“WHAT STARTUPS NEED TO KNOW ABOUT ABOUT CROWDFUNDING ”

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Materials Written By:

Nicholas J. Bakatsias, JD, LL.M.
Carruthers & Roth, P.A.
P.O. Box 540
Greensboro, NC 27402
(336) 379-8651
njb@crlaw.com

I. Introduction.

Crowdfunding involves raising money in relatively small increments from a large number of people through the use of the internet and social media platforms. This capital-raising phenomenon is expanding at an explosive rate in the global economy, and many market experts predict it will only continue to grow following the SEC's adoption of the JOBS Act crowdfunding regulations on October 30, 2015 that will permit companies to sell their securities to a broader pool of investors. "There is a great deal of enthusiasm in the marketplace for crowdfunding, and I believe these rules and proposed amendments provide smaller companies with innovative ways to raise capital and give investors the protections they need," said SEC Chair Mary Jo White. "With these rules, the Commission has completed all of the major rulemaking mandated under the JOBS Act."

More than $16.2 billion in capital was procured around the world in 2014 as a result of crowdfunding efforts - which more than doubled the capital raised in the previous year ($6.1 billion). Startup companies are increasingly utilizing this platform to secure the seed money necessary to launch their products. For instance, the creators of the Pebble smartwatch attracted more than $1 million in just over 24 hours on Kickstarter, on its way to a $10 million capital raise during its first crowdfunding campaign. The second crowdfunding launch for this consumer product raised over $20 million.

Using a streamlined approach to reach prospective investors by leveraging the power of the internet is attractive to many startup entrepreneurs in need of non-traditional sources of funding, especially when bank financing isn't available. Crowdfunding also provides business the opportunity to "test the waters" and gauge the potential market demand for a new concept before undertaking the additional expense associated with a full blown product launch (e.g., research and development costs, marketing expenses, etc.). In the event the test is successful in terms of projected market demand for the product, the company will then have an established customer base waiting once the product is fully launched.

The concept of "crowdfunding" has become increasingly popular in the capital-raising world, yet the phenomenon seems to have different meanings to different people. Given the buzz and excitement the crowdfunding concept has generated in recent months, it is important to understand what exactly crowdfunding is, and equally as important, what it isn't. As mentioned above, crowdfunding is a capital-raising process that relies on the internet and other social media to attract potential investment, typically in smaller amounts but from a large number of people. This vehicle of raising capital is particularly attractive to small startup businesses who may not have access to traditional capital markets or the resources to engage in venture capital fundraising endeavors.

Perhaps contributing to the confusion as to what exactly constitutes "crowdfunding", there are various types of "crowdfunding" models that have emerged in recent years including, equity based crowdfunding, donation/reward based crowdfunding, intrastate crowdfunding, and "accredited investor" crowdfunding. This paper will examine the various crowdfunding models and the benefits and drawbacks inherent in each such model.

II. What is Crowdfunding?

A. Overview of the JOBS Act

In an effort to spur job growth by easing the registration requirements for capital deprived companies, Congress passed the aptly named "Jumpstart Our Businesses Startups Act" ("JOBS Act") on April 5, 2012, a culmination of year long bipartisan efforts from both houses of Congress.[1] The legislative objective was to facilitate access to capital for small and medium size companies by creating a new regulated market for crowdfunding ventures and by reducing onerous regulatory reporting requirements. The hope is that the availability of a new source of investment funds, and the resulting infusion of much needed capital for private companies, would encourage the startup of new businesses and expansion of existing operations, thereby stimulating job growth.

In light of the substantial costs and burdens associated with the public sale of securities (including expensive SEC registration process, extensive filing requirements and ongoing SEC reporting obligations), most capital-seeking companies attempt to qualify for exemption from registration. However, prior to the SEC's recent adoption of the final rules required for implementation of key components of the JOBS Act, issuers seeking to attract capital through a private offering of securities faced various restrictions with respect to the manner in which those securities could be offered. Primarily, issuers were hampered in their ability to reach the large pool of potentially interested investors due to the prohibition on general solicitation and general advertising in private securities offerings.

Accordingly, many financial market participants welcomed the passage of the JOBS Act and its design to enhance the ability of entrepreneurs and private equity funds to raise capital by reducing barriers to investor solicitation. Among the new provisions enacted to enhance the economic impact of securities offerings generally, several significant changes focused primarily on reducing the burdens of private offerings exempt from SEC registration, including lifting the prohibition against general solicitations of potential investors, creating a new "Crowdfunding" exemption to expand the pool of eligible investors in limited offerings, and raising the holder-of-record threshold for registration under the Securities Act of 1934.

Since the promulgation of the JOBS Act, several key updates and implementing rules have been adopted by the SEC which are likely to materially impact the manner in which issuers seek to raise capital - particularly through the increased use of various crowdfunding vehicles as described below.

B. Rewards-Based Crowdfunding

There are three basic types of crowdfunding currently trending in the marketplace: rewards-based crowdfunding, donation-based crowdfunding and equity-based crowdfunding.

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[1] The JOBS Act, H.R. 3606, passed in the House of Representatives on March 8, 2012, and the Senate passed H.R. 3606 with an amendment to the crowdfunding exemption on March 22, 2012. The Senate's amendment was approved by the House of Representatives on March 27, 2013.

Reward-based crowdfunding involves an individual or company offering perks or rewards, such as merchandise, personal experiences, products, etc., to supporters in exchange for pledging funds in order to develop a project or concept. The projects range from service-based concepts, such as restaurants, to creative art initiatives such as independent films or documentaries, to consumer products, such as fit-bit watches and clothing lines. Instead of raising capital in exchange for a the possibility of earning an investment return through ownership of an economic interest in a business, these crowdfunders typically provide their supporters various recognition items or gifts (e.g., music downloads, tickets, calendars, etc.) in exchange for monetary contributions.

Project creators use platforms like Kickstarter and Indiegogo to solicit contributions and typically must meet a capital raise target within a certain period of time in order to realize the funds. In other words, if the campaign fails to attract sufficient funds to meet the target raise, the creators receive no funds and their supporters are not charged the pledged amount. However, if sufficient funds are pledged to meet the targeted threshold amount, the crowdfunding platform will collect the funds and deliver to the creator after deducting a platform service fee. For example, Kickstarter assesses a fee equal to 5% of the funds raised and collects fees of 3%-5% for its payment processors.

C. <u>Donation-Based Crowdfunding</u>.

A second form of crowdfunding is more charitable in nature and is referred to as donation-based crowdfunding. Sites such as GoFundMe and CaringBridge allow individuals, non-profit entities and other groups to raise money for most charitable purposes, including for payment of medical bills, natural disaster recovery funds, or sending school groups to competitions. A few of these donation-based crowdfunding sites charge the organizers a fee based on a percentage of the amount collected, while others (such as YouCaring) do not charge a fee other than that charged by payment processors. Note these donations are considered gifts and are therefore not taxable to the organizer.

D. <u>Equity-Based Crowdfunding</u>.

Equity crowdfunding involves companies selling their securities to a large number of outside investors who hope to realize a return on their investment. There are several types of equity crowdfunding. One form of equity crowdfunding was created under Title III of the JOBS Act of 2012 and was designed to create a new registration exemption under the Securities Act for issuers seeking to sell unregistered securities to the public. Until October of 2015, Title III crowdfunding was illegal as the SEC had yet to adopt the necessary implementing rules discussed below. However, following adoption of the implementing rules, Title III crowdfunding should be available in early 2016.

