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Establishing the Legal Framework for Crowdfunding in China

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Abstract

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Crowdfunding is a rapidly growing means of raising capital from a large crowd of people via the internet. In the U.S., Title III of the JOBS Act exempts offerings using crowdfunding from registering with SEC. To implement the statutory exemption, SEC issued Regulation Crowdfunding (Reg CF). Reg CF imposes certain obligations on issuers, investors, and funding portals.

Now in the U.S., offerings using crowdfunding proliferate. Among all these offerings, common stock, debt, and Simple Agreement for Future Equity (SAFE) are the most-issued types of securities. Revenue sharing note becomes a marked type of debt securities. The SAFE is a convertible security that can convert into equity security, in most cases, preferred stock. It is widely used in crowdfunding offerings and has two variants. Meanwhile, it also gives rise to suspicion over its safety, and even SEC's failed attempt to ban its use in crowdfunding offerings. However, its popularity shows no sign of decline.

In contrast, in China, crowdfunding industry used to prosper but now is dying due to regulatory clampdown. To resurrect the industry, two legal loopholes in China Securities Law (CSL) should be corrected. The first is only a modicum of securities are governed by CSL. Notes and SAFEs are outside of CSL's reach. The second is CSL's numeric benchmark for a public offering is neither scientific nor reasonable. But overall, the priority is to provide a statutory exemption for crowdfunding offerings in China. Reg CF and a rich body of relevant cases in the U.S. could be useful for China's rulemaking undertakings in crowdfunding.

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1. Introduction

Crowdfunding, a new and evolving financing method for startups and small businesses to raise money using the Internet, is now a worldwide phenomenon. The basic idea of crowdfunding is to raise money through relatively small contributions from a large number of people[1], i.e., a crowd, who may not be experienced investment experts. In light of current practices, the existing modes of crowdfunding can be categorized into five modes on the basis of what is promised in return for a contribution[2]. These five modes are donation mode, reward mode, pre-sale mode, lending mode and equity mode. They are to be sketched in the following, with the complexity of transaction structure of each mode ascending[3]:

Donation Mode：In this mode, the funders invest in the crowdfunding projects for gratuitous purposes and receive nothing in return.

Reward Mode and Pre-sale mode: These two modes are similar. In the former, the funders will receive a small reward, which could be a T-shirt or hallmarking the funder's name on the credits of the movie funded. In the latter, funders will receive the product that the fundraiser is developing after the product is launched. In such a case, a contribution to the fundraiser resembles pre-ordering a product.

Lending Mode: The lending mode of crowdfunding is also termed Peer-to-Peer (P2P) lending[4], for its bypassing the functioning of banks in the course of lending. In some cases, investors receive interest on the funds they loan. In other cases, they are only paid back their principals[5]. A study suggests that no platform allow lenders to lend directly to borrowers. In fact, P2P lending platforms either: (1) broker loan reimbursements through interest-free investments; (2) broker sale of issuer-backed securities by third parties; or (3) facilitate the origination of loans which are sold as securities to P2P investors

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[1] *See* Belleflamme P, Lambert T, Schwienbacher A. Crowdfunding: Tapping the right crowd[C]//International Conference of the French Finance Association (AFFI). 2011: 11-13.
[2] *See* Bradford C S. Crowdfunding and the Federal Securities Laws[J]. Colum. Bus. L. Rev., 2012, 2012: 1, 10-18;
[3] *See* Hemer J. A snapshot on crowdfunding[R]. Working papers firms and region, 2011, 9.
[4] *See* http://www.ukcfa.org.uk/what-is-crowdfunding. The UK Crowdfunding Association, or UKCFA, was formed in 2012 by fourteen crowdfunding businesses.
[5] *Supra* note 3.

who act as lenders[6]. The P2P lending sites can be either for-profit or non-profit[7].

Equity Mode: The equity-based crowdfunding is the most complicated form in the family of crowdfunding. Crowdfunding investors purchase equity secureities in this mode. Their returns could be a combination of the following: shares of the venture, dividends, and voting rights[8].

Both the lending mode and the equity mode may involve issuances of securities[9]. The distinction is securities issued in lending mode are debt instruments with fixed returns, while equity securities, such as common stock or preferred stock, are issued in the equity mode. Returns in the equity mode is contingent on the operation of fundraisers' firms or projects[10], and the funders in equity mode can exercise control over their invested projects if the securities they purchased are attached voting rights.

As indicated by an industry report, equity crowdfunding raises the largest amount of funds per project among all crowdfunding modes. 21% of equity crowdfunding projects raise over $250,000, which significantly outnumbers the average amount raised by other types of crowdfunding, whose fundraising amount on average is less than $10,000[11]. Meanwhile, the report also stated that equity crowdfunding, growing at an 114% compound annual growth rate in 2011, is the fastest-growing type of all crowdfunding categories.

As more and more investors and entrepreneurs become interested in investing and financing through equity crowdfunding, platforms come forward to intermediate transactions between interested investors and fundraisers. For instance, Wefunder, a leading crowdfunding platform, lobbied U.S. congress to

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[6] *See* Ian Galloway, Peer-to-peer lending and community development finance[J]. Federal Reserve Bank of San Francisco Working Paper, 2009-06: 2, https://www.frbsf.org/community-development/files/wp2009-06.pdf

[7] For instance, Lending Club and Prosper typify the for-profit lending sites, and Kiva is the leading non-profit lending site.

[8] *Supra* note 4.

[9] The definition of securities provided by Securities Act is very broad, including without limitation, "notes", "bonds", "debentures", and "evidence of indebtedness." See Securities Act § 2(a)(1). The scope of this definition is predicated on federal securities law, in particular, SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

[10] Feller J, Gleasure R, Treacy S. Crowdfunding: Past Research, Future Directions[J], 2013, available at http://opennessandtransparency.net/sites/default/files/2013_TOTO_Crowdfunding_Seminar_Report.pdf.

[11] See Massolution, Crowdfunding Industry Report: Market Trends, Composition and Crowdfunding Platforms (Abridged) (May 2012), available at http://www.crowdsourcing.org/document/crowdfundingindustry-report-abridged-version-market-trends-composition-and-crowdfunding-platforms/14277("Massolution").

provide an exemption for crowdfunding transactions from registration with SEC in 2012. Some online funding platforms engaging in private placements of securities were also paying attention to the burgeoning crowdfunding market[12].

In response to this trend, the U.S. Congress passed the Jumpstart Our Business Startups Act (JOBS Act). Title III of the JOBS Act adds a new section 4(a)(6) to the Securities Act of 1933. This section exempts the crowdfunding offering with an offering amount no more than $1 million from registering with SEC and mandates SEC to make rules implementing the crowdfunding exemption.

In 2013, SEC promulgated its proposed rules on crowdfunding exemption. And two years later, in October 2015, SEC eventually issued its long-awaited final rules of Regulation Crowdfunding ("Reg CF"), effective on May 16, 2016. Reg CF does not limit the type of securities issued using the crowdfunding exemption to equity securities. Under Reg CF, equity, debt, and convertible securities are all allowed to be offered by issuers. Hence, Reg CF transcends the bounds of equity crowdfunding, and makes the broader securities-based crowdfunding the normal.

Since the effective date of the Reg CF, there are more than 2,800 offerings of securities under the crowdfunding exemption, and the total amount raised now surpasses $440 million[13].

In March 2020, SEC proposed an overhaul to private placement exemptions in the U.S., including varuious amendments to Reg CF. In November 2020, SEC issued the final rule[14], which will take in early 2021. Under amended Reg CF, offering limit within 12 month now is $5 million, 5 times the origional $1 million limit. As such, issuers can use offerings under Reg CF raise much more capital. It is reasonably forseeable that the burgeoning crowdfunding industry would be further fuled by this increase in offering limit.

This article examines and compares legal frameworks and practices of crowdfunding in the U.S. and China. The rest of this article has four sections.

The first sections sumamries the legal framework in the U.S.. Prior to the addition of section 4(a)(6), i.e. crowfunding exemption, to the Securities Act,

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[12] For instance, Republic, another leading crowdfunding platform, is a spin-off of AngelList, a funding platform engaging in private placements of securities.

[13] *See* https://cloud1.worldtv.io/fmi/webd/nextpitchbigpic. This website crawls data from crowdfunding portals.

[14] *See* https://www.sec.gov/news/press-release/2020-273.

private issuers rely on exemptions such as Regulation D, especially Rule 506 to sell securities. Various requirements imposed by Reg CF on issuers, investors and funding platforms, and significant amendments to Reg CF in November 2020 are to be sketched.

The second section examines practices of offerings under Reg CF in the U.S.. At first the percentage of each type of security offered in Reg CF offerings is calculated. The finding is common stock, debt and Simple Agreement for Furure Equity ("SAFE") are consistently the most-issued types of securities. Then contratual terms of stock, debts, convertible notes and SAFEs are explored. The focus is particular on provisions in relation to voting rights and economic interests of each type of security. Further, the risks posed by SAFE to investors are discussed.

The third section first discusses the legal framework and rulemaking effort regarding equity crowdfunding in China. Then this section surveys how crowdfunding portals in China used to operate. Subsequently, the section goes to discuss how regulatory action taken by CSRC led to the demise of equity crowdfunding in China.

The fourth Section proposes a legal framework to revive China's dying crowdfunding industry. Two loopholes of China Secuties Law ("CSL") should be resolved. The first is only a small group of securities are governed by the CSL. Promissory Notes, convertible notes, and SAFEs are securities frequently issued in crowdfunding offerings in the U.S. However, the issuances of all of them are not governed by CSL. This loophole will preclude investors of these securities from the protections provide by CSL. This article suggests that the crowdfunding offerings in China should extend from equity securities to equities, debts, and convertibles. To serve this end, an encompassing range of securities should be governed by CSL. Second, the arbitrary numeric cutoff to determine a public offering in CSL is unreasonable. By looking to the definition of securities and public offering in the U.S., this article proposes amending these two loopholes in CSL. But above all, the section comes up with a framework of a crowdfunding exemption in CSL and proposes the principles of its implementing rules.

2. The Regulatory Framework of Crowdfunding in the U.S.

Securities Act of 1933 ("Securities Act or 33 Act") and Securities Exchange Act ("Exchange Act or 34 Act") are two pillars of the U.S. securities regulation regime. Securities Act regulates offerings and sales of securities in the primary market, while Exchange Act regulates transactions of securities in the secondary market.[15] The core idea of securities regulation in the U.S. is mandatory information disclosure[16] and restrictions on fraud, manipulation, and insider trading[17].

2.1 Pre-JOBS Regulation

In the U.S., an issuer intending to offer to sell or sell securities in the public market should file a registration statement with SEC[18] or find an exemption from the registration requirement[19]. The cost of preparing for and filling a registration statement, including legal fees, accounting fees and registration fee and printing fee, could be very high[20]. The costly registration

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[15] A primary is a market where new securities are issued. A secondary market is where securities already issued are traded. For a good general survey of the U.S. federal securities regulation, please see John C. Coffee Jr., Hillary A. Sale, and M. Todd Henderson, Securities Regulation: Cases and Materials, 13th ed. (St. Paul, MN:
West Academic, 2015), 56-69.

[16] See e.g., Primary Markets and the Securities Law: Capital-Raising and Secondary Trading, Donald Langevoort, 2017, at 6. available at https://capital-markets.law.columbia.edu/sites/default/files/content/docs/donald_langevoort-_final_draft.pdf. This article argues securities offerings poses a classic "lemon problem"- investors shop for investable securities while promoters possess private information about the quality of their ventures. In response, Securities Act tries to solve this problem by requiring mandatory, credible disclosure of information.

[17] See THE ESSENTIAL ROLE OF SECURITIES REGULATION, 55 Duke L.J. 711, at 733, arguing securities law "by adopting the restriction on insider trading, entrusts information traders with the role of providing efficient and liquid markets. As a result, securities regulation, through disclosure duties and restriction on fraud and manipulation, minimizes the costs and risks that information traders bear."

[18] Section 5(c) of Securities Act bars an issuer from offering to sell or selling a security until a registration statement has been filed with the SEC. U.S.C. § 77e(c). Section 5(a)(1) of the Act prohibits sales of a security until the registration statement of that security has become effective. U.S.C. § 77e(a)(1).

[19] Section 4 (U.S.C. § 77d) of Securities Act provides exemptions from the registration requirement in Section 5.

[20] For a deal value between $25m to $99m, the total of legal fees, accounting fee, registration fee, printing fee can be as high as over $7.4m. See

process prevents small businesses from selling their securities in the public market, forcing them to look for affordable exemptions under which they can issue securities at lower costs.

Securities Act provides some exemptions for issuers to make offering without registering with the SEC. These exemptions include[21] Section 4(a)(2) of Ssecurities Act, which provides an exemption for private offerings[22]; Regulation D under Securities Act[23], including Rule 504 to Rule 506; and Regulation A[24].

However, all the exemptions are to some extent inapplicable to startups and small businesses, for their exacting requirements on the qualification of issuers and fundraisers, and significant compliance costs. For instance, Section 4(a)(2) only exempts offerings not involving any public offering. The exact meaning of a "public offering" is not defined in the statute, but was decided by a Supreme Court case, which will be discussed later. If a startup intends to raise capital from a large group of investors, the Section 4(a)(2) may not apply. Regulation A requires issuers file Form 1-A with SEC. The burden and cost for preparing and filling a Form 1-A is substantial[25], which could discourage startups from using this exemption. Hence, startups and small businesses faced difficulties finding a viable means to raise capital.

Among all the Pre-JOBS available exemptions, the most important one is Rule 506 of Regulation D[26]. It imposes no limitation on the maximum aggregate offering amount using this exemption. Under Rule 506(b)[27], an issuer can offer securities to an unlimited number of accredited investors[28] and up to

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https://www.pwc.com/us/en/services/deals/library/cost-of-an-ipo.html.

[21] See e.g., Bradford C. Steven, Crowdfunding and the Federal Securities Laws[J]. Colum. Bus. L. Rev., 2012, 1, 44-49, naming Section 4(a)(2), Section 4(a)(5), Rule 504, Rule 505, Rule 506 as possible alternatives for small businesses to issue securities.

[22] 15 U.S. Code § 77d(a)(2).

[23] 17 CFR §§ 230.500 - 230.508.

[24] 17 CFR §§ 230.251 - 230.263.

[25] See Rutherford B Campbell, Jr., Regulation A: Small Businesses' Search for "A Moderate Capital", 31 Del. J. Corp. L. 77 (2006), 104-106 (noting the disclosure requirements of Form 1-A are burdensome for small businesses).

[26] SEC estimated offerings under Rule 506(b) in 2019 amounted to $1,492 billion, under Rule 506(c) $66 billion, by contrast, under Rule 504 only $0.228b, under Reg A: tier 1 $0.044 billion and Reg A: tier 2 $0.998 billon. Source: Table 4 -Overview of amounts raised in the exempt market in 2019 https://www.sec.gov/rules/final/2020/33-10824.pdf

[27] 17 CFR § 230.506(b).

[28] Rule 501(a) of Regulation D's definition of "accredited investors" includes: (1) affluent natural people, such as a natural person with income exceeding $200,000 or joint income with a spouse exceeding $300,000 for a certain period; a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million with some

35 non-accredited investors. These non-accredited investors should be sophisticated. However, under Rule 506(b), an issuer is unable to make general solicitation or general advertising [29], and should provide non-accredited investors with information that are generally the same as that disclosed in a registration statement, including financial statements[30].

Under Rule 506(c)[31], if all investors participating in a Rule 506 offering are accredited investors, the limitation on the number of purchasers, the requirement of disclosures and sophistication are excused. Rule 506(c) further unfetters the Rule 506(b)'s prohibition on general solicitation or general advertisement, provided all the purchasers are accredited investors, or the issuer takes steps to verify the purchasers' status as accredited investors. But the issuers under Rule 506 is still required to file Form D with the SEC, which incurs costs on issuers.

Some Internet funding portals, such as AngelList and Fundersclub, make use of the Rule 506 exemption to chanel offerings initiated by startups to accredited investors. For instance, AngelList Ventures states in its terms of service that investors on the site should qualify as accredited investors [32]. Fundersclub also requires interested investors to verify their status as accredited investors when siging up[33].

To verify an investor's status as accredited, Angelist pre-screens investors by asking their annual income, assets, and investment sophistication[34]. Meanwhile, they also pre-screen fundraisers by asking their financial healthiness and quality of projects. This pre-screening process precludes participation of small startups and investors. In addition, it is difficult for startups and small businesses to make attractive pitches to accredited investors,

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conditions; ….(2) institutional investors, such as a charitable organization, corporation or partnership; a bank, insurance company, registered investment company, business development company or small business investment company... 17 CFR § 230.501.

[29] 17 CFR § 230.502(c).

[30] 17 CFR § 230.502(b).

[31] 17 CFR § 230.506(c).

[32] See https://angel.co/terms, in its introduction, the terms indicate "if you are using the site as an Investor, you must qualify as an Accredited Investor, … and be sophisticated enough to protect your own interests."

[33] See https://fundersclub.com/how-it-works/, "In compliance with SEC regulations, you will need to verify that you are an accredited investor in order to invest on our platform."

[34] AngelList asks investors to complete a "accredited investor questionnaire" before they can purchase securities offered on this site under Rule 506. The questionnaire requires individual investors satisfy the minimum requirement of a natural person accredited investor with respect to net assets, annual income, or amount in investments, and upload evidence to verify their status as accredited investors. See https://angel.co/accreditation

to verify all their securities' purchasers as accredited investors, or to pay the costs incurred by the filing of Form D and charged by the portals.

