July 14, 2016

Leading the Crowd: An Analysis of the First 50 Crowdfunding Offerings

By Marc A. Leaf, Robert T. Esposito and Abigail Luhn

The Securities and Exchange Commission (SEC) is now accepting Form C filings from private companies seeking to sell securities through registered crowdfunding portals. We have been following the nascent crowdfunding space closely and will continue to monitor the adoption of crowdfunding as a new method of financing private companies.

In this alert, we will analyze offerings conducted through crowdfunding portals, offer tips for those thinking of entering the space, and provide a summary of the SEC's final rules and forms for equity crowdfunding ("Regulation Crowdfunding").

The Drinker Biddle Crowdfunding Report, an open data set providing information on the first 50 offerings conducted under the Regulation Crowdfunding exemption, is available for download. The report provides data on filing dates, issuers, type of security, investment amounts, funding portals and other information.

Analysis of the First 50 Offerings

In general. As of June 30, 2016, 50 companies have filed a Form C with the SEC to offer securities under the Regulation Crowdfunding exemption. Minimum target offering amounts range from $20,000 to $500,000 per offering, with a median of $55,000. All but one of these issuers, however, have disclosed that they will accept offers in excess of the target amount, including 27 issuers that say they will accept investments at or near the maximum permitted offering amount of $1,000,000. In contrast, 18 of the first 50 issuers elected to cap their offering at just $100,000, with the remainder setting an offering cap of between $200,000 and $500,000. In the aggregate, if this first wave of retail crowdfundings is successful, 50 small companies will raise an aggregate of $6 to $30 million in new capital to fund their businesses.

While announced offering durations range from 21 days to one year, the median period that issuers say they will keep their offerings open is just under six months, with about half electing an offering duration between 166 and 182 days.

Eighteen different jurisdictions of incorporation are represented among the first 50 issuers; however, nearly half of the initial filers (24) are Delaware entities.

Early data shows that issuers tend to be early-stage startups, with a median issuer age of just 354 days. Nevertheless, nine of the issuers were more than five years old, and the oldest was incorporated in 2003.

Regulation Crowdfunding does not restrict the type of securities that may be offered under the new regime, and the first 50 issuers offer a broad array of securities to prospective investors. The two most commonly offered securities, which constitute three-fifths of the first 50 offerings, are common stock (16) and the so-called Simple Agreement for Future Equity or "SAFE" (14)—a financing instrument developed by startup accelerator Y Combinator that has been described as "convertible debt without the debt".[1] Other securities being offered include debt securities (seven), preferred stock (six), LLC units (five), and convertible notes (two).

While a total of 12 funding portals have registered with FINRA to date, the early mover Wefunder portal hosts more than half (26) of the first 50 offerings. The StartEngine portal has secured eight offerings, with the remainder split among other portals, including SeedInvest, Next Seed, Flashfunders, and Venture.co.

Early Adopters.

- *Social Enterprises.* According to the Global Entrepreneurship Monitor's Special Topic Report on Social Entrepreneurship, social enterprises account for only 5.7 percent of entrepreneurial activity in the United States. However, early crowdfunding data shows that social enterprises are strongly represented among crowdfunding issuers. Seven issuers, representing 14 percent of the first 50 offerings, are either registered as benefit corporations or benefit LLCs, or are certified by B Lab as B Corps, and at least an additional nine issuers operate within traditional corporate forms with strong social and/or environmental missions. Combined, these issuers represent 32 percent of the first 50 offerings.
- *Raise a Glass.* Craft breweries, distilleries, and licensed establishments are also disproportionately represented among the first 50 issuers. Eight issuers, representing 16 percent

1 Paul Graham, "Announcing the Safe, a Replacement for Convertible Notes", Y Combinator Posthaven (Dec. 6, 2013).

of the first 50 offerings, fall into this category, including 2 distilleries, 2 craft breweries, 2 bars, as well as a frozen alcohol producer and a producer of ginger liqueur.

