A Comparison of the JOBS Act Crowdfunding Regulations (and When to Use Them)

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This practice note compares the different crowdfunding exemptions and will aid attorneys in understanding, on a practical level, when to use each exemption. If you have not yet read the summary of each exemption, you should consult the practice note entitled A Summary of Crowdfunding under the JOBS Act. A brief visual layout that compares the differing legal aspects of the crowdfunding regulations is available at www.crowdfundinglawyers.net/resources.

Regulation D, Rule 506(b), and 506(c) Are Iterations of the Traditional Private Placement Exemption

In recent years, the amounts raised through unregistered securities offerings have outpaced the amounts raised through registered securities offerings. According to an October 2015 study by Scott Bauguess, Rachita Gullapalli, and Vladmir Ivanov, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014 https://www.sec.gov/dera/staff-papers/white-papers/unregistered-offering10-2015.pdf, in 2014, Regulation D offerings raised some $1.3 trillion, and 99% of that amount was raised under the Rule 506 exemption. Regulation D's popularity is due, in part, to federal preemption of registration of the securities under state laws.

To understand the difference between Rule 506(b) and 506(c) of Regulation D, it is helpful to briefly understand each of their origins. Until recently, only Rule 506 existed—there was no delineation in (b) and (c). With the final rules of Title II of the JOBS Act approved, the traditional Rule 506 became Rule 506(b), and the new Title II-related rules became Rule 506(c).

Section 4(a)(2) / Rule 506(b) of Regulation D Is a Private Placement without General Solicitation

Rule 506(b) is by far the most common exemption from registration, and is a safe harbor for private placement offering exemption contained in Section 4(a)(2) of the Securities Act of 1933, so long as issuers follow certain rules, which include:

- No general solicitation or advertising to market the securities. This means that the activities of the issuer (or their agents) either do not involve an "offer" or there is a pre-existing, substantive relationship with the offerees.
- Limit the number of non-accredited investors to 35.
- Comply with Regulation D's information requirement. For accredited investors, the issuer has no specific disclosure requirement; rather, it must decide what information to give to accredited investors that is consistent with the anti-fraud prohibitions of the federal securities laws. For non-accredited investors, the issuer is required to provide disclosure documents that are generally the same as those used in Regulation A offerings. If an issuer provides information to accredited investors, it must make this information available to non-accredited investors as well (as a practical matter, all investors should receive the same information).
- Filing of a Form D. Issuers must file a Form D with the SEC and the state(s) in which sales of securities occur within 15 days of the first sale.

If issuers follow the above requirements, they can raise an unlimited amount of funds from an unlimited number of accredited investors with merely a notice filing, and without having to register the securities at the state or federal level. However, investors receive "restricted securities" and may not resell without registering the transaction with the SEC or being subject to the limitations of Rule 144 (or another exemption from registration).

Section 4(a)(2) / Rule 506(c) of Regulation D Is a Private Placement That Allows General Solicitation

The newly created Rule 506(c) became effective on September 23, 2013, as mandated by Title II of the JOBS Act. In its first three years, an estimated $33 billion, or roughly 2%, of Regulation D offerings was raised under the Rule 506(c) exemption.

The primary difference between Rules 506(c) and 506(b) is the tradeoff in the ability to generally solicit (SEC speak for "advertise") the securities offering. In exchange for the ability to, for example, tweet about or buy digital ads to advertise the securities offering, an issuer must take "reasonable steps" to verify that all purchasers of the securities are accredited investments, and the issuer must reasonably believe that all purchasers are accredited investors.

Whether the steps taken are "reasonable" is an objective determination by the issuer (or those acting on its behalf) in the context of the particular facts and circumstances of each purchaser and transaction. While there are two methods—the safe harbor method and principles-based method—of verifying an investor's accredited status, as a matter of practice, most issuers choose to follow the safe harbor method outlined by the SEC. Doing otherwise potentially exposes an issuer to a Section 5 violation if the SEC disagrees with the issuer's reasonable belief, or having taken reasonable steps, to verify an accredited investor's status.

