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# MAKING EQUITY CROWDFUNDING WORK FOR THE UNACCREDITED CROWD

*Jeff Thomas**

## I. Introduction

The idea behind equity crowdfunding is both simple and revolutionary. Entrepreneurs will be able to use the Internet to pitch business ideas to millions of potential investors and allow "anyone with a few dollars to spend [to] become an investor."[1] While this may seem like an obvious use of the Internet, until now, securities laws have prohibited new ventures from using this approach[2] to raise capital from "average Joes" and other unaccredited investors.[3] However, the Jumpstart Our Business Startups (JOBS) Act[4] creates a new "crowdfunding exemption" that will allow companies to raise up to $1 million every twelve months by selling their stock (or other unregistered securities) to both accredited and unaccredited investors, provided that the sales are made through registered intermediaries.[5] This article summarizes why the crowdfunding exemption is important, explains how its expected costs are problematic, and proposes ways to mitigate those costs without sacrificing investor protection.

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* Jeff Thomas is the Chair of the School of Business at Johnson & Wales University in Charlotte, NC. He also serves on the Board of Directors of Queen City Forward, an accelerator for social ventures. He has extensive experience in counseling entrepreneurial ventures through law firms and law school clinics in Chicago and Silicon Valley.

[1] C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10 (2012).

[2] *See, e.g.*, Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TRANSACTIONS: TENN. J. BUS. L. 63, 75 (2011) ("[S]ecurities laws . . . are a formidable barrier to investment crowdfunding in the United States.").

[3] Unaccredited investors (also referred to as non-accredited investors) are investors who are not within the definition of an "accredited investor." The term accredited investors includes natural persons: "whose individual net worth, or joint net worth with that person's spouse, exceeds $1,000,000"; "who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching

## II. Importance of the Crowdfunding Exemption

The crowdfunding exemption is important because it allows for new sources of capital for new ventures. New ventures, and the jobs they create, are significant to our economy.[6] New ventures also often need external capital,[7] but due to securities laws, it is difficult for them to raise that capital.[8] When selling stock and other securities, new ventures (and other issuers) must either register their securities under the Securities Act of 1933[9] (the Securities Act) or satisfy federal and state requirements for an exempt offering.[10]

On average, issuers must pay $2.5 million to initially register their securities under the Securities Act and an additional $1.5 million each year thereafter to comply with ongoing requirements, making registration impractical for most new ventures.[11] Without the crowdfunding exemption, unaccredited investors are limited in their ability to participate in exempt offerings,[12] and, as of 2010, only 7.4% of U.S. households were accredited based on the net worth standard.[13] Additionally, only a small percentage of the accredited households are likely to participate in exempt offerings.[14]

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the same income level in the current year"; or, who serve as a "director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer." *See* 17 C.F.R. § 230.501 (2013).

[4] Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at scattered sections of 15 U.S.C.A. (West 2012)).

[5] *See* JOBS Act §§ 301–05, 15 U.S.C.A. §§ 77–78 (West 2012).

[6] *See, e.g.*, *Vision Statement: Can Start-Ups Help Turn the Tide?*, HARV. BUS. REV., Sept. 2012, at 30 ("[N]ew businesses—and the jobs they create—are more important than ever."). An abstract is available at http://hbr.org/2012/09/can-start-ups-help-turn-the-tide/ar/1.

[7] *See, e.g.*, 2013 STATE OF ENTREPRENEURSHIP ADDRESS, EWING MARION KAUFFMAN FOUNDATION, FINANCING ENTREPRENEURIAL GROWTH 2 (2013), http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2013/02/soe%20report_2013pdf.pdf ("For the fast-growing (but mostly small) companies on the 2012 Inc. 500 list . . . one-third said access to external capital had been essential to company growth.").

[8] *See, e.g.*, Burkett, *supra* note 2, at 82–92.

[9] 15 U.S.C. §§ 77e–77f (2012).

[10] *See* Bradford, *supra* note 1, at 42–47.

[11] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. 66,428, 66,509 (proposed Nov. 5, 2013) (to be codified at scattered parts of 17 C.F.R.) (citing two surveys).

[12] *See id.* at 66,510–11.

[13] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,793 (July 24, 2013) (to be codified at 17 C.F.R. pts. 230, 239 & 242) (citing data from the Federal Reserve Board's Triennial Survey of Consumer Finances 2010).

