Venture Law BLOG
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The Entrepreneur Access to Capital Act and What It Could Mean for Startups

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There has been a lot of talk recently about a phenomenon called crowdfunding, a new type of fundraising that relies on social media and the Internet to raise small amounts of capital from large numbers of individuals. Despite the talk, crowdfunding remains impermissible under the securities laws absent a costly registration with the SEC and with state securities administrators. Last year, two people created a website, a Facebook page, and a Twitter account to solicit funds to be used to purchase Pabst Brewing Company. They received over $200 million in pledges from more than five million individuals, but were later subjected to cease-and-desist proceedings initiated by the SEC. Crowdfunding would seem to be a viable approach to small company capital formation, if only it were legal.

Today, most emerging growth companies wishing to raise capital without SEC registration limit their offerings to accredited investors and refrain from public solicitation and advertising. The SEC currently defines the term accredited investor, generally, to include numerous types of institutional investors and individuals with a net worth, exclusive of home, of at least $1 million or an annual income of at least $200,000 or $300,000 if the income of a spouse is included. By structuring their offerings in this way, companies are able to come within the exemption from the registration requirements of the federal Securities Act of 1933 provided by the SEC's Rule 506. As a result of the National Securities Market Improvement Act of 1996 (NSMIA), reliance on Rule 506 also exempts an offering from the registration and qualification requirements of state securities laws, the so-called blue sky laws.

Rule 506 permits up to 35 non-accredited investors to be included in an offering, but it requires that extensive disclosure be made to any such investors. The SEC's Rules 504 and 505, companions of Rule 506 in the SEC's Regulation D, also allow for the inclusion of non-accredited investors, but those rules also impose burdensome restrictions. Rule 505, like Rule 506, prohibits advertising and general solicitation, and requires that extensive disclosure be made to non-accredited investors. Rule 504 limits the amount that can be raised in a single offering to $1 million and prohibits advertising and general solicitation unless the offering is registered with a state securities administrator or the offering is limited to accredited investors.

Under the current law, Rule 506 offerings limited to accredited investors are generally preferred as the most efficient method for startups and emerging growth companies to raise capital. This preference for Rule 506 may change if newly proposed crowdfunding legislation is passed. On November 3rd, the House of Representatives passed H.R. 2930 approving the Entrepreneur Access to Capital Act. The bill would create a new category of exempt transaction by adding subsection (6) to Section 4 of the Securities Act – a crowdfunding exemption. The bill is intended to increase the funding available to small businesses. The crowdfunding exemption would allow for the issuance of securities without SEC registration, provided that:

• The aggregate value of the securities sold by an issuer in reliance on the exemption in any 12-month period did not exceed $1,000,000 (or $2,000,000 if the issuer provided potential investors with audited financial statements); and

• The aggregate value of securities sold by an issuer to any individual investor did not exceed the lesser of $10,000 or 10% of the investor's annual income.

Unlike Rule 506, the proposed exemption would not limit the number of investors, prohibit advertising and general solicitation or require that extensive disclosure be made to any investors. As a result, the exemption would, if enacted, permit the type of public fundraising utilized in the ill-fated attempt to acquire Pabst. The current bill does, however, contain a number of conditions that would need to be satisfied for the exemption to be available, including requirements that companies:

• Warn investors of the speculative nature of startups and the illiquidity risks that accompany them. (The issuer must include this warning on its company website);

• Warn investors that they are subject to restrictions on the resale of the securities purchased (as in Rule 506 offerings);

• Take reasonable measures to reduce the risk of fraud with respect to these transactions and not provide investment advice;

• Have each potential investor answer questions demonstrating an understanding of the level of risk and lack of liquidity inherent in investments in startups.

• State a target offering amount and ensure that a third party withholds the offering proceeds until at least 60% of the target offering amount has been raised.

• Outsource cash-management to a qualified third party, such as a registered broker or dealer.

Supporters believe that this legislation, if passed, could open up new sources of capital to startups because the exemption would permit companies to make wide-reaching solicitations for funding and would not limit the number of investors or impose burdensome disclosure requirements with respect to investors not qualifying as accredited investors. A company could pursue investments from almost anyone, whether or not the company had a prior relationship with them and whether or not they are wealthy or sophisticated. Proponents have argued that the exemption would grant small companies access to significant amounts of funding that they could not have raised under Regulation D because of the accredited investor requirements and the ban on general solicitation.

The bill would permit intermediaries to be involved in the offering without requiring that they be registered as broker-dealers. The broker-dealer registration requirement is currently a significant complicating factor in Rule 506 transactions. Finders and other intermediaries who might substantially assist issuers in raising capital are often not involved over concerns that they should be registered as broker-dealers. The bill would impose limited requirements on intermediaries, but nothing comparable to registration as a broker-dealer.

The bill passed by the House contains a number of features designed to make use of the exemption attractive to companies. The bill would amend the Securities Act to designate securities sold pursuant to the exemption as “covered securities,” so that they, like securities sold under Rule 506, would not be subject to the registration and qualification requirements of state blue sky laws. Furthermore, the bill states that securities sold pursuant to the exemption would not be considered “held of record” by persons who purchased them in the offering for the purposes of the requirement that a company register a class of securities under the Securities Exchange Act of 1934 when shares of the class are held of record by 500 or more holders and the company has at least $10 million in assets.

Despite the enthusiasm for the concept of crowdfunding, H.R. 2930 raises significant policy concerns as well as practical issues of implementation.

On a policy level, the use of crowdfunding by small issuers would seem to lead inevitably to results that the securities laws are designed to avoid. The public solicitation of large numbers of relatively inexperienced investors to invest in small untested companies with a minimum of disclosure and almost no supervision will result in unhappiness among at least some investors who lose their money and feel, rightly or wrongly, that they have be defrauded.

From the perspective of the issuers, while greater access to capital is to be desired, the use of crowdfunding would not be without costs. While the prospect of unhappy investors would seem a risk to investors and not issuers, issuers can incur significant costs dealing with disgruntled shareholders. Even if shareholder complaints do not arise, having large numbers of unsophisticated shareholders significantly adds to the administrative and governance responsibilities of small companies. While the initial purchasers may not “count” for the purposes of the 500 shareholder of record test under the Exchange Act, persons who acquire the securities from those persons will count. With the recently relaxed Rule 144 requirements, transfers are to be expected. A crowdfunding offering involving a large number of purchasers would lead the way, before long, to registration under the Exchange Act.

The proposed Act requires that the SEC issue such rules as may be necessary to carry out many of its provisions. This will not be an easy task for the Commission, and the outcome of the rulemaking process is impossible to predict. Several provisions in Act will be difficult to implement. How is it possible, for instance, for an issuer and its intermediaries to raise money from investors and advise them of the risks of investing in startups and illiquid securities all without providing investment advice? The Act requires that issuers relying on the exemption outsource cash-management functions to a third party custodian, such as a registered broker-dealer. Just how intrusive into the ordinary business of issuers should the implementation of this requirement be? Issuers must require potential investors to answer questions demonstrating the understanding of certain risks and other issues determined to the appropriate by the SEC. The implementation of this requirement could range from the perfunctory to the highly burdensome.

It is not clear whether crowdfunding will ever become a method that emerging companies can use to raise capital legally in the United States. The current bill may never be passed, and, if it is, it may be changed significantly before it becomes law. Furthermore, the bill obligates the SEC to adopt regulations implementing certain of its provisions. The regulations ultimately adopted by the SEC could significantly affect the usefulness of any crowdfunding exemption that is enacted.