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Ten Things You Need to Know Before Engaging in Accredited Crowdfunding

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It has been over a year since the Securities and Exchange Commission (SEC) permitted securities issuers to market their capital raises using general solicitation and general advertising while still qualifying for an exemption from public registration. During this time, hundreds of online crowdfunding platforms have launched-- seemingly overnight-- offering investment opportunities in private companies. For a company seeking to raise capital, these "accredited crowdfunding" platforms offer the tantalizing possibility of raising funds with the click of a button. As this new industry grows and develops, it's conceivable certain accredited crowdfunding platforms may become as ubiquitous as traditional broker-dealers. But in this nascent industry, how should a company seeking to raise capital for a new or existing venture go about selecting the most suitable crowdfunding solution? The following are 10 things you should know before engaging in accredited crowdfunding.

1.? Who is eligible to raise funds through accredited crowdfunding?

In the United States, securities offerings made pursuant to Rule 506 of Regulation D under the Securities Act of 1933 are not deemed "public" offerings under the securities laws and are therefore exempt from public registration with the SEC. With one exception, any company can make this type of "private" offering of its securities-- and raise an unlimited amount of money from accredited investors -- using general solicitation and general advertising, either on its own or using an intermediary such as an accredited crowdfunding platform. However, an issuer of securities is prohibited from making a private offering in reliance on Rule 506 if the issuer or certain "covered persons" including directors, executive officers, certain shareholders, and placement agents of the issuer have been convicted of securities fraud or other violations within 10 years of the proposed sale of securities (or five years in the case of the issuer). The "bad actor" disqualification rules apply to all Rule 506 offerings, regardless of whether general solicitation or general advertising is used.

2.? Which accredited crowdfunding platform is right for you?

There are hundreds of accredited crowdfunding platforms, and new ones are being launched every day. In order to determine which platform aligns most closely with a particular issuer's or investor's interests, it is vital to understand the regulatory scheme under which the platform operates, the fee structure, the types of issuers and investors the platform attracts, its managerial and financial resources, the amount of qualified website traffic it generates, and its industry vertical expertise. Each of these factors may impact the success of the offering.

Certain accredited crowdfunding platforms pool the capital raised from accredited investors into private investment funds, which in turn make investments in selected companies listed on the platform. Under this "VC fund/private fund adviser" model, the platform typically acts as an investment adviser to the specially created private funds, and its performance-based compensation hinges on the profits (if any) generated by the funds it manages. The platform (or a lead angel investor) may provide strategic advice and connections to the funds' portfolio companies. Although this model may appear to align the platform's and the issuer's interests, a platform (or a lead angel investor) focused on an accelerated return on investment and liquidity may induce a company to seek an earlier exit.

Other accredited crowdfunding platforms are registered broker-dealers, or are owned, operated by or partnered with registered broker-dealers. These platforms facilitate sales of the issuing company's securities directly to accredited investors. The broker-dealer model platforms receive transaction-based compensation, typically consisting of a percentage of the funds

raised, generally ranging from 1 to 10 percent, depending on the offering amount and type of deal. A company that completes a successful raise under this model may discover it suddenly has a large number of small individual shareholders.

Subscription-based platforms charge a flat monthly fee to companies for listing their securities offerings on the platform. The amount of the fee depends on the complexity of the offering and the optional services selected by the company, such as access to particular software or business plan assistance. Subscription model platforms are typically not registered as broker-dealers or investment advisers. Accredited investors and companies seeking funding connect through the platform but negotiate the terms of the investment without the platform's assistance. Companies using a subscription model platform must be prepared to spend significant time and effort courting and negotiating with potential investors.

3.? Why not DIY?

Some companies may find it appealing to raise money directly by making their own general solicitation offering via their company website. Putting aside the obvious challenge of raising a large amount of capital without the aid of an intermediary, placement agent or finder, a company conducting its own general solicitation will need to undertake certain steps to reasonably verify that all purchasers of the offering are accredited investors. Simply having the investors "check a box" indicating they meet the accreditation standard is not sufficient. The fact-intensive and time-consuming accredited investor verification process can be outsourced to a third-party provider, provided the issuer has a reasonable basis to rely on the third party's verification.

For any capital raise made through a general solicitation, but particularly for one conducted without an intermediary, the best practice is to have a robust offering document, drafted with the assistance of counsel, that describes the terms of the investment. Written disclosure of the risks of the investment will help protect the issuer in the event of a fraud claim.

4.? What's the company's ideal "cap table"?

In selecting a crowdfunding platform, it's important to consider the number and types of shareholders that would be most beneficial to the company. Having a single shareholder on the "cap table," as is typically the case under the "VC fund/private fund adviser" model, where the shareholder is the platform-advised fund, may relieve the issuer of logistical headaches, allowing it to focus primarily on its business operations. However, this approach may require the company to relinquish greater management control.

5.? Who will handle the due diligence process?