Another form of equity crowdfunding is colloquially known as "accredited investor crowdfunding" as only accredited investors can purchase securities offered in this form of registration exemption found in Rule 506(c) of the Securities Act. This form of crowdfunding

was also a product of the JOBS Act and has been an increasingly popular vehicle for raising capital over the last few years.

Finally, another equity crowdfunding-like vehicle that can be used by companies looking to raise capital by selling their securities was initially part of the JOBS Act and is known as Regulation A+. Like Title III crowdfunding, this registration exemption has opened up equity crowdfunding to a larger pool of investors – not just accredited investors.

The remainder of this paper will examine the various forms of equity-based crowdfunding in more detail and consider some of the tax implications associated with crowdfunding.

III. JOBS Act Title III Crowdfunding.

A significant change to the securities regulation milieu ushered in with the passage of the JOBS Act is, at least for smaller and mid-size businesses, the new "Crowdfunding" exemption which provides a platform for companies to raise small increments of capital from an unlimited number of investors without registering the securities.[2] The exemption was designed to create a new market for raising capital and can be generally thought of as a hybrid of social networking and a recognized stock exchange. By introducing Internet portals such as kickstarter.com to the capital formation process, Congress sought to facilitate the aggregation of small amounts of capital from a large pool of investors. Of particular significance is the fact that such offers can be made to unsophisticated investors as well, subject to certain limitations described below.

Capitalizing on the speed and efficiency that internet-based platforms can provide for capital seeking companies, many securities experts predict that this component of the JOBS Act will revolutionize the securities investment marketplace, especially for many startups that lack the seed capital to launch their operations. However, until recently, companies could not undertake Title III crowdfunding as the SEC had not yet adopted the rules necessary for implementation of the exemption.

On October 30, 2015, the SEC finally adopted the rules necessary for companies to sell securities through crowdfunding under Title III of the JOBS Act. The new crowdfunding rules will be effective 180 days after they are published in the Federal Register (May 16, 2016), and the forms enabling the funding portals to register with the SEC will be available January 29, 2016.

According to SEC Release 2015-249, the new crowdfunding regulations: (1) permit a company to raise a maximum aggregate amount of $1 million through crowdfunding offerings in a 12-month period; (2) permit individual investors, over a 12-month period, to invest in the aggregate across all crowdfunding offerings up to a certain amount depending on the investor's net worth and income.

[2] Title III of the JOBS Act has been codified in new Section 4(a)(6) of the Securities Act of 1933.

Codified as new Section 4(a)(6) of the 1933 Act, the "crowdfunding" exemption created under Title III of the JOBS Act is subject to the following conditions:

(i) The aggregate amount of capital that can be raised during any rolling 12-month period is limited to $1,000,000;

(ii) The maximum dollar amount that can be sold to any individual investor is limited as follows:

a. If the investor's annual income or net worth is less than $100,000, the maximum permissible investment amount is limited to the greater of $2,000 or 5% of the lesser of the investor's annual income or net worth;
b. If the investor's annual income and net worth is equal to or greater than $100,000, the maximum permissible investment amount is limited to 10% of the lesser of the investor's annual income or net worth, provided the maximum investment cannot exceed $100,000;

(iii) All sales must be facilitated through a registered broker-dealer or qualified funding portal intermediary (see restrictions on intermediaries below);

(iv) The issuer is subject to certain SEC filing requirements and intermediary and investor reporting obligations designed to disclose information about the issuer, its officers, directors, managers, and significant equity owners, the investment risks associated with the security, and certain other information (see required disclosures below);

(v) Resale of the securities is prohibited for a one-year holding period, provided that transfers to accredited investors, the issuer, purchasers in a registered offering, and pursuant to a divorce or death of the purchaser, are not subject to the one-year holding period; and

(vi) Federal preemption of blue sky laws apply (excluding antifraud statutes of the states).

1. Issuer Disclosure Requirements

Issuers conducting a crowdfunding offering must file certain information with the SEC and provide this information to prospective investors and the fundal portal which is facilitating the offering. Specifically, the JOBS Act also requires issuers to provide the following information to the SEC, investors and participating intermediaries:

(i) Name, entity type, website address and physical address of the issuer;
(ii) Names of all officers, directors, managers and 20% or more owners;
(iii) Description of the business plan and anticipated business activities;
(iv) Financial disclosures as follows:

a. If the target issue amount is less than $100,000, the issuer must provide its most recent income tax return and financial statements certified by the chief financial officer;
b. If the target issue is between $100,000 and $500,000, the issuer must provide independently reviewed financial statements;
c. If the target issue is greater than $500,000, the issuer must provide audited financial statements (subject to the exception for first-time crowdfunders as described below);

(v) Description of the expected use of the security sales proceeds;
(vi) The issue target amount, the deadline for reaching that target, and regular progress reports relative to meeting the target amount;
(vii) A written disclosure of the security price and a notice to investors alerting them of their right to rescind their purchase commitment prior to the sale;
(viii) Description of the capital structure and ownership of the issuer;
(ix) The terms of the securities;
(x) The valuation methodology used to price the securities; and
(xi) Certain other information related to the issuer.

Note that a company offering more than $500,000 (subject to the $1 million cap) of securities relying on these rules for the first time would be permitted to provide reviewed rather than audited financial statements, unless financial statements of the company are available that have been audited by an independent auditor. The final rules eased the burdens imposed by the proposed rules by exempting first time crowdfunding issuers raising over $500,000 from the requirement to provide audited financials.

In addition, companies relying on the crowdfunding exemption would be required to file an annual report with the Commission and provide it to investors.

2. Intermediary Rules and Restrictions

Under new Section 4(a)(6) of the 1933 Act and new Section 3(a)(80) of the Exchange Act, each crowdfunding intermediary must:[3]

(i) Register with the SEC as a broker or funding portal;
(ii) Register with the applicable self-regulatory organization (SRO), which is FINRA;
(iii) Take measures to ensure each investor understands the risks associated with the particular investment and with investments in startups and small business in general, and the risks of investment illiquidity, including providing educational materials relating to such topics;
(iv) Take appropriate steps to reduce fraud, including having a reasonable basis for believing that a company complies with Regulation Crowdfunding and that the company has established means to keep accurate records of securities holders;

[3] *See* Jones, Benji T., "The JOBS Act Becomes Law", Notes Bearing Interest, the North Carolina Bar Association (November 9, 2012).

(v) Within 21 days prior to the first security sale, provide the SEC and potential investors with the information required to be provided to the SEC and investors by the issuer (see above);
(vi) Restrict the issuer's access to the sales proceeds and allow investors to cancel their subscription at any time prior to reaching the target offer amount;
(vii) Take measures to protect the privacy of investor information;
(viii) Not compensate promoters or finders of potential investors;
(ix) Not provide directors or officers of the issuer with a compensatory interest in consideration of services performed;
(x) Not offer investment advice or provide investment recommendations;
(xi) Not solicit purchases or sales of the securities or compensate its employees for performing such services;
(xii) Not possess or handle investment funds;
(xiii) Provide communication channels to permit discussions about offerings on the platform;
(xiv) Provide disclosure to investors about the compensation the intermediary receives;
(xv) Accept an investment commitment from an investor only after that investor has opened an account;
(xvi) Have a reasonable basis for believing an investor complies with the investment limitations;
(xvii) Provide investors notices once they have made investment commitments and confirmations at or before completion of a transaction;
(xviii) Comply with maintenance and transmission of funds requirements; and
(xix) Comply with completion, cancellation and reconfirmation of offerings requirements.

