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Title III Crowdfunding: Outline For Portals And Issuers

This outline is for:

- Title III Crowdfunding portals
- Companies that want to raise money using Title III Crowdfunding
- People who want to know how Title III Crowdfunding works
- People with way too much time on their hands

The history of Title III Crowdfunding and what might happen to Title III Crowdfunding in the future are probably not very interesting to most readers. So I'm going to focus on the rules that were approved by the SEC on October 30, 2015, without spending too much time on what came before or what might come after.

Interested in reading the actual rules along with the SEC's explanation? They're only 686 pages. You can find them in the Legal Links section of my blog.

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Contact Information

Mark Roderick is spearheading Flaster Greenberg's Crowdfunding Practice. He speaks and writes regularly on Crowdfunding.

Expanding on his in-depth knowledge of capital-raising and securities law, Mark represents many portals and other players in the Crowdfunding field, spending much of his day helping entrepreneurs build an entirely new industry from the ground up. Mark also maintains a widely-read Crowdfunding blog at crowdfundattny.com.

In addition to Flaster Greenberg's Crowdfunding Practice, Mark is also a member of the firm's Mergers and Acquisitions, Business and Corporate, and Taxation Practice Groups. He represents entrepreneurs and their businesses across a wide range of industries, including technology, real estate and healthcare. Mark holds a Master's degree in mathematics as well as a J.D. from the University of Virginia.

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What Title III Crowdfunding Is And Where It Came From

Title III Crowdfunding allows a company looking for capital to:

- Advertise to potentially every investor in the world, using the Internet, and
- Raise up to $1 million of capital every 12 months
- From everybody, including non-accredited investors
- At a much lower cost than has ever been possible before.

Conversely, Title III Crowdfunding allows:

- Everybody, including non-accredited investors, to
- Find great companies from all over the world, using the Internet, and
- Invest in those great companies.

Title III Crowdfunding is referred to as "Title III" because it comes from Title III of the JOBS Act, which was signed into law by President Obama on April 5, 2012. The SEC issued proposed regulations on October 23, 2013 – that's right, more than two years ago – and we've been waiting for final regulations ever since, eyes to the heavens.

The JOBS Act also gave birth to Title II Crowdfunding, which became legal on September 23, 2013, and to Title IV Crowdfunding, which became legal on June 19, 2015. You can see a quick comparison of Title II, Title III, and Title IV on my Crowdfunding Cheat Sheet, and you can read more about Title IV in my Regulation A+ Primer.

Why Title III Is Important

Title III Crowdfunding is like nothing seen before in the U.S. securities industry. Title II Crowdfunding is an old-fashioned private placement where you're allowed to advertise. Title IV Crowdfunding is an old-fashioned Regulation A offering – a mini-IPO – but with higher limits. Title III is brand new.

Modern U.S. securities laws – the laws that govern the sale of stocks, bonds, and other securities – date back to the first administration of Franklin D. Roosevelt. During that entire 80 year period, a company seeking to raise money could not advertise the offering or sell to more than a handful of non-accredited investors without registering with the SEC, a long and expensive process. Title III changes that.

Using Title III Crowdfunding, a startup in Des Moines, Iowa or Camden, New Jersey or South Central Los Angeles can access every investor in the world at a modest cost, bypassing all the social, economic, and practical barriers that once stood in the way.

We're going to see lots of companies using Title III Crowdfunding and lots of portals springing up to help them. We're going to see a whole new ecosystem, which will complement, but not replace, the ecosystems around Title II and Title IV. We're watching in real time the transformation of the American capital formation industry, and it's pretty darned exciting.

Why Use Title III?

Use Title III Crowdfunding if you want or need to raise money from more than a handful of non-accredited investors.

EXAMPLE: A real estate developer needs $5 million to build a mixed-use project downtown. He could raise all the money he needs from accredited investors but would also like to involve non-accredited neighbors.

EXAMPLE: A company developed a new line of yoga wear and has 19,438 Facebook followers. The company wants to raise $775,000 to start manufacturing operations.

