



RECENT DEVELOPMENTS UNDER THE JOBS ACT

CROWDFUNDING AND FUNDING PORTALS

Dear Clients and Jaffe Friends:

Over a year has passed since enactment of the JOBS (Jumpstart Our Business Startups) Act and its Title III provisions which affect certain “crowdfunding” offerings.¹ As we await regulations,² entrepreneurs and others interested in Crowdfunding are not sitting idle. Operators have proliferated websites constructed to host Crowdfunding offerings once the SEC issues final rules. NASAA (North American Securities Administrators Association) reported late in 2012 that it found over 8,000 websites with the word “crowdfunding” in their names. While roughly three-quarters of the sites were mere placeholders, some 2,000 had content.³ Also, entrepreneurs have initiated a few interesting financing models. Some of these claim active crowdfunding activities that take advantage of securities law exemptions and short-form registration that currently are in place. Separately, regulators have made some noteworthy pronouncements and have begun to define the line of distinction between lawful and unlawful crowd funded offerings. This **Jaffe Update** is intended to share these developments with our clients and friends who have an interest in JOBS Act Crowdfunding and capital formation.

¹ Exemptions from registration under the Securities Act of 1933 (“33 Act”) for issuers of crowdfunding offerings, and from broker-dealer registration under the Securities Exchange Act of 1934 (“34 Act”) for funding portals, were signed into law on April 5, 2012 as Title III of the JOBS Act. 112th Congress, 2d Session, HR 3606, passed by the U.S. House of Representatives on March 8, 2012, passed in the Senate with amendments to Title III (adding enhanced investor protections to the Crowdfunding exemption), and then accepted by the House on March 22, 2012.

² The JOBS Act required the SEC to promulgate regulations to implement Title III within 270 days after adoption. JOBS Act Section 302(c). Many comments, and significant discussion, have been published identifying issues that must be addressed and positions for addressing them. At the one-year testimony on JOBS Act Implementation in April 2013, the SEC reported “there is still much to be accomplished” to the House Subcommittee on Investigations, Oversight and Regulations. <http://www.sec.gov/news/testimony/2013/tso41113lnjr.htm>

³ “Crowdfunding’s on Hold. So is Crowdfunding Fraud,” *Bloomberg Businessweek*, April 4, 2013; <http://www.businessweek.com/articles/2013-04-04/crowdfundings-on-hold-dot-so-is-crowdfunding-fraud> .

The JOBS Act enables a regulatory regime whereby issuers can lawfully conduct broadly-distributed offerings of investment securities through registered brokers or through regulated on-line “funding portals”. The relevant provisions establish new exemptions from 33 Act issuer registration requirements and 34 Act broker-dealer registration requirements. **These JOBS Act Crowdfunding exemptions from registration are not available to issuers or portal operators until the SEC adopts regulations to address adequate investor protection for these types of offerings.**

What is (and isn't) JOBS ACT Crowdfunding?

The term “crowdfunding” has been applied to a number of different types of fundraising and other community support activities, so some distinctions will help to avoid further confusion. Generic “crowdfunding” or “crowdsourcing” has developed and typically exists today as:

- a practice of raising money or other contributions of property or human effort;
- in relatively small individual amounts;
- from a large number of donors (often centered in a community);
- to fund projects motivated by artistic, social, charitable or community objectives.⁴

These offerings reward contributors, if at all, with the opportunity to participate, first rights to products or services, automatic upgrades or simple gratification from contributing. The distinguishing missing element is the expectation of financial returns or legal ownership. By contrast, “equity crowdfunding” generally refers to a process whereby:

- issuers raise funds;
- from a broad base of investors;
- who invest small amounts of capital;
- in exchange for an ownership stake in a business opportunity.

While investors may be motivated to invest for social or community reasons, there also exists an expectation of financial returns.⁵

The line of distinction between these two types of activities is easily blurred in the marketplace. However, the regulatory consequences for crossing that sometimes blurry line can be expensive and can result in serious financial and enforcement exposure for issuers, promoters and intermediaries.⁶

⁴ For example, “Dutch architects fund initial phases of construction of an ambitious bridge project to join two communities in Rotterdam split by World War II.” See “No Money for infrastructure? Crowd-fund it.” http://www.thestar.com/news/world/2013/04/02/dutch_city_crowdfunds_a_bridge.html . Similarly, Kickstarter is an on-line portal established to fund and support artistic projects. <http://www.kickstarter.com> . See also, e.g., <http://www.crowdtilt.com> .

