After Online Equity: De-Crowding and Accommodating Venture Capital

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I. INTRODUCTION

On October 23, 2013, the SEC released its proposed equity crowdfunding rules.[1] The proposed rules, which come over a year and a half after the Jumpstart Our Business Startups Act (JOBS Act) was signed into law, outline the details of how the legislation's new crowdfunding provisions will function. While many have lauded the new rules as potentially useful for capital-seeking startup companies, this new financing mechanism has two serious limitations. First, crowdfunding will require companies to incur significant costs in order to comply with the annual reporting requirements of the law.[2] Second, crowdfunded companies may also face difficulty in acquiring traditional venture capital. This Essay discusses the potential pitfalls of crowdfunding and explores measures that crowdfunded companies can take to avoid them.

II. BACKGROUND

Equity crowdfunding is a method of financing in which, generally, large numbers of individuals purchase relatively small dollar amounts of equity in a private company through an online intermediary.[3] Unlike other private-placement methods, such as those under Rules 505 and 506 of Regulation D, companies that sell equity through crowdfunding will be able to sell to an unlimited number of unaccredited investors without filing a registration statement.[4] Consistent with the JOBS Act, the proposed rules allow companies to sell up to $1,000,000 worth of securities through crowdfunding within a one-

1. *See* Sarah N. Lynch, *SEC Releases 'Crowdfunding' Rule*, REUTERS (Oct. 23, 2013, 6:05 PM), http://www.reuters.com/article/2013/10/23/us-sec-crowdfunding-idUSBRE99M03O20131023.

2. *See* Robb Mandelbaum, *What the Proposed Crowdfunding Rules Could Cost Businesses*, N.Y. TIMES BLOGS (Nov. 14, 2013, 7:00 AM), http://boss.blogs.nytimes.com/2013/11/14/what-the-proposed-crowdfunding-rules-could-cost-businesses/?_r=0.

3. *See* John R. Hempill & Lauren Lewis, *Crowdfunding Moves Forward: The SEC Issues Proposed Rules on Crowdfunding*, MONDAQ (Nov. 4, 2013), http://www.mondaq.com/unitedstates/x/272956/Securities/Crowdfunding+Moves+Forward+The+SEC+Issues+Proposed+Rules+on+Crowdfunding.

4. *See* 17 C.F.R. §§ 230.505-.506 (2013). Accredited investors are defined under Rule 501 to include certain institutional investors, business insiders, and individuals whose net worth (or joint net worth with their spouse) is over $1,000,000 or whose income is greater than $200,000 (or $300,000 in joint income with their spouse) for the past two years. *See id.* § 230.501.

year period,[5] so long as the offering is conducted through a broker or a funding portal[6] and the company meets a number of requirements.[7] These requirements include, among other things, making initial and annual disclosures to investors and the SEC,[8] and not advertising the terms of the offering except for notices that direct investors to the online intermediary.[9]

The legislation limits the amount that individual investors may contribute. Investors with an annual income and net worth of less than $100,000 are limited to the greater of $2000 or 5% of their annual income or net worth.[10] Investors with an annual income or net worth equal to or exceeding $100,000 are allowed to invest 10% of either their annual income or net worth (whichever is greater) up to $100,000.[11]

III. Disclosures and De-Crowding

A. Disclosure Requirements

Under the proposed rules, an issuer relying on the crowdfunding provisions of the JOBS Act must make certain initial disclosures to the SEC, investors, and the crowdfunding intermediary.[12] These disclosures include the names of the issuer's directors, officers, and major equity holders;[13] a description of the issuer's business and its capital structure; the risk factors of the business; the terms of the securities being offered; the intended use of the offering proceeds; and the manner in which the offering will be conducted.[14] The initial disclosures must also include the company's financial statements.[15] For an issuer raising less than $100,000, the financial statements must be certified by the company's principal executive officer,[16] while issuers raising between

5. *See* 15 U.S.C. § 77d(a)(6)(A) (2012); Crowdfunding, 78 Fed. Reg. 66,428, 66,551 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pt. 227.100(a)(1)).

