June 2016 Supplement to

Equity Crowdfunding for Investors

A Guide to Risks, Rewards, Regulations, Funding Portals, Due Diligence, and Deal Terms

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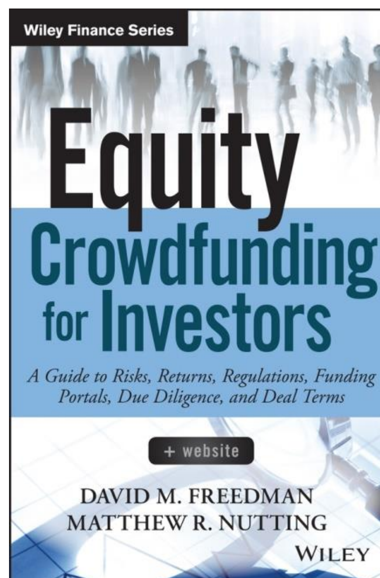

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June 2016 Updates

This supplement updates the following chapters of *Equity Crowdfunding for Investors:*

Chapter 3: Equity Crowdfunding Rules
Chapter 4: Intrastate Equity Crowdfunding Exemptions
Chapter 7: Equity Crowdfunding Portals
Chapter 10: Crowdfunding Securities
Chapter 12: Due Diligence
Chapter 13: Funding and Post-funding
Chapter 14: Liquidity and Secondary Markets

Since the book was published in June 2015, four important events took place that we are covering in this supplement:

- The Securities and Exchange Commission issued final rules under Title III of the JOBS Act of 2012, which legalized equity crowdfunding for all (including non-accredited) investors. We summarize the rules in this supplement, primarily in Chapter 3.

- The June 2015 launch of Regulation A+, based on Title IV of the JOBS Act, allows all investors to participate in "mini-IPOs" (summarized in new Chapter 3.5).

- Title III equity crowdfunding launched on May 16, 2016. We are adding details of this launch to Chapters 7 and 10.

- More than a dozen U.S. states have been added to the list of intrastate crowdfunding exemptions, covered in Chapter 4 of the book.

Chapter 3 Update:
Final Rules for Equity Crowdfunding

Title III of the Jumpstart Our Business Startups (JOBS) Act of 2012 legalizes equity crowdfunding and allows all investors, regardless of income or net worth, to invest in startups and growing private companies via crowdfunding portals. The JOBS Act was implemented in October 2015 when the SEC issued rules for (a) issuers of securities under Title III, (b) the operation of crowdfunding portals, and (c) the amount of money that people can invest in Title III offerings based on their income and net worth. The SEC specified that offerings on Title III portals can launch, and all investors can participate in them, starting in May 2016.

To offer equity on a crowdfunding portal (or through a broker-dealer operating an online offering platform under Title III[1]), the issuer must be a private company based in the United States and organized under the laws of a state or territory of the United States or the District of Columbia. Some categories of issuers are prohibited from using the new equity crowdfunding exemption. For example, investment companies, including mutual funds and private equity funds, may not raise capital via crowdfunding portals. Likewise a company will be disqualified if it has previously failed to file ongoing reports with the SEC as required by a previous offering of securities. In addition:

- Issuers may raise up to $1 million in any 12-month period through equity crowdfunding portals that are registered with the SEC. (Some legislators, notably Rep. Patrick McHenry of North Carolina, have proposed increasing the raise limit to $5 million.)
- All Title III offerings must go through an Internet-based intermediary, either a funding portal or a broker-dealer platform; and the intermediary must be registered with both the SEC and FINRA. Issuers may not sell securities on their own websites using the Title III exemption.
- Each issuer must provide accurate information, both to the SEC on Form C and to investors through the funding portal, concerning the following:
    - Its full name, legal status (form of entity, state, and date of organization), physical address, and website URL.
    - Names of officers, directors, and shareholders owning 20 percent or more of total equity. Also low long each officer and director has served in that position, and the business experience of each officer and director over the past three years. If any of those officers, directors, or 20 percent shareholder is identified by the SEC as a "bad actor," the company will be disqualified. A bad actor, according to securities law, is a convicted felon, person subject to a finance-related injunction or restraining order, person subject to SEC disciplinary action, etc.
    - Description of the business, number of employees, and business plan.
    - Capital structure—how the company currently finances its operations, which may include long-term debt, specific short-term debt, common equity, and preferred

[1] When we refer to equity crowdfunding portals, we intend to include Title III offering platforms operated by broker-dealers, unless otherwise stated. Most likely, broker-dealer platforms will closely resemble crowdfunding portals, but there are some key differences. A broker-dealer license is more difficult and costly to receive, but the license holder is permitted to offer investment advice. Funding portals for Title III offerings are easier to register but must not advise investors on potential investments.

equity. A description of current debt should include the amount, interest rate, maturity date, and other “material” terms. Descriptions of equity offerings conducted in the previous three years should include dates, exemptions relied on, types of securities, amounts sold, and use of proceeds.
    - Amount of capital the issuer is attempting to raise by the Title III offering (the target amount), the deadline for raising that amount, and the purpose and intended use of the proceeds raised from crowdfunding investors. The issuer must state whether it will accept funds in excess of its target amount, and if so the maximum it will accept and how it will allocate those extra funds.
    - Price of the securities being offered via Title III crowdfunding, or method used to determine the price. If the issuer does not set a fixed price at the start of the crowdfunding campaign, it must provide a final price before closing the offering—and an investor would have a right to rescind a commitment to purchase after the price is finally determined.