An Early Success Story? As of July 1, 2016, Beta Bionics, Inc., a Massachusetts benefit corporation (with B Corp certification from B Lab pending) that was one of the first-day filers of Form C, appears to be having the most successful equity crowdfunding offering to date. The social enterprise, founded by Boston University professor Ed Damiano in 2015, has developed the iLet, a "bionic pancreas" that the company claims will automatically regulate blood sugar levels for individuals with Type I diabetes. The Boston Globe reported that Damiano chose to utilize equity crowdfunding because of his intention to "keep this [Beta Bionics] within the Type 1 diabetes family." The early interest generated by the offering may reflect the potential of crowdfunding to take advantage of interest group dynamics.

Beta Bionics is offering shares of common stock at $100 per share – which Beta Bionics says represents a $100 million valuation for the company. In the first 50 days, the company received commitments totaling more than $600,000 from an aggregate of over 550 investors on the Wefunder portal. The offering, set to expire on December 19, 2016, has a maximum offering amount of $1 million and is on pace to be the first offering conducted under the Regulation Crowdfunding exemption to raise the maximum amount permitted by law in a 12-month period.

Practice Tips

In light of the early trends described above, the following practice tips may be instructive to private companies considering a Regulation Crowdfunding offering:

- *Scaled Disclosure Requirements are Based on Maximum, not Target, Offering Amounts.* As described below, issuers using Regulation Crowdfunding to raise $100,000 or less must file financial statements certified by the issuer's principal executive officer, but no third-party audit or review is required. Issuers raising between $100,000 and $500,000 (and first-time issuers raising above $500,000) must file financial statements reviewed (but not necessarily audited) by an independent auditor. Repeat issuers raising more than $500,000 must prepare and file audited financial statements.[2] On its face, Rule 201(t) of Regulation Crowdfunding indicates that these disclosure thresholds are based on "target offering amounts" over a rolling 12-month period. However, instruction 1 to paragraph (t) makes it clear that, if the issuer will accept proceeds in excess of the target offering amount, the applicable threshold is determined by the ***maximum*** amount that the issuer will accept in all offerings under Regulation Crowdfunding within such 12-month period.

2 In any case, issuers with audited or reviewed financial statements otherwise available must provide such financial statements, even if the amount to be raised falls below the applicable threshold.

- *Form C Must Be Complete When Filed.* The issuer's offering statement on Form C must be filed with the Commission and provided to investors and the funding portal/intermediary prior to commencement of the offering. While offering statements may be amended from time to time to disclose any material changes, additions or updates to the information provided to investors on the portal, the Form C must include all the information required by Rule 201 of Regulation Crowdfunding when filed.

- *Minimum Investment Amounts and Target Offering Amounts Tend to be Low.* Although the adopting release for Regulation Crowdfunding permits issuers to impose minimum and/or maximum investment amounts per investor, few crowdfunding issuers have sought to limit their potential investment pool in that way. The median minimum investment disclosed by the first 50 filers is $100, with only one offering setting a minimum in excess of $2,000 (i.e., the largest amount available to all crowdfunding investors, regardless of income or net worth). The low median target amount of $55,000 (as compared to a median of more than $1,500,000 for offerings under Regulation D)[3] suggests that an offering regime for sub-million-dollar offerings addresses a market need.

Below is a summary of the fundamental rules applicable to issuers, investors, and intermediaries in connection with offerings conducted under the Regulation Crowdfunding exemption.

Summary

On November 16, 2015, the SEC released final rules and forms for equity crowdfunding. These new rules were promulgated pursuant to Title III of the Jumpstart Our Business Startups Act ("JOBS Act"), which added Section 4(a)(6) to the Securities Act of 1933 (the "Securities Act"). Section 4(a)(6) provides an exemption from registration for private businesses that offer and sell securities to unaccredited investors via Internet platforms, a practice commonly referred to as "crowdfunding." Regulation Crowdfunding marks a departure from the general rule that limited the offering of private company securities to accredited investors (those with annual income in excess of $200,000, or with a net worth in excess of $1 million). Under Regulation Crowdfunding, eligible businesses may raise up to $1 million in a 12-month period from unaccredited investors without registering the offering with the SEC.

Regulation Crowdfunding took effect on May 16, 2016. The following section of this alert summarizes the new rules. For more detailed information, please refer to the SEC's Adopting Release (No. 33-9974) and 17 C.F.R. Parts 200, 227, 232, 239, 240, 249, 269, and 274.

