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Crowdfunding: The Brave New World of Raising Capital

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Traditionally, aspiring entrepreneurs looking for easy, low cost access to capital to fund their start-up businesses had limited means. Recently, sites such as Kickstarter and GoFundMe provided a platform, but the most companies could offer in exchange for a cash investment was a first look to the particular product or other creative reward, each of which, however, was not stock.

The elusive reward of stock was still available only to the general public if a company could afford to register its offer and sale of securities with the U.S. Securities and Exchange Commission (SEC) and meet its continuing obligation to file certain required reports, or could qualify for an exemption to registration under the Securities Act of 1933 (the "Securities Act") and Securities Exchange Act of 1934 (the "Exchange Act"). This exemption would most likely be the offer and sale to those few who could meet the definition of being an "accredited investor," generally an entity with assets exceeding $5 million or an individual whose net worth exceeded $1 million, and only after such accredited investor was provided with comprehensive disclosures on the part of the company, which are costly and time consuming to prepare.

Recognizing in part that access to the capital markets should not be limited to the domain of the few, and in view of the democratizing effect the Internet has had with respect to reaching prospective investors, the Jumpstart Our Business Startups Act (JOBS Act) was enacted April 5, 2012, and had as its primary purpose, "to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies." One of the most anticipated parts of the JOBS Act was the rules to be promulgated by the SEC pertaining to crowdfunding. Crowdfunding involves the use of the Internet to raise capital, generally from a fairly large number of people who each invest a relatively small amount.

Under the JOBS Act, crowdfunding will be an added exemption to SEC registration. The SEC was charged with promulgating rules that would set the regulatory framework for the sale of securities through crowdfunding. These rules were finally adopted Oct. 30, 2015 (known as Regulation Crowdfunding) with an effective date of May 16, 2016. Regulation Crowdfunding allows companies to sell

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securities to non-accredited investors through a qualified intermediary using Internet-based platforms, but not without certain limitations, disclosures and other restrictions.

What is the limit on how much a company can raise?

A company is permitted to raise only a maximum aggregate of $1 million through crowdfunding offerings within a 12-month period. An offering through crowdfunding, however, is not integrated with other exempt offerings so long as each offering complies with the requirements of the applicable exemption that is being relied upon.

Is there a limit on how much an individual can invest?

Yes, depending on the annual income or net worth of the individual investor. If an individual investor's annual income or net worth is less than $100,000, then over a 12-month period, he can invest in the aggregate across all crowdfunding offerings the greater of: (i) $2,000; or (ii) 5 percent of the lesser of his annual income or net worth. If both the investor's annual income and net worth are equal to or more than $100,000, then he can invest 10 percent of the lesser of his annual income or net worth. Notwithstanding these specifications, during the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings cannot exceed $100,000.

Can an investor purchase a security through crowdfunding and then immediately re-sell?

No, securities purchased through crowdfunding offerings cannot be resold for one year, with certain exceptions.

Can an investor change his mind?

Yes, an investor can cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the company's offering statement.

How does a company make a sale through a crowdfunding offering?

Transactions are required to take place through either a broker-dealer or a funding portal, registered with the SEC as an intermediary. Only one intermediary can be used, and the transaction has to take place through the intermediary's Internet-based platform.

What are the obligations of the intermediary?

If the intermediary is a funding portal, it would be required to register with the SEC on the new Form Funding Portal, and become a member of FINRA.

The intermediary would, among other things, have to: provide investors with educational materials; take certain measures to reduce the risk of fraud; establish means to keep accurate records of securities holders; make information that the company is required to disclose available to the public on its platform throughout the offering period and for a minimum of 21 days before any security can be sold in the offering; provide communication channels to permit discussions; disclose the compensation it receives to investors; have a reasonable basis for believing that an investor complies with the investment limitations; and comply with completion, cancellation and reconfirmation of offering requirements and notices to investors about their investment confirmations.

What are the prohibitions on a funding portal?

Funding portals are more limited than registered broker-dealers. They cannot: offer investment advice; make recommendations; solicit purchases, sales or offers to buy securities; compensate promoters or other persons for solicitations or based on the sale of securities; and hold, possess or handle investor funds or securities.

Who is not eligible for the crowdfunding exemption?

Certain companies are not eligible, including non-U.S. companies, Exchange Act reporting companies, certain investment companies, companies that are subject to disqualification under Regulation Crowdfunding, companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement, and companies that have no specific business plan or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Are there disclosure requirements?

Unfortunately, yes. Companies will still have to disclose certain information with the SEC, its investors and its intermediary, via an offering statement (Form C) that includes, among other things: the legal status of the company, its ownership and capital structure; names of its directors and officers, longevity in office and business experience for the past three years; name of each person who owns 20 percent or more of the company's outstanding voting securities; description of the company's business and its anticipated business plan; number of employees; discussion of the material factors that make an investment in the company speculative or risky; target offering amount and deadline to reach this target offering amount, and whether the company will accept investments in excess of the target offering amount; description of the purpose and intended use of the offering proceeds; description of the process to complete the transaction or to cancel an investment commitment; price to the public of the securities or method for determining the price; discussion of the company's financial condition; risks relating to minority ownership; and related-party transactions. Companies are also required to amend the disclosures to reflect any material changes for any crowdfunding offering that is not yet complete or terminated, and provide updates on the company's progress toward reaching the target offering amount.

Does a company also have to disclose financial statements?

Yes, for the two most recently completed fiscal years prepared in accordance with GAAP, together with information from the company's tax returns reviewed by an independent public accountant, or audited by an independent auditor, depending on the amount offered and sold.

Does a company have to file an annual report?

Yes, and it has to be provided to the SEC and to investors, also on Form C, which has to include certain items from the disclosure requirements.

How can a company advertise its crowdfunding offering?

Only in a very limited manner. A company can advertise through a notice that states only that the company is conducting a crowdfunding offering; the name of the intermediary and link to the intermediary's platform; the terms of the offering (amount, nature and price of the security, and closing date of the offering period); and the name, address, phone number, website, contact person's email address and a brief description of the company.

Regulation Crowdfunding is a new method of raising money through the Internet, and protection of the investor from potential fraud and abuse appears to have been the primary concern as reflected in the 685 pages the SEC needed to explain its limitations, disclosure requirements and other restrictions.

Despite the opportunity for non-accredited investors, a company will have to carefully weigh its motivations and goals in deciding whether to pursue a crowdfunding or other exempt offering. ■