FALL/2014

RESOURCE™

A GOODWIN PROCTER PUBLICATION FOR THE REAL ESTATE INDUSTRY

A Guide to Real Estate Crowdfunding Today

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A Guide to Real Estate Crowdfunding Today

The idea of creating large scale syndicates to purchase real estate is a classic concept.

Large scale syndication traces its roots directly back to the 1920's, when Manhattan-based real estate developer, Fred French, built the largest residential development in Midtown, using the "French Plan." French solicited small investments from large groups of investors in newspaper advertisements, promising a 6% return on their investment and a 50/50 split of any residual income. His investors subsequently became shareholders in a corporation that financed the acquisition and development of real estate.

The concept developed by Mr. French grew to dizzying heights, through the partnership of Harry Helmsley and Larry Wein in 1961. Together, the two men led the formation of large scale syndicates that owned more than 40 buildings worth over $16 billion today. Among the properties syndicated by Helmsely and Wien were the Equitable Building, the Plaza Hotel, the Graybar Building, and the Empire State Building. To buy the Empire State Building, Wein and Helmsley led a syndicate of over 3,500 investors contributing equity towards a $79 million purchase price – over $600 million in 2014 dollars.

While French, Helmsley, and Wein were each able to achieve great success with large scale syndication, their approach ultimately proved to be too unwieldy. The expense and administrative burden of large scale syndication ultimately led to the approach being largely replaced by more efficient mechanisms for pooling small individual investments such as insurance companies, REITS, and private equity funds.

Today, however, revisions to the securities laws and technological advances have given modern syndicators a decisive advantage against not only their own predecessors, but also against other conventional aggregators of capital. By allowing greater efficiency and access to investors, crowdfunding has changed the value proposition of large sector syndication, making it a force to be reckoned with in the modern financial environment.

It's an extremely exciting time in the industry, but it's important to keep in mind the potential challenges that come with these opportunities. In this special edition of *REsource*, we offer best practices for addressing issues in today's real estate crowdfunding market. Mark Schonberger and David Perechocky give some background analysis on how crowdfunding sites appear to be complying – or pushing the envelope – with respect to the SEC's new and proposed rules; Lynne Barr, Ben Saul, and Matt Saunig cover the key regulatory considerations that peer-to-peer lending platforms must address; Charlie Alovisetti discusses the evolution of third-party verification services; Steve Ellis and Nicole Tate-Naghi look at the sources of legal problems for aspiring crowdfunding entrepreneurs; and John Ferguson and Lauren Lebioda address the legal issues that sponsors need to consider when raising capital from non-U.S. sources.

As the industry continues to receive media attention and gain acceptance from investors, its expansion and maturation will continue to accelerate and its impact on society will continue to grow. We look forward to continuing this exciting journey with all of you and hope you find this issue of *REsource* a useful guide.

Lewis G. Feldman, Partner and Co-Chair of Goodwin Procter's Crowdfunding Practice

GOOD DEAL

Goodwin Procter Advises Trulia in $3.5 Billion Sale to Zillow

Goodwin attorneys recently advised Trulia in its $3.5 billion sale to Zillow. The transaction, which is expected to close in 2015, is a stock-for-stock transaction whereby Trulia shareholders will receive 0.444 shares of Class A Common Stock of Zillow for each share of Trulia, and current Zillow Class A and Class B Common Stock shareholders will receive one comparable share of the combined company. Zillow and Trulia were founded nearly a decade ago and have capitalized on Americans' increasing preference for researching purchases, including homes, online, rather than relying solely on a real estate agent. Our Technology Companies and Real Estate Practices are designed to accommodate our clients' needs as they grow and change. We bring a comprehensive, coordinated approach that interconnects business, new technologies and the law. We invite you to contact us to learn more.

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GOODWIN PROCTER

Accredited Crowdfunding: Real Estate Investing Goes High Tech

by Mark Schonberger and David Perechocky

New rules provide new opportunities. A range of new and varied companies are emerging, as developers, sponsors, entrepreneurs, and investors explore the forms of online real estate investing opportunities through crowdfunding. This article provides a legal overview of accredited crowdfunding and highlights some companies that are part of the real estate crowdfunding landscape.

Rule 506(b) vs. Rule 506(c) Offerings

There are two primary methods of raising capital online: Rule 506(b) offerings, which permit raising capital from "accredited" investors and up to 35 non-accredited investors, and Rule 506(c) offerings, which only permit raising capital from "accredited" investors. (Generally, an "accredited" investor is someone whose income is greater than $200,000 (or $300,000 with a spouse) in each of the prior two years and reasonably expects the same for

the current year, or whose net worth is at least $1 million excluding the value of the person's primary residence.) Both rules are securities law exemptions that permit online sales of securities without the requirement to register the securities with the SEC.

The key difference between 506(b) and 506(c) is that 506(c) permits the issuer to engage in "general solicitation," which means the issuer may engage in activities that drive traffic to its website in order to generate interest in an offering, such as advertising or publishing articles. If an issuer wants to rely on 506(b), it is only permitted to promote specific offerings to pre-screened investors, generally in a password-protected section of its website. Furthermore, permitted investors may not invest funds except after a "cooling off" period of approximately three to four weeks.