- Each issuer must provide an accurate description of the terms and risks of its offering, including the following (which we will explain further in Chapter 11, on deal terms, and Chapter 12, on due diligence):
    - Class of securities currently offered and previously issued (and the differences between them), and how the rights of existing shareholders will affect the rights of new crowdfunding investors/shareholders.
    - Holdings of 20 percent security holders.
    - How new crowdfunding equity is valued, and how that value may be affected by future rounds of capital investment and other corporate actions.
    - Risks associated with minority ownership (including lack of control and discounted valuation), future corporate actions, and related-party transactions.
    - Restrictions, if any, on the sale or transfer of the securities, in addition to the mandated one-year holding period (with exceptions as noted later in this chapter).
- Issuers must state whether they or any of their predecessors have failed to comply with the ongoing reporting requirements in previous Title III offerings.
- Issuers seeking to raise $100,000 or less must provide financial statements, certified by the company principal executive officer, typically the president or CEO. For those seeking between $100,000 and $500,000 in capital, financials must be *reviewed* by an independent accountant. Those seeking $500,000 to $1 million must have their financial statements *audited* by a certified public accountant, except for first-time Title III issuers. Those who have never before sold securities via Title III crowdfunding are exempt from the audit requirement and must simply have their financials reviewed. (If Congress increases the raise limit to $5 million, the audit requirement may kick in at $3 million.). Note that an audit may cost the issuer in the neighborhood of $15,000 to $25,000, a key point that we will discuss further. (We will discuss the differences between reviews and audits in Chapter 12.) For each period for which financial statements are provided, the issuer must include a summary of operations during that period.
- Issuers may sell shares to an unlimited number of investors in a deal, within the $1 million raise limit.

- Issuers must state, even though the portal has already done so in its educational materials, that their campaigns are all-or-nothing; and that if they fail to receive commitments for the target amount by the specified deadline, investors will receive prompt refunds.
- Issuers may not engage in general solicitation as defined in Title II offerings (see Chapter 2), and are strictly limited as to how they may advertise their offerings outside of the crowdfunding portals. The SEC rules allow issuers to publish a "limited notice," known in the securities industry as a "tombstone" notice, which directs potential investors to the portal where the full terms and disclosures of the offering are listed. A tombstone ad may include a statement that the issuer is conducting an offering of securities, and specify the type of securities, on a specific crowdfunding portal, with the portal's URL and/or hyperlink; the price of securities and closing date of the offering period; factual information about the company's industry, location, website, and contact information; and a brief description of the issuer's business. Publishers of tombstone ads must disclose that they are compensated by the issuers.
- If the issuer compensates a third party to promote its offerings (limiting its communications to the kinds of information that can be conveyed in a tombstone notice), that third party must disclose such compensation in its promotions. A paid promoter can't legally pretend to be an objective reviewer, for example.
- Issuers must file their offerings with the SEC on a newly created Form C and make that information available to investors at least 21 days before any sales can be made on a funding portal. Filings include information about officers, directors, and 20 percent shareholders; offering share price; target offering amount (raise) and deadline to reach the target; whether the company will accept investments above the target amount; financial statements; related-party transactions; and other information.
- Issuers must describe the intermediary's financial interest in the issuer's transaction, including the amount of compensation for conducting the offering on the portal, and whether that compensation consists of cash or equity. Issuers may compensate intermediaries with equity *if* the latter accepts such compensation, as long as it is at the same share price and on the same terms as in the crowdfunding offering.
- Offering information posted to a Title III crowdfunding portal may be presented in any number of formats, including text-based and PDF documents, videos, graphics, slide decks, etc. All the required information must be easily accessible on the portal itself, not linked to on other websites. The issuer may, of course, refer to additional information, beyond what is required on the portal, that appears on other websites.
- After a successful funding round is complete, issuers have to file annual reports with the SEC, and share them with investors as well (more about annual reports in Chapter 13). The current offering documents must state where on the issuer's website investors will be able to read the annual reports in the future, and the dates by which they will be available each year.
- Issuers may participate in equity crowdfunding offerings and other kinds of exempt offerings at the same time; these would be known as *parallel offerings.* Thus, it is possible to seek $1 million from everyday investors through a Title III offering *and* to seek concurrently an unlimited amount of capital from accredited investors through a Reg D offering, for example. The two parallel offerings must be treated as distinct rather than integrated.
- Under both federal and state law, issuers (including company officers, directors, sellers, and promoters of the offering) will be held liable for any fraudulent or intentionally misleading statements or material omissions made in connection with their offerings. If an issuer fails to