EXAMPLE: A company needs $350,000 for patents on a new heart valve. With a clever social media campaign the company might identify thousands of potential investors from those affected by heart disease.

To my mind, Title III is a creature of the Internet, sitting at the intersection of old-fashioned capital formation and modern social media. If you can attract social media followers, you can probably attract small investors.

Why Not Use Title III?

If you just need capital and nothing else, then you're probably going to have an easier time raising the capital from accredited investors using Title II.

If you need lots of capital from non-accredited investors, you might as well use Title IV.

Effective Date

Title III Crowdfunding becomes effective around May 6, 2016. But would-be portals can apply to the SEC starting on January 29, 2016.

Critical Limits of Title III

Limit on Amount Raised

An issuer may raise only $1 million during any rolling 12 month period using Title III Crowdfunding. The cap applies to affiliates of the issuer as well.

EXAMPLE: Company X raises $750,000 using Title III Crowdfunding. Company Y, which is under common control with Company X, may raise only $250,000 using Title III Crowdfunding during the same 12 month period. But it can raise as much it wants using other exempt offerings like Rule 506(b) or Title II.

Limits on Investors

Title III limits how much an investor – even an accredited investor – may invest, not just in a single Title III offering, but in all Title III offerings during a rolling 12 month period:

- If investor's annual income or net worth is less than $100,000, she can invest the greater of:
    - $2,000; or
    - 5% of the lesser of her annual income or net worth.
- If investor's annual income and net worth are both at least $100,000, she can invest the lesser of:
    - $100,000; or
    - 10% of the lesser of her annual income or net worth.

EXAMPLE: Investor Smith earns $100,000 per year and has a net worth of $150,000. Investor Smith makes his first Title III investment on December 1, 2016, investing $7,500 in Company X. On November 27, 2017 Investor Smith would like to make his second Title III investment, investing $5,000 in Company Y. But he can't; he can invest only $2,500 in Company Y. But he could invest $2,500 in Company Y on November 27, 2017 and another $2,500 (actually, another $10,000, if he wanted to) on December 1, 2017.

Spouses may combine their income and net worth.

Limits on Issuer

To use Title III, a company must be organized in the U.S. and may not be:

- A public reporting company; or
- An investment company; or
- A blind pool; or
- Disqualified under the "bad actor" rules.

EXAMPLE: Company X was formed as a Delaware limited liability company with the purpose of developing hotels in Rio de Janeiro, but doesn't own any property yet. Company X may use Title III Crowdfunding.

Limits on Advertising

A Title III issuer may run "tombstone" ads directing potential investors to the portal and giving the basic terms of the offering (e.g., the amount being raised and the price per share). But that's it. An issuer may not (except at the portal) advertise the details of the offering, using the Internet, print ads, airplane banners, or otherwise.

GOOD: "Like Pizazz Pizza? Invest in our future at www.portal.com #crowdfunding #pizazzpizza."

BAD: "Like Pizazz Pizza? Sign up for a 19% IRR! #getrichquick."

Title III Crowdfunding for Portals

The Role of Portals

In Title II Crowdfunding and Title IV Crowdfunding, a company that wants to raise money can put up a website and go for it. Not so in Title III. A company that wants to raise money using Title III must list on a qualified portal. The portal is the marketplace – the only marketplace – where prospective investors can browse among Title III issuers and offerings.

A Title III Crowdfunding portal is a highly-regulated, quasi-governmental entity, a sort of mini-SEC, responsible for policing issuers and their owners. Along with a marketing budget, put aside money for Compliance Officers and audits and FINRA examinations.

How To Become a Portal

If you're already registered with the SEC as a broker under section 15(b) of the Securities and Exchange Act of 1934, you're allowed to act as a Title III portal. If not, you have to:

- Complete and file Form Funding Portal with the SEC
- Register with FINRA

How Portals Make Money

Title III Crowdfunding portals will generate revenue in at least five ways:

1. Charging up-front fees to issuers
2. Charging commissions to issuers based on the capital raised
3. Taking financial interests in issuers
4. Accumulating and selling data
5. Selling advertising space

NOTE: A Title III portal may charge commissions to issuers without registering with the SEC as a broker -dealer.