[14] *See id.* at 44,794 (citing an analysis by the Securities & Exchange Commission's (SEC) Division of Economic and Risk Analysis that was based on the stock holdings of retail investors from more than 100 brokerage firms covering more than 33 million accounts during the period June 2010–May 2011).

Thus, the crowdfunding exemption is critical because it will provide cash-hungry new ventures with access to a large and currently under-tapped source of capital—unaccredited investors.

## III. Crowdfunding Exemption's High Expected Costs

In order to protect investors, the JOBS Act[15] and the Securities & Exchange Commission's (SEC) Proposed Crowdfunding Rules[16] impose several requirements on issuers[17] and intermediaries.[18] Unfortunately, the costs associated with these requirements may threaten the usefulness of the exemption in practice. As one practitioner notes:

To produce an offering disclosure document, enlist a funding portal, run background checks and file an annual report with the SEC year after year might well cost upwards of $100,000. The high expenses compared to the low maximum amounts that can be raised by a company and invested by an individual make public equity crowdfunding one of the costliest forms of (legal) capital raising.[19]

The SEC also provides cost estimates for issuers and intermediaries in the Proposed Crowdfunding Rules. These costs are summarized below.

[15] *See* §302(b), 15 U.S.C.A. § 77d1(a), (b) (West 2012).

[16] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. 66,428.

[17] *See* JOBS Act § 302(b), 15 U.S.C.A. § 77d-1(b) (West 2012). Examples of issuer requirements include: (i) providing the SEC, intermediaries, and investors with a description of issuer's (a) business, including its anticipated business plan, (b) financial condition (and, in some cases, reviewed or audited financial statements), (c) anticipated use of the offering proceeds, (d) ownership and capital structure, and (e) method for valuing the securities being offered; (ii) not advertising the terms of the offering, although issuers may direct investors to intermediaries; and (iii) reporting the results of operations (and, in some cases, providing reviewed or audited financial statements) each year to the SEC and investors. *See id.*; *see also* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,552–54 (stating proposed regulations regarding these requirements).

[18] *See* JOBS Act § 302(b), 15 U.S.C.A. § 77d-1(a) (West 2012). Examples of intermediary requirements include: (i) registering with the SEC and a self-regulatory organization; (ii) providing investor-education materials; (iii) ensuring each investor (a) reviews the investor-education materials, (b) affirms she understands that she may lose her entire investment and can bear such a loss, and (c) demonstrates she understands the applicable investment risks; (iv) obtaining background checks on officers, directors and stockholders holding 20% of each issuer; and (v) making each issuer's information, *see supra* note 17, available to the SEC and potential investors at least 21 days prior to the sale of issuer's securities. *See id.*; *see also* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,555–56 (stating proposed regulations regarding these requirements).

[19] Brian Korn, *SEC Proposes Crowdfunding Rules*, FORBES.COM (Oct. 23, 2013, 2:41 PM), http://www.forbes.com/sites/deborahljacobs/2013/10/23/sec-proposes-crowdfunding-rules/.

### A. SEC Estimates of Issuer Costs

The SEC estimates that issuers relying on the crowdfunding exemption would incur the following initial and ongoing annual costs for three different offering amounts[20]:

| | Offering Amount | | |
|---|---|---|---|
| | $50,000 | $300,000 | $750,000 |
| Initial Costs: | | | |
| Compensation to the intermediary[21] | $5,000 | $30,000 | $75,000 |
| Cost to prepare and file initial disclosure document[22] | $6,000 | $6,000 | $6,000 |
| Cost of review or audit of financials[23] | N/A | $14,350 | $28,700 |
| Other initial costs[24] | $460 | $460 | $460 |
| Total Initial Costs | $11,460 | $50,810 | $110,160 |
| Initial Costs as a % of the Offering Amount | 22.92% | 16.94% | 14.69% |
| | | | |
| Ongoing Annual Costs:[25] | | | |

[20] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,521 & n.918 (midpoints of the offering amount ranges provided by the SEC were used for this section). The SEC used both its ranges and these same midpoints to estimate items. *See id*.

[21] *See id.* (compensation to the intermediary is assumed to be 10% of the offering amount, which is the midpoint of the SEC's estimated range of an intermediary compensation fee of 5–15%).

