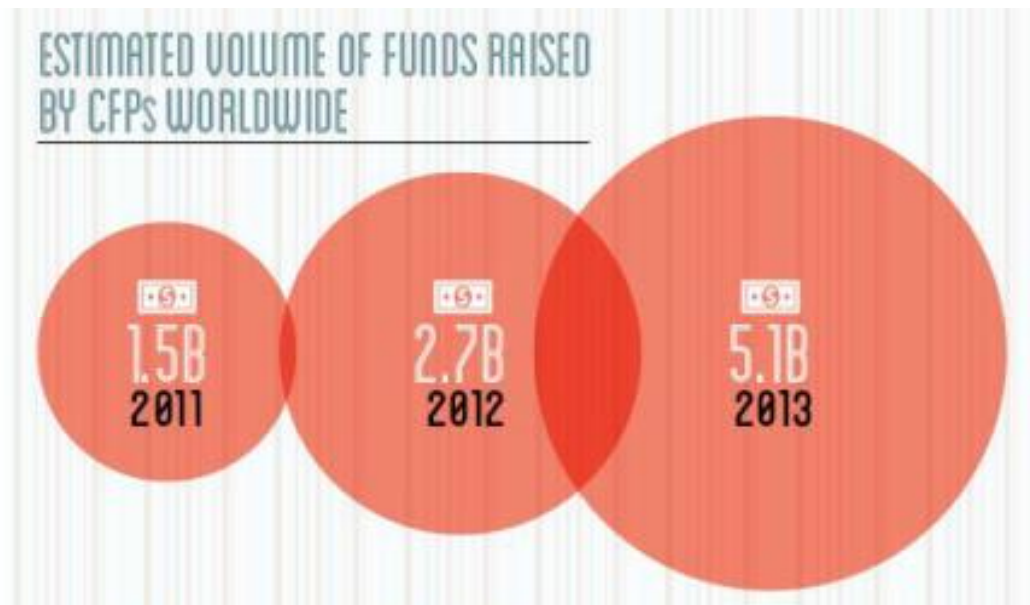
# Equity Crowdfunding

## A Legal Perspective

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## Introduction



Source: <http://www.crowdmapped.com/crowdfunding-trends-and-statistics/>

## Introduction

**KICKSTARTER**



**crowdfunder**



**AngelList**



**Quirky**

Early**Sh**res



**START SOME GOOD**.COM  
IGNITING IDEAS, INVESTMENT & IMPACT

## Introduction: Kickstarter Top Project Categories (excerpt)

Projects and Dollars

Category	Launched Projects	Total Dollars	Successful Dollars	Unsuccessful Dollars	Success Rate
All	137,375	\$1 B	\$871 M	\$119 M	43.56%
Film & Video	33,874	\$199.81 M	\$165.70 M	\$31.18 M	40.09%
Music	28,119	\$105.83 M	\$95.15 M	\$8.91 M	55.20%
Publishing	16,603	\$49.31 M	\$41.13 M	\$7.19 M	32.26%
Art	12,267	\$36.90 M	\$30.49 M	\$4.53 M	47.81%
Games	8,958	\$220.38 M	\$191.98 M	\$22.33 M	35.19%

Source: <http://www.kickstarter.com/help/stats?ref=footer>

## Introduction: Kickstarter Successful Projects (excerpt)

Successfully Funded Projects

Category	Successfully Funded Projects	Less than \$1,000 Raised	\$1,000 to \$9,999 Raised	\$10,000 to \$19,999 Raised	\$20,000 to \$99,999 Raised	\$100 K to \$999,999 Raised	\$1 M Raised
<b>All</b>	<b>57,810</b>	<b>6,235</b>	<b>36,649</b>	<b>7,714</b>	<b>6,043</b>	<b>1,111</b>	<b>58</b>
<b>Music</b>	15,150	1,465	11,233	1,766	653	32	1
<b>Film &amp; Video</b>	13,229	1,264	8,014	2,071	1,717	160	3
<b>Art</b>	5,659	1,070	3,892	465	217	15	0
<b>Publishing</b>	5,182	787	3,391	605	372	27	0
<b>Games</b>	2,997	163	1,156	564	817	267	30

Source: <http://www.kickstarter.com/help/stats?ref=footer>

## Introduction

### ***Games on Kickstarter***

- 8,958 campaigns.
- 35.2% success rate (vs. 43.6% for all categories).
- 30 projects over \$1MM (out of 58 projects in all categories).
- But ... 63% raise \$10,000 or less.

Source: Kickstarter; statistics through March 2014.