6. *See* 15 U.S.C. § 77d(a)(6)(C). The broker or fund portal must comply with a number of requirements as well. *See* 15 U.S.C. § 77d-1(a) (2012).

7. *See* 15 U.S.C. § 77d(a)(6)(D).

8. *See* 15 U.S.C. § 77d-1(b)(1), (4); Crowdfunding, 78 Fed. Reg. at 66,552 (describing initial disclosure requirements); Crowdfunding, 78 Fed. Reg. at 66,554 (describing ongoing reporting requirements).

9. *See* 15 U.S.C. § 77d-1(b)(2); Crowdfunding, 78 Fed. Reg. at 66,555.

10. 15 U.S.C. § 77d(a)(6)(B); Crowdfunding, 78 Fed. Reg. at 66,551. It is worth noting that the proposed regulation is different from the language of the legislation. The language of the statute says "either." However, the SEC changed this because the original language of the statute would mean that there could be investors who would fall into both groups simultaneously.

11. Crowdfunding, 78 Fed. Reg. 66,428, 66,551 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 227.100(a)(1)(ii)).

12. *See* 15 U.S.C. § 77d-1(b)(1) (2012); Crowdfunding, 78 Fed. Reg. at 66,552.

13. The JOBS Act and the proposed regulations require disclosure of the name and ownership level of each existing shareholder who owns more than twenty percent of any class of the securities of the issuer. *See* 15 U.S.C. § 77d-1(b)(1)(iii); Crowdfunding, 78 Fed. Reg. at 66,552.

14. *See* Crowdfunding, 78 Fed. Reg. at 66,553.

15. *See id*.

16. *See id*.

$100,000 and $500,000 must have their financial statements reviewed by a public accountant.[17] For amounts over $500,000, the financial statements must be audited by a public accountant.[18]

In addition to these initial disclosures, crowdfunded companies will also be subject to ongoing reporting requirements. A company that raises capital through the crowdfunding provisions will have to file an annual report of its operations and financial statements with the SEC.[19] Under the proposed regulations, the annual report must include most of the materials required in the initial filing, except for the information relating to how the offering was originally made.[20] Also, the annual financial statements will have to be reviewed in the same manner as they were for the initial disclosures, based on the amount of the offering.[21] An issuer will have to continue to comply with these ongoing reporting requirements until the company repurchases *all* of the securities issued through crowdfunding, becomes a reporting company under the Exchange Act, or liquidates or dissolves the business.[22]

B. De-Crowding

While the initial disclosures may not be a heavy burden for startup companies because they are a one-time event, the ongoing reporting requirements could become particularly onerous for some enterprises. Indeed, as the SEC noted in the report accompanying the proposed rules, the cost of audited financials alone could be $28,700 per year.[23] If a company raises just over $500,000, for example, it could pay over half of that amount just for its audited financials over the course of ten years. As one commentator has noted, companies raising smaller amounts could end up paying more for crowd capital than they would with a credit card.[24] Thus, under the current proposal, the ongoing compliance costs may not be worth it for some companies in the long run.

Of course, a high long-term cost does not mean that a company will not crowdfund. Given the difficulty of getting traditional venture capital or angel financing and the near impossibility of receiving a bank loan without substantial cash flow, many companies may ignore the long term and

17. Crowdfunding, 78 Fed. Reg. 66,428, 66,553 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. 227.201(t)(1)).

18. *See id.*

19. *See* 15 U.S.C. § 77d-1(b)(4) (2012); Crowdfunding, 78 Fed. Reg. at 66,554.

20. *See* Crowdfunding, 78 Fed. Reg. at 66,552.

21. *See id.*

22. *See id.* These specific conditions for terminating the ongoing reporting requirements were not present in the original legislation, so the SEC has the power to change them in the final rules. *See* 15 U.S.C. § 77d-1(b)(4).