"exercise reasonable care" and knowingly makes untrue or misleading statements, it must reimburse investors for their purchase of securities, plus interest. The issuer and its officers and directors bear the burden of proof in a dispute with investors with respect to this liability.
- Because Title III and the SEC rules thereunder are voluminous and complex, the SEC created a "safe harbor" for "insignificant deviations" from the restrictions and requirements of the regulations, so long as the issuer acts in good faith to comply.
- The Exchange Act of 1934 typically requires an issuer to go public if the company has more than 2,000 shareholders, or more than 500 shareholders who are non-accredited investors. Title III exempts crowdfunding securities from this shareholder threshold, with the expectation that crowdfunding is likely to bring in many investors.

After the issuer files Form C (electronically via the SEC's EDGAR data system), the SEC is not required to review or in any way evaluate the issuer's disclosures. It is *possible* that the commission will challenge offerings that appear to contain misleading statements or significant omissions. But investors should not assume that offerings on a crowdfunding portal have been reviewed by the SEC.[2]

Rules for Investors in Title III Securities

The ability of everyday people to invest small amounts of money in private companies represents a monumental shift in the private capital markets. The traditional rules that locked most non-accredited investors out of the markets aimed to protect presumably unsophisticated investors from the riskiest kinds of investments. With Title III, Congress attempted to balance the new freedom to invest, on the one hand, with requirements and restrictions designed to protect inexperienced angel investors, on the other hand. Such requirements include greater offering disclosure (as previously listed), and such restrictions include limits on the amount people can invest (and possibly lose). The amount of money that an investor can plow into equity crowdfunding deals *each year* depends on the investor's net worth and/or income, detailed here. Congress's intent was to help prevent catastrophic losses being incurred by unsophisticated investors in high-risk securities.

- If an individual's annual income or net worth is less than $100,000, he or she may invest the greater of (a) $2,000 or (b) 5 percent of the lesser of his or her annual income or net worth, over the course of the year.
- If the annual income and net worth of the individual are both greater than $100,000, he or she may invest up to 10 percent of the lesser of his or her annual income or net worth, but not more than $100,000, per year.
- Spouses may combine their incomes for the purpose of the income test. In calculating net worth, investors may not include the value of their primary residence.
- Investors may self-certify that they are not exceeding their investment limits. In other words, they do not have to submit tax returns or other documentation to prove it.

[2] For this and several other interpretations of the SEC rules under Title III, the authors relied primarily on commentary provided by CrowdCheck, available at http://www.crowdcheck.com/sites/default/files/CrowdCheck%20Regulation%20CF%20Memo.pdf.

- When registering on a funding portal, investors must demonstrate that they understand the risks of private equity investments. They can do that by studying the educational content on the portal (or other educational resource) and filling out a questionnaire.
- Investors must hold shares for at least one year after purchasing them via equity crowdfunding, with some exceptions (for example, they may sell shares back to the issuer or to an accredited investor, or transfer securities to a family-member or beneficiary in the event of death or divorce).
- Investors in crowdfunded securities may file a lawsuit against an issuer for rescission of funds if the issuer is liable for material misstatements or omissions in connection with the offering.[3]

Rules for Intermediaries (Funding Portals and Broker-Dealers)

As we explained earlier, companies cannot directly offer crowdfunding investments to the public. All Title III offerings must be funneled through an intermediary, which can be either a funding portal or a broker-dealer platform (not a passive bulletin board, which we defined in Chapter 2). In addition:

- Title III portals and platforms must register with the SEC and also with a self-regulatory organization (SRO). Currently FINRA is only SRO in the field of private securities. The registration process begins at the end of January 2016, although Title III portals cannot launch and begin taking commitments from investors until May 2016.
- Funding portals that are not broker-dealers may not offer investment advice or make recommendations to, or solicit investments from, individual investors. In this way, these portals are purely conduits between issuers and "the crowd," with some educational content added (see next item).
- Intermediaries must provide "investor education" content on their portals that helps investors understand, among other things, the risks of investing in private equity, including loss and illiquidity. They must ensure that investors review that material and affirm that they understand the risks before they invest, by filling out a questionnaire. We will describe this process further in Chapter 7.
- Funding portals and broker-dealer platforms can use both objective criteria (e.g., industry, geographic location, or number of employees) and subjective criteria (e.g., experience of management team, chances for success) in deciding which offerings list on their platforms. When issuers submit applications to an intermediary, the latter can "curate" offerings, i.e., determine which to accept and reject, based on whatever criteria they choose. The intermediary must not claim that its selection criteria make its offerings better or safer than any other's. Nor can an intermediary use its selection criteria as a way of giving investment advice to its registered investors.
- In deciding which offerings to "highlight" at any time, portals must use only subjective criteria designed to display a broad selection of issuers. They may not highlight offerings based on their judgment about the relative suitability or advisability of investing in them.

