Crowdfunding in the United States

Inability to raise sufficient capital is one of the chief causes of startup business failures. Traditional sources of capital used by more established businesses, such as banks or most venture capital funds, are not usually available to seed and early stage businesses. The capital markets offer another source of funding, but securities offerings in the United States must be registered with the Securities and Exchange Commission under the Securities Act of 1933 or be made in compliance with an exemption under that Act. Registration under the Securities Act is expensive and takes a significant amount of time. There are exemptions under the Securities Act for offerings not made to the public, but investors in these offerings are generally limited to “accredited” (rich) investors. While offerings of investments to “friends and family” are a common source of funding by startups, they are frequently not structured properly to comply with the law (startups having little money to spend on lawyers) and cause problems in later rounds of fundraising.

For several years, startup advocates have urged US regulators to permit crowdfunding to meet the need for small business funding. In this context, crowdfunding is generally defined as the selling of debt or equity securities, in small amounts, to large numbers of people over the internet. It is in some ways an extension of “friends and family” financing.

On April 5, 2012, the President signed the Jumpstart Our Business Startups Act (the “JOBS Act”) into law. Title III of the JOBS Act creates a new exemption from registration under the Securities Act of 1933 for crowdfunding.

Prior to the JOBS Act, unregistered offers to the public in this manner would have been a violation of Section 5 of the Securities Act. (In fact, until the SEC adopts implementing rules, these offerings generally would still involve a violation of the Act.)

The JOBS Act was passed over an extremely short period of time and some of its drafting reflects that urgency. There are several areas of Title III that appear somewhat inconsistent on their face, and that will require clarification by the SEC. In addition, there are numerous areas where the SEC is directed to adopt rules to implement Title III. The deadline for issuing these rules is 270 days after signature by the President, December 31, 2012. Before the SEC can adopt rules, it must first publish proposed rules
and give the public at least 30 days to comment. The SEC has not yet published any proposals.¹

**New crowdfunding exemption: Section 4(a)(6)**

The JOBS Act adds a new exemption from registration under the Securities Act, Section 4(a)(6). The new exemption is subject to the following conditions:

- The aggregate amount sold to “all investors” may not exceed $1 million in any 12-month period. It is possible that the SEC will not count offerings to “accredited” investors in the $1 million limit, so a crowdfunding offering could be much bigger than $1 million in total.

- An investor is limited in the amount he or she may invest in crowdfunding securities in any 12-month period:
  - If either the annual income or the net worth of the investor is less than $100,000, the investor is limited to the greater of $2,000 or 5% of his or her annual income or net worth.
  - If the annual income or net worth of the investor is $100,000 or more, the investor is limited to 10% of his or her annual income or net worth, up to a maximum of $100,000.

- The transaction must be made either through a broker, or through a “funding portal” (a new entity that will be registered and regulated under the Securities Exchange Act of 1934) which meets the requirements set out below.

- The issuer must comply with the disclosure and other requirements set out below.

On the face of the statute, failure to comply with these requirements would cause loss of the exemption under Section 4(a)(6). This is problematic because these are not straightforward requirements, and the SEC will be adding more. Unsophisticated issuers and newly-formed intermediaries may well inadvertently fail to comply with one of them. It would thus seem essential that the SEC issue a “substantial compliance” rule (which it has done in other contexts) that provides that the exemption from registration is not lost if immaterial mistakes are made.

¹ The SEC has solicited comments on rulemaking under the JOBS Act prior to any proposals. See http://www.sec.gov/spotlight/jobsactcomments.shtml. This may streamline the rulemaking and comment process, and permit a shorter-than-usual public comment period.
Requirements for intermediaries

The requirement that crowdfunding investments must be made through an intermediary is significant. It means that all relevant information about an investment will be available in one place, and that the regulators are able to look to the intermediaries to enforce rules regarding limits on investment amounts and to ensure that investors are properly informed. A person acting as an intermediary in a transaction involving the sales of securities for someone else pursuant to Section 4(a)(6) must:

- Register with the SEC as a broker or as a funding portal.
- Register with a self-regulatory organization or SRO (the only eligible SRO at present being FINRA, which regulates brokers and investment banks).
- Provide SEC-mandated disclosures (including disclosures relating to risk) and investor education material.
- Ensure that investors review the education material, affirm that they understand the risk of loss, and answer questions demonstrating an understanding of the risks involved in investing in small businesses and the risks of illiquidity and other matters to be determined by the SEC. Early indications are that there will be numerous funding portals, and that it may be more effective to handle investor qualification issues on an industry-wide basis, rather than requiring investors to go through the same process on multiple portals, although whether that will be possible will depend on the SEC’s rules.
- Take measures to reduce the risk of fraud as mandated by the SEC, including obtaining a background and “securities enforcement regulatory history” check on officers, directors and 20% equity holders of the issuer. SEC rulemaking will be necessary to clarify what intermediaries have to do with the results of these checks, as it is not clear whether something negative in a background check would result in an issuer not being able to make an offering, or whether disclosure of the problem would be sufficient.
- Make the required issuer information (discussed below) available to investors and the SEC at least 21 days before any sales take place.
- Ensure that the issuer gets the offering proceeds only when it has reached the target offering amount, and let investors cancel their commitment to purchase securities in accordance with rules to be set by the SEC.
- Make such efforts as the SEC may require to ensure that investors do not exceed the limits on investment set out above.
- Protect the privacy of information collected from investors.
Funding portals are exempt from having to register with the SEC as brokers (which is a very onerous process, requiring the brokers’ personnel to pass numerous exams and the brokers to meet capital requirements), but the SEC will be adopting rules establishing conditions for that exemption in addition to the statutory restrictions discussed below.