In exchange for the ability to engage in general solicitation, 506(c) issuers must perform a heightened verification process to confirm that investors are "accredited." This process may require investors to submit tax returns, bank statements and/or a credit report if the issuer is relying on the "safe harbors" for verification (it is common for potential investors to be reluctant to submit these documents). In contrast, investors in a 506(b) offering only need to complete a questionnaire self-certifying that they are accredited investors. Thus, visitors to websites that rely on 506(c) can easily access basic deal information because of general solicitation, but finalizing the investment may be more burdensome for the investor (at least for the initial investment) because of the heightened verification process.

In a recent keynote address, Keith Higgins, Director of the SEC's Division of Corporation Finance, observed that early adopters of online fundraising were reluctant to use 506(c) due to the verification burden. However, 506(c) offerings have become more prevalent as the cost of using third-party verification services decreases and issuers move beyond the "safe harbors" for verification and get more comfortable with the principles-based evaluation of "accredited" investor status highlighted by Mr. Higgins in his speech, both of which methods are permitted under 506(c).

Mini-Registered Offerings

Additional rules have been proposed that permit non-accredited investors to invest in online securities offerings (under the "Crowdfunding" rules pursuant to Title III of the JOBS Act as well as "Reg A+" which expands the current Reg A rules), but these rules have yet to be finalized by the SEC. It is only natural that additional crowdfunding sites will develop, and current sites will expand once these rules are passed. A few sites, such as Fundrise.com and Groundfloor.us, sponsor smaller offerings for non-accredited investors under Reg A or state law "Blue Sky" laws, but these companies will likely use the new rules once they take effect. Of particular interest are the Reg A+ rules, which will permit offerings of up to $50 million to non-accredited investors (effectively a "baby IPO"), while the "Crowdfunding" rules will only permit raising $1 million per year. Both offering types will be subject to heightened disclosure requirements including audited financial statements and ongoing reporting obligations.

Proprietary Portals vs. Multi-Operator Marketplaces

The chart on pages 6-7 highlighting a few of the websites surveyed, is divided into two categories: sites where the site sponsor offers its own deals ("proprietary portals") and sites where the site sponsor acts as an intermediary for deals offered by third parties ("multi-operator marketplaces").

Most, but not all, of the proprietary portals rely on the 506(c) exemption, permitting general solicitation: their offerings tend to be either co-investment opportunities with an active and knowledgeable sponsor or portfolio investments in a fund-like structure with the sponsor as the manager. A perceived benefit of proprietary portals is that the sponsor performs thorough

"As these platforms continue to receive media attention and gain acceptance from investors, the industry's expansion is likely to continue to accelerate. At the same time, this innovation raises questions regarding risks to market integrity, the need for investor education, and the importance of sound regulation."

diligence on the property and there is a relative alignment of interests because the site sponsor, often an established real estate investment company, is co-investing alongside the investor in every deal.

Multi-operator marketplaces are currently the more common type of crowdfunding sites. The site sponsor's involvement in each third-party deal it lists on its marketplace varies: some offer deal opportunities without claiming to do any diligence on the property and some claim to perform extensive diligence; some provide management and investor relations services for the issuers; and a few create their own special purpose entities (SPEs) and/or co-invest in the deals.

The structuring method of the investment in multi-operator marketplaces varies by site sponsor. Some site sponsors, like Groundbreaker.com and CrowdStreet.com, structure the investments directly into the issuer so that each online investor is a direct investor in the issuer. Others, like RealtyMogul.com and RealtyShares.com, aggregate the investors into an SPE managed by the site sponsor which in turn invests in the issuer. Other site sponsors may acquire the property outright and syndicate a portion of it to online investors, the approach taken by sites like PatchofLand.com and iFunding.com.

Single Asset vs. Portfolio Investments

Although most of the crowdfunding investments thus far have been for single assets, online general solicitation is also suitable for multi-asset investments and fund-like structures. An increasing number of fund sponsors may try to raise money from otherwise untapped online investors by incorporating a "crowdfunding sleeve" as part of their fundraises or raise money entirely online through 506(b) or 506(c). Two examples of multi-asset crowdfunding are Broadstone.com and FundingHamptons.com, both using 506(c). Broadstone allows investors to invest online in two sponsored investment products—a private net lease REIT and a private single-family rental fund. Funding Hamptons raises a partial blind pool to fund the development of a portfolio of luxury residential homes in the Hamptons.

Size Limitations and Other Considerations

Some companies utilizing crowdfunding, particularly portfolio companies or funds, may also need to find an exemption from registration as an investment company under the Investment Company Act of 1940, which means, depending on various factors, they would need to (i) limit the offering to not more than 100 beneficial owners (3(c)(1) exemption), (ii) meet the requirements of the "real estate exemption" which generally requires meeting certain asset tests and holding real estate and real estate-related assets in majority-owned subsidiaries (3(c)(5)/(6) exemption), or (iii) restrict the offering to "qualified purchasers" (generally someone who owns $5 million in investments) (3(c)(7) exemption). These limitations could be particularly restrictive for fund-like entities and multi-asset portfolios that want to expand their investor base because they may be limited to 100 investors if they are unable to rely on other exemptions.

In addition, a private company will be required to register with the SEC as a public company once it has 2,000 shareholders, or 500 non-accredited shareholders. This limitation on the number of shareholders could have implications on the effectiveness of a crowdfunding raise, if, for example, the sponsor wants to set a low minimum investment amount or there is high demand for the investment opportunity.