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[3] Under Section 12(a)(2) of the Securities Act of 1933.

Objective criteria may include, in addition to those listed in the previous item, the number of committed investors so far and the number days left in the funding period, for example.

- Intermediaries may provide search functions, allowing investors to find offerings based solely on objective criteria.
- Intermediaries must provide communication channels, such as forums and discussion groups, for investors to discuss offerings and collaborate on due diligence. Such channels are to be accessible and "transparent" to all individuals who register and establish accounts on the portals. Operators of funding portals may not participate in those discussions among investors, other than to establish guidelines for discussions and remove abusive or fraudulent participants.
- If issuers or their representatives are allowed to participate in discussions (for the purpose of responding to investors' questions), they must at all times identify themselves as issuers or engaging in discussion on behalf of issuers.
- Intermediaries may decide whether investors who participate in discussions must do under their registered (real) names or may do so under aliases. We recommend that if you rely on communications and collaborations with other investors, you should use portals that require real names in discussions, so you can assess the reliability of participants. The ability to use aliases might encourage inaccurate posts.
- An intermediary may not pool investors' funds into a single investing entity (as MicroVentures does for Reg D investments). In other words, each individual investor will invest directly in the company that offers shares.
- In order to reduce the occurrence of fraud, intermediaries must conduct background checks on officers, directors, and 20 percent equity holders of each issuer, and must disqualify an issuer if one of its officers, directors, or "participants" (such as promoters) in the offering is a bad actor.
- Intermediaries must have a "reasonable basis for believing" that the issuers listed on their portals have complied with their disclosure and registration requirements, and have established accurate record-keeping systems to keep track of their investors the securities purchased by investors.
- Intermediaries must also assess each offering for the risk of fraud, and refuse to accept an offering if they have a reasonable basis to believe that it presents the potential for fraud. If an intermediary becomes aware of fraudulent intent after accepting and listing an offering on its portal, it must cancel that offering.
- Depending on the facts and circumstances, an intermediary *may* potentially be liable in an offering where there is a fraudulent or intentionally misleading statement made by an issuer.
- Funding portals are permitted to advise issuers about the content of their offerings, types of securities, and deal terms; and may (but are not required to) provide pre-drafted templates or standardized forms that issuers can use to prepare various offering documents.
- Intermediaries must disclose to investors how they will be compensated by issuers in connection with offerings and sales made on their portals. They may accept a range of compensation, including flat fees, commission, and equity interest. Intermediaries should not receive any fees or compensation directly from investors.
- Intermediaries may accept equity in an issuer only as compensation for listing and other services that portals normally provide to issuers. Intermediaries may not take a financial interest (i.e., may not purchase equity) in addition to such compensation. If they take equity as compensation, it must be at the same price and under the same terms as offered to

individual investors in the same offering. Individual directors, officers, or partners of a funding portal may not, however, have a financial interest in any issuers using the portal's services—only the portal itself may.

- Intermediaries may not compensate any third parties (including promoters, finders, or lead generators) for identifying potential investors.
- An intermediary may not accept any investment commitment from an investor until the investor registers and opens an account on the portal.
- An intermediary may rely on investors' representations regarding their compliance with annual investment limits, based on income and net worth.
- Funding portals may not receive, manage, or hold investor funds, but must use a third-party escrow service for that purpose and release the funds to the issuer only when the offering is successful. The money is returned to investors from escrow if a campaign is not fully funded.
- If an issuer makes a significant change to the terms of an offering, the intermediary must within five days contact all investors who have made commitments to invest in that offering, and request that those investors re-commit or cancel in light of the new information.
- Intermediaries must make reasonable efforts to ensure that (1) issuers comply with offering limits and do not receive funds from investors until their target offering amount is achieved, (2) the personal information collected from investors is kept private and secure, and (3) investors do not exceed their limits based on income and/or net worth. SEC commissioner Luis A. Aguilar referred to this as the intermediaries' "gatekeeping role."
- Intermediaries may compensate a third party for referring investors to the portal, as long as the referral does not include personally identifiable information about individual investors. Compensation for referrals must not be based on the ultimate purchase of securities unless the third party is a registered broker-dealer.
- Funding portals may advertise their own existence in public media, including social media. They may identify specific issuers and/or offerings in their ads as long as (1) they use objective criteria for deciding which issuers or offerings to advertise, (2) those criteria result in a varied selection of issuers or offerings, and (3) the ads do not implicitly endorse one issuer or offering over others. Portals are prohibited from receiving special or additional compensation for identifying or highlighting particular issues or offerings in their ads.

Chapter 3.5
Title IV of the JOBS Act, also known as Regulation A+

On page 53 of the book, we stated (just below the “Deeper Dive” subhead) that “Title III is the only part of the JOBS Act that unequivocally opened the floodgate for the masses of non-accredited investors to participate in the private equity markets.” That was true until 2015 (after our book was printed), when the SEC unexpectedly opened Title IV securities to non-accredited investors as well.

