



ANGEL CAPITAL ASSOCIATION



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...



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Discussion

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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?
 - 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

- Purpose: Enable SEC to monitor market developments re: general solicitation www.sec.gov/rules/proposed/2013/33-9416.pdf
- 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
 - 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)
 - Must file Advance Form D 15 days prior to the event
 - File materials by day of use and include legends on materials
 - If company fails to file, it is out of compliance
 - Many will not realize they are out of compliance
- Can only cure once, and must occur within 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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