



CORPORATE

ALERT

POWER TO THE CROWD! THE PROMISE (AND PITFALLS) OF CROWDFUNDING

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On April 5th, President Obama signed the Jumpstart Our Business Startups (JOBS) Act. One of its key provisions is “Crowdfunding”, which amends the Securities Act of 1933 to add a new registration exemption intended to allow companies to raise capital from a large number of people through the internet and social media.

The JOBS Act directs the Securities and Exchange Commission (SEC) to pass rules to enact and regulate crowdfunding “for the protection of investors and in the public interest”. With such broad rulemaking authority, the SEC has the power to make or break crowdfunding as the future of startup capital. Crowdfunding’s success depends on whether the result will be a lean, efficient process for early stage capital raising, or an impractical and over-complicated set of rules that makes crowdfunding unappealing to startups and small issuers.

A Brief Overview of Crowdfunding

As the name implies, crowdfunding allows companies to raise small amounts of capital from a large number of investors through the internet and social media. Crowdfunding enables small startup businesses that may not have easy access to traditional fundraising methods (senior lending, mezzanine lending, venture capital, or other capital sources) to raise the capital necessary to further their business.

Traditional registration exemptions are often not available or difficult to use to raise capital online because of the limitless reach of the internet and the lack of a pre-existing relationship between the company and its investors. The JOBS Act addresses these problems by creating a new registration exemption for crowdfunding. A company will be able to raise up to \$1 million in a crowdfunding offering conducted through an SEC-registered funding portal or broker-dealer.

Qualifying the Offering Under the Crowdfunding Exemption

The JOBS Act amends the Securities Act of 1933 by adding a new Section 4(6). Section 4(6) provides an exemption from registration for transactions that meet the following criteria:

- The total amount sold to all investors in the offering during the preceding 12 month period does not exceed \$1,000,000.
- The total amount sold to a single investor during the preceding 12 months does not exceed:
 - if the investor’s annual income or net worth is below \$100,000, the greater of \$2,000 or 5% of the investor’s annual income or net worth;
 - if the investor’s annual income or net worth is \$100,000 or more, 10% of the investor’s annual income or net worth up to a maximum of \$100,000.

- The transaction is conducted through a broker or funding portal that complies with the requirements of new Section 4A(a) of the Securities Act of 1933 (see below).
- The issuer complies with the requirements of new Section 4A(b) of the Securities Act of 1933 relating to disclosure and other requirements of crowdfunding issuers.

The SEC is required to issue rules to protect investors who participate in crowdfunding within 270 days of April 5, 2012. Before these rules are issued, the crowdfunding exemption will remain unavailable.

Crowdfunding Intermediaries

Crowdfunding must be conducted through a broker or funding portal. These brokers or funding portals are required to, among other things:

- Register with the SEC and an applicable self-regulating organization (which many believe will be FINRA).
- Provide any disclosure that the SEC may require.
- Ensure each investor reviews education information, confirms that the investor understands the risk of loss of its investment and can bear such loss, and answers questions demonstrating that the investor understands the risks inherent in investing in startup companies, as well as other matters that the SEC may require by rule.
- Take measures to reduce the risk of fraud.
- No later than 21 days before the first sale to investors, make available to the SEC and potential investors any disclosure information provided by the issuer to meet the requirements of Section 4A(b).
- Ensure that the issuer may only receive the offering proceeds after the aggregate capital raised exceeds the targeted offering amount, as well as permit all investors to cancel their commitment to invest.
- Ensure that no investor exceeds the per-investor limits in any 12 month period.
- Comply with privacy and information protection requirements adopted by the SEC.
- Not compensate promoters, finders, or lead generators.
- Prohibit its directors, officers or partners from having any financial interest in any company that utilizes the broker or funding portal.

Disclosure and Other Requirements for the Issuing Company

As noted above, these intermediaries will be required to perform background checks on issuing companies to reduce fraud and ensure that potential investors understand the risks involved. In addition, the issuing company will need to publicly disclose information related to the offering, such as their business model, the company's capital structure, plans for the funds, and a description of the financial condition of the issuing company for the preceding years. The level of detail varies depending on the size of the offering: companies raising over \$500,000 will need to provide audited financial statements; companies raising between \$100,000 and \$500,000 will need reviewed financial statements; and companies raising under \$100,000 will need self-certified financial statements and the company's last tax return. In addition, issuers will be prohibited from advertising the crowdfunding offering, with the exception of directing potential investors to its funding portal or broker-dealer.

Crowdfunding investors won't count as holders of record, allowing the company to potentially have thousands of shareholders without triggering public company reporting requirements under the Securities Exchange Act of 1934. That said, a crowdfunded company will need to prepare an annual report for its investors and the SEC. The JOBS Act directs the SEC to prescribe the specifics required in the annual report, but provides little guidance on how demanding the SEC may make it.