2.2 Post-JOBS Regulation

2.2.1 Section 4(a)(6) of 33 Act and Regulation Crowdfunding

The JOBS Act is a monument for the development of crowdfunding industry in the U.S. To facilitate the financing for startups and small business of the U.S. Title III of the JOBS Act provides crowdfunding transactions with an exemption from registering with the SEC by adding Section 4(a)(6) to the Securities Act. This section provides that an offering of securities is exempted from registration if the offering meets the following requiremrnts: (1) the amount of the offering raised must not exceed $1 million within a 12-month period[35] and (2) individual investments within this period are limited to: (a) the greater of $2,000 or 5 percent of the investor's annual income, if annual income of the investor is less than $100,000; and (b)10 percent of annual income (not to exceed $100,000), if the investor's annual income is $100,000 or more; and (3) transactions must be conducted through an intermediary that either is registered as a broker or is registered as a new type of entity called a "funding portal [36] ". Congress further mandated the SEC to lay down detailed implementing rules.

In implementing this Congressional mandate, SEC promulgated its proposed rules in October 2013. The proposed rules addressed the regulatory framework by imposing disclosure duty on issuers, certain duties on the platforms and funding portals such as duty against fraud, and the upper limit of investments on investors.

In October 2015, two years after the publicity of the proposed rule, SEC issued its long-awaited final rule to regulate all issuances of securities under the crowdfunding exemption, including issuances of both equity and non-equity securities, which has taken effect on May 16, 2016. The final rule, also known as Regulation Crowdfunding[37], imposes various duties on companies and

[35] On March 31, 2017, SEC increased the upper limit of offerings to $1.07 million to account for inflation as required by the JOBS Act. 17 CFR§227.100(a)(1)
[36] 15 U.S. Code § 77d 4(6).
[37] 17 C.F.R §227.100-§227.503.

platforms, and upper limit of investment on investors[38].

1. Limits on Investors' investment amount

Reg CF put limits on how much each investor can invest in crowdfunding offerings on his/her annual income or net worth. If either the investor's annual income or net worth is less than $107,000, the limit equals the greater of $2,200 or 5% of the lesser of his/her annual income or net worth. If both the investor's annual income and net worth are at least $107,000, then the limit equals 10% of the lesser of his/her annual income or net worth, up to a maximum of $107,000[39].

2. Eligibility of Issuers

Certain companies are not eligible to issue securities under Reg CF. These illegible companies include[40]: non-U.S. companies; companies subject to reporting obligations under Section 13 or Section 15(d) of the Securities Exchange Act[41]; some investment companies; companies that are disqualified under Reg CF's disqualifiers[42]; companies that have failed to conform to the annual reporting requirements under Reg CF during the two years immediately prior to the filing of an initial offering statement (Form C); and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

3. Restrictions on Resale of Securities Issued

Securities purchased by investors Reg CF offerings generally cannot be resold for one year, unless the securities are transferred: (1) to the issuer of the securities; (2) to an accredited investor defined in Rule 501(a); (3) as part of an offering registered with SEC; or (4) to family member of the purchaser, to a trust controlled by the purchaser or created for the benefits of a family member of the purchaser[43].

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[38] See the final rule, please view https://www.sec.gov/rules/final/2015/33-9974.pdf. A good summary of the rule is available at https://www.sec.gov/info/smallbus/secg/rccomplianceguide-051316.htm#6

[39] 17 CFR § 227.100(a).

[40] 17 CFR § 227.100(b).

[41] These sections require publicly listed companies and some companies with numerous public shareholders file periodical reporting forms and forms regarding material change or action of such companies with SEC. 15 U.S.C. 78m or 78o(d)

[42] CFR§227.503(a) "Disqualification provisions"

[43] 17 CFR § 227.501

4. Disclosure by Issuers

Every issuer using Reg CF is required to file Form C, the initial offering statement for crowdfunding offerings, with SEC. Form C contains various items that requires issuers to disclose. Some important items are: information about officers, directors, and owners of 20 percent or more of the issuer; a description of the issuer's business and the use of proceeds from the offering; the price to the public of the securities or the method for determining the price, the target offering amount and the deadline to reach the target offering amount, whether the issuer will accept investments in excess of the target offering amount; a discussion of the issuer's financial condition and financial statements[44].

The extent of disclosing financial statements of the issuers is based on the aggregate amounts of securities sold and target offering amounts under Reg CF within the preceding 12-month period[45]:

(1) For issuers offering no more than $107,000: Financial statements of the issuer and certain information from the issuer's federal income tax returns, both certified by the principal executive officer;

(2) Issuers offering more than $107,000 but not more than $535,000: Financial statements reviewed by a public accountant that is independent of the issuer;

(3) Issuers offering more than $535,000:

For first-time Reg CF issuers: Financial statements reviewed by a public accountant that is independent of the issuer, unless financial statements of the issuer are available that have been audited by an independent auditor;

For issuers that have previously sold securities in reliance on Reg CF: Financial statements audited by a public accountant that is independent of the issuer.

In addition to filing Form C, the issuer is required to file Form C/A to report material changes of the offering[46] and Form C-U within 5 days after an offering reaches its target offering amount. Meanwhile, Issuers that have sold securities under Reg CF also are required to file an annual report on Form C-

[44] 17 CFR § 227.201
[45] 17 CFR § 227.201(t)
[46] 17 CFR § 227.203(a)(2)

AR no later than 120 days after the end of its fiscal year[47].

5. Requirements on Platforms

Every offering under Reg CF must be exclusively conducted through one online platform. The intermediary operating the platform must be a broker-dealer or a funding portal that is registered with the SEC and FINRA[48].

Reg CF require these intermediaries to provide investors with a broad range of educational materials, including the process of the offering, types of securities offered on the platform and accompanying risk of each type of security, restrictions on the resale of securities issued under Reg CF[49]; to take measures to reduce the risk of fraud[50]; to make information about the issuer and the offering publicly available to SEC and investors[51]; to provide communication channels on their platforms to permit investors to communicate with each other and with representatives of the issuer about offerings on the platform[52].

Reg CF requires funding portals facilitating crowdfunding offerings in reliance on the exemption should not offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities offered on its platform; compensate employees, agents, or others for such solicitation or based on the sale of securities displayed or referenced on its platform or portal; hold, manage, possess, or handle investor funds or securities[53].

2.2.2 Amendments to Reg CF

As Reg CF enacted various requirements on the disclosure of information by issuers and services that platforms should provide, the cost of compliance could be substantial[54]. Thus, SEC's rulemaking responsibility for crowdfunding is far from over.

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47 17 CFR §227.202; §227.203(b)(1)
48 17 CFR §227.100(a)(3)
49 17 CFR § 227.302(b)
50 17 CFR § 227.301
51 17 CFR § 227.303(a)
52 17 CFR § 227.303(c)
53 17 CFR § 227.402 (a)
54 *See* Steven Bradford C. (2018) The Regulation of Crowdfunding in the United States. In: Cumming D., Hornuf L. (eds) The Economics of Crowdfunding. Palgrave Macmillan, Cham. https://doi.org/10.1007/978-3-319-66119-3_9

In March 2020, SEC proposes substantial amendments to Regulation CF seeking to "address the gaps and complexities in the offering framework that may impede access to capital for issuers[55]". In November 2020, SEC issued the final rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets[56], which will become effective in early 2021.

This set of rules make various amendments to Reg CF, Reg A and Reg D. Amendments to Reg CF are particularly substantial.

First, the final rule raises the offering limit within 12 months from $1.07 million to 5 million[57]. As $5 million surpasses the authorization of Section 4(a)(6) of the Securities Act, SEC uses its general exemptive authority under Section 28 of the Securities Act[58] to justify the raise in offering limit.

Second, the final rule removes investment limit on accredited investors[59]. In other words, accredited investors can invest any amount they desire in an offering under Reg CF. Meanwhile, the calculation method for investment limits on non-accredited investors is revised from "the lesser of annual income or net worth" to the greater of their annual income or net worth[60].

Third, the final rule adopts Rule 3a-9 under the Investment Company Act to introduce the "crowdfunding vehicles" that act solely as conduits for investors to facilitate investing in issuers seeking to raise capital through a crowdfunding vehicle.[61] The vehicle can beneficially hold the securities issued under Reg CF, and thus appear on an issuer's cap table as a single line-item entry, avoiding the "messy cap table problem". Meanwhile, a vehicle counts as one investor for the purpose of reporting thresholder under Section 12(g) of the Exchange Act. This messy cap table problem and section 12(g) reporting

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[55] *See* statement entitled "Harmonizing, Simplifying and Improving the Exempt Offering Framework" by SEC chairman Jay Clayton issued on March 4, 2020, para. 3, available at https://www.sec.gov/news/public-statement/statement-clayton-harmonization-2020-03-04.

[56] 17 CFR Parts 227, 229, 230, 239, 240, 249, 270, and 274 [Release Nos. 33-10884; 34-90300; IC-34082; File No. S7-05-20], https://www.sec.gov/rules/final/2020/33-10844.pdf

[57] *Id,* 148.

[58] Section 28 of the Securities Act (15 U.S. Code § 77z–3) provides "The Commission, by rule or regulation, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors." Id, 148.

[59] *Id.*

[60] *Id*, 155.

[61] *Id*, 170-171.

thresholder will be discussed later in the subchapter of SAFE.

Meanwhile, the rule adopts Rule 241 and Rule 206 to allow Reg CF issuers to test the water. Under the new Rule 241, issuers can use generic solicitation of interest materials to test the waters for an exempt offering prior to the determination of which exemption the issuer will use[62]. Rule 206 is specifically provided to Reg CF offerings. The new Rule 206 allows issuers intending to offer securities under Reg CF to publicly solicit potential investors' interest, orally or in writing, prior to the filing of a Form C.

The rule also adopts Rule 148 that allows demo day communication. Under Rule 148, an issuer can make communication in connection with a seminar or meeting sponsored by a college, university, or other institution of higher education, a State or local government or instrumentality of a state or local government, a nonprofit organization, or an angel investor group, incubator, or accelerator[63].

These amendments could make Reg CF more enticing. More companies would choose Reg CF as the exemption to offer securities if their needs for capital are below $5 million. Meanwhile, as some types of general solicitations by issuers are allowed prior to the filling of Form C and issuers can attend meetings and seminars sponsored by angel investor groups, incubators, and accelerators to introduce themselves and their businesses to attendees comprised of experienced investors, the possibility of raising more capital is very likely to increase.

3. Current Practices of Crowdfunding Offerings in the U.S.

After the Reg CF took effect in May 2016, small businesses and startups are eager to utilize this new exemption. On June 30, 2019, only two months after the effective date of Reg CF, there were 50 issuers filling a Form C with SEC[64]. As of the third quarter of 2020, offerings under Reg CF raised $410.5M

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[62] *See* SEC Adopts Final Rules Improving and Harmonizing the Exempt Offering Framework, https://www.natlawreview.com/article/sec-adopts-final-rules-improving-and-harmonizing-exempt-offering-framework

[63] *Supra* note 56, at 88.

[64] https://www.faegredrinker.com/en/insights/publications/2016/7/leading-the-crowd-an-

in total, and the amount raised through such offerings in that quarter was the largest ever among all quarters since 2016[65]. Wefunder, one of the largest crowdfunding portals, alone has helped 435 startups raise more than $130m through Reg CF offerings to date[66].

In this part, first the types of securities offered in offerings under Reg CF are to be discussed. Then the essential terms of contracts accompanying the issuance of each type of security, especially terms with respect to voting rights and economic interests for investors, will be explored. Finally, the risks of SAFE - a special convertible security, will be discussed as SEC attempted to ban its issuance in Reg CF offerings.

3.1 Types of Securities Offered and Amount Raised

In June 2019, SEC issued its official report on offerings under Reg CF. This report surveyed offerings under Reg CF during the period from May 2016 to December 2018[67], and produced valuable observations and results.

SEC estimated that during the considered period, there were1,351 offering launched, and 519 of which were completed. The 519 completed offerings raised $108.2 million in total, with the average being $208,400 and median $107,763[68].

The SEC estimation was lower than some industrial statistics. For instance, Crowdfund Capital Advisors estimated that $194 million was raised during the same period as SEC's report[69]. Another industrial report provided by StartEngine, a leading crowdfunding platform, estimated that as of December 2018, offerings under Reg CF raised $161.5 million in total, $75.8 million of which was raised in 2018[70].

The differences in estimation between SEC and industry reports could

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analysis-of-the-first-50-crowdfunding-offerings.

[65] See https://www.startengine.com/blog/equity-crowdfunding-q3-2020-review/.

[66] See https://wefunder.com/results, accessed October 2020.

[67] *See* Regulation Crowdfunding Report 2019 by SEC, pp.13-14, https://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding/2019Report

[68] Id, p15.

[69] See https://www.crowdfundinsider.com/2019/02/144537-there-are-47-finra-regulated-reg-cf-portals-in-2018-109-3-million-was-raised-using-this-security-exemption/. This report pointed out that in 2018 alone, $108 million was raised.

[70] *See* https://www.startengine.com/blog/equity-crowdfunding-2018-review/

be attributed to different data sources they used[71]. But all these reports reflected the growing use and popularity of Reg CF offerings.

SEC further examined the types of securities issued in Reg CF offerings. In terms of number of offerings, 48% of offerings issued equity securities, 27% debts, 21% SAFEs, and 4% others. In terms of target amount sought, 42% of all target amounts were to be raised by equity, 30% debts, 25% SAFEs, and 3% others[72].

For corporations, equity securities are primarily common stock and preferred stock. For limited liability companies and limited partnerships, equity securities refer to membership units and limited partnership interests. Debts include straight debts and convertible debts that can convert into equity securities. SEC did not provide a breakdown of percentage of each subtype of securities in its report. To delve into the percentage of subcategories of each security further, we collect and analyze the data sourced from SEC filings and provided by crowdfunding platforms.

Table 1: Types of Securities Offered and Amount Raised[73]

[71] Numbers of Reg CF offerings could be collected from Form C filings on SEC EDGAR system by both SEC and industry reports. Form C is the initial offering statemen. If an issuer intends to amend its original Form C, a Form C/A is required to file. An issuer can file multiple Form C/As. For an offering that has been amended, information should be collected from the latest amendment. Meanwhile, Reg CF requires an issuer to file a progress update on Form C-U within 5 business days after reaching 100% of its target offering amount. SEC's data on completed offerings should be collected from all Form C-U fillings.
However, relying solely on information contained in SEC Form C fillings is insufficient. As many offerings in-progress have also raised money but are incomplete, issuers of these offerings will not file Form C-U with the SEC. Meanwhile, as a Form C-U could be filed five days after an offering reaches its target, relying information solely on Form C-U fillings possibly omits the offerings that reached their targets while have not yet filed. Since all offerings under Reg CF should be made on a funding portal, the data collected and web-crawled from funding portals could be more accurate and timelier than data collected solely from SEC filings.

[72] *Supra* note 67, pp. 19-20.

[73] The percentage of each type of securities is calculated by the number of offerings. Apart from the data of securities offered in 2020 Q1, which is directly extracted from SEC data set (https://www.sec.gov/dera/data/crowdfunding-offerings-data-sets), other data is provided by StartEngine report of crowdfunding quarterly review (https://www.startengine.com/blog/equity-crowdfunding-index/). SEC provides structured data containing each item in Form C fillings every quarter and stores these items in six .tsv files. However, SEC datasets mix relevant information from Form C, Form C/A, Form C-U, Form C-AR, Form C-TR (filed when an issuer terminates its annual reporting obligation), and Form C-W (filed when an issuer withdraws from the offering it filed using Form C) into a

Types of Securities offered	2016-2019Q4	2020 Q1	2020 Q2	2020 Q3
Common Stock	29.70%	28.80%	23.90%	20.90%
Debt	22.50%	28.80%	26.60%	25.30%
SAFE	20.90%	23.90%	26.60%	27.50%
Membership Units	8.20%	3.10%	2.30%	5.40%
Convertible Note	8.10%	6.70%	7.80%	13.30%
Preferred Stock	7.90%	6.80%	8.30%	6%
Revenue Sharing Note	2.10%	0.90%	1.80%	
Other		0.9%	2.80%	1.60%
Amount Raised	$282.6M	$33.3M	$48.2M	$72.9M
Count	2099	223	218	316

Source: SEC, StartEngine

Since May 2016, the time when Reg CF took effect, there have been

single .tsv file. What is worse, SEC stores the type of form submitted in the FORM_C_SUBMISSION.tsv, while stores other crucial information, such as types of securities offered, target offering amount, net income of issuers, in FORM_C_ISSUER_INFORMATION.tsv. This arrangement of information complicates data wrangling for locating and assorting needed information. In extracting the data of types of securities offered in 2020 Q1, only information contained in Form C fillings is filtered in, and information contained in other types of forms is disregarded. The SEC data contained 227 Form C fillings in 2020 Q1, 4 more than StartEngine reported. But the SEC data also contains 5 null values, resulting in effective count equaling 222. Meanwhile, the SEC data characterizes non-voting common stock, Class B common stock as different categories from common stock, crowd SAFE, SAFE and SAFE unit as different, too. This categorization is disregarded. All sub-types of common stock, SAFEs and preferred stock are calculated as a single type.

more than 2,800 Reg CF offerings launched. Among all these offering, the most-offered types of securities have been consistent: common stock, debt, and SAFE. Interestingly, As opposed to VC financings in which preferred stocks are typically provided to investors or IPOs in which common stocks are predominantly offered to public investors, in Reg CF offerings, debts and some non-traditional securities are frequently offered.

