CLIENT ADVISORY:

A PRIMER ON CROWDFUNDING

Overview

It is not clear when the term "crowdfunding" was first used, but there is little doubt that its popularity soared on the heels of the 2012 Jump Start Our Business Startups Act (the "JOBS Act"). The JOBS Act expanded a number of provisions of federal securities laws, with the goal of making it easier for businesses to raise capital to fund growth and create jobs, in part by paving the way for increased use of the Internet as a fund raising platform. The term is now widely used by business people and investors. However, much like "hedge fund", the term "crowdfunding" means different things to different people. The purpose of this memorandum is to provide an overview of the current state of crowdfunding and perhaps dispel some misconceptions.

In general, Internet-based crowdfunding can be divided into two broad categories: (i) rewards or donation websites (e.g., Kickstarter, indiegogo, etc.) where the person contributing cash does so purely as a donation or receives only a token product or service; and (ii) websites that offer investors a true investment opportunity. On donation or rewards based sites, people at all income levels can make contributions to fund projects ranging from production of a film or play, development of a new software program or smart phone app to opening a restaurant or other retail business. These sites pre-date the JOBS Act and are not regulated by federal or state securities laws because people contributing money are either making an outright donation or receiving a nominal reward (tickets to the film, a copy of the new software or smart phone app, etc.) but they do not receive any interest in the company sponsoring the project.

Prior to the JOBS Act, it was difficult to use a website to raise investment capital by offering investors stock or a promissory note of the sponsoring company because the most commonly used provisions of federal securities laws prohibited advertising and general solicitation of investors. Clearly, use of the Internet to solicit investors would violate the no general solicitation rule.

The JOBS Act amended key provisions of federal securities laws, paving the way for a number of different approaches to crowdfunding. Although the JOBS Act was passed in 2012, some of the changes have not yet taken effect. These changes require that final regulations be adopted by the Securities Exchange Commission (the "SEC") and that has taken far longer than originally hoped.

General Solicitation of Accredited Investors

In response to the JOBS Act, the SEC has adopted Rule 506(c) which now permits private companies to use advertising and general solicitation, but only for solicitation of accredited investors. Rule 506(c) is being used by a large number of companies to raise equity or debt financing via the Internet, both directly by the companies themselves or with assistance from so-called "funding portals" (e.g., Circle Up, FlashFunders and others). Funding portals are websites that match companies looking to raise money with qualified investors. Historically, a funding portal would have required registration as a securities broker-dealer, which is a complex process. Under the JOBS Act, these funding portals may now be exempt from registration as securities broker dealers. Although they are still required to register as funding portals with the SEC, this is a less daunting requirement.

Internet offerings under Rule 506(c) are particularly attractive to companies seeking investment capital because there are no maximum dollar limitations, no per-investor limits on the amount that can be invested and they are exempt from state registration. Furthermore, they do not require the company to have audited financial statements and they do not have any ongoing reporting requirements.

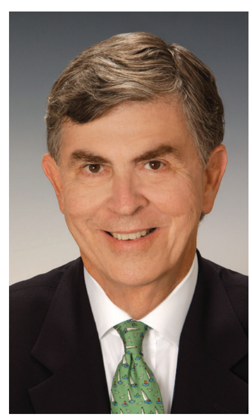
While the JOBS Act has authorized the following two forms of investment crowdfunding, neither is available yet because the SEC has not issued the necessary final regulations:

Title III of the JOBS Act This part of the JOBS Act will permit companies to offer debt and equity securities to both accredited and non-accredited investors via the Internet using a registered broker-dealer or an approved funding portal. Once final regulations are issued, companies will be permitted to raise up to $1 million per 12 month period. There are limitations on the amount that may be invested by non-accredited investors, based on their income and net worth. Although registration will not be required under state securities laws, this crowdfunding exemption will require extensive pre-sale information disclosure by the company, as well as audited financial statements for larger offerings. There also will be post-sale reporting obligations imposed on the company. Because of the high cost of compliance and the relatively small amount of capital that can be raised, it remains to be seen whether this approach to crowdfunding will have any practical appeal to early stage companies.

Title IV (Regulation A+) Once the SEC issues regulations, Title IV of the JOBS Act will permit private companies to raise up to $50 million per 12 month period via a general solicitation to both accredited and non-accredited investors using the Internet. This portion of the JOBS Act has been unofficially dubbed "Regulation A+" due to its similarities to the decades old but seldom used Regulation A.

Regulation A+ also faces a number of hurdles that may reduce its practical value to companies that want to raise capital via crowd funding. First, it will require substantial pre-sale informational reporting (akin to a "mini-registration statement") and pre-sale approval by the SEC. It will also require the company to comply with substantial ongoing reporting requirements. Perhaps most importantly, the scope of state regulation of Regulation A+ offerings is not yet clear. The JOBS Act exempts securities sold to "qualified purchasers" from state regulation and provides that the term "qualified purchaser" will be defined by final SEC regulations. However, proposed regulations issued by the SEC in 2013 were heavily criticized by state securities regulators and were not made final. Any expanded requirement for state review of Regulation A+ offerings would probably render new Regulation A+ as expensive and impractical as existing Regulation A. New regulations are expected later this year.

For additional information, please contact your regular PLDW attorney or call Attorney William F. Miller at 508-771-1360 or 401-824-5100, or email wmiller@pldw.com.



WILLIAM F. MILLER
Partner

William F. Miller is a Partner with Pannone Lopes Devereaux & West LLC and a member of the Corporate & Business Law Team. He is a highly skilled attorney with more than 30 years of experience who focuses his practice on corporate and business law matters, including mergers and acquisitions, angel, venture capital and private equity financing, commercial contract matters, intellectual property protection and licensing, and entity and investment fund formation. Mr. Miller frequently advises early stage technology companies, manufacturers, service and distribution companies as well as investors in such companies.

PLDW
PANNONE LOPES DEVEREAUX & WEST LLC
counselors at law

317 Iron Horse Way, Suite 301 Providence, RI 02908
tel 401 824 5100 • fax 401 824 5123