[22] *See id.* The Form C would be used to provide the required initial offering information about the issuer and the offering. *See id.* at 66,524. The SEC estimates it will take 60 hours to prepare and file the Form C and any amendment to disclose material information. *See id.* at 66,540. The SEC estimates that 75% of that burden, or 45 hours, would be carried by the issuer but that the other 25%, or 15 hours, would be carried by outside professionals charging $400 per hour. *Id.* Thus, the $6,000 amount reflects only the cost of outside professionals working for 15 hours at $400 an hour—it does not include any cost for the estimated 45 hours of issuer time. If, for example, issuer time was valued at $50 per hour, this would increase estimated costs by $2,250. Total Initial Costs would then be $13,710 for a $50,000 Offering Amount, or 27.42% of the Offering Amount.

[23] *See id.* at 66,521. For offerings of more than $500,000, the financial statements must be audited; for offerings of more than $100,000, but not more than $500,000, the financial statements must be reviewed by an independent public accountant; and offerings of $100,000 or less require merely that the issuer's principal executive officer certify that the financial statements are true and complete in all material respects. *See* JOBS Act § 302(b), 15 U.S.C.A. § 77d-1(b)(1)(D) (West 2012).

[24] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,521 & nn.919–20 (assuming a cost of $60 to obtain an EDGAR access code on Form ID and $400 to prepare and file progress updates on Form C-U).

[25] These costs must be incurred until: (i) "issuer becomes a reporting company required to file reports under Section 13(a) or Section 15(d) of the Exchange Act [of 1934]"; (ii) "issuer or another party repurchases all of the securities issued in reliance on [the crowdfunding exemption]"; or (iii) "issuer

| | | | |
|---|---|---|---|
| Cost to prepare and file annual disclosure document[26] | $4,000 | $4,000 | $4,000 |
| Cost of review or audit of financials[27] | N/A | $14,350 | $28,700 |
| Total Ongoing Annual Costs | $4,000 | $18,350 | $32,700 |
| Ongoing Annual Costs as a % of the Offering Amount | 8.00% | 6.12% | 4.36% |

Thus, considering these estimates, a new venture that sells $50,000 of stock would initially net only $38,540 and it must continue to pay outside professionals an additional $4,000 each year to comply with ongoing reporting requirements. Although these costs already seem high, additional issuer costs, intermediary costs, and other costs must also be factored in.

liquidates or dissolves its business in accordance with state law." *Id.* at 66,554.

[26] *See id.* at 66,521. The Form C-AR would be filed annually with the SEC, beginning the year after the initial offering. *See id.* at 66,540–41. It would include information substantially similar to that reported via the Form C. *See id.* at 66,541. The SEC estimates it will take 40 hours to prepare and file each Form C-AR. *See id.* The SEC estimates that 75% of that burden, or 30 hours, can be carried by the issuer but that the other 25%, or 10 hours, would be carried by outside professionals charging $400 per hour. *See id.* Thus, the $4,000 amount reflects only the cost of outside professionals working for 10 hours at $400 an hour—it does not include any cost for the estimated 30 hours of issuer time. If, for example, issuer time was valued at $50 per hour, this would increase estimated costs by $1,500. Total Ongoing Annual Costs would then be $5,500 for a $50,000 Offering Amount, or 11% of the Offering Amount.

[27] *See supra* text accompanying note 23. Costs to review or audit financial statements may be required in connection with each year's Form C-AR. *See* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,554.

### B. SEC Estimates of Intermediary Costs

To qualify for the crowdfunding exemption, issuers must use a registered broker or funding portal.[28] The SEC estimates the following initial and ongoing annual costs for three different types of intermediaries[29]:

| | Intermediaries That: | | |
|---|---|---|---|
| | Register as Brokers | Register as Funding Portals | Are Already Registered as Brokers |
| Initial Costs: | | | |
| Registration and Membership Costs[30] | $275,000 | $100,000 | N/A |
| Compliance Costs[31] | $245,000 | $67,000 | $45,000 |
| Platform Development Costs[32] | $250,000 | $250,000 | $250,000 |
| Total Initial Costs | $770,000 | $417,000 | $295,000 |
| | | | |
| Ongoing Annual Costs: | | | |
| Registration and Membership Costs[33] | $50,000 | $10,000 | N/A |
| Compliance Costs[34] | $180,000 | $40,000 | $30,000 |
| Platform Development Costs[35] | $40,000 | $40,000 | $40,000 |
| Total Ongoing Annual Costs | $270,000 | $90,000 | $70,000 |

[28] *See* JOBS Act, § 302(a), 15 U.S.C.A. § 77d(a)(6)(C) (West 2012).

[29] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,526–28.