Funding portals are subject to a number of restrictions, many of which do not apply to brokers registered with the SEC. Funding portals may not:

- Pay for finding potential investors. This is in fact unlikely to present much of a problem, as portals are much more likely to wish to promote their services to businesses seeking crowdfunding.

- Give investment advice or recommendations. They may sort or “curate” issuers (so that investors can find the kind of company they are looking to invest in), and may offer their services only to certain types of issuers, but any selectivity with respect to issuers may be problematic. The definition of “investment advice” is extremely broad, and the limited guidance available in this area is likely to present significant uncertainty. Portals will need to be able to weed out obviously fraudulent or problematic issuers. They will want to be able to select issuers on the basis of their perceived quality or likely success. They might not be permitted to do the latter.

- Solicit offers or sales to buy the securities offered on the portal. This broad prohibition will require significant clarification from the SEC, especially since the posting of a crowdfunding offering is in itself the solicitation of an offer.

- Compensate anyone for such solicitation or based on the sale of securities on the portal.

- Hold or manage funds. Portals would not be able to hold securities either, or act as nominees in the way some commenters have requested (in order to deal with the issues presented by dealing with a large number of small shareholders), unless registered as Stock Transfer Agents, which would prove burdensome to small entities.

- Permit their officers, directors or partners from having a financial interest in an issuer using their services. The prohibition is drafted in such a way that it might permit the portal itself to have an interest in an issuer, and some portals have expressed a desire to invest in issuers to show “skin in the game.” Even if not expressly covered by this prohibition, however, discussions with SEC Staff have indicated that such investments might be deemed prohibited “investment
advice.” In light of Congressional interest in this issue, SEC clarification will be necessary.

- Undertake other activities to be specified by the SEC.

The SEC will also specify by rule the circumstances that will disqualify a broker or portal from offering securities under Section 4(a)(6).

One area in which SEC guidance will be necessary is with respect to communications among potential investors. The current donation-based crowdfunding model on platforms such as Kickstarter includes chat boards on which potential donors can interact with the person requesting donations, and also with each other. This interaction among the “crowd” has identified frauds in the past, and is likely to be a feature of investment crowdfunding portals. If a portal were to moderate such chat boards, how much discretion would it have to remove comments without coming close to giving investment advice? The existence of chat boards may also be a factor in whether the SEC permits issuers to list on multiple portals or not. The SEC appears to regard it as important to funnel all information (including analysis by chat board participants) to one location in order to ensure that all investors have access to the same information.

Requirements for issuers

The issuer must be incorporated or organized under the laws of a US state. It may not be an “investment company” under the Investment Company Act of 1940 (a mutual fund or UIT), and cannot be an SEC-reporting company.

Issuers of crowdfunded securities must:

- Provide the SEC and investors and the intermediary with the following information:
  - Name, legal status, web address and physical address.
  - Names of officers, directors and 20% shareholders.
  - Description of business and anticipated business plan.
  - Description of financial condition AND:
    - If raising $100,000 or less, tax returns and financial statements certified by principal executive officer.
    - If raising $100-500,000, reviewed financial statements.
    - If raising $500,000 or more, audited financial statements.
The SEC Staff have informally indicated that any audit will not be in accordance with the standards that apply to public companies, but it will still be an expensive process in comparison with the size of the offering. Much SEC clarification is needed in this area, in particular with respect to potential aggregation of several sub-$500,000 offerings, and guidelines with respect to compliance for recent start-ups.

- Description of intended use of proceeds of offering.

- Target offering amount, deadline to reach that amount, and regular updates regarding progress toward target.

- Price of securities or method to determine that price (with the ability for investor to rescind commitment to purchase after the price has been determined).

- Description of ownership and capital structure of the issuer, including:
  - Terms of securities offered and each other class of securities of the issuer (and the differences between them), including how those terms might be limited, diluted or qualified by the rights of other classes of security.
  - A description of how exercise of rights of controlling shareholders could affect the rights of crowdfunding shareholders.
  - Identification of holdings of 20% security holders.
  - How securities offered are valued and how they may be valued in the future, including during corporate actions.
  - Risks of minority ownership, risks associated with future corporate actions, including additional issuances of shares, sale of issuer’s assets and related party transactions.