The safe harbor method consists of:

- Reviewing copies of any Internal Revenue Service form that reports income for the two most recent years, along with a written representation by the investor of similar projected income status for the upcoming year
- Reviewing one of the following forms along with a written representation by the investor that all liabilities relevant to net worth have been disclosed:
  - Assets: bank statements or statements of securities holdings, certificates of deposit, tax assessments, and satisfactory independent appraisal reports
  - Liabilities: consumer reports from national consumer reporting agencies
- Obtaining written confirmation that one of the following persons has taken reasonable steps to verify accredited investor status within the prior three months: a registered broker-dealer, SEC-registered investment adviser, licensed attorney, or certified public accountant

Choosing between the Rule 506(b) and Rule 506(c) Exemptions

Because the primary difference between the Rule 506(b) and 506(c) exemptions is whether the issuer is able to generally solicit, or advertise, its offering, the question of which exemption to utilize centers primarily around whether the issuer has a sufficient pre-existing network of investors that would enable them to raise the offering amount.

Rule 506(c) Issuers Might Not Otherwise Be Able to Raise the Maximum Offering Amount without Advertising Their Offering

Issuers with a large pre-existing network of accredited investors, or who have a track record of being able to raise a similar amount, are well advised to use the Rule 506(b) exemption. Oftentimes, those raising under the Rule 506(c) exemption plan to conduct at least part of their offering via an online platform or may need to generally solicit their offering to "top off" their funding round. Some issuers have more philosophical or practical reasons for choosing to utilize the Rule 506(c) exemption—some companies want to be able to attract investors outside of their immediate network (but may not want retail investors), whereas others may use a concurrent Rule 506(c) offering alongside a Regulation Crowdfunding offering to either take investment dollars from accredited investors if their Regulation Crowdfunding campaign exceeds $1 million, or to accept higher investment amounts than otherwise allowed under Regulation Crowdfunding.

Rule 506(c) Issuers Trade Ease of Transaction for the Ability to Advertise

Additionally, most issuers opt to use a Rule 506(b) exemption simply because the investment process contains less friction. Many accredited investors are reluctant to turn over documentation and information related to their annual salary or net worth—especially to an issuer—although investors who regularly use online investment platforms are now growing more accustomed to the process. Many issuers turn to third-party verification services—especially ones with privacy considerations built into the system—to reduce the awkward tension that arises when an issuer asks their investor for detailed and highly personal financial information.

Additionally, the accredited investor verification process also requires a good amount of back-and-forth between the investor and issuer (or third-party verification provider), especially if the investor initially submits documentation that is insufficient to meet the accredited investor standards. And finally, although an investor can get a third-party verification letter, many accountants and attorneys are reluctant to provide their clients with such a letter (or will charge their clients a hefty amount to issue the letter) which, in turn, frustrates the investor.

Rule 506 Does Not Correlate to Capital-Raising at a Particular Time in a Company's Lifecycle

Lastly, it's important to contrast the Rule 506 exemptions from the exemptions that allow retail investors (or the "crowd") to invest. Whereas Regulation Crowdfunding or Regulation A are crafted for use at a particular time in the company's lifecycle, the Rule 506 exemptions are evergreen, and can be used at any point in the capital raising process.

In short, while Rule 506(c) enables investors to advertise their offering and attract accredited investors outside of an issuer's pre-existing network, unless that ability to advertise is expected to dramatically affect their ability to raise funds, most issuers are still better off utilizing the traditional 506(b) exemption

Regulation Crowdfunding Is Primarily for New Businesses

Regulation Crowdfunding (Reg CF) became effective on May 16, 2016 and has raised some $12.5 million in its first six months. As of the date of writing, Reg CF allows issuers to raise up to $1 million from retail investors, though it contains several restrictions:

- All offerings much be conducted through a registered funding portal
- Although general solicitation is allowed, any advertising done off-portal is largely restricted to "tombstone advertising"
- Some offerings may require reviewed financial statements or audited financial statements, though as a practical matter, most issuers voluntarily opt for reviewed financials since they hope to raise more than $500,000

At the time of writing, many industry experts expect some version of the Fix Crowdfunding Act to be passed by the Senate. Depending on which version is passed, the maximum offering amount of a Regulation Crowdfunding offering could be raised to $5 million every 12 months.

