

It Takes a Crowd to Raise a Startup

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The recent Facebook IPO was a wake-up call in many ways. Over-hyped and overpriced, the offering is likely to have substantial implications for the IPO market generally over at least the next several months, and the hue and cry of Facebook's public investors (and plaintiffs' attorneys) may not subside for much longer than that. With that backdrop, what many people do not realize is that Facebook's *unregistered* shares had traded among a small group of select investors via the secondary markets for several years. Many of these trades resulted in large profits—for sellers and buyers—in a market that was closed to the general public. Historically, investing in startup companies has been left to wealthy friends and family of the founders, venture capital ("VC") firms and angel investors. For the most part, the general public has been restricted from making early investments in private companies until they reached the public markets and, at that point, the opportunity for meteoric growth and exponential returns has often since passed.

The passage of the Jumpstart Our Business Startups Act (the "JOBS Act") signed into law by President Obama on April 5, 2012, represents a landmark change in private company investing. Among the other changes created by the JOBS Act (for a summary of the JOBS Act, please click <http://www.manatt.com/newsletter-areas.aspx?id=186294>), Title III of the JOBS Act, the "CROWDFUND Act," authorizes "crowdfunding," as an exemption under Section 4 of the Securities Act of 1933—as amended, the "Securities Act"—which will allow certain U.S. businesses to raise equity capital from both accredited and nonaccredited investors without registration with the Securities and Exchange Commission ("SEC"). Also significant, the crowdfunding exemption preempts the application of state blue sky laws to securities issued through the crowdfunding transaction. The crowdfunding exemption will allow the general public to contribute to and share in the growth of small businesses, one of which might just be the next Facebook.

Prior to the crowdfunding exemption, absent registering the securities with the SEC (or an exemption from such registration requirements), online offers and sales of stock by small companies were generally impermissible. Under the existing private placement exemptions from the registration requirements under the Securities Act, general solicitation by the issuer is not permitted in any offering of securities. As a result, 99% of the U.S. population, otherwise not qualified as accredited investors under the Securities Act, have been effectively restricted from actively participating in these private equity markets. Even those investors that are accredited investors under the Securities Act have been effectively precluded from investing in startup companies due to lack of knowledge of or access to these companies. Instead, startups, whose funding needs exceed the capability of friends and family but do not rise to the level of the typical VC firm, have had to rely primarily on angel investors to supply them with capital, which in turn has yielded angel investors greater returns than every other asset class over the past decade. Under the existing private placement exemption from registration under the Securities Act, companies are prohibited from generally soliciting or advertising an offering of their stock unless the company has a preexisting relationship with the investors. Consequently, this significantly limited private companies' ability to raise capital.

Crowdfunding will diversify the profile of investors participating in private company offerings as well as the types of private companies that receive funding. The majority of VC and angel investments are reserved for technology-based and other high-growth companies. As a result, less than 1% of small businesses typically receive outside equity investments. In light of banks' generally tighter lending policies, the ability of these small businesses to secure adequate financing is further constrained. Crowdfunding will provide much-needed capital to a myriad of small companies that attract crowd funders' interest.

The crowdfunding exemption will allow startup companies, emerging businesses, and other small issuers to solicit investments directly from the general public and sell up to \$1 million of securities in crowdfunding transactions within a 12-month period, subject to certain restrictions, which include:

Limits on Amount Sold

The aggregate amount of securities sold to any investor pursuant to the crowdfunding exemption, as well as any other sales by the issuer to the investor within the previous 12-month period, cannot exceed:

- if the investor's annual income or net worth is less than \$100,000, the greater of \$2,000 or 5% of the investor's annual income or net worth; or
- if the investor's annual income or net worth is \$100,000 or more, 10% of the investor's annual income or net worth, but not more than \$100,000.

Required Disclosures

Section 4A(b) of the JOBS Act provides that a company offering or selling securities pursuant to the crowdfunding exemption must file with the SEC and provide the funding portal and investors with certain company information, including:

- *Purpose:* Stated purpose and use of the proceeds of the offering.
- *Target Amount:* Issuers will need to disclose a target offering amount and the deadline to reach the target offering amount. Issuers will need to provide regular updates regarding their progress in meeting the target offering amount.
- *Financial Disclosures:* Description of the financial condition of the issuer, which includes offerings that, together with all other crowdfunding offerings within the preceding 12-month period, have, in the aggregate target offering amounts of:
 - *\$100,000 or less:* income tax returns for the most recently completed year and the issuer's financial statements certified by its CEO to be true and complete in all material respects;
 - *More than \$100,000 but not more than \$500,000:* financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the SEC; and
 - *More than \$500,000:* audited financial statements.
- *Price:* Price of the securities, the method for determining the price, and the final price and all other required disclosures with a reasonable opportunity to rescind the purchase commitment.

- *Ownership & Capital Structure:* Terms of the securities and how these terms may be modified, how the securities being offered are valued, and examples for how such securities may be valued in the future depending upon certain corporate actions.

Requires Intermediary Broker or Funding Portal Registered with the SEC

Capital-raising transactions must be conducted through an intermediary or "funding portal" that is registered with the SEC and is prohibited from having any financial interest in an issuer using its service. Under Section 4A(a) of the JOBS Act, a person who acts as an intermediary must, among other things, ensure that the investors understand the risks of the investment, that each investor complies with the dollar limits described above, and that the offering proceeds are provided to the issuer only when at least the target offering amount is raised and that all investors are provided an opportunity to cancel their commitments to invest.