23. *See* SEC. & EXCH. COMM'N, PROPOSED RULES: CROWDFUNDING 359 (Oct. 23, 2013), *available at* http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

24. *See* Mandelbaum, *supra* note 2.

crowdfund anyway. Moreover, there may be some companies whose later-stage growth did not pan out, making the disclosures relatively more costly than anticipated. We could see a whole generation of crowdfunded companies strangled by the reporting requirements and looking for a way out.

How will these companies terminate their disclosures? As previously mentioned, there are only three ways: buy back all of the crowd shares, go public, or go broke.[25] Going public would, of course, be the most desirable option. But it is not a viable one for most companies, even if they have decent growth potential and cash flow. This leaves a share repurchase as the only other way. However, a share buy-back could present a serious issue: there is a potential holdout problem. Because the company will have to repurchase *all* of its crowdfunded shares[26]—and there could be thousands of shareholders—one stubborn shareholder could keep a company from de-crowding.

C. Share Buy-Back Rights

The easiest way to get around the holdout problem is to ensure that crowdfunded companies have the right to repurchase crowd shares. This can be done contractually or through a provision attached to preferred shares.[27] Because of the difficulty of having potentially thousands of crowdfunders sign shareholder agreements, however, the better route will likely be the latter. Under this approach, the company would issue preferred shares to crowdfunders with an optional redemption right attached in favor of the company. This right would be written into the company's certificate of incorporation and would carry over to any person who subsequently purchased the preferred shares.

The provision itself would likely be structured to give the company the right to purchase the crowdfunded shares for their fair market value[28] only upon the occurrence of a particular event. For example, the right could be conditioned on the total number of crowdfunding shareholders falling below a certain threshold. Using this provision, the company could conduct a voluntary buy-back to acquire the majority of the crowd shares. Then, once the threshold has been reached, the company could exercise its optional redemption rights to eliminate any dissenting crowd shareholders.[29]

25. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,554 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. § 227.202(b)).

26. *See id.*

27. *See* ALAN S. GUTTERMAN, TECHNOLOGY-DRIVEN CORPORATE ALLIANCES: A LEGAL GUIDE FOR EXECUTIVES 276 (1994).

28. I write "fair market value" because, at any lower price, it is unlikely that crowdfunders would purchase the shares in the first place.

29. Of course, the board would have to do so in a fair manner so as not to breach the fiduciary duties owed to the remaining crowd shareholders.

D. Squeeze-Out Mergers

Assuming a company's crowd shares are not subject to an optional redemption right, the traditional way of getting around this problem is through a squeeze-out merger. Under this approach, a group of noncrowd shareholders would purchase as many crowd shares as possible. Afterwards, they would attempt to affect a merger with a newly created shell company to squeeze out the remaining crowd shareholders. Assuming the noncrowd shareholders acquire a sufficient number of the company's shares,[30] they would be able to effect the merger over the dissent of holdout shareholders. Under the merger agreement, the remaining crowd shareholders would receive at least the fair market value[31] of their shares in cash, and the shell company would merge into the crowdfunded company. As a result, the shell would disappear, leaving only the formerly crowdfunded company with only noncrowd shareholders.

E. Potential Problems

Unfortunately, both of these approaches to reacquiring shares have potential problems. In the case of an optional redemption right, the inclusion of such a provision in a preferred share issuance would likely chill the initial sale to crowdfunders. Investors, hoping to achieve a high upside on their investment, may be wary of granting the company the right to buy back their shares prematurely. Regarding squeeze-out mergers, the risk of shareholder litigation and the cost of the associated legal legwork would be quite high. While the hurdles would not be as numerous as those for a public company going private, state corporate law would still present challenges. Because the directors of a company and any controlling shareholders owe fiduciary duties to minority shareholders,[32] a company would need to take precautionary steps to ensure the transaction was conducted in a fair manner and on fair terms.[33] If going-private transactions are any indication, we could see crowdfunded companies attaining fairness opinions and creating special committees,[34] both of which are time consuming and expensive.

Most importantly, both of these techniques for de-crowding assume that the company and/or a group of noncrowd shareholders have sufficient funds on hand to effect the repurchase.[35] In the startup space, this is a big assumption.

