

Crowdfunding & Pre-owned Digital Marketplaces

Recent “Hot Topics” in Silicon Valley



Author David Hoppe

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In the past year, there has been a flurry of important developments in the United States in legislation, case law and new technologies that may cause major changes for large and small businesses and entrepreneurs in the US and abroad. Two recent such “hot topics” in the US have the potential to cause a major shift in the way small businesses raise capital and change the ability of content producers and more established businesses to monetize their digital assets.

The first of these is crowdfunding and the potential effect of recent US legislation which will enable “equity crowdfunding”. We will then move to recent efforts to develop marketplaces for “used” or secondhand digital goods which could affect potential revenue streams for content producers and publishers. These current hot topics will likely change the landscapes for the US, Japanese and other international businesses trying to raise funds or capitalize on digital content, and we will address the long-term impacts which may be expected as a result.

Crowdfunding

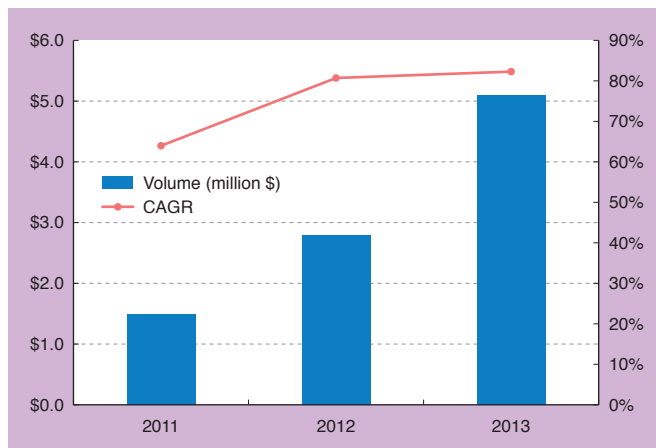
An Introduction

Even though many are still dealing with the effects of the recent global recession, it seems as if giving away money has never been so popular. Crowdfunding, where individuals collectively support the funding of projects or businesses, has become popular throughout the world and especially in the US. In 2012, crowdfunding volume worldwide grew 81% to \$2.6 billion, surpassing the 64% growth in 2011. The US accounted for about 60% of the worldwide volume in 2012. In Japan and the rest of Asia, crowdfunding has not caught fire as quickly, and crowdfunding volumes in the Asian region only accounted for 1% of the worldwide crowdfunding volume.

There is a range of crowdfunding models in the US. Under the “all-or-

CHART 1

Worldwide crowdfunding volume & growth



Source: Mass Solution 2013 CF, “The Crowdfunding Industry Report”

nothing” approach (such as that used by Kickstarter, the largest crowdfunding platform in the US) funders must reach their goal to collect any funding, while other current crowdfunding platforms use the “keep-it-all” approach. While established crowdfunding platforms in the US like Kickstarter and IndieGogo continue to show dramatic growth, a crop of new, smaller platforms is fast rising to bite at their heels both at home and internationally.

The types of projects attempting crowdfunding have grown much more diverse as well. In its beginning, crowdfunding was used mostly to raise money for creative projects such as rock albums, movies, and other arts-related projects. In fact, one of the earliest crowdfunding was Electric Eel Shock, a Japanese rock band, who successfully raised money from fans in 2004 and 2006 to independently record an album. Now, a wide variety of projects are attempting funding, with most successful campaigns raising less than \$10,000. The most successful crowdfunding campaigns have garnered a lot of attention, such as the millions raised to fund the development of video games or game consoles. But not all campaigns have been so lucky. In fact, only 44% of campaigns on Kickstarter reached their goal. The strong growth in both demand for and supply of good crowdfunding projects means that fundraisers and backers will need to better differentiate themselves from the pack.

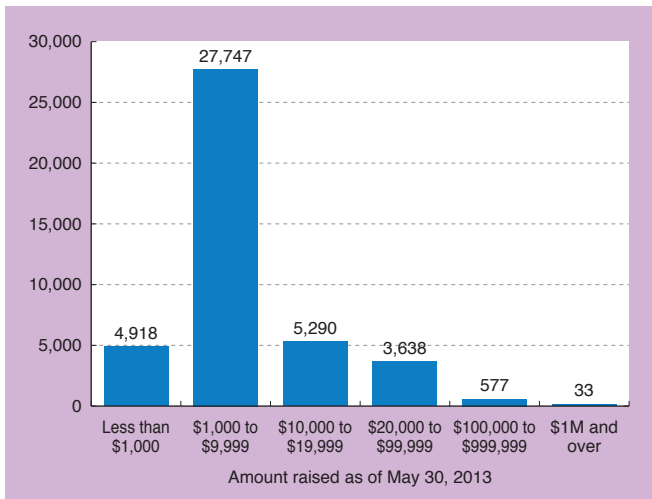
“Donation” versus Equity Crowdfunding

Under the primary model in the US used by crowdfunding platforms, “investments” are little more than donations. While crowdfunding projects incentivize backers by offering “rewards” such as digital downloads of the completed project (whether it be an MP3, DVD, etc.) and free t-shirts, no equity or return on investment is pledged in return for contributing the capital to build the game. Funders participate in campaigns out of sheer desire to see the projects fulfilled, rather than to realize a gain on an investment.

