Crowd Funding—A Funny Thing Happened on the Way to the Investment Bank

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Once upon a time, a budding young author, working as a porter on the railroads to support himself and his family, couldn't get any traditional media companies to publish his book. So this "rebellious" young man approached some neighbours, showed them a sample chapter and convinced them to fund publication of his book! He went on to write more and one novel attracted the attention of a motion picture production company in Los Angeles—they wanted to create a screenplay from the book and make a movie! But alas, only if he relinquished control.

What was this entrepreneurial young man to do? Well, what any creative, passionate entrepreneur might do. He started his own film production company and not surprisingly, the first project was production of a feature film based on that book. To finance the fledgling company and the production, this clever and creative young man approached many of the connections he had made as a porter working among wealthy travellers on the railroad and sold them stock in his film company for $75 to $100 a share! Over the course of his career as a writer and film maker, this rebellious young man wrote seven novels, wrote motion picture adaptations for other authors and went on to be a critically acclaimed director and producer of over 40 films.

Had this tale taken place in the 80 years between 1933 and 2013, the hero of our story, a creative genius, entrepreneur and thought provoking social commentator, would have been charged with violating the US securities laws and regulations. Raising money for entertainment and media productions or any start-up venture for that matter—while not necessarily easy—was simple before 1933. On July 10, 2013, the US Securities and Exchange Commission ("SEC") took the first step towards making it simple again. However, until the new rules came into effect, you still couldn't "invest" and businesses and other ventures still couldn't "raise capital" through equity or securities offerings through crowd funding.

Lets' start with some basics

According Wikipedia, "crowd funding" refers to the "collective effort of individuals who network and pool their money, usually via the Internet, to support efforts initiated by other people or organizations."[1] and most of you know that "crowd funding" companies and the online websites used to raise capital for startup or struggling projects or ventures arose well before the SEC's new rules were announced last year. How could this be? Well, what you may not have realised is that when it came to the use of crowd funding to raise capital, it was still not legal to solicit, offer or otherwise make available any form of securities or equity investment (I'm over-simplifying, but that is the net effect) through online, crowd or other web-based funding schemes.

To put our crowd funding discussion in context, a "security" can be described as any transaction in which money is provided to some common enterprise (e.g., business venture, film production, a worthy cause or a civic organisation) where the investor has an expectation that profits will be returned based on the efforts of others involved in the enterprise. While there are additional tests that the SEC and State courts in the United States may use, which involve risk to capital, the ability to sell or re-sell the investment (security), it is important to distinguish the investment in a "security" from a donation, gift or loan of money or the purchase of something and agreeing to pay more than it's worth, from an investment.

If you put these together, you realise that you could not raise equity funding or solicit investments through crowd funding which provided an expectation of profit or contained a risk of the loss of capital investment—in much the way the traditional stock markets function when they allow individuals to purchase and sell securities. Although international crowd funding is not the subject of this article, it is also worth noting that equity-based crowd funding has been allowed in the United Kingdom for some time already and by the end of 2013, platforms such as Crowdcube had assisted companies in raising almost $10 million. A Deloitte report published last year projected that crowd funding portals will have raised about $3 billion globally last year.[2]

Crowd funding sites almost exclusively exist on the web and their support comes from general solicitation through online and social media platforms. Consequently, the essence of crowd funding is the use of general solicitations and advertisements offering investment opportunities which, until now was incompatible with securities laws that restricted the ability to make public

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1 See *http://en.wikipedia.org/wiki/Crowdfunding* [Accessed March 10, 2014].
2 See *http://www2.deloitte.com/global/en/pages/technology-media-and-telecommunications/articles/tmt-technology-predictions-2013-crowd-funding-portals.html* [Accessed March 10, 2014].

communications to attract investors. Indeed, you couldn't advertise or offer to sale of any securities, because until recently you could only solicit and offer the investment to "accredited investors". But more on that later.

Crowd funding without equity. Much ado about nothing?

So why the buzz about crowd funding prior to the recent SEC action. Well, to some extent the operation of crowd funding platforms still provided a modicum of "power to the people" even without the sale of securities and potential profit-making investments. Even before the new rules announced by the SEC last year became effective in the United States, there already were four major categories of crowd funding activity. I'll call them the "rewards", the "pre-payment," the cause-related" and the "loan models".

