

LEGAL UPDATES

Alternative Methods of Raising Capital: Regulation Crowdfunding

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According to a [report](#) from Startup Genome, global venture capital funding has declined by about 20 percent since the COVID-19 crisis began in December. While the United States has currently fared better than other countries, 15 percent fewer deals occurred in each month of the first quarter of 2020 compared to 2019. Another [report](#) by the Natural Venture Capital Association warned that “venture capital investment is expected to drop significantly.” Given the climate, many cash-strapped startups may want to consider alternative methods from traditional venture backed financing rounds to raise capital.

One such method is through a Regulation Crowdfunding offering pursuant to Section 4(a)(6) of the Securities Act of 1933 (Securities Act). In 2019, approximately \$1,492 billion were raised pursuant to Rule 506(b) of Regulation D while only approximately \$62 million were raised pursuant to Regulation Crowdfunding. As such, many founders may be unaware of the possibility of raising capital through a crowdfunding offering. Additionally, a crowdfunding offering may be uniquely attractive to certain issuers given the ability to communicate with investors or potential investors on the intermediary’s platform. Cash-strapped startups in adversely affected industries can directly communicate how they have been affected by COVID-19, their proposed solutions, and appeal to investor and consumer good will for support during these difficult times.

The aim of this note is to explain the Regulation Crowdfunding exemption and the temporary rules so that startups and early stage companies can evaluate whether it is a viable method for them to raise capital.

Regulation Crowdfunding Explained

What is Crowdfunding?

Crowdfunding is a way for individuals or entities to raise capital from a large number of individuals usually through the internet and social media. Perhaps the most commonly known form of crowdfunding is raising funds for specific

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products, projects or ventures from supporters through an online website like Kickstarter or GoFundMe. Regulation Crowdfunding was adopted under Title III of the JOBS Act in 2012 and permitted issuers to also raise capital via crowdfunding.

Eligible Issuers

Certain categories of issuers are ineligible from Regulation Crowdfunding offerings. These include (i) issuers that are not organized in the U.S., (ii) reporting issuers, (iii) investment companies; (iv) issuers who have failed to make required Form C filings in the two years before a crowdfunding offering, (v) issuers with no specific business plan or a business plan that indicates that it plans to engage in a merger or acquisition with an unidentified company or companies, or (ii) issuers where any “covered person” was involved in a disqualifying event.

Funding Limits

Regulation Crowdfunding permits an issuer to raise up to \$1.07 million online from the public, including non-accredited investors. Further, in a release on March 4, 2020, the Securities and Exchange Commission (SEC) announced proposed rules that would increase the offering limit under Regulation Crowdfunding from \$1.07 million to \$5 million. At this point in time, it is uncertain when a final rule by the SEC might be expected, and whether it would include the proposed increase.

Regulation Crowdfunding imposes per individual investment limitations as follows: (i) individuals with either an annual income or net worth less than \$107,000 may invest the greater of \$2,200 or 5% of the lesser of the investor’s annual income or net worth; and (ii) individuals with both an annual income and net worth of at least \$107,000 may invest 10% of the lesser of the investor’s annual income or net worth. Investments by business entities should be calculated by revenue and net assets of the most recently completed fiscal year.

Crowdfunding Intermediaries

Regulation Crowdfunding requires crowdfunding offerings to be conducted through a broker-dealer or a funding portal that complies with Section 4A(a) of the Securities Act. Broker-dealers generally have stricter screening requirements and due diligence requirements than funding portals. However, some funding portals impose more screening and diligence requirements than those required by law.

Issuers interested in looking into potential broker-dealers or funding portals can look to the lists of registered broker-dealers and funding portals maintained by the Financial Industry Regulatory Authority (FINRA). Additionally, in 2019 the top four funding portals were:

Funding Portal 2019 Capital Raised (In Millions)

<u>WeFunder</u>	\$32.87
<u>StartEngine</u>	\$28.59
<u>Republic</u>	\$20.07
<u>SeedInvest</u>	\$7.23

Source: Crowdwise: 2019 US Equity Crowdfunding Stats – Year in Review



Disclosure Requirements

Issuers are required to prepare and file a [Form C](#) with the SEC and provide it to the relevant intermediary. Among other information, issuers are required to provide certain financial information depending upon the aggregate amount sold (in a rolling 12-month period) as follows:

- Issuers Offering \$107,000 or Less. Financial statements (US GAAP) of the issuer and certain information from the issuer's federal income tax returns for the two most recently completed fiscal years, or such lesser period during which the issuer has been operating. Both of these must be certified by the issuer's principal executive officer. If the issuer has audited financial statements, the issuer must provide those financial statements and will not be required to include information reported on the issuer's federal tax returns.
- Issuers Offering Between \$107,000 and \$535,000. Financial statements (US GAAP) reviewed by a public accountant that is independent of the issuer. If the issuer has audited financial statements, the issuer must provide those instead.
- Issuers Offering More than \$535,000. First time Regulation Crowdfunding issuers need only provide financial statements (US GAAP) reviewed by a public accountant that is independent of the issuer, unless the issuer has audited financial statements. Issuers that have previously sold securities pursuant to Regulation Crowdfunding need to provide financial statements (US GAAP) audited by a public accountant that is independent of the issuer.

Unless regular progress updates are provided by the intermediary, issuers must prepare progress updates on its progress toward meeting the target offering amount within five business days after reaching 50% and 100% of the target offering amount by filling a Form C-U with the SEC. Additionally, The Form C must be publically available on an intermediary's platform for a minimum of 21 days before the issuer can close the offering.

