PRIVATE EQUITY AND VENTURE CAPITAL COMMITTEE // FALL 2021

PREFERRED RETURNS

Crowdfunding the Venture Capital Firm: How the SEC's Expansion of Equity Crowdfunding Could Redefine Venture Capital Fundraising

Layla Dotson Lumpkin
Partner, Thompson Hine

M. Daya Bean
Associate, Thompson Hine

In February 2021, Backstage Capital, a venture capital firm that focuses on investing in companies led by underrepresented founders (women, people of color, and LGBTQ+ community members), raised approximately $1 million in nine hours from nearly 1,600 investors in an equity crowdfunding offering on Republic, an online investing and crowdfunding platform. After amendments to Regulation Crowdfunding went into effect on March 15, 2021, Backstage executed another fundraising campaign, and by April 1, it had successfully raised $5 million from nearly 6,800 investors. Backstage's innovative approach of applying crowdfunding to the venture capital firm structure exemplifies the expanded possibilities of equity crowdfunding.

Regulation Crowdfunding – The Basics

The term "crowdfunding" is used broadly and has been popularized by "reward crowdfunding" and "donation-type crowdfunding" platforms such as Kickstarter, Indiegogo, and GoFundMe. Crowdfunding allows companies to raise capital in relatively small amounts from the general public. Reward crowdfunding on sites such as Kickstarter or Indiegogo allows companies to solicit funds from the public in exchange for a benefit to the investor, like the opportunity to try a new product or receive a discount on a future purchase. On a donation-type crowdfunding platform like GoFundMe, individuals and organizations raise funds to support a cause or a person in need. The Jumpstart Our Business Startups (JOBS) Act of 2012 took this "evolving method of raising capital that has been used to raise funds through the Internet for a variety of projects" to the next level by permitting companies "to offer and sell securities through crowdfunding" (commonly referred to as equity crowdfunding). Crowdfunding securities can be equity, debt, revenue share, SAFEs or convertible notes.

Section 4(a)(6) of Title III of the JOBS Act permitted equity crowdfunding by creating a new exemption from the requirement that the offer and sale of securities be registered under the Securities Act of 1933, and the SEC introduced Regulation Crowdfunding in 2015 to implement Title III. Since its release, the number of companies using equity crowdfunding has increased each year. In 2020, 1,035 companies raised $214.9 million, up from $104.7 million by 541 companies in 2019.

The SEC's initial adoption of Regulation Crowdfunding included the following requirements and limitations:

- Allowed maximum raise of $1,070,000 in a 12-month period
- Limited investment amount based on an investor's annual income or net worth (e.g., an investor with annual income or net worth less than $107,000 could invest the greater of $2,200 or 5% of annual income or net worth)
- Required that equity crowdfunding transactions be conducted exclusively through a broker-dealer or funding portal registered with the SEC and FINRA
- Excluded certain types of companies, e.g., non-U.S. companies, investment companies, companies that have no specific business plan or whose business plan is to engage in a merger or acquisition with an unidentified company (i.e., SPACs), and bad actors
- Required issuers to disclose certain information by filing Form C through the EDGAR system and that such information be publicly available 21 days before any securities are sold
- Limited promotion to only using a notice that points the investor back to the intermediary's platform.
- Required issuers to file an annual report with the SEC and provide it to investors
- Required issuers offering more than $107,000 to provide financial statements reviewed by a public accountant (or audited by a public accountant if the issuer previously used Regulation Crowdfunding)
- Restricted resales of securities for one year, subject to certain exceptions (e.g., if transferred to the issuer, an accredited investor, etc.)

In November 2020, the SEC adopted several amendments to the Securities Act that took effect in March 2021 to "facilitate capital formation and increase opportunities for investors by expanding access to capital for small and medium-sized businesses and entrepreneurs across the United States." The amendments to Regulation Crowdfunding included:

- Increased the maximum offering amount to $5,000,000 in a 12-month period
- Removed the investment limit for accredited investors
- Changed the calculation for the investment limit for non-accredited investors
- Permitted the use of special purpose vehicles that act solely as a conduit for the investment in the crowdfunding issuer
- Allowed the issuer to solicit interest about the potential offering prior to filing Form C (if the solicitation materials meet certain requirements)

