Background Materials for MIT Round Table:

"Can Crowdfunding Democratize Access to Capital?"

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1. Some Simple Economics of Crowdfunding

Full chapter available at:
http://www.nber.org/chapters/c12946

Agrawal, A., Catalini, C., Goldfarb, A. (2013). “Some Simple Economics of Crowdfunding” In Innovation Policy and the Economy. Volume 14. NBER, University of Chicago Press.

Early-Stage Capital

Credit Card Debt

Family & Friends

Super Angels

0

Home Equity Loans

$10K-$50K

Angels

Seed Round

$100K-$1.5M

Venture Capital

Series A > $10M

Crowdfunding

Equity-Crowdfunding

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Evidence From Non-Equity Crowdfunding Markets

- Funding is **not geographically constrained** and highly skewed (Agrawal, Catalini, and Goldfarb 2011)
- Funding propensity increases with **accumulated capital** and may lead to herding (Agrawal, Catalini and Goldfarb, 2011; Zhang and Liu, 2012; Kuppuswamy and Bayus 2013)
- **Friends and family** funding play a key role in the early stages of fundraising (Agrawal, Catalini, and Goldfarb 2011)
- Funding follows existing agglomeration, and may **substitute** for traditional sources of financing (Agrawal, Catalini, and Goldfarb 2013)
- Funders and creators are initially **overoptimistic** about outcomes (Mollick 2013)

Incentives of Crowdfunding

Entrepreneurs

- Lower cost of capital (global matches, bundling, lower information asymmetry)
- Feedback and demand estimation

Investors

- Early-access to investment opportunities, products
- Mixed incentives: philanthropy, consumption utility etc.
- Formalization of contracts (F&F) and provision point mechanism
- Crowd due diligence

Disincentives of Crowdfunding

Entrepreneurs

- Disclosure
- Crowding out professional investors
- Investor management

Investors

- Incompetence
- Fraud
- Low returns without diversification
- Lack of incentives for individual due diligence

2. Overview of the JOBS Act

JOBS Act

- **Title I:** changes to the IPO market
- **Title II:** general solicitation through rule 506(c) (accredited investors)
- **Title III*:** regulation crowdfunding (unaccredited investors)
- **Title IV*:** regulation A+

