

Crowdfunding Mortgages for Pennsylvania Real Estate Investment

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By Bradley S. Dornish, Esquire

Solicitation of mortgage backed loans for real estate investment has long been regulated and greatly limited by both Federal and Pennsylvania Securities laws.

Federally, under the Securities Act of 1933, the offer and sale of securities is required to be registered. Under the Securities Exchange Act of 1934, once a registered offering is made, the offeror is subject to ongoing reporting obligations over the life of the investments. Many exceptions to the requirements of these laws are limited to investors known as “accredited investors,” those with high net worth and investing experience.

Pennsylvania real estate investors seeking private money backed by mortgages to buy and/or renovate Pennsylvania investment properties with funds from Pennsylvania residents, may be able to avoid the imposition of Federal Securities Laws, but Pennsylvania has its own Securities Law, the Pennsylvania Securities Act of 1972. Under that Act, the offering of securities in Pennsylvania is regulated, subject to very limited exemptions. Offers to no more than 50 persons over the course of a year which result in sales to no more than 25 investors who meet the Pennsylvania standards for “accredited investors” avoid registration under the Pennsylvania Securities Act, but still must be documented as “limited offerings” with thick, detailed Private Placement Memoranda requiring detailed legal disclosures and accountant prepared financial forecasts. These costs can be substantial. The last private placement I was involved in ran over \$10,000.00 in legal fees and more than that in accounting fees, taking a year to prepare before the first solicitation could be made.

For these reasons, we have long directed our clients away from raising capital by selling shares or interests in proposed real estate mortgages, unless they are ready to spend tens of thousands of dollars on securities compliance in an effort to raise millions of dollars of real estate

financing. Most investors with purchase and development plans which meet these threshold requirements also have the cash or equity and good credit to finance through bank loans at lower cost and with shorter turnaround times.

Since the emergence of the internet as a primary means of communication and connection between those with needs and those with skills or money, the ways of doing business have changed substantially.

First, crowdsourcing became a means by which those with problems were able to find those with skills and desire to solve those problems without hiring the problem solvers and creating an in-house research and development team. Much innovation by small business relies, at least in part, on crowdsourcing and major companies have also turned to the crowd to augment their own research and development.

Crowdfunding has taken longer to develop in the United States due to the complex Federal and State Securities Laws described above. The first crowdfunding activities here were on a non-equity donation basis, where someone with a business dream asked for, and sometimes received, small donations from the crowd, with no expectation of return of capital, interest or equity in the business. Certainly, this avoided securities problems but meant that there was no investment benefit to those in the crowd who parted with their money.

The Jumpstart Our Business Startups Act, known as the JOBS Act, was enacted in April of 2012 and established a regulatory structure for startups and small businesses, including real estate investors, to raise capital through securities offering using crowdfunding on the internet.

At that time, Title II of the JOBS Act directed the Federal Securities Commission to amend its Rule 506 of Regulation D to permit general solicitation or general advertising in offerings under Rule 506 but still required that all purchasers of the securities had to be accredited investors. Title III of the JOBS Act added a new Section 4(a)6 {15 U.S.C. 77d(a)(6)} to the Securities Act and that exemption created the greatest opportunity for crowdfunding business investment including mortgage loans on investment real estate.

The Section 4(a)6 crowdfunding exemption has specific requirements and limitations, which include:

- The amount of capital raised must not exceed one million dollars in a twelve (12) month period.

- Individual investments in all crowdfunding issuers in a twelve (12) month period are limited to:
 1. the greater of \$2,000 or five (5%) percent of annual income or net worth, if the annual income or net worth of the investor is less than \$100,000; and,
 2. ten (10%) percent of annual income or net worth (not to exceed an amount sold of \$100,000), if annual income or net worth of the investor is \$100,000 or more.
- Transactions must be conducted through an intermediary that either is registered as a broker dealer or is registered as a new type of entity called a “funding portal.”

Section 4A of the Securities Act was also part of Title III of the JOBS Act. That section, 77 U.S.C 77a, requires the issuers of crowdfunding securities and the intermediary broker-dealers or the funding portals who connect those securities to the investors, must provide certain specific information about the investment, the issuer and the intermediary, to the investors, take offer actions and provide notices and information regarding the transactions to the Securities Commission.