Despite easing some of the obligations on issuers from what was required under the proposed rules, the final rules seem to be more onerous than the proposed rules as they pertain to the intermediary crowdfunding portals. For instance, the adopted rules obligate the portals to deny potentially fraudulent offerings, and preclude intermediaries from providing investment advice to investors, engaging in the offer or sale of securities, or possessing investment funds. On the other hand, the final rules do permit the investment intermediaries to receive securities from the issuer as compensation, provided those securities have the same terms as the securities being offered in the crowdfunding offering. In addition, the adopted rules allow the intermediaries to rely on the representations made by the issuers, unless they know of a reason not to rely on such representations.

3. Analysis of the New Crowdfunding Regulations

The proposed rules released two years ago were widely criticized as being too costly and complex from a compliance perspective. The rules adopted on October 30, 2015 substantially revised the proposed rules to address some of those concerns.

The new rules are also more flexible for issuers in terms of what information they must disclose to the Commission. Whereas the proposed rules required disclosure of tax returns and related information of certain principals of the issuer, the final rules adopt of Q&A disclosure

process which is easier for the issuer to complete.

Crowdfunders will be able to broadly advertise their offerings, including by posting them on portals like Kickstarter for prospective investors consider. (Kickstarter has said that it is not interested in expanding into equity crowdfunding, though its competitor, Indiegogo, said it may open up to equity crowdfunding).

Dozens of equity investment portals have sprung up in recent years, since the lift of the ban against general solicitation under Rule 506(c), but until now, only accredited investors have been allowed to take advantage of the deals advertised on them (see discussion below regarding "accredited investor crowdfunding"). The adoption of the final Title III crowdfunding rules now opens up similar opportunities to non-accredited investors. Some of the accredited investor platforms now plan to expand into the nonaccredited investor market. For example, SeedInvest, a portal that has facilitated 50 funding deals in the last three years, expects to begin offering deals next year to a wider pool of investors. According to Ryan Feit, the site's founder and CEO, "[t]here's no question that there's a lot of pent-up demand from ordinary investors. At the end of the day, that means there will be more capital available for small business."

IV. Accredited Investor Crowdfunding.

A. In General.

Two critical elements of the JOBS Act that have had a substantial impact in the private placement environment are: (1) the lift on the ban against general solicitation and advertising in Rule 506(c) offerings; and (2) increasing the holder-of-record threshold with respect to the number of investors to whom securities can be sold without registration under the 1934 Act. The synergistic effect of these two changes has ushered in a new wave of offerings by capital-seeking enterprises sometimes referred to as "accredited investor crowdfunding."

The allowance of general solicitation of accredited investors in connection with Rule 506(c) offerings will undoubtedly continue to have a substantial impact on the securities markets. At a minimum, the new 506(c) rules will open up many securities offerings to expansive forms of solicitation and advertising, including:

- Internet ads;
- Cable network advertising;
- Solicitations to a company's customer base;
- Catalogue ads;
- Facebook and Twitter ads;
- Offers to magazine subscribers or credit card account holders; and
- University alumni offers.

Significantly, securities offered under new Rule 506(c) of Regulation D qualify as "covered" securities and thus will generally avoid substantive federal and state regulation. Rule 506 offerings can be sold to an unlimited number of investors, subject to 1934 Act registration requirement for issuers with more than a certain number holders of record. Importantly, the

JOBS Act raised the holder-of-record limit for purposes of 1934 Act registration from 500 to 2,000.[4] **As a result, issuers can conduct a Rule 506(c) offering through general solicitation and widespread advertising, without registration under the Exchange Act of 1934, so long as: (i) all purchasers are "accredited investors" (or the issuer has reasonable belief they are); (ii) the issuer takes reasonable steps to verify accredited status of its investors; and (iii) the issuer has less than 2,000 holders of record following the offering.**

Consequently, the securities landscape is experiencing a wave of "crowdfunding" placements, however not in the form contemplated by Congress when it created the "Crowdfunding" exemption under Title III of the JOBS Act. Instead, the more prevalent crowdfunding exemption that has arisen has taken the shape of an **"accredited investor crowdfunding"** mechanism, as private issuers seem more inclined to attract investment capital through general solicitations and advertisements targeted at "accredited investors" so as to fall within the safe harbor of new Rule 506(c).

Part of the reason the markets will likely continue to experience a proliferation of "accredited investor crowdfunding" under Rule 506(c), in contrast to the new "Crowdfunding" exemption created under Title III of the JOBS Act, is due to the significant expenses, burdens and limitations associated with undergoing a Title III "Crowdfunding" offering. As mentioned above, the maximum aggregate offering in a Title III Crowdfunding offering is limited to $1,000,000 and the potential capital an issuer can receive from an individual investor is capped at relatively low ceilings.[5]

Another limiting attribute of the Title III Crowdfunding exemption stems from the requirement that the offering must be conducted through a regulated intermediary (broker-dealer of funding portal). Intermediaries and issuers must comply with extensive reporting and disclosure requirements to participate in Crowdfunding offerings, which will require substantial legal, accounting and intermediary fees for offerings limited to $1,000,000 in the aggregate. In addition, both issuers and intermediaries are subject to ongoing reporting obligations under Title III of the JOBS Act, which will further drive up the costs associated with such offerings.

In addition, even though the new Crowdfunding exemption is not limited to accredited investors, or subject to the 2000 record holder limitations applicable to Rule 506 offerings, most issuers will (consistent with historical trends) limit securities sales to accredited investors in order to minimize disclosure requirements since accredited investors are assumed to be sophisticated and in less need of detailed disclosures.

In summary, issuers relying on Rule 506(c) "accredited investor crowdfunding" can raise an unlimited amount capital, from an unlimited number of accredited investors (subject to

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[4] Title V of the JOBS Act amended Section 12(g)(1)(A) of the Securities Act of 1934 to increase the holder-of-record threshold to 2,000.

[5] As mentioned above, investments by investors with less than $100,000 of annual income or net worth are limited to the greater of 5% of the lesser of net worth and annual income or $2,000. With respect to investors with annual incomes exceeding $100,000, the maximum investment amount is limited to 10% of the lesser of net worth and annual income with a cap of $100,000.

registration under the 1934 Act if there are more than 2,000 equity owners), without incurring the additional expense likely to be assumed by Title III Crowdfunding issuers as a result of ongoing SEC reporting requirements, continuing dealings with funding portal intermediaries, heightened scrutiny with respect to disclosures to non-accredited investors, and the need to compensate professional advisors to ensure compliance with the cumbersome Title III Crowdfunding rules. Accordingly, the marked relaxation of investor solicitation allowed under new Rule 506(c), coupled with the flexibility to have up to 2,000 investors, will arguably make 506(c) offerings the preferred vehicle for issuers planning to undertake a private offering of its securities through crowdfunding.

Let's take a closer look at the rules applicable to Rule 506(c) offerings.

B. Rule 506(b) Exemption.

Prior to the creation of the Rule 506(c) exemption under the JOBS Act (discussed below), the registration exemption allowed under Rule 506(b)[6] was widely deemed to be the most attractive and often used safe harbor for small companies, mostly due to the limited blue sky law compliance required as a result of federal preemption under the National Securities Markets Improvements Act of 1996 (NSMIA). The federal preemption of state registration of offerings made under Rule 506 of Regulation D stripped much of the regulatory review authority of state securities regulators who, to that point, had routinely policed questionable offering practices. In addition, the exemption available under Rule 506(b) permits a capital-seeking company the flexibility to sell its securities to an unlimited number of accredited investors and up to 35 non-accredited investors.

The exemption allowed under Rule 506(b) requires that non-accredited purchasers (or their purchaser representative) must have sufficient knowledge and expertise in financial and business matters to evaluate the merits and risks of the prospective investment.[7] In addition, there is currently a prohibition against general solicitations under Rule 506(b), but this restriction is not applicable to offerings conducted pursuant to new Rule 506(c) following the enactment of the JOBS Act. Note that, despite the creation of the Rule 506(c) safe harbor, Rule 506(b) is still an available option for private issuers.