[30] *See id.* at 66,528. The initial and ongoing costs for an entity to register as a broker would be higher than the initial and ongoing costs for an entity to become a funding portal since the SEC assumes brokers would provide a broader range of services, such as providing investment advice, soliciting investors, and managing customer funds and securities. *See id.* at 66,527. For intermediaries already registered as brokers, there would be no incremental registration or membership costs. *See id.* at 66,541. The SEC also estimates it would take an intermediary approximately 220 hours to register as a broker-dealer compared to 110 hours to register as a funding portal, and that it would cost intermediaries $10,000, on average, to register with a national securities association. *See id.* at 66,542.

[31] *See id.* at 66,528.

[32] *See id.* This equals the midpoint of the range provided by the SEC, which varies from $100,000 to $400,000 and depends on whether an intermediary can tailor an existing platform to comply with the JOBS Act or would need to develop a new platform from scratch. *See id.* at n.987.

[33] *See supra* note 30.

[34] *See supra* note 31.

[35] *See supra* note 32.

The SEC also estimates that, on average, intermediaries will generate $200,000 per year in revenue from offerings made under the crowdfunding exemption.[36] Thus, it may be difficult for intermediaries to cover these and additional overhead costs even if they are able to collect 10% of the amounts they help issuers raise.

### C. Other Costs

As mentioned above, the SEC estimates do not reflect all of the costs that issuers will have to bear when using the crowdfunding exemption. Additional issuer costs include an expected return for the investors[37] and the value of issuer time required to prepare and file the initial offering document[38] and ongoing annual disclosures.[39] Moreover, the SEC estimates do not include transactional costs that investors will incur. For instance, reasonable investors will require time to learn about an issuer's business (for example, the issuer's current and anticipated products, customers and revenue model) as well as the terms of the offering (such as the rights attached to the shares being offered, the number of shares outstanding, and the rights attached to the outstanding shares). Because some people will be investing only a few hundred dollars (or even just "a few dollars")[40] it would be easy for an investor's transaction costs to be a significant percentage of, or even exceed, her total investment amount.[41] Furthermore, costly disputes related to offerings may arise in the future.

[36] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,539, 66,543 (estimating that each offering will average $100,000, that each intermediary will facilitate an average of 20 offerings annually, and that each intermediary will be compensated with 10% of the offering amount).

[37] Early stage investors generally expect large returns given the risk of their early stage investment. *See, e.g.*, CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW 137 (3d ed. 2008) ("Venture capitalists generally are not interested in investing unless the expected return is in the range of 35 to 45% compounded annually.").

[38] *See supra* note 22.

[39] *See supra* note 26.

[40] Bradford, *supra* note 1.

[41] For example, if X is contemplating an investment of $200 into venture V and X's time is worth $200 an hour, once X spends just one hour learning about V's business and the terms of the offering, X's transactional costs will equal 100% of the contemplated investment amount.

## IV. Ways to Mitigate the Exemption's Costs without Sacrificing Investor Protection

If the issuer, intermediary, and other costs are too high, use of the crowdfunding exemption will be limited. This will leave the large unaccredited investor market under-tapped and new ventures without the funds they need to thrive. There are, however, several ways to mitigate the expected costs without sacrificing investor protection. Five suggestions for mitigating costs are provided below.

### A. Allow Intermediaries to Acquire Equity Interests

Funding portals and other intermediaries should be allowed to take an equity interest in the issuers they service in lieu of at least a portion of the cash fees,[42] provided that intermediaries taking such an interest do so as a standard practice. While the Proposed Crowdfunding Rules prohibit intermediaries from doing this,[43] the JOBS Act itself does not.[44] Furthermore, the JOBS Act's legislative history in fact supports the idea of allowing intermediaries to invest in issuers using their services in order to protect investors.[45] Granting an intermediary an equity interest would still result in an economic cost to issuers and doing so may not always improve an issuer's cash position.[46] However, there would be many instances where granting equity in lieu of paying cash to an intermediary would improve an issuer's cash position.[47] Reserving this additional cash is critical for issuers.[48] Moreover, intermediaries who acquire equity interests in issuers would likely service only those issuers they see unique value in—namely, ventures they believe are currently underpriced. This perceived discount by intermediaries could be shared with issuers in the form of a lower stated fee.[49]

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[42] *See supra* note 21 (estimating that an intermediary's fee will be 5% to 15% of the offering amount).