* proposed but not adopted

3. General Solicitation (Title II)

Traditional Deals versus General Solicitation

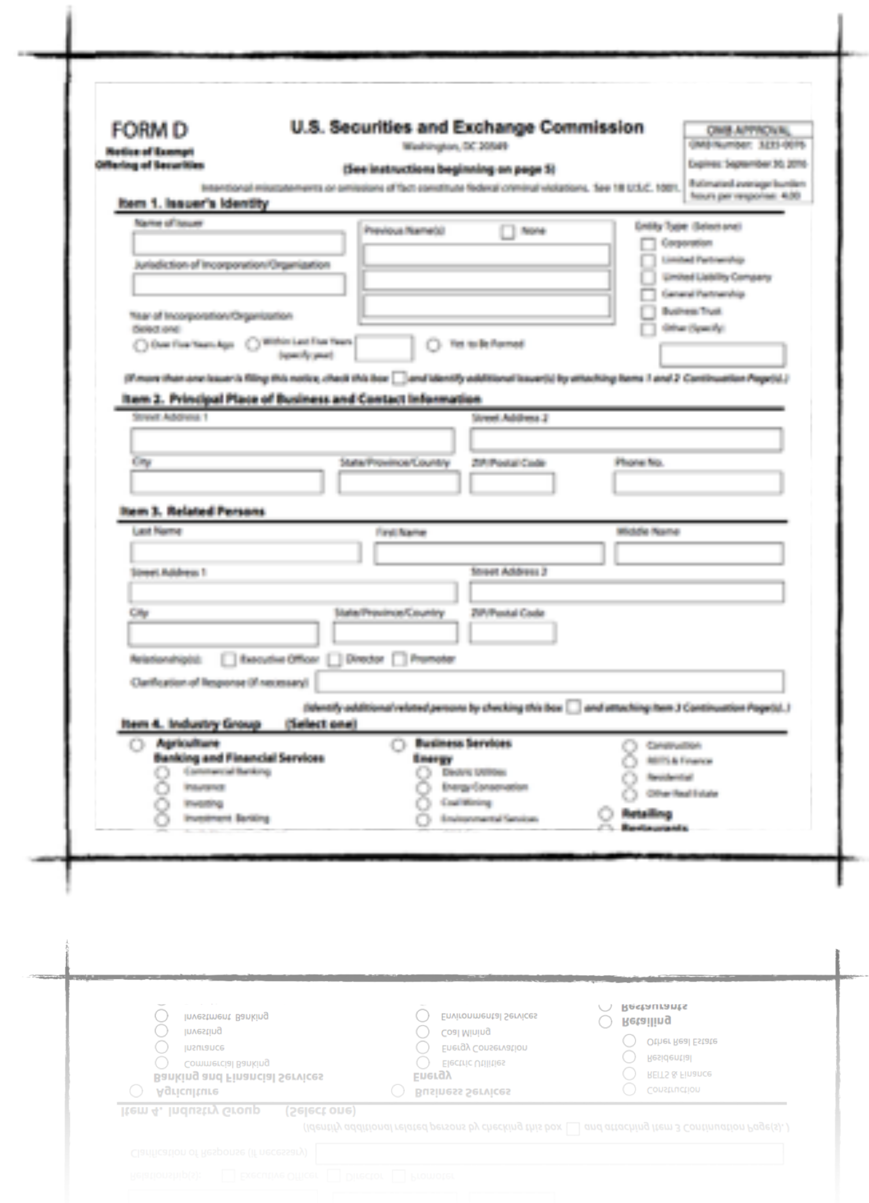
- **Companies can raise unlimited amount of capital from accredited investors**
  - Individual net worth (or joint with a spouse) > $1 million, excluding primary residence.
  - Individual annual income >$200,000 in each of the 2 most recent years ($300,000 joint with a spouse), and a reasonable expectation of the same income level in the current year
- **Offerings are exempt from state blue sky review**
- **TRADITIONAL DEALS: offerings under rule 506(b)**
  - Most of traditional deals, ~1 trillion dollars over 15,000 deals per year
  - Accredited investors self-certify their status. Up to 35 non accredited investors allowed
- **GENERAL SOLICITATION: offerings under Rule 506(c)**
  - Companies have to file Form D 15 days in advance of public mention and at the end of sale (proposed)
  - Failure to file Form D leads to a 1 year ban from 506(c) and 506(b) - (proposed)
  - Issuers must take reasonable steps to verify accredited status (adopted)
  - Disclosures: information about the issuer, use of proceeds, methods used to verify status of investors (e.g., IRS forms, third party).

General Solicitation (Title II)

- Situations that could potentially push a traditional 506(b) deal into general solicitation, i.e. 506(c):
  - Demo days where the general public is invited and fundraising, financial projects are discussed
  - Interviews with the media, blogs, social media where fundraising is mentioned
- *"Eliminating the ban on general solicitation and advertising **may also facilitate boiler-room cold calling and other high-pressure sales techniques**. History shows that, when stock promoters are allowed to advertise and solicit the public without any sort of registration or qualification whatsoever, it opens the door to fraudsters and scam artists of every description"* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171491128
- *"According to a separate analysis by the SEC, lifting the so-called general solicitation ban has resulted in nearly **900** new offerings that **raised a combined $10 billion**. Over the same period, **9,200** offerings were filed by small firms under the old rules, raising a total of more than **$233 billion**, the agency said."* http://online.wsj.com/news/articles/SB10001424052702304163604579532251627028512

General Solicitation (Title II)

- Startups should not make forecasts: e.g., “*our user base grew 10% last month*” is allowed; “*we’re expecting to grow 10% a month*” is not.
- Investors can use non-facts to later sue the company
- Updates to fundraising materials need to be communicated to the SEC (proposed but not adopted)


FORM D

Notice of Exempt Offering of Securities

U.S. Securities and Exchange Commission

Washington, DC 20549

(See instructions beginning on page 5)

OMB APPROVAL

Item 1. Issuer's Identity

Item 2. Principal Place of Business and Contact Information

Item 3. Related Persons

Item 4. Industry Group (Select one)

General Solicitation (Title II)

"It is my opinion, and that of those who we do business with, including our securities lawyers, that these proposed rules effectively make General Solicitation **a non-starter for startup companies**.