C. New Rule 506(c) Safe Harbor

Despite the ban on engaging in general solicitations, the Rule 506 exemption (now re-codified as Rule 506(b)) has been the most attractive safe harbor for issuers seeking to avoid the costs and burdens associated with securities registration due to its flexibility and preemption of state registration laws. In a move that has materially increased the attractiveness of Rule 506 offerings, the JOBS Act mandated that the SEC adopt rules allowing general solicitations and advertisements in connection with Rule 506 offerings, provided that all purchasers qualify as "accredited investors." The new 506(c) exemption became effective on September 23, 2013.

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[6] Formerly referred to as Rule 506 prior to the adoption of Rule 506(c).

[7] 506(b)(2) under the Securities Act, 17 C.F.R. § 230.506(b)(2).

The new Rule 506(c) safe harbor contains elements and advantages similar to the 506(b) exemption from SEC registration. For instance, in both a 506(b) and 506(c) private placement, the issuer can raise an unlimited amount of capital from a large number of investors. However, in a divergence from the requirements of Rule 506(b), issuers relying on Rule 506(c) can now reach a larger pool of potential investors by engaging in general solicitation and advertising communications that previously were prohibited as long as certain conditions are satisfied:

- (i) the issuer takes "reasonable steps" to verify each purchaser is an accredited investor;
- (ii) at the time of sale of the securities, all purchasers are in fact accredited investors or the issuer reasonably believes that they are accredited; and
- (iii) the requirements of Rule 501, Rule 502(a) and Rule 502(d) of Regulation D are satisfied.

It is significant to note that a purchaser who does not actually qualify as an accredited investor will not undermine the availability of 506(c), provided that the issuer took reasonable steps to verify accredited investor status and the issuer had reasonable belief that all such purchasers were accredited at the time of sale. On the flip side, the fact that all purchasers are in fact accredited will not relieve the issuer of its obligation to undertake the accredited investor verification process.

1. Reasonable Steps to Verify Accredited Investor Status

An issuer relying on the registration exemption created under new Rule 506(c) is permitted to engage in broad-based general solicitations, even if it has no information on the financial status of the investors, provided the issuer (i) has reasonable belief of accredited investor status and (ii) has taken reasonable steps to verify the same with respect to actual *purchasers* of its securities. Instead of requiring adherence to rigid verification procedures, the SEC chose to adopt a more flexible "principles based" regime, to be evaluated using a sliding-scale approach, in determining whether the issuer has taken the necessary "reasonable steps" to verify accreditation. As articulated by the SEC, the sliding-scale approach means "the more likely it appears that a purchaser qualifies as accredited, the fewer steps the issuer would have to take to verify accredited investor status, and vice-versa."[8]

Under this principles based approach, the SEC identified the following factors that should be analyzed by the issuer in conducting its verification process:

(i) the nature of the purchaser and the type of accredited investor involved;
(ii) the amount and type of information the issuer has with respect to the prospective purchaser; and
(iii) the nature and terms of the offering.

Essentially, the principles-based methodology implicates an objective determination that a purchaser is accredited under all the facts and circumstances.

[8] SEC Release No. 33-9415

The SEC has indicated that relying on an investor to "check the box" as to their accredited status, without more, will not satisfy the verification requirement. In addition, issuers are encouraged to retain information relevant to the verification process in order to demonstrate the reasonableness of its verification procedures. Finally, as with the other exemption amendments under the JOBS Act, the relaxation on general solicitations in Rule 506 offerings would not be effective until the SEC issued implementing rules and regulations, which finally transpired on July 22, 2013.

2. Nature of the Purchaser.

If the prospective investor is an individual, the purchaser would likely need to provide the issuer information about his or her net worth or income in order for the issuer to credibly analyze accreditation status. Note that some individuals may be hesitant to provide such financial disclosures due to concerns over privacy, especially if the issuer does not engage a third party intermediary to conduct the verification process. In light of the high failure rate of may startup businesses, investors may be concerned about what will happen to their confidential financial information in the event the startup closes its doors.

3. Amount and Type of Information the Issuer has about the Purchaser.

Obviously, the more information the issuer has regarding the accredited investor status of the potential investor, the fewer steps it will need to take to fulfill the verification requirement. The SEC indicated the following types of information would be relevant in the analysis: (i) information included in public filings (such as compensation disclosed in a proxy statement), (ii) reliable independent third party information (such as industry publications that provide the average compensation received by those in employment positions similar to the prospective purchaser), and (iii) other information produced by a third party whom the issuer engaged to determine the accredited investor status of the purchaser.

4. Nature and Terms of Offering.

The SEC also indicated that the means through which the issuer communicates to prospective investors is also relevant in determining whether the issuer satisfied its reasonable verification obligations.[9] The broader and more extensive the general solicitation/advertising is (e.g., through a website open to the public or through mass mailings), the more steps that must be taken to verify accredited investor status. As mentioned above, simply permitting the investor to "check a box" representing accredited investor status will not be sufficient according to the SEC.[10] With respect to the terms of the offering, fewer verification measures will be required where the minimum investment requirements are more substantial, provided the issuer is reasonably satisfied that third-party financing will not fund the purchaser's ability to satisfy the minimum subscription expenses.

[9] SEC Release No. 33-9415.
[10] *Id.*

Providing additional guidance to the principles-based approach described by the SEC where there are not sufficient principles-based factors present, the Commission also articulated four non-exclusive methods for verifying whether individual prospective investors qualify as accredited investors. The non-exclusive methods include:

> (i) when predicated on income levels, a review of applicable IRS forms related to the two most recent years that evidence the requisite income levels necessary for accreditation, coupled with a written representation stating the investor reasonably expects to qualify as an accredited investor in the coming year;
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> (ii) if based on net worth, a review of relevant financial documents stating assets and liabilities (such as bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, appraisal reports, and consumer credit reports issued by one of the nationwide consumer reporting agencies) dated within the last three months, coupled with a written representation that all liabilities of the investor have been disclosed;
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> (iii) if based on the written verification from a qualified independent third party (such as a licensed attorney, certified public accountant, a registered broker-dealer or investment advisor, etc.), a written acknowledgment that such third party has taken reasonable steps within the last three months to verify the investor has met the accredited investor criteria; and
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> (iv) if relying on the prospective purchaser's previous participation in a 506(b) offering conducted by the issuer prior to the enactment of Rule 506(c) who remains an investor in such issuer, a written certification by such investor that he or she is still an accredited investor.

Importantly, while these verification options are not the exclusive methods for satisfying the purchaser verification requirements of Rule 506(c), the SEC has indicated they will constitute safe harbors for compliance absent any actual knowledge of the issuer that the particular investor is not in fact accredited. In addition, in light of the burden imposed on issuers to prove reasonable steps to verify accreditation have been taken, issuers should ensure proper recordkeeping of all documents germane to such analysis (e.g., copies of the PPM, solicitation materials, copies of investor qualification documents, documents demonstrating reasonable steps to verify were taken, copies of completed subscription documents, participating broker certification statements, etc.).

Finally, it is important to remember that the verification prong is a separate and independent condition from that requiring that the issuer has "reasonable belief" that all investors meet Rule 501's definition of an accredited investor – both prongs must be satisfied when relying on Rule 506(c). Accordingly, if all of the purchasers actually constitute accredited investors, the safe harbor will not be available if the issuer does not take reasonable steps to verify the same (unless the issuer has actual knowledge of accredited investor status). On the other hand, an issuer who does not engage in general solicitation efforts will only need to demonstrate the issuer had a reasonable belief that the purchaser is accredited.