3.2 Major Contractual Terms of Each Type of Securities

3.2.1 Equity Securities

Major types of equity securities issued in Reg CF offerings are common stock and preferred Stock. Remarkably, common stock is persistently among the most popular securities issued in Reg CF offerings, and outnumbers preferred stock by a landslide. However, to the contrary, in most VC financing, venture capitalists favor preferred stock far more than common stock[74].

Common stock grants investors some rights, including voting rights as stated in the issuer's charter and state corporate law, such as the right to vote in the elections of directors; the right to receive dividends when declared, and the right to approve or veto some fundamental transactions of the issuer, such as a sale of all or substantially all of the issuer's assets or the issuer being acquired by another corporation. Meanwhile, when preferred stockholders exercise their contractually stipulated rights, the board of directors of the issuer only owes fiduciary duties to common stockholders, and the board can fulfill its fiduciary duties to the common stockholders irrespective of the best interests of preferred stockholders[75].

But it seems many investors in common stock offerings under Reg CF do not care much about their voting rights. In fact, in the third quarter of 2020, there were 20 offerings that issued common stock under Reg CF issuing non-

[74] *See* e.g., William W. Bratton, Venture Capital on the Downside: Preferred Stock and Corporate Control, 100 Mich. L. Rev. 891 (2002), at 892 "Convertible preferred stock is the dominant financial contract in the venture capital market, at least in the United States." (footnotes omitted)

[75] See e.g., In re Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013), holding "A board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights. Preferred stockholders are owed fiduciary duties only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock."

voting common stock and Class B non-voting common stock[76], accounting for nearly 1/3 of all Reg CF common stock offerings in this quarter.

In offerings issuing common stock carrying voting rights, there could be in place some limitations on subscribers exercising their voting rights. In fact, terms in many Reg CF common stock offerings include a "voting proxy" provision. This provision requires subscribers to this common stock offering appoint CEO of the issuer as subscribers' proxy and attorney. Then CEO in his/her discretion can vote subscribers' shares on behalf of the subscribers[77].

The inclusion of this provision is ubiquitous in Reg CF common stock offerings[78]. As a matter of practice, investors purchasing common stock of an issuer in pursuance to offering terms with this voting proxy provision in fact transfer their voting rights to the issuer's CEO, and cannot exercise their voting rights *per se*, until the issuer goes public in the future through an IPO.

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[76] Data is sourced from SEC 2020 Q3 crowdfunding data sets. SEC data sets put information from the original Form C and amended Form C/A in one spreadsheet. To avoid overlap, if issuers filed Form C and Form C/A, only information from the latest Form C/A was collected. Non-voting common stock is attached no voting rights. Class B common stock is issued by an issuer that adopts the dual-class stock structure. Under this structure, Class A common stock grants voting rights to founders of the issuer, Class B common stock issued to public investors generally grants no voting rights or voting rights inferior to the Class A common stockholders. The voting rights attached to each class of stock are set out in the issuer's articles of incorporation.

[77] A typical voting proxy provision is:

"Voting Proxy. Each Subscriber shall appoint the Chief Executive Officer of the Company (the "CEO"), or his or her successor, as the Subscriber's true and lawful proxy and attorney, with the power to act alone and with full power of substitution, to, consistent with this instrument and on behalf of the Subscriber, (i) vote all Securities, (ii) give and receive notices and communications, (iii) execute any instrument or document that the CEO determines is necessary or appropriate in the exercise of its authority under this instrument, and (iv) take all actions necessary or appropriate in the judgment of the CEO for the accomplishment of the foregoing. The proxy and power granted by the Subscriber pursuant to this Section are coupled with an interest. Such proxy and power will be irrevocable. The proxy and power, so long as the Subscriber is an individual, will survive the death, incompetency, and disability of the Subscriber and, so long as the Subscriber is an entity, will survive the merger or reorganization of the Subscriber or any other entity holding the Securities. However, the Proxy will terminate upon the closing of a firm-commitment underwritten public offering pursuant to an effective registration statement under the Securities Act of 1933 covering the offer and sale of Common Stock or the effectiveness of a registration statement under the Securities Exchange Act of 1934 covering the Common Stock."

This provision is widely used in Reg CF common stock offerings, especially such offerings on StartEngine. See offering memorandum (Exhibit A to Form C) of Comsero Inc., MF Fire, Inc., Carnot Compression Inc., Hawaiian Ola Brewing Corp. (Form C/A dated 09/30/2020), etc.

[78] In fact, of StartEngine's six in-progress Reg CF common stock offerings raising $1M or more as of early December of 2020, 2 issues non-voting common stock, 3 voting common stock offerings include the "voting proxy" provision, and only 1 offers common stock without limitations on voting rights.

Even in common stock offerings without limitations on voting rights, common stockholders collectively invest $1.07 million - the maximum amount under current Reg CF an issuer can raise, in a corporation valued at $15M, these common stockholders still own a fraction of the corporation and are minority stockholders. As minority, these common stockholders still lack the power to decide the outcomes of elections of directors and other material issues requiring voting of stockholders and have to rely on the existing corporate leadership to manage the corporation.

As terms of preferred stock are stipulated through intensely negotiated and tailored contracts, preferred stock is a contractually created security[79]. But most preferred stocks share something in common: they give the holders some preferences over common stockholders. Preferred stockholders have rights to receive specified dividends ahead of common stockholders. If the board of directors of a company skips declaring and paying dividends, preferred stockholders' claim to unpaid dividends could be cumulative, which means any unpaid dividend will accumulate and the corporation should pay preferred stockholders the accumulated amount of these unpaid dividends before paying any dividend to common stockholders[80].

In addition to this dividend preference, preferred stockholders also enjoy liquidation preferences. Liquidation preferences entitle preferred stockholders to be paid the original investment amount or some multiple of their investments before common stockholders receive any money in liquidation events stated in the preferred stock purchase agreement[81]. The liquidation preferences always significantly exceed preferred stockholders' initial investment amount[82]. The clauses of liquidation preferences always accompany the dividend preference.

Liquidation multiple is one form of preferred stockholders' liquidation preferences. This preference entitles preferred stockholders to receive an amount equal to their initial investment amount × liquidation multiple before

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[79] *See* e.g., In re Appraisal of Metromedia Int'l Grp., Inc., 971 A.2d 893, 899 (Del. Ch. 2009), "A preferred shareholder's rights are defined in either the corporation's certificate of incorporation or in the certificate of designation, which acts as an amendment to a certificate of incorporation. Thus, rights of preferred shareholders are contractual in nature[.]" By contrast, common stockholder's rights are directly provided by state corporate law.

[80] *See* e.g., William W. Bratton & Michael L. Wachter, A Theory of Preferred Stock, 161 U. PA. L. REV. 1815 (2013), 1825; Korsmo, Charles R. "Venture capital and preferred stock." 78 Brook. L. Rev. 1163 (2012), 1171.

[81] *See* Glossary: Liquidation Preference <Practical Law>, https://us.practicallaw.thomsonreuters.com/1-384-7000. Liquidation events include winding-up, change of control of a corporation, merger, consolidation, etc.

[82] *See* Korsmo, supra note 6, at 1173.

any sale or liquidation proceeds are paid to common stockholders[83]. Though can be as high as 3x, according to a report, the proportion of the liquidation multiple preference in all VC financing contracts is as small as 4%[84].

Preferred stockholders can also have participating or non-participating liquidation preferences. The participating preference entitles preferred stockholders to receive a stated liquidation preference in addition to a pro-rata share of any remaining proceeds available to common stockholders on an "as-converted to common stock" basis[85]. By contrast, if the preferred stock is non-participating, then a holder of the preferred stock should choose receiving either the stated liquidation preference or a share of the proceeds in proportion to his or her equity ownership after converting preferred into common stock[86].

Capped liquidation preference will impose a cap on how much a preferred stockholder can receive in liquidation. Under the capped liquidation preference, a preferred stockholder can receive the stated liquidation preference plus a pro-rata share of the remaining proceeds on an as-converted basis. However, there is a cap on the total return the preferred stockholder can receive.

Someone argues that investors' willingness to accept common stock in early-stage financing of startups is due to their lack of sophistication[87]. As concluding a set of preferred stock purchase agreements needs intensive negotiations over some key provisions, such as anti-dilution[88], liquidation preferences, preferred investors' voting rights and information rights. Unsophisticated investors unable to negotiate these complicated terms incline to invest in common stock, whose purchase agreement in early-stage financing consists of much simpler terms such as the stock price and the number of shares

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[83] Assume preferred stockholders invested $3 million in a startup, the startup is acquired for $15 million and the liquidation multiple is 2. Then preferred stockholders will be receive $6 million out of the $15 million proceeds.

[84] WilmerHale, a prestigious law firm, surveyed hundreds of VC financing transactions dated 2014-2019 and found only 4% of VC financing agreements in 2019 included a liquidation multiple. See WilmerHale 2020 Venture Capital Report, https://www.wilmerhale.com/en/insights/publications/2020-venture-capital-report

[85] *i.e.*, as if the preferred stock had converted to common stock, in short for "as-converted basis".

[86] *See* https://www.seedinvest.com/blog/startup-investing/liquidation-preferences

[87] *See* Coyle, John F. and Green, Joseph, Contractual Innovation in Venture Capital, Hastings Law Journal, Vol. 66, p. 133, 2014, at 148.

[88] A dilution refers to a reduction in equity value per share, earnings per share or relative ownership percentage resulting from subsequent equity issuances by a company. *See* Glossary: dilution <Practical Law>, https://ca.practicallaw.thomsonreuters.com/0-504-3650?originationContext=document&scopedPageUrl=Home%2fPracticalLawGlobal&transitionType=DocumentItem&contextData=(sc.Default). An anti-dilution provision protects an equity holder from dilution due to subsequent offering of equity securities.

offered.

However, common stock has a major disadvantage in early-stage financing, including Reg CF financing. The payments to stockholders are subordinated to payments to creditors when a company is liquidated[89]. As preferred stockholders enjoy contractual liquidation preferences over common stockholders, common stockholders could be left with nothing if all remaining proceeds are paid to preferred stockholders.

The emergence of the open-sourcing Series Seed documents provides an accessible, cost-effective set of documents for preferred stock offerings in Series Seed[90]. Using this set of documents can substantially shorten the negotiation process and save legal fees as it sets asides provisions that will only be used in late stage of equity financing and provides standard terms for provisions used in early-stage equity financing, such as a liquidation preference of one time(s)[91] the original issue price plus declared but unpaid dividends. If this set of documents are used more broadly in equity offerings under Reg CF, the percentage of preferred stock could increase.

3.2.2 Debt

Debt securities provide fixed returns to investors. The major type of debt securities issued in Reg CF offerings is promissory note, including term note and revenue share note (RSN) [92].

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[89] Under Section 507 of the Bankruptcy Code (11 U.S. Code § 507), in a liquidation, stockholders are paid behind creditors.

[90] *See* https://www.seriesseed.com/.

[91] The liquidation Preference provision in the term sheet of Series Seed documents is worded as "One times the Original Issue Price plus declared but unpaid dividends on each share of Series Seed, balance of proceeds paid to Common. A merger, reorganization or similar transaction will be treated as a liquidation." Id.

[92] Many Form C filling issuing debts simplistically reported the security it offered as "debt". About half of debt issuers further clarified the type of debt it offered. In 2020 Q3, only one debt issuers reported the security if offered was bond, the rest of debt issuers reported the security if issued was note. But it is still quite confusing as revenue share note is a kind of promissory note and falls within the definition of debt securities, yet it sometimes appeared as a standalone category of security. MainVest, a platform specializing in intermediating projects issuing revenue share notes, helped close 119 projects predominantly offering revenue share note in 2020, roughly accounting for 1/7 offerings initiated (but only a very small fraction of total amount raised). This fact makes the 1.8-2.1% percentage of revenue share note among all securities issued very unreliable. Another funding platform specializing in promoting debt offerings is NextSeed (now was acquired by Republic). Offerings on NextSeed typically issued term note and revenue share note. Meanwhile, the debt instrument promoted by

Revenue share debts, whose basic structure is the investor get repaid a percentage of the issuer's future revenue, have been already used for financing oil and gas companies and in film production, while is relatively new in financing the early cycle of ventures[93].

The fundamental distinction between RSN and term note is that the repayment of RSN is tied with the issuer generating some revenues. If the issuer of RSNs does not generate revenue after the closing of the offering under Reg CF, the repayment will not start[94].

The key provisions of a RSN are the payment multiple and Revenue share percentage. If an investor invests $10,000 in an issuer offering RSN, and the payment multiple is 2, the investor is entitled to be repaid $10,000×2=$20,000 on maturity date. The higher the payment multiple, the greater the investor will be repaid. When the issuer starts to repay, the amount of each payment the investor will receive is the purchaser's share percentage[95]× revenue sharing percentage ×revenue of the issuer generated during the corresponding period.

To further clarify how a RSN works, assume an investor invested $2000 in a RSN offering, and the offering raised $200,000 in total. The investment multiple is 2, and the hypothetical revenue sharing percentage is 5%. Then the investor's share percentage is 1%, and the issuer is entitled to be repaid $4,000 as of the maturity date. The maturity date is 5 years, and the payment is made quarterly.

Table 2[96]

Quarter	Revenue	×Revenue Sharing	Total payment to all	× Investor's	Repayment to the

Wefunder is also revenue share note. Hence, the article addresses term note and revenue share note as major forms of debt securities issued in Reg CF offerings.

[93] See J. Brad Bernthal, The Evolution of Entrepreneurial Finance: A New Typology, 2018 BYU L. Rev. 773, at 791.

[94] The investment contract provided by MainVest defines the sharing start date as the day when the issuer has revenue greater than 1 dollar, and the first payment day as some point in time after the sharing start date. In other words, the RSN would be repaid only after issuer has revenue.

[95] The purchaser's share percentage refers the ratio of the investor's purchase amount of to the total amount raised.

[96] The whole case is hypothetical.

		Percentage	investors	percentage	investor
1	0	5%	0	1%	0
2	$200,000	5%	$10,000	1%	$100
3	$ 400,000	5%	$20,000	1%	$200
4	$ 500,000	5%	$25,000	1%	$250
5	$800,000	5%	$40,000	1%	$400

If the investor receives $2,000 before the maturity date of the RSN, then the issuer's obligation of repayment will be terminated. Conversely, if the investor receives an amount less than $2,000 on the maturity date, then the issuer owes the investor the amount of $2,000 less the amount already paid to the investor.

The advantage of RSN, as touted by MainVest, is to align incentives of both investors and an issuer to generate more revenues for the issuer[97]. The disadvantage is as the amount of repayment to investors is correlated with the issuer's revenue, it could fluctuate, and is unpredictable in some situations such as in the Covid-19 pandemic era.

The following table summarizes the terms of 40 offerings in-progress on MainVest[98].

Table 3: Summary of Terms of RSN Offerings on MainVest

[97] *See* https://mainvest.com/revenue-sharing-notes.

[98] *See* https://mainvest.com/businesses/grid, accessed October 2020. MainVest requires businesses raising funds on the site provide projections of revenue and gross profit in next five years, and balance sheets, if available.

Investment Multiple	1.2-2, median around 1.5-1.6. Sometimes issuers offer higher multiple to early investors. Some issuers offer lower multiple if the debts are repaid in full at a certain period ahead of maturity.
Business's Revenue Sharing Percentage	Percentage of gross revenue. The revenue sharing percentage increases simultaneously with the increase in total amount raised in the offering. Could vary drastically across offerings. As high as 6%-9.6%, as low as 0.3%-1.5% and 0.7%-1.2%, widest range is 0.6%-6%.
Minimum Investment Amount	Typically, 100
Repayment Schedule	Quarterly
Maturity Date	4-10 years

The term note is a traditional promissory note. The term note provides an annualized interest rate, maturity date, and repayment schedule. The note issuers promise to pay back investors principal plus interest in full on the maturity date. As compared to variable payments to investors in the case of RSN, term note's monthly payments to investors are fixed[99].

The following table compares the term note with the RSN.

Table 4: Comparison of Term Note and RSN

Type of Notes	Return on Investment	Payments	Benefits	Downsides

[99] *See* Sample Promissory Note (fixed), National Consumer Law Center, https://www.nclc.org/images/pdf/foreclosure_mortgage/counseling_resources/sample_documents/b-2_prom_note_fixed.pdf

Term Note	Annualized Interest Rate	Fixed, paid monthly	Consistent and predictable payments with a stated interest rate.	If the issuer pays back the principal in full early, then the investor loses a portion of expected interest.
Revenue Sharing Note	A multiple on the investment principal.	Varied. The amount varies based on the issuer's revenue generated. Payments can be made monthly, quarterly, even yearly.	If the issuer does well, the investor will be paid back ahead of the repayment schedule and thus earn a higher return.	Some issuers offer a lower multiple if they pay back in full early. The investor will not be repaid until the issuer generates revenue.

3.2.3 Convertible Note

Though the popularity of convertible notes lags far behind common stock, debts, and SAFEs in Reg CF offerings, it still worth mentioning as not only it competes with preferred stock for the no.4 most-issued securities under Reg CF, but also it is the foundation of the SAFE.

