

Will the JOBS Act Jump-Start the Video Game Industry? Crowdfunding Start-Up Capital

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I.	INTRODUCTION	142
II.	CROWDFUNDING AND THE VIDEO GAME INDUSTRY	143
	A. <i>Before Title III of the JOBS Act</i>	147
	B. <i>After Title III of the JOBS Act</i>	149
	C. <i>Equity-Based Crowdfunding and Start-Up Companies</i>	150
	1. The \$1 Million Investment Cap	150
	2. The Exemption from Registration and the Cost of Compliance.....	153
	3. Title III of the JOBS Act Provides an On-Ramp for an IPO	158
	D. <i>Equity-Based Crowdfunding and Investors</i>	160
	1. Equity-Based Crowdfunding Allows Investors To Buy into the Success of Start-Up Companies.....	160
	2. Crowdfunding Securities Are Still Subject to the Fraud Provisions in the Securities Act and the Exchange Act.....	161
	3. The Investor Caps Help Minimize Risk.....	163
	E. <i>Equity-Based Crowdfunding and Funding Portals</i>	165
	1. The Funding Portal Platform	165
	2. Monetizing the Funding Portal Platform	166
	3. The Burden of Registration and Compliance	168
III.	ACCREDITED CROWDFUNDING AND THE VIDEO GAME INDUSTRY	170
	A. <i>Before Title II of the JOBS Act</i>	171
	B. <i>After Title II of the JOBS Act</i>	172
	C. <i>Accredited Crowdfunding and Start-Up Companies</i>	173

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1.	The New Rule 506(c) Exemption Is Limited Exclusively to Accredited Investors.....	173
2.	The Risks and Rewards of Advertisement in Connection with Rule 506 Offerings.....	173
3.	The Burden of Verifying Accredited Investor Status.....	175
D.	<i>Accredited Crowdfunding and Accredited Investors</i>	177
E.	<i>Accredited Crowdfunding and the Private Placement Portal</i>	178
1.	Advertisement in Connection with Rule 506(c) Offerings Creates Robust Networks of Accredited Investors	178
2.	Monetizing the Private Placement Portal Platform.....	179
IV.	CONCLUSION	181
A.	<i>Equity-Based Crowdfunding</i>	181
B.	<i>Accredited Crowdfunding</i>	182

I. INTRODUCTION

Crowdfunding is a new trend in fundraising whereby start-up companies raise small amounts of money from large networks of people gathered online at the Web sites of intermediaries that facilitate such transactions.¹ In the midst of America's recovery from a colossal economic crisis, the Jumpstart Our Business Startups Act (JOBS Act) was enacted on April 5, 2012, with bipartisan support.² The JOBS Act was designed with certain small business owners in mind³ and made two

1. Crowdfunding is a global trend. See Vinaya Naidu, *Crowdsourcing Platforms Build Relationships and Not Just a Fan Base, Says Arun Mehra from Talenthouse*, BUSINESS 2 COMMUNITY (Mar. 2, 2013), <http://www.business2community.com/expert-interviews/crowdsourcing-platforms-build-relationships-and-not-just-a-fan-base-says-arun-mehra-from-talenthouse-0416262> (discussing the emergence of, and synergy between, crowdfunding platforms and social media in India and explaining that India has over 120 million people online with over half of them on Facebook, which makes India #3 in world rankings); see also Lori Schock, *Outline of Dodd-Frank Act and JOBS Act*, SEC. & EXCH. COMM'N (June 9, 2012), <https://www.sec.gov/News/Speech/Detail/Speech/1365171490596>.

2. See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012). The JOBS Act effectively created an opportunity for the general public to invest in start-up companies for the first time since the 1930s. Sam Gustin, *Will Crowdfunding Drive a New Wave of Startup Investing?*, TIME (Mar. 13, 2012), <http://business.time.com/2012/03/13/will-crowdfunding-drive-a-new-wave-of-startup-investing/#ixzz2T18f29Mc>. See generally *Small Business and the SEC*, SEC & EXCH. COMM'N, <http://www.sec.gov/info/smallbus/qasbsec.htm#fsl> (last modified Oct. 10, 2013).

3. See Jumpstart Our Business Startups Act § 701 (mandating that the SEC provide online information and conduct outreach “to inform small and medium sized businesses, women

fundamental changes, among others,⁴ to federal securities laws regarding crowdfunding.⁵

Title III of the JOBS Act created section 4(6) (crowdfunding exemption) of the Securities Act of 1933 (Securities Act), which permits the offer for sale, or sale, of unregistered securities exclusively through a new type of intermediary called a “funding portal” (equity-based crowdfunding).⁶ Title II of the JOBS Act eliminated the restrictions on general solicitation and advertising in connection with offerings made to accredited investors pursuant to Rule 506(c) of Regulation D under the Securities Act (new Rule 506(c) exemption) and created section 4(b) of the Securities Act; this provides an exemption from registration as a broker-dealer for certain intermediaries that facilitate private offerings made under the new exemption.⁷ The crowdfunding exemption and new Rule 506(c) exemption are noteworthy and impact investors, intermediaries, and entrepreneurs involved in the capital markets. This Article narrows its focus and gives an overview of how Titles II and III of the JOBS Act impact the capital markets of the video game industry, specifically.

II. CROWDFUNDING AND THE VIDEO GAME INDUSTRY

The video game industry is a billion-dollar industry with a consumer base of over one billion users.⁸ It is also an integral part of the global entertainment industry and is driven by the constant advancement

owned businesses, veteran owned businesses, and minority owned businesses of the changes made by [the JOBS] Act”).

4. The JOBS Act made other significant changes to federal securities laws that are beyond the scope of this Article. Title I of the JOBS Act, Reopening American Capital Markets to Emerging Growth Companies, established the emerging growth company, an issuer that has total annual gross revenues of less than \$1 billion. Title IV of the JOBS Act, Small Company Capital Formation, increased the amount of capital that can be raised under Regulation A from \$5 million to \$50 million. Title V of the JOBS Act, Private Company Flexibility and Growth, and Title VI of the JOBS Act, Capital Expansion, each increased the threshold for registration for shareholders of record. *See id.* §§ 101-108, 401-402, 501-504.

5. Indeed, equity-based crowdfunding, as defined *infra*, has become an overnight sensation.

6. *See* Securities Act of 1933, 15 U.S.C. § 77d (2012).

7. Title III of the JOBS Act is entitled the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012,” or the “Crowdfund Act,” and Title II is entitled “Access To Capital For Job Creators.” *See* Jumpstart Our Business Startups Act §§ 201, 301-305.

8. The video game industry generated \$25.1 billion in 2010, and from 2005 to 2010 the revenue stream doubled, during a time when the U.S. economy was struggling. Christian Genetski, Brown v. EMA/ESA: *U.S. Supreme Court Stops California from Playing Games with the First Amendment*, 15 SMU SCI. & TECH. L. REV. 135, 136 (2012). “Computer and video game companies directly and indirectly employ more than 120,000 people in thirty-four states, with an average employee salary of around \$ 90,000.” *Id.*

of the underlying technology used to produce and play video games.⁹ Furthermore, the rise of mass-multiplayer video games has given the video game industry a preexisting foundation of social networks that correlate with specific genres of video games. The video game industry consists of many different players and business models, but it is predominately composed of console manufacturers, video game publishers, and developers. Downstream retail stores and online marketplaces distribute video game titles to end-users, a group consisting of consumers and video game fans alike.¹⁰

At first glance, such statistics signify promising times for early-stage independent third-party video game developers (hereinafter referred to as “start-ups,” “start-up companies,” or “start-up company issuers”). However, many start-ups are not able to fund new projects to completion.¹¹ As a result, many attempt to raise capital online through various crowdfunding intermediaries.

These crowdfunding intermediaries are companies that host online marketplaces that match start-up companies with people who are willing to support their business model by providing online monetary contributions in exchange for nominal gifts (“reward-based crowd-

9. See Kenneth Hwang, *Blizzard Versus Bnetd: A Looming Ice Age for Free Software Development?*, 92 CORNELL L. REV. 1043, 1043-44 (2007).

10. For example, in early June of 2013, GameStop Corp., the world’s largest videogame retailer, whose stock rose 6.2% for the second-biggest gain in the S&P 500 after Microsoft Corp., responding to questions about trade-in rights on its new Xbox One console, said that “users may sell titles back to retailers or give them to friends provided they have approval from the publisher.” Nikolaj Gammeltoft, *S&P 500 Posts Biggest Two-Day Gain Since January on Jobs*, BLOOMBERG (June 7, 2013, 3:49 PM), <http://www.bloomberg.com/news/2013-06-07/u-s-stock-futures-little-changed-before-payrolls-report.html>.

11. Innovative game titles, platforms, and accessories continue to thrive by developing new ways to create, or tap into existing, markets and bring value to investors. The “number of gamers continues to soar (past a billion), and, . . . in spite of some phenomenal crash landings, entrepreneurs and investors are still going big with new game startups.” Dean Takahashi, *The News That Shook the Game World in 2012*, VENTUREBEAT (Dec. 27, 2012, 12:00 PM), <http://www.venturebeat.com/2012/12/27/the-news-that-shook-the-game-world-in-2012/>. “By the third quarter [of 2012], mobile-game startups accounted for 42 percent of all investments in the industry and 22 percent of the transaction value.” *Id.*; see Nicholas Jackson, *Infographic: Video Game Industry Statistics*, ATLANTIC (June 3, 2011, 2:32 PM), <http://www.theatlantic.com/technology/archive/2011/06/infographic-video-game-industry-statistics/239665/> (reporting the computer and video game industry’s revenue for 2009 as \$ 10.5 billion). Indeed, the video game industry has been praised and ridiculed for the medicinal, educational, and addictive nature of video games. See Genetski, *supra* note 8. “Casual video games, cartoons and mobile phone apps are the newest ways companies and nonprofits are trying to reach people with financial education.” Paula Aven Gladych, *3 Unorthodox Online Tools To Promote Financial Literacy*, BENEFITSPRO (May 2012), <http://www.benefitspro.com/2012/05/29/3-unorthodox-online-tools-to-promote-financial-lit> (“[R]esearchers observed students who played educational video games [and those students] did better on district benchmark exams [making] gains of 8.07 points, out of 25, while students who didn’t play the games only increased their scores by 3.74 points.”).

ing”).¹² Kickstarter, for example, works by letting project creators propose a project with a target monetary goal and deadline. If the target amount is met, the project gets funded; otherwise, the project backers pay, and receive, nothing.¹³

The end-game, no pun intended, for all video game companies is to produce a marketable product. Through crowdfunding, start-ups are in a unique position to raise money directly from their prospective consumer base. Start-up companies have the ability to establish their game titles as brands and develop a very personal connection with both prospective consumers and investors. For game developers, crowdfunding creates the economic freedom necessary to foster creative freedom, because the content of a video game no longer has to be tightly related to its commercial viability.¹⁴ Start-up companies can use crowdfunding to tap into the crowd of gamers who are tired of the status quo and crave innovation.¹⁵ In doing so, they can mitigate the risks associated with producing video game titles outside of mainstream genres,¹⁶ because they can simultaneously crowdfund and gauge interest in their product from the amount and frequency of investments.¹⁷ Furthermore, they build

12. See *Kickstarter School*, KICKSTARTER, <http://www.kickstarter.com/help/school> (last visited May 23, 2013).

13. “If the project succeeds in reaching its funding goal, all backers’ credit cards are charged when time expires. If the project falls short, no one is charged. Funding on Kickstarter is all-or-nothing.” David McGrail, *Crowdfunding a Chapter 11 Plan*, 32 AM. BANKR. INST. J., no. 1, Feb. 2013, at 30, 30 (citing *Kickstarter Basics: Kickstarter 101*, KICKSTARTER, <http://www.kickstarter.com/help/faq/kickstarter%20basics> (last visited Jan. 4, 2013)).

14. Many scholars have discussed the intersection of the production of violent video games and the First Amendment as it pertains to legislative restrictions on sales of these games. See Derigan Silver & Ruth Walden, *A Dangerous Distinction: The Deconstitutionalization of Private Speech*, 21 COMMLAW CONSPPECTUS 59, 98 (2012) (citing *Brown v. Entm’t Merchants Ass’n*, 131 S. Ct. 2723, 2749 (2011) (Alito, J., concurring) (discussing protections afforded by the First Amendment to video games in which “[v]ictims are dismembered, decapitated, disemboweled, set on fire, and chopped into little pieces,” in the face of state-law attempt to restrict sales of these games to minors)).

15. It appears as though some of the “crowd” is larger than the rest. “Some additional causes of decline in levels of physical activity include . . . the growing popularity of television, computers, and video games, and the marked decline of physical education in schools.” Stephen A. McGuinness, *Time To Cut the Fat: The Case for Government Anti-Obesity Legislation*, 25 J.L. & HEALTH 41, 46 n.26 (2012).

16. When fans buy into the new video game production, it paves the way for bragging rights amongst the crowd of gamers and prospective investors because fans will be incentivized to promote the start-up company’s final product.