Conclusion

As these platforms continue to receive media attention and gain acceptance from investors, the industry's expansion is likely to continue to accelerate. At the same time, this innovation raises questions regarding risks to market integrity, the need for investor education, and the importance of sound regulation. ■

This article is intended only to identify regulations and is not intended to provide detailed guidance on the steps required to comply with any particular law.

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The chart on pages 6 and 7 , highlighting a few of the websites surveyed, is divided into two categories: sites where the site sponsor offers its own deals ("proprietary portals") and sites where the site sponsor acts as an intermediary for deals offered by third parties ("multi-operator marketplaces").

Company	Business Model	Minimum Investment	Site Sponsor Provides			Direct or Indirect Investment in Issuer
			Due Diligence Services	Co-invest-ment	Administrative Services	
PROPRIETARY PORTALS (Site Sponsor = Issuer/Property Owner)						
Broadstone Rochester, NY Industry Focus: Net lease Single-family rentals	Site sponsor manages two fund-like investment vehicles Private REIT (net lease) Private fund (single-family homes)	$250,000 (net lease) $50,000 (single-family)	Yes	Yes	Yes	Direct
The Carlton Group New York, NY Industry Focus: General commercial real estate	Site sponsor offers deal opportunities. JV investments throughout U.S. and Europe.	$1,000,000	Yes	Yes	Yes	Direct
MULTI-OPERATOR MARKETPLACES (Site Sponsor = Intermediary)						
Patch of Land Los Angeles, CA Industry Focus: Single-family rehab and other residential real estate debt	Peer-to-peer lending opportunities offered by issuers. Site sponsor funds loans and then syndicates to investors.	$5,000	Yes (3rd party diligence firm)	Yes	Yes	Direct
RealCrowd Palo Alto, CA Industry Focus: General commercial real estate	Deal opportunities from various issuers.	$5,000	No	No	Yes	Direct
Realty Mogul Beverly Hills, CA Industry Focus: General commercial real estate; debt	Deal opportunities from various issuers.	$10,000	Yes	No	Yes	Online investors aggregated into LLC vehicle by site sponsor.
RealtyShares San Francisco, CA Industry Focus: General commercial real estate	Deal opportunities from various issuers.	$5,000	Yes	No	Yes	Online investors aggregated into LLC vehicle by site sponsor.

*=Information not available.

Securities Law Exemption	Deal Information That Becomes Available Upon			Waiting Period	Compensation to Site Sponsor Paid By		Is Site Sponsor a Registered Broker/ Dealer?
	Website Access	Name Registration	Full Registration		Investors	Issuer	
506(c)	-	Intro	Full deal information	No	1% asset management fee. 3% management fee. *Additional fees for single-family vehicle:* 10% property management fee 3% acquisition fee 3% disposition fee	N/A	No
506(c)	Intro	-	Full deal information	No	*	N/A	No
506(c)	-	Full deal information	-	21 days	None	Monthly interest (9%-18%) origination points closing fees	No
506(c)	Intro	Full deal information	-	No	None	Upfront access fee; monthly fee for investor manager software.	No
Originally 506(b) Now 506(c)	-	-	Full deal information	21 days	Management fee for admin., legal, ongoing reporting, communications.	Upfront fee Ongoing fee 4% promote	No (partner with Wealth-Forge)
506(b) Plans to use 506(c) in some future offerings	-	-	Full deal information	*	Management fee for ongoing reporting and communications.	Fee for legal, accounting, and compliance costs.	No

The Legal Landscape for Peer-to-Peer Lending

by Lynne Barr, Benjamin Saul, and Matthew Saunig

Peer-to-peer (P2P) lending is a rapidly growing vehicle for consumer and business purpose lending. It can provide fast, efficient access to capital, particularly for small businesses, and relatively attractive financing to consumers who may not otherwise qualify for traditional loans from mainstream lenders. Investors are also attracted by the business model, because of the ease with which they can invest in loans and earn relatively high rates of return. Like all lending activities, however, P2P lending is heavily regulated. While some of the regulatory burdens can be reduced by structuring the business appropriately, regulatory costs – both in dollars and time – need to be factored into strategic planning. This article discusses some of the key regulatory considerations that P2P lending companies must address.

State Licensing

States regulate lending practices principally through licensing requirements. A range of licensing requirements for the originating, brokering, and servicing of loans exists. Prior to engaging in P2P lending, a company should make sure that it is appropriately licensed in the states in which it will be brokering, making, or servicing loans. Licensing requirements vary from state to state, and whether a particular state's licensing requirements are triggered depends on various factors, including the size of the loans being made, interest rates and fees, and whether the loans are secured by real estate or are made for business purposes. Further, most states assert jurisdiction over out-of-state companies that make loans to residents of the state, particularly consumer loans.

In an effort to minimize certain lender licensing requirements, some P2P lending companies have used bank sponsors to make loans, as banks are generally exempt from state licensing requirements. Use of a bank lender, however, does not completely relieve a company from all state licensing requirements. For example, licensure as a loan broker may be required to the extent a company is arranging loans. Additionally, servicing the loans can implicate certain loan servicer or collection agency licensing requirements.