A convertible note is a note that will convert into equity stock when stated conversion events take place. As a note on its face, convertible notes also bear a maturity date and interest rate. But unlike nonconvertible promissory notes that will pay back investors by cash in compliance with a stated repayment schedule, as illustrated in the prior subsection, the accrued but unpaid interest of convertible notes will also convert into equity stock together with investors' principals.

One of the most outstanding terms in the convertible note contracts is the conversion price cap. If investors invest in a company by purchasing notes and then find the company's valuation soars later, they could regret their

decisions to investor in the form of notes instead of equity, as they lose a good opportunity to generate coveted returns and participating in the company's next rounds of equity financing will be considerably costly. To address this problem, the "conversion price cap", which will give holders of convertible notes in a company advantages over equity investors of later rounds of equity financing with respect to the price of equity stock issued, was invented[100]. If a conversion price cap applies in the conversion of convertible notes into equity securities, the conversion price could be substantially lower than the price of the equity securities.

The most widely used mechanism of the "conversion price cap" is the conversion discount[101]. The conversion discount gives convertible noteholders a discount on the price of the equity stock issued in next financing when conversion occurs. For instance, assume a discount is 20%, the price of the preferred stock issued in next equity financing, say Series A, is $1 per share, and a $1,000 convertible note converts into the Series A preferred stock, the price of the stock that the convertible note investor will receive is $1x (1-20%) =$0.8. In this instance, the $0.8 conversion price is $0.2 lower than the price of the Series A preferred. At the conversion price, the number of shares of the Series A preferred that the convertible note investor will receive is $1,000/$0.8=1250. Whereas an investor of Series A who pays $1,000 for the preferred stock issued will only receive 1000 shares. Thus, for the discount, the holder of the $1,000 convertible note will receive 250 shares or 25% more than a $ 1,000 preferred stockholder. The premium of 250 shares or 25% ownership is the return for convertible note investors under a 20% discount.

The post-conversion amount that a convertible note investor can receive under a discount can be formulated as follows:

$$PostConversion\ Amount = \left(\frac{1}{1 - Discount}\right) * Note\ Purchase\ Amount$$

The valuation cap is also common as a conversion price cap. It puts a ceiling on the pre-money valuation[102] of the issuer for convertible noteholders.

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[100] *See* Coyle, John F. and Green, Joseph, Contractual Innovation in Venture Capital, Hastings Law Journal, Vol. 66, p. 133, 2014, 163.

[101] Fenwick surveyed over 100 convertible notes offering during January 2019 to March 2020 and found 82% percent of convertible notes issued in seed financing (Fenwick called it "First Money") contained a discount. Of all the discounts set, the median is 20%. See Convertible Debt Terms – Survey of Market Trends 2019/2020, https://assets.fenwick.com/documents/Convertible-Debt-2020.pdf

[102] Pre-money valuation is defined as the valuation of the issuer immediately prior to the injection of money from the first equity financing.

When conversion occurs, convertible noteholders are entitled to convert their notes at the valuation cap, instead of the actual valuation of the issuer in at the time of conversion. Although the application of a valuation cap will be discussed in the following At Ease Rentals Corp. Convertible Notes Offering case study, the post-conversion amount that a convertible note investor can receive under a valuation cap can be formulated as follows:

$$PostConversion\ Amount = \left(\frac{Actual\ Vuation\ at\ Conversion}{Valuation\ CAP}\right) * Note\ Purchase\ Amount$$

A valuation cap often appears in a convertible note agreement in partnership with a discount but is seldom a standalone provision[103]. Notably, a discount and a valuation cap cannot apply simultaneously. Investor should choose one they deem more desirable when conversion occurs[104].

A few convertible note agreements also include a Most Favored Nation (MFN) provision. Under this provision, if the company subsequently issues convertible notes with terms superior to the previously issued convertible notes, the previous convertible noteholders can elect to exchange their notes for subsequent notes with superior terms[105].

The conversion provisions are also crucial. A popular convertible note template on the marketplace is the debt version of Keep It Simple Security documents devised by 500 Startups, a startup accelerator based in San Francisco[106]. The examination of conversion provisions of convertible notes will be based on the KISS convertible note template.

Both a discount and a pre-money valuation cap are in place in the KISS convertible note. The KISS convertible note will convert into preferred stock when the company raises no less than $1 million in next round of equity

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[103] *Supra* note 101, p4.

[104] *See* Chaplinsky, Susan J. and Becker, Joseph M., Convertible Notes: A Form of Early-Stage Financing, p3. Darden Case No. UVA-F-1925, Available at SSRN: https://ssrn.com/abstract=3682592

[105] *See* https://www.holloway.com/g/venture-capital/sections/elements-of-convertible-instruments?sn=%23most-favored-nation

[106] See the convertible note version of KISS, https://500startups.app.box.com/s/8ybxx9y3bhk4mte50v7k. KISS is devised by 500 Startups in partnership with Cooley, a prestigious law firm based in Silicon Valley specializing in startup financing. The KISS convertible note is used by some funding portals as the default convertible note template, such as SeedInvest, see https://www.seedinvest.com/blog/raise/500-startups-kiss-convertible-note.

financing selling preferred stock. By default, the converted preferred stock would be the same series as the preferred stock issued in next equity financing, but at the option of the company it could also be a separate "shadow" series of preferred stock[107]. The shadow series has nearly all the same rights as the series issued in the next equity financing, except the liquidation preference per share of the shadow series equals the conversion price[108].

The intent of issuing the shadow series is to eliminate the liquidation preference premium that the provisions of discount and valuation cap could create. As illustrated earlier, the application of the discount enables convertible holders to receive more shares of preferred stock than investors of subsequent equity financing. Assume a liquidation preference, structured as a liquidation multiple such as one time the price of the preferred stock, in the example of the 20% discount, if the $1,000 convertible holder converts the note into the same series of preferred stock issued in next financing, the noteholder would have a liquidation preference of $1,250. The consequence would give the noteholder two premia over a $1,000 preferred stockholder: the stock ownership premium – 250 more shares than the preferred stockholder; and the liquidation preference premium – an extra $250 in liquidation. If the note converts into the shadow series whose liquidation preference equals the conversion price, here the discount price ($0.8 per share), after conversion the holder of 1,250 shares of shadow series would have a liquidation preference equal to that of the holder of 1,000 shares of preferred stock issued in next financing.

If a corporation transaction occurs prior to the conversion of the notes[109], such as the company is acquired prior to conversion of the notes, convertible holders can select to receive either (1) all accrued and unpaid interest due plus twice the purchase price of the notes; or (2) the company's common stock at the cap, i.e., at the conversion price calculated as dividing the valuation cap by the numbers of all shares of common stock on a fully-diluted basis[110].

If the note matures but still does not convert or is not paid in a corporate transaction, then the bondholders of the majority interest can elect to convert

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[107] *See* section 1(a) of the KISS note template, supra note 106.

[108] *Id*, section 1(q). In addition to the liquidation preference, price-based anti-dilution protection and dividend rights are also adjusted in accordance with the conversion price. The conversion price here is defined as the lesser of applying the discount or the valuation cap, and the conversion amount equals the purchase amount of the notes plus accrued unpaid interest.

[109] The corporate transition defined in KISS convertible note equals to "change of control" and "dissolution events" in other alike agreements. The corporate transaction here includes a merger, consolidation, sale of all or substantially all of assets ("change of control"), liquidation, winding-up, and dissolution ("dissolution events").

[110] *See* section 1(h) of the KISS note template, supra note 106.

the accrued unpaid interest plus the purchase amount into a newly created Series Seed preferred stock at the cap in pursuance to the terms and provisions contained in the most recent Series Seed documents[111].

The KISS convertible note also includes an MFN provision. Meanwhile, a major investor, defined as an investor who invests $50,000 or more in the offering, is entitled to access financial statements of the issuer (information rights) and invest in next equity financing on the same terms and at the same price with other investors up to his or her purchase amount of the notes (participation rights)[112].

In sum, the KISS convertible note is very friendly to investors. It provides participation rights and information rights to a major investor, and an MFN provision. It also provides both the discount and valuation cap. But more crucial is it provides particular protections to investors in the events of acquisition of the company, similar substantial transactions, and especially liquidation and dissolution of the company prior to conversion. In such events, investors can select to be paid back as much as interest plus twice their principals, or to receive common stock of the company in anticipation of pro-rata shares of proceeds resulting from the transaction. This protection on substantial corporate transaction gives investors a chance of large return if the company is to be acquired for a good price, or a liquidation preference if the company is to be liquidated. Similarly, on maturity, the KISS notes can convert into a series of preferred stock, which could also give investors desirable future returns. Above all, as the terms in the KISS convertible note is comprehensive, investors and issuers can negotiate their agreements based on modifying the standard KISS terms, such as removing the MFN provision.

In addition to the KISS standard convertible note, a variant named "Crowd Note" is also adopted by some crowdfunding platforms. The crowd note is virtually a convertible note in nearly all aspects, except the crowd note contains no maturity date and automatic conversion provisions[113]. For no automatic conversion provision in place, the benefit is claimed to keep issuers' cap table "clean"[114], and help founders of the crowd note issuers dispense with obligations to a large number of shareholders, such as provide information to and keep records of numerous shareholders[115].

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111 *Supra* note 106.
112 *Id*, Section 5.2 of KISS note.
113 *See* https://microventures.com/crowd-note-vs-convertible-note-whats-the-difference
114 *Id*. The issue of "clean cap table" will be addressed in the subsequent SAFE subsection.
115 *Id*.

Let us see how a discount and valuation cap work in a real-world offering of convertible notes.

A Case Study: At Ease Rentals Corp. Convertible Notes Offering[116]

Summary of Terms

Offering Amount (principal)	Minimum $120,000 Maximum $500,000
Interest Rate	6%
Maturity	36 months
Discount	20%
Valuation Cap	$5,000,000 pre-money valuation
MFN	No

First let us use to case to illustrate how a discount and valuation cap work.

Assume the corporation raises $500,000 in the convertible notes offering. For simplicity's sake, accrued interest will omitted in our discussion.

Under the 20% discount, if the corporation issues equity stock at $1 per share, then each convertible noteholder will receive the equity stock issued at $1× (1-20%) =$0.8 per share. Then the $500,000 collectively paid by all convertible noteholders will convert into $500,000/$0.8=625,000 shares of equity stock, 1.25 times the shares that subsequent equity investors will receive.

Then we discuss how the $5,000,000 pre-money valuation cap works. If the corporation is valued at $10,000,000 in next financing and offer equity shares at $1 apiece, then under the valuation cap, the convertible noteholder would convert into equity shares as if the corporation is valued at $5,000,000. In this case, the convertible noteholders can own $500,000/$5,000,000=10% of the corporation's equity stock after conversion or receive equity stock at the

[116] At Ease Rentals Corp. provides an online leasing platform. It filed Form C with SEC in June 2020. The offering memorandum of convertible note is appendix 2 to the Form C. see https://sec.report/Document/0001808653-20-000001/

price of $0.5 per share.

In the above situation, a valuation cap yields more return than a discount, as $0.5 is lower than $0.8. if the corporation's pre-money valuation is $8,000,000, then the price of equity under the discount and valuation cap is the same at $0.8. However, if the corporation's pre-money valuation in next round of financing is below $5,000,000, say $4,000,000, converting the $500,000 notes only amounts to $400,000 in the following equity stock, meaning the stock price is $1.25 per share for noteholders. In this situation, the discount is more favorable to noteholders, and the convertible noteholders will not select to convert their notes at the cap.

Noteworthy, the issuer provides that in a non-qualified equity financing, which means the amount raised in an equity financing below the stated threshold of a qualified financing, the company can at its discretion issue a shadow series of equity stock to noteholders. The shadow series has no contractual voting rights, inspecting rights or information rights. Meanwhile, the legally vested voting rights will be granted to the funding portal through a voting proxy agreement. The liquidation preference of the shadow series is also based on the conversion price. This optional conversion provision gives noteholders a choice to convert their notes in a non-qualified equity financing.

3.2.4 SAFE

The SAFE has consistently been one of the most popular types of securities issued in Reg CF offerings, and became the most-issued security among such offerings in the third quarter of 2020. SAFE was invented by Y Combinator ("YC"), a reputable startup accelerator, in 2013[117].

As YC announced that the SAFE was much simpler than convertible note, the greatest distinctions between these two instruments are the SAFE does not have the terms of interest rate and maturity date. Hence, interest will not accrue under a SAFE agreement. In contrast, the valuation cap and discount remain in SAFE contracts. In sum, it removes convertible note's characteristics of debts, and keeps the rest.

SAFE doses not fit the equity/debt dichotomy. It has no two crucial

[117] For a good account of how Y Combinator SAFE contract was invented, see Coyle, John F. and Green, Joseph, Contractual Innovation in Venture Capital, Hastings Law Journal, Vol. 66, p. 133, 2014, 168-171.

hallmarks that debt securities have: maturity date and an interest rate. Also, unlike equity securities, it does not grant investors voting rights and rights to receive dividend. Thus, some legal scholars define the SAFE as an equity derivative contract[118].

YC provides four versions of SAFE templates – SAFE with Valuation Cap, no Discount; SAFE with Discount, no Valuation Cap; SAFE with Valuation Cap and Discount; and Safe with MFN, no Valuation Cap or Discount[119]. As their names suggest, their distinctions are the selection and combination of the provisions of valuation cap, discount, and MFN.

The discount provision in YC SAFEs functions similarly to its counterpart in convertible notes. The MFN is somewhat different. Under the MFN provision in the corresponding YC SAFE template, if the company issues any subsequent convertible securities with terms that investors deem preferable to their SAFEs, these investors can elect to amend their SAFEs to be identical to those preferable subsequent convertible securities[120]. Subsequent convertible securities include, for instance, other SAFEs, convertible debt instruments and other convertible securities[121]. As such, if the company issues convertible notes with better terms than previous SAFEs, SAFE holders are also entitled to enjoy the better terms on newly issued convertible notes.

The valuation cap is considered by some funding platforms to be the most important term in SAFE agreements[122]. Different from the pre-money valuation cap in convertible notes, the valuation cap in SAFEs puts a cap on the post-money valuation of the cap[123]. YC defines "post-money" in SAFEs as the

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[118] *See* Coyle, John F. and Green, Joseph, The SAFE, the KISS, and the Note: A Survey of Startup Seed Financing Contracts (August 13, 2018). 103 Minnesota Law Review Headnotes 42 (2018), at 46, "The SAFE is best conceptualized as an equity derivative contract by which the investor commits capital to the company today in exchange for the right to receive stock in the company in a future financing if certain contractual conditions are met."

[119] *See* https://www.ycombinator.com/documents/

[120] *See* Section 7 "MFN" Amendment Provision, YC SAFE: MFN only, https://www.ycombinator.com/assets/ycdc/Postmoney%20Safe%20-%20MFN%20Only%20v1.1-e34548a382b732f12461b19fea3da24f06873d1903b4b55bf13aa25bb55911f3.docx

[121] *See* Id, Section 2 Definitions Subsection "Subsequent Convertible Securities".

[122] Wefunder states on its website that "The Valuation Cap is the most important term of a convertible note or a SAFE", https://help.wefunder.com/deal-terms/295252-valuation-cap; see also Wefunder comment on SEC proposed rule on Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, at p.3 ("The valuation cap is the most important term"), infra note 69.

[123] *See* template SAFE contract-valuation cap, no discount. See https://www.ycombinator.com/assets/ycdc/Postmoney%20Safe%20-%20Valuation%20Cap%20Only%20v1.1-5e6f7dd124b848071137eae5e4630b2edbe2c15e5d6258364652676679358 5ed.docx

period after (post) all the SAFE money is accounted for but before (pre) the new money in next round that offers equity, converts, and dilutes the SAFEs[124].

The initial SAFE contracts designed by YC provided a pre-money valuation. YC explained that when SAFE was invented, the funding amounts raised by SAFEs had been much smaller. In response to a changing situation that funding amounts in financing using SAFEs were growing larger, YC redesigned the post-SAFE-money SAFE. YC argues that this cap provides both investors and founders a huge advantage – "the ability to calculate immediately and precisely how much ownership of the company has been sold"[125]. Thus, founders could promptly know how much the dilution is caused to their common stock as soon as investors know how much ownership they have purchased[126].

In addition to the valuation cap, terms in relation to conversion and liquidation also differ significantly from those in convertible notes.

A YC SAFE will automatically convert into a separate series of preferred stock, named "SAFE Preferred Stock" when the company conducts "equity financing". The SAFE preferred stock in large part has rights identical to those in the preferred stock issued to new investors, except the liquidation preference, price-based anti-dilution protection and dividend rights of SAFE preferred stock are based on the conversion price[127], rather than the price of newly issued preferred stock. In essence, the SAFE preferred stock is the equivalent of the shadow series preferred stock in the KISS note.

Noteworthy, all YC SAFE templates define the "equity financing" as financing transactions issuing and selling preferred stock[128]. To clarify, if the company issues common stock, which is also a kind of equity securities, a YC SAFE will not convert into preferred stock, as an offering of common stock does not qualify as a transaction of equity financing under such a YC SAFE term. YC SAFE's definition of equity financing is identical to the definition of the same term in the KISS note.