Or

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In October of 2013, the SEC published proposed new rules for crowdfunding, which generated almost 500 detailed comments from industry groups, state securities regulators, investor organizations, Members of Congress and others. After consideration of all of those comments, final rules for “Regulation Crowdfunding” were published by the SEC in 2015, and became effective May 16, 2016. With these rules in

place, borrower/issuers, Crowdfunding Portals and lender/investors can now feel comfortable moving forward with compliant crowdlending transactions.

The first clarification offered in Rule 100(a)(1) of Regulation Crowdfunding is a clear limit of one million dollars in the aggregate amount a borrower/issuer can borrow from all crowdlending investor/lenders in a twelve (12) month period. This limit is on the total amount loaned and does not allow for deduction of the amount of fees and costs the borrower/issuer pays to the funding portal to process and place the loan transaction. The rule also makes clear that there is a control group test for the aggregation. This means that you, as a borrower/issuer, cannot increase the amount of money you can borrow by forming one or more additional entities.

Under Regulation Crowdfunding Rule 100(c), an investor/lender is limited to investing the greater of \$2,000 or five (5%) percent of the lesser of the investor’s annual income or net worth if either net worth or annual income is less than \$100,000. An investor whose net worth and annual income both exceed \$100,000 is limited to investing ten (10%) percent of the lesser of annual income or net worth, in any event not to exceed \$100,000 across all crowdfunding investments, even if the crowdfunding investor/lender is an “accredited investor”.

The SEC provided the following chart to help explain the rules.

Investor

Annual Investment	Investor	Calculation	Limit
\$ 30,000 (\$1,500)	\$ 105,000	Greater of \$2,000 or 5%	\$30,000 \$ 2,000
\$ 150,000 (\$4,000)	\$ 80,000	Greater of \$2,000 or 5%	\$80,000 \$ 4,000
\$ 150,000 \$100,000	\$ 100,000	10% of	\$ 10,000
\$ 200,000 \$200,000	\$ 900,000	10% of	\$ 20,000
\$1,200,000 \$100,000)	\$2,000,000	10% of \$1,200,000 (Capped at \$100,000)	\$100,000

Next under Rules 100(a)(3) and 300(c), borrower/issuer is limited to using a single portal and its associated platform for each proposed loan. This is

to help assure transparency for the transaction, making it easier to confirm the maximum aggregate borrowing of the borrower/issuer and the maximum permitted investment of each lender/investor.

Regulation Crowdfunding Rule 100(b) excludes from using crowdfunding foreign issuers and investment companies, as well as Exchange Act reporting companies (companies issuing securities listed on securities exchanges like the New York Stock Exchange). The Rule also prevents those borrower/issuers who are delinquent in providing their annual Regulation Crowdfunding reports to the SEC under Rules 202 and 203(b), from issuing additional offering of securities under this Section. So, a borrower who wants to continue borrowing up to a million dollars each year under Regulation Crowdfunding has to keep up on all annual required reports or will be shut off from further use of the borrowing process.

The information required to be disclosed when money is sought through Crowdfunding is clear: Rule 201(a) and (c) requires a borrower/issuer to disclose information about each person having a twenty (20%) percent or greater interest in the borrower/issuer and information about the business experience over the past three (3) years of its officers, directors or others with similar roles.

Rule 201(d) requires disclosure of the business and business plan of the borrower/issuer, but is flexible to allow the scope of those disclosures to match the amount of money sought.

Rule 201(i) requires a description of the use of proceeds sufficient to permit prospective lender/investors to evaluate the investment. The level of detail is determined based upon particular facts and circumstances, and the rules contemplate that even a range of possible uses of proceeds without a single definitive plan can be the basis for a request for funding under this Regulation.

There are additional disclosure requirements on the identity and compensation of the intermediary or crowdfunding portal, risk factors of the investment, other debt of the borrower/issuer, as well as its other exempt offerings and related party transactions. Rule 201(y) added a catchall provision for the borrower/issuer to disclose any material information *to not make the rest of the information disclosed not misleading in light of the circumstances under which they were made*. Disclosures of the financials of the borrower/issuer are also scaled to the amount of the loan being requested. For amounts up to \$100,000, disclosure of total income, taxable income and total tax on tax returns and

financial statements certified by the principal executive officer covering the past two fiscal years are sufficient for offerings more than \$100,000 up to \$500,000. Rule 201(t)(2) adds a requirement for accountant reviewed financial statements and for offerings more than \$500,000, a one-time use of reviewed financial statements, followed by a general requirement for audited financial statements.

All statements issued are to be prepared in accordance with Generally Accepted Accounting Principles (GAAP).

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