Aside from pitching a business plan and its viability to potential investors, issuing companies must be prepared to be subjected to a thorough due diligence investigation of the company; its founders, management team and operations; and the proposed use of proceeds. Before choosing a platform, issuers should consider the extent of due diligence conducted and who is conducting the due diligence. Accredited crowdfunding platforms that are registered broker-dealers are required to conduct a reasonable investigation of the issuer and the securities when recommending securities sold in offerings made pursuant to Regulation D.? In contrast, subscription-based crowdfunding platforms generally are not responsible for due diligence, which must be conducted by each investor independently. With regard to the VC fund/private fund adviser platforms, if an experienced and reputable lead angel commits to making a large investment at the outset of a fundraising campaign, it would be reasonable to assume the lead angel would have conducted some basic due diligence and vetting of the issuer and the proposed venture's likelihood of success.

Some investors prefer to use accredited crowdfunding platforms that curate or vet the offerings listed. Other investors, mindful of the high risk of failure of most startups, may prefer to do their own vetting and due diligence.

6.? Who will handle investor relations?

Before launching an accredited crowdfunding campaign, a prospective issuer would be wise to consider who will handle the company's investor relations (IR) and how it plans to communicate with its shareholders after the closing of the offering. Investor relations consists of the management of ongoing relations and communications of vital corporate and financial information between a company and its shareholders. The primary purpose of IR is to maximize a company's market value in the eyes and minds of the investment community. In a small or growing startup, IR is typically handled by the company's chief financial officer or treasurer, with the assistance of an inside public relations (PR) team or an outside PR or IR agency.

7.? What's the purpose of a transfer agent?

Although raising capital can be exciting, the less glamorous intricacies of the form in which the company will issue shares should not be neglected. Before launching a fundraising campaign, the company should decide whether it will issue paper certificates or the securities will be held in electronic book-entry form. To keep track of its shareholders, the number of shares owned and how the stocks are held, securities issuers typically engage independent transfer agents that issue and cancel stock certificates to reflect changes in ownership. A company may maintain its own share register and act as its own transfer agent, but attempting to do so may be impractical or unreliable if the company is small and has numerous shareholders.

8.? How will the closing of the crowdfunded offering be handled?

The closing is the most critical step of any securities offering. Therefore, it is essential to have in place a compliant but efficient and secure method to collect, centralize, store and seamlessly transfer third-party funds and exchange closing documents. Many accredited crowdfunding platforms outsource this process to vendors that provide independent escrow accounts for each crowdfunding project, collect e-signatures and funds from multiple accredited investors, and either safely return funds if the securities offering fails to reach its desired minimum threshold in time or disburse the funds at closing, when the offering reaches its funding goal.

9.? Can a foreign company (successfully) raise investment capital in the United States or engage in a dual cross-border offering?

During the past year there have been several successful equity crowdfunding campaigns undertaken by foreign startups in the United States. Odyssey Airlines conducted a dual equity crowdfunding campaign in the United Kingdom and the United States via London-based Crowdcube, a leading European crowdfunding platform, and San Diego-based Crowdfunder. OurCrowd, which was founded in Israel in February 2013, is at the forefront of multijurisdictional accredited equity crowdfunding, having raised more than \$60 million from approximately 5,000 accredited investors mostly in the United States, for 46 startups based primarily in Israel. Companies that raise funds from both U.S. and non-U.S. investors must consider the regulatory and compliance implications of making multijurisdictional offerings.

10.? What is the outlook for accredited crowdfunding platforms internationally?

Equity crowdfunding has become a truly global phenomenon, with more than 1,000 platforms operating worldwide, and is emerging as a multibillion-dollar global industry. The global crowdfunding market grew from an estimated \$1 billion in 2010 to more than \$5 billion in 2013, with the North American market accounting for \$3.7 billion, according to The Wall Street Journal. The World Bank estimates the global investment crowdfunding market is expected to reach \$93 billion by 2025, while some venture capital professionals predict it could grow to \$300 billion. As the market continues to grow and evolve, potential initial public offerings of leading global investment crowdfunding platforms are being contemplated by various industry participants. Consolidation and M&A activity in this sector are also expected to accelerate.

According to the World Bank's 2013 infoDev report, there were approximately 87 investment crowdfunding platforms in the United Kingdom, 53 in France, 34 in Canada, 34 in the Netherlands, 27 in Spain, 26 in Germany, 17 in Brazil, 15 in Italy, 10 in India and 4 in Russia. Australia legalized crowdfunding seven years ago, and by 2013 it had approximately 12 investment crowdfunding platforms. Overall, in the developing countries, the investment crowdfunding market is still relatively small. The greatest growth potential may lie in China. CTQuan, a Beijing-based equity crowdfunding platform founded in 2011, recently raised \$4 million. According to the World Bank, investment crowdfunding in China is expected to grow to approximately \$50 billion by 2025.

This is an exciting time for accredited crowdfunding platforms and companies seeking new sources of capital. Both the legal framework and business practices governing private offerings are in rapid transition. It's virtually impossible for a company in fundraising mode to ignore the opportunities presented by accredited crowdfunding, but in order to maximize its chances of having a successful capital raise, an issuer must carefully evaluate the merits of different platforms' accredited crowdfunding models; think through the mechanics of the closing, securities transfers and shareholder communications; and understand how each accredited crowdfunding platform addresses its legal and compliance obligations.

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