Do's and Don'ts for Portals

Title III Crowdfunding portals are not allowed to:

- Offer investment advice or recommendations
- Solicit purchases, sales, or offers of securities on the platform
- Compensate employees or agents for soliciting purchases, sales, or offers of securities on the platform

But here are things portals are allowed to do:

- Select which issuers to list on the platform
- Apply objective criteria to highlight certain offerings on the platform, as long as those criteria don't include investment recommendations
- Provide search functions or other tools for investors
- Advise issuers about their offerings, and help prepare offering documents
- Pay compensation to or receive compensation from licensed broker-dealers under limited circumstances
- Compensate a third party for referring a person (e.g., an issuer) to the portal
- Advertise the existence of the portal

Communications Channels

A Title III Crowdfunding portal is required to maintain communications channels – for example, a chat room – where prospective investors can communicate with one another and with representatives of the issuer. In the chat room:

- Unless the portal is a registered broker, it may not participate except to establish guidelines and remove potentially abusive or fraudulent content. It may not, for example, provide investment advice.
- The whole world must be allowed to see the discussion, but only those registered with the portal are allowed to post.
- Representatives of the issuer, and anyone engaged in promoting the offering, must clearly identify themselves.
- The portal must keep records of all of these chats.

Portal as Policeman

A Title III Crowdfunding portal must:

- Have a reasonable basis for believing that each investor satisfies the per-investor limits; and
- Have a reasonable basis for believing that the issuer is complying with all of its obligations; and
- Have a reasonable basis for believing that the issuer has established means to keep accurate records of the holders of its securities; and
- Conduct background checks on the issuer and its principals; and
- Deny the issuer access to the platform if:
- The portal believes the issuer is disqualified under the “bad actor” rules; or
- The portal has a reasonable basis for believing the issuer or the offering presents a potential for fraud; or
- The portal is unable to assess the risk of fraud.

Portal as Educator

When an investor signs up, the Title III Crowdfunding portal must provide educational material, including:

- The process for buying securities at the portal
- The risks of buying securities
- Restrictions on resale
- The investor’s right to cancel her commitment
- The need for the investor to carefully consider whether an investment is appropriate

The most current version of these educational materials must be available on the platform at all times.

Electronic Delivery

Cancel the FedEx and UPS accounts! Everything in Title III Crowdfunding must be handled via electronic delivery only.

Escrow Account

A Title III Crowdfunding portal that isn't a registered broker may not hold investor money or securities. All funds must be handled through an escrow account administered by a bank, broker, or other qualified person.

Recordkeeping Obligations

A Title III Crowdfunding portal is required to keep lots of records, including:

- Records of issuers and investors
- Records of all communications that occur on or through the portal, including chat rooms
- Records of all transactions
- All documents

These records must be kept for at least five years, the first two in an easily-accessible place.

All records must be produced, reproduced, and maintained in the original, non-alterable format, and surrendered for inspection by the SEC or FINRA on demand.

Regulation By FINRA

Title III Crowdfunding portals must register with the Financial Industry Regulatory Authority, a private organization that regulates licensed brokers and other members of the financial industry. As a member of FINRA, a Title III portal will be subject to ongoing reporting and supervision.

Title II Portals as Title III Portals

Title II and Title III are very different: the former wholly unregulated, like the wild West, the latter highly regulated, like a bank. And the investors are different: accredited investors in Title II, non-accredited investors in Title III.

Will the two markets develop separately, like Neiman Marcus and Walmart? Or will they grow together in one big marketplace, like Amazon?