If the SEC's intention, with these proposed additional rules, is to neuter General Solicitation to the point that it is legal but nobody avails themselves of it, they will succeed"

Fred Wilson
Union Square Ventures

Discover More on General Solicitation

- http://www.sec.gov/news/press/2013/2013-124-item1.htm
- http://www.sec.gov/news/press/2013/2013-124-item2.htm
- http://www.sec.gov/news/press/2013/2013-124-item3.htm
- http://www.sec.gov/rules/final/2013/33-9415.pdf
- http://www.crowdcheck.com/sites/default/files/CrowdCheck%20Memo%20on%20New%20Regulation%20D.pdf

4. Proposed Regulation Crowdfunding (Title III)

Unaccredited Investors (Title III)

- **Investment caps** (over a 12 month period):
  - Companies can raise up to **$1M** from unaccredited investors through one intermediary (platform or broker)
  - Unaccredited investors can fund **$2K to $100K**
    - 5% of annual income or net worth (<$100K)
    - 10% of annual income or net worth (>$100K)
- **Shareholders limit** is not affected (2,000), i.e. crowdfunders don't count
- Companies can raise a separate round from accredited investors under the usual rules

Company Disclosures (Title III)

- **Minimum** and **maximum** amount to be raised; **close date**
- Resumes of company principals (last 3 years)
- High level cap table, discussion of risks and other classes of stock, # of employees, business plan, use of proceeds
- **Income tax return and US GAAP financials**
  - if raising <$100K CEO certifies
  - if raising $100K-$500K certified by Certified Public Accountant (CPA)
  - if raising >$500K must be audited
- Yearly electronic updates to investors and SEC