- **The reward:**

  I am a musician (not really, it's just an example) and I will offer to write a song about you or anyone you choose, if you pay me $1,000. For $5,000, I'll not only write the song, but if I'm nominated for a major music award (e.g. Grammy, VMA, CMA), I'll get you two tickets to the show. Those are "rewards" for you giving me money.

- **The pre-payment or advance sale:**

  Give me $5 now and when my song is completed, but before it's released and available to the general public for $7, I will send you a copy. For fun, I might combine the pre-payment and rewards model and offer to autograph it for another $5.

- **The cause-related plea:**

  Listen, I am talented and you love good music, but I'm starving. Please just send me $10 so I can eat, rent recording studio time, try and publish and distribute my music. Pure online begging with no expectation of anything in return.

- **The loan:**

  I would like you to help finance the production of my music, my tour (I'll send you a t-shirt) by lending me some money. I promise to pay you back when I start making money—but, WITHOUT interest. There must be no expectation anyone who lends money will make a profit (interest) on the loan and while there may still be lending laws that apply to how this is done, if I don't pay you interest, it won't trigger the prohibitions under securities' laws.

By the way, while we are mainly concerned with securities laws for now, don't lose sight of the potential tax implications of raising money through crowd funding. In general, if a company receives money without any offsetting liability and it is neither a capital contribution or a gift, a tax lawyer may well advise you to include it as income. In light of the models above that are not fund raising, equity-based injections of capital the tax implications cannot be ignored and if a reward is received, a company may well need to report the income as sales income. But I will leave that to the tax lawyers and accountants.

Jumpstarting business: The United States enables equity-based crowd funding

Now back to equity based crowd funding and fast forward to 2012 in the United States. The Jumpstart Our Business Startups Act (" the JOBS Act") was signed into law in the United States on April 5, 2012 and s.201(a)(1) of the JOBS Act directed the SEC to remove the prohibition on general solicitation or general advertising for securities to accredited investors. In short, the issuer of a security can now advertise and solicit virtually anyone, so long as they still limit actual sales to individuals who are reasonably believed to be accredited investors. While there were a number of other changes and securities laws are complex (Hint: always consult a lawyer about your own specific circumstances), here is a summary of some of the important changes that apply to our crowd funding discussion.

In implementing Title II of the JOBS Act, the July 2013, SEC publication of its final rules made several important changes to the accredited investor regulations under r.506(c), which is part of reg.D of the Securities Act of 1933. An "accredited investor" is an individual with: (a) a combined net worth, excluding primary residence, in excess of US$1,000,000; or (b) an annual income of $200,000 over the previous two years ($300,000 for couples).

From a purely legal view, the JOBS Act removed the prohibition against public or general solicitations and offerings effectively creating a special kind of solicitation under the newly promulgated r.506(c), allowing general advertising and solicitation of equity fund raising and offerings. This special exemption from the general rule concerning solicitation, however, still requires that only accredited investors be purchasers of the securities. However, instead of prohibiting the offering, advertising or solicitation only to individual known to be accredited investors, the rule now allows general or public advertising so long as the issuer of the securities (equity) takes reasonable steps to verify that these individuals are, indeed, accredited before being allowed to purchase them.

Who is an "accredited investor"?

In its desire to provide a degree of flexibility and creativity, the SEC did not create specific criteria upon which this verification is to be accomplished. Consequently, the practical challenge for lawyers advising both crowd funding platforms and enterprises wishing to raise capital through the issuance and sale of equity (securities) is to meet the verification requirements in a legally defensible manner. The SEC did provide some guidance on this point which generally falls into two categories, a non-exclusive list of steps necessary for an issuer to make the verification and a rules or principle-based approach. However, a word of caution. Whatever approach is used, the obtaining of necessary information and the integrity of record-keeping necessary to document the steps taken will likely be crucial to any company needing to substantiate the reasonableness and thoroughness of its efforts in any regulatory or judicial proceeding.