I think they're going to grow together, like it or not. In Crowdfunding, the investors are like consumers, the companies raising money are like manufacturers (think of their stock as a product), and the portals themselves are like stores. Although the customer base might be different between Title II and Title III, in the minds of consumers the products are the same. I think a Crowdfunding portal will have to make its products available to all consumers, like any other store.

Non-U.S. Portals

A company organized outside the U.S. or with its principal place of business outside the U.S. may still qualify as a Title III Crowdfunding portal, as long as:

- The SEC has in place an information-sharing arrangement with the SEC-equivalent in the other country.
- The company must designate an agent for service of process in the U.S., i.e., a place where the company can be sued.
- The company must provide an opinion of counsel that it is able under the law of its home jurisdiction to provide the SEC and FINRA with ready access to its books and records.

Title III Crowdfunding for Issuers

Nature of the Issuer's Business

You can use Title III Crowdfunding to raise money for any business, as long as you're not an investment company or a blind pool.

> **EXAMPLE:** You can use Title III Crowdfunding to create a fund that flips houses. You can't use Title III Crowdfunding to buy minority interests in other companies that flip houses.

Offering Disclosure Requirements

A Title III issuer is required to make extensive disclosures, using the newly-developed Form C. This is a non-exclusive list of the information required:

- Name, address, website
- Directors and officers
- Each person's principal occupation and employment for the last three years
- Names of each person owning 20% or more of the issuer's voting securities
- Risk factors
- Business and business plan
- Use of the proceeds of the offering
- Ownership and capital structure
- Description of how rights exercised by the principals could affect purchasers
- Compensation paid to portal
- Description of previous offerings
- Insider transactions
- Discussion of financial condition
- Updates on the progress of the offering
- How the issuer will deal with over-subscriptions

And a critical catch-all:

- Any material information necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading

NOTE: Not surprisingly, the list of required disclosures isn't too much different than the information you would expect to see in a traditional offering memorandum.

Approval of SEC Not Required

Although Form C must be filed with the SEC, is does not require the *approval* of the SEC. You file and start selling.

One Portal Only

A Title III Crowdfunding offering may be conducted on only one portal.

Financial Information

Along with all the other disclosures, the issuer is required to provide this financial information:

Where the amount of the Title III offering, together with all other Title III offerings of the same issuer within the last 12 months, is:	The issuer must provide:
$100,000 or less	• The issuer's total income, tax income, and total tax, as reported on the issuer's Federal tax return, certified by the principal executive officer of the issuer; and • Financial statements of the issuer, certified by the principal executive officer of the issuer. • If financial statements are available that have been reviewed or audited by a public accountant that is independent of the issuer, then those financial statement will be used instead.
More than $100,000 but not more than $500,000	• Financial statements that have been reviewed by a public accountant that is independent of the issuer, but if financial statements are available that have been audited by a public accountant that is independent of the issuer, then those financial statement will be used instead.
More than $500,000	• If this is the issuer's first Title III offering, financial statements that have been reviewed by a public accountant that is independent of the issuer. • If this is not the issuer's first Title III offering, financial statements that have been audited by a public accountant that is independent of the issuer.

All financial statements must be prepared in accordance with GAAP. Financial statement reviews must be conducted in accordance with the Statements on Standards for Accounting and Review Services issued by the Accounting and Review Services Committee of the AICPA. Financial statement audits must be conducted in accordance with either (i) auditing standards of the AICPA, or (ii) the standards of the Public Company Accounting Oversight Board.

Compensating Promoters

An issuer may pay a third party to promote the Title III offering using the communication channels (e.g., the chat room) on the portal's platform.

NOTE: This is a HUGE opportunity for public relations firms.

Giving Investors the Right to Back Out

Even after an investor has committed to invest, the issuer must allow the investor to back out until the time that is 48 hours before the time the issuer has specified as the offering deadline.

If there is a material change to the offering or to the information provided by the issuer, then all previous investor commitments will be automatically cancelled unless investors affirmatively reconfirm their commitments.