Crowdfunding Venture Capital

The exclusion of certain types of companies from claiming the crowdfunding exemption as issuers would appear to exclude venture capital firms from offering investments via equity crowdfunding. Under 17 CFR 227.100(b), the crowdfunding exemption does not apply to transactions involving the offer or sale of securities by any issuer that is "an investment company, as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), or is excluded from the definition of investment company by section 3(b) or section 3(c) of that Act (15 U.S.C. 80a-3(b) or 80a-3(c))." An investment company is defined under 15 U.S.C. 80a-3 as any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." Venture capital funds typically fit the investment company definition but may be exempt from the provisions of the Investment Company Act of 1940 that require investment companies to register and be subject to significant regulation. However, the crowdfunding exemption specifically does not apply to companies, such as venture capital funds, that would otherwise fit the description of an investment company except are carved out of the definition by 15 U.S.C. 80a-3(b) or 80a-3(c). In its "Final Rule: Crowdfunding" release, the SEC stated that its reason for excluding certain types of issuers, including investment companies, was that while such exclusions could limit crowdfunding investors' investment choices:

… we are not creating additional exemptions for these categories of issuers. In reaching this determination, we have considered that the primary purpose of Section 4(a)(6), as we understand it, is to facilitate capital formation by early stage companies that might not otherwise have access to capital. As a general matter, we do not believe that … investment companies … constitute the types of issuers that Section 4(a)(6) and Regulation Crowdfunding are intended to benefit. Moreover, we believe that certain of these issuers, such as … investment companies, may present unique risks that would make them unsuitable for the scaled regulatory regime associated with securities-based crowdfunding transactions.

Backstage seems to draw a distinction between the venture capital funds and the services required to operate a venture capital firm. While Regulation Crowdfunding may not allow an issuer to raise money and then invest it in a portfolio of early stage companies, it would not prevent a service provider from funding its operations. According to its Form C filing, the money Backstage raised will not be invested in any of its funds that deploy capital directly to portfolio companies in exchange for ownership but will be used to fund the services provided by the general partners who are the investment advisers to its funds (e.g., pay for salaries, technology, etc.). The investment advisory services include conducting sourcing activity, reviewing deal flow, making investment decisions, supporting portfolio company growth and providing reporting to investors. In exchange for their investment to help cover the firm's operational costs to provide these advisory services, the crowdfunding investors will get a percentage of the management fee and of any fee paid or allocated to the funds' general partners based on the performance of their portfolio companies.

Why would a venture capital firm do this? In an Inc. article, Backstage Capital founder Arlan Hamilton said that the management fees have not been enough to cover even one person on their five-person team. In April of this year, another emerging venture capital fund, Earnest Capital, raised over $1 million from 811 investors through equity crowdfunding.

As Hamilton stated, "… leveraging the crowdfund allows [emerging funds] to have finances and have runway for a significant amount of time, and it puts [emerging funds] in a financially stable position, independent of the funds that we raise for management." Both the Backstage and Earnest Capital examples highlight one of the many challenges emerging funds managers face: initially, management fees paid to the fund manager in a traditional fund structure may not be enough to cover expenses or pay those expenses when due. Equity crowdfunding could bridge the gap to address this inequity by allowing the fund manager to capture broad community support if they do not have the capital to sustain the venture capital firm's operations in the early days. While equity crowdfunding its operations may never be contemplated by a larger or more established venture capital firm, it may create new possibilities for

managers who are in the earlier phases.

The Future of Equity Crowdfunding

Since the March 2021 amendments to Regulation Crowdfunding increased the limit on the amount that can be raised by nearly $4 million, allowed investment through SPVs, and removed the cap on investment for accredited investors, equity crowdfunding is ripe to take on increasing importance in the startup ecosystem and change the venture capital investment landscape. The application of equity crowdfunding to operating entities of venture capital firms is an example of its untapped potential as an investment vehicle for early stage and mature companies and to increase access to capital for underrepresented founders. According to the SEC Office of the Advocate for Small Business Capital Formation's 2020 Annual Report, "[i]ncreased diversity among fund managers, the location of funds, and the size of funds should improve access to capital for entrepreneurs, as well as opportunities for investors to support a more diverse pool of talented entrepreneurs." Although the SEC did not tie equity crowdfunding to supporting pooled investment vehicles, applying equity crowdfunding to the venture capital structure could reduce barriers for and increase diversity among fund managers, which should exponentially magnify access to capital for diverse entrepreneurs.

-

-

-

-

-