Reg CF Issuers Tend to Be Newer Businesses with Lower Valuations

As a practical matter, most issuers contemplating a Reg CF offering tend to be new or early-stage companies for the simple reason that the $1 million funding cap deters more established or valuable companies. Companies looking to raise substantially more than $1 million often will not bother to spend the time, energy, or resources needed to conduct a Reg CF offering. For example, if a company aims to raise funds in exchange for equity, the maximum offering amount of $1 million would correspond to the crowd's ownership in 50% of a company with a $2 million valuation, or the crowd's ownership of 20% of a company with a $5 million valuation. Few founders want to give away much of their company, so the lower fundraising limit on Reg CF effectively limits usage of the exemption to newer companies with lower valuations.

Acceptance by a Funding Portal Often Governs Whether an Issuer May Utilize the Reg CF Exemption at All

Another bar on Reg CF's usage is the requirement to be listed on a registered funding portal. Although there are several registered funding portals (with many more to come), there are only a few that have a serious track record of being able to help their issuers raise capital. Many of the more serious funding portals receive a number of applications from potential issuers and accept less than 1% of all applications. Thus, the chances of being accepted on a top-rated funding portal are low, and issuers sometimes will decline to use a less selective funding portal, citing lack of confidence that they will be able to conduct a successful crowdfunding campaign. "If the top portals don't have confidence that we'll have a successful campaign, I don't have confidence that we'll have a successful campaign on a lower-tier funding portal," said one client.

Successful Reg CF Issuers Tend to Be Consumer-Facing

Because Reg CF issuers typically sell their securities to retail investors, it's important for the crowd to easily understand the issuer's business. As a result, Reg CF issuers tend to be consumer-facing business-to-consumer (B2C) businesses instead of business-to-business (B2B) companies. Although there are always exceptions, an enterprise B2B SaaS platform may have a more difficult time raising funds from the crowd as compared to, say, a restaurant, a company that makes unique selfie sticks, or a technology dating app. The retail crowd has a much easier understanding of the latter companies than the former.

Reg CF Issuers Sometimes Make a Philosophical Decision to Create Brand Evangelists

Highly sought-after companies often have little or no need for capital. As a result, many quality Reg CF issuers are companies that have made a strategic and/or philosophical decision to offer a stake in their company to consumers, in order to create brand evangelists. Some of the first successful Reg CF issuers, such as Legion M and Youngry, have explained that building consumer engagement and ownership were key to their overall business missions. Legion M, a fan-owned movie studio that raised $1 million from over 3,000 investors, sees those backers as a guaranteed audience and evangelists of future releases from the studio. While some issuers might limit the number of investors they allow—usually by taking the commitments with the highest dollar amounts, Legion M's aim was to take as many investors as possible. As a result, they limited the amount of investment for some larger investors.

Explains Youngry CEO Ash Kumra, "With Regulation Crowdfunding, you're now asking your core customers, audience members, users—people who believe in your idea—to fund you. But, instead of just getting some perk or reward, which may become outdated, contributors potentially get an ownership stake in the business. It causes a paradigm shift for the contributor—they begin to think like an owner and will more likely find ways to help the business grow. Case in point—during Youngry's Regulation Crowdfunding campaign, we did over 20 events. The majority of those events were actually set up by our own backers because they were invested as owners, and wanted to give us opportunities to talk about our company and campaign and, thus, gain more exposure."

Reg CF Issuers Must Be Willing to Dedicate Resources to the Campaign

Companies may first envision crowdfunding as a method that makes money rain from the sky with relatively little effort; this fantasy could not be further from the truth. Reg CF campaigns—and any fundraising campaign for that matter—require diligence, time, money, and resources. Most successful crowdfunding campaigns—whether Reg CF, Reg A, or even rewards-based campaigns on Kickstarter—engage digital marketing companies to advertise their crowdfunding campaign, and spend the better part of the campaign doing interviews and events to attract investors. Some funding portals give issuers an allowance for digital advertising or find other ways of supporting their issuers, aside from e-mail blasts to their investor mailing list. Companies that are unable to support a certain marketing spend or unwilling to devote significant time towards promotion of the crowdfunding campaign are strongly advised against undertaking a Reg CF campaign.

The Amended Regulation A Allows for Modified Small-Cap IPOs

Title IV of the JOBS Act became effective on June 19, 2015, and provided amendments to the old and rarely used Regulation A (sometimes called "Reg A+"), which allows non-accredited investors to participate in a company's "mini-IPO." Whereas the old regulation only allowed issuers to raise a maximum of $5 million per year and required a long and grueling process, the amended regulation raises the funding cap to $50 million every 12 months, and has a much more streamlined process.