In a liquidity event, defined as an IPO, a directly listing and a change-

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[124] *Supra* note 119.
[125] *Id.*
[126] For the distinction between a pre-money valuation cap and YC's post-money valuation cap, see paragraph 2 of Section "Simple Agreements for Future Equity", https://www.natlawreview.com/article/seed-funding-basics
[127] *Id,* Section 1(a) "Equity Financing" and Subsection "equity financing" of Section 2 "Definitions".
[128] *Id*, Subsection "Equity Financing" of Section 2 "Definitions".

of-control such as an acquisition, YC SAFE holders are entitled to receive the greater of their purchase amount of these SAFEs (cash-out amount) or the amount in portion to shares of common stock as if their SAFEs convert into common stock at the price equal to the valuation cap divided by all common stock outstanding (conversion amount)[129]. Therefore, if an IPO or an acquisition happens, SAFE holders can only receive cash, unable to convert their SAFEs into common stock. Further, in a dissolution event, such as a liquidation, SAFE investors can only receive the purchase amounts.

The YC SAFE template provides that the liquidation priority of a SAFE is the same as non-participating preferred stock[130]. If SAFE holders elect to receive the cash-out amount, the payments are junior to payments to debt instruments, on par with payments to other SAFEs and preferred stock, and senior to payments to common stock. If SAFE holders elect to receive the conversion amount, the payments are junior to those to debt instruments, and on par with payments to common stock and other SAFEs and preferred stock on an as-converted to common stock basis[131].

The YC SAFE deviates from the KISS note in terms of conversion and liquidation. The KISS note will convert in the shadow series only when the company elects to do so, in contrast, the YC SAFE will convert automatically into the SAFE preferred stock. Further, when an acquisition or liquidation of the company happens, YC SAFE holders cannot convert their SAFEs into common stock prior to the acquisition or liquidation, instead, they can only receive cash. If these holders select to receive the cash-out amount, they are only paid back the purchase amount of the SAFEs. In contrast, in an event of acquisition or liquidation of the company, the KISS noteholders can either convert their notes into common stock, or a cash payment equal to unpaid interest plus twice the purchase amount of their notes. Apparently, the term of cash payments to KISS noteholders is much more generous than the cash-out amount for holders of YC SAFEs. Meanwhile, if the company is to be acquired in a stock-for-stock acquisition, after KISS noteholders convert their notes into common stock of the company prior to the acquisition, such KISS noteholders will become common stockholders of the acquiror. This result gives KISS noteholders a

[129] *Id*, Subsection 1(b) "Liquidity Event, Subsection "Liquidity Capitalization", "Liquidity Event" and "Liquidity Price" of Section 2 "Definitions". All common stock outstanding here includes preferred stock and convertibles calculated on an as-converted to common stock basis.
[130] *Id,* Section 1(d).
[131] *Id*.

possibility of significant future returns if the stock price of the acquiror goes up.

In addition to the prevalent YC SAFEs, there are two variants of SAFEs that are widely used in Reg CF offerings.

The first variant is crowd SAFE designed by Republic, a leading funding portal focusing predominantly on SAFE offerings.

A Republic crowd SAFE differs from the original YC SAFE in many respects. First, the crowd SAFE allows securities issued in an equity financing to be common stock and preferred stock. Thus, a crowd SAFE is convertible when the company issues common stock in next equity financing[132]. Second, even an equity financing or a series of equity financings happen, issuers of crowd SAFE can elect to convert crowd SAFEs into a shadow series preferred stock or extend the conversion beyond all rounds of equity financings to avoid conversion until a liquidity event happens[133]. In a liquidity event, such as an acquisition or an IPO, holders of crowd SAFEs can choose to receive either the purchase amount or convert their SAFEs into shares of common stock or preferred stock if issued by the company[134]. Third, the holders of the converted shadow series will have no contractual voting and information rights and should enter into a voting proxy agreement with Republic under which Republic is authorized to exercise shadow series stockholders' legally vested voting rights[135].

Republic expressly states its crowd SAFE is "super founder-friendly"[136]. Under its terms, the conversion of a crowd SAFE into common or preferred stock could happen as late as an IPO or acquisition of the SAFE issuer takes place. Republic explains the intent of such a conversion provision is to address the "messy cap table" problem[137]. A cap table is a list of a company's securities and their holders[138]. If an offering of SAFEs involves numerous investors, then a long list of holders of SAFEs will appear on the issuer's cap table, making

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[132] *See* subsection "capital stock" and "equity financing" in Section 2 "Definition", Republic Crowd SAFE example template for C Corp with discount and valuation cap, https://republic.co/crowdsafe/download/cap_and_discount_c_corp

[133] *Id*, Section 1(a).

[134] *Id,* Section 1(b).

[135] *Id*, Subsection "CF Shadow Series" of Section 2.

[136] *See* the first paragraph, https://republic.co/crowdsafe#:~:text=Crowd%20SAFE%20is%20an%20investment,to%20achieve%20their%20growth%20milestones.

[137] *Id.*

[138] *See* https://www.cooleygo.com/what-is-a-cap-table/

issuer's cap table look messy.

A messy cap table could cause both legal and practical issues. Section 12(g) of the Exchange Act requires an issuer with total assets exceeding $10 million and a class of securities held by either 2,000 holders, or 500 non-accredited investors, to register that class of securities with SEC[139]. Reg CF exempts a crowdfunding issuer with total assets at the end of its last fiscal year of $25 million or less from the Section 12(g) registration requirement[140]. Put differently, if a company with total assets of more than $25 million issues a class of SAFEs to more than 500 non-accredited investors, then the issuer shall register the class of SAFEs with SEC. This could impose significant cost on a startup. Meanwhile, as a matter of practice, venture capitalists and late-stage investors could feel negative when they see a messy cap table comprised of numerous small investors.

By delaying the conversion of SAFEs to an IPO or acquisition, the Republic crowd SAFE allows all SAFE investors to appear on a cap table collectively as one line item[141] as SAFE investors are not stockholders and have no ownership of the issuer before conversion. In doing so, the crowd SAFE resolves the problem that venture capitalists disfavor a messy cap table full of small SAFE investors. However, all crowd SAFE investors still count towards the Section 12(g) threshold[142].

The Second variation is the Wefunder SAFE. Wefunder in fact uses the templates of YC SAFEs as its default SAFE agreements[143]. But Wefunder has adopted the lead investor mechanism since May 2020[144]. A lead investor enjoys broad authority, especially exercising voting rights on behalf of all SAFE investors. As such, Wefunder adjusted provisions of the standard YC SAFE to accommodate the authority of the lead investor.

All SAFEs sold on Wefunder are beneficially owned by XX Investments LLC, a SEC-registered transfer agent serving as a custodian, instead of being held by individual investors. This setting allows the XX Investment LLC to appear on the issuer's cap table as one line item and does not count toward the

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139 15 U.S. Code § 78l(g).
140 17 CFR 240.12g-6
141 See "Clean the Table", supra note 136.
142 *See* paragraph 4, https://help.wefunder.com/lead-investors/how-is-xx-and-a-custodian-better-than-the-crowd-safe
143 "Wefunder offers the Y Combinator SAFEs as part of our default contracts you can use out of the box, modified only to allow unaccredited investors." See https://help.wefunder.com/#/terms-and-contracts
144 See https://help.wefunder.com/leads, accessed November 2020.

Section 12(g) thresholder[145].

The Wefunder SAFE will grant voting rights to the custodian, and the custodian's exercise of voting rights is directed by the lead investor. It is the lead investor who ultimately votes on behalf of all Wefunder SAFE investors. Meanwhile, terms of the Wefunder SAFE can be amended by one lead investor, except the valuation cap[146]. A lead investor's compensation correlates to the performance of the issuer. Investors are required to contribute 10% of profits they receive from the issuer[147].

In addition to the terms with respect to the lead investor, the Wefunder SAFE also have some other unique terms. It allows the issuer to repurchase a minor investor's SAFE at any time prior to conversion. This repurchase by the issuer is to reduce the mess on the issuer's cap table. Meanwhile, once the SAFE converts into equity, minor shareholders should grant the current CEO a power of attorney to vote all shares on their behalf. This provision is to centralize the voting rights and accelerate the process of next financing[148].

The attitude toward SAFE bifurcates significantly among crowdfunding platforms. StartEngine unambiguously expressed its aversion to the SAFE. In a blogpost, [149] its CEO put forward reasons why SAFE are unsafe for crowdfunding investors[150], amazed at some other platforms on which nearly half of crowdfunding fundraisers had issued SAFE, and touted 68% of crowdfunding offerings on StartEngine had issued common stock[151]. In a stark contrast to StartEngine, Republic announces that in a crowdfunding offering on that site, investors typically receive a Crowd SAFE security[152]. It seems StartEngine and Republic are at two opposite extremes in the treatment of the SAFE.

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[145] Supra note 142, paragraph 3 and 4.
[146] *Supra* note 142.
[147] *See* Wefunder comment, at p.9, infra note 173.
[148] *See* section "Wefunder Crowdfunding SAFE", https://wefunder.com/faq/securities
[149] *See* Are SAFE Notes Not Safe for the General Public? https://www.startengine.com/blog/are-safe-notes-not-safe-for-the-general-public/.
[150] *Id*. These reasons include:(1) as the conversion of SAFE into equity securities depends on another funding round of the issuer, in fact the change of next funding round is very rare, thus the conversion of SAFE is uncertain; (2) SAFE holders have no claim to the payment of dividend as equity securityholders generally have; (3) SAFE holders have no voting rights in the ventures they invest in; (4) SAFEs have little liquidity in secondary market. As securities issued under Reg CF are allowed to trade after one year of issuance, SAFEs, if not converted, are hard to value and thus have little liquidity in the secondary market.
[151] *Id.*
[152] See https://republic.co/learn/investors/what-the-deal-terms-mean.

Wefunder, the rest of the "big three" crowdfunding platforms, adopts a centrism attitude to the use of the SAFE. Wefunder provides templates of convertible note, SAFE[153] and Revenue Share[154]. Wefunder recommends early-stage technology startups having reasonable chance of being funded by venture capital funds adopt a convertible note or a SAFE, while early-stage brick and mortar businesses with expected positive cash flow use a revenue share contract[155].

3.3 Is the SAFE Truly Safe?

After Y Combinator invented SAFE and touted its standardization, the use of SAFE quickly gains traction in the West Coast and in seed financing for technology startups[156], while has little recognition in the broader ambit of financing for American startups and seed companies[157]. As such, some literature argues that SAFE is designed to startups in the technological area that have access to venture capital funds and high possibility of next equity financing. In contrast, the SAFE may not be the best form of securities that should be used in crowdfunding offerings for non-tech companies[158].

One risk surrounding the SAFE is as SAFE is a convertible security, board of directors of the issuing company of the SAFE does not owe fiduciaries duties to SAFE holders. Delawar courts have long held that obligation of issuers of convertible securities to convertible holders are prescribed by terms of the agreements under which the convertibles are issued. Hence, until convertibles are converted into common stock, convertible issuers do not owe fiduciary duty to convertible holders, as corporations only owe fiduciary duty to holders of their equitable interest, i.e., stockholders, especially common stockholders[159].

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[153] The templates of SAFEs provided by Wefunder are directly drawn from Y Combinator.
[154] Wefunder defines its revenue share contract as a promissory note under which a repayment amount, typically 1.5 times to 3 times the amount investors invest in the offering, will be paid back to investors. See https://help.wefunder.com/#/contracts/304788-loans-promissory-notes
[155] See https://help.wefunder.com/#/terms-and-contracts.
[156] According to a report by AngelList, nearly 80% of the early-stage financing on AngelList in the period of Jan-July 2019 was done through SAFEs. See https://angel.co/blog/for-seed-funding-safes-have-won-against-convertible-notes. AngelList is a San-Francisco based website funneling funds from accredited investors to startups and venture funds.
[157] According to the 2019 Angel Funders Report, of all angel investing deals across the U.S. and Canada, 44% used convertible notes, in contrast, only 1.6% opted for SAFEs. See https://www.angelcapitalassociation.org/angel-funders-report/
[158] See e.g., Green, Joseph and Coyle, John F., Crowdfunding and the Not-So-Safe SAFE, 102 Virginia Law Review Online 168 (2016), 174.
[159] See e.g., Simons v. Cogan, 549 A.2d 300 (Del. 1988), holding the issuing corporation of

In this light, to realize their conversion rights, SAFE holders rely on issuers' bona fide implementing of the SAFE agreement, risking losing the protection of state corporate law. But this jurisprudence also applies to convertible notes. As such, the lack of protection by state corporate law is not a risk unique to SAFE holders.

SEC has been long concerned with the risk of the SAFE in Reg CF offerings. On May 9, 2017, SEC issued an investment bulletin to alert potential investors interested in SAFEs to its accompanying risks[160]. SEC cautioned, SAFE investors in fact receive no common stock, as SAFE could only convert to actual equity upon the happening of some triggering events, such as the issuer is acquired by or merged with other company, or the issuer goes public or get funded by another round of financing involving issuing equities[161]. SEC further stressed that a triggering event contained in a SAFE agreement could never happen[162]. For instance, if a triggering event is the company's next financing, but the company makes enough money to sustain itself and does not plan to conduct any financing, then the triggering will not happen, and SAFE holders are forced to continuingly hold their SAFEs with no likelihood of conversion. Or if a triggering event is the company issuing preferred stock in next financing, but the company issues convertible notes, more SAFEs or common stock, then the triggering event is not satisfied, and SAFEs will not convert into equity securities.

SEC's particular vigilance of SAFE is somewhat justified. As illustrated above, the SAFE inherits mots of its terms from its progenitor - the convertible note. On its face, a SAFE is a convertible security as it can convert into equity securities. However, as SEC noted, the triggering events for conversion of SAFEs can be deliberately crafted to circumvent conversion, SAFE investors in theory can be passed out of conversion until the issuer is acquired or goes public, the probability of which is supposed to be low[163].

Some legal literature casting doubt on the safety of SAFE echoes the SEC's suspicion that the conversion of SAFEs is precarious. For instance, Green

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convertible debentures did not owe fiduciary duty to convertible debenture holders, "Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist. The obvious example is stock ownership."

[160] *See* https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes

[161] *Id*.

[162] *Id*.

[163] In 2019, there were 110 private companies going public through IPOs. See table 4, Initial Public Offerings: VC-backed IPO Statistics Through 2019, Jay R. Ritter (https://site.warrington.ufl.edu/ritter/files/IPOs2019VC-backed.pdf). In contrast, there were 713 companies raising capital using Reg CF in 2019 (source: Crowd Fund Capital Advisors).

and Coyle highlight the risk that a non-tech company never raise additional equity capital, sells itself or goes public[164]. They argue that for non-tech companies they can launch products and services and generate positive cash flow after initially raising funds through issuing SAFEs under Reg CF without the need of raising additional equity capital or a sale. They also point out since the resulting series of preferred stock after SAFE's conversion has no voting rights, as provided by Republic Crowd SAFE and Wefunder SAFE with lead investor, SAFE holders have to rely on the issuer's founders to take charge corporate affairs without any say, and more sophisticated investors, such as a lead investor in Wefunder SAFE's case, to negotiate favorable terms for themselves[165].

In conclusion, they suggest that if an issuer intends to offer SAFE-like securities, a better option is the convertible note, as convertible note has maturity date and interest rate. However, in their opinion, common stock, preferred stock, and debt instruments are the most ideal types of securities that issuers should use in Reg CF offerings[166].

However, as mentioned earlier, common stock issued under Reg CF in large part is non-voting common stock or common stock with a voting proxy provision under which common stockholders grant their voting rights to the issuer's CEO. Consequently, holders of common stock of these types also have no voting rights as SAFE holders. The greatest benefit of common stockholders in this context is the issuer's board of directors owes fiduciaries duties to common stockholder as required by state corporate law.

The most outstanding risk specific to the SAFE stems from its conversion. The conversion of YC SAFEs into preferred stock is problematic. As the YC SAFE narrowly defines "equity financing" as financing events issuing preferred stock, a YC SAFE will not convert into the stated SAFE preferred stock in any round of the issuer's subsequent financing offering common stock.

Republic crowd SAFE poses particular risks to investors. Under its term, the issuer can elect not convert the SAFE into equity stock in any subsequent round of equity financing, until the issuer goes public through an IPO or a change of control occurs[167]. It is obvious that the chance of an IPO or an

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[164] *Supra* note 152, p. 177.
[165] *Id*, p. 179.
[166] *Id*, pp. 181-182.
[167] In a liquidity event, Republic SAFE investors can select to receive a cash payment equal to the original purchase amount or shares of equity stock equal to the purchase price/the liquidity

acquisition is quite low. If no liquidity event happens and the issuer never converts the SAFEs into equity stock even a round or rounds of equity financing have been consummated, the crowd SAFE investors will hold their SAFEs for an indefinite period of time.

An empirical study surveyed 750 offerings from May 2016 to May 2018 and found during that period, nearly a quarter of offerings issued SAFEs[168]. Successful SAFE offerings slightly outnumbered unsuccessful ones, and the success rate of technology companies issuing SAFEs were three times that of non-technology companies issuing SAFEs[169]. They also found larger issuers had a higher success rate in reaching their Reg CF offering goals, and that larger issuers were more likely to issue preferred stock than SAFEs[170]. As such, the authors also suggested that SAFE could not be the ideal security in Reg CF offerings[171].

Even though some empirical and scholarly studies did not favor SAFEs in Reg CF offerings, SAFEs are continuingly popular. The proponents of the SAFE in the crowdfunding industry are so strong that they even thwarted SEC's regulatory effort to ban the use of SAFE in offerings under Reg CF.