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30. The threshold could be a majority of shares or a higher threshold depending on the requirements of the state corporate statute and the company's charter. *See* DEL. CODE ANN. tit. 8, § 251(c) (West 2013).

31. Noncrowd shareholders would need to receive the fair market value because, otherwise, the board approving the transaction and any controlling shareholder could be in breach of their fiduciary duties. *See* Gregory R. Samuel & Sally A. Schreiber, *Going Private Transactions*, 40 TEX. J. BUS. L. 85, 100 (2004).

32. *See* Samuel & Schreiber, *supra* note 31, at 100–01.

33. *See id.*; *see also* Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983).

34. *See* Samuel & Schreiber, *supra* note 31, at 100–01.

35. The company would have to do so without impairing the company's share capital or impairing its ability to pay its debts. *See* DEL. CODE ANN. tit. 8, § 160 (West 2013).

These techniques will likely only be used by more established companies with substantial cash flow but not strong growth potential.[36] Thus, of the companies that would want to de-crowd, only a very small section of those may be able to. Indeed, the companies most burdened by the costs of complying with the law would be the least likely to have the cash to afford such a repurchase.

IV. ACQUIRING VENTURE FUNDING

A. Potential Problems

Another problem with crowdfunding is that it may inhibit a company's ability to acquire subsequent financing because venture capitalists are apprehensive about investing in companies with large numbers of unaccredited investors.[37] Large numbers of shareholders can mean an investor relations nightmare and a substantial increase in the risk of shareholder litigation.[38] These are both issues that venture capitalists would rather avoid.

Of course, this begs the question: why would a crowdfunded company want a subsequent round of venture financing? There are several reasons. First, one million dollars per year may not be enough to properly grow the business. Indeed, in the first quarter of 2013, the average venture capital investment was four million dollars.[39] And for some industries, such as biotech, the capital demands tend to be even higher.[40] Second, even if one million dollars per year is enough, a crowdfunded company may believe it can get a more favorable and less dilutive price per share from a venture deal than from another round of crowdfunding. Lastly, there are certain nonfinancial benefits to working with venture capitalists. Venture firms can provide guidance on how to run and grow the business and can introduce companies to valuable contacts, such as suppliers, customers, and potential acquirers.[41]

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36. Companies with high growth potential generally look for *more* investor money and do not try to cash out existing shareholders.

37. *See* Andy Brownfield, *Here's What You Need To Know About Proposed Crowdfunding Rules*, CINCINNATI BUS. COURIER, Oct. 24, 2013, http://www.bizjournals.com/cincinnati/blog/2013/10/heres-what-you-need-to-know-about.html?page=all.

38. *See* Cheryl Conner, *'Do You Really Want Dumb Money?' Berry Schuler, on Crowdfund Equity's Dark Sides*, FORBES, Nov. 3, 2013, http://www.forbes.com/sites/cherylsnappconner/2013/11/03/do-you-really-want-dumb-money-barry-schuler-on-crowdfund-equitys-dark-sides.

39. *See* Scott Shane, *Why Equity Crowdfunding Isn't a Threat to Venture Capital*, ENTREPRENEUR (Oct. 7, 2013), http://www.entrepreneur.com/article/228738.

40. *See* Brian Gormley, *The Hidden Costs of Running a Biotech Company*, WALL ST. J. BLOGS (Sept. 21, 2013, 4:23 PM), http://blogs.wsj.com/venturecapital/2009/09/21/the-hidden-costs-of-running-a-biotech-company (noting that average cost of running clinical trial for some venture-backed biotech companies is $33 million over two to four years).

41. *See* Shane, *supra* note 39.

B. Potential Solutions: No Preemption and the Two-Entity Structure

A crowdfunded company that wants to raise a round of venture capital cannot simply de-crowd the company using the methods previously discussed. A crowdfunded company that is looking for additional capital likely would not have the cash to repurchase crowd shares. Moreover, venture capitalists are unlikely to make any capital injection for the purpose of cashing out crowd shares because they want their investment to be put towards growing the company. Thus, crowdfunded companies looking for funding will need to find other ways to soothe venture capitalists' concerns.

