

RIW's Gary Bubb Offers Thoughts on New SEC Crowdfunding Regulations

By Gary Bubb on May 23, 2016



SEC Crowdfunding Regulations: Crowded with Obstacles

May 16, 2016 was the kickoff date for "equity" crowdfunding under Title III of the Jumpstart Our Business Act (the "JOBS Act," signed into law in 2012). Historically, crowdfunding has been a financing method that companies ("issuers") use to raise capital by obtaining small amounts of money from a large group of people – the "crowd." Typically, the issuer rewards its multiple small investors with a first-run product that the issuer produces. Kickstarter and Indiegogo have been helping issuers with this for some time.

Equity crowdfunding permits an issuer to raise capital (up to \$1,000,000 in any 12-month period) by issuing, to crowd members, equity securities in the form of stock or debt, or a combination, that give the investors a piece of the upside in the issuer's business. Since equity securities are involved, equity crowdfunding is subject to securities laws designed to protect investors from misrepresentation and fraud. Title III of the JOBS Act governs equity crowdfunding.

Equity crowdfunding was greeted with enthusiasm when the JOBS Act passed in 2012. However, it took the Securities and Exchange Commission three years to come up with the governing regulations, and they are so cumbersome that equity crowdfunding may not be an appealing option for a mature small business, much less a start-up. This article summarizes the impediments that an issuer must overcome in order to effectively use equity crowdfunding.

Broker-dealers / Portals. An issuer must use an "intermediary" to raise the capital. The intermediary must either be a registered broker dealer or a "crowdfunding portal" that is registered with the SEC. The entire crowdfunding effort is processed on a dedicated portion of the portal's website. Portals, as such, cannot give investment advice, they can't handle investor money, and they can't solicit purchases, sales or offers to buy the crowdfunding securities that the issuer is selling on their platform. The SEC has largely shifted the burden of providing accurate disclosure from the issuer to the portals, and they are arguably jointly responsible for misrepresentations and other misinformation that might be communicated in the offering. The cost of administering a portal is high and difficult to recover, particularly if the portal accepts its fee in the form of issuer stock.

Expensive Money. The business plan and other disclosures required of issuers are set forth in a "Form C" that must be provided to the SEC, the investors and the portal. The issuer bears the cost of completing the Form C, whether by a securities lawyer engaged by the issuer or the portal itself, or both. The costs to a start-up issuer of an equity crowdfunding can be steep. Typically, a portal will charge 8% of the amount raised. The cost of a required

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review or audit by an independent public accountant is daunting. While the costs can be defrayed if the portal accepts payment in the form of stock of the issuer, there are strict guidelines on the type of "equity" compensation the portal can receive that make this method of payment unattractive. Under the circumstances, it's not clear why an issuer seeking capital would choose equity crowdfunding over a "rewards" type of crowdfunding like Kickstarter, or a standard equity raise using existing exemptions for capital raises to accredited investors. For example, Title II to the JOBS Act permits a company to utilize general solicitation in a capital raise that is sold only to investors who are "accredited investors." It is not clear that equity crowdfunding can compete effectively on cost with other exempt methods of raising capital.

Financials Must be Reviewed or Audited. For an equity crowdfunding raise between \$100,000 and \$500,000, the issuer's financials must be reviewed by an independent public accounting firm. For amounts between \$500,000 and \$1,000,000, a first-time equity crowdfunding company can still utilize reviewed financials, but otherwise the financials must be audited by a public accounting firm. For a startup, the costs of a review are daunting, and the costs of an annual audit prohibitive, particularly in light of the fact that the issuer must reach its crowdfunding goal or return any money that has been forwarded by investors.

Too Many Shareholders / Members. Equity crowdfunding places significant restrictions on the amount of money that an investor can invest in crowdfunding transactions. If the issuer is a limited liability company (the preferred choice of most startups because of ease of governance and tax flexibility), a successful crowdfunding will result in a tremendous number of new members, each of which must receive a K-1 and other tax related documentation at the end of each year. No issuer (LLC or corporation) can issue voting stock in a crowdfunding because of the intolerable governance situation that would be triggered. It appears that crowdfunding issuers must issue non-voting securities that can be eliminated (redeemed) at the issuer's option if the company is successful and hopes to receive follow-up financing. Crowdfunded companies will not be attractive to private equity and venture capitalists, and it's clear that, over time, the crowdfunding investors must be eliminated for the issuer to move forward. As the equity crowdfunding market matures, investors will have to accept a limited upside that gives the issuer an opportunity to rid itself of the crowdfunding dead weight when the real money is poised to join the party.

No Solicitation. "Reward" based crowdfunding is based on aggressive solicitation of money from friends, family, word of mouth, advertising and social media. Since equity crowdfunding involves the issuance of equity or debt securities, the securities laws prohibiting general solicitation must be observed. Issuers cannot "pre-sell" their crowdfunding securities – any attempt to gauge the market before the crowdfunding offering begins could be construed as prohibited "general solicitation." This could be the case even if the issuer restricts its pre-crowdfunding advertising to general promotion of its products without discussion of the securities that will be offered.

The Fix is In. Congress is aware of the problems with equity crowdfunding. At this point, bills have been proposed (such as the "Fix Crowdfunding Act") that would increase the offering limit from \$1,000,000 to \$5,000,000, permit pooling of investors into a single special purpose vehicle that could be treated by the issuer as one stockholder, and permit the issuer to "test the waters" before jumping into a crowdfunding round. Stay tuned.

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