17. John S. (Jack) Wroldsen, *The Social Network and the Crowdfunding Act: Zuckerberg, Saverin, and Venture Capitalists’ Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 592 (2013) (“[W]ithout crowdfunding, a company would have to engage in market research to understand and know its customers, fund the development of a product through debt or equity financing, market the product to potential customers, and ultimately sell the product to its customers (often through a middleman), crowdfunding accomplishes each of these tasks.”).

social networks of supporting investors, receive consumer feedback, and collect data for future business ventures. In contrast, big publishers that produce “AAA” video game titles,¹⁸ such as Electronic Arts and Activision, publicly disclose their risk-averse business strategy of predominately backing titles with proven track records of popularity such as first-person shooters.¹⁹

Another derivative effect of crowdfunding is that it can provide a start-up company with flexibility in selecting its principal place of business operations. Because investors and start-up companies meet online through an intermediary, start-ups no longer have to flock to Silicon Valley to attract angel investors and venture capitalists.²⁰ Instead, they can establish their business operations or development studios in areas where they can receive favorable tax treatment and attract talented programmers.²¹ Crowdfunding allows start-up companies to compete with mega-publishing companies for talented programmers by increasing their access to seed money, which can supplement overhead costs, such as payroll, software licenses, and hardware.²²

18. “AAA being industry jargon for big, mainstream titles with multimillion-dollar budgets.” Chris Suellentrop, *Indies Grab the Controls at a Game Conference*, N.Y. TIMES (Mar. 31, 2013), http://www.nytimes.com/2013/04/01/arts/video-games/game-developers-conference-celebrates-indie-creators.html?pagewanted=all&_r=0.

19. “In North America and Europe combined, *Call of Duty Black Ops II* was the #2 best-selling title in dollars.” Activision Blizzard, Inc., Quarterly Report (Form 10-Q) (Mar. 31, 2013). “Activision has reaped approximately \$3 billion in sales for the *Call of Duty* game series alone . . .” Deana Pollard Sacks, *Constitutionalized Negligence*, 89 WASH. U. L. REV. 1065, 1082 (2012). “While many new products are regularly introduced in our industry, increasingly only a relatively small number of high-quality ‘hit’ titles account for a significant portion of net revenue, and an even greater portion of net profit.” Activision Blizzard Inc., Annual Report (Form 10-K/A) (Dec. 31, 2012).

For example, our four largest franchises in 2012—Call of Duty, Diablo, Skylanders and World of Warcraft—accounted for approximately 83% of our net revenues, and a significantly higher percentage of our operating income, for the year. We expect that a limited number of popular franchises will continue to produce a disproportionately high percentage of our revenues and profits.

Id. at 14.

20. Paul Allen, the co-founder of Microsoft, has openly discussed his intent to open offices in Silicon Valley to invest in new technology companies. Dan Graziano, *Microsoft Co-Founder’s Multi-Billion Dollar Venture Firm Eyes Silicon Valley*, BGR (Apr. 2, 2013, 9:56 PM), <http://bgr.com/2013/04/02/microsoft-paul-allen-investment-silicon-valley-410238/>.

21. David Kocieniewski, *Rich Tax Breaks Bolster Makers of Video Games*, N.Y. TIMES (Sept. 10, 2011), <http://www.nytimes.com/2011/09/11/technology/rich-tax-breaks-bolster-video-game-makers.html>.

22. “We rely on independent third-party software developers to develop some of our software products. Because we depend on these developers, we are subject to . . . risks [such as] continuing strong demand for top-tier developers’ resources, combined with the recognition they receive in connection with their work . . .” Activision Blizzard Inc., Annual Report, *supra* note 19, at 24-25. A Kickstarter project creator and video game programmer, Rick Dakan, stated that

A. *Before Title III of the JOBS Act*

Prior to the enactment of Title III of the JOBS Act, crowdfunding was generally limited to the reward-based model because equity-based crowdfunding involves transacting securities.²³ A crowdfunding transaction that offers investors a potential return on their investment constitutes an investment contract and security.²⁴ Securities being offered for sale or sold through crowdfunding must be registered with the Securities Exchange Commission (SEC) unless there is an applicable exemption.²⁵

Section 2 of the Securities Act defines an issuer as “every person who issues or proposes to issue any security.”²⁶ Accordingly, a start-up company that attempts to sell investors nonexempt securities would be deemed an “issuer” within the meaning of section 2 of the Securities Act. Furthermore, with few exceptions, a crowdfunding intermediary that

his “biggest mistake was rushing in and hiring a programmer instead of taking [his] time and finding a true start-up oriented founder who was a programmer.” Erik Kain, *Fully Funded Kickstarter Game Goes Belly Up—Haunts: The Manse Macabre’ Is Out of Money as Programmers Call It Quits*, FORBES (Oct. 18, 2012, 8:42 PM), <http://www.forbes.com/sites/erikkain/2012/10/18/fully-funded-kickstarter-game-goes-belly-up-haunts-the-manse-macabre-is-out-of-money-as-programmers-call-it-quits/>.

23. Seedrs, one of the first U.K.-based equity crowdfunding platforms to seek and receive regulatory approval in the United Kingdom, serves as a model for aspiring foreign and U.S.-based funding portals and intermediaries. BRADLEY D. BELT, CHRIS BRUMMER & DANIEL S. GORFINE, MILKEN INST., *CROWDFUNDING: MAXIMIZING THE PROMISE AND MINIMIZING THE PERIL* 11 n.19 (Aug. 2012). “The Internet and social media has made crowdfunding possible and, in the last few years, a number of crowdfunding websites have proliferated.” Schock, *supra* note 1.

Pebble, a company developing a “smart” wrist-watch, raised \$ 10.3 million from 69,000 people through Kickstarter Oculus Rift, . . . raised about \$ 2.5 million. There are now crowdfunding sites specifically geared toward mobile application developers, social entrepreneurs, musicians, and many other groups and industries.

McGrail, *supra* note 13. “Tim Schafer’s Double Fine Productions . . . raised more than \$1 million on its first day and wound up raking in \$3.3 million in 30 days” Takahashi, *supra* note 11.

24. See Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1740 (2012) (“[The] broad concept of an ‘investment contract’ as a security means that crowdfunding for business ventures cannot bypass the securities laws by using something other than stock or other traditional investment vehicles [and the] statutory term ‘investment contract’ is broadly construed and would clearly encompass any fundraising effort that expressly or impliedly offers investors a potential return on their investment.”). The *Howey* test, named after the landmark U.S. Supreme Court case *SEC v. W.J. Howey Co.*, provides that an “investment contract” (an investment in a common enterprise with the expectation of receiving a profit primarily or principally from the efforts of others) is included within the definition of a security. 328 U.S. 293, 297 (1946).

25. See 15 U.S.C. § 77f.

26. *Id.* § 77b(a)(4).

transacts securities must register as a broker-dealer. A broker-dealer is defined as a person or entity that engages in the business of effecting transactions in securities for the account of others.²⁷

To date, reward-based crowdfunding intermediaries have avoided broker-dealer registration by prohibiting investors from receiving a potential return on their investment. In contrast to the equity-based model of crowdfunding, offering a free copy of a start-up company's final game in exchange for a donation is not considered a security, and therefore, reward-based fundraising is unregulated by the SEC.²⁸ However, in 2011, after a number of successive revisions, legislatures passed Title III of the JOBS Act, and the possibility of implementing an equity-based crowdfunding model became a certain reality.²⁹ The

27. The SEC staff interprets "engaged in the business" to mean regular participation in transacting securities, not a mere isolated occurrence. *Mass. Fin. Servs., Inc. v. Sec. Investor Prot. Corp.*, 411 F. Supp. 411, 415 (D. Mass. 1976). Factors indicating that a person is "engaged in the business" include, among others, receiving transaction-related compensation; soliciting securities transactions; holding oneself out as a broker, as executing trades, or as assisting in settling securities transactions; and participating in the securities business with some degree of regularity. In addition to indicating that a person is "effecting transactions," soliciting securities transactions is also evidence of being "engaged in the business." A crowdfunding intermediary may be deemed to be "effecting transactions in securities" by assisting start-up company issuers in structuring prospective securities transactions, identifying potential purchasers of securities, soliciting securities transactions, and taking transaction orders. *MuniAuction, Inc.*, SEC No-Action Letter, 2000 WL 291007, at *1 (Mar. 13, 2000) (describing participating in "effecting transactions in securities" as participating "at key points in the chain of distribution"). Section 15(a)(1) of the Exchange Act provides that a "broker" or "dealer" of securities must register with the SEC absent an applicable exemption. Securities Exchange Act of 1934 § 15(a)(1), 15 U.S.C. § 78o (2012). To illustrate, Kickstarter would be deemed a broker-dealer, and subject to the registration requirements of the Exchange Act, if its project creators offered equity ownership interests, because Kickstarter would be involved in structuring the transaction terms and conditions, identifying potential investors, and taking orders in connection with the sale, or offer for sale, of the project creators' securities. Furthermore, because Kickstarter takes 5% of the funds raised by a project creator as a servicing fee, Kickstarter would be deemed to be receiving transaction-based compensation, a major factor in the determination of broker-dealer status. See *Kickstarter Basics: Kickstarter 101*, *supra* note 13; *BondGlobe, Inc.*, SEC No-Action Letter, 2001 WL 103418, at *3 (Feb. 6, 2001) (explaining that receiving transaction-related compensation is heavily emphasized by the SEC as a factor in determining whether a person is a broker). A commission or "salesman's stake" includes "compensation based, directly or indirectly, on the size, value or completion of any securities transactions." *AngelList LLC & AngelList Advisors LLC*, SEC No-Action Letter, 2013 WL 1279194, at *10 (Mar. 28, 2013). Registration as a broker dealer helps protect investors from the inherent conflict of interest created by a broker's self-interest in receiving a "salesman's stake" if the securities transaction is completed. *Id.*

28. In *SEC v. W.J. Howey Co.*, the United States Supreme Court explained that the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." 328 U.S. 293, 299 (1946).

29. See *Wroldsen*, *supra* note 17 (explaining that the House of Representatives passed a version of an equity crowdfunding exemption, the Entrepreneur Access to Capital Act, and the Senate passed the Democratizing Access to Capital Act of 2011). Notably, Congress gave the

following Part discusses how Title III of the JOBS Act impacts crowdfunding in connection with the video game industry.

B. After Title III of the JOBS Act

Title III of the JOBS Act created new section 4(6) of the Securities Act, which exempts qualified crowdfunding transactions from certain registration requirements of the Securities Act.³⁰ Pursuant to the crowdfunding exemption, a start-up company can issue securities through social networking Web sites³¹ without the burden and expense of registering such transactions under the Securities Act.³² However, a start-up company cannot fundraise directly from the crowd. Instead, it must make its offering to the crowd through a registered broker or a funding portal.³³

SEC 270 days from the enactment of the JOBS Act to deliver the final rules. However, much to the frustration of hopeful independent game companies, upon reaching the mandated deadline, the SEC had not delivered its final rules. Robb Mandelbaum, *'Crowdfunding' Rules Are Unlikely To Meet Deadline*, N.Y. TIMES (Dec. 26, 2012), <http://www.nytimes.com/2012/12/27/business/smallbusiness/why-the-sec-is-likely-to-miss-its-deadline-to-write-crowdfunding-rules.html>. Until final rules are issued, investors, intermediaries, and entrepreneurs cannot legally engage in equity-based crowdfunding. In a hearing, Representative Kerry Bentivolio (R-Mich.), vented his frustration with the SEC's delay in issuing final rules by stating: "The SEC expects reporting companies as their regulator to respect their deadlines. Congress is your regulator. Is it fair for us to expect you to respect our deadlines?" Sarah N. Lynch, *Republicans Accuse SEC of Dragging Its Feet on JOBS Act*, REUTERS (Apr. 11, 2013, 12:52 PM), <http://www.reuters.com/article/2013/04/11/us-sec-jobsact-idUSBRE93A0JB20130411>.

30. Schock, *supra* note 1 (explaining that the JOBS Act has changed "[t]he one thing that crowdfunding could not do as a result of restrictions under the federal securities law," which "was to offer an ownership interest, or a share in the profits of the business or venture").

31. The power of social networking is evidenced by the contemporary phenomenon of viral videos that are viewed by millions and spread through social networks like Facebook and Twitter. See Rosemary Ford, *Gone Viral: Online Videos Turning Regular People into Celebrities*, EAGLE-TRIB. (Apr. 10, 2011), <http://www.eagletribune.com/latestnews/x1075334051/Gone-viral-Online-videos-turning-regular-people-into-celebrities>.

32. According to the SEC, the current registration scheme imposes indirect and direct costs. "The indirect costs include uncertainty and delay arising from the possibility of Commission staff review (including the possibility of losing a market window), market overhangs, short-selling and related activities, and publicity constraints. Direct costs include legal, accounting, underwriting, printing and filing fees." ADVISORY COMM. ON THE CAPITAL FORMATION & REGULATORY PROCESS, U.S. SEC. & EXCH. COMM'N, REPORT OF ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES 2 (July 24, 1996), *available at* <http://www.sec.gov/news/studies/capform/capffull.txt>. For over half a century, the SEC has implemented a disclosure system for the registration of public offerings under the Securities Act and the periodic reporting requirements of the Securities Exchange Act of 1934. See Miriam R. Albert, *Company Registration in Its Historical Context: Evolution Not Revolution*, 9 U. MIAMI BUS. L. REV. 67, 70 n.11 (2001) (citing THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 78 (3d ed. 1996)) (discussing the "company registration proposal" proposed by the SEC in July 1996).

33. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315 (2012).

A funding portal is a new type of intermediary created by Title III of the JOBS Act that is exempt from registering as a broker-dealer.³⁴ Funding portals are defined under new section 3(a)(80) of the Securities Exchange Act of 1934 (Exchange Act) as intermediaries that offer or sell securities for the accounts of others solely pursuant to section 4(6) of the Securities Act.³⁵ In practice, each funding portal, like Kickstarter, would have a Web site where investors could meet and be matched with start-up companies to invest collectively in and fund new video game productions.

The following Part addresses the utility that Title III of the JOBS Act conveys to start-up companies and concludes that, collectively, the burdens, risks, and limitations of Title III and the Crowdfunding Proposed Rules (Proposed Rules, as defined *infra*) eliminate the crowdfunding exemption as a viable alternative to reward-based crowdfunding unless a start-up company's target amount for its fundraising efforts is at least near \$1 million.³⁶

C. Equity-Based Crowdfunding and Start-Up Companies

1. The \$1 Million Investment Cap

For start-up companies, this bill is a potential "game changer."³⁷ The upside to the crowdfunding exemption is that it allows an issuer to sell up to \$1 million in securities in a twelve-month period to certain investors.³⁸ The downside is that a start-up can *only* raise \$1 million pursuant to this exemption.³⁹

The crowdfunding exemption requires that the start-up company (including all entities controlled by or under common control with such start-up company,⁴⁰ as well as any predecessor of the start-up company)⁴¹

34. *Id.*

35. *Id.* § 304.

36. Crowdfunding, 78 Fed. Reg. 66428 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

37. "The 'game changer,' as President Obama put it in the Rose Garden as he signed the bill, was a provision to let small companies 'crowdfund[.]'" Mandelbaum, *supra* note 29.

38. Nonaccredited investors are those who do not meet the \$200,000 annual income or \$1 million net worth thresholds required under federal law to become an accredited investor. 15 U.S.C. § 77b(a)(2)(15) (2012) (defining an accredited investor); Jumpstart Our Business Startups Act § 302; 17 C.F.R. § 230.501 (2012).

39. Jumpstart Our Business Startups Act § 302(a).

40. For purposes of determining whether an entity is "controlled by or under common control with" the start-up-company issuer, the issuer would be required to consider whether it has "control" as defined in Securities Act Rule 405. Crowdfunding, 78 Fed. Reg. at 66432 n.35.

limit its sale of securities to \$1 million in a twelve-month period.⁴² In contrast, reward-based crowdfunding allows for the possibility of raising an unlimited amount of money and retaining equity ownership, and the fundraising is unregulated by the SEC. However, raising up to \$1 million through equity-based crowdfunding would be helpful to start-up companies if it could be used as an *additional* source of capital to fill the gaps between more traditional fundraising methods.⁴³

Prior to the issuance of the Proposed Rules, commenters opined about the uncertainty as to the frequency and number of unregistered offerings that a start-up company could initiate contemporaneously with its equity-based crowdfunding efforts.⁴⁴ If a start-up company would be limited exclusively to equity-based crowdfunding as a means to raise capital on an annual basis, such a limitation could negatively impact the utility of the crowdfunding exemption.

Additionally, there may be concern about how the SEC would apply the “integration doctrine” to offerings made pursuant to the crowdfunding exemption. Since 1933, the integration doctrine has provided a method for determining whether multiple transactions of securities should be considered part of the same offering. The integration doctrine prevents an issuer from avoiding the registration requirements of the Securities Act by dividing a single offering into multiple transactions

41. *Id.* (explaining that if an issuer reaches the \$1 million investment cap and subsequently reorganizes into a new entity, it would not be permitted to make additional offers and sales in reliance on the crowdfunding exemption during the relevant twelve-month period).

42. Jumpstart Our Business Startups Act § 302(a).

43. “Thirty years ago your primary source of early-stage investment would really be your close friends and family and this really close network With the rise of social networks and your Facebook friends and Twitter followers and these other acquaintances, these other ties in the network, in essence the breadth of access to resources increases.” Christine Dobby, *Entrepreneurs Tap into Virtual World To Fund Startups*, FINANCIAL POST (Oct. 16, 2012), <http://business.financialpost.com/2012/10/16/entrepreneurs-tap-into-virtual-world-to-fund-startups/> (quoting Robert Mitchell at the Richard Ivey School of Business in Ontario).

[T]he law must allow for the coupling of crowdfunding in joint-investment structures with accredited parties, like angels, VCs, banks or CDFIs . . . working with, not against, existing financial services and knowledge infrastructure . . . is critical to bringing crowdfunding to local communities in a meaningful way.

. . . .
As the law is written, it is unclear if such structures would be legal. . . . [T]he law would have to exempt accredited investors from the crowdfunding investor caps. Additionally, the restriction on “investment advice or recommendations” by funding portals would need to be clarified. (This provision is particularly unclear and shrouds a number of other common-sense practices in legal uncertainty.)

Jonathan Sandlund, *From the Milken Institute: A Must-Read Crowdfunding Report*, THECROWDCAFE (Sept. 5, 2012), <http://www.thecrowdcafe.com/crowdfunding-maximizing-the-promise-and-%EF%BF%BC%EF%BF%BCminimizing-the-peril-a-roundtable-discussion/>.

44. Crowdfunding, 78 Fed. Reg. at 66431.

in order to imply artfully that each transaction is not part of a single offering. With regard to equity-based crowdfunding, the integration doctrine would be used to discern whether a start-up company has exceeded the \$1 million cap under the crowdfunding exemption or, alternatively, whether it has raised \$ 1 million or less through equity-based crowdfunding and other amounts pursuant to other exemptions for private offerings, such as Rule 506 of Regulation D.⁴⁵

In the Proposed Rules, the SEC declined to increase the \$1 million investment cap. However, the SEC did determine that the crowdfunding exemption should “provide an additional mechanism for capital raising for startup and small businesses and not . . . affect the amount an issuer could raise outside of that exemption.”⁴⁶ Moreover, under the Proposed Rules, only funds raised pursuant to the crowdfunding exemption are counted toward the \$1 million investment cap.⁴⁷ More specifically, in calculating the \$1 million investment cap in the relevant twelve-month period, a start-up company issuer must calculate the sum of all amounts of securities previously sold under the crowdfunding exemption and the amount the start-up company issuer intends to raise in reliance on the crowdfunding exemption. This sum cannot exceed \$1 million.⁴⁸ However, funds raised by alternative means, including offerings that fall under other exemptions from registration under the Securities Act, donations, or reward-based crowdfunding efforts, will not be counted in determining whether a start-up company issuer has exceeded or will exceed the investment cap.⁴⁹ In the Proposed Rules, the SEC explains further that an offering made pursuant to the crowdfunding exemption should not be integrated with other exempt offerings made by the start-up company issuer if each offering complies with the requirements of its respective applicable exemption.⁵⁰ Therefore, start-up companies can employ various methods of fundraising in addition to and contemporaneously with equity-based crowdfunding, thus increasing their sources of capital.⁵¹

The following Part engages in a cost-benefit analysis of the regulatory burden of compliance and concludes that it may be

45. Rule 506 of Regulation D is discussed in greater *infra* Part III.

46. Crowdfunding, 78 Fed. Reg. at 66432.

47. *Id.*

48. *Id.*

49. *Id.*

50. *Id.*

51. *Id.* (explaining that a start-up company issuer could complete an offering made in reliance on the crowdfunding exemption “that occurs simultaneously with, or is preceded or followed by, another exempt offering”).

inappropriate to entice certain start-up companies to adopt an equity-based model of crowdfunding.⁵²

2. The Exemption from Registration and the Cost of Compliance

Prior to the crowdfunding exemption, the expense and burden of registering an offering turned many start-up companies away from issuing registered securities as a means to raise money.⁵³ Pursuant to the crowdfunding exemption and subject to certain caveats discussed *infra*, issuers can avoid the cost and burden of formally registering offerings with the SEC.⁵⁴ Additionally, crowdfunding securities are “covered securities” within the meaning of section 18 of the Securities Act and are therefore exempt from the registration requirements of state “blue sky” laws.⁵⁵ Exemption from registration under applicable federal and state securities laws is a tremendous economic benefit for start-up companies.

Although the regulatory burden has been lessened under the crowdfunding exemption, section 4A(b)(1) of the Securities Act requires that start-up companies make numerous disclosures to the SEC and provide such disclosures to the relevant funding portal and potential investors.⁵⁶

Generally, a start-up company must provide each investor, in writing and prior to the sale, with the final price of the securities offered for sale and all required disclosures. The following discussion highlights certain disclosure requirements set forth in the Proposed Rules that are readily

52.

Policymakers continually face the challenge of effectively balancing the benefits of encouraging small business formation against the investor protection goals of the securities laws. Without the crowdfunding exemption that was recently enacted by Congress and signed into law, crowdfunding would not be a viable capital-raising method in light of the costs of complying with securities registration

Hazen, *supra* note 24, at 1738.

53. “Zynga: The Internet video game firm went public [in] December [2011] at a valuation of \$10 billion. [As of August 2012], the company is worth a mere \$2.24 billion, down a shocking 69% from the IPO price.” Sam Gustin, *The Social Media Tech IPO Boom: An Insider’s Game?*, TIME (Aug. 13 2012), <http://business.time.com/2012/08/13/was-the-social-media-tech-ipo-boom-a-big-scam/>; Wroldsen, *supra* note 17, at 597 n.59 (“Registration is a nonstarter for most crowdfunding websites and crowdfunded ventures because of the expense and prolonged nature of the process.” (quoting Joan MacLeod Hemingway & Sheldon Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 911 (2011) (internal quotation marks omitted))).

54. 15 U.S.C. § 77d (a)(6) (2012); Jumpstart Our Business Startups § 302(a).

55. Notably, section 18 of the Securities Act also preempts state law with regard to securities issued pursuant to a Rule 506 offering. Securities Act of 1933 § 18, 15 U.S.C. § 77r-1.

56. *Id.* § 77d-1.

distinguishable or noteworthy when compared to the statutory requirements of Title III of the JOBS Act.

a. Management

With regard to disclosing general information about the start-up company's management, in the Proposed Rules, the SEC defines an "officer" to include traditional officers (i.e., president, vice president, secretary, treasurer, principal financial officer, or comptroller) and "any person routinely performing corresponding functions."⁵⁷ Furthermore, the SEC clarifies that a start-up company issuer would be required to disclose the names of persons, as of the most recent practicable date, who are the beneficial owners of 20% or more of the start-up company's outstanding voting equity securities.⁵⁸

b. Form C

In the Proposed Rules, the SEC proposes that start-up company issuers can satisfy the requirement of section 4A(b)(1) of the Securities Act, as amended by the JOBS Act, by offering disclosures to the SEC in filing Form C.⁵⁹ Furthermore, while the SEC's Proposed Rules articulate general guidelines with regard to the type of information that start-up companies must disclose, the rules give no guidance on the format and method of conveyance of material information to the prospective investors. Moreover, the Proposed Rules do not mandate a specific disclosure format.⁶⁰

c. Target Offering Amount

Title III of the JOBS Act and the Proposed Rules require that start-up companies disclose the target offering amount and the deadline for reaching that amount.⁶¹ The Proposed Rules require a start-up company to prepare regular updates on its progress toward meeting its target offering amount by means of an updated Form C and provide such

57. Crowdfunding, 78 Fed. Reg. at 66438.

58. *Id.* at 66439 (explaining that adopting such an approach in calculating 20% beneficial ownership eases the burden on start-ups, in that it provides for tracking of fewer beneficial owners in connection with certain "bad actor" disqualification rules and disclosure requirements because it does not differentiate between multiple classes of securities with different voting powers).

59. *Id.* at 66453 (explaining that start-ups can fulfill the requirement of providing Form C disclosures to investors by directing the investors to the funding portal, where they can obtain a copy of the Form C and any amendments or updates thereto).

60. *Id.* at 66441.

61. *Id.* at 66440.

updates to potential investors and the funding portal.⁶² Such updates must be provided no later than “five business days after the issuer reaches particular intervals—*i.e.*, one-half and 100 percent - of the target offering amount.”⁶³ If a start-up company desires to accept proceeds that exceed its target offering amount, it is required to file a final progress update on Form C no later than five business days after the offering deadline, disclosing the total amount of securities sold.⁶⁴

The Proposed Rules require that a start-up company amend its disclosure for any material change in the terms of the offering or disclosure previously provided to investors. Such amendments must be filed with the SEC on Form C and provided to investors and the funding portal.⁶⁵ Subsequently, in the case of a material amendment filed on Form C, investors have five business days to reconfirm their investment commitments; otherwise, such commitments are subject to automatic cancellation.⁶⁶

Relatedly, the Proposed Rules require that a start-up company disclose certain procedures regarding cancellation of an investor’s commitment to invest, notification of when the target offering amount is met, and closing of the offering prior to the disclosed deadline upon reaching the target amount.⁶⁷ Additionally, the Proposed Rules require start-ups to disclose that if investment commitments do not meet or exceed the target offering amount by their deadline, no securities will be sold, all investor commitments will be cancelled, and committed funds will be returned.⁶⁸

62. *Id.* at 66449.