The first and most important measure that companies should take is ensuring that crowdfunded shares do not have preemption rights.[42] If the crowd shareholders have been granted preemption rights, this will likely be a deal breaker for venture funds because of the nature of Rules 505 and 506 under Regulation D. Per Rules 505 and 506, the number of nonaccredited investors allowed to participate in a private placement is limited to thirty-five.[43] Should more than thirty-five nonaccredited crowd shareholders hold preemptive rights and want to participate in a round of funding, Rules 505 and 506 could not be used. This would severely hamper a company's ability to raise capital through a private placement, presenting an unacceptable risk for most venture funds.

The second issue that companies will need to address is regarding the sheer number of shareholders. In order to deal with this, startup companies will want to carefully consider their capital structure before engaging in a round of crowdfunding. In particular, startups will want to consider ways of grouping and separating crowdfunders.

One way startup companies could do this is by assuming a two-entity structure. Under this approach, the founders would initially create a holding company—either a corporation or a LLC—which would, in turn, create a wholly-owned subsidiary to actually run the business (i.e., the operating company). After creating the subsidiary—a corporation[44]—the founders would cause the holding company to sell shares to crowdfunding investors. Once the holding company receives the cash from the crowfunding round, it would then make a capital contribution to the subsidiary through a share purchase. As a result, the subsidiary would hold all the proceeds from the crowdfunding round and be entirely owned by the holding company, while the holding company would be owned by a combination of the founders and the crowdfunders.

This arrangement would leave the company in a more venture-friendly structure than a single-entity arrangement because all the crowdfunders would

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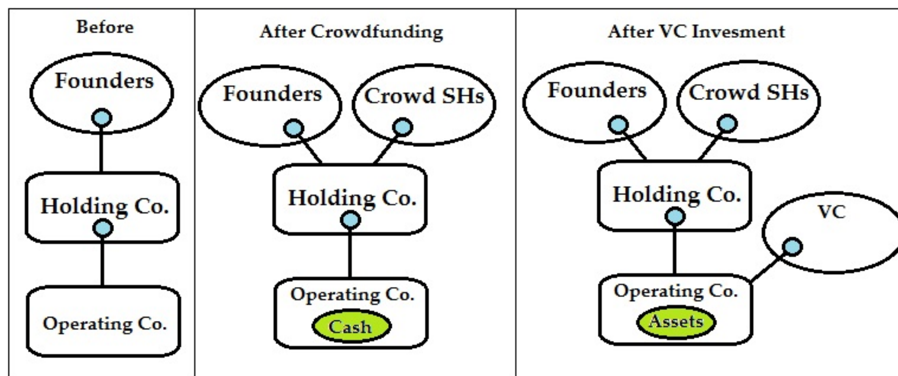
42. A preemption right is the right to acquire subsequently-issued shares on the same terms as those offered to a third party. *See* RUPERT PEARCE & SIMON BARNES, RAISING VENTURE CAPITAL 206 (2006).

43. *See* 17 C.F.R. §§ 230.505-.506 (2013).

44. For reasons why, see Ethan Stone, *Will Investors Put Money into an LLC?*, FOUNDERS SPACE, http://www.foundersspace.com/fund-raising/will-investors-put-money-into-an-llc (last visited Jan. 28, 2014).

be isolated to the holding company and represented as one large shareholder of the operating company. A venture fund looking to invest would simply purchase shares in the operating company, leaving it with only one shareholder to deal with: the holding company. The director(s) of the holding company would be responsible for crowdfunder relations, leaving the venture-appointed directors of the operating company to focus on growing the business. Moreover, this arrangement could simplify the de-crowding techniques discussed in Part III. Should the operating company want to de-crowd at any time in the future, it would only need to repurchase the shares of one shareholder, which would eliminate the potential holdout problem.