Moreover, there are often substantive state requirements with which licensed entities have to comply. Licensees frequently have recordkeeping, disclosure, surety bond, minimum net worth, and reporting requirements, among others. Licensees are also subject to examination by the appropriate state regulators and may have to notify regulators of significant corporate changes (e.g., address changes and changes in ownership). State licensing regimes may also impose certain restrictions on the practices of licensees, including advertising restrictions.

Federal and State Consumer Protection Laws

Federal and state laws also regulate the conduct of lending business by imposing substantive requirements, such as usury ceilings and anti-discrimination laws, and extensive disclosure requirements, particularly for consumer loans, on lenders and brokers.

P2P lenders generally must comply with state usury laws, but partnering with a bank to act as the lender can be advantageous because a bank can "export" the interest rate and fees permitted to it under the laws of the state where it is located. There have been recent legal challenges to such arrangements, alleging that they are schemes to circumvent state usury laws and that the non-bank company is the "true lender."

The federal Equal Credit Opportunity Act and some state laws prohibit creditors and others that regularly participate in credit decisions from discriminating against credit applicants and borrowers (both consumers and businesses) with respect to any aspect of a credit transaction on prohibited bases, such as race, color, religion, national origin, sex, marital status, or age. Therefore, even if a P2P lending company uses a bank sponsor to make the loans, compliance with anti-discrimination laws is still required.

The federal Truth in Lending Act and numerous state laws contain substantive restrictions and disclosure requirements on consumer purpose loans of all types, including mortgage loans. Substantive rules relating to mortgage loans have mushroomed in the years since the housing crisis began and regulate all aspects of mortgage lending, from detailed tests to determine whether the consumer has the ability to repay the loan to foreclosure and loss mitigation requirements.

Federal and state laws relating to financial privacy, anti-money laundering and terrorist financing, data collection, the validity of electronic transactions, data security, and real estate-related protections (such as lead paint certifications) may also be applicable to P2P lending activities.

Secured Loans

In the event that P2P loans are secured by either real or personal property, there will be filing requirements that must be complied with in order to perfect the lender's security interest in the collateral. Each state has its own version of the Uniform Commercial Code, which governs the types of filings that need to be completed in order for a lender to make its security interest in the collateral property a matter of public record. The filings afford the lender more protection in the event of a borrower default on the underlying loan. With respect to loans secured by an interest in real property, the mortgage or deed of trust must be recorded in the appropriate local recorder's office.

Securities Regulations

As part of their business model, P2P lending companies usually sell payment-dependent notes to investors. Under the federal Securities Act of 1933, these payment-dependent notes are considered securities. In connection with these notes being treated as securities, P2P lending companies should consider whether any other federal or state securities laws apply. These requirements may include registration, disclosure and conduct obligations. Such requirements should be considered prior to the issuance or sale of any payment-dependent notes to investors.

Conclusion

Given the significant regulatory oversight of P2P lending, the structure of the business needs to be influenced by a company's tolerance for supervision and the costs of compliance. Although certain regulatory obstacles can be avoided by structuring lending operations in certain ways (e.g., through the use of a bank sponsor as the lender), any company seeking to engage in the P2P lending business needs to implement and maintain a legal compliance structure that addresses the myriad federal and state requirements applicable to lending and securities. ■

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CROWDFUNDING AND ACCREDITED INVESTOR VERIFICATION

by Charles Alovisetti

New regulatory regimes often create new business opportunities and the Jumpstart Our Business Startups (JOBS) Act is no exception. About a year ago, on September 23, 2013, issuers were permitted, for the first time and subject to certain restrictions, to use general solicitation in connection with private placements of securities under the newly created Rule 506(c), something that had been prohibited since the enactment of the Securities Act of 1933. If an issuer takes advantage of this new flexibility, it is required to take reasonable steps to verify that all of the purchasers are accredited investors, in addition to meeting the other applicable requirements of Regulation D of the Securities Act. The verification requirement is separate and independent of the condition that sales be limited to accredited investors, and it must be satisfied even in an instance where all of the purchasers are accredited investors. Verification is a new requirement and remains an obligation only when general solicitation is employed.

Historical Basis

Instead of providing a strict list of rules to follow, the SEC set forth a principles-based verification process, together with a non-exclusive list of acceptable verification methods. The SEC also permitted issuers in certain circumstances to rely on third-party verification of a person's status as an accredited investor. For example, the non-exclusive list of acceptable verification methods deems an issuer to satisfy the verification requirement in Rule 506(c) if the issuer obtains a written confirmation from a registered broker-dealer, an SEC-registered investment advisor, a licensed attorney, or a certified public accountant that such person or entity has taken reasonable steps within the prior three months to verify that a purchaser is an accredited investor. These third parties satisfy the verification requirement in Rule 506(c) and since they are already subject to regulatory or licensing requirements, the issuer can rely on their work without any independent verification efforts. An issuer, however, may also be entitled to rely on the verification of accredited investor status by a person or entity other than one of the explicitly listed third parties, provided: (i) such third party (a) takes reasonable steps to verify that the purchasers are accredited investors, and (b) has determined that such purchasers are, in fact, accredited investors, and (ii) the issuer has a reasonable basis to rely upon such verification.

While the SEC accepted that it may prove costly to pay for the verification services of a lawyer or accountant due to professional liability concerns, it did note that because uniform verification methods were not required and a conceptual approach was adopted, issuers and entrepreneurs could benefit from the regulatory flexibility to adopt innovative approaches to verification, including the development of reliable third-party databases of accredited investors and verification services. In a prescient footnote to the final rules, the SEC noted that new services may develop to verify accredited investor status.