Equity crowdfunding is far less common in the US due to securities regulations limiting investors and investments. In equity crowdfunding

CHART 2

Kickstarter projects successfully funded



Source: Kickstarter

investors receive actual ownership interests in the sponsoring company (or perhaps particular projects) in exchange for their investments. Projects that provide equity in return for funding are attractive to potential backers for a number of reasons – not only will funders get to support a favorite project, but they get to be shareholders able to participate in the company’s or project’s success. In addition, equity crowdfunders benefit from additional regulatory safeguards in place to make sure that the promises of the crowdfunded project are delivered.

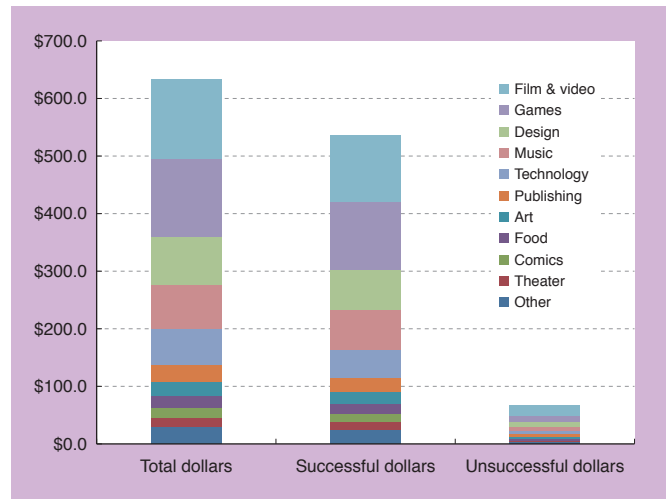
Despite the significant potential benefits for both fundraisers and funders, just 4% of all US crowdfunding dollars were equity investments. Currently, companies may only issue equity to investors if the equity is registered with the Securities and Exchange Commission, a hugely expensive and time-consuming process that winds up being available generally to companies that are already well-capitalized.

One exemption from the registration requirement, known as Rule 506 under Regulation D, allows companies to issue stock in unregistered transactions to “accredited investors”. Accredited investors are typically individuals with a net worth of more than \$1 million, or whose income exceeded \$200,000 in the previous two years. Startups and small businesses often use the Rule 506 exemption to raise early-stage financing. It is estimated that approximately \$895 billion was raised in 2011 under Rule 506 (more than five times the \$169.9 billion raised in global IPOs in the same year).

However, wheels are in motion that may change this situation in the coming months. In 2011, crowdfunding proponents led a rally in Washington to loosen securities law restrictions. This led to the “Jumpstart Our Business Startups Act” (or “JOBS Act”) that was signed into law on April 5, 2012. The JOBS Act is intended to encourage funding of small businesses by permitting a wider pool of small investors with fewer restrictions. The bill mandates changes in securities laws representing a huge departure from the philosophy that has underpinned US securities regulation since the Great Depression. The JOBS Act will provide a new exemption from SEC registration requirements for certain types of small offerings and permit crowdfunding sites to raise funds from non-accredited investors.

CHART 3

Kickstarter projects to date (million \$ as of May 30, 2013)



Source: Kickstarter

Regulating Equity Crowdfunding

Under the JOBS Act, a startup or small business may sell up to \$1 million of stock during any 12-month period through an intermediary such as a broker or an SEC-approved crowdfunding portal. The crowdfunding company must submit initial and annual filings to the SEC and investors, including financial information, business plans, capital structure and risks of investment.

Non-accredited investors will be allowed to invest in startups subject to certain limitations on their investment based on their income. Investors are limited to investing \$100,000 in crowdfunding offerings in a 12-month period, and they must hold their securities for one year, subject to certain exceptions.

The SEC has allowed issuances to accredited investors under Rule 506 on the premise that accredited investors can protect themselves and adequately detect fraud, thus reducing issuer liability and transaction costs. Since this premise may not apply in the case of non-accredited investors and startups, the JOBS Act requires the SEC to draft regulations with strong investor protections.

Crowdfunding proponents have also warned the SEC that the costs of stringent investor protections, such as audited financials and verification of investor qualifications, may make crowdfunding prohibitively expensive. Further, if equity crowdfunding winds up being too regulated, the basic objective of the JOBS Act will not have been met.

Although it’s been over a year since the JOBS Act became law, the SEC has yet to work through the details and draft the applicable regulations. The regulations were due on Jan. 5, 2013 but have not yet been issued. Significant progress is not expected until 2014. Additional delay may result from a requirement in the JOBS Act that the Financial Industry Regulatory Authority (FINRA), a non-governmental organization, set forth its own guidelines for crowdfunding portals.

Looking Ahead

Equity crowdfunding, when it finally arrives, will likely open a new world of financing opportunities for entrepreneurs and small businesses. While expectations are that increased availability of investment and more

successfully-funded projects will result, it seems clear that equity crowdfunding will not be the best choice for all campaigns. Hopefully this new crowdfunding channel will bring even more attention and legitimacy to traditional “donation” crowdfunding, however, also benefitting small projects and businesses who wish to continue using that approach.