In March 2015, the SEC issued final rules under Title IV, colloquially known as Regulation A+. The rules went into effect in June 2015. Under Title IV, the moribund Regulation A exemption was expanded from a $5 million raise limit to a $50 million limit, and it now preempts blue sky review (i.e., no need for approval by every state in which the offering is made) for offerings over $20 million. Blue sky review is still required for “Tier 1” offerings under $20 million.

Some Regulation A+ offerings will be listed through online offering platforms. Such platforms may be dedicated to Reg A+ offerings, or they may feature a mix of Regulation D and Regulation A+ offerings. But Reg A+ offerings, like Reg D offerings, are not required to go through intermediaries. Moreover, Reg A+ offerings are allowed to “test the waters,” measuring potential interest by investors, before undertaking the obligations of an offering.

Even when a Reg A+ offering gets listed on an online platform like EarlyShares, the issuer has no obligation to conduct any sort of Q&A forum or chat with potential investors, as will be required on Title III equity crowdfunding portals. So can we say that Reg A+ is crowdfunding? We don’t think so, but many people apply the term “crowdfunding” loosely to a broad array of funding platforms, even some that exclude the crowd of non-accredited investors. Before the JOBS Act, Regulation A issuers could sell unrestricted securities to non-accredited as well as accredited investors. The expanded Reg A+ still lets non-accredited investors participate, but it limits their annual investment in offerings above the $20 million threshold to 10 percent of their income or net worth, whichever is greater. All investors can invest an unlimited amount in offerings up to $20 million.

By contrast, the offering platforms that list Reg D offerings, under Rules 506(b) and 506(c), are open only to accredited investors. Platforms that feature intrastate offerings (under Section 3(a)(11) of the Securities Act of 1933) are open to accredited and non-accredited investors alike, but only in two dozen or so states and the District of Columbia—the number of states is growing.

There has been much confusion in the media about Reg A+, as some reporters have referred to it as “an opportunity for non-accredited investors to buy equity in startups.” In fact, Title IV was originally structured mainly for growth- and later-stage companies that are not quite ready to file IPOs. New York securities lawyer Brian Korn calls Reg A+ the “minor leagues for IPOs,” and others refer to it as the “mini-IPO,” as issuers are required to go through a “scaled-down registration” process and file a prospectus-like document called an “offering circular” with the SEC. The benefits of Reg A+ for seed-stage and startup companies seem limited mainly because Tier 1 offerings up to $20 million still require blue sky review and compliance, which can be

costly and time-consuming. Time will tell whether seed-stage companies try to take advantage of Reg A+ rather than (or in addition to) Reg D, intrastate, or Title III equity crowdfunding.

The Confusing Universe of Offering Platforms

As a result of the various kinds of private securities offerings that can be listed online, and the conflicting definitions of "equity crowdfunding," there is much confusion in the marketplace—even among professionals who practice in the area of private securities, but especially among entrepreneurs and investors—about the differences between the exemptions and platforms where you find these offerings.

Kinds of Equity Offerings on Internet-based Platforms					
	Online Launch	**Raise Limit in 1 Year**	**Investor Status**	**Investment Limit**	**Intermediary Required?**
Reg A+ Tier 1	2015	$20 million	All investors	No limit	No
Reg A+ Tier 2	2015	$50 million	All investors	Depends on income/worth	No
Reg D Rule 506(b)	2011	No limit	Accredited only	No limit	No
Reg D Rule 506(c)[1]	2013				
Intrastate Equity Crowdfunding	2013 (Georgia was first)	Ranges $1m to $4m	All investors	Depends on income/worth	Varies with state
Title III Equity Crowdfunding	2016	$1 million[2]	All investors	Depends on income/worth	Yes: online portals[3]

Notes:
1. This "new" exemption allows general solicitation, under Title II of the JOBS Act of 2012.
2. The House of Representatives has proposed raising this limit to as much as $5 million.
3. Issuers must use either non-broker-dealer funding portals or broker-dealer platforms, both of which must be registered with the SEC.

The table above shows the most important differences, from an investor's point of view, between the four kinds of equity offerings that you will (eventually) find on online offering platforms, assuming Title III equity crowdfunding will someday emerge from regulatory hell. We expect that Congress will fix Title III of the JOBS Act, probably in 2015, the SEC will issue final rules under Title III, and equity crowdfunding portals will launch in 2016.

We use the term "equity crowdfunding" only in relation to (a) Title III of the JOBS Act, which requires issuers to interact with all (including non-accredited) investors on funding portals; and (b) those states where intrastate securities exemptions allow equity offerings to be listed on online funding platforms and which allow non-accredited investors to invest and interact with issuers. In fact, Title III (and the SEC's proposed rules thereunder) is the only part of the JOBS Act that specifically mentions the crowd, crowdfunding, or funding portals. Some intrastate exemptions do, but most do not, refer to equity crowdfunding or funding portals as intermediaries.

