



Equity Crowdfunding

A new way to raise money.

BY KATHRYN K. LINDAUER AND JENNIFER CHANCE

So you have a great idea for a new business but don't have the money to get it off the ground. Equity crowdfunding is now a popular way to draw attention (and potential funders) to startups. But is it the right choice for you?

What is equity crowdfunding?

By putting itself on an online equity crowdfunding portal, a company makes its fundraising needs known to a wide range of people who can decide whether to invest in the business. Rewards-based crowdfunding campaigns—where investors receive a gift, such as a T-shirt—have been around for awhile (think Kickstarter projects) and are exempt from securities laws because investors aren't getting "securities." Under the Jumpstart Our Business Startups Act, enacted in 2012, companies may now use equity

crowdfunding to raise capital in exchange for debt or equity securities.

What's permissible?

Prior to the JOBS Act, it was illegal to sell securities through a "general solicitation" unless the securities were registered under applicable federal and state securities laws. Among other restrictions, a company couldn't raise funds by using advertisements published in newspapers or social media without registering its securities.

Under the JOBS Act, companies can now use a general solicitation to sell their unregistered securities as long as the only purchasers of the securities are "accredited investors" (which include individuals who meet certain income or net worth requirements). To take advantage of this rule, a company must take reasonable steps to verify that

the purchaser is accredited. Right now, this is the only way that companies can sell their securities using equity crowdfunding. However, companies are taking advantage of this. It has been estimated that as much as \$500 million to \$1 billion was raised through equity crowdfunding campaigns in 2014.

What federal proposals are underway?

Title III of the JOBS Act allows limited investments in privately held companies from non-accredited investors. However, private companies may not rely on the Title III exemptions until the Securities and Exchange Commission adopts rules relating to equity crowdfunding transactions. The law and proposed regulations are quite stringent and could make it difficult for private companies to use equity crowdfunding to raise money from nonaccredited investors.

Under the proposed rules, a private company will be able to sell only a maximum of \$1 million of securities in reliance on this exemption in a 12-month period. Amounts that can be raised from individual investors are severely limited. Companies will be required to make a significant amount of financial and other information available to the SEC and to prospective investors prior to the sale and to update the information annually. Also, the equity crowdfunding portals that companies use to raise money will be required to comply with numerous requirements.

What's going on in Texas?

The Texas State Securities Board recently passed regulations under which intrastate equity crowdfunding offerings by private companies to nonaccredited investors would be exempt from registration in Texas. Under the regulations, which took

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effect Nov. 17, 2014, the maximum amount that a company can raise in reliance on this exemption is \$1 million in any 12-month period and nonaccredited investors can invest no more than \$5,000 in any offering.

To rely on this exemption, the issuer must be organized and have its principal place of business in Texas. At least 80 percent of its gross revenues must be derived from operations in Texas, at least 80 percent of its assets must be located in Texas, and at least 80 percent of the net proceeds of the offering must be used for Texas operations. In addition to other requirements, the offering must be made exclusively through a website operated by a registered general dealer or a registered Texas crowdfunding portal. All communications to investors must occur on the crowdfunding website via message boards accessible by all other prospective investors. Companies may distribute links to the crowdfunding portal—but these may be distributed only to investors located in Texas. Thus, using social media to advertise an intrastate equity crowdfunding offering is generally prohibited.

Why not equity crowdfund?

If a company sets a low minimum investment and its equity crowdfunding campaign is successful, it will end up with a large number of shareholders. Dealing with shareholders can be time-consuming and difficult. Among other matters, a company's shareholders (including competitors) have rights to inspect company books and records under certain circumstances. Additionally, shareholder meetings will be cumbersome to arrange and it may be difficult to get shareholder consent when it is necessary. Future investors may hesitate to invest in a company that has many shareholders. This problem can be solved by setting a high minimum investment and limiting the number of invest-

ments a company takes in or taking investments only through a company created for that purpose.

Additionally, federal and state rules governing certain types of equity crowdfunding, and the nature of equity crowdfunding itself, will require that a company disclose a tremendous amount of information to a very large number of people. If you want to keep your idea confidential, it will be impossible to do so.

Under the traditional private placement exemptions, a company selling unregistered securities that fails to comply with the specific regulatory requirements for exemption may be able to fall back on the exemption provided by Section 4(a)(2) of the Securities Act as long as no general solicitation has taken place. However, a company that loses its crowdfunding exemption will have no statutory exemption from registration. Selling unregistered securities without an exemption can have severe consequences for the issuer.

A few tips on getting started.

A company wanting to use equity crowdfunding should first create its "pitch." This should cover the same information the company would give to an investor they meet in person—including information about the products or services offered by the company, the management team, and other pertinent details. The company should also create a short informational video for prospective investors. Doing this doubles the chance of success. You should be prepared to drive people to a crowdfunding portal by using social media, although under Texas regulations, companies are subject to limitations.

Company directors, officers, and employees can let the people in their circle of family and friends know about the equity crowdfunding campaign (again, as long as it is done in compliance with the relevant crowd-

funding exemption).

As with any securities offering, be sure that prospective investors receive all material information about the company—including an extensive list of risk factors. **TBJ**



KATHRYN K. LINDAUER

practices law at Winstead and has more than 30 years of experience in corporate, securities, and business law. Her practice includes securities offerings, mergers and acquisitions, corporate governance, and representation of closely held and emerging growth companies, including angel and venture capital financings. She can be reached at klindauer@winstead.com.



JENNIFER CHANCE

practices law at Winstead, where she focuses on corporate and securities law. Her practice includes securities offerings, corporate governance and compliance, and mergers and acquisitions. She can be reached at jchance@winstead.com.

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