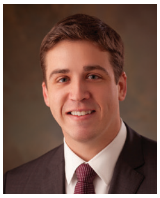
Crowd Control

Preparing for the New World of Equity-based Crowdfunding

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By the end of 2012, the Securities and Exchange Commission will issue regulations that lift the term "crowdfunding" from obscure corners of the internet and inject it into common parlance as a component of American capital markets. Under the new Jumpstart Our Business Startups Act (JOBS Act), crowdfunding will allow small businesses and startups to solicit equity investors from the online masses without filing registration statements with the SEC. The idea is to use the internet to connect entrepreneurs with prospective investors without going through traditional channels such as venture capital firms, private equity firms or angel investors.

The concept of crowdfunding is not exactly new. Over the past several years, a number of websites have emerged to allow small businesses, artists and nonprofit organizations to solicit and collect a large volume of small-dollar contributions. *The Economist* reported in June that around 10 percent of the films shown at the Sundance and Cannes film festivals this year had been crowdfunded.

New Opportunities

Many entrepreneurs have employed "perks-based" crowdfunding, in which contributors receive some kind of non-financial, non-equity reward for their payment. For example, using a prominent perk-based crowdfunding site, Kickstarter, the creators of the Pebble wristwatch caught the world's attention in April 2012 by raising $10.3 million from nearly 69,000 investors. Their "perk" was to offer samples of the startup product to the first contributors.

Until now, however, it has been illegal under the securities laws for crowdfunding startups to offer equity shares in their companies. That will change when the SEC issues new rules to govern "equity crowdfunding." The JOBS Act authorizes equity crowdfunding by creating an exemption from the registration requirements of the Securities Act of 1933 for crowdfunding transactions.

Principal Limitations

As of the time of this article, the SEC has not yet issued its proposed rules, but the JOBS Act text itself provides some information about what will be some of the principal limitations on equity crowdfunding.

First, there are limitations on the size and nature of crowdfunded investments. On the issuing side, a company will be limited to raising $1 million in any 12-month period by selling its shares through crowdfunding. On the investor side, limitations depend on the investor's income or net worth. Specifically, investors will only be permitted to invest 10 percent of their annual income or net worth in crowdfunded companies, up to a maximum aggregate investment of $100,000. For investors with an annual income or net worth below $100,000, a lower limitation of the greater of 5 percent or $2,000 applies. With limited exceptions, crowdfunded shares will not be transferable within the first year after purchase.

Second, the JOBS Act requires certain disclosures by crowdfunding companies. Each company will be required to describe its business plan, including "a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer." Additionally, each company must specify its "target offering amount" and the deadline to raise that amount. If it fails to reach its target by the deadline, all investors who had committed to buy will get their money back. The price of shares or the "method for determining the price" must also be specified, and investors must be given an opportunity to rescind their commitment to purchase after the final price is determined.

Third, the JOBS Act imposes requirements for financial disclosures that vary based on the amount of capital sought. For targets of more than $500,000, audited financial statements are required. For amounts between $100,000 and $500,000, a company must provide financial statements "reviewed by a public accountant" under standards to be established by the SEC. For targets of less than $100,000, a company must file its most recent tax returns and unaudited, unreviewed financial statements "certified by the principal executive officer."

Should a company make material misrepresentations in its disclosures, the statute authorizes lawsuits by any person who suffers damages. These lawsuits may be based on misleading statements as well as misleading omissions in the disclosures.

Fourth, there are restrictions applicable to the websites (referred to as "intermediaries") that connect investors to startups. Intermediaries must register with the SEC and the Financial Industry Regulatory Authority (FINRA) and must provide disclosures and investor-education information that will be specified by the SEC regulations. Intermediaries will also be required to take measures to reduce fraud risk, including obtaining a background check on the officers and directors of crowdfunding companies.

While the regulations expected from the SEC later this year will further define the limitations on crowdfunding, what is clear now is that new opportunities are on the horizon. If you have a startup company with a good idea, you may have more ready access to capital. If you are a venture capitalist, you may have more investment opportunities, but you will also have more competition. Perhaps the crowdfunding statute will provide a new tool for unscrupulous fraudsters as well. However, one thing is certain. With Utah's entrepreneurial spirit and tech-savvy population, the state will almost certainly be at the center of the crowdfunding storm. UB