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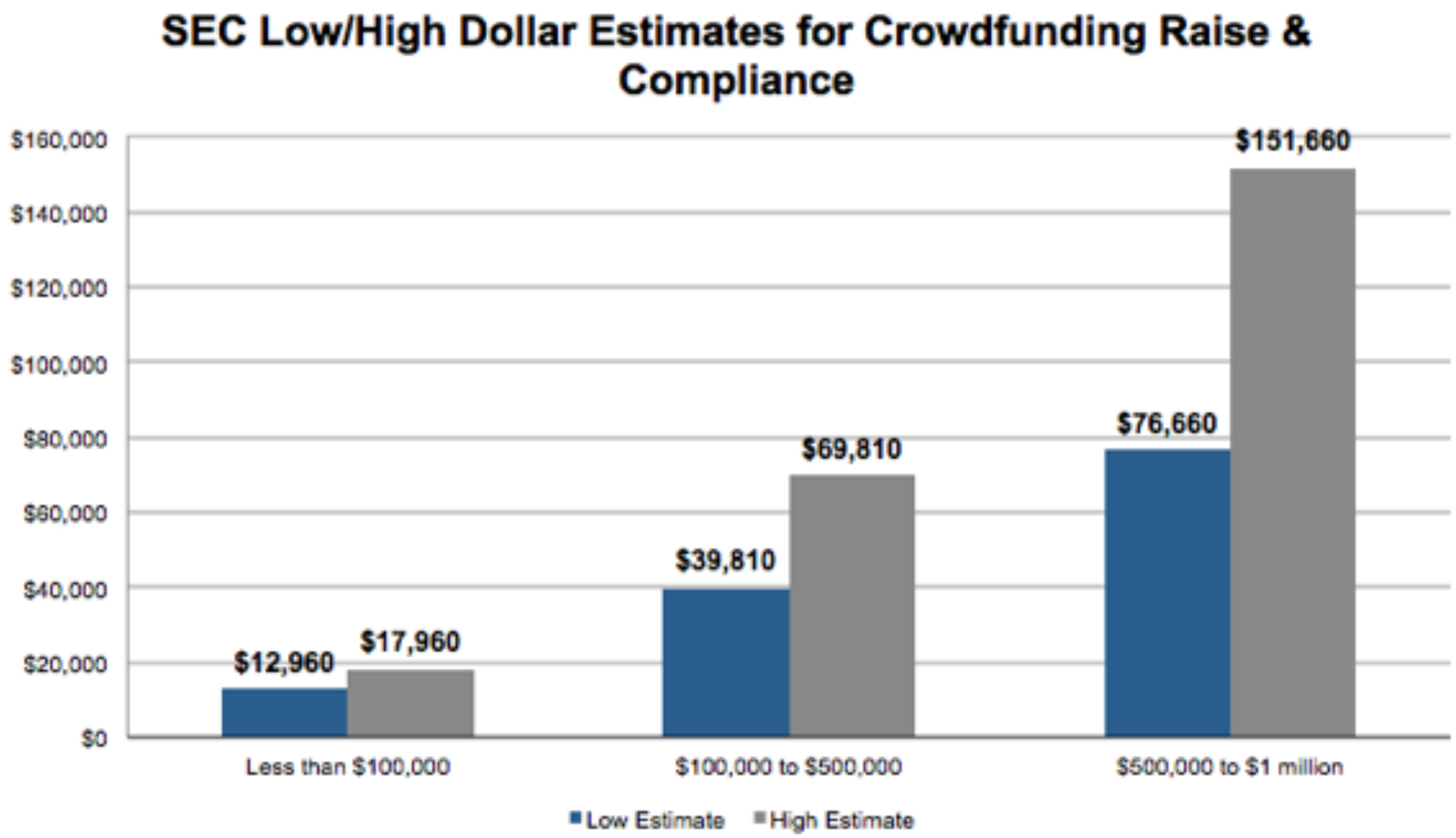
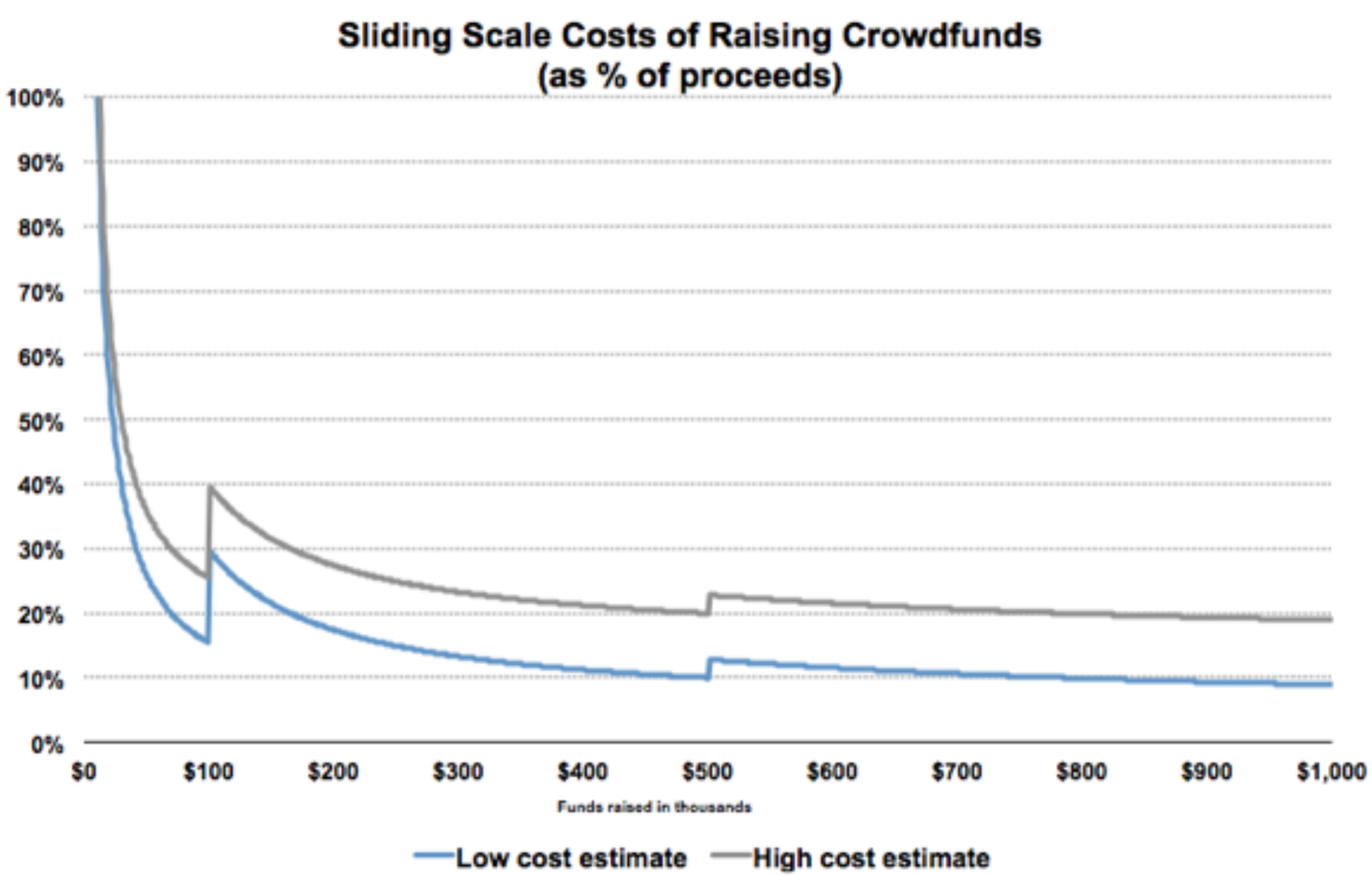
Estimated Cost of Compliance with Accounting Requirements