63. *Id.*

64. *Id.* In connection with a start-up company’s required disclosure, with regard to its use of the proceeds of the offering, the SEC states that if a start-up company indicates that it will accept proceeds in excess of the target offering amount, the start-up company will be required to provide additional information on the purpose and intended use of any *excess* proceeds. *Id.* Moreover, the SEC explains that in lieu of setting limits on oversubscriptions, a start-up company may disclose the maximum amount of oversubscriptions it would accept, how such oversubscriptions would be allocated, and the intended purpose of those additional funds. *Id.* at 66457.

65. *Id.* at 66450 (explaining that a start-up company would determine whether changes in the terms of the offering or disclosure are material based on the facts and circumstances, and whether there is a substantial likelihood that a reasonable investor would consider them important in determining whether to purchase the securities).

66. *Id.*

67. *Id.* at 66441.

68. *Id.*

d. Ownership and Capital Structure

The Proposed Rules require that start-ups disclose the number of securities being offered and/or outstanding, any voting rights and limitations attributable to such securities as well as a description of any restrictions on transfer.⁶⁹

e. Additional Disclosures

In addition to the statutory disclosure requirements set forth in Title III of the JOBS Act, the Proposed Rules suggest that a start-up company be required to disclose certain information about the funding portal or other intermediary through which the equity-based crowdfunding transaction is conducted, certain legends included in the offering materials, and the number of employees of the start-up company.⁷⁰ The start-up company must also include certain risk factors, material terms of any indebtedness, exempt offerings conducted within the past three years, and certain related party transactions.⁷¹

f. Financial Disclosures

The level of financial disclosure required is linked to the target amount the start-up company is seeking to raise. In calculating this amount, the Proposed Rules require that a start-up company combine the amounts offered *and sold* pursuant to the crowdfunding exemption (within the preceding twelve-month period) with the target offering amount (and any amount accepted over the target offering amount).⁷² Furthermore, the Proposed Rules require start-ups to file with the SEC and provide to investors the funding portal financial statements in accordance with U.S. GAAP (covering the shorter of the two most

69. *Id.*

70. *Id.* at 66442. Appropriately, according to the SEC, the disclosure of the number of employees employed by the start-up company is meant to provide data to evaluate how many jobs the crowdfunding exemption creates. *Id.* at 66443.

71. *Id.* at 66442. With regard to disclosures pertaining to certain related party transactions, the Proposed Rules require a start-up company to make such disclosures with regard to transactions between the start-up company and its management. In certain cases, any promoter of the start-up company, 20% beneficial owner, or immediate family members of the foregoing persons are included. *Id.* Furthermore, disclosure about related-party transactions is limited to transactions occurring within the start-up company's last full fiscal year, and for only transactions involving amounts in excess of 5% of the sum of the aggregate amount of capital raised in the preceding twelve-month period under the crowdfunding exemption and the amount sought to be raised under the current offering under the exemption. *Id.*

72. *Id.* at 66445 (explaining that the SEC does not believe that a start-up company should be required to aggregate amounts offered but not sold in prior offerings).

recently completed fiscal years⁷³ or the period since the start-up's inception).⁷⁴ Under the Proposed Rules, a start-up company is required to include a discussion of any material changes to its financial condition that have occurred subsequent to the period for which financial statements have been provided.⁷⁵

For target amounts of \$100,000 or less, the start-up company must file and disclose its most recent income tax returns and its financial statements, which must be certified by its principal executive officer.⁷⁶ If the target amount is more than \$100,000, but less than \$500,000, the start-up company must file and disclose its financial statements. Those statements are then reviewed by an independent public accountant in accordance with the applicable accounting standards.⁷⁷ Finally, if the target amount is more than \$500,000, the start-up company must file and disclose its audited financial statements.⁷⁸ The Proposed Rules require that a start-up company provide a narrative discussion of its financial condition. The SEC has stated that such narrative discussion should be similar in nature to the management's discussion and analysis of financial condition and results of operations required by Item 303 of Regulation S-K for registered offerings.⁷⁹ Again, the SEC does not set forth a one-size-fits-all disclosure requirement, and there is no need for duplicative disclosure with regard to a start-up company's business plan; however, the SEC expects start-ups to present all material information to investors "in a clear and understandable manner."⁸⁰

Because crowdfunding involves a large number of investors becoming equity holders, it requires extensive bookkeeping of all investments and percentage ownership in the business in order to determine the share of profits to which each investor is entitled. Even with the current reward-based model of crowdfunding, intermediaries are

73. *Id.* The SEC explains that during the first 120 days of the start-up company's fiscal year, it would be able to conduct an offering in reliance on the crowdfunding exemption, using financial statements for the fiscal year prior to the most recently completed fiscal year, if the financial statements are unavailable or are not required to be filed. *Id.*

74. *Id.* (explaining that financial statements include a balance sheet, income statement of cash flows, and a statement of changes in the owners' equity).

75. *Id.* at 66446.

76. *Id.*

77. *Id.*

78. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315 (2012).

79. Crowdfunding, 78 Fed. Reg. at 66444.

80. *Id.*

finding the administrative work of recording donor or backer contributions and sending the respective rewards to be onerous.⁸¹

g. Ongoing Reporting Requirements

The Proposed Rules require that a start-up company that *has sold* securities pursuant to the crowdfunding exemption file a report annually, no later than 120 days after the end of the most recent fiscal year covered by the report.⁸² Furthermore, such annual reports must be posted on the start-up company's Web site.⁸³ The annual report must be filed with the SEC on Form C and disclose similar information to that required in the offering statement (i.e., the financial condition of the start-up company issuer).⁸⁴ A start-up company's obligation to make such annual disclosure ceases upon the earliest of: the start-up company's becoming an Exchange Act reporting company, the start-up company or a third-party purchasing or repurchasing all of the securities issued under the crowdfunding exemption, or the start-up company liquidating or dissolving in accordance with applicable state law.⁸⁵

3. Title III of the JOBS Act Provides an On-Ramp for an IPO

A major factor in deterring companies from choosing to go public and the resulting decline in the number of IPOs in the past decade is the expensive and myriad of regulations created by the Sarbanes-Oxley Act of 2002.⁸⁶ As a result, it now takes, on average, approximately ten years for a company to go public, whereas, prior to Sarbanes-Oxley, it "used to take businesses four and a half years to grow large enough to go public."⁸⁷

Importantly, Title V of the JOBS Act amends section 12(g) to increase the threshold of holders of record beyond which companies

81. Heesun Wee, *How Equity Crowdfunding Just Might Upend Film Financing*, CNBC (May 15, 2013), <http://www.cnbc.com/id/100724191> ("[P]roducers want to work with as few a number of investors as possible due to the administrative burden that comes with raising equity from investors.").

82. Crowdfunding, 78 Fed. Reg. at 66451 (explaining that the ongoing reporting requirement is inapplicable to start-ups that offer securities pursuant to the crowdfunding exemption, but do not actually sell any securities thereunder).

83. *Id.*

84. *Id.*

85. *Id.* (explaining that any start-up company terminating its annual reporting obligations would be required to file, within five business days from the date of termination, a notice to investors and the Commission that it will no longer file and provide annual reports).

86. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (enacted July 30, 2002).

87. U.S. Senator Pat Toomey, *Toomey's Take: The Jobs Act: A Success Story*, PAT TOOMEY U.S. SENATOR FOR PA. (Apr. 18, 2012), http://www.toomey.senate.gov/?p=op_ed_column&id=560.

must register under the Exchange Act.⁸⁸ Under section 12(g) of the Exchange Act, as amended by Title V of the JOBS Act, if a company has fewer than 2000 holders of record of its equity securities and fewer than 500 unaccredited investors, the company does not trigger the registration and reporting requirements of section 12(g).⁸⁹ Title III of the JOBS Act creates section 12(g)(6) of the Exchange Act, which provides start-up companies with an on-ramp for an IPO by excluding securities issued under the crowdfunding exemption from section 12(g) of the Exchange Act.⁹⁰ The net effect is that start-up companies can remain private while increasing their shareholder bases and achieving incremental fundraising milestones prior to going public. This occurs without triggering the registration and reporting requirements of section 12(g) of the Exchange Act.⁹¹ Moreover, the Proposed Rules provide that securities issued pursuant to the crowdfunding exemption are permanently exempted from the record holder count under section 12(g) of the Exchange Act.⁹²

However, the determination of the status of investors that become equity holders (accredited or nonaccredited) and the source of the interest that they hold (whether it was obtained pursuant to the crowdfunding exemption) each require extensive record keeping and resources.⁹³ Thus, for start-up companies on a shoestring budget, the burden of maintaining compliance may outweigh the benefit of having an on-ramp to an IPO.

88. Jumpstart Our Business Startups Act, Pub. L. No. 11-106, § 501, 126 Stat. 306, 325 (2012). Title V of the JOBS Act is entitled “Private Company Flexibility and Growth.” *Id.*

89. “Thus a company could have 1999 accredited investors, or 499 unaccredited investors and 1500 accredited investors or 300 unaccredited investors and 1699 accredited investors as record shareholders and stay outside of the ‘34 Act obligations.” Robert B. Thompson, *The JOBS Act: Raising the Threshold for ‘34 Act Obligations*, CONGLOMERATE (Apr. 24, 2012), <http://www.theconglomerate.org/2012/04/the-jobs-act-raising-the-threshold-for-34-act-obligations.html>. However, if such shares are transferred, the transferees will be counted as holders of record.

90. Jumpstart Our Business Startups Act § 303.

91. Wroldsen, *supra* note 17, at 611-16 (discussing equity crowdfunding within a staged fundraising effort and the legislative intent behind the JOBS Act to provide for the incremental progression in capitalization for small companies, ranging from crowdfunding investors to venture capitalist).

92. Crowdfunding, 78 Fed. Reg. 66428, 66498 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

93.

[T]he Division of Enforcement must determine whether the securities were acquired pursuant to an employee compensation plan in transactions exempt from registration . . . pursuant to a crowdfunding transaction . . . all such holders must be excluded from the number of holders of record. This adds a degree of difficulty to determining the threshold number.

STAFF OF THE U.S. SEC. & EXCH. COMM’N, REPORT ON AUTHORITY TO ENFORCE EXCHANGE ACT RULE 12G5-1 AND SUBSECTION (B)(3) 30 (Oct. 15, 2012), *available at* <http://www.sec.gov/news/studies/2012/authority-to-enforce-rule-12g5-1.pdf>.

D. Equity-Based Crowdfunding and Investors

The equity-based model of crowdfunding allows investors to buy into the success of the development of new game titles and minimizes the risk of loss due to the protection of the fraud provisions in the Securities Act and the Exchange Act (as well as the built-in caps on the amounts invested). Yet what is good for the start-up company is not always best for the investor. For example, under the reward-based model, a project creator can raise seed money without giving up equity in their company or ownership of their intellectual property.⁹⁴ This paradigm is shifted by the implementation of the crowdfunding exemption⁹⁵ because the crowdfunding exemption creates a potential upside for investors who participate in equity-based crowdfunding.

1. Equity-Based Crowdfunding Allows Investors To Buy into the Success of Start-Up Companies

For the first time, pursuant to the crowdfunding exemption, ordinary video game fans are able to go online and invest in games that they enjoy and, as a result, receive a financial return on their investment and participate in the economic success of the video game's popularity.⁹⁶ Moreover, video game fans can invest in accordance with their personal interests while belonging to a distinct social network comprised of consumers, video game fans, and investors.⁹⁷

94. For example, "Ouya" is a Kickstarter success story that raised nearly ten times its target amount to build its Android-based gaming console for under \$100. Ouya raised enough money to hire employees and prepare to ship and sell their consoles. Jenna Wortham, *Ouya Game Console Ends Kickstarter Campaign With \$8.5 Million*, *BITS* (Aug. 9, 2012, 8:24 AM), http://bits.blogs.nytimes.com/2012/08/09/ouya-game-console-ends-kickstarter-campaign-with-8-5-million/?_r=0. Importantly, developing a console is an expensive endeavor that may not be sustainable through equity-based crowdfunding efforts. See Nabyla Daidj & Thierry Isckia, *Entering the Economic Models of Game Console Manufacturers*, 73 *COMM. & STRATEGIES* 23 (2009). Alternatively, early-stage console development companies should consider accredited crowdfunding, discussed *infra* in Part III, as a means to create the multimillion dollar production budget necessary to compete in the video game console market. See Sharon Pian Chan, *Let the Games Begin*, *SEATTLE TIMES* (Oct. 25, 2009), <http://community.seattletimes.nwsourc.com/archive/?date=20001025&slug=TT6Q23HI6> (explaining that for console manufacturers, "the money is in sales of their own game titles and licensing fees from third-party game sales").

95. "[M]any securities crowdfunding platforms in the UK are operating in a gray area of the law since they have not applied for and received approval from the [Financial Securities Authority.]" BELT, *supra* note 23, at 11 n.19.

96. Wroldsen, *supra* note 17, at 613 (citing C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 *COLUM. BUS. L. REV.* 1, 105 (2012)) (explaining that investments pursuant to the reward-based model of crowdfunding "are subject to the same risk of loss as crowdfunded securities, but do not offer the upside potential of a securities investment").