3 See, Scott Baugess, Rachita Gullapalli, and Vladimir Ivanov, "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014" (Division of Economic Research and Analysis, October 2015), *available at* https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf.

Rules for Issuers

An issuer's offering under the Regulation Crowdfunding exemption must satisfy the following requirements and must be offered through a registered broker-dealer or funding portal that satisfies the requirements described below under "Rules for Intermediaries."

Eligibility. Certain companies are ineligible from offering securities through the Regulation Crowdfunding exemption, including:

- Non-U.S. companies;
- Companies that already report under the Exchange Act of 1934 (the "Exchange Act");
- Investment companies and certain companies excluded from the definition of "investment company";
- Companies that are disqualified under Regulation Crowdfunding's disqualification guidelines;
- Companies without a specific business plan, or with a business plan to merge with or acquire an unidentified company or companies; and
- Companies that have failed to comply with annual reporting requirements during the two years immediately preceding the filing of an offering statement.

Investment Limit. An issuer may raise an aggregate, maximum amount of $1 million in a 12-month period though crowdfunding offerings. Issuers are permitted to raise capital through other exempt offerings, such as those conducted under Rule 506, which would not be counted towards the $1 million limit under Regulation Crowdfunding.

Disclosure Requirements. Regulation Crowdfunding enumerates a list of disclosure requirements for issuers. The required disclosure must be filed with the SEC on Form C and disclosed to investors and the relevant intermediary. These disclosures include, but are not limited to:

- Information about the issuer and its officers, directors, and owners of 20 percent or more of the issuer's stock;
- A description of the issuer's business and the use of proceeds from the offering;
- The price of the securities offered, or the method for determining the price;
- The target offering amount, the deadline to reach that amount, whether the issuer will accept investments in excess of the target offering amount, the method for allocating oversubscriptions, and procedures for the cancelation of an investment commitment;
- A discussion of the issuer's financial condition, including certain related-party transactions;
- A description of the rights, restrictions and limitations on any securities outstanding or being offered by the issuer, including debt securities;
- Material risk factors and terms of any of the issuer's debts or exempt offerings conducted by the issuer in the prior three years; and
- Certain financial disclosures, discussed below.

Financial Disclosures. All issuers are required to file with the Commission and provide to investors and the relevant intermediary a complete set of their financial statements (balance sheets, income statements, statements of cash flows and statements of changes in owners' equity), prepared in accordance with U.S. GAAP. For offerings up to $100,000, such financial statements must be certified by the principal executive officer (and accompanied by a certified statement of the issuer's total income, taxable income, and total tax as reported on the issuer's federal income tax return, if one has been filed), but generally need not be audited or reviewed by an independent accountant.[4]

For offerings between $100,000 and $500,000, and for offerings greater than $500,000 if it is the issuer's first offering under Regulation Crowdfunding, such financial statements must be reviewed by an independent accountant, but generally need not be audited.

For offerings greater than $500,000 that do not qualify for accommodation as first-time offerings, such financial statements must be audited by an independent accountant. In addition, if any issuer has audited or reviewed financial statements already prepared for another purpose, such issuer must file such audited or reviewed financial statements and make them available to investors and the intermediary, whether or not required by the size of offering.

The above financial statements are required for the issuer's two most recently completed fiscal years (or the two fiscal years prior to the most recently completed year, if no more than 120 days have passed since the last year-end). Independent accountants need not be registered with the PCAOB.

Amendments to Disclosures. Any material changes, additions or updates to the information provided to investors through the intermediary must be disclosed on Form C: Amendment ("Form C/A"). If there is a material change to the terms of an offering or to the information provided by the issuer, the intermediary must provide notice to each investor and any commitment not reconfirmed within five business days will automatically be cancelled.

4 PEO certification and tax return information is not required for any issuer that provides audited or reviewed financial statements in accordance with Regulation Crowdfunding.