It is important for all service providers of Reg A+ issuers, including attorneys, to carefully evaluate the suitability of companies for a Reg A+ offering. All too often, companies that cold-call an attorney after having Googled the regulation make for poor Reg A+ candidates.

Reg A+ Tends to Be Suitable for More Mature Companies

Regulation A+ is often termed a "mini-IPO" for good reason. In contrast with Reg CF, which is largely geared towards newer businesses trying to prove a concept or gain early traction, Reg A+ is better suited towards more-established companies that have already proven a concept, gained significant traction, and are looking for growth capital or an early or partial exit. A potential Reg A+ issuer would be advised to meet all or most of the below criteria:

- Capital raised to date: $3 million+
- Annual revenue/pre-sales: $2 million+
- Number of customers/e-mails: 5 thousand or more
- Number of authentic social media followers: 5 thousand or more
- Number of employees: 10 or more
- Number of physical locations: 1 or more
- Marketing budget: $150 thousand or more

The three most important criteria are capital raised to date, annual revenue/pre-sales, and number of customers. While it is helpful for a company to have significant organic social media followers and large customer e-mail lists, a larger marketing budget can help issuers make up for weakness in these areas; conversely, an issuer with a larger e-mail list and influential social media presence may not need to spend as much on marketing.

There are exceptions to the rule, however; companies with moonshot ideas that excite and intrigue retail consumers, and which require large amounts of capital to get started, could conceivably use Reg A+ to get off the ground.

Reg A+ Issuers Should Have Businesses Understandable to Lay Investors

Additionally, because an issuer is trying to attract retail investors, it's helpful to have a product that consumers love and easily understand. For example, consumers understand automobiles, video games, and real estate, but may have a more difficult time understanding and evaluating B2B software, biotechnology, stem cell research, or licensing schemes to patent portfolios. Although it's not impossible to do a Reg A+ offering in these latter products, until Wall Street analysts begin regularly evaluating and providing recommendations on these securities, issuers may have a more difficult time to convey esoteric technical information to the retail investors.

Tier 2 is Vastly Easier to Utilize Than Tier 1

Tier 2 of Reg A+ allows an issuer to raise up to $50 million every 12 months, as opposed to Tier 1 that restricts the maximum offering amount to $20 million every 12 months. While Tier 2 has heightened disclosure requirements, in practice, it is a much easier exemption to utilize because it allows for federal pre-emption. This means that issuers utilizing Tier 2 of Reg A+ need only be qualified at the federal level by the SEC, and that review will be on a disclosure basis instead of a merit basis.

Tier 1 offerings do not enjoy federal pre-emption. Issuers utilizing Tier 1 will need to subject their offering to both review by the SEC and the states in which they plan to sell their offering. Although the states now use a new and improved "coordinated review process" to more efficiently review the offering, anecdotally, many attorneys still find the Tier 1 state process harrowing. Some states employ a merit-based review regime instead of a disclosure-based review regime, meaning that some state regulators may make it very difficult to qualify a Reg A+ offering. In one recent case, a filing that garnered fewer than 10 comments from the SEC drew more than 90 comments and questions from state regulators.

Ironically, this means that Tier 2 offerings end up being both easier and less expensive to qualify than Tier 1 offerings, even though Tier 1 offerings have a lower maximum offering amount. Many law firms—including some big law firms—have moved towards a flat fee basis for Reg A+ offerings generally, but either refused to file Tier 1 offerings or bill on an hourly basis for comments received during the Tier 1 process.

Reg A+ Requires Pre-planning

Unlike Regulation D and Regulation CF offerings that allow for more immediacy in raising funds, Reg A+ offerings require qualification by the SEC (and sometimes, state regulators). Issuers should plan for a four- to six-month process that will include preparing financials, drafting the offering circular, and a back-and-forth comment process with the SEC (and states, if a Tier 1 filing). Novel filings may take an even longer period of time. Companies with more immediate capital requirement needs should not use Reg A+, or should consider a bridge financing round in the interim.

Related Content

For additional information on Crowdfunding, see the following practice notes:

- Comparing Crowdfunding Instruments: Common Stock, Preferred Stock, Convertible Notes and SAFEs
- Regulation A Plus
- A Summary of Crowdfunding under the JOBS Act
- Crowdfunding Intermediaries under the JOBS Act