[43] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,555–56 (to be codified at 17 C.F.R. pt. 227) ("An intermediary . . . may not have a financial interest in an issuer that is offering or selling securities in reliance on [the crowdfunding exemption] through the intermediary's platform, or receive a financial interest in an issuer as compensation for services provided to or for the benefit of the issuer in connection with the offer or sale of such securities.").

[44] *See* JOBS Act § 302(b), 15 U.S.C.A. § 77d-1(a)(11) (West 2012) (prohibiting an intermediary's "directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using its services" but not prohibiting the intermediary *itself* from having such an interest).

[45] *See* 158 CONG. REC. S2231 (daily ed. Mar. 29, 2012) (statement of Sen. Scott Brown) ("[I]ntermediaries should also be allowed to take an equity stake in offerings. This however, does not mean that intermediaries should be able to choose which offerings to participate in but rather it should be a standard process for any offering that the intermediary facilitates. This will incentivize an intermediary to focus on issuer quality over quantity, providing more vetting for investors and greater alignment of interests.").

[46] For example, an issuer's cash position would not improve if: (i) the issuer is selling $1 million of stock; (ii) there is sufficient investor demand; and, (iii) the shares being granted to the intermediary for its services "count" towards the JOBS Act's $1 million offering cap. *See supra* text accompanying note 5.

[47] For example, when an issuer grants its stock to an intermediary for services and those shares are in

### B. Let Unaccredited Investors Test into Accredited Status

The crowdfunding exemption is important because it gives new ventures bona fide access to unaccredited investors—a large source of potential capital. However, this access could be broadened by amending the accredited investor definition[50] to welcome *currently* unaccredited investors who demonstrate they are capable of investing in exempt offerings (for example, by passing an appropriate exam). These investors could then participate in "506(c) offerings" which are currently not subject to many of the crowdfunding exemption's requirements such as: (i) the use of an offering document; (ii) an annual reporting obligations; (iii) the use of a registered intermediary; and, (iv) the $1 million offering amount cap.[51] Thus, changing the accredited investor definition could generate many of the benefits of the crowdfunding exemption, at a much lower cost, for those that pass the exam. Although such an exam would likely have imperfections, amending the accredited investor definition to consider an investor's knowledge of

addition to shares the issuer would have otherwise sold to investors. This would be the case if the shares to the intermediary would not cause the offering to exceed the $1 million JOBS Act cap or if the shares would not "count" towards the amount being raised (for example, if the SEC adopts final rules both allowing intermediaries to take equity interests and stating that said equity does not count towards the offering amount). Moreover, the issuance of the additional shares must not trigger incremental costs, such as kicking in the requirement to provide audited financial statements, that would offset the amount of cash saved by not paying the intermediary's fee in cash.

[48] *See, e.g.*, GUY KAWASAKI, REALITY CHECK: THE IRREVERENT GUIDE TO OUTSMARTING, OUTMANAGING, AND OUTMARKETING YOUR COMPETITION 107 (2008) (quoting the great Silicon Valley corporate finance lawyer, Craig Johnson: "The leading cause of failure of startups is death, and death happens when you run out of money.").

[49] For example, if intermediary Z values venture V's shares at $1 each while investors are expected to value V's shares at $0.60 each, Z and V could split the $0.40 per share difference in valuations. That is, if intermediaries typically charge a 10% fee and V is raising $600,000, Z would require only 60,000 shares to equal the $60,000 fee and not 100,000 shares (even though 100,000 shares would need to be sold to investors to bring in a $60,000 cash fee). Further, both V and Z would prefer a transaction with 80,000 V shares to a $60,000 cash fee. When using the investor value, this would suggest V is paying only an 8% fee ($48,000/$600,000) even though Z would value 80,000 shares at as much as a 13.33% cash fee ($80,000/$600,000). While one may argue it is illogical to consider more than one value for the same V's shares, new ventures are unique. First, as a typical *Shark Tank* episode illustrates, it is common for people (and Sharks) to disagree about the value of new ventures. Second, whatever the "objective" value is, it is based on assumptions that can quickly change and, when those assumptions change, the impact can be significant. For example, one new client contract could cause a venture to quadruple its total sales. Regardless, if intermediaries are allowed to take an equity stake in issuers, they have an economic incentive to welcome those they see as good bets. The intermediaries thus would serve a vetting role, leading to greater capital flow from more confident investors.

[50] *See supra* note 3 and accompanying text.