⁵ In this **Jaffe Update**, we have capitalized the word crowdfunding when referring to JOBS Act Crowdfunding to distinguish this activity from traditional, non-security crowdfunding.

⁶ The SEC has filed fraud charges against a Washington State company and its owner for falsely claiming plans to raise billions from JOBS Act offerings. “SEC Seeks to Halt Scheme Raising Investor Funds Under Guise of Jobs Act,” April 25, 2013. <http://www.sec.gov/news/press/2013/2013-73/htm> . NASAA, an organization of State

Market Developments

The principal entrepreneurial equity Crowdfunding market activities to date have been:

- The creation of websites geared to become SEC-registered intermediaries or funding portals for handling Crowdfunding offerings;
- Formation of companies and organizations separate from intermediaries to provide ancillary services to facilitate Crowdfunding offerings; and
- Companies conducting offerings through website portals in compliance with current regulations.

WEBSITE DEVELOPMENT AND ANCILLARY SERVICE PROVIDERS:

As noted above, websites have been developed with the goal of becoming SEC-registered broker-operated intermediaries or SEC-registered funding portals that will host Crowdfunding offerings when the exemptions go into effect.⁷ Some of these site operators also are developing the capacity to provide the necessary ancillary services that will be required for completing JOBS Act compliant offerings. Most of these companies consist of a website, in various stages of development, that offers funding and related ancillary services to companies in search of capital and to potential investors seeking investment opportunities. Common to all of these sites is that they seek to convey the message that “we are here, we are ready, and as soon as the regulators clarify how we may proceed, we will be funding deals.”

In addition, several new companies focus on just providing the ancillary services that issuers and intermediaries will require to effectively conduct Crowdfunding offerings, without an apparent intention of becoming a registered intermediary. Most of the ancillary service providers that are not also purporting to act as intermediaries have put up sites, but have not yet provided services to issuers or intermediaries.

The most common categories of proposed ancillary services offered to issuers and funding portals are:⁸

- Due diligence – assistance in investigating and reporting on an investee’s business elements, financial reporting and assertions (projections), legal compliance, management qualifications, market dynamics and opportunities, etc.
- Disclosure – assistance with assuring the accuracy and clarity of terms of the securities offered, business plan and financial projection assumptions (including market research), management description; etc.⁹

securities administrators, established a Task Force to search the internet for increased signs of fraud. <http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/> .

⁷ Section 302(b) of the JOBS Act requires an intermediary in a Crowdfunding offering to register with the SEC either as a broker or as a funding portal (a newly defined entity under Section 3(a)(80) of the 34 Act).

⁸ See, e.g., <http://www.initialcrowdoffering.com/> and <http://www.crowdcheck.com/> .

⁹ The JOBS Act specifies certain disclosures required of funding portals and issuers engaged in Crowdfunding offerings. See, e.g., Section 302(b), Sec. 4A(a)(3) and Sec. 4A(b)(1). In addition, JOBS Act Section 302(b), Sec.

- Investor Relations and Management – manage shareholder lists,¹⁰ enable “crowd” feedback on offerings, inter-investor communications, company information and updates, facilitate online meetings, online shareholder voting, handle payments of dividends and distributions, download stock certificates, etc.
- Other General Business Services – common business services, but geared to startups, such as insurance, accounting, legal, payroll, stock transfer, etc.¹¹

The manner in which these services are provided will have regulatory implications and it is not clear how these sites will comply with existing regulation, or whether the SEC and state regulators will carve out exemptions for their activities. For example, if a site publishes opinions from the “crowd” that compare the quality of one investment with that of others, will the site operator be subject to the registration requirements as an investment advisor or, perhaps, be subject to regulation as a rating agency?