Make a list; check it twice

The list-based approach is not exclusive, but it is always wise to consider guidance directly from the SEC. In this methodology, there are four mechanisms specifically identified by the SEC. First, simply verifying an individual's income using documents from the Internal Revenue Service (e.g. tax returns, partnership returns, employment income), all based on the notion that the penalties for improperly reporting or falsifying tax records is a sufficient deterrent that an issuer can reasonably rely upon these documents to verify accredited investor status. Anyone permitted to actually purchase an equity interest will have to provide at least this information over the last two years, as well as a written representation she or he expects a similar level of compensation in the current year.

Secondly, an individual can substantiate their status as an accredited investor on the basis of their net worth. In substantiating their assets, potential purchasers can submit brokerage and bank statements, evidence of holdings and appraisals. That said, the issuer must correspondingly check that individual's liabilities by obtaining credit reports from a recognised credit reporting agency and require the purchase to represent, in writing, she or he has disclosed all liabilities.

Thirdly, the issuer might also obtain explicit written confirmation of its efforts from a broker-dealer or investment advisor registered with the SEC or from an attorney or CPA.

Last, but not least, if an individual has previously invested in an offering from the same issuer (presumably the issuer has already verified the accredited investor status), then if they submit certification in writing that they remain an accredited investor, the SEC will accept that as support (but not necessarily conclusive evidence) that the individual is an accredited investor.

Evaluating investors using common cents

The principle or rules-based approach is more conceptual and the SEC has provided some criteria or factors to consider in making reasonable efforts to verify accredited investor status. The specific criteria identified by the SEC in its rules asks some basic questions: Who is the purchaser? What amount and kind of information is made available? What is the nature of the offering being made?

Thus, if information is publicly available about individuals or institutions, fewer additional steps may be required. Similarly, the availability of income tax returns, current filings with securities' authorities and other data about an individual's income, net worth, assets and liabilities—such as from high profile executives—all weigh upon a determination of what, under the circumstances, is reasonable. The nature and amount of the offering may also be a factor to consider. If the investment has a high minimum threshold or if the individual routinely invests through an investment advisor in opportunities with the same company or related companies, the additional effort required may be less than might be applicable to an unknown investor being offered participation at a relatively low level.

Bottom line, it is up to the issuer of the securities, not the purchaser or the platform, to be able to substantiate that the efforts made to determine accredited investor status were reasonable under the circumstances. It would not be beyond the realm of possibility for robust services to spring up whose sole function will be to provide verification of accredited investor status in crowd funding situations, much the same way credit reporting agencies are called upon to verify credit worthiness. Whether or not the SEC will consider that reasonable, only time and the availability of such a service, will tell.

What's next?

It is also worth noting that there is a Title III of the JOBS Act, entitled *Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure*. This part of the JOBS Act was designed to create a true, publicly available crowd funding process for the general public—non-accredited as well as accredited investors. The JOBS Act imposed a deadline upon the SEC to propose rules implementing Title III—December 31, 2012—which came and went without those rules. Not surprisingly given the complexity of the task. That said, this past October (2013), the SEC formally voted to propose those rules. In theory, Title III has noble purposes: to provide the average, smaller non-accredited investor with investment opportunities and information normally reserved for the wealthy and to give startup companies access to more capital in smaller amounts, easily raised online. Unfortunately, along with the noble purposes and good intentions are a host of potential problems that may well make this effort a quagmire and a nightmare, rather than a dream. There are on-going reporting requirements, investment limitations, and annual capital raising limitations, among other things. Many of these requirements may make the number of companies and the number of investors who will actually seek to take advantage of the opportunity smaller and the value of the opportunity itself, lower and much less attractive to everyone.

Stay tuned

In closing, let's turn back to the hero of my opening "Once upon a time" story about the young entrepreneur trying his hand at crowd funding. In 1918, Oscar Micheaux wrote *The Homesteader*, a novel dedicated to Booker T. Washington. That novel generated a fair amount of interest and led the Los Angeles based Lincoln Motion Picture Co to offer to make the book into a feature film. Micheaux insisted on being directly involved in adapting his novel to the big screen, the studio resisted and negotiations fell apart. So, with the help of investors buying stock for $100 or less, that is how the Micheaux Film and Book Co got its start and produced the feature film *The Homesteader*. While that could not have happened from 1933 until 2013, it may soon be possible again.