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New crowdfunding rules adopted on October 30

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On October 30, the SEC adopted new rules for Title 3 of the Federal Jobs Act after significant delays. Title 3 is the portion of the act which authorizes investments in businesses and real estate by individuals who are not accredited investors. Prior Jobs Act rules relaxed the advertising restrictions for offers to accredited investors.

The new rules may be of limited value for the typical New York real estate sponsor, however.

First, Title 3 crowdfunding must be accomplished through approved funding portals. Experts are mixed as to the likelihood that the portals will be able to create a sustainable business at prices that will be acceptable.

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Investors are limited to investments of the greater of $2,000 or 5% of their annual income or net worth if their annual income and net worth are both less than $100,000 or 10% of their annual income or net worth if the annual income or net worth is equal to or greater than $100,000. Having many small investors is an administrative challenge in terms of disclosure, answering questions, etc. While intermediaries may offer services to deal with the administrative aspects, the additional costs may be problematic.

And, of course, for all offerings whether under Title 3 or not, potential liability for claims of securities fraud remain and a New York real estate sponsor may want to avoid dealing with the less sophisticated investors that are expected to participate in the new portals.

While Title 3 is affected by these issues, the Title 2 rules which loosened the restrictions on general solicitation including advertising to accredited investors remain in effect. My overall impression is that there have been only limited numbers of closed deals in New York using the Title 2 rules. Title 2 does not require a portal, any website will work, but it does require a reasonable investigation of the qualification of each investor as an accredited investor and, if a broker is used, the broker must be a federally licensed securities broker unless a limited exception is available. Sites like Patch of Land and Fundraise have started to close real estate crowdfunding deals although not many in New York.

Another issue is whether the crowdfunding for a particular deal is structured as debt or equity. In the majority of the real estate deals I have seen, it has been structured as debt which has surprised me – the investor gives up the possibility of a big return in exchange for the more modest debt returns without getting the benefit of leverage while at the same time having many of the same risks as equity. Lenders are just now starting to grapple with the ramifications of additional debt in the capital stack. But equity crowdfunding is much more complicated involving the potential for phantom tax and other thorny issues.

The crowdfunding method of capital raising for real estate will continue to develop and sponsors, brokers and lenders should follow the area closely.

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