97. "Games will no doubt continue to provide fun and entertainment, but they also increasingly provide a foundation through which people connect with one another or reestablish

Under Kickstarter's terms of use, start-up companies are contractually bound to follow through on their projects and give backers recourse if they do not. However, under the reward-based crowdfunding model, start-up companies that seek donations cannot issue refunds when the funding obtained reaches the target amount but is insufficient to support the production to completion.⁹⁸ Kickstarter's terms of use take an all-or-nothing approach, which means that they require start-up companies to fulfill all rewards of their project or refund any backer whose reward they do not or cannot fulfill.⁹⁹ In contrast, under the equity-based model of crowdfunding, investors become interest holders of the start-up company and, therefore, have recourse through enforcement of the fiduciary duties imposed on controlling equity holders and management under the company's governing documents and applicable law, to the extent that such duties have not been waived.¹⁰⁰

2. Crowdfunding Securities Are Still Subject to the Fraud Provisions in the Securities Act and the Exchange Act

Because crowdfunding is transacted online, it is difficult for investors to know whether a start-up company is legitimate.¹⁰¹ For

long lost connections with old friends." Genetski, *supra* note 8, at 136. Since 2001, the advent of online social gaming has spread beyond the PC platform to encompass major console platforms and mobile devices. See Khanh T.L. Tran, *The Game Business Grows Up*, ASIAN WALL STREET J., June 25, 2001, at T4, available at 2001 WLNR 9979207. Start-ups and funding portals can take advantage of these preexisting social networks of fans of particular genres and titles by marketing their crowdfunding efforts to these niche groups.

98. For example, Mob Rules Games, a project fully funded on Kickstarter, struggled with keeping its talent due to an insufficient budget. "Mob Rules Games' last budget report was posted to their website in April, prior to the start of the Kickstarter drive. Since then, the money trail can only be guessed at." Kain, *supra* note 22 (discussing Mob Rules Games' problematic receipt of insufficient funds to complete their project).

99. *Terms of Use*, KICKSTARTER, <http://www.kickstarter.com/terms-of-use> (last updated Oct. 2012).

100. The Delaware General Corporation Law (the DGCL) provides that the business and affairs of a corporation are to be managed under the direction of its board of directors. DEL. CODE ANN. tit. 8, § 141 (2013). Notably, section 102(b)(7) of the DGCL permits a Delaware corporation to eliminate or limit a director's personal liability for breaching the duty of care through an exculpatory provision in the certificate of incorporation. *Id.* § 102(b)(7). Exculpatory provisions eliminate liability for gross negligence or recklessness and, consequently, require a shareholder plaintiff to prove a breach of a director's duty of good faith or loyalty in order to recover on behalf of the corporation. The effect of such exculpatory language is that a director may not be held liable for breaching his duty of care regardless of fault or the resulting harm.

101. *Internet Fraud*, SEC. & EXCH. COMM'N, <http://www.sec.gov/investor/pubs/cyberfraud.htm> (last modified Feb. 1, 2001) ("It's easy for fraudsters to make their messages look real and credible and sometimes hard for investors to tell the difference between fact and fiction. That's why you should think twice before you invest your money in any opportunity you find online While legitimate online newsletters may contain valuable information, others are tools for fraud

example, an investor that engages in reward-based crowdfunding through intermediaries like Kickstarter must rely on the transparency and accuracy of the project creators' voluntary disclosures to determine if a funded project will actually be followed through to completion.¹⁰² As with all other exempt securities and offerings regulated by the SEC, crowdfunding securities are still subject to the fraud provisions in section 17 of the Securities Act and Rule 10(b)(5) under the Exchange Act (even though crowdfunding securities are exempt from registration under the Securities Act).¹⁰³ Furthermore, new section 4A(c) of the Securities Act creates a private right of action for investors against start-up company issuers for material misstatements and omissions made in disclosure materials.¹⁰⁴ Additionally, the SEC is required to adopt rules to disqualify start-up company issuers from offering securities in crowdfunding transactions, and broker-dealers and funding portals from effecting or participating in crowdfunding transactions, if they have been subject to certain securities related, or regulatory, sanctions.¹⁰⁵ Even though crowdfunding securities are covered securities, the JOBS Act also preserves state enforcement authority, including enforcement against fraud.¹⁰⁶

... Online bulletin boards are a way for investors to share information ... [although] some messages may be true, many turn out to be bogus—or even scams.”)

102. An entrepreneur explains his skepticism in launching his hardware, stating, “When we started, a lot of people worried that we were going to be like a video game, we were going to be a \$5 million bill before we could even get it out to the audience.” Jennifer Larino, *Startup Close-Up: Kinobi*, NEW ORLEANS CITY BUS. (July 2, 2012, 3:34 PM), <http://neworleanscitybusiness.com/blog/2012/07/02/startup-close-up-kinobi/> (subscription only).

103. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315 (2012). Not only could the SEC bring an action against the fraudulent actor, but the buyer or seller who suffers from the fraud could also bring an action against the fraudulent actor. 17 C.F.R. § 240.10b-5 (2013).

104. Matt Drange, *Crowdfunding Advertising an SEC Concern*, SFGATE (Oct. 23, 2012, 8:23 PM), <http://www.sfgate.com/business/article/Crowdfunding-advertising-an-SEC-concern-3976053.php> (explaining that a “concern for startups considering crowdfunding as a way to raise capital is that they can be held liable in shareholder lawsuits if fraudulent offers are posted on crowdfunding portals”).

105. See Jumpstart Our Business Startups Act § 4A.

106. *Id.* § 305. “The idea [behind the JOBS Act] was that numerous new companies would get financing, and in that way promote job growth. Critics warned that some provisions might simply make it a lot easier to commit securities fraud.” Floyd Norris, *Fraud Case Delayed By 2 Months, High & Low Finance*, N.Y. TIMES (Nov. 1, 2012), <http://www.nytimes.com/2012/11/02/business/sec-charges-company-that-filed-under-jobs-act-with-fraud.html>. “Investor protection becomes an issue when social networks are used for widespread solicitation of funds for business enterprises . . .” Hazen, *supra* note 24, at 1737.

3. The Investor Caps Help Minimize Risk

Investors must consider the inherent risk of failure associated with start-up companies and the problem of illiquidity with regard to the equity interests obtained.¹⁰⁷ Additionally, because of the nature of the video game business, there are industry-specific risks of loss to investors with start-up companies, such as widespread piracy¹⁰⁸ and the risk of litigation.¹⁰⁹ For example, in an effort to thwart piracy, start-up companies and established video game companies frequently bring causes of action under the Copyright Act of 1976 and the Digital Millennium Copyright Act.¹¹⁰

To protect against this risk, all investors are subject to an investment cap, a limitation on the amount of money they may legally invest based on their net worth. Under the Proposed Rules, if both an investor's annual income and net worth are less than \$100,000, that investor is limited to investing the greater of \$2,000 or 5% of annual income or net

107. Start-up companies are traditionally riskier and have a higher rate of failure than other businesses. "According to the U.S. Small Business Administration, approximately 50 percent of new businesses [in the] last five years or more, and only about 33 percent [in the] last 10 years or more [have failed]." Virginia Bridges, *Five Reasons That Small Businesses Fail*, NEWS & OBSERVER (May 19, 2013, 12:01 AM), <http://www.heraldnet.com/article/20130519/BIZ/705199989> (explaining that small business fail because they run out of cash, the owners get burned out, the customer base is taken for granted, there is a poor reaction to competition, and there is a failure to update technology).

Or to put it more bluntly: "[The video game] industry is so young that we still have studios that are successful despite themselves," said Trevor Fencott, chief executive of Bedlam Games, a Canadian developer of next-generation console games "But in this environment, do you really want to hand a check over to a developer that's brilliant but really bad at running a business?"

Brooks Barnes, *Talent Agents a New Force in the Video Game Industry*, N.Y. TIMES (Mar. 26, 2010), http://www.nytimes.com/2010/03/27/technology/27agent.html?_r=0.

108. An opinionated video game fan expresses his point of view as follows:

\$ 60 for one video game? Forget that, I'm going to download it. If I spend \$ 60 on this game, that means having to skip a future game I might like even more I think \$ 20 is the max I'd pay for a digital game. Someone out there right now is thinking, "What?! We spent \$ 25 million making this game, there's no way we can make a profit selling it at \$ 20." Not my problem. If you want me to buy it, you've got to get the price down. Here's an idea, don't drop \$ 25 million making one stupid game.

Andrew V. Moshirnia, *Giant Pink Scorpions: Fighting Piracy with Novel Digital Rights Management Technology*, 23 DEPAUL J. ART TECH. & INTELL. PROP. L. 1, 26 (2012).

109. Investors need disclosure regarding risks of the business such as lawsuits over intellectual property or publicity rights. Jennifer E. Rothman, *The Inalienable Right of Publicity*, 101 GEO. L.J. 185, 188 (2012) (discussing "several pending cases [in which] current and former college athletes are suing a video game company and the National Collegiate Athletic Association (NCAA) for licensing and using their identities without permission in video games and other 'commercial' enterprises").

110. See generally Digital Millennium Copyright Act, Pub. L. No. 105-304, 112 Stat. 2860 (1998) (codified in scattered sections of 17 U.S.C. (2012)).

worth.¹¹¹ If either the annual income or net worth of the investor exceeds \$100,000, that investor may invest the greater of 10% of its annual income or net worth, but in no event more than \$100,000.¹¹² Income and net worth are calculated under the same terms as they would be for an accredited investor.¹¹³ The investor cap may seem like a burden rather than a benefit.¹¹⁴ However, both the investor cap and the \$1 million dollar cap on the issuer's target amount are limitations that allow the SEC to protect investors from fraud and instill public confidence in the markets because of the small amounts of money involved.¹¹⁵

In the case of a failing start-up company, investors that become equity holders may not be able to liquidate their stock, limited partnership interests, or membership interest. This is because there are transfer restrictions in place that prevent investors from selling their equity interests. More specifically, securities that start-up companies issue through equity-based crowdfunding may not be transferred by the purchaser during the first year from the date of purchase unless they are transferred back to the start-up company, or in limited circumstances.¹¹⁶ Lastly, there is no well-established secondary market for the securities of video game start-up companies.¹¹⁷ The problem is that, generally, there is not a large marketplace for securities in privately held start-up companies, and the potential marketplace becomes even smaller upon consideration of the specific industry and type of security involved in the case of independent video games.¹¹⁸

111. Jumpstart Our Business Startups Act, Pub. L. No. 112-106 § 302(a), 126 Stat. 306, 315 (2012); Crowdfunding, 78 Fed. Reg. 66428, 66433 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

112. Crowdfunding, 78 Fed. Reg. at 66433.

113. *Id.*

114. Surprisingly, the average gamer, and potential crowdfund investor, is thirty-seven years of age. *Crowdfunding Video Games: Money To Play With*, ECONOMIST (Sept. 8, 2012), <http://www.economist.com/node/21562213>; Genetski, *supra* note 8, at 135 (explaining that teenagers are often thought of as the largest demographic of video game players).

115. Jumpstart Our Business Act § 302(a).

116. *Id.* § 302(b).

117. The "first market" is the initial forum where the issuer and investor transact the sale of securities through the funding portal and the "secondary market" is the forum where the investor attempts to sell those securities to a subsequent investor. Notably, by definition, a funding portal is excluded from effecting secondary market transactions in securities sold by a start-up pursuant to the crowdfunding exemption. Crowdfunding, 78 Fed. Reg. 66428, 66459 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

118. "In September 2011, for the first time in 29 months, no IPOs whatsoever were conducted. As a result, an unknown number of investors in private companies have been left holding shares in companies that they would likely wish to sell but cannot because there is inadequate information available for prospective purchasers." Stephen F. Diamond, *The Facebook Effect: Secondary Markets and Insider Trading in Today's Startup Environment*, SANTA CLARA L. DIGITAL COMMONS (Mar. 17, 2012), <http://digitalcommons.law.scu.edu/facpubs/192>.

The next Subpart addresses the regulatory burden and other disincentives that funding portals may encounter when facilitating equity-based crowdfunding transactions between video game start-up companies and investors.

E. Equity-Based Crowdfunding and Funding Portals

The Proposed Rules apply not only to funding portals, but also to persons associated with a funding portal¹¹⁹ (excluding any persons functioning solely in a clerical or ministerial capacity).¹²⁰ In order for a start-up company to use a funding portal, it must open an account, which requires that the funding portal obtain, at minimum, the basic identifying contact information of the start-up company.¹²¹

1. The Funding Portal Platform

The Proposed Rules require that a start-up company issuer use a funding portal in connection with an offering made in reliance on the crowdfunding exemption.¹²² Additionally, the Proposed Rules prohibit the use of more than one funding portal to conduct an offering or concurrent offerings made in reliance on the crowdfunding exemption.¹²³ The Proposed Rules define a “platform” to mean, in relevant part, a Web site through which a funding portal acts as an intermediary in an equity-based crowdfunding transaction.¹²⁴ The effect of the aforementioned requirements is that a start-up company must select and use only one funding portal to effect an equity-based crowdfunding transaction, and such transaction must transpire through said funding portal’s Web site (or through an application downloaded from Google Play or Apple’s app store for example).¹²⁵ In fact, the Proposed Rules contemplate crowds physically gathered together in locations that provide access to

119. Crowdfunding, 78 Fed. Reg. at 66458. Meaning, generally, any partner, officer, director, or manager of a funding portal; any person directly or indirectly controlling or controlled by a funding portal; or any employee of a funding portal. *Id.*

120. *Id.*

121. *Id.* at 66465.