In addition to the bulletin reminding investors of the risks of the SAFE, in March 2020, SEC took one step further, attempting to banning the issuance of SAFEs in Reg CF offerings. In its proposed rule entitled Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets[172], SEC proposed to ban the issuance of SAFE in crowdfunding transactions. SEC argued the offer and sale of SAFEs to "retail

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price if no equity financing happened prior to the liquidity event or the purchase price/the first equity financing price if one or multiple rounds of equity financing occurred prior to the liquidity event. A liquidity event is defined as an IPO or a change of control transaction. A change of control includes a controlling block of the issuer being acquired, a merger or a consolidation, a sale of all or substantially all assets, etc. Supra note 132.

[168] Smirnova, E., Platt, K., Lei, Y. and Sanacory, F. (2020), "Pleasing the crowd: the determinants of securities crowdfunding success", Review of Behavioral Finance, Vol. ahead-of-print No. ahead-of-print, table 2. https://doi.org/10.1108/RBF-07-2019-0096. This article sampled closed Reg CF offering from May 2016 to May 2018 and tried to figure out the factors in relation to the success of a Reg CF offering. A closed offering refers to an offering past its deadline to raise target amount of offering; a successful offering refers to a closed offering met or surpassed its target offering amount. A larger issuer refers to an issuer with more assets

[169] *Id*, table 2 and 3. The distinction of success rate between tech SAFE issuers and non-tech SAFE issuers is statistically significant.

[170] *Id*, table 4 and 7.

[171] *Id*, p16.

[172] 17 CFR Parts 227, 229, 230, 239, 249, 270, and 274 [Release Nos. 33-10763; 34-88321; File No. S7-05-20]

investors in an exempt offering could result in harm to investors who may face challenges in analyzing and valuing such securities, or who may be confused by the descriptions of such securities on the funding portals[173]". SEC intended to limit the types of securities issuers can offer in Reg CF offerings to equity securities, debt securities, and convertibles[174].

After the proposed rule was publicly available for comments, SEC noted a number of commentators opposing the prohibition of issuing SAFEs under Reg CF[175]. Weighing these dissident comments, SEC dropped its proposal banning the use of SAFEs in crowdfunding offering, instead, reminded issuers of SAFEs in crowdfunding offerings of their disclosure obligations under 17 CFR § 227.201(m)[176].

Wefunder and Republic's success to persuade SEC to scrap the ban on the use of SAFE could be attributed to the importance of WeFunder and Republic in the Reg CF offering industry and the importance of the SAFE for each platform[177]. As Republic and StartEngine have their own unreserved yet diametrically opposite preference over SAFEs, issuers in effect select the type of security they are inclined to offer by choosing the platform on which they will launch their campaigns. Meanwhile, investors frequenting platforms specializing in promoting SAFE offerings could also be more open to campaigns issuing SAFEs. This platform-specific preference over SAFEs complicates the task of reaching a straightforward conclusion on the effect of

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[173] *Id*, p157.

[174] Id. SEC pointed out that after the amendment, eligible securities under Reg CF would be consistent with eligible securities provisions of Regulation A.

[175] See Final Rule: Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 17 CFR Parts 227, 229, 230, 239, 240, 249, 270, and 274, Release Nos. 33-10884; 34-90300; IC-34082; File No. S7-05-20, at 184. Nearly all the dissident comments were from the crowdfunding industry, including representatives from notable crowdfunding portals, such as CEO of Wefunder, deputy general counsel of Republic, partner general counsel of Y Combinator. These comments highlighted the importance and popularity of SAFE in seed and crowdfunding financing, argued that SAFE terms were simplified so as to make ordinary investors understand them without resorting to costly legal services, and stressed that many of SAFEs issued were converted into preferred stock and that investors buying SAFEs did not care about voting rights. See e.g., Wefunder comment , at https://www.sec.gov/comments/s7-05-20/s70520-7246786-217248.pdf; Republic comment, at https://www.sec.gov/comments/s7-05-20/s70520-7258471-217640.pdf; Y Combinator Comment, at https://www.sec.gov/comments/s7-05-20/s70520-7254270-217568.pdf.

[176] *Id.* This rule mainly bears on requiring an issuer disclose whether the security the issuer is offering has voting rights, and whether such voting rights are limited or diluted.

[177] Wefunder does not recommend SAFE directly, however, a large portion of offerings on Wefunder issued and are issuing SAFEs. To date, offerings issuing SAFEs on Wefunder have raised $51.8 million (source: kingscrowd), accounting for one third of the $151 million raised by all Reg CF offerings on Wefunder (source: Wefunder).

SAFEs in Reg CF offerings, as the success rate of SAFE offerings could vary across platforms, let alone vary across tech-issuers and non-tech issuers. Thus, more empirical studies are needed to determine the effect of SAFEs in Reg CF offerings.

4. China's Regulation and Practices of Equity Crowdfunding

As shown above, there are various types of securities issued in offerings under Reg CF, far beyond equity securities. While in China, regulators employ the term "equity crowdfunding financing" to describe financing activities whereby companies issue equity securities through online funding platforms[178]. The reason of Chinese regulators' omission of debt securities in crowdfunding financing could be prior to 2020, for private issuers, the type of debt security that governed by Securities Law of People's Republic of China (China Securities Law or CSL) was only corporate bond[179]. The then effective CSL required companies intending to issue corporate bond have substantial assets and profits[180]. This requirement precluded startups, which typically have few or even negative profits, to issue corporate bonds on open markets. Meanwhile, a startup will face difficulty obtaining good ratings for its bonds, which compels to the startup to pay a high interest rate[181]. Thus, startups in China seldom issue bonds for financing. However, common stock and preferred stock were not the prevalent types of securities issued in China's crowdfunding transactions either.

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[178] *See* Section 9 of Guiding Opinions of the People's Bank of China, the Ministry of Industry and Information Technology, the Ministry of Public Security, et al, on Promoting the Sound Development of Internet Finance, No.221 [2015] of the People's Bank of China, https://www.pkulaw.com/CLI.4.251703(EN)

[179] For the evolution of securities governed by CSL, see Section 4.1 of this article.

[180] Article 16 of 2014 CSL required a corporation intending to issue bonds have RMB30M in assets and profits payable for one-year interest, See Article 16, CSL 2014, https://www.pkulaw.com/CLI.1.233280(EN)

[181] *See* e.g., High Yield Bond Primer by S&P Global, https://www.spglobal.com/marketintelligence/en/pages/toc-primer/hyd-primer#sec1

4.1 Basic Regulatory Framework of Equity Crowdfunding in China

CSL provides that all the public offerings of stock, corporate bond, and some other types of securities[182] should be registered with China Securities Regulatory Commission (CSRC)[183]. Article 9 of CSL[184] defines "issuing securities to unspecified or specified offerees accumulatively more than 200" a public offering. The specificity of offerees is interpreted to be determined by the special relation between offerees and the issuer[185]. Put differently, this section sets up the number of offerees as the parameter to determine a public offering. Thus, offering stock through equity crowdfunding shall be registered with CSRC or be held illegal, unless the number of offerees is less than 200, and the offerees are specific to issuers.

4.2 Rulemaking Efforts in Equity Crowdfunding

In December 2014, Securities Association of China (SAC) enacted its proposed rule on private equity crowdfunding financing[186]. SAC is a self-regulatory organization under the guidance of CSRC. SAC could exercise supervisory power over its member securities companies and practitioners of the securities industry, and subject them to disciplinary action when they violate SAC rules.

The SAC rule on equity crowdfunding prescribed the standards for the investors, fundraisers (interchangeably with "entrepreneurs") and funding portals participating in the equity crowdfunding transactions. In respect of funding portals, the SAC proposed rule required that all the funding portals register with and apply for membership of the SAC, have net asset of no less than RMB 5 million and at least two professional investment advisors, maintain necessary technology facilities and management, and assume some

[182] See Article 2 of CSL and supra note 123. Each revision to CSL added some types of securities to its regulatory reach.
[183] See article 9 of CSL 2020, http://www.pkulaw.cn/CLI.1.338305(EN). Prior to 2020, all public offerings should be approved by CSRC. 2020 CSL only requires public offerings be registered with CSRC.
[184] This was Article 10 in 2014 CSL. In 2020 CSL, this article is numbered Article 9.
[185] Lin Ye, Securities Law, 4th Edition, China Renmin University Press, 2013, 87-88. This book does not specify what constitutes a special relation. And there are few cases clarifying the "specificity" element in the definition of public offering.
[186] Regulation on Private Equity Crowdfunding Financing (Provisional) (Exposure Draft), SAC [2014] No. 236. Now the rule is taken down from the SAC website and only third-party source can be found, see e.g., http://www.pkulaw.cn/CLI.DL.6316.

responsibilities including verifying the authenticity of information provided by investors and entrepreneurs, verifying the legality of projects, monitoring frauds, and educating investors. The rule also prohibited the funding portals from engaging in certain types of activities, such as insider trading, defrauding investors, and directly making loans[187].

Regarding investors and fundraisers, the SAC rule required that fundraisers be barred from publicly issuing securities or issuing securities to unspecific offerees, and shareholders of the fundraisers or the resulting companies after the consummation of each crowdfunding financing be no more than 200 in aggregate[188]. Obviously, the SAC rule strictly observed the Section 10 of 2014 CSL and prohibited fundraisers from publicly offering securities in reliance on crowdfunding. Under this requirement, if a fundraiser already has some shareholders such as its founders and key employees, the number of investors that can buy stock issued by the fundraiser in a crowdfunding offering would be 200 less the number of the fundraiser's existing shareholders. As every fundraiser has at least one shareholder, the number of investors finally purchasing the stock issued would be always less than 200.

Particularly, the SAC rule limited investors eligible to participate in the equity crowdfunding to the following three types: (1) accredited investors designated by CSRC[189]; (2) entities or individuals investing no less than RMB 1 million in a single financing project; and (3) some institutional investors such as pension funds[190].

As the name of the proposed rule suggests, this rule structured offerings of securities under crowdfunding strictly as private placements. Under this proposed rule, only a handful of investors such as affluent personal investors, large financial institutions, are eligible to participate in crowdfunding offerings. Meanwhile, fundraisers can only issue securities to less than 200 specific investors. In sum, this proposed rule disregarded the component "crowd" of "crowdfunding", rather, it only provided another venue of private offerings to a

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[187] *Id*, Article 5-9.
[188] *Id*, Article 12.
[189] According to the CSRC, the accredited investors refer to: entities with assets no less than RMB 10 million; individuals with financial assets no less than RMB 3 million or with annual income of RMB 500 thousand in recent three consecutive years; pension funds, private equity funds and other institutional investors. See Article 12 of Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds, Decree No.105 of the China Securities Regulatory Commission, 2014, https://www.global-regulation.com/translation/china/159262/interim-measures-for-the-supervision-and-administration-of-private-investment-funds.html
[190] *Supra* note 186, Article 14.

very select group of investors.

However, the SAC proposed rule never became a final rule. In 2015, a joint notice issued by People's Bank of China – China's central bank, CSRC and other eight regulatory authorities within State Council – China's central administration[191], clarified that equity crowdfunding financing is regulated by CSRC. This was the first time that the regulatory authority to regulate crowdfunding in China was demarcated. Now that CSRC becomes the only regulatory body to regulate crowdfunding, SAC, which is supervised by CSRC, in consequence was not empowered to make rules on equity crowdfunding.

CSRC reiterated that it had been considering enacting rules for equity crowdfunding for multiple times, and even made it a priority in its 2019 rulemaking undertakings, however, the long-awaited CSRC rule on equity crowdfunding is still far from in sight. Efforts to provide a legal framework for crowdfunding in China seem faltering now. After six years of SAC's first proposed rule, five years of CSRC being authorized to regulate equity crowdfunding, a binding rule still does not exist. In fact, CSRC has not issue any provisional rule yet. The absence of an effective rule poses great legal risk to equity crowdfunding in China.

4.3 China's Equity Crowdfunding Practice

There used to be some equity crowdfunding portals in China, just to name few, Renrentou[192] (means everyone can invest") and Tianshijie (Angels' Street). To circumvent the requirement that all public offerings of stock shall be registered with CSRC, these portals intermediate to help investors and entrepreneurs reach an agreement under which they form a limited partnership enterprise (can be roughly regarded as the counterpart of limited partnership under the U.S. law), of which investors serve as limited partners, and entrepreneurs serve as general partners. Entrepreneurs raising capital through a funding portal only promise to provide investors with limited partnership enterprise interest (LPE interest), a kind of equity stake that is not governed by CSL, in exchange for investors' injection of money. As a special vehicle, the LPE will hold shares of the resulting company in proportion to the amount raised through the crowdfunding transaction. The resulting company is the

[191] *Supra* note 171.
[192] Can visit through http://www.renrentou.com/, accessed 2016. All the information was collected from its official website.

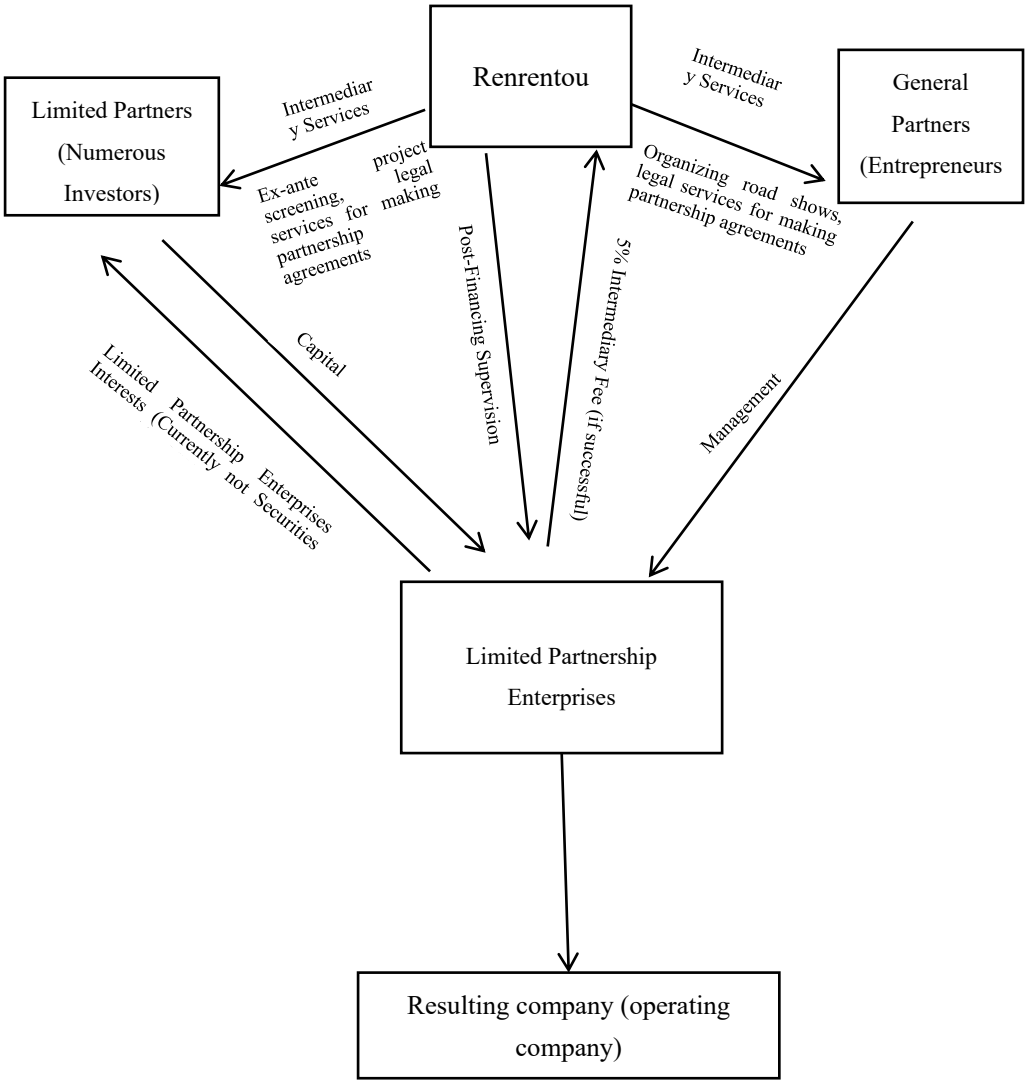
operating company that does business and that is in fact run by the entrepreneurs. If the resulting company generates profits, then the profits will be distributed among investors and entrepreneurs in accordance with negotiated terms in the LPE agreement.

This structure in theory would work well. As limited partners, investors' primary right is to participate in the distribution of profits generated by the LPE. In general, limited partners have no managerial power over the LPE they invest in. Through managing the LPE, entrepreneur-general partners control the resulting company. If the resulting company makes profits, then the profits will flow back to the LPE, and in turn, to investors and entrepreneurs.

The intermediary services that Renrentou provides include ex-ante screening of projects, promotion of projects such as organizing road shows for entrepreneurs, and legal services for entering into partnership agreements. Its operational mode is illustrated in the following diagram[193]:

[193] Now Renrentou is discontinued.

Diagram 1: The Operational Mode of Renrentou



Other crowdfunding portals basically model after Renrentou's transactional structure with minor variations. But some portals, for example Tianshijie, develop their own threshold for investors to participate in the projects posted on their websites and categorize investors as lead investors and participant investors on the ground of investors' annual income, prior investment experience, risk preferences, and the like.

4.4 The Demise of Equity Crowdfunding Industry in China

Equity crowdfundig in China used to be propsperous. The first two

equity crowdfunding platforms were founded in 2011. In 2014, there were 21 platforms. As of 2014, the three leading platforms raised RMB132 million, a big haul within only three years. The average amount raised per project was between RMB3 million-5 million, some large projects even raised more than RMB10 million[194].