Looking ahead, it is possible that Reg. A+ will work alongside rather than overlap with Title III equity crowdfunding and Reg D offerings, to provide a seamless progression of capital-raising options for companies, from early seed-stage startups using Title III, on to early growth-stage companies fueling expansion with Reg D, and then to Reg. A+ for pre-IPO later growth.

Chapter 4 Update:
Intrastate Securities Exemptions, with Crowdfunding Rules

The following table summarizes the intrastate securities exemptions that were implemented by the end of November 2015.

Intrastate Securities Exemptions (as of November 19, 2015)				
State	**Year Enacted**	**Annual Raise Limit ($)**	**Investment Limit for Non-accredited Inv's**	**Equity Crowdfunding Portals?**
Alabama	2014	1 million	$5,000 / year	Allowed
Arizona	2015	2.5 million	$10,000 / deal	Required
Colorado	2014	2 million	$5,000 / deal	Allowed
Dist. of Columbia	2014	2 million	Based on income/worth	Allowed
Florida	2015	1 million	$10,000 / deal	Allowed
Georgia	2011	1 million	$10,000 / deal	Allowed
Idaho	2012[4]	2 million	$2,500 / deal	Not yet determined
Illinois	2015	$4 million	$5,000 / year	Allowed
Indiana	2014	2 million	$5,000 / year	Required
Kansas	2011	1 million	$5,000 / deal	Allowed
Maine	2014	2 million	$2,000 / deal	Allowed
Maryland	2014	100,000	$100 / deal	Prohibited
Massachusetts	2015	2 million	Based on income/worth	Allowed
Michigan	2013	2 million	$10,000 / year	Allowed
Minnesota	2015	2 million	$10,000/ year	Required
Mississippi	2015	1 million	Based on income/worth	Required
Montana	2015	1 million	$10,000 / year	Allowed
Nebraska	2013	250,000/2yr	N/A	Prohibited
New Jersey	2015	1 million	$5000 / deal	Required
Oregon	2015	250,000	$2,500	Allowed
South Carolina	2015	$1 million	$5,000 / deal	Allowed
Tennessee	2015	1 million	$10,000 / deal	Allowed
Texas	2014	1 million	$5,000 / deal	Required
Vermont	2014	2 million	$10,000 / deal	Allowed
Virginia	2015	2 million	$10,000 / deal	Allowed
Washington	2014	1 million	Based on income/worth	Allowed
Wisconsin	2013	2 million	$10,000 / deal	Required

[4] Year of first administrative order.

Chapter 7 Update:
Equity Crowdfunding Portals

The sidebar titled "Funding Portals Spooked by Title III Liability Issues," starting on page 119, is no longer relevant. As a result of the clarifications in the SEC's final rules under Title III, EarlyShares decided it would not expand its offerings into Title III (in addition to Regulation D offerings) until it could evaluate whether the Title III deal flow is sufficient, some time after the May 16, 2016, launch.

EarlyShares did expand into Title IV (Regulation A+) real estate offerings in January 2016, with minimum investment amounts for all investors (including non-accredited investors) set as low as $500.

As of June 1, 2016, Indiegogo has not yet committed to including Title III equity offerings on its platform in addition to rewards-based campaigns.

Portal May Accept Equity as Compensation from Issuers

On page 121 of our book, we stated that under Title III portals can receive payments from issuers in the form of a flat fee, usually on a monthly basis, or they can charge a percentage of the capital raised on the portal. In addition, under the SEC's final rules, portals may accept equity from the issue, but only under the same terms (including price per share) as those offered to investors.

On page 122, we stated that non-broker-dealer funding portals may not "have a financial interest in an issuer that uses their platform…." That is no longer true. As stated above, a portal can accept equity as compensation. But a portal may not purchase equity in any of its issuers in addition to (or instead of) accepting equity as compensation.

On page 123, we stated that EarlyShares focuses on growth companies and real estate projects. It has since narrowed its scope to real estate exclusively.

The Launch of Title III Equity Crowdfunding – Finally!

On May 16, 2016, the following four crowdfunding portals listed Title III offerings.

> **Wefunder** (www.wefunder.com). Wefunder dominated the market with 10 Title III offerings on May 16 (entertainment, telecom, biotech, retail/community development, food/beverage, consumer product). By May 23, Wefunder had 20 Title III offerings.
>
> **StartEngine** (www.startengine.com). StartEngine launched five Title III offerings on May 16 (health tech, music, craft beverage, social networking for gamers). Two days later it had a total of six Title III offerings.
>
> **NextSeed** (www.nextseed.com). One Texas-based real estate offering was listed on NextSeed.

SeedInvest (www.seedinvest.com). SeedInvest posted two Title III offerings (business services, consumer product).

Wefunder, NextSeed, and SeedInvest prominently displayed the minimum investment amount for each offering. Nine of the eleven offerings on Wefunder and NextSeed had minimums of $100. SeedInvest minimums were $500 and $2,000.