Some of these required disclosures, especially those relating to minority rights and dilution, are sophisticated concepts and issuers may require assistance in drafting appropriate disclosure. Portals and other providers may supply templates and standard disclosure, but even so, unsophisticated issuers may not even be able to identify the disclosure that applies to their own situation.

- Other information prescribed by the SEC.

- Not advertise the terms of the offering, except for notices which direct investors to the broker or funding portal. The SEC may provide guidance as to the nature of these notices. Guidance as to how social media may be used will be very important, and the circumstances under which social media or other
communications by others (Twitter “retweets,” for example) might be attributed to the issuer will require clarification.

- Not compensate anyone for promoting its offerings without disclosing that compensation. It is not clear whether this prohibition would cover, for example, paid advertising by the portal, or to what extent portals are able to highlight a particular company using their services.

- Provide the SEC with annual reports of results of operations and financial statements in accordance with SEC rules.

- Comply with other SEC investor protection requirements.

The SEC will specify by rule the circumstances that will disqualify an issuer from offering securities under Section 4(6).

**Liability**

Issuers (and control persons including directors and principal officers) are subject to liability for statements they make. If the issuer (a) makes an untrue statement of a material fact or omits to state a material fact necessary to make its statements, in light of the circumstances in which they were made, not misleading, and (b) cannot sustain the burden of proof that it did not know, and in the exercise of reasonable care, could not have known, of such untruth or omission, it must reimburse the purchase price of securities plus interest. Some commentators have objected to what seems to be a high level of liability for a relatively modest offering size, especially for officers and directors, but most businesses seeking crowdfunding are going to be relatively small, and most officers and directors are going to be in a position to identify untruths or omissions made in the course of the transaction, as they will be the persons making those statements.

Intermediaries may also be misleading for misleading statements made on their sites. The SEC may clarify the extent to which the intermediaries are liable.

**State law**

The offer and sale of securities in the United States is regulated both by the federal government and the various states. Complying with both federal and state rules is prohibitively expensive for small companies. The JOBS Act provides that the states are “pre-empted” from requiring crowdfunding offerings to be registered with state regulators but there is no restriction of the states’ ability to take enforcement action with respect to fraud or deceit by issuers, brokers or funding portals. States may impose
fees if they are the principal place of business of the issuer or if more than half the purchasers of a crowdfunding offering are in that state. A funding portal’s home state may regulate the portal, but cannot impose rules that are different or additional to what is required under the JOBS Act. The SEC will make issuer information available to state regulatory authorities.

**Resale restrictions**

For a year, securities sold under Section 4(a)(6) can only be resold:

- Back to the issuer.
- To an “accredited investor”.
- In a registered offering of securities (such as an IPO).
- To a family member or on death or divorce.

The SEC may adopt other restrictions. Some commenters have requested the ability to create “liquidity platforms” for crowdfunded securities, which will not be possible unless such platforms are registered as stock exchanges or alternative trading systems. The JOBS Act does not create any exemptions from registration for conducting after-market trading activities.

**Impact on the capital-raising process**

It is difficult to evaluate the impact of crowdfunding on the securities laws and the capital-raising process in general. Crowdfunding advocates believe that it will revitalize the IPO market and meet the need for early-stage capital that is currently unavailable to small businesses. Others worry that fraud, or perceived fraud, will make the market unattractive to investors. The SEC and FINRA have not yet indicated the approach they will take with respect to rule writing. The factors most likely to drive the impact of crowdfunding on the broader markets are:

- The extent to which small businesses find crowdfunding an attractive and easy option for early-stage funds.
- Attractiveness of the market to investors, which will be influenced by both their perception of fraud and the extent to which they understand the risks presented by investments in early-stage or small companies.
• The approach taken by the regulators.

The last factor is likely to prove crucial, and finding the balance between investor protection and opportunity in the context of small offerings will prove difficult. It is quite likely that whatever rules are adopted in the coming year will not be the regulators’ final word on the subject.

From the point of view of entrepreneurs crowdfunding offers a startup several advantages. Crowdfunding investors are likely to be patient investors, and not to demand the high returns that angels who make large investments or venture capitalists seek. Companies will not need to be in located in tech hubs or operate in “hot” industries or have connections with large investors. Crowdfunding may provide many companies with the seed money they need to get to the next stage of financing.

Like any other type of financing, however, crowdfunding raises a host of business concerns in addition to the legal ones. A decision to pursue crowdfunding, whether the raise is ultimately successful or not, can have a major impact on the trajectory of a company. Before seeking crowdfunding, wise companies will need to assess their immediate and longer term needs, how their future plans may be impacted, and how much time and effort they can devote to managing a large number of new investors. Ultimately, they may decide that the better course of action is to forgo crowdfunding for the time being.

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