Figure 1



Is this type of arrangement (see Figure 1) allowed under the proposed crowdfunding rules? It appears so. Under the SEC's proposal, the crowdfunding exemption does not apply to, inter alia, companies without business plans or whose only plan is to engage in an acquisition with an unidentified company.[45] Also, the exemption does not apply to investment companies.[46] This arrangement, however, does not fall within either of these categories because the company whose shares are to be acquired is known, and the holding company would not qualify as an investment company.[47]

C. Potential Problems with a Two-Entity Arrangement

Of course, this arrangement is not without its drawbacks. The holding company would add complexity as well as additional costs for annual filings and franchise taxes. Also, having two entities makes a future exit transaction

45. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,551 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. § 227.100(b)).

46. *See id*.

47. *See* 15 U.S.C. § 80a-3(a) (2012).

more complicated than it otherwise would be, because it may be necessary to merge the holding and operating companies before an IPO or buyout. The two-entity arrangement could also impact the success of the crowdfunding round. Crowd-investors may not understand the need to corral them into a separate entity. Even if they do, individual crowdfunders may be concerned that they are more susceptible to being squeezed out under the two-entity arrangement, a risk that would need to be explained in the initial disclosure.[48] This could mean less money or more founder dilution during the initial crowdfunding round.

Regarding the tax implications, a two-entity structure could be more costly for crowdfunders and founders. Depending on how much of the operating company is owned by the holding company, shareholders of the holding company could be taxed at the shareholder, holding company, and operating company levels.[49] Fortunately, however, the triple taxation issue likely would not be a problem for most startups. Generally, even if a startup is profitable, all of its excess revenue is reinvested to grow the company and not distributed through dividends. Thus, the holding company and its shareholders would not be receiving any dividends to be taxed. Even if the company needed to make a cash dividend in the future, it could affect a tax-free merger[50] beforehand to put the company back into a one-entity structure. Alternatively, the founders could simply structure the holding company as a LLC, making it a tax-transparent entity.[51]

Perhaps most importantly, this iteration of the two-entity arrangement would have the unintended effect of corralling the founders along with the crowdfunders. This could be problematic because the company would be unable to cash out crowdfunders through a repurchase of the holding company's shares without also cashing out the founders at the same time. Also, the arrangement could complicate founders' relationships with venture financiers and create potential conflicts of interest.

The corralling problem, however, could be avoided by tweaking the two-entity structure. This could be done by having the operating company initially owned by the founders instead of the holding company. Once the entities were set up, the founders would cause the holding company to sell shares to crowdfunders and dilute their holdings effectively to zero.[52] After that, the holding company would use all of the proceeds to purchase newly issued shares

48. *See* Crowdfunding, 78 Fed. Reg. at 66,552.

49. *See* PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 34 (5th ed. 2010).

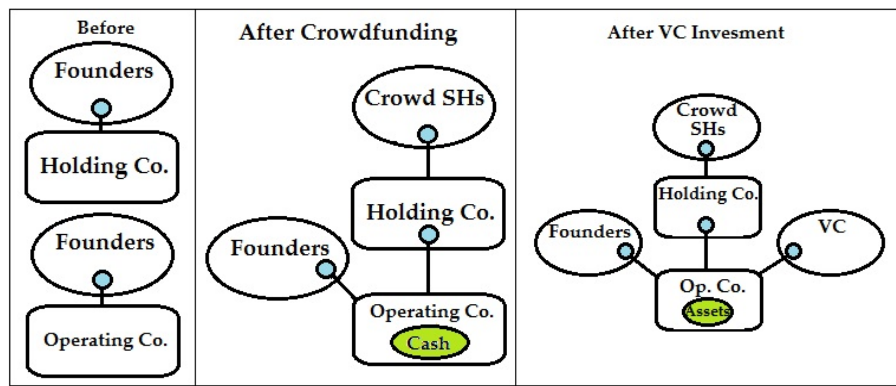
50. *See* I.R.C. § 368 (2012). *See generally* Joseph R. Gomez, *Tax Aspects of Mergers and Acquisitions for the Corporate Lawyer*, 5 J. SMALL & EMERGING BUS. L. 321, 334-43 (2001).