> **EXAMPLE:** Company X is raising money using Title III Crowdfunding. Midway through the offering, the CFO of Company X is arrested for possession of marijuana. Maybe that's a material change that requires cancellation of all commitments, maybe it isn't.

Foreign Investors

Non-U.S. persons, often referred to as "foreigners" in this country, may invest in Title III offerings. That includes Canadians and Finns.

Integration with Other Offerings

A company may conduct a Title III Crowdfunding offering without regard to other kinds of offerings conducted before, after, or at the same time.

> **EXAMPLE:** Company X is raising $750,000 in a Title III Crowdfunding offering. Company X may simultaneously raise money in a Title II offering, in a Rule 506(b) offering, or in any other kind of exempt offering. A company raising $750,000 in a Title III Crowdfunding offering could even launch a Title IV offering, although if it was thinking about Title IV it should have done that in the first place, duh.

Crowdfunding Shareholders Don't Count Toward Reporting Limits

Normally, any company with assets greater than $10 million and a class of equity securities held by 2,000 or more persons, or 500 or more persons who are not accredited investors, must register those securities with the SEC. Investors who buy securities in a Title III Crowdfunding offering don't count toward either threshold.

Ongoing Reporting

Having raised money using Title III Crowdfunding, an issuer is required to file annual reports with the SEC (also posted on the issuer's website), providing financial statements and a list of disclosures. The financial statements don't have to be reviewed or audited, but if reviewed or audited financial statements exist, they must be provided.

The issuer must continue filing annual reports until the earlier to occur of:

- The issuer is dissolved under state law
- The issuer or another party buys all of the securities issued in the Title III offering
- The issuer has filed at least one annual report and has fewer than 300 shareholders of record
- The issuer has filed at least three annual reports and has total assets no greater than $10 million

Bad Actor Rules

Title III Crowdfunding may not be used if anybody in this group:

- The company itself
- Any of its corporate predecessors
- Any affiliated issuer
- Any director, officer, general partner, managing member, or owner of at least 20% of the voting securities
- Any promoter
- Any director, officer, general partner, or managing member of a promoter

has engaged in specified wrongdoing in the securities industry.

EXAMPLE: Ned owns 22% of the voting stock of Company X. Poor Ned is sentenced to prison for marijuana possession on February 21, 2017. Company X is free to raise money using Title III. Had Ned been convicted of securities fraud instead, Company X could have been prohibited from using Title III – unless his voting stock were converted to non-voting stock.

(Moral of story: if Ned used marijuana more often, maybe he would haven't have been so consumed with money.)

NOTE: These "bad actor" rules apply only where the wrongdoing took place after Title III comes into effect, i.e., the beginning of May 2016.

EXAMPLE: On March 31, 2016, poor Ned is convicted of securities fraud involving the murder of Cecil the Lion. No problem! But Company X will have to disclose the conviction.

NOTE: A company may apply for an exception to these rules.

Liability of Issuers to Investors

Investors in a Title III Crowdfunding offering can sue the issuer for any material misstatements or omissions, unless the issuer can demonstrate that it didn't know about the misstatements or omissions and couldn't have known using reasonable care. The group of persons who could be personally liable includes:

- The company
- Its directors
- Its principal executive officer(s)
- Its principal financial or accounting officer
- Its controller

Issuers and related parties could have liability under state law as well.

How Much Will A Title III Offering Cost?

Can a small company, a startup, afford a Title III Crowdfunding offering? That's been the key question since the JOBS Act was enacted.

I think $7,500 of legal and accounting fees for the issuer is achievable, maybe even less once everything is automated. That's a very low number in the scheme of securities offerings.

The question is, how much will the Title III portal charge? What business model will work for portals? Will they need to charge high fees up front, or can they make money taking financial interests in issuers and charging fees that are contingent on the success of the offering?

I'm optimistic. I believe in technology. We'll see.

Resales of Securities

Securities purchased in a Title III offering may not be transferred for one year, except:

- To the issuer
- To an accredited investor
- As part of a registered offering
- To a family member

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