## Introduction

## ***Reward Crowdfunding vs. Equity Crowdfunding***

ravensdale/in extremo t-shirt



ravensdale t-shirt



Project Ravensdale, Black Forest Games

Kickstarter

Source: <http://www.kickstarter.com/projects/project-giana/project-ravensdale?ref=category>

## ***Topics***

1. Fundraising Online under the New Law.
2. Requirements for Launching an Equity Crowdfunding Campaign.
3. Requirements Once the Campaign is Over.
4. Crowdfunding for Accredited Investors.
5. Strategies for Accessing Equity Crowdfunding.

# ***The New Crowdfunding Law A "Game Changer"...?***

## US Regulation of Crowdfunding

### ***Basic Historical Principles of US Securities Regulation***

- No “general solicitation.”
- No sales of securities without prescribed disclosure.
- Intermediaries (broker/dealers, trading platforms) highly regulated.
- Ongoing public disclosure.

## US Regulation of Crowdfunding

### ***Exception: Private Placements***

- Accredited investors: net worth of \$1 million; or income of \$200K (\$300K with spouse).
  - 2.8% of US population.
- Up to 35 non-accredited investors.
- Annual limit of \$5 million; unless any non-accredited investors are “sophisticated.”
- Private placement memorandum for non-accredited investors.
- Audited financials.
- Restricted securities: may not resell for at least one year.
- Notice filing with SEC.

## US Regulation of Crowdfunding

### ***Exception: Private Placements***

Amount of capital raised in US private markets compared to IPOs:

4x

Estimated annual size:

\$1.2 trillion

# US Regulation of Crowdfunding

The CROWDFUND Act:

"**C**apital **R**aising **O**nline **W**hile **D**eterring **F**raud and **U**nethical **N**on-**D**isclosure Act of 2012," signed April 5, 2012



H. R. 3606



## One Hundred Twelfth Congress of the United States of America

AT THE SECOND SESSION

*Began and held at the City of Washington on Tuesday,  
the third day of January, two thousand and twelve*

### An Act

To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

#### SECTION 1. SHORT TITLE.

This Act may be cited as the "Jumpstart Our Business Startups Act".

#### SEC. 2. TABLE OF CONTENTS.

The table of contents of this Act is as follows:

Sec. 1.	Short title.
Sec. 2.	Table of contents.
TITLE I—REOPENING AMERICAN CAPITAL MARKETS TO EMERGING GROWTH COMPANIES	
Sec. 101.	Definitions.
Sec. 102.	Disclosure obligations.
Sec. 103.	Internal controls audit.
Sec. 104.	Auditing standards.
Sec. 105.	Availability of information about emerging growth companies.
Sec. 106.	Other matters.
Sec. 107.	Opt-in rights for emerging growth companies.
Sec. 108.	Review of Regulation S-R.
TITLE II—ACCESS TO CAPITAL FOR JOB CREATORS	
Sec. 201.	Modification of exemption.
TITLE III—CROWDFUNDING	
Sec. 301.	Short title.
Sec. 302.	Crowdfunding exemption.
Sec. 303.	Exclusion of crowdfunding investors from shareholder cap.
Sec. 304.	Funding portal regulation.
Sec. 305.	Relationship with State law.
TITLE IV—SMALL COMPANY CAPITAL FORMATION	
Sec. 401.	Authority to exempt certain securities.
Sec. 402.	Study on the impact of State Blue Sky laws on Regulation A offerings.
TITLE V—PRIVATE COMPANY FLEXIBILITY AND GROWTH	
Sec. 501.	Threshold for registration.
Sec. 502.	Employees.
Sec. 503.	Commission rulemaking.
Sec. 504.	Commission study of enforcement authority under Rule 12g5-1.
TITLE VI—CAPITAL EXPANSION	
Sec. 601.	Shareholder threshold for registration.
Sec. 602.	Rulemaking.
TITLE VII—OUTREACH ON CHANGES TO THE LAW	
Sec. 701.	Outreach by the Commission.

# US Regulation of Crowdfunding

7/26/13

Information regarding the use of the crowdfunding exemption in the JOBS Act

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## U.S. Securities and Exchange Commission

### Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act

On April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law. The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.

<http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm>

[Home](#) | [Previous Page](#)

Modified: 04/23/2012

## US Regulation of Crowdfunding

### ***The New Equity Crowdfunding Exemption***

*"For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."*

-- President Obama, April 2012 signing ceremony.