D. Advantages of New Rule 506(c)

The creation of a new registration exemption under Rule 506(c) has many advantages for issuers who wish to engage in general solicitations and advertising in order to attract investment capital from a larger pool of potential purchasers. Obviously, the ability to broaden the potential investment base by advertising to prospective investors whom otherwise would not have known about the issuer will be very attractive to issuers. In addition, similar to Rule 506(b) offerings, private offerings made pursuant to new Rule 506(c) require only "notice filings" to SEC and the states – no requirement to file private placement memoranda and other offering materials with the SEC or the state (pursuant to NSMIA).[11]

Further, no specific disclosures from the issuer will be required if the offering is limited to "accredited investors" - which is required to engage in general solicitations under 506(c) anyway. This flexibility leaves the decision to the issuer's discretion as to what information to disclose in order to provide full disclosure and avoid anti-fraud liability.[12]

Significantly, disgruntled investors cannot sue for negligent misrepresentation (i.e., lack of due care) under federal securities laws due to the Supreme Court decision in Gustafson v. Alloyd,[13] which held that the Section 12(a)(2) liability provisions of the 1933 Act do not apply to private securities sales. Investors can only assert federal claims under Section 10(b) and Rule 10b-5 of the 1934 Act which requires that **actual intent to defraud** (scienter) or reckless indifference to the accuracy of the representations made in the offering must be proven by the plaintiff. Practically speaking, it is very difficult to meet that standard since it is based on intent. While dissatisfied investors can still assert various state law claims, the *Gustafson* decision made it extremely difficult for investors to win in a properly conducted Rule 506 offering.

E. Models of "Accredited Investor Crowdfunding"

Since the ban against general solicitation was lifted by the SEC on September 23, 2013, the securities environment has seen an increase in the formation of "accredited crowdfunding" platforms in connection with Rule 506(c) private offerings. These third party intermediaries provide capital-seeking companies the attractive possibility of procuring private investment from accredited investors with the click of a mouse. In light of the tremendous opportunities general solicitation now allows companies in search of capital, we are likely to see a proliferation of these "accredited crowdfunding" internet platforms continue to emerge as this new industry evolves from its infancy stage.

In addition to the increasing number of accredited investor crowdfunding platforms being launched on a daily basis, there are several types of internet platforms that have emerged as well, some of which may be more attractive to capital-seeking companies depending on such factors such as the regulatory scheme applicable to such platforms, the fee structures involved, the

[11] Note FINRA requires participating broker-dealers to file copies of PPMs within 15 days of the date of sale, but these filings are only notice filings
[12] SEC Rule 502(b)(1)
[13] 513 U.S. 561 (1995)

industry focus of the platforms, the management structure and financial recourses of the platforms, and the amount of website traffic they can provide.

1. <u>"Venture Capital" Crowdfunding Model</u>

One type of accredited crowdfunding platform that has grown in popularity is the "venture capital fund" or "private fund adviser" model. These platforms typically pool the investment capital they receive from accredited investors and subsequently invest in the various companies registered on the platform, similar to investment clubs. Essentially, under this model, the platform serves as an investment advisor to the pooled capital private fund and charges a performance-based fee contingent on the profits of the fund as determined by the success of the companies in which the fund invests. The platform itself (or a major angel investor involved with the fund) may provide strategic business advice and other resources to the companies which comprise the fund's portfolio. Thus, the "Venture Capital" model allows issuers to receive advice/vetting from professional advisers that choose to include their securities in diversified funds offered to accredited investors.

In addition, having only one investor should significant curtail many of the logistical and administrative hurdles an issuer may otherwise face when raising capital, thereby allowing it to maintain focus on operating the actual business of the company. However, the "single investor" fund may demand greater veto power and managerial control with respect to the company's business operations, which may not be ideal for the issuer's principals. Further, the issuing companies should remember that the platform's overarching interest may support accelerated investment returns and liquidity which could pressure the issuer into an earlier exit strategy.

Significantly, through its response in the *AngelList* and *FundersClub* No Action Letters discussed below, the SEC permitted these venture capital fund advisers to use internet-based platforms to facilitate investments and receive incentive compensation and reimbursement of expenses *without* requiring broker-dealer registration. It is important to keep in mind that the Investment Company Act of 1940 essentially limits the number of investors in such funds to 100 investors before registration is required, but the no-action letters are significant for these venture-capital crowdfunding platforms who stay within such parameters.

2. <u>"Broker-Dealer" Crowdfunding Model</u>

Another type of accredited investor crowdfunding platform is known as a "broker-dealer" platform as these platforms are owned and/or operated by registered broker-dealers. As opposed to aggregating the capital raised into a pool of investment funds, these platforms effect sales of the issuer's securities directly to accredited investors in exchange for transaction-based compensation. Typically, the compensation received will be calculated as a percentage (usually in the 3%-10% range) of the funds raised from accredited investors. One potential drawback of this model of accredited investor solicitation is that the issuer may ultimately end up with a substantial number of individual equity owners to whom fiduciary and management responsibilities may be owed.

3. <u>"Subscription-Based" Crowdfunding Model</u>

A third type of accredited investor platform is characterized as "subscription based" platforms as they charge capital-seeking companies flat monthly fees in order to list the securities on the platform's website. These platforms typically offer the companies a number of service options such as business plan advice or access to robust software, but generally do not raise to the level of broker-dealer activity and thus do not register as such. The platform offers an environment where accredited investors and equity-seeking companies can connect and negotiate the terms of investment without the platform's involvement. Obviously, companies utilizing subscription-based platforms must be prepared to allocate time and resources to attracting and negotiating the terms of investment with the platform's subscribed accredited investors.

4. "Do It Yourself" Crowdfunding Model

Despite the proliferation of these crowdfunding platforms, some issuers elect to generally solicit investors and advertise through their own website without the use of a third party intermediary. While this approach may save costs in terms of third party fees paid, the issuer must be prepared to devote sufficient resources and time to the accredited investor verification process required by Rule 506(c). The SEC has already flatly stated that simply having a prospective investor "check the box" as to their accreditation will not be sufficient to satisfy the "reasonable belief" threshold required in order to satisfy the safe harbor. The verification process may involve reviewing financial statements, tax returns, business records, etc., which will undoubtedly be a time-consuming and fact-intensive undertaking.

For that reason, many capital seeking companies have chosen to outsource those responsibilities to third party platforms and simply pay the attendant fee or other compensation required by the platforms. For those "do it yourself" 506(c) offering companies, it will behoove them to prepare an expansive private placement memorandum replete with disclosures of the investment terms and the risks of investment.

5. Factors to Consider Choosing a Platform Model

Issuers undertaking a Rule 506(c) offering should anticipate and prepare for the extensive due diligence potential investors or funds are likely to undertake when evaluating that company as an investment option. The "due diligence" element should factor into an issuer's decision in choosing a type of investment platform (or choosing the "do it yourself" approach). As such, the issuer should determine the extent of due diligence offered by the various platforms and who will be conducting those investigative services.

For instance, broker-dealer platforms are required to undertake reasonable due diligence efforts in investigating a company prior to recommending the purchase of its securities in a private offering under Regulation D. At the other end of the spectrum, very little due diligence is expected of "subscription-based" crowdfunding platforms as such investigative efforts is left to the prospective investors. Somewhere in between are the "venture capital – private fund adviser" model platforms which typically involve a sophisticated fund or established angel investor who is likely to conduct a certain level of due diligence on its own before investing in a

particular company. From the investor's perspective, some prospective investors may choose to rely on the due diligence efforts of the accredited investor platforms, while others may prefer to conduct their own due diligence before making an investment in a company listed on the platform.