Rules for Intermediaries

Offerings conducted under the Regulation Crowdfunding exemption must be made exclusively through a registered broker-dealer or funding portal. These crowdfunding intermediaries are required to, among other things:

- Register with the SEC as a broker or as a funding portal;
- Provide educational materials and other information about the offering and the issuer to prospective investors;
- Attempt to reduce the threat of fraud;
- Have a reasonable basis to believe that no investor has made Regulation Crowdfunding investments in the aggregate that exceed the applicable limits for that investor. Intermediaries may rely upon representations of issuers concerning compliance with this requirement unless an intermediary has reason to question such representations; however, an intermediary is responsible for tracking each investor's crowdfunding investments made through the intermediary's platform (or any platform operated by an affiliate of such intermediary);
- Provide communication channels allowing for discussions about the offerings on the platform;
- Give notice to each investor regarding: (i) the dollar amount of the investor's investment commitment; (ii) the price of the securities, if known; (iii) the name of the issuer; and (iv) the investment commitment cancellation deadline;
- Disclose the manner in which the intermediary is compensated in connection with the offerings and sales of securities;
- Facilitate the offering and sale of crowdfunded securities; and
- Maintain and preserve records of offerings, transactions and communications occurring on or through the portal for a period of five years.

Prohibited Intermediary Activities.

Regulation Crowdfunding prohibits intermediaries from conducting any of the following activities:

- Offering investment advice or recommendations;
- Soliciting purchases, sales, or offers to buy securities offered or displayed on its crowdfunding portal, or compensate employees, agents, or other persons for such solicitation;
- Permitting officers, directors, and partners of the intermediary from having any financial interest in an issuer using the intermediary's crowdfunding platform; or
- Holding, possessing or handling investor funds or securities.

Rules for Investors

Crowdfunding transactions under Section 4(a)(6) of the Securities Act are available to both accredited and unaccredited investors. However, Regulation Crowdfunding restricts the amount any individual may invest, in the aggregate across all crowdfunded offerings, in any 12-month period, as follows:

- If an investor's annual income or net worth is *less than* $100,000, then the *greater of*: (i) $2,000 or (ii) 5 percent of the *lesser of* the investor's annual income or net worth.
- If an investor's annual income *and* net worth are *greater than* $100,000, then 10 percent of the *lesser of*: (i) the investor's annual income or (ii) the investor's net worth, in each case, not to exceed $100,000.

For purposes of investment limits under Regulation Crowdfunding, annual income and net worth are calculated in accordance with Section 501 of the Securities Act for determining whether an individual is an accredited investor. No individual investor is permitted to invest an aggregate amount in excess of $100,000 in crowdfunding offerings in any 12-month period.

The table below, taken from the SEC's release, provides examples of an individual investor's aggregate investment limits in any 12-month period.

Investor Annual Income	Investor Net Worth	Calculation	Investment Limit
$30,000	$105,000	Greater of $2,000 or 5% of $30,000 ($1,500)	$2,000
$150,000	$80,000	Greater of $2,000 or 5% of $80,000 ($4,000)	$4,000
$150,000	$100,000	10% of $100,000 ($10,000)	$10,000
$200,000	$900,000	10% of $200,000 ($20,000)	$20,000
$1,200,000	$2,000,000	10% of $1,200,000 ($120,000), subject to $100,000 cap	$100,000

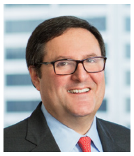
Source: Securities and Exchange Commission

Any securities issued in an offering conducted under Regulation Crowdfunding are subject to a one-year restriction on transfer, unless such transfer is made: (i) to the issuer of the securities; (ii) to an accredited investor; (iii) as part of a registered offering; or (iv) to a family member of the purchaser or certain trusts.

If you have any questions about this alert, please do not hesitate to contact the authors or your usual Drinker Biddle contact.

Corporate and Securities Team

Primary Contact



Marc A. Leaf
Partner
New York
(212) 248-3276
marc.leaf@dbr.com

DrinkerBiddle®
www.drinkerbiddle.com
CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY | NEW YORK | PENNSYLVANIA | WASHINGTON DC | LONDON
© 2016 Drinker Biddle & Reath LLP. All rights reserved. A Delaware limited liability partnership. Promotional Materials 2017. One Logan Square, Ste. 2000, Philadelphia, PA 19103-6996 (215) 988-2700 *office* (215) 988-2757 *fax*
Jonathan I. Epstein and Andrew B. Joseph., Partners in Charge of the Princeton and Florham Park, N.J., offices, respectively.