[51] *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44,771, 44,804 (July 24, 2013) (to be codified at 17 C.F.R. §230.506(c)). 506(c) offerings also allow issuers to "offer securities through means of general solicitation, provided that . . . all purchasers of the securities [are] accredited investors" and several other requirements are met. *See id.* at 44,776 ("Issuers relying on Rule 506(c) for their offerings will not be subject to the prohibition against general solicitation found in Rule 502(c).").

exempt offerings would make the regulation smarter. Instead of concluding from an individual's net worth and income levels that she is incapable of investing in exempt offerings, the exam would allow her to prove that she has the knowledge and experience in financial and business matters reasonably necessary to evaluate the risks and merits associated with investments in early stage ventures—and thus eliminate much of the need for costly protections assuming the opposite.[52] Perhaps this is why the SEC has requested comment on the current accredited investor definition.[53]

### C. Use Strategic Templates and Deal Structures

Intermediaries should require issuers to use essentially the same formation and financing documents or templates to organize entities and complete financings. Repeatedly using smart templates and deal structures should reduce transaction costs, promote consistency between documents and among transactions, protect entrepreneurs and investors, and help ensure compliance with laws and regulations.[54] This is why leading accelerator programs and attorneys who regularly represent venture capital-backed companies already use templates to form and finance the ventures they help.[55] Given that crowdfunding investors will typically invest smaller amounts than venture capitalists, and therefore transactions costs are likely to represent a larger percentage of their investment, templates seem even more important in the equity crowdfunding setting. Moreover, intermediaries could strategically design the templates and deal structures to make the most of the unique requirements imposed by the JOBS Act[56] and Proposed

[52] However, to protect against investors losing too much, there could be limits on the amount people may invest in such offerings (for example, limits based on a percentage of an investor's net worth and/or income levels).

[53] *See* Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44,806, 44,830 (proposed Jul. 24, 2013) (request from the SEC for comment on whether the net worth and income tests are "the appropriate tests for determining whether a natural person is an accredited investor" and, if not, "what other criteria should be considered as an appropriate test for investment sophistication").

[54] *See Model Legal Documents*, NATIONAL VENTURE CAPITAL ASSOCIATION, http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136 (last visited Mar. 28, 2014) (expressing similar goals with respect to a set of model documents the National Venture Capital Association makes available for venture capital financings: "The model documents aim to: reflect and in a number of instances, guide and establish industry norms; be fair, avoid bias toward the [investor] or the company/entrepreneur; . . . include explanatory commentary where necessary or helpful; anticipate and eliminate traps for the unwary (e.g., unenforceable or unworkable provisions); provide a comprehensive set of internally consistent financing documents; promote consistency among transactions; and reduce transaction costs and time.").

[55] *See, e.g.*, Leena Rao, *YC-backed Clerky Helps Startups Save Time And Money On Legal Incorporation, Stock Issuance Forms And More*, TECHCRUNCH (Mar. 11, 2013), http://techcrunch.com/2013/03/11/yc-backed-clerky-helps-startups-save-time-and-money-on-legal-incorporation-stock-issuance-forms-and-more/. For an example of actual templates for startups, see *Open Sourced Model Seed Financing Documents*, TECHSTARS.COM, http://www.techstars.com/docs/ (last visited Mar. 28, 2014) (publishing templates prepared by Cooley LLP).

[56] *See supra* notes 17 & 18.

Crowdfunding Rules.[57] The JOBS Act's legislative history[58] and Proposed Crowdfunding Rules[59] support intermediaries taking this approach. However, to further reduce the risk of engaging in the unauthorized practice of law, intermediaries should consider taking precautionary steps such as requiring issuers to use the templates and deal structures, instead of merely advising issuers on what to do. Furthermore, issuers should be encouraged to seek legal counsel.[60]

It is beyond the scope of this article to provide details about how equity crowdfunding templates and deal structures should be structured. However, by way of example, a funding portal could require issuers using its service to:

- Be formed as Delaware C corporations, with the funding portal providing templates for issuers' Certificate of Incorporation, Bylaws and initial corporate resolutions;[61]
- Prepare an executive summary, pitch presentation, and business plan to be made available on the funding portal's website, with the funding portal providing templates designed to ensure that the necessary information is provided in a logical and concise format;[62]
- Use a two-class equity system whereby inexpensive common stock is granted to or reserved for employees and more expensive preferred stock, with special rights,[63] is sold to outside investors thereby allowing issuers to raise external funds with less demoralizing dilution to the employee-owners than would otherwise occur;[64]

[57] *See supra* notes 17 & 18.