Another element of the capital-raising process that should be considered when choosing whether to engage a crowdfunding platform, and if so what type of platform, is who will be responsible for handling investor relations after the offering has closed. Investor relations will involve varying degrees of communications between the company and its equity owners regarding business operations, governance matters and financial information. Obviously, the more established and respected investor relations reputation a platform may have within the investment community, the greater an issuer's potential market value may be from the perspective of potential investors. On the other hand, many startups elect to designate their internal chief financial officer as the point person for coordinating investor relations and disseminating information and communications to its shareholders.

Companies undertaking Rule 506(c) offerings should also consider the closing logistics involved in a private offering undertaken through general solicitation, as that is the most important step involved in the process. The SEC has promulgated various rules and requirements with respect to the handling of investor funds, and thus it is important for an issuer to have an efficient process for collecting, storing and transferring investor funds and exchanging closing documents, which complies with the SEC mandates. Third party escrow agents often work with private issuers and/or crowdfunding platforms to provide various closing services such as collecting and depositing funds, obtaining and assembling e-signatures from accredited investors, and disbursing funds to the issuer at closing if the offering is successful, or back to the prospective investors if the offering fails for some reason (e.g., it falls short of the offering's minimum investment threshold).

V. "Intrastate Crowdfunding"

Perhaps growing impatient with the SEC's delay in issuing the implementing rules necessary for use of Title III "Crowdfunding", several states promulgated state specific investment grade crowdfunding safe harbors. Alabama, Georgia, Idaho, Indiana, Kansas, Maine, Maryland, Michigan, Nebraska, Tennessee, Washington and Wisconsin have all passed legislation allowing some form of crowdfunding, provided it is conducted solely within the confines of its geographic borders. States are predicating the adoption of the crowdfunding safe harbor on a different federally approved safe-harbor – the "intrastate exemption" of Rule 147. Rule 147 requires that that the issuer and all investors reside in the same state and all offers are made within that state.

A proliferation of new platforms that specialize in intrastate crowdfunding have begun to form such as *localstake.com* and *potluckcapital.com*. The SEC has recently released interpretive rules regarding the use of "intrastate crowdfunding" offerings through reliance on the Rule 147 safe harbor focused on securities offered and sold strictly within a state's borders.

The SEC guidance stated Rule 147's bright line rules would not be violated by a instrastate crowdfunding efforts provided:

(1) issuers engaging in general solicitation and advertising through internet platforms limit the offers of securities solely to residents of the state in which the issuer is also a resident;

(2) any third party internet portals used in the offering implements adequate measures to ensure the securities are offered only to residents of that state;

(3) issuers using their own websites or social media to promote the securities implement technological measures to limit actual offers to prospective investors whose Internet Portal (IP) address originates from a particular state and prevent offers from being made to IP addresses originating outside of that state.

In addition, the SEC suggested including conspicuous legends and disclaimers making it clear to potential investors that the offer is limited to residents of a particular state. The SEC guidance also encouraged issuers to restrict information access to those persons who confirm their in-state status through a representation or by providing their in-state residential address.

Issuers relying on the Rule 147 safe harbor for exemption from federal registration must still comply with the applicable state securities registration requirement. However, the recent SEC guidance provides comfort to those issuers seeking to rely on the new crowdfunding exemptions passed by several states that, in doing so, the offering will not run afoul of the Rule 147 federal exemption found under Section 3(a)(11) of the Securities Act of 1933.

VI. "Regulation A+ Crowdfunding"

Another JOBS Act equity crowdfunding-like vehicle that can be used by companies looking to raise capital by selling their securities is known as Regulation A+. Like Tittle III crowdfunding, this registration exemption has opened up equity crowdfunding to a larger pool of investors – not just accredited investors.

The SEC released final regulations applicable Regulation A+ on March 25, 2015, which generally permit issuers to raise up to $50 million over 12 months from both accredited and unaccredited investors. There are two tiers of capital raises under Regulation A+, with different rules applicable to each one.

Under a Tier 1 offering, the company can raise up to $20 million with no limits on how much a person can invest. However, Tier 1 offerings are subject to state securities regulations in the jurisdictions in which they offer securities, while Tier 2 offerings are exempt from state registration as Tier 2 offerings are.

Under a Tier 2 offering, the company can raise up to $50 million, but individuals who are not accredited investors can only invest up to the greater of 10% of their annual income or 10% of their net worth. Non-individual investors who do not qualify as accredited investors are

limited to 10% of the greater of annual revenue or net assets at fiscal year-end. Tier 1 issuers must have their financial statements reviewed by their CPA, while audited financial statements on ongoing SEC reporting obligations are required of Tier 2 companies.

Regulation A+ offerings have been referred to as "mini IPOs" as the securities are unrestricted and can be freely sold in secondary markets. In addition, companies relying on Regulation A+ can "test the waters" before fully committing to the offering through the distribution of solicitation materials to the public both before and after filing an offering statement with the SEC. If a company only seeks to gauge the potential interest of the public, it will not be required to submit the solicitation materials to the SEC before first use, provided that the solicitation materials must be attached as an exhibit when the company files the offering statement with the SEC. When merely testing the waters, companies must include a legend on the solicitation materials stating that: (1) no money or other consideration is being solicited; (2) no sales will be made or commitments to purchase accepted until the offering statement is qualified; and (3) a prospective purchaser's indication of interest is non-binding.

All Reg A+ filings are done electronically through EDGAR where they will be available to the public. The issuer must also deliver a preliminary offering circular to potential investors at least 48 hours prior to the sale. Issuers relying on Reg A+ must file financial statements prepared in accordance with GAAP with the SEC. The Reg A+ rules require balance sheets and other financial statements for the last two fiscal years. In addition, Tier 2 offering financial statements must be audited in accordance with GAAS or standards issued by the Public Company Oversight Board.

There are ongoing filings requirements with the SEC, including annual reports (Form 1-K), semiannual reports (Form 1-SA), current reports (Form 1-U) and an exit report (Form 1-Z). Under Tier 1 offerings, the Form 1-Z exit report must be filed within 30 days of the termination or closing of the offering in order to disclose certain summary information about the capital raise such as the number of securities sold and the amount of capital raised.

Because of the preemption of Reg A+ rules over the Blue Sky laws with respect to Tier 2 offerings, Tier 2 offers can reach broadly and can utilize solicitation materials (with the appropriate legends) to test the waters without having the endure the review and comment process with the states. Tier 1 offerings, on the other hand, are in fact subject to Blue Sky laws so will likely be more local or regional in terms of geographic scope.

VII. Tax Implications of Crowdfunding

A. Income Tax Issues

As mentioned above, substantial sums of money are raised through crowdfunding efforts, but little attention is given to the tax implications of raising funds in this manner. Part of the reason is that Congress and the IRS have yet to provide guidelines and regulations specific to the various forms of crowdfunding. Accordingly, businesses and their accountants must apply general tax principles when determining how to treat crowdfunding income for tax reporting purposes.

In rewards-based and donation-based crowdfunding, issuers use third party payment processers such as PayPal and Venmo to secure capital from interested supporters. These processers are required to issue a Form 1099-K - "Payment Card and Third Party Network Transactions" – to a crowdfunder who collects over $20,000 and has at least 200 transactions in a given year in order to report unadjusted gross revenues. Obviously there is a distinction in terms of how rewards versus donation based crowdfunding revenues will be treated by the IRS, as donations are likely to be characterized as gifts, while capital received in exchange for rewards is likely to generate taxable income to the campaign creator.

