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Using the Internet to Raise Money: Securities Laws and Crowdfunding

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There are many services available to emerging companies to raise money through crowdfunding. As an entrepreneur or leader of a company evaluating these options, it is important to understand the basic legal foundations of these different options.

A significant dividing line between crowdfunding options is whether the person contributing money expects to participate in the profits of the business. If so and if the company is issuing an ownership interest to the investor in the business, the issuer must comply with both federal and state securities laws. This is sometimes referred to as the equity model of crowdfunding.

If the contributor has no expectation of earning a profit from its contribution, on the other hand, securities laws are not relevant. Two common forms of non-equity crowdfunding are the donation model and the rewards model.

The Donation Model

The donation model very simply involves a donation of funds to the company. The contributor does NOT receive any stock or ownership interest in the company or project, and by definition, there are no securities law issues with this type of fund raising.

The Rewards Model

The rewards model is very similar to the donation model except the contributor receives some token of appreciation. The rewards may vary depending on the amount of the donation and may or may not be related to the project that is being funded.

The donation and rewards models can be effective ways of raising money for projects that capture the interest of a broad audience, like creative projects involving music or movies, but it is less effective for ventures that do not have a compelling story to attract the interest of the crowd.

The Equity Model—Accredited Investor Model (Rule 506(c) Offering)

In the equity model of crowdfunding, investors will acquire an ownership interest in the company. Because the company is now issuing a security, it must comply with federal and state securities laws.

Prior to September 2013, companies that wanted to raise money in a typical private placement sale of securities were not permitted to conduct a general solicitation or advertise their offering on the Internet or elsewhere. In September 2013, however, the Securities and Exchange Commission relaxed the prohibition on general solicitations and adopted rules governing an equity model of crowdfunding.

This equity model of crowdfunding permits a company to advertise its offering as long as all of the investors are accredited investors and the company takes reasonable steps to verify that the investors are accredited investors.

The type of due diligence required to verify that an investor is an accredited investor may vary based on an objective determination by the issuer of the securities in the context of the particular facts and circumstances. The factors to be considered in this analysis are:

- the nature of the purchaser and the type of accredited investor that the purchaser claims to be;
- the amount and type of information that the issuer has about the purchaser; and
- the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.

For example, if the terms of the offering require a very high minimum investment amount and a purchaser is able to meet those terms, then the likelihood of that purchaser satisfying the definition of accredited investor would be relatively high and it may be reasonable for the issuer to simply confirm that the purchaser’s cash investment is not being financed by a third party to verify the purchaser’s status as an accredited investor.

Generally, however, additional due diligence will be required and the SEC gave the following, non-exclusive, examples of the kinds of due diligence necessary:

- to verify that an individual meets the minimum annual income test, the issuer may review the investor’s federal tax returns, Form W-2’s, Form 1099’s, or Schedule K-1’s for the last two years, and
- to verify that an individual meets the minimum net worth test, the issuer may review the investor’s credit report,

bank statements, brokerage account statements, and appraisal reports issued by third parties, as applicable.

The Equity Model—Proposed New Rules

The SEC has proposed rules for a second form of equity crowdfunding. **As of the date of this publication, these rules are not yet finalized and you cannot raise money using this form of crowdfunding.**

Like the Accredited Investor model described above, the proposed rules permit a general solicitation of securities; however, the investors do NOT need to be accredited investors. Instead, the issuer must comply with certain other restrictions. Some of the more important restrictions are that:

1. The offering must be conducted online.
2. The company is limited to raising $1,000,000 in a 12-month period using this type of offering.
3. Even the most affluent investors would be limited to investing up to $100,000 in any 12-month period in these types of offerings, and the limits would be lower for investors with lower net worth or annual income.
4. Finally, the company will be required to file its offering documents with the SEC, and after the offering, the company will be required to file annual reports with the SEC.

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