Who Will be A Crowdfunding Issuer?

Crowdfunding will appeal to certain categories of small companies:

1. *The Young and Isolated.* Crowdfunding will help most companies during their earliest stages. Most startups are bankrolled by their founder and the founder's friends and family. But not every entrepreneur has the money – or the friends with the money – to launch their business. Crowdfunding offers them hope. They will have access to a new investor base—the “Crowd.”

Moreover, crowdfunding will eliminate the geographical boundaries of capital formation. Angel investors tend to cluster in metropolitan areas (like Silicon Valley), forcing many companies to move in order

to gain access to start-up capital. Crowdfunding will eliminate the need for personal connections to early investors and thus spread the availability of start-up capital. Rural entrepreneurs will turn to crowdfunding to finance startups that the local bank would never consider.

2. *The Strategic (or Idealist) Issuer.* Crowdfunding excites a certain kind of person: the twitter-literate, socially networked, youthful and entrepreneurial. Crowdfunding should excite the companies looking to excite that person. Some small companies will be able to use crowdfunding as a branding opportunity. It will offer the opportunity to demonstrate a grass-roots, anti-big business ethos, and so will be popular with the same companies that market themselves as progressive, green, or socially-conscious. New B-Corporations hoping to be the next Patagonia or Ben and Jerry's will likely consider crowdfunding for their first round of investment.

In addition, crowdfunded companies will have a large number of investors, which means a large group of potential customers who are literally invested in the company's success. Investors are more likely to spread the word to their friends and family and purchase those products or services themselves. Already, many small companies use "pre-sales" on Kickstarter as a method of building brand loyalty before they even begin production. Web-based businesses will be particularly able to take advantage of this aspect of crowdfunding.

Not All Gold Glitters – the Drawbacks to Crowdfunding

Crowdfunding might be exciting, but here are some significant risks and potential pitfalls to consider before any fundraising.

1. *Registration and Reporting Requirements.* The SEC has the potential to make crowdfunding excessively costly. Even without additional SEC regulations, crowdfunding requires more disclosure than private offerings conducted under Regulation D's safe harbors. Moreover, if the crowdfunding rules are too complex, the risk of violating securities law increases, raising the cost of compliance further. The SEC has the ability to crush crowdfunding with onerous disclosure and reporting requirements. Until the SEC's rules are released, the expected utility of crowdfunding will remain uncertain.

2. *Corporate Structure.* After a crowdfunding, the

number of a company's shareholders could potentially go from a few to a few thousand over night. Any company contemplating a crowdfunding will need to carefully consider its corporate structure first in order to arrange strategies for maintaining control of the company and prepare for subsequent investment rounds. From choice of entity and corporate governance issues to capital structures and tax elections, a crowdfunding issuer will need to address a host of legal and strategic issues all at once.

3. *Big Company Hassles.* While state securities law is preempted by the JOBS Act, state corporate law is not. Corporations will still need to notify shareholders before an annual meetings, regardless of their numbers or the cost. Each state's corporate code is different, and some impose greater costs than others. Some states, like Pennsylvania and Delaware, permit notice by email. New Jersey, on the other hand, requires a corporation to get a shareholder's consent before it can email notice, and that consent can be revoked at any time.

A larger number of investors means a greater likelihood of finding yourself saddled with a troublemaker. Unsatisfied investors might sue, accusing the company of fraud during the crowdfunding or a breach of fiduciary duties. A \$25 investor could claim that the company made a material misstatement during the offering, which would allow him rescind his investment. As it stands now, the small chance that an individual would sue over a small amount would protect the company. However, if one person made a large enough investment to justify the initial costs of a lawsuit, others could join the suit easily.

What's worse: the JOBS Act defines "issuer" unusually broadly to include the issuing company's officers and directors. Potentially, if the company did make a material misstatement during an offering and subsequently went belly up, angry investors could go after the management for their money. Unless the SEC does something to significantly limit this liability, very few directors or officers will be willing to incur such large personal risks.

Crowdfunding companies will open themselves up to the kind of risks that small companies rarely need to consider. Start-ups will need to prepare for these hassles and ask themselves if crowdfunding is worth the

headaches that may come along with it.

Follow-On Financing and Crowdfunding

One of the greatest unknowns in crowdfunding is how the venture capital firms will view companies who have raised early capital through crowdfunding. Venture capital firms do not like complicated early capital structures, which is a significant risk with crowdfunding, as noted above. Companies interested in crowdfunding need to carefully consider their need for additional capital and its likely sources. If venture capital is in your company's future, then you will need to develop a forward-looking strategy for crowdfunding your early capital.

Final Words

Crowdfunding is the marriage of social media and startup finance. Whether this marriage will work is yet to be seen, but the results of the SEC's rulemaking over the next few months will be vitally important to its chances for success. We will continue to monitor this closely and keep you apprised of important developments.

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