*"The thing about crowdfunding is that it brings together unsophisticated issuers with unsophisticated investors ... what could possibly go wrong?"*

-- Barbara Roper, Consumer Federation of America

## US Regulation of Crowdfunding

### ***The New Equity Crowdfunding Exemption***

- Annual dollar limit on sales by companies.
- Annual dollar limit on purchases by investors.
- Must be through crowdfunding website registered with SEC.
- Required disclosure by company.

## US Regulation of Crowdfunding

### The New Crowdfunding Exemption (cont'd)

- Background checks on officers, directors, major shareholders.
- All-or-nothing campaigns.
- Investor cancellation right up until 48 hours before campaign ends.
- Ongoing reporting requirements.
- Restricted securities: no transfer for one year.
  - Other than to accredited investor, or back to company.

## US Regulation of Crowdfunding

### ***Size Limitations***

- Crowdfunding companies can sell up to \$1 million per year to general public.
  - No limit on sales to accredited investors through a parallel campaign.
- Annual limit on crowdfunding investments by individuals:
  - Annual income and net worth less than \$100K in last 12 months: 5% of income / net worth or \$2000, whichever greater.
  - Annual income or net worth \$100K or more in last 12 months : 10% of income / net worth, with cap of \$100K.
  - Crowdfunding website must have “reasonable basis” to believe that an investor satisfies the investment limitations.

## US Regulation of Crowdfunding

### ***Crowdfunding Portal Sites***

- Crowdfunding sites must register with SEC and self-regulatory organization.
- Subject to ongoing SEC oversight.
- Can't handle investor funds.
- Can't advertise, solicit sales of securities, pay success compensation, etc.
- Directors, officers can't have interests in crowdfunding companies.
- Issuers can only use one crowdfunding site for an offering.

## US Regulation of Crowdfunding

### ***Other Requirements for Crowdfunding Sites***

- Provide investor disclosure regarding risks.
- Require investors to review education information, answer questions showing understanding of risks.
- Bank must hold funds until campaign targets reached.
- Have “reasonable basis” to confirm that investors don’t exceed annual limits.

## US Regulation of Crowdfunding

### ***Offering Statement*** (filed with SEC and given to investors)

- Names of directors, officers, 20% shareholders.
- Business description, including number of employees.
- Description of financial condition.
- Description of capital structure.
- Use of proceeds.
- Risk factors.
- Related-party transactions.
- Campaign target and deadline.
- Offering price.
- Progress updates.
- Amendment required if material change to previous disclosure
  - Investors must reconfirm their commitment; may back out

## US Regulation of Crowdfunding

### ***Financials***

- Requirement is based on company's total campaign targets for year:
  - If less than \$100K, must provide tax returns and financials certified by CEO.
  - If \$100K to \$500K, audited financials not required; but financials must be "reviewed" by CPA.
  - If over \$500K, financials must be audited.
    - Indiegogo: "a massive dealbreaker".

## US Regulation of Crowdfunding

### ***Background checks***

- Officers, directors
- Major stockholders (20%)

## US Regulation of Crowdfunding

### ***Ongoing Reporting***

- Must file financial statements annually with SEC and post on company website.
  - Competitors may view.
- No quarterly or extraordinary event reporting required.
- Companies don't need to count crowdfunding investors in number of shareholders that triggers extensive ongoing reporting requirements.

## US Regulation of Crowdfunding

### ***Civil Liability***

- Crowdfunding investors may sue companies *and directors/officers* if “material misstatement or omission” in disclosure about the crowdfunding financing.
  - May be based on written or oral statements.
  - Defense: did not have knowledge of misstatement or omission.
  - May sue for purchase price with interest.
- Potential personal liability to directors and principal officers!

## US Regulation of Crowdfunding

### ***Criminal Liability***

- Also if “material misstatement or omission” in statements about the crowdfunding financing.
- Applies to both companies and directors and principal officers.
- But requires “intent to deceive” or at least “recklessness”.

## US Regulation of Crowdfunding

### ***Eligible Companies***

- Must be US corporation or LLC.
- Use special-purpose Delaware LLC for games/campaigns?

## US Regulation of Crowdfunding

### ***Too Much Work?***

- Maybe ... but 58% of respondents in study conducted by CrowdfundIQ indicate “high interest” in early-stage investing.
- Expect 1-2 investments per year, average \$1300 each.

Source: <http://www.slideshare.net/earlyiq/crowdfundiq-benchmark-study>

# ***Crowdfunding for Accredited Investors***

***More Money, Less Work?***

## US Regulation of Crowdfunding

### ***Crowdfunding Portals for Accredited Investors***

**AngelList**



## US Regulation of Crowdfunding

### ***Crowdfunding for Accredited Investors***

- Avoid most of the crowdfunding regulations.
- Until now, site visitors could not view content until they had gone through registration wall, certifying accredited-investor status.
- Under new regulations, crowdfunding sites directed at accredited investors can show investment opportunities and other content before requiring certification.
- Expected to increase funding opportunities through these sites.