Crowdfunding platforms such as Kickstarter and Indiegogo provide very little guidance to users regarding the potential tax consequences of engaging in a crowdfunding campaign. They basically just advise that crowdfunding may result in taxable income to the project creator. Kickstarter's terms of use provide that the platform cannot give tax advice, but that the income may be taxable while certain expenses of conducting the campaign may be deductible.

As mentioned above, capital raised through rewards-based crowdfunding is likely to constitute taxable income under Section 61 of the Internal Revenue Code in the year of receipt. The question then becomes what expenses are deductible, which will require an analysis of the nature of the crowdfunding activity (i.e., whether it is a trade or business or hobby), whether a startup business is involved, the accounting method adopted by the creator, and the value of rewards provided to the supporters.

Regarding the analysis of the nature of the activity, the creator will be able to deduct all allowable trade or business expenses under Section 62 of the Code if the activity is deemed to be a trade or business. On the other hand, the deductible expenses incurred by the creator of a hobby activity will be limited to the applicable income under Section 183. The characterization of hobby versus trade or business is a facts and circumstances analysis which focuses on nine factors, including whether the activity is operated like a business, whether the owner is experienced or knowledgeable in that business, and whether it is carried on for personal or recreational purposes.

Assuming the crowdfunded business constitutes a trade or business for federal income tax purposes, the startup and organizational costs incurred by the campaign creator should be analyzed. Ordinarily, the taxpayer would capitalize those costs unless an election is made under Section 195 for startup costs or under Section 248 (for corporations) or Section 709 (for partnerships) to deduct up to $5,000 of those costs (subject to reduction to the extent such costs exceed $50,000). The taxpayer will deduct the costs in the year the trade or business becomes active and amortize the balance over 15 years. Note that the taxpayer is deemed to have made the election to deduct unless an affirmative election to capitalize is made on the initial return.

Importantly, startup and organizational expenses are only deductible when the business becomes "active", which could vary depending on the particular facts and circumstances. This is an important point for crowdfunding campaigns, as the capital raise alone may not give rise to the level of activity necessary to deduct the expenses until a later year when the business becomes active.

Note that both Kickstarter and Indiegogo advise supporters that they do NOT guarantee the success or completion of a crowdfunding campaign or the delivery of a reward. Accordingly, the creator will be deemed to be in complete control of the funds once they are received, and under the claim of right doctrine, the income will be taxable in the year of receipt irrespective of the taxpayer's accounting method. This may create a timing issue and cash flow problem for the creator since the income may be taxable in one year, but the associated expenses may not be deductible until the next year when the business becomes active. If the negative impact on cash flow is sufficiently significant to jeopardize the completion of the project, the creator may decide to prematurely end the crowdfunding campaign in order to accelerate the deduction of some or all of the allowable expenses.

Another tax uncertainty that arises in crowdfunding campaigns is the value that is allocated to the rewards provided to supporters. This can often be very difficult to ascertain. For example, what value would be placed on the opportunity to meet the creator or receive an autographed picture? Where the value of the reward cannot be easily ascertained, further analysis is warranted to determine if all or part of the contributed capital is actually a nontaxable gift under Section 102.

Under the *Duberstein* case, something is a gift for federal income tax purposes if it is given out of "detached and disinterested generosity" (363 U.S. 278). Therefore, the IRS would probably deny gift treatment where the reward has a value approximately equal to or greater than the contribution. Is it fair to assume that there is some value to the rewards provided by the campaign creators in exchange for the monetary contribution, so complete gift characterization is unlikely unless the contributors choose to not to accept the reward.

Note that Section 118 permits corporations to treat certain receipts by nonshareholders as nontaxable contributions to capital. While most crowdfunding creators do not operate their campaigns through a corporation, doing so may provide a tax planning opportunity if the supporter does not receive a reward in exchange for the capital contribution. However, under *Chicago, Burlington & Quincy R.R. Co.,* 412 U.S. 401 (1973), the Supreme Court provided five factors that must be met in order for a contribution by a nonshareholder to qualify as a nontaxable contribution to capital: (1) the contribution must be a permanent part of the entity's capital structure; (2) the contribution cannot be compensation for services rendered (or products received in the case of a crowdfunder); (3) the contribution must benefit the transferee commensurately with its value; (4) the contribution will ordinarily be used to produce additional income; and (5) the contribution must be bargained for. With respect to crowdfunding campaigns, it will be a challenge to satisfy the last factor since supporter information is not provided by the platform to the creator.

At the end of the day, crowdfunding entrepreneurs would be prudent to seek the advise of their tax professionals as they navigate the nebulous tax rules applicable to their capital raise efforts.

B. <u>Sales and Use Tax Issues</u>

Another issue to address is whether crowdfunders will be subject to sales and use taxes in various states. Under *Quill vs. North Dakota* (504 U.S. 298 (1992)), the analysis of a state's jurisdiction to assess sales and use tax on an out-of-state seller will largely depend on whether the vendor has "substantial nexus" with the taxing state. The U.S. Supreme Court held that "substantial nexus" for sales and use tax collection means that a seller has "physical presence" in the state, which requires more than a connection through the U.S. mail or common carrier within the state.

Most crowdfunding campaign creators will be individuals with physical presence in only one state, but may have substantial nexus in additional states through the crowdfunding platform they utilize. In an effort to address the exploding e-commerce marketplace, approximately 15 states have promulgated "click-through nexus" provisions in their statutes which basically presume nexus if the out-of-state seller pays a commission to a domestic person who refers customers to the out-of state seller through the internet (provided a sale is consummated and the annual sales exceed a stated dollar threshold). Accordingly, if the platform provides a link to facilitate crowdfunding contributions in exchange for a fee, and the platform has substantial nexus in that state, these click-through nexus provisions may create nexus for the project creator.

Most states impose sales tax on the retail sale of tangible personal property and certain specified services. In addition, the electronic delivery of digital products such as videos, e-books, music, etc., that are often the form of rewards in many crowdfunding campaigns, are generally subject to sales tax in many states. Accordingly, in the event a project creator provides a tangible reward in consideration of a contribution in a crowdfunding campaign, many states will likely characterize the transaction as a retail sale subject to sales tax (unless otherwise exempt). Alternatively, some states may take the position that the project creator is subject to use tax due to the promotional nature of the tangible rewards provided. Other questions arise such as what is the appropriate tax base to which the tax applies.

In addition, there are questions of timing in terms of when the taxable transaction occurs in a crowdfunding campaign and thus when should the tax be reported. If the campaign involves a fixed funding goal, some state take the position that taxes do not need to be reported until the funding goal is realized since the funds do not vest with the creator until the goal is met. Other states may take the position that a sale occurs upon issuance of the reward/contribution and allow a credit if the crowdfunding target amount is not reached.

Given the potential for assessment of sales and use tax, project creators and their CPAs should be cognizant of the presence of their applicable platform in a particular state in order to assess their sales and use tax exposure.

VIII. Finding Investors in the New JOBS Act Securities Regime.

Under Rule 506(b), issuers could use intermediaries or "finders" to identify potential investors provided that the intermediary limited its involvement and had a substantial and pre-existing relationship with the prospective investor sufficient to allow the intermediary to understand the financial sophistication of such investor. Thus, an issuer's decision as to whether

to conduct an offering under Rule 506(b) or 506(c) may depend in part on the extent of such preexisting relationships with potential investors.

To the extent the issuer has substantial and preexisting relationships with a sufficient number of potential investors, it may choose to rely on Rule 506(b) so as to avoid the burdensome accredited investor verification requirements. In addition, unlike under a 506(c) offering, the issuer could sell securities to up to 35 non-accredited investors if it so chose. In contrast, under a 506(c) offering, intermediaries need not have a substantial or preexisting relationship with a prospective investor in order to conduct general solicitations or general advertising.