[58] *See* 158 CONG. REC. S2231 (daily ed. Mar. 29, 2012) (statement of Sen. Michael Bennet) ("[F]unding portals should be allowed to engage in due diligence services. This would include providing templates and forms, which will enable issuers to comply with the underlying statute. In crafting this law, it was our intent to allow funding portals to provide such services.").

[59] *See* Proposed Crowdfunding Rules, 78 Fed. Reg. at 66,560 (to be codified at 17 C.F.R. §227.402(b)) ("A funding portal may . . . [a]dvise an issuer about the structure or content of the issuer's offering, including assisting the issuer in preparing the offering documentation.").

[60] For example, legal counsel could advise on the risks associated with using the templates and assist with matters not covered by the templates, such as becoming "qualified to do business" in the state where the issuer's offices are physically located. In this way, attorneys will become familiar with the templates and be able to efficiently provide add-on services.

[61] Orrick, Herrington & Sutcliffe LLP provides examples of such templates. *See Start-Up Forms: Corporate Formation*, ORRICK, HERRINGTON & SUTCLIFFE LLP, http://www.orrick.com/Practices/Emerging-Companies/Startup-Forms/Pages/Forms-Corporation.aspx (last visited Mar. 28, 2014).

[62] *See, e.g.*, KAWASAKI, *supra* note 48, at chs. 8, 9, & 17 (providing rules of thumb for what should be included in an executive summary, investor pitch, and business plan—as well as how to format such items).

[63] An example of such a right is a "liquidation preference." A liquidation preference ensures that, if a company is acquired (or otherwise liquidated), any assets remaining after payment of the company's debts get distributed first to the preferred stock holders—until they receive an amount at least equal to

- Make their common stock subject to "vesting" to help ensure that employees earn their stock over time,[65] with the funding portal providing a template Common Stock Purchase Agreement and related forms;[66]
- Raise exactly $100,000, thereby eliminating the need for reviewed or audited financial statements;
- Use standard capitalization tables (for example, a fixed number of shares of common stock could be granted to or reserved for each issuer's employees thereby allowing employees and investors to more quickly understand what their ownership interests represent and more easily compare valuations of different issuers); and,
- Reserve the right to redeem their preferred stock at a multiple of the price it was originally issued at, thereby giving issuers a path to escape the ongoing annual costs imposed by the crowdfunding exemption.[67]

Repeated use of the same templates and deal structures should lead to familiar standards and even a "one size fits many" model.[68] In addition to significantly reducing transaction costs, such a model would help ensure that parties take necessary and desired steps, thereby increasing issuer compliance, investor protections, and economic value.

### D. Leverage Educational Organizations

Having a "one size fits many" model would give schools exciting new ways to connect their students in the classrooms to real world new ventures. Instead of simply reading about different types of business entities and seed financings, students could complete projects using the same templates used by live issuers relying on the crowdfunding exemption. Among other things, this would empower more students and alumni to launch their own ventures. Schools could even form, or develop a relationship with, funding portals.[69] Reputable entrepreneurship programs at prestigious universities

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their original investment plus any accrued and unpaid dividends. *See e.g.*, BAGLEY & DAUCHY, *supra* note 37, at 150; FENWICK & WEST LLP, VENTURE CAPITAL FOR HIGH TECHNOLOGY COMPANIES 13 (2010) [hereinafter FENWICK VC GUIDE], http://www.fenwick.com/FenwickDocuments/venture_capital_final_2010.pdf.

[64] *See, e.g.*, BAGLEY & DAUCHY, *supra* note 37, at 64–65; FENWICK VC GUIDE, *supra* note 63, at 13.

[65] *See, e.g.*, BAGLEY & DAUCHY, *supra* note 37, at 93–94; FENWICK VC GUIDE, *supra* note 63, at 2.

[66] Orrick, Herrington & Sutcliffe LLP provides such templates, including a Common Stock Purchase Agreement with vesting provisions, an "Assignment of IP and Other Assets" form, and paperwork to help with 83(b) elections. *Start-up Forms: Founders' Stock Purchase,* ORRICK, HERRINGTON & SUTCLIFFE LLP, http://www.orrick.com/Practices/Emerging-Companies/Startup-Forms/Pages/Forms-Founders.aspx (last visited Mar. 28, 2014).

[67] *See supra* note 25.

[68] When items need to differ from the standard, they will be highlighted on a concise schedule of exceptions, thereby making it easy for parties to see what changes are needed for particular deals.