Issuers must also file an annual report on Form C-AR with the SEC and publish the form on the issuer's website within 120 days after the end of each fiscal year. Annual reports are required until one of the following events occurs: (i) the issuer becomes a reporting company, (ii) the issuer has filed at least one annual report and has fewer than 300 holders of record, (iii) the issuer has filed at least three annual reports and has total assets that do not exceed \$10 million, (iv) the issuer or another party repurchase all of the securities issued pursuant to Regulation Crowdfunding, or (v) the issuer liquidates or dissolves.

Advertising, Communication and Promoters

Outside of the intermediary's platform, issuers are only permitted to advertise their offerings through limited notices. However, there are no restrictions on an issuer's ability to communicate with investors or potential investors on the intermediary's platform; provided that the issuer and persons acting on behalf of the issuer must identify themselves and their affiliation in all such communications. After taking reasonable steps to ensure any paid promoters clearly disclose any compensation, issuers are allowed to compensate people to promote the crowdfunding offering through communication channels provided by the intermediary.

Types of Securities Offered

There are no restrictions on the type of securities offered in a Regulation Crowdfunding offering. Crowdfunding issuers offer five main types of securities: (i) common equity, (ii) preferred equity, (iii) convertible securities, (iv) straight debt, and (v) debt with revenue sharing. Based on a 2019 report by the SEC, issuers undergoing a crowdfunding offering issued equity 48 percent of the time, debt 27 percent of the time, and SAFEs (simple agreements for future equity) 21 percent of the time. While the report did not offer granularized breakdown of the types equity and debt issued, common equity and SAFEs appear to be the most common type of securities issued in a crowdfunding offering.



Restricted Securities

The securities purchased in a crowdfunding offering are restricted securities and cannot be transferred unless the securities are transferred to (i) the issuer of the securities, (ii) to an “accredited investor”, (iii) as part of a registered offering, or (iv) to a member of the family or a trust of the purchaser, or in connection with the death or divorce of the purchaser.

Exempt from Section 12(g)

Section 12(g) of the Exchange Act of 1934 requires an issuer with total assets of more than \$10 million and with a class of securities held by 2,000 accredited investors or 500 non-accredited investors to register the class of equity securities. However, securities issued in pursuant to Regulation Crowdfunding are exempt from the Section 12(g) record holder limit if (i) the issuer is current in its ongoing annual reports, (ii) has total assets as of its last fiscal year of \$25 million or less, and (iii) has engaged the services of a transfer agent registered with the SEC. Additionally, so long as the issuer continues to timely file its annual reports, there is a two-year transition period before it is required to register the class of securities after meeting the above conditions.

Costs

There is limited information on costs incurred by issuers during a Regulation Crowdfunding offering as it is not required to be disclosed in the Form C. However, a [2018 consulting survey by Crowdfund Capital](#) found that the average offering incurred \$16,878 (median \$10,600) in expenses and raised an average of \$319,040 (\$164,375 median). Traditional Seed or Series A financings are rarely this cheap.

Temporary Rules – COVID Relief

In May, the SEC implemented temporary rules aimed at expediting the offering process. These temporary rules apply to offerings initiated between May 4, 2020 and August 31, 2020. To rely on the temporary rules, the issuer must meet the existing eligibility criteria and (i) cannot have been organized or operating less than six months prior to the commencement of the offering, and (ii) cannot have previously violated the SEC’s crowdfunding rules. An issuer relying on any of the temporary rules must prominently disclose that the offering is being conducted on an expedited basis due to the circumstances relating to COVID-19 and is pursuant to the SEC’s temporary regulatory COVID-19 Relief.

The temporary rules allow an issuer to omit financial information from its initial Form C filled with the SEC and commence the offering before the financial information is provided to investors. However, the financial statements are required to be included in an amendment to the Form C prior to the acceptance of any investment commitments in the offering. Issuers can therefore gauge whether there is interest in the offering before undertaking the cost of preparing financial statements. Issuer’s relying on this temporary rule must prominently disclose that (i) the financial information has been omitted and is not currently available and will be provided in an amendment to the offering materials, (ii) that the investor should review the complete set of offering materials, and (iii) no investment commitments will be accepted until after such financial information has been provided.

The temporary rules permit issuer’s offering between \$107,000 and \$250,000 over a 12-month rolling period may provide financial statements of the issuer and certain information from the issuer’s tax returns certified by the principal executive officer instead of financial statements reviewed by an independent public accountant. Issuers relying on this temporary rule are required to provide a statement to this effect. Further, the temporary rules also suspend the requirement that an offering statement be publically available on the intermediary’s platform for at least 21 days before any securities sold. Instead, an issuer may sell the securities as soon as the issuer has received binding investments commitments covering the target offering amount. Regulation Crowdfunding gives investors an unconditional right to cancel an investment commitment up to 48 hours prior to the deadline identified in the offering materials. However, the temporary rules permit an investor from canceling their investment commitment within 48 hours from the time of the



commitment. Issuers relying on this temporary need to include a description of the process to complete the transaction or cancel an investment commitment.

Conclusion

Regulation Crowdfunding is not suited for every startup. Startups operating in stealth mode or with capital requirements well in excess of the \$1.07 million limit should instead consider alternative capital raising methods. However, Startups looking for a smaller bridge financing or those with enthusiastic users or public sentiment should seriously evaluate whether a Regulation Crowdfunding offering is suitable for them, especially under the temporary rules.

For further information or if you have specific questions, please reach out to the Lathrop GPM attorneys in our [Emerging Companies & Entrepreneurs Practice](#).