Evolution of Third-Party Verification Services

As the SEC anticipated, a number of new businesses emerged that provide accredited investor status verification. While these platforms seek to streamline the verification process, they are not without their critics. The Angel Capital Association has voiced concerns regarding privacy and the verification process, given that purchasers would be asked to provide sensitive financial documentation to unfamiliar online businesses. Concerns

> "The verification requirement is separate and independent of the condition that sales be limited to accredited investors, and it must be satisfied even in an instance where all of the purchasers are accredited investors. Verification is a new requirement and remains an obligation only when general solicitation is employed."

regarding privacy, especially in the context of newly-formed online businesses, will need to be addressed in the future by issuers, crowdfunding portals, and verification platforms. In response to these concerns, crowdfunding portals have begun to prominently display and discuss their data security and privacy policies on their websites.

The role of third-party verification services is not likely to expand in scope once the proposed rules regarding retail crowdfunding under Title III of the JOBS Act and Regulation A+ come into effect. Under the proposed crowdfunding rule, purchasers do not need to be accredited investors. But a purchaser's investments cannot exceed certain thresholds based on income and net worth. The SEC's proposed rules regarding retail crowdfunding permit an issuer to rely on an intermediary (all retail crowdfunding transactions must be conducted through a registered intermediary) to verify the limits regarding the aggregate amount of securities purchased. The issuer does not need a reasonable basis to rely on such verification, as long as the issuer does not know the purchaser has exceeded, or would exceed, the investor thresholds as a result of purchasing securities in the issuer's offering. An intermediary may reasonably rely on a purchaser's representations of their annual income, net worth, and the amount of the purchaser's other investments unless the intermediary has reason to question the reliability of the representation. Similarly, pursuant to the proposed offerings under Regulation A+, the amount of securities a purchaser can acquire is limited to a certain percentage of a purchaser's annual income and net worth. Issuers can rely on a purchaser's representations of compliance with the proposed investment limitation unless they knew, at the time of sale, that such representations were false. Absent a change to the proposed rules upon enactment, there will not be any need for third-party verification services in connection with the final part of the JOBS Act.

As crowdfunding changes the financial landscape, third-party verifiers will continue to provide an important service. However, as the Angel Capital Association notes, third-party verification is not without its risks. Issuers and crowdfunding portals must be careful to do their diligence before outsourcing critical compliance functions. Prior to engaging a third-party provider, issuers or crowdfunding portals should discuss the third-party provider's policies and practices with a qualified attorney. Two key areas of concern are privacy and the method used for accredited investor verification. Since accredited investor verification by its nature requires disclosure of sensitive financial information, it is crucial that the third party take appropriate measures to maintain the privacy of any disclosed materials. The internal process of accredited investor verification should also be reviewed and compared with the SEC's non-exclusive list of methods. This may be as simple as reviewing the description of services on a third party's website. While third-party verification services offer certificates certifying to an investor's accredited status, reliance on such a certificate alone, without any knowledge of the third party's process, may not be enough to establish a record that the issuer had a reasonable basis to rely upon the third party. Third-party verification services allow issuers and crowdfunding portals to avoid costly and time-consuming accredited investor verification, but they cannot be used blindly. Issuers should be aware of the need to have a reasonable basis to rely on these services.

Barriers to Entry

The crowdfunding third-party verification sector is still new and continuing to evolve quickly. Currently, as a result of very low barriers to entry, there are a large number of new third-party verifiers. And although the future is uncertain, it seems likely that purchasers will prefer to entrust sensitive financial information to a reputable company and, once comfortable with the procedures of a particular verification service, crowdfunding portals are also likely to be repeat customers. These factors, combined with the easy scalability of verification, should result in the emergence of clear winners sooner rather than later. ■

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POTENTIAL PITFALLS TO CROWDFUNDING

by Steven Ellis and Nicole Tate-Naghi

The Jumpstart Our Business Startups (JOBS) Act was expected to create and expand opportunities for people to invest directly in a wide variety of commercial projects through what is known as "crowdfunding." The Act attempts to reduce and streamline the statutory and regulatory barriers that apply to the operation of online crowdfunding platforms. But crowdfunding, while exciting, poses risks. As the popularity of investments through this burgeoning industry increases, businesses should keep in mind the risks and avoid potential pitfalls, such as liability for failure to register and liability under federal securities laws, state securities laws, and generally applicable common law principles and statutes.

Failure to Register

Several years before the JOBS Act, peer-to-peer ("P2P") lending sites Prosper Marketplace ("Prosper") and Lending Club were two of the early players in crowdfunding. In P2P lending, private lenders and borrowers (individuals or small businesses) come together to make loans without an intermediary (such as a bank or broker). Prosper and the Lending Club took the position that these lending transactions did not involve the sale of "securities" under federal law and therefore did not require registration with the SEC. The SEC, however, did not agree and issued cease-and-desist orders in 2008 that shut down these crowdfunding platforms. Although both platforms ultimately obtained proper registration and reemerged, the message from the SEC was clear: crowdfunding may be a new and technologically innovative way for people to make investments and for businesses to obtain capital, but the old rules still apply; if crowdfunding platforms are selling unregistered securities without satisfying the registration exemption requirements, the SEC will exercise its power and authority to investigate these platforms and shut them down.