Offering Process Restrictions

Companies may not advertise the terms of the offering except for notices directing investors to the broker or funding portal.

Issuers may not compensate anyone, directly or indirectly, for promoting the offering through the intermediary's communication channels without taking the proper steps, which the SEC shall determine, to ensure that such promoter discloses that compensation in each promotional communication.

Issuers must also comply with such other requirements as the SEC may prescribe.

Investors may not resell securities purchased pursuant to the new exemption for one year, beginning on the date of purchase, except to the issuer, to an accredited investor, as part of an SEC-registered offering, to family members or in connection with death or divorce.

How Crowdfunding Will Impact You

The ultimate impact of the crowdfunding exemption will not be known until the SEC promulgates its final rules, but we believe this reform will have a significant effect on a number of levels.

Companies

For companies seeking to raise startup capital from a broad group of investors, the crowdfunding exemption may ultimately provide a viable alternative to current offering exemptions. With the emergence of social media and other Internet technologies, crowdfunding will provide companies with access to more potential investors at reduced transaction costs to the company. Crowdfunding transactions may also facilitate liquidity to entrepreneurs and employees who hold startup common stock. In addition, equity-based "crowdfunders" who have a vested interest in the company may be more likely to become loyal customers. Similarly, by raising crowdfunding money, a company can show that there is a real demand for its offering and validation of its product or technology.

At the same time, issuers will also need to weigh the ongoing costs that will arise with crowdfunding offerings, such as the annual reporting requirement contemplated by the

legislation. Another consideration is the potential of lawsuits from investors. Purchasers in crowdfunding offerings will be entitled to bring rescission claims against the issuer in accordance with the Securities Act provisions applicable to registered offerings. The offerings are also expressly subject to antifraud or "10b5" type liability on the part of issuers and control persons. Investors who purchase securities offered pursuant to the crowdfunding exemption would have a private right of action for rescission under Section 12(b) and Section 13 of the Securities Act for material misstatements and omissions. "Issuers" for liability purposes will include directors or partners of the issuer, the principal executive officers, principal financial officer, controller or principal accounting officer and any person who offers or sells the security in the offering. Moreover, it is not yet known how much intermediaries such as brokers and funding portals will charge issuers once SEC and SRO regulations apply to their ongoing crowdfunding operations.

Impact on Future VC and Company Transactions

The crowdfunding exemption is anticipated to significantly impact the future of VC transactions and VC-funded companies. Effects and considerations may include:

- Increases liquidity for investors and reduced transaction costs associated with selling noncontrolling interest in a private startup.
- Provides additional funding sources to allow companies to further develop and maximize their exits.
- Disclosure requirements, including the requirement to provide audited financials should the company raise more than \$500,000.
- Possible need to cash out the crowdfunding investors in order to obtain VC funding.
- Potential muting of high-powered performance incentives embedded in the VC capital structure if VCs no longer are as incentivized to monitor entrepreneurs or contribute value-added services.
- Process of obtaining stockholder approval for subsequent rounds of financing is more complicated and it is more difficult to get a large number of investors to agree to a lockup or facilitate an initial public offering.
- Reduces the possibility of misalignment of incentives between VCs and startups by providing additional funding source to allow the company to reach an exit beneficial to all stakeholders.
- Founders will not have to give up control early on to outside investors.
- Increases the value of common stock in startups by creating a market by which to value the common stock and reduces the discount price of common stock relative to preferred stock.
- Increases transparency because investors will be able to communicate directly with the company online and have access to a wide community of investors and company information.
- Increases the market size of possible investments.
- Reduces information asymmetry by providing greater access to information about startups and allows an independent evaluation of the company by the investor.

- Reduces transaction costs by lowering information costs to the buyer (e.g., illiquid markets have no mechanism through which new buyers can rely on the market prices set by other traders).
- Greater liquidity increases the possible number of startups that will receive VC funding ex ante, and this reduction to the illiquidity premium may create a new class of startups.
- Provides additional funding to potentially redeem stock of existing shareholders.

Intermediary Considerations

Brokers and potential funding portals will need to consider compliance with the applicable regulations. In particular, intermediaries will be required to provide considerable amounts of information in connection with these offerings and will play a significant role in terms of "self-regulating" these crowdfunding transactions.

Conclusion

The crowdfunding exemption, a small but significant piece of the JOBS Act, will allow the general public to contribute to and share in the growth of startups, the latent potential of which will be significant. Consider that last month, despite the long odds (1 in 176 million), Americans across the country contributed an estimated \$1.5 billion for a chance to win the Mega Millions lottery. This collective wager is seen by many as a cheap investment for the opportunity to reap a significant reward that would change the life of the winner. Imagine now what might happen if the American public had invested the nearly \$1.5 billion in something other than a distant dream, something that could not only change an individual's life but also affect the U.S. economy at large—small businesses. While the general public may have been precluded from purchasing shares in Facebook prior to its initial public offering, crowdfunding may enable them to find, fund and profit from a different sort of jackpot—"the next big thing."

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Mr. Mayo's practice focuses on a wide variety of business and transactional matters. He represents both emerging companies and venture capital investors in seed and venture capital financings (equity and debt), mergers and acquisitions, strategic partnerships and general corporate matters. Mr. Mayo also regularly works with venture capital funds assisting in fund formation matters and affiliate fund partnerships.

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