The SEC has recently increased its efforts to identify and sanction unregistered “finders” who engage in broker like activities and receive compensation in connection with the procurement of investors for the issuer without being registered under the 1934 Act.

An unresolved question debated by securities market players is how the increased SEC scrutiny of finder activities will affect the involvement of securities trading platforms. One of the stated objectives of the JOBS Act was to encourage the engagement of intermediary platforms that could assist accredited investors invest in startups and other private companies. In fact, the JOBS Act includes a specific exemption from broker-dealer registration for these platforms provided certain conditions are satisfied, one of which prohibits the platform’s receipt of “compensation in connection with the purchase or sale” of a security.

Despite the restriction on the receipt by the platform of compensation tied to the purchase or sale of securities, the JOBS Act permits such trading platforms to charge user fees to those who wish to access the platform. However, substantial doubt exists within the securities industry as to the practical significance and ultimate use of this fee allowance. Accordingly, the current issue is to ascertain what fee packages that fall between these two ends of the compensation spectrum will be permitted by the SEC.

In March of 2013, the SEC issued two “no action letters” that provide additional guidance as to what forms of platform compensation will not constitute “transaction based compensation” and thus will be allowed. In *AngelList LLC and AngelList Advisors LLC* (SEC No-Action Letter, March 28, 2013) and *FundersClub Inc. and FundersClub Management LLC* (SEC No-Action Letter, March 26, 2013), the SEC granted no-action relief allowing venture fund advisors to receive “carried interests” for providing passive advisory and consulting services to facilitate investments and to be reimbursed for documented expenses.

The SEC indicated the platforms may receive expressions of investment interest from accredited investors with respect to a particular start-up, and once the investment interest becomes appreciable, a platform-affiliated advisor may then establish a “transaction vehicle” (such as a limited liability company) that can accept funds from accredited investors and subsequently invests in the subject issuer. The model contemplates compensating the advisor with a carried interest to be realized upon the sale of the investment based on the profitability of the issuer. The carried interests were not deemed to be “transaction based compensation” tied to the success of security sales, but instead were distinguished as incentive fees predicated on the future performance of the fund. Note, however, neither the advisor nor the platform may

actually handle investor funds or issuer securities, as all investment funds and securities must be handled by a bank or other financial institution. In addition, the platforms must register as investment advisors with the federal and applicable state security commissions.

Irrespective of these restrictions, the recent SEC no-action letters suggest the facilitation of capital formation by such platforms and similar intermediaries not registered as brokers will increase in the future, especially given the relaxation of general solicitation prohibitions in private offerings. Further, the SEC's decisions in these two no-action letters suggest other compensation arrangements tied to the performance of the underlying security (as opposed to the sale of a security) may be permissible. Significantly, similar incentive compensatory packages based on the performance of the security may be implemented by issuers when engaging finders and other third party intermediaries assisting with the solicitation of investors, provided other broker-related activities are limited.

IX. Changes to the Definition of "Accredited Investor"

The term "accredited" investor is defined in Section 2(a)(15) of the Act to include "any person, who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, qualifies as an accredited investor under rules and regulations which the Securities and Exchange Commission shall prescribe." The Securities and Exchange Commission has adopted Rule 215, which sets forth net worth and income requirements for qualification of accredited investors.

For natural persons, the basic tests are either net worth, with one's spouse, of more than $1 million (excluding the value of the principal residence) or net income of more than $200,000 in each of the two most recent years (or $300,000 with one's spouse). These threshold amounts will be adjusted for inflation every 5 years starting in 2017. Debt secured by a principal home up to the estimated fair market value of the home at time of sale are not included as a liability, but any debt in excess of the fair market value of the residence is included in the calculation.

When the SEC revised the definition of "accredited investor" in July of 2010 to exclude the value of one's personal residence, the pool of accredited investors decreased from 9% to 7% of the population. The Government Accountability Office issued a report in July of 2013 stating that revising the net worth threshold in the definition of "accredited investor" from $1,000,000 to $2,300,000 to adjust for inflation would decrease the number of qualifying households from 8.5 million to 3.7 million. Obviously, such a drastic reduction in the number of prospective accredited investors could significantly dampen the private investment landscape in the United States and stunt economic growth.

The GAO report also referenced other important factors/criteria that the SEC should consider in lieu or, or in addition to, the current test as it revises the definition of "accredited investor". These include: (i) a liquid investments requirements (i.e., a minimum dollar threshold of assets that can be easily liquidated and whose value can be easily verified); (ii) use of a registered investment advisor; (iii) other "sophistication-based" criteria such as self-certification, licensing or other educational standards that may establish the sophistication level of an investors (e.g., lawyers, accountants, financial advisers, etc., could automatically qualify).

Obviously, requiring investors to have a substantial amount of liquid investments in order to qualify as "accredited" would better ensure investors could absorb potential losses, but would almost certainly reduce the pool of eligible investors and investment capital. As such, many experts anticipate that the SEC will expand the test for "accredited investor" eligibility by introducing more factors related to the nature or sophistication of the investor regardless of income level, thereby expanding the universe of accredited investors. Education-based factors may qualify brokers, lawyers, CPAs, persons with MBAs, etc. to qualify as accredited regardless of income level.

In fact, some industry experts have suggested the SEC may introduce the option of taking an "accreditation" test to prove one's sophistication level. Whether people will be inclined to sit for such a test remains to be seen.

X. Conclusion.

Access to readily available capital is often the lifeline for many Main Street businesses. Under the current regulatory landscape, companies seeking to attract outside capital through the sale of securities to unrelated investors essentially have two choices: (i) register the securities with the SEC and the applicable state security administrations, or (ii) find an exemption from registration under the federal and state securities laws. Due to the burdensome requirements associated with securities registration, which is often prohibitively expensive for many small businesses, exemption qualification is almost always the more attractive option. Given the difficult economic environment currently limiting the ability of private companies to secure institutional financing on reasonable terms, lawmakers have taken legislative measures to stimulate the capital markets by encouraging private investment in small businesses.

Since the ban against general solicitation was lifted by the SEC on September 23, 2013, the securities environment has seen an increase in "accredited investor crowdfunding" in connection with Rule 506(c) private offerings. This variant of "crowdfunding" allows capital-seeking companies the opportunity to attract private investment from accredited investors through internet platforms generally advertising the company's securities. In light of the tremendous opportunities general solicitation now allows companies in search of capital, we are likely to see a proliferation of these "accredited crowdfunding" internet platforms in the coming years.

In addition, with the SEC's recent adoption of the Title III Crowdfuding Regulations, we are likely to see a dramatic increase in the use of crowdfunding as a vehicle for raising capital. Equity crowdfunding has a global presence with over a thousand crowdfunding platforms currently functioning world-wide. The global crowdfunding industry increased from $1 billion in 2010 to greater than $5 billion in 2013, and the World Bank projects equity crowdfunding to exceed $93 billion by the year 2025. In fact, some venture capital experts project the crowdfunding industry to grow upwards of $300 billion by 2025, depending on various regulatory parameters in play during that time.

Accordingly, this crowdfunding phenomenon permeating the US and global capital markets has generated a great deal of excitement in the private equity sphere, especially for

upstart companies looking to get their business off the ground, or for existing companies looking to expand their operations. The rapidly changing private securities offerings landscape has presented great opportunities for many capital-seeking companies, but they must carefully consider and weigh the benefits and risks associated with the various types of crowdfunding currently operating in order to decide which form of crowdfunding is most suitable for their needs.