Unaccredited Crowdfunding: The Beginning of the End, or the End of the Beginning? 
An Update & Discussion

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Forced SEC to Develop Rules

- Set a variety of forces in motion
- Genuine tension at work between the forces promoting crowdfunding and the forces against it
- SEC caught in the middle, trying to do its traditional job: regulate the capital markets, drive capital formation and keep investors safe
- Result is presently a mess of half-baked rules
Three Key Buckets You Need to Understand

I. Accredited General Solicitation
   – Now Allowed since September – 506(c)

II. Accredited Platforms
    – New models, new approaches, new questions

III. Unaccredited Crowdfunding
    – Proposed rules, weighing comments, could hit by end of year.

Past, present, future.
I. General Solicitation

• Old Rule
  – No public discussion (i.e. general solicitation – see appendix)
  – Accredited only (with limited but useful exceptions)
  – Take investors word for it

• New Rule
  – You can talk about it, but only to Accredited Investors so what’s the point? (Hint: platforms are the point)
  – But if you do, you absolutely must make sure everyone is accredited and have to collect intrusive information to back it up.
  – And you may have to comply with Reg D – prefiling etc (see appendix)

**How does this make any sense? Most groups are saying: keep it simple and flexible: Stick with traditional 506(b) silent deals.**
II. Accredited Platforms

• Old Status Quo
  – Invitation only, Accredited only
  – Traditional non-generally solicited deals

• New Patterns Emerging
  – Since general solicitation rules allow them to hype more…
  – All they have to do is smooth out the Accredited Investor testing…
  – And build tools for things like syndication
  – Will be interesting to watch this space, especially in light of the new crowdfunding rules.

*I see interesting potential here, but I have some major reservations which we can talk about in a moment...*
III. Pending Crowdfunding Rules

- Title III of Jobs Act forces SEC to do this
- Comments closed in Feb – hundreds of pages, 600+ commenters
- Will take a lot of work to weigh comments
- SEC hopes to implement by end of year
- Comments pretty substantive, rules may very well change,
- I think late 2014 implementation is likely to slip
What are the New Crowdfunding Rules?

- Issuers can raise up to $1M per year
- Investors can invest a % of their wealth/income (stairstep)
- Inc./worth $100K: $2000/5% Over $100K 10%. Cap at $100K/yr
- Raise must be done through a portal or broker-dealer
- Portals required to do background checks on issuers
- No advertising beyond portal (password protected)
- Issuers raising more than $500K must submit audited financials
- Disclosure filing required 21 days before first securities sale
- Annual reports from issuer (or maybe portal)
Problems with the New Crowdfunding Rules

• As proposed, really expensive - SEC estimates:
  – $35-55K for 200K Raise
  – $90-190K for a $500-$1M raise
• Essentially a mini-IPO
• Disclosure is really significant (more on that in a moment) and ongoing – tough way to raise a few bucks
• Company gets massive number of strangers with little skin in the game
• Not clear how later investors will view these crazy cap tables
Stringent Disclosure Requirements

At least 21 days PRIOR to raising money you must publicly disclose:

- Your business plan
- Your use of proceeds
- Your financial condition
- Your number of employees
- Price, target size and target date of round
- Your ownership and capital structure
- All the material risks

And you have to keep all this up to date as things change
Net Effect: Dead on Arrival

• Unless these rules change significantly, they are not an attractive way to raise money. Makes dealing with angel groups look easy!

• Tension between politicians on one side and state securities regulators and professional money managers on the other.

• Accredited Investor definition controversy is perfect example of this

• SEC mandate is to keep order – they don’t think mass investing of private illiquid securities without disclosure and oversight is a good idea.
Discussion: Net Impact of all this?

- Mass crowdfunding is probably not a terrific idea – I suspect cannot be made safe enough for SEC without destroying its essential purpose.
- Accredited portals are interesting for Angel groups, but...
- They assume some big facts not yet in evidence:
  - Investing by mouse-click works?
  - Great deals will be shared with me?
  - Valuations will stay sane?
  - Headless rounds are ok?
  - Value-add is not important?
  - Fraud will not be an issue?
  - Someone will take care of the next round?

- IMHO: these are puppies not lottery tickets…
Discussion

For More Information:

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Appendix
SEC “Definition” of General Solicitation is Broad

- SEC Rules State that General Solicitation includes:
  - Any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast
  - Any seminar or meeting whose attendees have been invited by general solicitation

- Gray Area: Are common angel deal flow sources “general solicitation”?
  - Demo Days and Pitch/ Business Plan Competitions/Speed Rounds
    - Often sponsored by
      - Accelerators/ Incubators
      - Colleges/Universities
      - Econ Development Orgs (non-profit and government)
      - Law firms

- Startups MUST Seek Counsel on these Issues
Generally Solicited Offerings Require

- **All** purchasers must be accredited investors
  - Old rule allowing up to 35 non-accredited investors does **not** apply
  - May preclude “Friends and Family” from 506(c) offering
  - Definition of Accredited Investor
    - Person with income of $200,000 per year; or spouses with $300,000; or
    - Person with net worth of $1 million or more, excluding value of home

- The issuer must take “**reasonable steps to verify**” that all purchasers are accredited.
  - “Check the box” self-certification is not acceptable for verification
  - Issuer must document steps taken with each purchaser

- Issuers must file Form D and specify reliance on 506(b) or 506(c)
- Issuer can change offering from 506(b) to 506(c) – but can’t reverse
Questions Entrepreneurs Should Ask Attorney
Is My Offering General Solicitation or Not?

• Pitch events or demo days? – Under what circumstances are they general solicitation or not?
  o e.g., if deal terms aren’t discussed, could my deal fit “quiet” rules?
• How does “conditioning the market” apply, if I’m seeking funds, but don’t mention it at a pitch event?
• Pitch events – Do you agree with event host on their reasoning that the event is not general solicitation?
• Quiet deals – How do we ensure my offering doesn’t fall into 506(c) rules for general solicitation?
Proposed New Rule Reg D / Form D

• Requires 15-day advance filing before any general solicitation begins
• Missed deadline must be cured within 30 days; can only do this once
• If missed filing isn’t cured, issuer can’t reuse any 506 exemption for a year
• All written solicitation material must be furnished to SEC prior to public use
• Legends must be placed on all written general solicitation material
  o Lengthy – longer than a “tweet”
• Extensive additional disclosure required on Form D filing
• Must file terminating Form D within 30 days of the closing of the offering
Proposed Rules Are Problematic for Startups

• Highly complex and difficult for startups – probably unworkable
• If startup relies on 506(c)
  o Must file Advance Form D 15 days prior to the event
  o File materials by day of use and include legends on materials
  o If company fails to file, it is out of compliance
  o Many will not realize they are out of compliance
• Can only cure once, and must occur with 30 days
• If not cured, company may not again use Rule 506 for one year

Proposed rules would put many startups out of business

REMEMBER: not required yet
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