Other Federal Securities Laws

Notwithstanding the passage of the JOBS Act, crowdfunding currently is subject to a variety of federal statutes and regulations. For example, under Rule 506(b), which predates the JOBS Act, online sites may come within the private offering exemption, but they cannot engage in general solicitation and may accept investments only from (self-certified) accredited investors. Under Rule 506(c), promulgated in 2013, crowdfunding platforms may engage in general solicitation but they must take reasonable steps to verify independently that the investors are accredited, and all solicitation materials must be filed with the SEC. Title III of the JOBS Act permits non-accredited individuals to invest through crowdfunding platforms, but issuers may not raise more than $1 million per year, various registration and disclosure statements must be filed with the SEC by the issuers and the platforms, and other implementing regulations – contemplated by the JOBS Act – have not yet been finalized. In addition, the SEC has proposed Regulation A+ rules that would further relax restrictions on crowdfunding platforms and investments, but these rules have not yet been finalized either.

Navigating through the existing hodgepodge of applicable federal statutes and regulations is no easy task. Companies looking to raise money through crowdfunding (as well as companies considering the launch of new crowdfunding platforms) must carefully consider which statute or regulation to proceed under and carefully monitor compliance. Although the potential rewards of crowdfunding are great, companies that fail to comply with the governing federal law face the very real risk of unwelcome scrutiny, and potentially even more unwelcome adverse action from the SEC.

Even if all requirements are met for the issuance of these new securities, there remains a risk of liability if the opportunity that was funded through crowdfunding fails. It's not uncommon for lawyers who specialize in suing on behalf of large classes of shareholders to allege violations of section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 regarding fraud, fraudulent misrepresentations, deceptive practices, or omissions in the sale of securities. Defending against such lawsuits, even if the company's defenses are strong, can be very costly, and settlement is often the only viable option because of the crushing burden of preparing for trial.

State Securities Laws

Under current law, crowdfunding entities are also generally subject to scrutiny under state securities ("Blue Sky") laws. There is widely publicized tension between federal and state securities regulators on the subject of crowdfunding. It is likely that Blue Sky regulators will monitor closely those who participate in this area and in some cases will rely on creative arguments under state law if they see perceived abuses, even though federal regulations may preempt state law. In one recent highly publicized case, the Ohio State Department of Commerce, Division of Securities, filed a cease-and-desist action against SoMoLend Holdings and its principal, alleging that the company, operating through two crowdfunding platforms, had sold more than $2 million of unregistered securities through general solicitations, outside of any exemption, in violation of Ohio law. According to Ohio, SoMoLend sold these securities through false statements regarding, among other things, past and current performance and future projections. In addition, Ohio alleged that SoMoLend continued to provide a platform for the sale of unregistered securities not covered by any exemption for almost two years after Ohio warned SoMoLend not to engage in such conduct.

Generally Applicable Common Law Principles and Statutes

All states have common law principles and statutes that prohibit fraud, false or misleading advertising, and other forms of false, misleading, or deceptive business practices. These are generally applicable laws, not based on or tied specifically to the sale of securities, but potentially applicable in the crowdfunding context. These laws may provide state officials, even those who are not charged with enforcing Blue Sky laws, with opportunities to challenge crowdfunding practices that they may perceive as unwise from a policy perspective.

Earlier this year, for example, the Washington State Attorney General brought an action against Altius Management ("Altius"). According to the complaint, Altius used a crowdfunding platform (Kickstarter) to obtain investment in a venture that would create and sell Asylum Playing Cards featuring artwork by a Serbian artist. Altius promised that investors would receive various rewards, such as a deck of the Asylum Playing Cards. After receiving more than $25,000 in funding, Washington alleged, Altius never produced the rewards and refused to refund the amounts received from investors. Washington sued Altius under a generally applicable state statute prohibiting false, fraudulent, or misleading statements in business transactions. Washington did not invoke state or federal securities laws in its complaint.

An interesting note from the Altius litigation is that Washington sued the company obtaining the investments but not Kickstarter, the crowdfunding platform that Altius used. Whether, and to what extent, there is any theory under which the crowdfunding platform itself could also be held liable for false, fraudulent, or misleading statements made by the business remains largely unexplored. Nonetheless, it is a risk that must be considered by crowdfunding platforms, as future litigation exploring the possibility of such liability seems inevitable.

Some crowdfunding platforms have already taken steps to attempt to minimize potential liability for fraudulent representations by companies using their platforms. Kickstarter, for example, includes provisions in its terms of service that disclaim any fiduciary duty to investors, any duty to monitor the truthfulness of the statements made by companies that use its platform, and any representation as to the accuracy of any data or information provided by those companies. By directly disclaiming responsibility for monitoring the accuracy of the companies using the platform, Kickstarter and other platforms seek to escape liability for statements by those companies that are later alleged to be false, fraudulent, or misleading. Whether disclaimers provide an effective shield when there are allegations of misconduct by companies being funded is likely to be tested in future cases.