Source: Crowdfund Capital Advisors



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Restrictions (Title III)

- Company cannot use general solicitation, but can redirect investors to fundraising platform
- Securities cannot be resold for a period of 1 year and cannot be resold to unaccredited investors
- "*Ineligible companies include non-U.S. companies, companies that already are SEC reporting companies, certain investment companies, companies that are disqualified under the proposed disqualification rules, companies that have failed to comply with the annual reporting requirements in the proposed rules, and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies*" http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677

Funding Portals (Title III)

- Need to register with FINRA
- **Cannot use subjective assessment** (e.g., perceived quality) to select the ventures, cannot offer advice
- **Cannot take an equity stake** in the company (transaction based model only)
- Need to **educate investors**, reduce the risk of fraud, provide channels for investors to discuss the offering
- **Are liable** for errors, omissions, or fraud by the issuer (as is their management)
- They can advise companies on presentation materials, but not on content
- They cannot solicit purchases of the securities offered on their portal

Issues Raised on Title III

- Investment caps per investor, per deal
- Burdensome accounting requirements (particularly <$500K)
- Companies do not have the ability to "test the waters" before fundraising
- Portals cannot curate deals, but are liable for misstatements in the disclosures
- Portals can only use a transaction model, but an equity model (e.g., carry) would align incentives with investors
- Disclosure requirements currently do not scale with the size of the fundraising

On Optimal Disclosure

"From an investor's standpoint, excessive illumination by too much disclosure can have the same effect as inundation and obfuscation — it becomes difficult or impossible to discern what really matters. More disclosure, in short, may not always yield better disclosure."