The securities offered on the Wefunder platform included common stock (3), preferred stock (1), straight debt (2), LLC units (2), profit sharing (1), and "simple agreement for future equity," known as SAFE (12). The overwhelming preference for the SAFE, created in 2013 by tech accelerator Y Combinator, is a significant development. We will add SAFEs basics in the Chapter 10 update.

Aggregation and Rating
As of June 14, 2016, we know of only one website that aggregates and rates Title III offerings (both debt and equity): Stratifund.

Stratifund uses a proprietary algorithm, developed by experienced securities professionals, to rate both Title III (Regulation CF) and Title IV (Regulation A+) offerings. Read more about Stratifund's rating system here: http://www.financialpoise.com/crowdfundinginvestor/news/stratifund-aggregates-rates-equity-crowdfunding-deals/.

Chapter 10 Update:
Crowdfunding Securities

In Chapter 10 we covered stock, LLC shares, and convertible debt. A significant percent of Title III offerings are using a new security called the simple agreement for future equity (SAFE).

Y Combinator, a well-known tech accelerator, created the SAFE in 2013, and uses it to fund most of the seed-stage startups that participate in its three-month development sessions.

The SAFE is something like a warrant entitling investors to shares in the company, typically preferred stock, if and when there is a future valuation event, i.e., if and when the company next raises "priced" equity capital, or is acquired, or files an IPO.

Since 2013, the SAFE was used in perhaps 1 percent or 2 percent of equity offerings on Regulation D platforms under Rule 506(c), also known as equity crowdfunding for accredited investors. In the period from 9/23/13 to 9/23/15, among the Rule 506(c) offerings tracked by Crowdnetic, 69 percent used straight equity (e.g., preferred stock), 20 percent used convertible debt, 9 percent used straight debt, etc.

The SAFE may have found its ideal niche in Title III offerings, also known as equity crowdfunding for all investors – although we won't know how effective it really is for several years. Upon the launch of Title III (under Regulation CF) on May 16, 2016, a majority of the 20 equity offerings listed on Wefunder, the dominant Title III portal, use the SAFE.

Founders Love It

SAFEs are attractive to founders, especially at the pre-revenue stage, for two reasons. First, they're very simple. The founders don't have to hire a lawyer to draft the agreement (although I wouldn't discourage them from getting good legal advice). Y Combinator released four basic versions of the agreement in December 2013, all of them five pages plus signatures, which issuers can adapt. Simplicity is attractive to inexperienced angel investors too.

Second, like convertible debt, there is no need for issuers and investors to agree on a current valuation or share price – those numbers are fixed at a later date, in a liquidity event, presumably when the company has more revenue, and presumably in a priced funding round with more sophisticated venture investors, or in an acquisition or IPO.

Also like convertible debt, the SAFE deal terms can include valuation caps and share-price discounts, to give early crowdfund (CF) investors a lower price per share than later venture capital (VC) investors or acquirers get in that liquidity event. That's justice, because earlier investors take more risk than later investors in pursuit of the same equity.

Unlike convertible debt, there is no debt with a SAFE. There is no maturity date either, which means investors have to wait an unspecified amount of time before they can get their hands on the equity they bought, if that ever happens.

Investor Protection

On the surface, it appears that the SAFE offers investors less protection than convertible debt. For such a sacrifice, investors should be very generously rewarded, right? It seems the magnitude

of the reward depends entirely on low caps and/or high discounts, since those are the only variable terms – a feature of the SAFE's exquisite simplicity.

Experienced angel investors are skeptical about whether issuers are willing to offer sufficiently generous discounts in particular. Of the 11 issuers that use SAFEs for their offerings on Wefunder, all include valuation caps (ranging from $2 million to $20 million) but only two include discounts (10 percent and 15 percent). Considering the much greater level of risk that seed-stage investors take on compared with later-stage investors, 15 percent might not seem like much of a reward to sophisticated angel investors. Try 50 percent, which would represent a 2x valuation jump from the CF round to the liquidity event, quite reasonable when the time between events is indefinite.

But crowdfunding investors under Title III will be more socially motivated than traditional angels whose primary motivation is ROI. Average Title III investors (a) will gravitate to simplicity, (b) might not be able to judge whether the valuation cap makes any sense whatsoever, and (c) will often settle for a half-decent discount on share price just to get in on the ground floor of an exciting startup – a privilege that was largely unavailable to them before Title III of the Jumpstart Our Business Startups Act of 2012 was implemented this year.

In fact, even some experienced angel investors care less about deal terms than about the brilliance of the business concept, the ability of the founders to execute their plan, and the growth potential of the market for the company's product or service. Paul Graham, one of America's premier angel investors and a founder of Y Combinator, wrote this in 2009:

> Don't spend much time worrying about the details of deal terms, especially when you start angel investing. That's not how you win at this game. When you hear people talking about a successful angel investor, they're not saying, "He got a 4x liquidation preference." They're saying, "He invested in Google."
>
> When angels make a lot of money from a deal, it's not because they invested at a valuation of $1.5 million instead of $3 million. It's because the company was really successful.