REGULATION D COMPLIANT ACCREDITED-INVESTOR-ONLY PORTALS/OFFERINGS:

Entrepreneurs have proliferated capital formation programs (both before and since the JOBS Act was enacted) that have similarities to the type of portal-based Crowdfunding that is expected to be permitted by the final Crowdfunding regulations. These models currently are operating and likely will provide useful examples of market solutions for JOBS Act exempted Crowdfunding offerings conducted through registered brokers or funding portals.

Some portal operators in the US have set up web-based sites to match business investment opportunities with only “accredited investors” (as defined in Rule 501(a) of Regulation D promulgated under the 33 Act). If properly structured and executed, accredited-investor-only offerings qualify for issuer exemptions from the registration requirements of the 33 Act pursuant to commonly used provisions of Regulation D. These portals have a history pre-dating the JOBS Act and have become commonplace for registered broker-dealer fundraising activities.¹²

4A(c) creates a private right of action by an investor against the issuer (broadly defined to include principals) for material misstatements or omissions.

¹⁰ Commentators already have emphasized the importance of maintaining and tracking large numbers of shareholders that will result from Crowdfunding offerings. *See, e.g.*, “Keeping Track of Investors a Key Concern Regarding Crowdfunding, SEC Official Says,” Bloomberg BNA, Securities Regulation & Law Report, 45 SRLR 658, 4/15/2013, available by subscription only.

¹¹ *See, e.g.*, “Crowdfunding Insurance Coming By Way Of Baltimore Startup Asurvest,” <http://nibletz.com/2013/02/04/crowdfunding-insurance-coming-baltimore-startup-asurvest/>.

¹² Where the portal operator is registered as a broker-dealer under the 34 Act, the typical securities regulatory issues have revolved around prohibitions against general solicitation or general advertising in sourcing investors. *See, e.g.*, Rule 502(c) of Regulation D. Title II of the JOBS Act, Section 201, added a new Rule 506(c) in Regulation D which permits general solicitation in Regulation D accredited investor only offerings. While the provision eliminating the prohibition is effective law, issuers and intermediaries have been reluctant to expand solicitation activities until the SEC promulgates JOBS Act implementation regulations clarifying the extent of effort required to comply with the Rule 506(c) requirement that the issuer take reasonable steps to verify that purchasers are accredited investors. Developments with Rule 506(c) are the subject of an upcoming **Jaffe Update**.

Two recent SEC no-action letters have confirmed that the operators of “Y-Combinator” funds (essentially, on-line venture capital funding portals) need not register as broker-dealers so long as they are not compensated for raising money and observe other restrictive practices.¹³ Unlike fully-funded VC funds, these funding portals connect investors to individual early-stage business investment opportunities, which in turn only receive funding if there is enough investor commitment to close the offering. By seeking investment only from accredited investors, these offerings claim exemption from 33 Act registration under Reg D (typically Rule 506). Employing the accepted regime of pre-qualifying investors as accredited before permitting them to view the offering information averts the general solicitation prohibition of Rule 502(b).¹⁴ These operators also must comply with, or establish exemption from, 34 Act registration as brokers or investment advisors.

Following are some examples of sites that appear to be operating in the US under the Reg D compliant, accredited investor only regime:

AngelList -- <https://angel.co/> -- startup ventures.

FundersClub -- <https://thefundersclub.com/> -- startup ventures

Micro Ventures -- <http://www.microventures.com/> -- startup ventures

Mosaic -- <https://joinmosaic.com/> -- sells notes to fund small, clean energy projects.

A careful review of these sites, and the related SEC no action letters (where present), can provide a useful guideline to operators seeking to establish funding sites that can actively conduct issuer offerings marketed exclusively to accredited investors. Further, we expect that these operators will take on Crowdfunding offerings and will become, or will establish “sister sites” to become, registered intermediaries or funding portals when the regulations issue.