122. *Id.*

123. *Id.* at 66435.

124. *Id.*

125. *Id.* The Proposed Rules also provide for the use of mobile applications to facilitate equity-based crowdfunding transactions. *Id.* Notably, the Proposed Rules state that a funding portal may perform “back office and other administrative functions offline.” *Id.* The SEC states further that examples of such “functions” include “document maintenance, preparation of notices and confirmations, preparing internal policies and procedures, defining and approving business security requirements and policies for information technology, and preparing information required to be filed or otherwise provided to regulators.” *Id.*

computers, tablets, mobile devices, and the Internet for the purpose of allowing the crowd to invest collectively through the funding portal platforms.¹²⁶ Accordingly, funding portals play a key and indispensable role in equity-based crowdfunding transactions.

Additionally, the Proposed Rules require that a funding portal provide channels of communication on its platform that can be viewed by the entire general public, but that limit the ability to post comments to only those persons who have opened accounts with the funding portal.¹²⁷

2. Monetizing the Funding Portal Platform

For some intermediaries, registering as a funding portal is not an attractive alternative to broker-dealer registration or operating reward-based crowdfunding platforms like Kickstarter. For example, Title III of the JOBS Act does not clearly set forth the fees funding portals may charge for their services.¹²⁸ Furthermore, reward-based crowdfunding Web sites have already successfully maneuvered around registration as a broker-dealer.¹²⁹ Additionally, new section 3(a)(80) prohibits funding portals, but not brokers, from offering investment advice, soliciting investors to purchase securities on their platforms, and handling investor funds or securities.¹³⁰

Generally, the Proposed Rules prohibit a funding portal and its management from having any financial interest in a start-up company using their services. More specifically, such persons would be prohibited from receiving a financial interest in the start-up company as a form of compensation for services rendered in connection with an offering in reliance on the crowdfunding exemption.¹³¹ The SEC explains in the Proposed Rules that this requirement is designed to protect investors from conflicts of interest between funding portals facilitating the equity-based crowdfunding transaction and any financial stake in the offerings

126. *Id.* at 66436.

127. *Id.* at 66472.

128. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315 (2012). It is clear that funding portals may not compensate promoters or finders for providing personal identifying information of any potential investor and must prohibit management from having any financial interest in an issuer using its services. *Id.*

129. Because a reward is not a profits interest in the video game start-up project, a reward is not a security. *See* SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (explaining that the test to determine whether a reward in exchange for a donations is a security “is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others”). Broker-dealers are subject to regulation and are authorized to sell securities to investors and to offer investment advice. *See* Drange, *supra* note 104.

130. Jumpstart Our Business Startups Act § 3(a)(80).

131. Crowdfunding, 78 Fed. Reg. at 66460.

that said funding portals may have.¹³² However, the Proposed Rules do permit a funding portal to compensate a person for directing start-ups or potential investors to the funding portal's platform, if the person does not provide the funding portal with the "personally identifiable information" of any investor.¹³³ The Proposed Rules define "personally identifiable information" as "any information that can be used to distinguish or trace an individual's identity, either alone or when combined with other personal or identifying information that is linked or linkable to a specific individual."¹³⁴ Furthermore, unless such person is a registered broker, they are not given any transaction-based compensation.¹³⁵

Furthermore, when engaging an investor to use its platform by opening an account, a funding portal must clearly disclose the manner in which it will be compensated in connection with an offering relying on the crowdfunding exemption.¹³⁶

Video game talent agencies and consulting firms, such as Digital Development Management, are a trending phenomenon in the video game industry that should consider registering as a funding portal pursuant to Title III of the JOBS Act.¹³⁷ Video game talent agencies not only match game development companies with elite programmers, they also assist in structuring multimedia deals between publishing and start-up companies and matching companies with third-party financiers.¹³⁸ Accordingly, registering as a funding portal would be a natural progression for video game talent agencies as they already participate in the capital markets of the video game industry. Furthermore, because some video game talent agencies have established networks of venture capitalists and angel investors, it would also be plausible to see such agencies participate in accredited crowdfunding as private placement portals.

132. *Id.* at 66461.

133. *Id.* at 66477.

134. *Id.* at 66477-78.

135. *Id.* at 66477.

136. *Id.* at 66468.

137. Barnes, *supra* note 107 (explaining that video game agents are classified in two categories: first, the "broad Hollywood agencies that extrapolate their movie and television approach to the pinnacle of the video-game business [and] on the other end of the spectrum are scrappy, under-the-radar companies like Digital Development Management . . . that focus solely on video games").

138. *Id.*

3. The Burden of Registration and Compliance

Funding portals and brokers must register with the SEC and any applicable self-regulatory organization (SRO). A funding portal would be required to register with the SEC, disclosing information similar to that required for broker-dealers, but in a streamlined and less extensive format. Currently, the Financial Industry Regulatory Authority (FINRA) is the only national SRO registered under section 15(a).¹³⁹ Thus, all registered funding portals will be required to register with “a similar system, if created,”¹⁴⁰ and become subject to its unreleased funding portal rules, in addition to SEC registration requirements.¹⁴¹ Furthermore, the Proposed Rules, and likely the rules promulgated by FINRA, would require funding portals to have fidelity bond coverage at a minimum of \$100,000.¹⁴² In the Proposed Rules, the SEC explains that, subject to certain exceptions with regard to sensitive information, the information that a funding portal provides shall be accessible to the public.¹⁴³

Once registered, funding portals must comply with numerous disclosure and due diligence requirements for each crowdfunding transaction effected on their platform. For example, the funding portal must take measures to prevent fraud, not handle investor funds or securities, ensure that all offering proceeds are only provided to the issuer when the target amount is reached or exceeded, allow the investors to cancel their commitments to invest, and ensure that investor caps are not violated.¹⁴⁴ The Proposed Rules require that a funding portal have a reasonable belief that a start-up company complies with all relevant

139. Securities Exchange Act of 1934 § 3(a)(26), 15 U.S.C. § 78s(a)(1) (2012) (explaining that an SRO is “any national securities exchange, registered securities association, registered clearing agency”). “[T]he JOBS Act does not limit the FINRA rules applicable to registered broker-dealers engaging in crowdfunding activities.” *Regulatory Notice 12-34*, FINRA (July 2012),

<http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p131268.pdf>.

140. Crowdfunding, 78 Fed. Reg. at 66428, 66442 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

141. On January 10, 2013, FINRA provided prospective funding portals with a form for voluntarily submitting information on a confidential basis, free of charge. According to FINRA, such voluntary submission will help FINRA understand the funding portal community and develop rules specific to funding portals. The form requests information from the prospective funding portal such as details about the portal and a description of how the funding portal intends to maintain compliance with the requirements set forth in the JOBS Act. The form also requests information regarding investor education, the risk of fraud, adherence to the aggregate selling limits, and protection of the privacy of information collected from investors. *See Interim Form for Funding Portals*, FINRA, <http://www.finra.org/Industry/Issues/Crowdfunding/P197635> (last visited Oct. 9, 2013).

142. Crowdfunding, 78 Fed. Reg. at 66478, 66482 n.549.

143. *Id.* at 66459.

144. *Interim Form for Funding Portals*, *supra* note 141.

regulations and has systems in place to keep accurate records of investors.¹⁴⁵ Furthermore, a funding portal may rely on the representations of the start-up company, absent actual knowledge that the representations are not true.¹⁴⁶ If a funding portal does not have a reasonable basis for believing a start-up company's representations, it must deny access in order to prevent a potential for fraud.¹⁴⁷ The Proposed Rules also require that a funding portal conduct a background and securities enforcement regulatory history check on each start-up company that intends to use its platform; this requirement also applies to the start-up company's management and 20%-beneficial owners.¹⁴⁸

Additionally, the Proposed Rules provide that a start-up company issuer may rely on efforts that a funding portal makes in order to determine whether investors are in compliance with the relevant investor limitations.¹⁴⁹ However, funding portals are permitted to rely on investors' representations that they are in compliance with the investor limitations.¹⁵⁰

Funding portals also have a duty to ensure that each investor understands the investor-education information given to them and that the prospective investors are risking the loss of their entire investment.¹⁵¹ Furthermore, under the Proposed Rules, funding portals have a duty to keep the investor education materials current.¹⁵² Funding portals must also obtain representations from investors prior to accepting any commitment that the investor has reviewed the education materials and understands the risks; the Proposed Rules give each funding portal discretion to develop its own form of questionnaire to elicit these representations.¹⁵³

145. *Id.*

146. Crowdfunding, 78 Fed. Reg. at 66462.

147. *Id.* at 66461.

148. *Id.* at 66463. The SEC explains further that if during an offering a funding portal becomes privy to certain disqualifying information with regard to the start-up, the funding portal must promptly cancel the offering and return any committed funds to investors. *Id.*

149. *Id.* at 66434 (explaining that a start-up company issuer may only justifiably rely on the efforts of a funding portal in the absence of knowledge that investor limitations had not been or would not be exceeded as a result of the offering made pursuant to the crowdfunding exemption).

150. *Id.* at 66466.

151. *Id.* at 66465. The educational material must be in plain language and otherwise drafted to provide effective communication to the prospective investors. *Id.* at 66465-66. The content includes, among other things, information about the process of offering, investment risks, and illiquidity. *Id.* at 66466-77.

152. *Id.* at 66467. For example, a change in the types of offerings conducted on a funding portal's platform could invoke a duty for a funding portal to update its investor education materials. *Id.*

153. *Id.* at 66471.

Lastly, funding portals must protect the privacy of the information collected from investors.¹⁵⁴ Considering the breadth of the disclosure and administrative requirements for funding portals to maintain compliance with federal securities laws and the lack of clarity as to how to monetize a platform, many prospective intermediaries will opt to participate in the reward-based model of crowdfunding in spite of the new crowdfunding exemption.

Even though the registration requirements have been lessened under the crowdfunding exemption (because of the small sums of money involved in securities issuances), the costs of due diligence and compliance make crowdfunding impractical for some start-up company issuers and intermediaries. The new exemption may have some value for offerings upwards of \$250,000, as the issuer may be able to justify transaction costs and employ professionals to allay liability concerns. Still, the Proposed Rules offer a safe harbor provision for certain insignificant violations of procedural or disclosure requirements that arise during the facilitation of an equity-based crowdfunding transaction.¹⁵⁵ Additionally, the funding portal may be able to extract higher fees, but as the potential offering amount increases, the use of an alternative federal exemption becomes more plausible.

III. ACCREDITED CROWDFUNDING AND THE VIDEO GAME INDUSTRY

Before the JOBS Act mandated the crowdfunding exemption, there were several existing exemptions to the federal securities registration requirements available to start-up companies. For example, as an alternative to crowdfunding, start-up companies may use the exemption set forth in Rule 506(b) of Regulation D to raise money. In recent years, annual fundraising efforts from Rule 506(b) private offerings have totaled almost \$1 trillion.¹⁵⁶ These results were achieved despite a

154. For example, the JOBS Act prohibits portals from using personal information to target ads to investors, a tactic frequently employed by consumer Web sites like Google and Amazon. Drange, *supra* note 104.

155. Crowdfunding, 78 Fed. Reg. 66428, 66496 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

156. Notably, this amount almost equals the proceeds obtained from all SEC registered offerings combined. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44771, 44773 (July 24, 2013) (to be codified at 7 C.F.R. pts. 230, 239, 242), <http://www.sec.gov/rules/proposed/2012/33-9354.pdf> (citing VLADIMIR IVANOV & SCOTT BAUGUESS, CAPITAL RAISING IN THE U.S.: AN ANALYSIS OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION, 2009-2012 (Feb. 2012), available at http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf).

regulatory structure that, prior to the JOBS Act, prohibited the use of general solicitation and advertising.¹⁵⁷

Generally, Title II of the JOBS Act directed the SEC to amend Rule 506 to permit general solicitation and advertising for securities offerings made pursuant to the new Rule 506(c) exemption and to create a new private placement intermediary that allows for crowdfunding.¹⁵⁸ The following Subparts discuss Title II of the JOBS Act and how it impacts issuers, investors, and intermediaries in the video game industry.

A. *Before Title II of the JOBS Act*

Rule 506(b) offerings are primarily limited to accredited investors, and prior to the JOBS Act, Rule 506 prohibited start-up companies from engaging in general solicitation or advertising in connection with securities offerings.¹⁵⁹ Instead of advertising a private placement, some companies undertaking private capital-raising activities were able to access a larger group of potential investors by engaging a registered broker-dealer that had preexisting relationships with accredited investors.¹⁶⁰ However, this alternative might not have been available to a start-up company if it were undercapitalized and too early in its development.

Additionally, Rule 506(b) exempts transactions that do not involve public offerings and limits the number of nonaccredited investors to thirty-five.¹⁶¹ Because crowdfunding relies on the participation of the crowd (generally exceeding thirty-five nonaccredited investors and likely constituting a public offering), prior to the JOBS Act, Rule 506 offerings were not practical investment vehicles for the purpose of crowdfunding. This was especially true considering that acquiring funds from people

157. 17 C.F.R. § 230.502(c) (2011).

158. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306, 313 (2012).