Pre-Owned Digital Marketplaces

The evolution of marketplaces to resell digital content has gained serious momentum in the US in the past few months. Two of the largest players in the technology space, Apple and Amazon, have been recently granted or filed US patent applications outlining the makings of a digital secondhand market. The discussion below reviews US copyright law, current offerings attempting to create a used digital marketplace and related litigation, and future offerings by major players that could upend the market in the US and other countries.

US Copyright Law

US copyright laws protect copyright owners by giving them the exclusive right to distribute and reproduce their copyrighted material. An exception to the copyright owner’s exclusive distribution right is the “first sale” doctrine, which permits legitimate buyers of copyrighted works to sell, display or otherwise dispose of their particular copies without permission from the copyright owner. Under this first sale exception, owners of books, CDs, videos, etc. are able to sell or give away their used goods without violating copyright law.

The evolution of digital technology poses new questions to the applicability of the first sale doctrine. First, it is unclear if the first sale doctrine protects the resale of digital content. Digital content is generally sold under a license agreement, so that the buyer is not the “owner” of the digital content, but rather a licensee subject to a license agreement with the distributor (such as Amazon or iTunes). As a licensee, the first sale doctrine arguably does not apply. Moreover, license agreements under which digital content is transferred can differ. For example, online music sold by Amazon may not be transferred. However, the iTunes terms of sale provide for a transfer of title that allows iTunes customers to subsequently resell their songs. In this way, owners of digital music face much greater restrictions due to their license agreements than, say, owners of physical copies of the same music (e.g. a CD), who are limited by copyright law.

ReDigi

One US company currently relying on the first sale doctrine to apply to digital content is ReDigi. ReDigi has set up an online digital marketplace for used digital music, and offers a cloud service in which users may store, stream and eventually sell and buy digital music. ReDigi claims that its technology ensures compliance with copyright law by ensuring that sellers do not retain copies of their content sold on their computer or other connected devices, and verifying that only music purchased through iTunes (and thus transferrable under the iTunes terms of service) is sold through the platform. ReDigi has sought to appease the claims of artists and other copyright holders who have claimed that pre-owned marketplaces would further devalue their digital content, by offering artists a 20% cut of the resale price.

In 2012, Capitol Records sued ReDigi for copyright infringement

related to Capitol digital content available for resale on the ReDigi site. A New York federal court ruled in March 2013 that ReDigi’s service was not protected under US copyright law. The court found that the process of uploading music on ReDigi’s cloud server resulted in an unauthorized new copy of the content, in violation of copyright law. ReDigi had claimed that a copy was not created but that the migration of music to the cloud was analogous to a train, and that no copy was created. Because the court found that the reproductions themselves were not lawful, ReDigi could not avail itself of the first sale doctrine and, therefore, was liable for infringement of Capitol’s copyrights. The court’s ruling was not surprising, as most had predicted that the decision would reaffirm the notion that there is no digital first sale doctrine in the US.

Recent Patents from Major Players

Whether the ruling against ReDigi has a chilling effect on the pre-owned digital marketplace remains to be seen. However, before the ReDigi ruling was handed down, the possibility of a secondhand digital marketplace had already attracted the attention of major players. This year, Amazon and Apple filed and were granted US patent applications related to pre-owned marketplaces.

In January 2013, Amazon was granted a broad patent for a secondary market for digital objects which would allow users to store digital content they have purchased in a “personalized data store” and then sell, rent, gift, loan or trade this content by transferring it to other users’ stores. In Amazon’s marketplace, content would be deleted from the seller’s data store after transfer, and there would be a limit to the number of times content can be traded. According to Amazon’s patent, “When a digital object exceeds a threshold number of moves or downloads, the ability to move may be deemed impermissible and suspended or terminated.”

In March of this year, Apple submitted a patent application outlining a system which would allow users to sell or give digital content to each other by transferring files rather than reproducing them. Apple’s system is similar to the patent already granted to Amazon, although Amazon’s approach requires transactions to be made via a central marketplace while Apple’s proposed approach would also allow direct user-to-user transfers. Similar to Amazon’s patent, Apple’s patent application also covers gifting and loan as well as resale of digital content. Lending digital content could cause a major ripple effect in countries such as Japan where renting CDs is common (this practice is not common in the US).

The Road Ahead

It is unknown when a digital marketplace from Amazon or Apple may be set up, as both companies have declined to comment on their patents. As we have seen from the Capitol Records suit against ReDigi and the backlash Amazon encountered when it started selling used books, it is likely that media companies and publishers will endeavor to hinder the creation of the first successful digital marketplace. When the time does come, we will see another major shift in how content producers, publishers and consumers are finally able to monetize their digital assets.

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David Hoppe is the founder of Gamma Law, a law firm based in San Francisco focused on the games, media and music businesses. A proficient Japanese speaker, he works extensively with Japanese clients and on Japan-related transactions.