OTHER WEB-BASED PORTALS/OFFERINGS:

Some other “one-off” models have emerged in the US that incorporate some or all of the characteristics generally associated with equity crowdfunding. One model being used to fund community-based real estate projects is FundRise.¹⁵ FundRise was founded by second-generation, experienced real estate developers and facilitates development and funding of small real estate-based business opportunities. An interesting example project is Fundrise 906 H Street NE LLC. Fundrise arranged to fund acquisition costs and expenses of approximately \$1.5 million through private investment, compliant with current exemptions from registration, and loans. It now plans to raise \$350,000 from community investors in amounts as small as \$100 to

¹³ See AngelList and FundersClub SEC no action letters referenced in Regulatory Pronouncements below.

¹⁴ IPOnet, SEC No-Action Letter (July 26, 1996). The Staff found that this internet matchmaking network arrangement did not constitute general solicitation or advertising on the principle there was a substantive, pre-existing relationship between the portal and prospective investors. IPOnet’s website allowed prospective investors to register with IPOnet as an accredited investor only after completing a detailed investor questionnaire to verify status as an accredited investor under Rule 501(a) of Reg D. After accredited status was confirmed, the prospective investor would obtain a password allowing access to pages with specific offerings.

¹⁵ <https://www.fundrise.com/> .

help defray nearly \$1 million in development costs. The offering is being conducted through a Regulation A (a simplified registration for public offerings of less than \$5 million), SEC-registered offering coordinated with State regulators in Virginia and DC.¹⁶ Fundrise’s website claims several closed financings that have either relied on Reg D compliant accredited-investor-only exemptions or have been completed in accordance with Regulation A.¹⁷

A thorough search will reveal numerous other sites that claim to be funding companies or projects with crowdfunding features.¹⁸ Viewers will note that many of these crowdfunding sites are not based in the US and therefore may be subject to a different regulatory framework. Also, despite claims of regulatory compliance, US sites should not be mimicked or used as models unless they are first vetted by competent securities counsel for full conformity to applicable regulations.

Regulatory Statements:

While we have not yet seen enabling regulations from the SEC, regulators have made several important statements on Crowdfunding issues since enactment of the JOBS Act. In addition to statements and rulings from SEC Commissioners and staff, FINRA has taken several initiatives that add clarity to how they will approach their role in regulating registered broker intermediaries and funding portals. The important coordination and enforcement roles of State regulators has evoked suggestions from NASAA on Crowdfunding issues that cause the greatest concern, and likely will bring further regulatory focus from the States’ perspective. Some key pronouncements are referenced below:

SEC PRONOUNCEMENTS:

- 4/25/2013 – SEC seeks to Halt Scheme Raising Investor Funds Under Guise of JOBS Act – complaint against Daniel F. Peterson and USA Real Estate Fund 1 – <http://www.sec.gov/litigation/litreleases/2013/lr22685.htm>
- 4/16/2013 – SEC Commissioner Luis A. Aguilar cautions against weakening investor protections in a speech before the North American Securities Administrators Association – <http://www.sec.gov/news/speech/2013/spch041613laa.htm>
- 4/11/2013 – House Republicans press SEC on implementing JOBS Act provisions -- <http://www.reuters.com/article/2013/04/11/us-sec-jobsact/idUSBRE93A0JB20130411>

¹⁶ A copy of the Registration statement and other information is available on Fundrise’s website or from the SEC’s EDGAR database. <https://fundrise.com/offerings/3/view> or <http://www.sec.gov> .

¹⁷ Title IV of the JOBS Act establishes a new exemption (33 Act §3(b)(2)), dubbed “Reg A +” for offerings of up to \$50 million registered pursuant to a simplified registration regime similar to the current Regulation A. Implementation of Reg A+ awaits SEC regulations and will be discussed in a future **Jaffe Update**.

¹⁸ For example, one list compares features of both “non-investment-based” crowdfunding sites and equity-based funding sites. Wikipedia -- http://en.wikipedia.org/wiki/Comparison_of_crowd_funding_services/ .