However, the turning points was just on the horizon.

In August 2015, CSRC isssued a notice on Conducting Special Inspections of Institutions Engaging in Equity Financing via the Internet[195]. This notice marked a U-turn of regualtory mentanlity on equity crowdfunding. The notice defined equity crowdfunding as enterprenuers publicly raising capital by offering equity on internrt ctowdfunding platforms, admitting that equity crowfunding transactions are "public, small-sum and open to crowd[196]". In doing so, this notice excluded private offerings from the definition of equity crowdfunding. The position that offerings under equity crowdfunding are public is diametrically opposite to the position adopted by the SAC proposed rule, which made equity crowdfunding offerings private.

After alleging the public nature of equity crowdfunding, the notice reinterated that all public offerings should be register with CSRC, non-public offering should not use public advertising or general solicitation, and private fund managers should raise capital only from accredited investors. The notice further required local governements inspect and correct illegal and non-compliant conduct on all equity crowdfunding platforms, especially focusing on whether financiers on funding platforms engage in general solicitation, whether securities are issued to unspecific investors, whether the number of shareholders exceeds 200 cumulatively, and whether private equity funds are raised in the name of equity crowdfunding[197].

In December 2017, on its website, CSRC stated that the experiment of equity crowdfunding had not started. CSRC warnd that any platform promoting its services of equity crowdfunding could make misstatements or engage in illegal activities[198]. This announcement expressly unravelled CSRC's position. Unless and untill the rule on equity crowdfunding is issued by CSRC, equity

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194 *See* Internet crowdfunding Annual Report 2014, translated from Chinese, http://www.199it.com/archives/339253.html

195 No. 44 [2015] of the General Office of the China Securities Regulatory Commission, https://www.pkulaw.com/CLI.4.256388(EN)

196 *Id*, Paragraph 1.

197 *Id*, paragraph 3.

198 http://www.csrc.gov.cn/pub/newsite/tzzbh1/tb12386rx/201712/t20171207_328398.html

crowdfunding in China is adamantly deemed illegal by CSRC.

Now it seems the equity crowdfunding industry in China is all but dead. Renrentou, Tianshijie and Dajiachou, these used-to-be prosperous secutrities-based crowdfunding platfroms in China are now discontinued[199]. Other alive crowdfunding platforms such as the crowdfunding platform oeprated by JD finance, an affiliate of JD, one of China's leading e-commerce corporations, stucture the campaigns on their platforms as reward-based crowdfunding, and bar any offerings of securities in compaigns initiated on their platforms.

The reason of the regulatory crackdown at equity crowdfunding in China was murky. The great crash of China's stock market in late 2015 could be a catalyst. In August 2015, China's Shanghai Composite Index plummted 43% percent from its peak in July 2015[200]. The CSRC notice requiring local governments inspect crowdfunding platforms was also issued in August 2015.

Meanwhile, since 2016, China's fraud-ridden peer-to-peer lending platforms go broke acorss the board. P2P investors in China have lost more than $115 billion[201]. P2P is different from crowfunding, however, the horrifying outcome of the collapse of P2P platforms probably discouraged China's regulators from further allowing public offerings to be launched on internet platforms.

5. Establishing the Legal Framework for China's Crowdfunding Industry

Establishing a legal framework for China's crowdfunding industry is a slog. First, the legal framework should be beyond the "equity" crowdfunding. As illustrated earlier, the majority of securities issued in offerings under Reg CF are not equity. A sensible legal framework should allow debts, convertibles, and non-traditional securities like SAFEs to be issued in crowdfunding offerings in association with equity securities.

Second, a well-advised legal framework should balance the capital

[199] When accessing the website of Renrentou, it shows this website has not obtained ICP (Ministry of Industry and Information Technology) filling status. Websites of Tianshijie and Dajiachou are both blank.

[200] https://www.vox.com/2015/7/8/8911519/china-stock-market-charts

[201] https://www.businessinsider.com/chinese-p2p-investors-lost-115-billion-in-regulatory-crackdown-2020-8

formation of the market against investor protection. If the disclosure obligations under the framework are too tenuous, investors lacking material information cannot make well-informed decisions. If the legal obligations are too heavy, considering the amount that can be raised through equity crowdfunding is relatively small to IPO or private placements, the desirability of crowdfunding would be undermined.

The legal obstacles to China's equity crowdfunding industry are not only the absence of a rule enacted by CSRC, but also the narrow range of "securities" governed by CSL and the unreasonable definition of a "public offering" in CSL. The narrow range of securities governed by CSL is likely to strip investors in crowdfunding offerings of the protection by CSL's antifraud provisions. The unreasonable definition of a "public offering" in CSL would also impede the development of crowdfunding in China.

But above all, the absence of a crowdfunding exemption in CSL poses the greatest problem to crowdfunding in China. Without a statutory exemption, CSRC has no authority to exempt crowdfunding offering from CSL's registration requirement. Adding a section mirroring Section 4(a)(6) or Section 28 of the Securities Act to CSL should be carefully considered by Chinese legislators.

5.1 Definition of Securities in the U.S. and China

CSL was promulgated in the year of 1998 and took effect in 1999. Subsequently, it underwent two major revisions in 2015 and 2019. Though very limited, each revision broadened the range of securities regulated by CSL.

In the 1999 CSL, the law did not provide a general definition of securities. Instead, it stated that the law applied to issuance and trading of stocks and corporate bonds, and other financial instruments recognized as securities by China State Council. This implied that the staturoy meaning of "securities" was unknown. What we know was the range of securities that the law intended to regulate.

The statutory range of stocks and corporate bonds is conspicuously narrow. One reason for then Chinese legislature to enact such a narrow range of securities could be the securities law had to honor the correponding rule of China Company Law (CCL)[202]. When the 1999 CSL was promulgated, the

[202] *See* Yuwa Wei, *The Development of the Securities Market and Regulation in China*,

governing Company Law was passed in 1993 and took effect in 1994. The 1994 CCL only allowed corporations to issue and transfer stocks and bonds. For avoiding conflicts of these two basic laws governing transactions invloing issussing securities by Chinese corporations, the broadening of the range of securities in CSL depended on an overhaul of CCL[203].

In the 2015 revision to CSL, government bond and shares of securities investment funds were added to the statutory reach of CSL, and China State Council were authorized to regulate the issuance and transfers of derivates. In the 2019 or the latest revision, which took effect at the beginning of 2020, depository receipts was further added to the regulatory reach of CSL. Meanwhile, the 2019 CSL also authorized China State Council to reguate asset-backed securities and asset management products. After these three major revisions, the statutory reach of CSL now extends to issuances and transfers of stocks, corporate bonds, despository receipts, government bonds, shares in securities investment funds, and other securities designated by China State Council[204].

After 22 years of its birth, CSL still applies to very limited types of securities. In this light, interests of LPE fall outside of the reach of CSL. Investors who purchasing LPE interests issued by issuers on crowdfunding portals are unable to protect themselves by invoking CSL if they are defrauded. In such a dilemma, the primary legal basis for investors to reclaim their losses could be found in contract law.

While in the US, the range of securities protected by securities laws is much broader than that of China. Section 2(a)(1) of the 1933 Securities Act (33 Act) provides a definition of "security" by enumerating a cascade of eligible financial instruments, such as note, stock, bond, debenture, various derivates, future, as "securities"[205]. The definition of a "security" provided in the

27 LOY. L.A. INT'l & COMP. L. REV. 490-493 (2005), arguing the 1994 China Company Law and 1999 China Securities Law regulated the issuance of securities altogether.

[203] *See* Tomasic, Roman A. and Fu, Jane, The Securities Law of the People's Republic of China: An Overview (1999). Australian Journal of Corporate Law, Vol. 10, pp. 268- 289, 1999, Available at SSRN: https://ssrn.com/abstract=1440759

[204] See Article 2 of Securities Law of the People's Republic of China (2019 Revision), available at http://www.pkulaw.cn/ CLI.1.338305(EN). It is noteworthy that this article does not provide a general definition or exhaustive enumeration of "securities". It only states that issuance and transfers of some kinds of financial instruments are governed by CSL. This article also delegates broad power to China State Council by administrative regulations to broaden the range of securities governed by CSL. Further, regulation implicating issuance and resale of asset-backed securities and asset management products are expressly delegated to China State Council in this article.

[205] In the Securities Act, the term "security" means "any note, stock, treasury stock, security

Exchange Act[206] is slightly different from the corresponding definition in the Exchange Act but is treated almost identical to that in the Securities Act by courts[207]. The enumeration of financial instruments as securities are quite thorough, however, there is still much ambiguity left in the statutory language. Especially, some non-traditional securities, such as investment contract, are not given clear definitions in both 33 Act and 34 Act. Therefore, courts are left to clarify the statutory meaning of undefined securities.

The seminal and landmark case reviewing the broad definition of securities in 33 Act is SEC v. W. J. Howey Co.[208], decided by the U.S. supreme court in 1946. The respondent W. J. Howey Company and Howey-in-the-Hills Service Inc. (collectively "Howey Company") were two Florida corporations under common management and control. Howey Company used mails and instrumentalities of interstate commerce to sell a land sale contract selling citrus acreage and a service contract cultivating and developing these citrus groves to perspective buyers outside Florida, without registering the offer and sale of these contracts with SEC. SEC instituted an action to enjoin the Howey Company from the offer and sale of these contracts.

The supreme court upheld SEC's request, holding that these two contracts fell within the "investment contract" in Section 2(a)(1) of 33 Act, and thus should be registered with SEC[209]. The Howey court held that an investment contract could constitute a security where there is a contract "whereby a person invests his money in a common enterprise and is led to expect profits solely

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future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract… or, in general, any interest or instrument commonly known as a "security", … any of the foregoing. 15 U.S.C. § 77b(a)(1).

[206] Section 3(10) of Exchange Act provides the definition of a "security" as follows:
The term ''security'' means any note, stock, treasury stock, security future, security-based swap, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, …, or in general, any instrument commonly known as a ''security''; … or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

[207] See e.g., Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985). In footnote 1, the supreme court noted "We have repeatedly ruled that the definitions of "security" in § 3(a)(10) of the 1934 Act and § 2(1) of the 1933 Act are virtually identical and will be treated as such in our decisions dealing with the scope of the term." (citing Marine Bank v. Weaver, 455 U.S. 551, 555, n. 3 (1982); United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 847, n. 12 (1975))

[208] 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946)

[209] *See* SEC v. W.J. Howey Co., 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946)

from the efforts of the promoter or a third party[210].” This decision becomes the benchmark of legal standards to determine whether an investment contract constitutes a security that should be governed by 33 Act.

Lower courts have fleshed out the Howey test in their application of the test. The fifth circuit broke down the Howey test into three factors, requiring plaintiffs claiming the contract in question constituting an investment contracts and thus a security to prove: “(1) an investment of money; (2) in a common enterprise; and (3) on an expectation of profits to be derived solely from the efforts of individuals other than the investor[211].” Meanwhile, as the word “solely” in the Howey test set a formidable high bar, some courts non-literally interpreted “solely”, holing that the requirement of “solely from the efforts of a third party” could also be met by “predominantly[212]” or “undeniably significant[ly][213]” from a third party.

The original Howey test and the line of its subsequent cases ensure flexibility for courts to adopt their approaches to interpret many kinds of financial instruments as investment contracts[214]. In effect, courts applying the Howey test manage to bring as many kinds of financial instruments as possible within in the ambit of securities, hence afford protection of 33 Act to investors thereunder[215].

Courts typically applies Howey test to determine whether limited partnership interests are securities[216]. Under the Howey test, courts commonly view limited partnership interests as securities[217]. Courts sometimes analogize

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[210] *Id*, 298-99.

[211] See Williamson v. Tucker, 645 F.2d 404, 417 (5th Cir. May 1981).

[212] *See* e.g., SEC v. International Loan Network, 968 F.2d 1304, 1308 (DC Cir. 1992).

[213] See e.g., Miller v. Central Chinchilla, 494 F.2d 414, 418 (8th Cir. 1974).

[214] *See* Miriam R. Albert, The Howey Test Turns 64: Are the Courts Grading This Test on a Curve, 2 WM. & MARY Bus. L. REV. 1 (2011). The author argues that Congress deliberately enacted a broad and flexible concept of “security”. The Howey court crafted the flexible test in recognition of the Congressional intent, and courts subsequently apply the Howey test to maintain its flexibility.

[215] *See* T. Gabaldon, A Sense of Security: An Empirical Study, Journal of Corporation Law, Vol. 25, No. 2, 307, 332-333 (2000). This article finds that during 1982-1998, 234 cases asking “what-is-a-security” (determining whether a financial instrument in question is a security) implicated the term “investment contract”, accounting for 61% of “what-is-a-security” cases. Of all the 234 cases, only 44 or 19% applied test other than or in addition to Howey.

[216] *See* e.g., Masel v. Villarreal, 924 F.3d 734 (5th Cir. 2019), as revised (June 6, 2019), reviewing limited partnership agreements under Howey, focusing on the managerial power that limited partners can exercise over the partnership, holding that limited partnership interests constitute securities if they meet Howey three-pronged test.

[217] *Supra* note 215, p.334. This article finds during 1982-1998, 25 cases asking whether

the interest of a limited partner to that of a stockholder in a corporation[218], as directors are statutorily empowered caretakes of a corporation's business and affairs[219], stockholders rely on directors and management to attend to their investments in this corporation. Similarly, limited-partner-investors rely on efforts of general-partner-managers to gain profits from the common enterprise they invest in, as the power of limited partners is quite constrained. For instance, limited partners typically have no say in managing the business and affairs of partnership and are unable to dissolve the partnership. In consequence, if limited partners virtually have no control over and few powers to run the partnership, their interests in the partnership will be deemed as securities under Howey[220].

Notes, which are clearly included in the definition of securities in the Securities Act[221], are used in many non-investment situations. Courts found many kinds of notes should not be treated as securities, such as notes given in connection with home mortgages, consumer financing, and short-term liens on small businesses[222]. The U.S. supreme court held that "Congress' purpose in enacting the securities laws was to regulate investments", and "the phrase 'any note' should not be interpreted to mean literally 'any note'" but must be interpreted as regulating investment instruments as well[223]. To determine whether a note is a security under securities law, the supreme court adopted the "family resemblance" test in Reves v. Ernst & Young[224]. Under this test, a note

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limited partnership interests constitute investment contracts were brought, 80% percent of which were held in favor of the plaintiffs, i.e., court found limited partnership interests in question were securities. For case law, *see* e.g., S.E.C. v. Murphy, 626 F.2d 633 (9th Cir. 1980) "Under the test for an investment contract established in SEC v. W. J. Howey Co., a limited partnership generally is a security[.]" (citing Goodman v. Epstein, 582 F.2d 388, 408-09 (7th Cir. 1978), McGreghar Land Co. v. Meguiar, 521 F.2d 822, 824 (9th Cir. 1975); 1 A. Bromberg, Securities Law: Fraud s 4.6 (332) (1969))

[218] *See* Youmans v. Simon, 791 F.2d 341 (5th Cir. 1986). The fifth circuit reasoned that limited partners exercise few or no power to take an active part in the management of a partnership, nor are personally liable for liabilities of the partnership. Thus, limited partnership interests satisfy the Howey test and are securities under 33 Act.

[219] Delaware General Corporation Law§141(a) provides "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors…"

[220] *Supra* note 218, focusing on the extent of managerial control limited partners can in essence exercise over the partnership.

[221] *Supra* note 206, "the term of 'security' means 'any note…'"

[222] *See* e.g., Futura Dev. Corp. v. Centex Corp. (1st Cir. 1985), citing Chemical Bank v. Arthur Andersen and Co., 726 F.2d 930 (2d Cir.), Exchange National Bank v. Touche Ross and Co., 544 F.2d 1126 (2d Cir.1976.).

[223] See Reves v. Ernst & Young, 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990), 61-63.

[224] The court held that Howey had been designed to find out whether an instrument is an investment contract under securities law. If the Howey is to be applied to case involving notes as well, then the statutory enumeration of various kinds of securities would be superfluous. *Id*, at 64.

is presumed to be a security, and the presumption can be only rebutted by a showing that the note bears a strong resemblance to one of judicially crafted categories of instruments that are not securities [225]. When categorizing instruments as non-securities, courts should consider four-factors: (1) the motivations prompting a reasonable seller and buyer to enter into the transaction[226]; (2) the plan of distribution of the instrument[227]; (3) reasonable expectations of the investing public[228]; (4) the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary[229]. Under this test, term notes and RSNs can be easily categorized as securities and thus are subject to the reach of securities laws in the U.S.

Consider securities laws and cases, had the offerings of limited partnership interests that nearly all Chinese equity crowdfunding transactions involved happened in the U.S., they would constitute issuances of "securities" and must be registered or find an exemption under 33 Act. However, the offerings and resale of LP enterprise interests are not regulated by CSL. This first excuses issuers of mandatory disclosure they are otherwise required if CSL regulates the issuance and resale of LPE interests, and second precludes investors from protection of CSL's anti-fraud provisions provides. In aggregate, investors rights could be severely undermined if frauds in association with transaction of LPE interests do take place.