51. *See* J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, LIMITED LIABILITY COMPANIES: A STATE-BY-STATE GUIDE TO LAW AND PRACTICE § 12:1 (West 2013).

52. The founders would still technically hold shares in the holding company, but their ownership stake would be so small it would be inconsequential. They could, of course, subsequently sell their remaining shares in the holding company to completely eliminate their holdings.

in the operating company. The terms of the issuance could be governed by a contract between the holding company and the operating company that was executed before the crowdfunding and was disclosed to crowdfunders. Thus, the price and percentage of equity that the holding company would be purchasing would be known before the crowdfunding. The result of this arrangement would be that the operating company would hold all the cash and be owned by both the founders and the holding company. The operating company could then bring on venture investors in the same manner as in the first iteration.

Figure 2



It is less clear whether this second iteration (see Figure 2) is allowed under the proposed crowdfunding regulations. Under the SEC's proposal, investment companies or companies that would be investment companies but-for the exemptions of Sections 3(b) and 3(c) of the Investment Company Act[53] may not use the crowdfunding exemption.[54] Investment companies, in turn, include any issuer which (1) "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities" and (2) "owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets."[55] Under the second prong of the definition, "investment securities" do not include securities issued by majority-owned subsidiaries of the owner.[56] This means the first iteration would be okay because, at the time of the crowdfunding, the operating company would be wholly-owned. Under the second iteration, however, the operating company would be owned by the founders, not the holding company.

53. *See* 15 U.S.C. § 80a-3(a)-(c) (2012).
54. *See* Crowdfunding, 78 Fed. Reg. 66,428, 66,551 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. § 227.100(b)).
55. 15 U.S.C. § 80a-3(a).
56. *See id*.

Thus, the holding company would arguably be in the business of owning the securities of the operating company, and it would certainly be proposing to acquire “investment securities” with a value of greater than 40% of its assets.

V. CONCLUSION

As discussed in Part III, the costs of annual reporting for crowdfunded companies could be quite high. As a result, it is likely that we will see some companies in the future looking to de-crowd. Doing so, however, will present challenges. Large numbers of relatively small investors and the SEC’s proposed rules mean that holdout shareholders could be a serious problem. In order to get around them, companies seeking crowdfunding will need to act with foresight and ensure they have a repurchase right. If not, they may be forced to undertake the more risky and costly approach of a squeeze-out merger.

Of course, because the SEC’s proposed rules are not final, the difficulty of de-crowding might still be mitigated. If the SEC changes its rule by terminating ongoing reporting requirements once the number of crowdfunders falls below a certain threshold—for example, thirty-five—this would greatly lower the risk of a holdout and make it easier for companies to de-crowd. However, even if the SEC adjusts the termination conditions, companies will still need to have the cash on hand to buy back crowd shares. This means many startups, short on cash, will likely be stuck eating the cost of annual disclosures.

As discussed in Part IV, crowdfunded companies who are seeking venture capital will need to act proactively to make themselves more appealing. Most importantly, crowdfunded companies should ensure that they do not grant crowdfunders preemption rights. Also, companies may want to consider isolating crowd shareholders in a separate legal entity before seeking venture financing. This will decrease the number of shareholders the venture fund has to deal with, allowing them to focus on growing the company. As far as what the structure should look like, it appears that the first iteration discussed would be allowed under the proposed regulations, but it has the draw-back of lumping founders in with crowd shareholders. The second iteration, while it eliminates this problem, may not be allowed under the proposed rules.

What does all this mean for startups? Companies considering crowdfunding should evaluate their options very carefully. Once crowd shareholders are brought on board, they will be costly and difficult to get rid of. Moreover, crowd shareholders could prevent some companies from acquiring the venture financing they need. While crowdfunded companies can adopt a two-entity structure to make themselves more venture-friendly, this arrangement comes with a number of costs.