- 3/28/2013 -- SEC no action position on broker-dealer registration of AngelList --
<http://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf>
- 3/26/2013 – SEC no action position on broker-dealer registration of FundersClub --
<http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf>
- 3/11/2013 – Newly confirmed SEC Chair Mary Jo White lists completion and publication of final JOBS Act and Dodd-Frank regulations among top SEC priorities -
<http://crowdfundingpr.wordpress.com/2013/03/11/mary-jo-white-senate-hearing-testimony-lists-jobs-act-crowdfunding-rules-as-1st-on-sec-agenda/>

FINRA PRONOUNCEMENTS:

- 4/5/2013 – FINRA to apply manipulation standards and other usual tools to crowdfunding portals – Comments of Robert Colby, FINRA Chief Legal Officer, to subcommittee meeting at the American Bar Association’s Business Law Section Spring Meeting in Washington, D.C. –available from BNA by subscription only
- 3/14/2013 – Richard G. Ketchum, Chmn and CEO of FINRA addresses Consumer Federation of America on investor protection and market integrity –
<http://www.finra.org/newsroom/speeches/ketchum/p222651>
- 1/10/2013 – FINRA issues voluntary interim form for crowdfunding portals –
<http://www.finra.org/newsroom/newsreleases/2013/p197636>

NASAA PRONOUNCEMENTS:

- 4/16/2013 – NASAA President urges private right of investors to sue in Crowdfunding offerings -
<http://www.nasaa.org/22565/nasaa-president-heath-abshures-remarks-at-nasaa-sec-19d-conference/>
- 12/5/2012 – NASAA Sees Sharp Spike in Crowdfunding Presence on the Internet –
<http://www.nasaa.org/18951/nasaa-sees-sharp-spike-in-crowdfunding-presence-on-the-internet/>
- 5/24/2012 – CFIRA Unveils Anti-Fraud Initiative for Crowdfunding, and Invites NASAA to Participate in Advocacy Efforts – <http://www.cfira.org/?p=223>
- 5/23/2012 – CFIRA Responds to NASAA’s Crowdfunding Concerns and Invites NASAA to Participate in Advocacy Efforts - <http://thesoholoft.com/2012/05/30/cfira-responds-to-nasaa%E2%80%99s-crowdfunding-concerns-and-invites-nasaa-to-participate-in-advocacy-efforts/>

Takeaway:

All of the Crowdfunding activity since enactment of the JOBS Act has come from portal operators and ancillary service providers getting ready to facilitate offerings once regulations are in place. The human and financial capital invested in this effort has produced little in the way of job creation and less in “jumpstarted” businesses. This experience has become a poster child for the notion that business abhors nothing more than uncertainty. At the minimum, investors in these sites have seen their potential returns pushed out for more than a year.

Notwithstanding the limbo in Crowdfunding activity, issuers and sites that actually have conducted and completed offerings seem to have pursued the better course to developing successful Crowdfunding platforms. While they have had to comply with the current regulatory scheme, FundRise, AngelList and FoundersClub and other similar sites have been building their web formats, services and procedures, while creating some fee revenue to defray investment costs.¹⁹ The practical experience gained from executing offerings likely will prove as important as the revenue generated from completing deals on these sites. These benefits include:

- Working out the bugs in site functionality;
- Learning to deal with a variety of interactions with investors;
- Managing issuer disclosures and regulatory compliance; and
- Coordinating and improving ancillary services.

The SEC certainly is feeling the pressure to complete and issue Crowdfunding regulations. However, predicting the date these regulations will issue is fools’ gold. There is a path to developing and improving Crowdfunding platforms that truly can be as ready as possible for operation when the regulations issue. The pragmatic takeaway for would-be operators is simple – build sites to lawfully conduct offerings compliant with current regulations. At the same time, incorporate as many of the generally expected Crowdfunding features as lawfully possible. Develop, or establish alliances with other providers to develop, the critical ancillary services the Crowdfunding sites (or other servicers) will have to provide. Entrepreneurs who follow this path are likely to have a market lead over the many sites lined up and waiting in the wings. More importantly, their developments and market-based refinements are likely to inform and lead the detailed features of solutions acceptable to regulators and markets. As usually is the case, active and successful market players will play a large role in the development of the ultimate, acceptable Crowdfunding regulatory regime.

¹⁹ It’s likely that these offerings have borne the higher legal and other costs of complying with current regulation. But as this has been the go-to option available for capital formation for small businesses, the higher agency costs have to be accepted to get an equity financing completed lawfully.

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