Again, many experienced angels may disagree with that approach, because they *must* maximize return on investment *every time* in order to be successful – that's their full-time job. Graham's advice is better suited to part-time angels whose primary motivation is to help entrepreneurs they admire, support community development, own a piece of their favorite hangout or brand, or simply have as much fun as those "Shark Tank" investors seem to have.

Drilling into SAFE Terms

The SAFE was originally drafted by Carolynn Levy, a lawyer and Y Combinator partner. Here are the most important terms that are featured in the SAFE:

- Along with valuation and share price, many terms of the equity agreement – including distribution preferences, anti-dilution mechanisms, conversion from preferred to common stock, protective provisions, and other details – are deferred to the future liquidation event.

- If the issuer is unsuccessful and dissolves the business before there is a liquidity event, SAFE holders may receive their investment back (without interest) prior to any distribution to company stockholders, if cash is available for that purpose.
- Often the SAFE holder's liquidation preference is 1x (equal to the original SAFE investment) even if later investors get a higher liquidation preference for the same preferred stock equity. For this reason, SAFEs are said to convert into "shadow preferred" stock.
- Some SAFES provide that in the event of a merger, acquisition, or IPO, a SAFE holder may convert the SAFE into shares of common stock rather than preferred, calculated based on the valuation cap; or opt to get the original investment refunded.

Resources

Here are some authoritative articles that cover the basics of SAFEs:

- Y Combinator's Startup Documents page, which introduces the SAFE, with links to four different versions of the document (with or without caps and discounts).
- "Better SAFE than Sorry?" published in January 2015 by the McCarter & English law firm.
- A 2016 *National Law Review* article by lawyers Stephanie Zeppa and Andrew Kreider.

Chapter 12 Update:
Due Diligence

On page 206 we stated that CrowdCheck, a premium due diligence service, charges about $1,000 for the most basic report (which provides assurance that the offering complies with the law). That amount applied to Regulation D offerings, and it is still accurate. However, for Title III offerings CrowdCheck expects that it will charge about $1,500 for the most basic report.

On page 217 we stated that if a company is raising more than $500,000 (up to $1 million), then audited financial statements are required. The SEC's final rules exempted first-time issuers from that requirement.

Chapter 13 Update:
Funding and Post-funding

On page 238 we wish to add that if the issuer changes the terms of an offering at any time, it must within five days contact all committed investors and give them the option of re-committing to the deal in consideration of the new terms.

On page 239 we wish add that the SEC's final rules under Title III specify that annual reports must be filed with the SEC and posted on the issuers' websites within 120 of the issuer's fiscal year-end. The reports do not have to be audited or reviewed by outside accountants. Annual filing requirements under Title III continue until one of the following occurs:

- The issuer goes public and becomes a fully reporting registrant with the SEC.
- The issuer has filed at least one annual report and has no more than 300 shareholders of record.
- The issuer has filed at least three annual reports and has no more than $10 million in assets.
- The issuer or another party purchases or repurchases all the securities sold in the Title III deal.
- The issuer stops doing business.

Chapter 14 Update:
Liquidity and Secondary Markets

On page 245 we wish to add the following: In its final rules under Title III, the SEC clarified that the one-year holding period (with noted exceptions) applies not only to the original purchaser of Title III securities but also to subsequent purchasers in secondary market transactions. Moreover, the preemption from blue-sky regulations (state securities laws) applies only to the original crowdfunding-based offer and transaction, not necessarily to the secondary transaction. This makes equity crowdfunding securities profoundly illiquid, so investors should focus on the long-term opportunities for growth and exit strategies.

On page 250, just before the subhead "Title III Secondary Markets," we wish to add the following:

Proposed Venture Exchange Law
Congress and the SEC are exploring the idea of allowing "venture exchanges" to facilitate trading of securities issued by small companies. The proposed Main Street Growth Act, for example, would permit venture exchanges to connect buyers and sellers of small-company securities, but not to process transactions between those parties. The act defines small companies as those—both public and private—with assets under $2 billion. Here is a link to the Main Street Growth Act, sponsored by Rep. Scott Garret of New Jersey:
http://financialservices.house.gov/uploadedfiles/bills-114hr-pih-msga-g000548.pdf.

On page 251, before the Conclusion, we wish to add the following:
In January 2016, PeerRealty, a Regulation D offering platform focusing on real estate deals, plans to launch CFX Markets, the first secondary market for crowdfunding investments. CFX will list not only real estate securities sold via PeerRealty but also various kinds of Reg D securities sold via at least 22 other Reg D platforms including PropertyStake (real estate) and CrowdFranchise (franchises).

Significantly, the issuer of securities will not have control over the terms of any transaction (such as minimum share price, maximum number of shares, or restrictions on who may buy, aside from basic SEC rules) on the CFX Markets platform.