Commissioner Daniel M. Gallagher (SEC)
http://www.sec.gov/News/Speech/Detail/Speech/1370540680363#.U3JSX60bBCA

Discover More on Title III

- Laws, K. (2013) “Crowdfunding regulations summary”. Available at: http://goo.gl/Pm0PSk
- http://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm
- http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677
- http://blogs.law.harvard.edu/corpgov/2014/03/09/sec-crowdfunding-rulemaking-under-the-jobs-act-an-opportunity-lost/
- http://blogs.law.harvard.edu/corpgov/2013/12/06/jobs-act-title-iii-crowdfunding-moves-closer-to-reality/
- http://blogs.law.harvard.edu/corpgov/2013/10/30/sec-proposes-crowdfunding-rules-under-jobs-act/
- http://www.crowdcheck.com/sites/default/files/Regulation%20Crowdfunding%20Memo%2C%204%28a%29%286%29.pdf
- http://boss.blogs.nytimes.com/2013/11/14/what-the-proposed-crowdfunding-rules-could-cost-businesses/
- http://boss.blogs.nytimes.com/2013/10/28/a-year-late-s-e-c-weighs-in-with-585-pages-of-crowdfunding-rules
- http://venturebeat.com/2014/01/02/it-might-cost-you-39k-to-crowdfund-100k-under-the-secs-new-rules/
- http://venturebeat.com/2014/02/08/how-to-save-crowdfunding-before-its-dead-on-arrival/
- http://www.crowdfundinsider.com/2014/01/29734-secs-proposed-crowdfunding-regulations-six-deadly-sins/
- http://www.crowdfundinsider.com/2014/02/31793-five-issues-fix-sec-regulation-crowdfunding/
- http://www.sec.gov/rules/proposed/2013/33-9470.pdf

5. Proposed Regulation A+ (Title IV)

Existing Regulation A

- Allows unregistered public offerings **up to $5M**
- Available to US and Canadian companies
- **Companies can "test the waters"** for potential interest in the offering
- Financial statements do not need to be audited
- General solicitation is available
- Securities can be resold
- **State blue sky review makes it difficult to navigate for companies**: *"In recent years, Regulation A has been used very rarely, and issues have been raised that the cost and complexity of federal and state law compliance make it less practical than other Securities Act exemptions."* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540518165

State Blue Sky Review

“The year was 1980. The headline in the Wall Street Journal on December 12, 1980 read ‘Massachusetts Bars Sale of Stock as Risky.’ It seems that the State of Massachusetts, in its zeal to protect investors, was one of a handful of states to bar “ordinary investors” from participating in what it viewed as a (too) hot IPO. Having raised the initial offering price to $22.00 per share, a company about to complete its IPO was told by the State of Massachusetts that its offering did not meet its stringent blue sky standards. In its opinion, the offering price was too high relative to its earnings and book value. The result—the offering was withdrawn from the State of Massachusetts—and the offering was only made available to retail investors in 27 states. Today the stock trades at over $500.00 per share. The name of the company was Apple Computer—a company whose market capitalization ultimately made it the most highly valued public company in the world.”

- Samuel S. Guzik

http://blogs.law.harvard.edu/corpgov/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/

Regulation A+

- The objective is to extend the existing "regulation A" exemption **to deals up to $50M** in exchange for additional disclosures and ongoing reporting by the company
- Lower disclosure burden than a full SEC registration
- **TIER 1: <$5M in a 12 month period**
  - Currently not exempt from state blue sky requirements (SEC solicited feedback on this)
- **TIER 2: $5M to $50M in a 12 month period**
  - Sales to "qualified purchaser" **would not require state registration and qualification** (no state blue sky requirements)
  - **Audited financial statements**
  - Investors limited to purchasing no more than 10% of the greater of their annual income or net worth
  - Company needs to file annual and semiannual reports (similar to public company reporting)

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Higher Risk of Fraud?