159. 17 C.F.R. § 230.502(c). “Although the terms ‘general solicitation’ and ‘general advertising’ are not defined in Regulation D, Rule 502(c) does provide examples of general solicitation and general advertising, including advertisements published in newspapers and magazines, communications broadcast over television and radio, and seminars whose attendees have been invited by general solicitation or general advertising.” Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44773.

160. The SEC has addressed how a broker-dealer acting as a private placement agent can establish a substantial network of preexisting customers such that there would be no general solicitation when an issuer engages that broker to offer its securities. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 77 Fed. Reg. 54464, 54467 n.40 (proposed Aug. 29, 2012) (to be codified at 17 C.F.R. pts. 230, 235) (citing E.F. Hutton & Co. Inc., SEC No-Action Letter, 1985 WL 55680 (Dec. 3, 1985)).

161. 17 C.F.R. § 230.502(b).

with whom the issuer has no preexisting relationship is a critical component of crowdfunding.¹⁶²

Prior to the enactment of Title II of the JOBS Act, online securities offerings to accredited investors pursuant to Rule 506 were permitted only if the issuers avoided nonaccredited investors and did not engage in general solicitation or advertisement. For example, in *IPONET*, the SEC permitted a Web site that was only accessible by accredited investors to post advertisements, prospectuses for public offerings, and private placement memoranda for private offerings (allowing the accredited investors to indicate interest in investing).¹⁶³ Furthermore, in *Lamp Technologies Inc.*, the SEC permitted a similar Web site that charged investors a fee for participating on the site.¹⁶⁴ In each case, *IPONET* and *Lamp Technologies Inc.*, the SEC staff concluded that these activities did not constitute general solicitation or advertising under Regulation D.

B. After Title II of the JOBS Act

Section 201(a)(1) of the JOBS Act directs the SEC to amend Rule 506 to permit an issuer to engage in general solicitation or advertising in a private offering, provided that all purchasers of the securities are accredited investors and the issuer takes reasonable steps to verify that claim.¹⁶⁵ Rule 506(c), as amended by the JOBS Act, also includes a nonexclusive list of methods that issuers may use to satisfy the verification requirement for purchasers who are natural persons. The amended rule also revises Form D to require issuers to indicate whether they are relying on Rule 506(c) of Regulation D, which permits general solicitation or advertising.¹⁶⁶

Section 201(c) of the JOBS Act adds new section 4(b) to the Securities Act. This section provides an exemption from registration as a broker-dealer under section 15(a) of the Exchange Act, with respect to a Rule 506(c) offering, for an intermediary that operates a Web site or platform¹⁶⁷ that facilitates the offer, sale, purchase, or negotiation of

162. President Obama's presidential campaign raised close to \$750 million crowdfunding. Wroldsen, *supra* note 17, at 592-93.

163. *IPONET*, SEC No-Action Letter, 1996 WL 431821 (July 26, 1996).

164. *Lamp Technologies, Inc.*, SEC No-Action Letter, 1997 WL 282988 (May 29, 1997).

165. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44780.

166. Additionally, in implementing Section 926 of the Dodd Frank Wall Street Reform and Consumer Protection Act, the SEC adopted additional amendments to Rule 506 to disqualify issuers and other market participants from utilizing Rule 506 if felons and certain other "bad actors" participate in such an offering. *Id.* at 44771.

167. According to the SEC, "Congress specifically intended to capture social media and Internet websites when it enacted Section 4(b)(1)(A)." See *Jumpstart Our Business Startups Act*:

securities, or that permits general solicitation or advertising in connection with new Rule 506(c) offerings (hereinafter “private placement portal”).¹⁶⁸ An intermediary qualifies for this exemption only if it receives no compensation in connection with the purchase or sale of the securities, does not have possession of customer funds or of the securities transacted and is not disqualified under section 3(a)(39) of the Exchange Act.¹⁶⁹

C. Accredited Crowdfunding and Start-Up Companies

1. The New Rule 506(c) Exemption Is Limited Exclusively to Accredited Investors

Rule 506 is the most popular means for conducting a private placement offering because it permits start-up company issuers to raise an unlimited amount of money and preempts state securities laws that require registration of an offering.¹⁷⁰ In contrast to Rule 506(b), which allows for up to thirty-five nonaccredited investors to participate in the offering, Rule 506(c) is applicable only to accredited investors.¹⁷¹ Because, presumably, most start-up companies would want friends and family to invest in the new business venture, taking advantage of permitted advertisement under the new Rule 506(c) exemption may not be worth excluding these prospective nonaccredited investors.

2. The Risks and Rewards of Advertisement in Connection with Rule 506 Offerings

Pursuant to the removal of the ban on advertising and solicitation in connection with a Rule 506(c) offering, start-up companies may market offerings through newspapers, magazines, e-mail, and the Internet (e.g., Web sites, blogs, Facebook, and Twitter). Therefore, under certain

Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act, SEC. & EXCH. COMM’N (Feb. 5, 2013), <http://www.sec.gov/divisions/marketreg/exemption-broker-dealer-registration-jobs-act-faq.htm>.

168. Securities Act of 1933 § 4, 15 U.S.C. § 77d (2012).

169. *Id.* § 4(b)(1)-(3). Section 3(a)(39) of the Exchange Act provides certain statutory “bad actor” disqualification provisions with regard to membership in a SRO. Securities Exchange Act of 1934 § 3(a)(39), 15 U.S.C. § 78c(a)(39).

170. Securities Act of 1933 § 18, 15 U.S.C. § 77r-1.

171. Under Rule 501, an individual is an accredited investor if they have an individual net worth—or joint net worth with a spouse—that exceeds \$1 million at the time of the purchase, excluding the value of the primary residence of such person. Or, if they have income exceeding \$200,000 in each of the two most recent years, or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year. 17 C.F.R. § 230.501(a) (2012).

circumstances, start-up companies that do not have access to established networks of accredited investors individually or through a broker-dealer have the opportunity to create such networks through their efforts in general advertisement and solicitation. Increased exposure to information about development strategies, budgets, employees, and performance would attract accredited investors to invest in early-state video game companies.¹⁷² For start-up companies that want to engage in staged fundraising, advertising pursuant to the new Rule 506(c) exemption would allow these companies to access larger capital markets by attracting accredited investors.¹⁷³

On the other hand, because the JOBS Act does not alter the anti-fraud provisions with regard to Rule 506 offerings, participants may have reservations about advertising aggressively, if at all. Such reservations may be caused by the risk that any particular form of general advertisement or solicitation may contain a material misstatement or omission that may potentially create liability as mentioned under section 17 of the Securities Act and Rule 10(b)(5) of the Exchange Act. Additionally, start-up companies that have relationships with investment banks and access to developed networks of accredited investors may not need additional advertisement for successful fundraising efforts.¹⁷⁴

172. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44796.

173. In structuring its business, a start-up video game company may opt to model their projects after the typical private equity fund. In the context of the video game industry, "game funds" could be created and expanded pursuant to the new concepts set forth in the JOBS Act as discussed herein. In such a case, hypothetically, an independent game developer would form or sponsor a new company (Newco) as a limited partnership and a general partner as a limited liability company. Newco would then create a wholly-owned subsidiary, an operating company (IP Holdco) which would hold all of the developed intellectual property and proprietary information. IP Holdco would most likely be formed as a limited liability company, in order to facilitate its future sale of IP Holdco, and would be managed by Newco's general partner. The general partner would conduct all of the business activities, day-to-day operations, and administration on behalf of IP Holdco and for the benefit of Newco's limited partners. Specifically, the general partner, in its capacity as manager of IP Holdco, would enter into contracts with programmers and licensors of game engines on behalf of IP Holdco. Under this structure, crowdfunding investors would pool their investments into Newco in exchange for limited partnership interests of Newco. Because all of the working capital is invested into Newco rather than the general partner or IP Holdco, Newco is protected from the liabilities of the general partner and IP Holdco. The independent game developer, or sponsor, can expand this structure by creating additional limited liability companies for the purpose of insulating other unrelated intellectual property from the claims of creditors or litigants. Advantages of using a limited partnership or limited liability company include favorable tax treatment, flexibility, and limited liability.

174. Notably, in the Proposed Rules, the SEC staff discussed the potential pitfalls of noncompliance with an applicable exemption from registering an offering through the use of permitted general advertising and solicitation. The SEC notes that start-up company

3. The Burden of Verifying Accredited Investor Status

In order to rely on Rule 506(c) and avail itself of the ability to engage in general solicitation or advertisement, a start-up company must take reasonable steps to verify that each purchaser is an accredited investor. The burden of verifying that each purchaser is an accredited investor is great, considering that the definition of “accredited investor” in Rule 501(a) includes natural persons and entities that fall within any of eight specific categories in the rule.¹⁷⁵

The SEC’s release regarding the amendments to Rule 506 (Final Rules) indicates that in conformity with its proposed release, the “reasonableness” determination is meant to be an objective determination based on the particular facts and circumstances of each transaction.¹⁷⁶ The Final Rules explain that it would be impractical to mandate a one-size-fits-all verification method because of the numerous ways in which a purchaser can qualify as an accredited investor.¹⁷⁷ To that end, the SEC has noted, in particular, certain factors that may be considered by the issuer in determining what sort of verification would be reasonable under the circumstances. Such factors include

the nature of the purchaser and the type of accredited investor that the purchaser claims to be; the amount and type of information that the issuer has about the purchaser; and the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as a minimum investment amount.¹⁷⁸

The SEC’s Final Rules explain further that the information obtained through analysis of the foregoing factors would assist a start-up company issuer in determining “the reasonable likelihood that a potential purchaser is an accredited investor.”¹⁷⁹ Such a determination would then

conducting a concurrent exempt offering for which general solicitation is not permitted [must ensure] that purchasers in that offering were not solicited by means of the offering made in reliance on [the crowdfunding exemption.] Similarly, any concurrent exempt offering for which general solicitation is permitted could not include an advertisement of the terms of an offering made in reliance on [the crowdfunding exemption] that would not be permitted under Section 4(a)(6) and the Proposed Rules.

Crowdfunding, 78 Fed. Reg. 66428, 66432 (proposed Oct. 23, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249).

175. 17 C.F.R. § 230.501(a) (2012); Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. at 44779.

176. *Id.* at 44778.

177. *Id.* at 44777.

178. *Id.* at 44778.

179. *Id.*

affect the types of “reasonable” steps that a start-up company issuer must take to verify that such purchaser is in fact an accredited investor.

Moreover, after considering the facts and circumstances surrounding the offering, if it appears that the a prospective purchaser is an accredited investor, it would then be deemed reasonable if the start-up company issuer took fewer steps, and in certain instances no further steps, to verify accredited investor status. On the other hand, if, after the start-up company issuer’s consideration of the aforementioned factors, the likelihood of a potential investor meeting the accredited investor standard is relatively low, it would then be reasonable for the start-up company issuer to take more extensive steps to ensure the prospective purchaser is, in fact, an accredited investor. Furthermore, in its Final Rules, the SEC indicated that because the start-up company issuer has the burden to prove its compliance with the verification rule as required for a Rule 506(c) offering, it would be prudent for such a start-up company, and its third-party verification service providers, if any, to retain records regarding the steps taken to verify the accredited investor status of each purchaser.¹⁸⁰ The SEC noted further that if a person who does not meet the accredited investor criteria purchases securities in a Rule 506(c) offering, the issuer would not necessarily lose the ability to rely on Rule 506(c) as long as the issuer took reasonable steps to verify, and had a reasonable belief, that the purchaser was an accredited investor.¹⁸¹

Importantly, in its Final Rules, the SEC added a nonexclusive list of four specific verification methods for natural persons that satisfy the verification requirement of Rule 506(c). First, in verifying whether a natural person is an accredited investor on the basis of such person’s income, a start-up company issuer can satisfy the verification requirement by obtaining and reviewing copies of any Internal Revenue Service form that reports income (e.g., Form W-2, Form 1099, Schedule K-1 of Form 1065, and a copy of a filed Form 1040) for the two most recent years.¹⁸² Second, in verifying whether a natural person is an accredited investor on the basis of net worth, a start-up company issuer can satisfy the verification requirement by reviewing certain documentation evidencing the assets and liabilities of the prospective

180. *Id.*

181. *Id.*

182. *See id.* at 44781.

purchaser from within the prior three months.¹⁸³ In each case, the documentation must be accompanied by a written representation from the prospective investor, and in certain circumstances the investor's spouse, that it is accurate.¹⁸⁴ Third, a start-up company issuer may be deemed to satisfy the verification requirement of Rule 506(c) by obtaining written confirmation (from a registered broker-dealer, a registered investment adviser, an attorney, or a CPA) that the start-up company issuer has taken, within the prior three months, reasonable steps to verify that such purchasers are accredited investors.¹⁸⁵ Lastly, a start-up company issuer may satisfy the verification requirement of Rule 506(c) by obtaining a certification by a natural person that that person qualifies as an accredited investor if, prior to the effective date of Rule 506(c), September 23, 2013, such natural person participated in a Rule 506(b) offering of the start-up company issuer and remains an investor of the issuer.¹⁸⁶

D. Accredited Crowdfunding and Accredited Investors

If reached through effective advertisement, accredited investors may recognize the potential upside in funding the development of a start-up company and then marketing a complete, or near complete, video game development company for sale.¹⁸⁷ Furthermore, because accredited crowdfunding is limited to accredited investors who are deemed to be sophisticated, start-up companies can employ certain favorable provisions in their underlying governance documents that allow for the quick sale of the start-up company after its early stages of development, which is a concept often referred to as an "exit strategy."¹⁸⁸ The utility of

183. *Id.* For assets, such documentation may include bank statements and other statements of securities holdings, CDs, tax assessments and appraisals prepared by independent third parties, and, for liabilities, a credit report from one of the nationwide consumer reporting agencies. *Id.*

184. *Id.*

185. *Id.*

186. *Id.*

187. "A direct consequence of the rapid sales growth and competition in this industry has been that distributors of content (called publishers) have acquired an increasing amount of successful independent developers in the pursuit of the next hit game, as a way to control and retain key creative talent." Ricard Gil & Frederic Warzynski, Vertical Integration, Exclusivity and Game Sales Performance in the U.S. Video Game Industry 3 (Mar. 2011) (unpublished manuscript) (on file online in the Munich Personal RePEc Archive), *available at* http://www4.gsb.columbia.edu/filemgr?file_id=738269.