Indiegogo, an international crowdfunding site, formerly stated to investors that it would catch "any and all cases of fraud." But, after one of the companies on its platform, Healbe GoBe, was investigated for fraudulent representations (including misrepresentations regarding the quality of its product and its location), Indiegogo removed the statement and substantially modified its overall messaging. Even the most compliance-focused and rigorous crowdfunding platform may not be able to police all companies that seek funding through it. Whether the law will evolve in the direction of allowing solid defenses for platforms that work diligently and in good faith to spot and remove offenders remains to be determined.

Continued litigation, including potential class action litigation, regarding allegations of fraud by companies obtaining investments through crowdfunding is likely. The flip side of the flexibility of crowdfunding, and its ability to provide individuals the ability to invest directly in small companies and start-ups, is that some crowdfunding investors may be less sophisticated, and less careful, than large institutional or accredited investors. The issue of whether crowdfunding platforms may be subject to liability for the false statements of the companies using their platforms remains open, and is a risk factor that crowdfunding platforms should consider, and protect themselves against, as the industry continues to develop and expand. ■

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THE SUMMER OF CHANGE

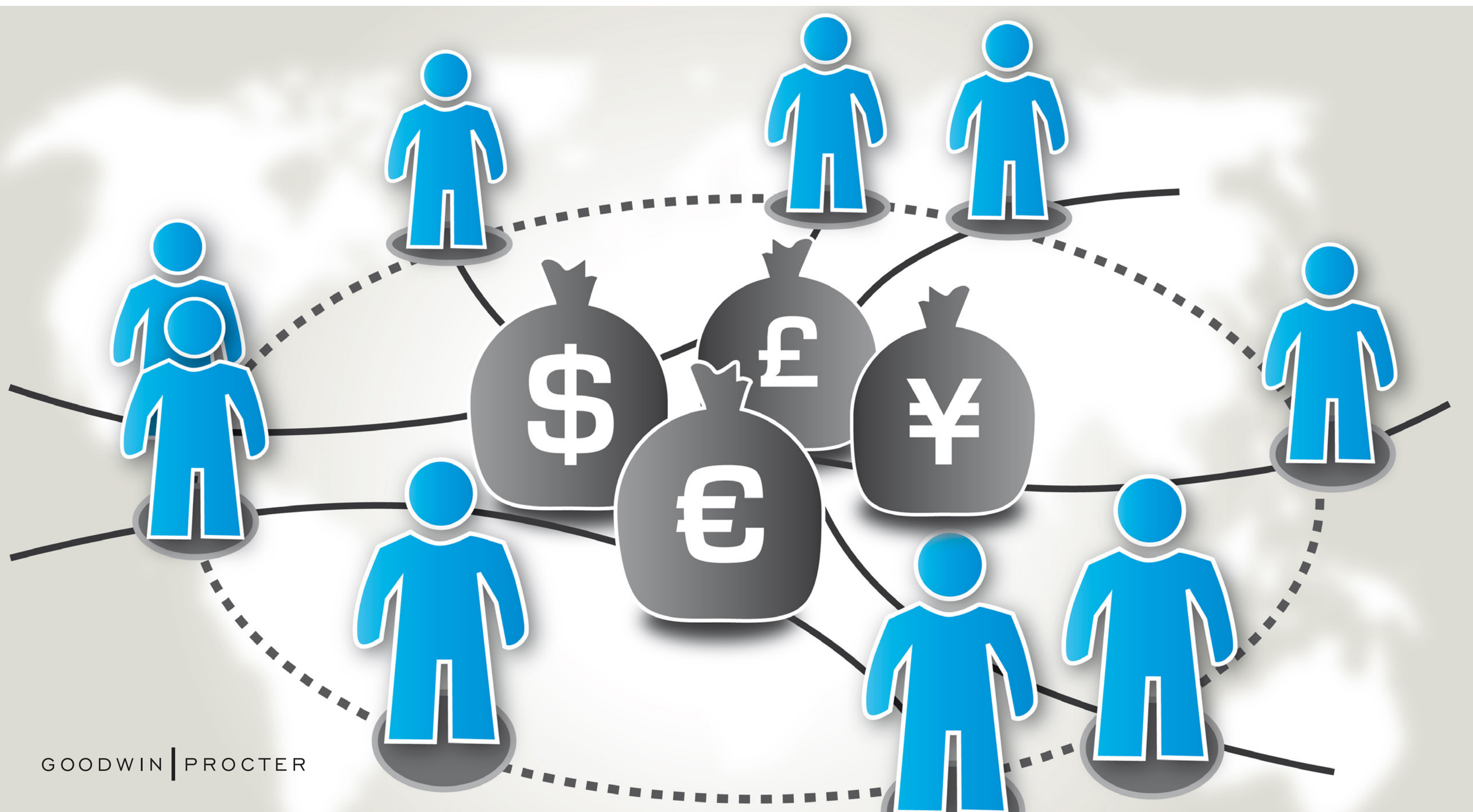
by John Ferguson and Lauren Lebioda

Both sides of the Atlantic returned from their 2013 summer holidays poised for a different, and somewhat opposite, capital-raising world. Within a single calendar quarter, from July 2013 through September 2013, raising capital in the European Union became much more regulated while almost concurrently the U.S. was opening up the long-closed channel of an unregistered general solicitation. Beginning July 22, 2013, Europe tightened capital raising with the implementation of the long-anticipated Alternative Investment Fund Managers Directive (AIFMD) in the European Economic Area (EEA), with one-year transitions in certain jurisdictions ending in July 2014. AIFMD requires the registration of investment "funds" to raise capital in the EEA, either by registering the fund, in the case of a non-EU manager, or via registration of an EU manager who is then "passported" to raise capital in the EEA. By contrast, as restrictions tightened in Europe, a new, more permissive marketing channel was opened in the U.S. with the September 23, 2013 adoption of Rule 506(c) – the so-called crowdfunding rule – by the Securities and Exchange Commission (SEC). This additional safe harbor under Regulation D ("Reg D") of the Securities Act of 1933 "lifted the ban on general solicitation."