## US Regulation of Crowdfunding

### ***Crowdfunding for Accredited Investors***

No:

- Limitations on offering size (in most cases).
- Limitations on per-investor purchases.
- All-or-nothing campaign requirement.
- Legally-required background checks.
- Ongoing reporting requirements.
- Restrictions on non-US issuers.

Also, reduced risk of civil/criminal liability.

# **Strategies for Accessing Equity Crowdfunding**

## Strategies for Accessing Crowdfunding in the US

### ***Approaches***

1. Equity crowdfunding.
2. Reward crowdfunding.
3. Accredited investor crowdfunding.

## Strategies for Accessing Crowdfunding in the US

### ***Equity Crowdfunding***

- \$1 million annual limit.
  - (58 Kickstarter projects to date have raised \$1 million or more.)
- Financials (may have to be audited).
- Disclosure at time of campaign.
- Ongoing disclosure.
- SEC oversight; liability risk.

## Strategies for Accessing Crowdfunding in the US

### Equity Crowdfunding (cont'd)

#### ***Cost***

- Current Reward-Based crowdfunding site fees:
  - Kickstarter:\* 5%; Amazon Payments (required): 3-5%.
  - Indiegogo: 4% (9% if don't reach goal); payment processing: 3%.
  - RocketHub: 4% (8% if don't reach goal); payment processing: 4%.
- Audited financials.
  - "Review" of financials -- \$4,000 to \$20,000 for small/mid-sized company.
  - Audit: \$7,000 to \$50,000.

\* - (Kickstarter announced it won't be offering equity campaigns.)

## Strategies for Accessing Crowdfunding in the US

### Equity Crowdfunding (cont'd)

#### ***The Problem of Too Many Small Shareholders***

- May scare off institutional investors.
- Concerns:
  - More complicated to get stockholder approval for future rounds.
  - Small investors won't put in their share of future rounds.
  - Litigation risk.
- Administrative hassle.

## Strategies for Accessing Crowdfunding in the US

### Equity Crowdfunding (cont'd)

#### ***Structure***

- Issue new shares in the operating company.
- Set up special-purpose vehicle for the game.
- Issue partnership-type “equity” interests in profits from game.
- Non-US companies need to set up US entity.

## Strategies for Accessing Crowdfunding in the US

### Equity Crowdfunding (cont'd)

#### ***And ... you've now got shareholders!***

- Pressure to deliver short-term results?
- Expect dividends?
- Possible ability to elect board member(s).
- Secondary market for stock may create complications for equity incentives.

... and have to share profits from game.

## Strategies for Accessing Crowdfunding in the US

### Equity Crowdfunding (cont'd)

***Will the amount of new money generated by equity crowdfunding and accessible to small/medium-sized companies be enough to make all this worthwhile?***

## Strategies for Accessing Crowdfunding

### ***Reward Crowdfunding***

- Tax implications.
- No requirement of US entity; but may not be able to run campaigns on some crowdfunding sites from all countries.
- Should segregate funds; preferably establish separate company.
- Basically unregulated.

## Strategies for Accessing Crowdfunding

### Reward Crowdfunding (cont'd)

- Fees to crowdfunding site and payment processor.
- Refund right? Consider...
  - Credit card chargebacks.
  - Fraudulent pledges.
  - Inability to go forward with project; refund to contributors.