188. Part of an exit strategy would be to avoid restrictive antiassignment or change of control provisions in license agreements. *See generally* Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH., 62 A.3d 62 (Del. Ch. 2013) (discussing the assignability of intellectual property license agreements in the context of a reverse triangular merger).

an exit strategy in this context and the market for the purchase of a start-up company exist because large video game companies need income and growth opportunities, and therefore are willing to pay a premium for a start-up company with a developed video game title, established revenue stream, and potential to grow. Typically, large video game companies do not want to invest in early-stage development projects for several years without any income to generate dividends for equity holders.¹⁸⁹ Furthermore, it is likely that large video game companies only want the opportunity to obtain control after the initial development phase has been completed, the popularity and market reaction to the game have been proven, and the relationships between talented programmers and the start-up company have been established.

E. Accredited Crowdfunding and the Private Placement Portal

1. Advertisement in Connection with Rule 506(c) Offerings Creates Robust Networks of Accredited Investors

Title II of the JOBS Act creates a new opportunity for intermediaries to facilitate Rule 506 offerings between accredited investors and issuers. Section 201(a)(1) of the JOBS Act directed the SEC to amend Rule 506 to permit general solicitation and advertising for securities offerings made pursuant to the new Rule 506(c) exemption, which makes it easier for start-up companies to inform the public that they are seeking to raise capital through the sale of securities. In an effort to reduce the regulatory burden and cost imposed by Rule 506 offerings, the JOBS Act also provides an exemption from registration as a broker-dealer under section 15(a)(1) of the Exchange Act¹⁹⁰ to intermediaries assisting with offerings pursuant to the new Rule 506(c) exemption.¹⁹¹ In this respect, a start-up company can raise money by

When preparing transfer restriction provisions, indirect transfers by a change in control of a participant should be considered. A change in control may be defined to include (i) a transfer of stock in a venturer by its ultimate parent entity, (ii) a change in management in the venturer in which specified individuals cease to be in control or (iii) a change in control of an ultimate parent entity.

Byron F. Egan, *Joint Venture Formation*, 44 TEX. J. BUS. L. 129, 143 (2012).

189. The concept of structuring a company, from its inception, with a future sale to a larger company in mind has been successfully used in many midstream joint venture transactions. See Arthur J. Wright & Anna Irion, *You Found It, Now What Do You Do with It? Gas and Oil Gathering in New Shale Plays*, 58 ROCKY MT. MIN. L. INST. 5-1, 5-21 to -24 (2012).

190. See *Jumpstart Our Business Startups Act: Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, *supra* note 167.

191. Securities Exchange Act of 1934 §§ 15(a)(1), 3(a)(5)(A), 15 U.S.C. §§ 180, 18c(a)(5)(A) (2012).

advertising to a crowd of accredited investors gathered on a private placement portal's Web site. Furthermore, as discussed in greater detail *infra*, a private placement portal can generate revenue pursuant to coinvestment in the securities offered on its platform and fees charged for the provision of ancillary services.¹⁹²

Additionally, private placement portals benefit from the removal of the ban on general advertising and solicitation because, through effective advertisement, investors are given the opportunity to draw meaningful distinctions between a private placement portal and its competitors.¹⁹³ In theory, a private placement portal that advertises and possess a robust network of accredited investors can charge a higher fee for facilitating Rule 506 offerings.

2. Monetizing the Private Placement Portal Platform

The SEC interprets the term “compensation” broadly in connection with the purchase or sale of securities pursuant to the new Rule 506(c) exemption. The SEC has interpreted “compensation” to include transaction-based compensation and “any direct or indirect economic benefit to the person or any of its associated persons” in connection with the purchase or sale of securities.¹⁹⁴ The receipt of any such compensation by a private placement portal would subject its platform to disqualification from the exemption from registration as a broker-dealer. Thus, the SEC's broad interpretation of “compensation” places a substantial limitation on the ability of private placement portals to monetize their efforts by charging transaction-based fees or creating economic benefits from the transactions taking place on their platform.¹⁹⁵

192. Ancillary services include “the provision of due diligence services, in connection with the offer, sale, purchase, or negotiation of such security, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors” and “the provision of standardized documents to the issuers and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service.” Securities Act of 1933 § 4(b)(3)(A)-(B), 15 U.S.C. § 77d.

193. Under the crowdfunding exemption, start-up company issuers and funding portals cannot engage in unrestricted general solicitation. However, general solicitation is allowed to anyone who accesses the funding portal's Web site. Additionally, the start-up company issuer may not advertise the terms of the offering with the exception of notices that direct investors to the funding portal. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(b), 126 Stat 306, 315 (2012).

194. See *Jumpstart Our Business Startups Act: Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, *supra* note 167 (explaining that “Congress did not limit the condition to transaction-based compensation”).

195. The SEC has also included salary paid to employees to promote, offer, and sell shares of the privately offered funds as compensation to that person in connection with the purchase or

However, according to the SEC, Congress expressly permitted private placement portals to obtain compensation through coinvestment in the securities offered on their Web site platform.¹⁹⁶

Two SEC no-action letters, *AngelList LLC and AngelList Advisors LLC (AngelList)*,¹⁹⁷ and *FundersClub Inc. and FundersClub Management LLC (FundersClub)*,¹⁹⁸ requested relief from the SEC from registration as broker-dealers under section 15(b) of the Exchange Act and may prove instructive to aspiring Rule 506(c) private placement portals.¹⁹⁹ Although each grant of no-action relief was based on unique facts and circumstances, together, these letters address whether a carried interest constitutes transaction-based compensation or economic interest in the transaction as well as the scope of “ancillary services” in the context of a venture capital fund adviser.

In *AngelList*, the SEC granted no-action relief based, in relevant part, on the representation that

AngelList Advisors and any Lead Angel (if applicable), [would] . . . receive compensation equal to a portion of the increase in value, if any, of the investment as calculated at the termination of the investment in the . . . [separate investment vehicle formed for the sole purpose of investing in certain portfolio companies] (*i.e.*, carried interest), and will not receive any transaction-based compensation [a commission or management fee as compensation for its advisory services,]

and therefore would have no “salesman's stake” in any securities transactions.²⁰⁰ The carried interest, as described in *AngelList*, is tied exclusively to the overall profitability of companies and represented compensation for the services and advice AngelList provides to its clients. In *FundersClub*, the SEC granted no-action relief based, in relevant part, on the representation that both FundersClub Inc. and FC

sale of securities, excluding such employees from relying on the exemption from registration as a broker-dealer set forth in Section 4(b) of the Securities Act. *See id.*; *see* FundersClub Inc. and FundersClub Management LLC, SEC No-Action Letter, 2013 WL 1229456 (Mar. 26, 2013) (“[O]nce FundersClub, FC Management or persons associated with them receive compensation or the promise of future compensation, as described in their incoming letter, they will no longer be able to rely on Section 201 of the JOBS Act.”).

196. *See Jumpstart Our Business Startups Act: Frequently Asked Questions About the Exemption from Broker-Dealer Registration in Title II of the JOBS Act*, *supra* note 167 (explaining that for purposes of Section 4(b) of the Securities Act, profits obtained from coinvestment, are permissible forms of compensation). However, the SEC has not given any guidance on the other types of fees permitted (such as listing fees, introductory fees, finder fees, etc.).

197. *AngelList LLC and AngelList Advisors LLC*, *supra* note 27.

198. *FundersClub Inc. and FundersClub Management LLC*, *supra* note 195.

199. *Id.*; *AngelList LLC and AngelList Advisors LLC*, *supra* note 27.

200. *AngelList LLC and AngelList Advisors LLC*, *supra* note 27, at *3, *11.

Management would not receive any transaction-based compensation other than the carried interest for FC Management's "traditional advisory and consulting" services.²⁰¹

It is obvious from the fact that no-action relief was granted by the SEC in both of the above-mentioned letters that receiving a carried interest would not constitute transaction-based compensation; otherwise, registration as a broker-dealer would be required. However, because the SEC has interpreted the term "compensation" under new section 4(b) of the Securities Act broadly, it is likely that a carried interest would be deemed to be either a direct or an indirect economic benefit derived from the offer for sale or sale of securities, even though a carried interest is not considered transaction-based compensation.²⁰² Therefore, a private placement portal that receives a carried interest would subject the platform to the risk of disqualification from the exemption from registration as a broker-dealer.²⁰³

IV. CONCLUSION

A. *Equity-Based Crowdfunding*

Start-up companies that want to issue securities in exchange for start-up capital now have more options than ever. However, start-up companies must give thoughtful consideration to the cost and burden associated with any equity-based crowdfunding effort. The crowdfunding exemption may prove beneficial to start-up companies if the target amount is high enough to justify the fees, risks, limitations, and burden of compliance associated with equity-based crowdfunding, and if the start-up company raises enough money to properly launch a video game title or reach a significant milestone in its production. The crowdfunding exemption's \$1 million cap on investment during any twelve-month period will not deter start-up companies if equity-based crowdfunding

201. With regard to ancillary services provided, FundersClub and FC Management represented that FC Management "exercises any management rights negotiated with the start-up company and provides the start-up company with strategic and networking assistance." FundersClub Inc. and FundersClub Management LLC, *supra* note 195, at *2.

202. Further confusion is added by the fact that in FundersClub, the SEC noted that the represented activities "appear[ed] to comply with Section 201 of the Jumpstart Our Business Act of 2012 ("JOBS Act"), in part because they and each person associated with them receive no compensation (or the promise of future compensation) in connection with the purchase or sale of securities." *Id.* at *2 n.1.

203. Some commenters argue that a carried interest is a coinvestment and is therefore an expressly permitted form of compensation for private placement portals. The basis of this argument is that a carried interest is a form of sweat-equity and therefore representative of a nonmonetary contribution or coinvestment made by the private placement portal.

can be integrated with other sources of fundraising start-up capital. In light of the benefits and despite the drawbacks, this Article concludes that certain start-up companies should put the effort into planning a fundraising effort pursuant to the new crowdfunding exemption.

Funding portals have a new alternative to reward-based crowdfunding with the passage of the crowdfunding exemption. The market for reward-based crowdfunding may be saturated at this point, and the leaders of the new trend in equity crowdfunding have an opportunity to capitalize on the fresh and novel concept of the crowdfunding exemption. Because the level of involvement of the general public is so great, economies of scale may allow a sophisticated intermediary to capitalize on the crowdfunding bubble. Investors also have a great opportunity to realize an upside on their investment pursuant to equity-based crowdfunding. Investors also have access to the Securities Act and Exchange Act that protect them against fraud. Furthermore, investors can participate in an industry and a hobby that is shared by millions of people.

B. Accredited Crowdfunding

Section 201(c) of the JOBS Act makes a new online platform available for matching start-up companies with potential accredited investors. However, the lack of guidance with regard to the proper interpretation and application of these rules presents uncertainty to investors, start-up companies, and private placement portals that need to comply with new Rule 4(b) of the Securities Act.²⁰⁴

The removal of the ban on general solicitation and advertisement in connection with Rule 506(c) offerings also presents opportunities to start-up companies. Moreover, a Rule 506(c) offering may become more plausible upon approaching higher stages, or later milestones, in a company's fundraising strategy. Given the widespread use of the Internet and social media, aggressive and savvy advertisement may generate enough access to accredited investors to incentivize start-up companies to utilize the new Rule 506(c) exemption.

However, problems may arise in the lack of guidance and the uncertainty as to how a private placement portal can monetize the new exemption from registration as a broker-dealer. To date, private placement portals are limited to compensation through fees charged for

204. The term "private placement" refers to "transactions in which the offer and sale of securities by the issuer are exempt from registration under the Securities Act." Gladstone Capital Corp., et al., Notice of Application, 77 Fed. Reg. 40389 n.2 (June 29, 2012).

ancillary services or revenue from coinvestment in connection with Rule 506(c) offerings that use general solicitation or advertisement.

Furthermore, because the majority of video game fans would not qualify as accredited investors, such fans would have more of an opportunity to profit from equity-based crowdfunding, rather than investing in a private offering pursuant to the new Rule 506(c) exemption. However, through the use of effective advertisement, accredited crowdfunding may result in a much higher level of investor activity in the fundraising efforts of start-up companies, in contrast to private offerings made prior to the JOBS Act and pursuant to Rule 506(b).