The Old World Order

Historically, many issuers and fund sponsors relied on the safe harbor provided under Rule 506 of Reg D to avoid registration of an offering with the SEC, which required, among other things, that the sponsor not engage in any "general solicitation" in the U.S. While "general solicitation" has never been precisely defined by the SEC, it is generally considered to include the following activities related to any planned or ongoing offering: (i) advertisements (including publicly accessible websites); (ii) articles, notices, or interviews published in any newspaper or magazine, or broadcast over television, radio, or the internet; (iii) communications at any conference, seminar, or meeting to which attendees have been invited by any communication that itself is a general solicitation; and (iv) any type of publicity generally.

For those raising capital both within and outside the U.S. concurrently, two separate safe harbor exemptions have historically been concurrently relied upon: the above-described Rule 506 Reg D offering in the U.S. and an offshore (non-U.S.) offering conducted under Regulation S ("Reg S"). The key requirements to complying with Reg S are: (i) the offer and sale must be conducted outside the U.S. (i.e., the sponsor must be outside



"In an ironic twist, the free-speaking U.S. sponsor now, however, essentially needs to effectively be concerned about two sets of 'directed-selling efforts' restrictions."

the U.S. when it makes the offer and the investor must be outside the U.S. when it acquires the interest) and (ii) no "directed selling efforts" are made in the U.S. by the sponsor or any of its agents or representatives.

Much to the frustration of those raising capital outside of the U.S. under Reg S, "directed selling efforts" is a fact-specific and potentially complex analysis. Even if not restricted by the local non-U.S. jurisdictions from which the capital was being raised, articles, notices, interviews, and other communications which could reasonably be expected to find their way into or be accessible from the U.S. would give U.S. securities lawyers great pause.

The New World Order

Under new Rule 506(c), sponsors are expressly permitted to engage in "general solicitations," so long as certain other requirements are satisfied, including that all the purchasers be "accredited investors" and that the issuer takes reasonable steps to verify such accredited investor status. The new freedom under Rule 506(c) allows issuers to broadly market their offerings, including utilizing online capital raising tools, advertising in publications, and freely speaking at conferences and to the press.

While this represents a significant growth opportunity for raising U.S. capital, a sponsor nonetheless still has special considerations to take into account if raising non-U.S. capital – both from the U.S. and non-U.S. perspectives. If relying on Rule 506(c) – even with respect to non-U.S. sourced capital – the heightened verification of accredited investor status still applies. In the absence of being able to rely upon self-certification, this can prove challenging.

The natural reaction would be to continue to rely upon two concurrent offerings, one under Reg D under new Rule 506(c) and one under Reg S. The SEC confirmed in its release adopting Rule 506(c) that an issuer may concurrently rely upon Rule 506 (including new Rule 506(c)) and Reg S and that, so long as the requirements under each are satisfied, the onshore offering (i.e., Rule 506) and offshore offering (i.e., Reg S) will not be integrated.

For the non-U.S. offering, as always the laws of the local jurisdictions apply; this now includes AIFMD in the EEA. AIFMD represents a significant tightening of the regulations for the management and marketing of alternative investment funds (AIFs) in the EEA. The ultimate goal of the AIFMD is to develop and adopt a uniform set of rules by 2018 that will govern the marketing and management of AIFs within the EEA, including requirements that non-EEA sponsors establish a place of business and obtain authorization in the EEA prior to marketing any AIFs in the EEA. However, the AIFMD became effective on July 22, 2013 and the industry is currently operating in an interim period (i.e., until 2018) during which compliance with each member states' local private placement requirements and the minimum requirements specified in the AIFMD is required. In other words, a jurisdiction-by-jurisdiction patchwork approach is required.

What's New is Old and What's Old is New

In the new world of crowdfunding and AIFMD, roles have reversed. With a goal of protecting investors, marketing funds and raising capital, the EEA has become more restrictive and regulated. At the same time, with the goal of facilitating capital-raising and economic development, pursuant to the Jumpstart Our Business Startups Act (the JOBS Act), the U.S. has opened up a channel to raise capital in a dramatically less restrictive manner. In an ironic twist, the free-speaking U.S. sponsor now, however, essentially needs to effectively be concerned about two sets of "directed-selling efforts" restrictions. One needs to avoid a U.S. general solicitation under Rule 506(c) from finding its way into Europe such that it could constitute "marketing" under AIFMD. And at the same time, if a U.S. sponsor is concurrently marketing in Europe in compliance with the AIFMD and does not wish to comply with the heightened accredited investor requirements of 506(c), then such efforts still need to not constitute directed selling efforts into the U.S. (notwithstanding a concurrent general solicitation in the U.S.) to preserve Reg S availability for the offshore offering. ■

For more information on the AIFMD, please visit: www.goodwinprocter.com/AIFMD

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