[69] To reduce liability exposure, the funding portals would be set up as separate entities.

have already undertaken initiatives to help their students and others raise capital for new ventures.[70] A funding portal could revolutionize this process and create new ways to engage students, parents, alumni, and others—and to raise funds to support entrepreneurship education.[71] To the extent that schools and other organizations, such as accelerators, can extract educational value from the equity crowdfunding process, the high costs of the exemption would become more tolerable. That is, the costs would support both the exempt offerings and entrepreneurship education objectives. Further, if alumni and others are motivated to invest in student ventures for both economic and non-economic reasons, expected returns should become more issuer-friendly and participating unaccredited investors would receive an education while experiencing the thrill of being angel investors.

Moreover, expenditures already being made could help reduce the incremental cost of building and running a funding portal. For example, a university's existing business plan competitions, social networks,[72] and news publications could all be used to help drive potential issuers and investors to funding portals and thus reduce issuer search costs and intermediary marketing costs. Additionally, business plan competitions could adopt rules mirroring the crowdfunding exemption's requirements, thus reducing future compliance costs for ventures choosing to pursue equity crowdfunding. By way of further example, law school clinics already assisting entrepreneurs[73] could be tapped to provide issuers with affordable assistance. If there is a "one size fits many" model, law students and clinicians could more easily "ramp up" and offer clients a defined and meaningful new service, such as offering entrepreneurial ventures assistance with the crowdfunding exemption process.

[70] *See, e.g.*, *U-M Based Student-Led Investment Funds*, THE SAMUEL ZELL & ROBERT H. LURIE INSTITUTE FOR ENTREPRENEURIAL STUDIES, http://www.zli.bus.umich.edu/wvf/ (last visited Mar. 28, 2014) (providing summaries for three different "Wolverine/Student Venture Funds": the Wolverine Venture Fund, the Zell Lurie Commercialization Fund, and the Social Venture Fund); *About the Irish Entrepreneurs Network*, THE IRISH ENTREPRENEURS NETWORK, https://www.business.nd.edu/gigot/irishangels/about_ia.cfm (last visited Mar. 28, 2014) (describing the Irish Entrepreneurs Network as consisting of "a select group of Notre Dame alumni and friends having experience with entrepreneurial endeavors" and having a mission to "serve as a focal point for entrepreneurially-minded members of the Notre Dame family worldwide").

[71] Instead of itemizing charitable deductions, people who invest in for-profit ventures that fail could take a more favorable ordinary loss deduction. *See* I.R.C. § 1244 (2012).

[72] Social network ties have been found to be important in non-equity crowdfunding. *See, e.g.*, Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 14 (2014).

[73] *See e.g.*, *Law School Entrepreneurship Clinics*, EWING MARION KAUFFMAN FOUNDATION, http://www.entrepreneurship.org/entrepreneurship-law/law-school-entrepreneurship-clinics.aspx (last visited Mar. 28, 2014) (listing U.S. law school clinics that provide assistance to entrepreneurs and innovators).

### E. Arbitrate Disputes in a Forum Designed for Equity Crowdfunding

Issuers, investors, and intermediaries should agree to arbitrate disputes related to offerings made under the crowdfunding exemption. These parties should also agree to use a forum that specializes in equity crowdfunding and is willing to become familiar with its unique players, rules, templates, deal structures, and repeat issues. The Financial Industry Regulatory Authority (FINRA) currently operates the largest dispute resolution forum in the securities industry.[74] Given the need to mitigate costs further in the equity crowdfunding setting, and its potential educational nature, perhaps an organization like FINRA could work with law school clinics to develop something that resembles a chain of minor league dispute resolution forums.[75] In addition to respecting the laws and practical issues surrounding equity crowdfunding, such an organization could provide expedient and affordable services to issuers, investors, and intermediaries while also creating unique experiential learning opportunities for students.

## V. Conclusion

New ventures are important to our economy. We can support these ventures by giving them better access to capital. In theory, the crowdfunding exemption will open the door to unaccredited investors—a large and currently under-tapped source of capital. However, the crowdfunding exemption is expected to impose significant costs on issuers, intermediaries, and investors. In order to make equity crowdfunding work for the unaccredited crowd, we must mitigate those costs without compromising investor protection.

[74] *See Arbitration & Mediation*, FINRA, http://www.finra.org/ArbitrationAndMediation/index.htm (last visited Mar. 28, 2014).

[75] To avoid potential conflicts, some clinics could help with exempt offerings while others could assist with arbitrating disputes.