Look back to Reg CF crowdfunding offering in the U.S, issuances and resales of SAFEs, common stock and preferred stock can easily fall within the scope of securities contained in Securities Act and Exchange Act in accordance with either the plain yet broad language of the definition of securities in each act or the flexible Howey test. Meanwhile, notes are presumptively treated as securities. If new types of investment contracts emerge, courts can readily subject these new instruments in accordance with the Howey three-pronged test to the regulatory reach of SEC. In turn, SEC can exercise its statutorily mandated power to protect investors' rights despite the proliferation of new financial instruments. Crowdfunding offerings are undoubtedly under SEC's watch whatever kinds of securities are issued in these transactions.

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[225] *Id*, at 67.
[226] If the buyer's purpose is to invest and generate profit and the seller's purpose is to finance, then the instrument is likely to a security. Id, 66.
[227] i.e., If there is "common trading for speculation or investment" for an instrument. Id, 66.
[228] Id, 66-67.
[229] *Id*, at 67.

In contrast, the rigidity in CSL prevents CSRC from regulating offerings and resale of LPE interests. As illustrated above, CSL only applies to issuance of and trading in a limited range of securities, and LPE interests are plainly outside of that range. Moreover, CSL does not provide a general definition of "securities" nor an extensive security as investment contract is. Under such circumstances, Chinese courts are left no room to extend the application of CSL to offerings involving LPE interests, as opposed to what U.S. courts can do under Howey and its progeny. Although China State Council can designate other securities as securities regulated by CSL, the designation by China State Council needs authorization of law or People's Congress. Under CSL alone, China State Council cannot designate LPE interests as securities regulated by CSL[230].

In Sum, issuances and resale of LPE interests in China eschew the oversight of CSRC. CSL expressly does not apply to issuance and resale of LPE interests. Neither courts nor State Council can extend the application of CSL to issuance and resale of LPE interests. By no means can CSRC exercise its regulatory power over crowdfunding transactions offering and reselling LPE interests. In consequence, crowdfunding investors cannot resort to securities law or CSRC when they are defrauded.

5.2 Definition of a "Public Offering" in the U.S. and China

As illustrated in the foregoing section, LPE interests are not securities regulated by CSL. Consequently, issuance and resale of LPE interests are not subjected to the registration requirement and anti-fraud provisions in CSL. However, even if LPE interests are regulated by CSL, CSL's offeree-number-based definition of "public offering" could also impede the protection of crowdfunding investors.

Article 9 of CSL requires any public offering register with relevant regulatory bodies. This article defines a public offering as (1) An offering of securities to unspecific offerees; (2) An offering of securities to more than 200 specific offerees cumulatively, and (3) other offerings stipulated by law and administrative regulations[231]. This definition of public offering was in place in

[230] In 2019 CSL, except enacting regulations involving transactions of asset-backed securities and asset management products, no articles expressly empower China State Council to designate other securities as securities regulated by CSL.

[231] See Article 9 of Securities Law of the People's Republic of China (2019 Revision), available at http://www.pkulaw.cn/ CLI.1.338305(EN). This article excludes employee offered

2014 CSL and keeps intact in the 2019 revision. Put differently, it has been good law for at least 6 years.

Case Law in the US adopts a different approach to defining a public offering. Section 4(2) of Securities Act exempts transactions by an issuer not involving any public offering from registering with SEC[232]. However, Securities Act does not provide a clear definition of a "public offering". Thus, the job to figure out the meaning of a "public offering" is left to courts.

The U.S. Supreme Court took up clarifying the meaning of "public offering" in SEC v. Ralston Purina[233]. The respondent Ralston Purina was a private corporation. It sold nearly $2million of stock to its employees across many states in the U.S. from 1947-1951using mails, without registering these offerings with SEC. SEC sued to enjoin Ralston Purina's unregistered offerings. SEC argued that Ralston Purina sold stock to a substantial number of offerees[234], thus rendered Ralston Purina unable to utilize the non-public offering exemption. Although the supreme court noted SEC applied some kind of numeric test in determining whether an offering is public or non-public, the court nevertheless held "there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation[235]." Instead, the court focused on whether the class of offerees affected needs the protection of the Securities Act to determine a "public offering." The court held that "an offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering[236]", the inquiry "turns on the knowledge of the offerees[237]", and the investors should have "access to the kind of information which registration should disclose[238]."

Ralston Purina's progeny continues to develop the bifold "knowledge of offerees and access to information" standard it set out. The Fifth Circuit's

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securities under employee stock ownership plan from the cap of 200 specific offerees. Further, a non-public offering is barred from using public advertising or general solicitation.

232 15 U.S.C. § 77d (2).

233 Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (U.S. 1953)

234 *Id*, 121. In 1947, 243 employees of Ralston Purina bought the unregistered stock, 414 in 1949, 411 in 1950, and the 1951 offer solicited 165 applications to purchase.

235 *Id,* 125.

236 *Id.*

237 *Id*, 126.

238 *Id*, 127. The court reasoned that though executives could have information in tantamount to those made available in a registration statement, absent such special circumstance, employees are just commonplace members of the investing public. The court found many of those employees buying stock issued by the respondent lacked access to the information that should be otherwise disclosed in registration. Ultimately, the court held the non-public offering exemption inapplicable to Ralston Purina's offerings in question.

fleshed out the Ralston Purina standard in Doran v. Petroleum Management Corp.[239], stressed sophistication of investors cannot substitute their access to information[240], because "the shrewdest investor's acuity will be blunted without specifications about the issuer[241]". Thus, the private offering exemption will not apply unless "each offeree ha[s] been furnished information about the issuer that a registration statement would disclose or that each offeree has effective access to such information[242]".

Sophistication of an offeree is critical when an offeree has access to information but does not receive actual disclosure of the information from the issuer. Under the foregoing circumstance, the "investment sophistication of the offeree assumes added importance, for it is important that he could have been expected to ask the right questions and seek out the relevant information[243]".

The two cases formulated a two-pronged test to determine when a non-public offering takes place: investors have (1) sophistication and (2) access to information that a registration statement would disclose. Courts would use the number of offerees as non-decisive metric in deciding whether an issuer can invoke the private offering exemption[244]. That being said, an offering to a very small group of offerees who are unsophisticated but have access to information is a public offering, so is an offering to a very small group of offerees who are sophisticated but lack access to information.

The single numeric benchmark of defining a public offering falls short

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239 545 F.2d 893 (5th Cir. 1977)

240 *Id*, 902, holding "a high degree of business or legal sophistication on the part of all offerees does not suffice to bring the offering within the private placement exemption", "sophistication is not a substitute for access to the information that registration would disclose".

241 545 F.2d 893, at 903. The court further pointed out "for an investor to be invested with exemptive status he must have the required data for judgment".

242 545 F.2d 893, at 897. The court noted the distinction between offerees who had furnished information that a registration statement would have provided and offerees who had not furnished such information directly but who were in a position to obtain the information, i.e., had access to such information. The court claimed in both situations, the information was available to offerees. *See* 545 F.2d at 903.

243 545 F.2d at 905.

244 *See* e.g., Doran v. Petroleum Management Corp. 545 F.2d 893 (5th Cir. 1977), holding "the number of offerees" is only an factor in deciding whether an offering qualifies for the private offering exemption and "one factor weighs heavily in favor of private status of offering is not sufficient to ensure availability of exemption"; S.E.C. v. Murphy, 626 F.2d 633, at 645. (9th Cir. 1980), finding courts have developed comprehensively flexible tests for the private offering exemption, focusing on (1) the number of offerees, (2) the sophistication of the offerees, (3) the size and manner of the offering, and (4) the relationship of the offerees to the issuer.

in capturing the essence of a public offering. As U.S. courts have persistently stressed, the statutory registration requirement is to provide information necessary for investors to make well-advised investment decisions[245]. In an offering, even more than 200 specific offerees can all be very knowledgeable and experienced who know the securities they invest in well and have access to information they deem necessary to make informed decisions. In this situation, these more-than-200 specific offerees may not need the information a registration process could provide. Conversely, even a handful of specific offerees can be inexperienced, vulnerable to issuer's deceptive scheme, and have no access to information they need to make informed decisions. These few investors are unquestionably the subject that the registration requirements are intended to protect. Premising the definition of public offering predominantly on the number of offerees will inappropriately exclude unseasoned investors from the protection that a registration process can provide, especially in terms of providing material information necessary for an investor to make informed investment decisions.

The "sophistication and information" approach developed by U.S. courts to determining a public offering is more reasonable than the offeree-number-based standard in CSL. Assume there are 199 specific papa-and-mama investors, they have little economic and investment knowledge, little experience in investment, and use their life savings to buy secueities for purpose of earning more retirement funds; and 201 sophisticated investors or corporate insiders who have sufficient access to information of the issuer, resources to weign their investment choices, and deep pockets to pay legal fees if disputes arise. Which group needs the protection of the regisration process? The answer is quite straightforward: It it the former group that actually need the protection, especially the disclosure of information a public offering process affords. However, under CSL's numeric benchmark of public offering, offerings to 199 specific offerees who are inexperienced, risk-vulnerable, and have no access to information needed, does not constitute a public offering, and thus a registration is exempted. This opens a door for malicious scammers to defraud vulnerable investors.

The central idea of equity crowdfunding is to help fundraisers raise funds from a variety of small investors seeking investment opportunities. In other words, small unsophisticated investors constitute a large part of

[245] *See* e.g., S.E.C. v. Bronson, 14 F. Supp. 3d 402 (S.D.N.Y. 2014), noting "Registration "protect[s] investors by promoting full disclosure of information thought necessary to informed investment decisions." (citing SEC v. Ralston Purina Co., 346 U.S. 119, 124, 73 S.Ct. 981, 97 L.Ed. 1494 (1953))

crowdfunding investors. As to unsophisticated investors, they should not be expected to "ask the right questions and seek out the relevant information". Instead, law should dictate issuers to disclose crucial information to these investors. But under the current offeree-number-based definition of public offering, if a crowdfunding issuer plans to issue securities to 199 specific unsophisticated offerees, this issuance would be deemed as a private offering. As the registration process is exempted, in the absense of rules specifically targetting this situation, there is no mandatory disclosure of information to these investors. This will make them extraordinarily vulnerable to financial frauds. On the other hand, under the strict numberic cutoff between a private and a public offering, equity crowdfunding issuers cannot offer securities to more than 201 offerees, otherwise the offering will be public and should be registered. This arbitrary numeric benchmark hurts both offerors and offerees.

5.3 Establishing the Framework in China

5.3.1 An Encompassing Definition of Securities in CSL

It is crucial to recognize that there are far more types of securities than stock and bond are used in financing. As the U.S. supreme court noted in Howey, investors devised "countless and variable schemes" to seek the use of money of others on the promise of profits[246]. Some debt securities such as revenue share notes, convertible securities such as convertible notes, and some non-traditional securities such as SAFEs, are frequently used in financing of startups. The SAFE is especially favored in Reg CF offerings. All these types of securities are not regulated by CSL.

As Such, CSL should add notes, convertible securities, and non-traditional investment instruments in between the debt and equity instruments such as SAFEs to its definition of securities. But this is not enough. Under Howey, investment contracts can be interpreted by courts to encompass many kinds of investment instruments such as limited partnership interests. Likewise, CSL should be amended to include a general, broad, and malleable type of "security", as the investment contract is in U.S. securities laws. This type of security in CSL should enable courts to interpret it broadly to the effect of regulating the mushrooming new types of investment instruments. Frankly, the definitions of securities provided by Securities Act and Exchange Act have great referential value for amending the corresponding part in CSL.

[246] 328 U.S. 293, at 299.

Meanwhile, Chinese legislators should also look to the development in the definition and types of securities under Howey and Reeves. The three-pronged test set out by Howey and its line of cases delineates the characteristics of an investment contract, while the four factors considered in Reeves carry weight in deciding not only whether notes, another crucial while variable instruments, are securities, but also whether courts should extend the regulatory reach of securities laws to investment instruments other than notes. The jurisprudence embodied in these two remarkable cases, can be directly incorporated in the process of amending CSL's corresponding section.

5.3.2 An Exemption and the Implementing Rule

But the most important undertaking to revitalize China's crowdfunding industry is to provide an exemption for it.

The exemption should realize the purpose of crowdfunding is to provide small investors with oppurtunities to invest and startups with venues to raise capital, thus should allow non-accredited investors to participate in crowdfunding offerings.

The exemption could be as terse as the Section 4(a)(6) of the Securities Act. It can only provide the offering limit, the limit on investor's investments in offerings under the exemption, and some other basic requriements, such as each offering should be exclusively conduct on funding platforms registered with CSRC. The undertaking of enacting implementing rules should be left to CSRC.

The disclosure obligations for issuers under the implementing rules should be scaled back relative to the registration requiments in an IPO. The costs of the disclosure required by the implementing rules should be proportional to the offering limit provided by the statutory exemption.

Reg CF and its amendments in November in 2020 should be carefully studied for the purpose of implementing rules. The gist of Reg CF is a tiered disclosure requirement for issuers. Issuers with different target offering amounts are subjec to different disclosure requirements. Well-designed tiered disclosure requirements would not defer small issuers from participating in the offering.

Meanwhile, some kind of general solicitations should be allowed. As issuers under crowdfunding are small businesses and startups instead of well-known corporations, if any kind of general solitation is barred, their offering could not appeal to a large group of investors.

And the implementing rules should require funding platform undertake responsibilities to educate investors, reduce risks of fraud, and provide infrasture such as data room displaying the financials and status quo of issuers and channels on the platforms allowing investors communicate with each other and with executives of the issuer.

5.3.3 A Sophistication/Information-Based Definition of Public Offering

If crowdfunding offerings are exempted from registration, the definition of a public offering would not matter much to exempt offferings. The definition would matter if some kinds of securities are not allowed to offer under the crowdfunding exemption, for instance, assume SAFEs are not allowed to offer under the crowdfunding exemption, SAFE issuers could stucture an offering as non-public that are not required to register.

To rationalize the definion of public offering in CSL, the first step is too remove the arbitrary 200 threshold. This thresholder of 200 specific offerees has little scientific or emperical underpinnings. In fact, a one-size-fits-all numeric cutoff to determine a public offering may not exist.

Second, CSL should include a clear definition of the specificity. The language in CSL is too vague to determine what kind of investors are specific while the other kind are not.

By employing the sophistication/access to information, entrepreneurs can peddle their projects to more than 200 sophisticated investors in crowdfunding transactions. Deeming this kind of transactions as non-public offerings can facilitate their consummation, and reduce concomitant transaction cost, especially cost incurred by over-disclosure and over-communication, as sophisticated investors could be more adept to extract information they need or have unique access to information of the issuer and the offering.

On the other hand, issuing securities to a small number of inexperienced offerees can constitute a public offering even though only a few offerees are involved. The flat investor-number-based definition of public offering flaws in capturing the purpose of defining an issuance as a public offering - to grant the offerees of a public offering the protection of securities law. Necessarily, transaction cost, especially disclosure cost, will arise in this case. To address this dilemma, entrepreneurs can provide these inexperienced offerees with

information that would provide to or can be inferred by knowledgeable and skilled investors. CSRC can also formulate a curtailed disclosure requirement under which material information should be provided to unseasoned investors in crowdfunding offerings.

6. Conclusion

Since Reg CF took effect, thousands of offerings have been made and hundreds of millions have been raised. The growth of the crowdfunding industry shows no signs of slowing down. After the raise in offering limits takes effect in 2021, the deveopment of crowdfunding is expected to accelerate[247].

One controversy in Reg CF offerings in the U.S. is the safety of the SAFE, especially the Republic crowd SAFE that allows the company to put off the conversion of the SAFE as late as an IPO or acquisition.

However, the most outstanding reason for the delayed conversion – to clean the cap table could be addressed by the use of a crowdfunding vehicle. As the Rule 3a-9 under the Investment Company Act will take effect in 2021, delaying the conversion of the SAFE to an IPO or acquisition cannot be justified any more. If then the corresponding provision is not modified to allow automatic conversion, the Republic Crowd SAFE could soon lose appeal.

Even though YC provides its templates, the terms of each SAFE issued vary. Investors should pay particular attention to the triggering events of conversion, limitations on voting rights, and profiles of SAFE issuers. Both emperical and scholarly studies view tech-startups are better SAFE issuers than non-tech companies. But overall, preferred stock and common stock are deemed as more ideal types of securities that should be issued in Reg CF offerings.

Nevertheless, the popularity of the SAFE never loses steam. The reason why the SAFE is so popular in Reg CF offerings is worth further studying. Meanwhile It is still too early to assert that SAFE is unsafe. More emperical studies are needed to explore how investors evaluate the terms and desirability of SAFEs, and how the conversion of SAFEs operates in the real world.

[247] Crowdfund Capital Advisors estimated the amount raised through Reg CF offerings in 2021 could double that in 2020 and reach half a billion, see https://www.crowdfundinsider.com/2021/01/170982-239-million-was-raised-using-reg-cf-during-2020-amount-could-double-in-2021/

It is also puzzling why there are so many common stock offerings on StartEngine and so few preferred stock offerings overall. Common stock is not widely accepted by venture capitalists as it lacks liquidation preferences. Documents provided by Seed Series could substantially simplify the negotiation process of issuing preferred stock. It is worth observing that whether the popularity of preferred stock in offerings under Reg CF will improve.

While in China, the crowdfunding industry is dying due to regulatory clampdown. To resurrect the industry, CSL needs to be further revisited and revised to bring more securities such as notes and SAFEs to its regulatory reach, and to provide an exemption from registration for crowdfunding offerings. Meanwhile, CSRC should faithfully and efficiently exercise its rule-making authority to implement the statutory exemption if enacted. Reg CF and its latest amendments are best references for China's pertinent rulemaking undertakings.