## Strategies for Accessing Crowdfunding

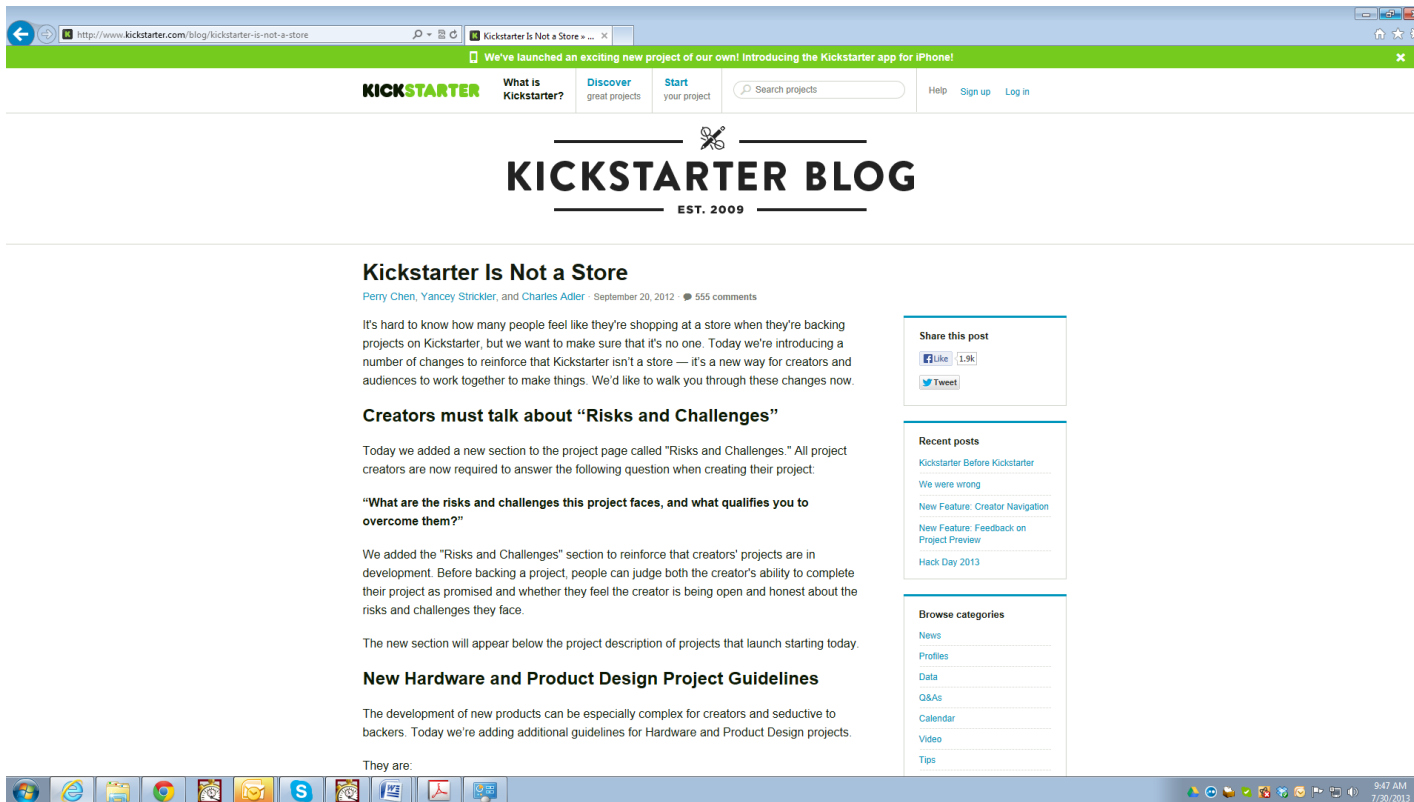
### Reward Crowdfunding (cont'd)

- Delays in delivering rewards
  - 84% of top 50 funded projects on Kickstarter ship late.
- *"Project Creators are required to fulfill all rewards of their successful fundraising campaigns or refund any Backer whose reward they do not or cannot fulfill."* Kickstarter TOU.

Sources: <http://money.cnn.com/2012/12/18/technology/innovation/kickstarter-ship-delay/index.html>

# Strategies for Accessing Crowdfunding

## Reward Crowdfunding (cont'd)



## Strategies for Accessing Crowdfunding in the US

### ***Effect of Equity Crowdfunding on Reward Crowdfunding***

- Reduce demand for reward crowdfunding?
- Increase demand for reward crowdfunding?
- Make reward backers more selective, demanding?
- Have no effect?

## Strategies for Accessing Crowdfunding in the US

### ***Accredited Investor Crowdfunding***

- No dollar limit on campaign size  
(depends on site: some may have \$5 million annual limit).
- Audited financials required.
  - But if can't obtain without "unreasonable effort or expense," then only balance sheet needs to be audited.
- Disclosure at time of campaign: Up to the company.
- Ongoing disclosure: None required legally.
- No ongoing SEC oversight.

## Strategies for Accessing Crowdfunding in the US

### Accredited Investor Crowdfunding (cont'd)

#### ***Cost***

- Crowdfunding site fees, including payment processing: 7-10% (?)
- Audited financials.
- Lawyer to prepare offering disclosure document.

## Strategies for Accessing Crowdfunding in the US

### Accredited Investor Crowdfunding (cont'd)

#### ***Strategies***

1. Fund entirely through reward crowdfunding if possible and cost-effective.
2. Fund through accredited investor portal to access larger amounts, if possible.
3. Consider parallel campaigns through accredited investor portal and general equity crowdfunding portal.
4. Fund through general equity crowdfunding portal.