*"One result of the JOBS Act is that, taken together, general solicitation, crowdfunding, Regulation A-plus, the so-called 'IPO on-ramp,' and increases in the number of record holders a company may have before it has to register under the Exchange Act — have the effect of blurring the lines between public and private companies. In effect, rather than a simple distinction between private placement and public offering, or between reporting company and non-reporting company—**there are now different degrees of publicness.** This situation raises a number of concerns for the investing public: First, there is the potential risk of a "race to the bottom," in which **companies are incentivized to seek out the regulatory approach that allows them to access the most investor funds with the least possible oversight.** Another risk is that, with a wide range of disclosure and governance regimes that may potentially be adopted, investors may be misled, or otherwise be unaware, of the rules applicable to a particular offering and the underlying security. Moreover, the lack of transparency relating to these offerings **may also lead to an increase in fraud or manipulation in the secondary market.** For example, while it is not yet known whether a reliable secondary market will develop for Regulation A-plus securities, any such market will almost certainly be less transparent than the market for listed securities—even with the proposed ongoing reporting obligations for Tier 2 offerings"*

Commissioner Luis A. Aguilar (SEC)
http://www.sec.gov/News/Speech/Detail/Speech/1370541436767#.U3KJD61dXPY

Discover More on Regulation A+

- http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540518165
- http://blogs.law.harvard.edu/corpgov/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/
- http://blogs.law.harvard.edu/corpgov/2014/01/04/promoting-investor-protection-in-small-business-capital-formation/
- http://www.sec.gov/rules/proposed/2013/33-9497.pdf
- http://www.crowdcheck.com/sites/default/files/Comparison%20of%20506%2C%20CF%2C%20Reg%20A.pdf

6. Intrastate Crowdfunding Exemptions

Intrastate Exemptions

- **Intrastate offerings often rely on exemption 3(a)(11) of the Securities Act**

- **Intrastate crowdfunding exemptions**
  CO, GA, ID, IN, KS, ME, MI, WI, WA

- **In progress**
  AK, AL, CT, MD, MO, NC, NJ, SC, FL, TN, TX, VA, UT

- **Rejected**
  NM and MS

- **More details**

  - https://s3.amazonaws.com/wac6web/statecrowdfundinglaw.html

  - http://www.crowdcheck.com/sites/default/files/Summary%20of%20Intrastate%20Crowdfunding%20Exemptions_0.pdf

7. Proposed Equity Crowdfunding Improvement Act

Equity Crowdfunding Improvement Act

- The bill by Congressman Patrick McHenry aims to change Title III
- **New investment caps -** companies can raise up to (over 12 months):
  - **$500K** with self-certified financials
  - **$3M** with financials independently reviewed by a public accountant
  - **$5M** with an audited financial statement
  - Unaccredited investors can fund **$5K or 10%** of annual income or assets
- Funding portals only need to register with the SEC (not FINRA), can **curate deals**, and are **not liable** for issuers.
- Investors must understand the level of risk and risk of illiquidity
- No annual reporting required by the companies
- Investment companies can be crowd funded (e.g., diversified funds)

Discover More on the Equity Crowdfunding Improvement Act

- http://financialservices.house.gov/uploadedfiles/bills-113hr-pih-crwdfnd-m001156.pdf

- http://www.crowdfundinsider.com/2014/05/37673-jobs-act-2-0-congressman-mchenrys-cure-six-deadly-sins-crowdfunding-regulation/

8. Comparing the Different Options

	506(b) Traditional Regulation D (existing)	Title II 506(c) General Solicitation (adopted*)	Title III Crowdfunding (proposed)	Title IV A+ Tier 1 (proposed)	Title IV A+ Tier 2 (proposed)
Investors	Accredited investors; up to 35 non-accredited	Accredited investors	All investors	All investors	All investors
Solicitation	No general solicitation	Public	No general solicitation. Can redirect to funding portal	Public	Public
Investor Verification	Accredited self-certify	Issuers must take reasonable steps to verify accredited status	Self-certification on investment caps	Not required	Self-certification on investment caps
Review	No SEC review	No SEC review	No SEC review	SEC reviews and declares "qualified"	SEC reviews and declares "qualified"
Limits on investment amount	No limit	No limit	Min $2K and max $100K. 5% of income/ net worth if <$100K (10% if >$100K)	No limit	10% of income or net worth per deal
Offering size	No limit	No limit	$1M	$5M	$50M

* some of the rules are proposed (e.g. disclosure updates to SEC), but not adopted

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Send feedback and comments to catalini@mit.edu