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## **CROWDFUNDING – ONE STEP FORWARD, ONE STEP BACK**

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The United States House of Representatives (the “House”) continues to pursue crowdfunding legislation despite some opposition in the United States Senate (“Senate”). On March 8, 2012, the House passed the Jumpstart Our Business Startups Act (the “JOBS Act”) by a bipartisan effort with a 390-23 margin.<sup>1</sup> The JOBS Act is a legislative package of economic and jobs bills that focus on increasing access to capital for small businesses through the reformation of the federal securities laws. The package includes, without limitation:

- (i) The Access to Capital for Job Creators Act, which seeks to allow general solicitation and advertising under the private transaction exemptions in Section 4(2) of the Securities Act of 1933 (the “Securities Act”) and Rule 506 of Regulation D pursuant to the Securities Act (“Regulation D”);<sup>2</sup>
- (ii) The Small Company Capital Formation Act, which expands the capital limitations in Section 3(b) of the Securities Act and Regulation A of the Securities Act (“Regulation A”) to allow general solicitation for up to \$50 million in capital.<sup>3</sup> Currently, an offering under Regulation A is limited to \$5 million;<sup>4</sup> and,
- (iii) The Entrepreneur Access to Capital Act (“EACA”), which allows private companies to seek up to \$1 million from investors, or \$2 million if the company provides audited financial statements to investors, through crowdfunding, which would allow small businesses to use the internet to raise modest amounts of money in exchange for stock.<sup>5</sup> An individual’s investment would be limited to the lesser of (a) \$10,000; or (b) 10% of the investor’s annual income, in order to minimize investor risk in the enterprise.<sup>6</sup>

The passage of the JOBS Act in the House puts increased pressure on the Senate, which thus far has failed to pass a bill that would allow for crowdfunding. EACA and the crowdfunding movement, in general, have received substantial support from the House, which originally passed EACA, independent of any other bill, on November 3, 2011, and President Obama, who called on Congress to pass crowdfunding legislation in his Startup America initiative. However, EACA was originally stalled by the Senate on concerns of internet securities fraud raised by the North American Securities Administrators Association. Responding to these concerns, Senators Scott Brown and Jeff Merkely proposed more restrictive crowdfunding bills; but after several months, the Senate failed to move forward on either piece



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of legislation. Now that the House has passed EACA a second time, Senator Harry Reid introduced similar legislation this week and pledged to quicken the legislative process.<sup>7</sup>

### **Competing Missions and Agency Delays**

Despite Senator Reid's fulfillment of his promise to timely introduce crowdfunding legislation, the Securities and Exchange Commission ("SEC") and Chairman Mary Schapiro may have succeeded in stalling crowdfunding for a second time. In a letter sent to the Senate Banking Committee on March 15, 2012, Chairman Schapiro addressed the EACA legislation, stating that the bill does not go far enough to protect investors. In Chairman Schapiro's opinion, the Senate should increase oversight by the SEC intermediaries brokering the offerings and require additional disclosures by the issuers. Chairman Schapiro believes that crowdfunding "needs additional safeguards to protect investors from those who seek to engage in fraudulent activities."

Calling EACA's rulemaking period "not achievable" in her letter, Chairman Schapiro also signaled a possible delay in the rulemaking process, which could prevent crowdfunding from becoming a reality for 18 months after the passage of an act. As a result, crowdfunding offers would not become a reality until 2014.

Chairman Schapiro's opinions regarding crowdfunding highlight the sometimes conflicting objectives of the SEC which are to protect investors on the one hand, while facilitating capital formation on the other. These competing interests have led to overly complex and costly rules for businesses trying to raise capital. Regulation D and Regulation A, which were both designed to facilitate capital formation, are now full of complexity making it more costly for a business to rely upon them. Unfortunately, crowdfunding legislation seems to be headed down the same path.

The SEC should consider that the EACA does not take away the basic protections provided for under the Securities Act. First, the general anti-fraud provisions, including the requirement that the issuer provide all material information and make no material misstatements of fact in connection with the sale of a security, will still be available for crowdfunding offers. Second, EACA places substantial due diligence and oversight requirements on intermediary websites hosting issuer offerings. Although the burden on intermediaries does not rise to that of a broker-dealer, EACA successfully strikes a balance between providing increased protections for investors by requiring intermediaries to: (i) vet the issuer and offering, including conducting issuer background checks; and (ii) continuously monitor the offering through recordkeeping requirements and reporting obligations to the SEC, thereby keeping the costs to the intermediary (which will ultimately be passed on to the issuer) to a minimum.<sup>8</sup> Finally, EACA also contains the "Bad Boy Rule" from Section 926 of the Dodd-Frank Wall Street Reform and Consumer



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Protection Act, which disqualifies felons and bad actors from relying on transactional exemptions in the securities laws.

In addition to the protections built into EACA, investors are also safeguarded from fraud through the reputational factors in internet capital raising. First, any fraud that occurred through an intermediary would immediately tarnish the intermediary's reputation and the intermediary would lose goodwill, and subsequently, business. In fact, issuer offerings may be more successful with intermediaries creating stable and safe markets. For example, in 1996 Spring Street Brewing Company ("Spring Street") conducted the first initial public offering over the internet through a direct public offering. Although Spring Street raised \$2 million from approximately 3,500 investors, approximately 500,000 potential investors viewed and rejected the offering.<sup>9</sup> The founder of Spring Street, Andy Klein, believed that the low investor conversion rate was attributable to the fact that the company did not use "an intermediary who's in the business of evaluating the company, doing due diligence, and putting its reputation on the line with the company's reputation," as a crowdfunding intermediary would be required to do.<sup>10</sup> Consequently, it is to the advantage of both the issuer and the intermediary to ensure a safe and fraud-free market through substantial due diligence of the issuer; this alone should provide the incentive to properly vet and monitor issuers and offerings. Furthermore, internet users are technology savvy and likely to use the resources available to them to conduct any additional due diligence or research. Although information will certainly be more limited than information available for a public offering, as with any investment, a careful and independent review of companies and management can expose fraud and scams.

If you have any questions regarding this press release, please contact Steven J. Thayer at (312) 641-2100.

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<sup>1</sup> Ed O'Keefe, *House Pass Jobs Bill with Wide Bipartisan Margins*, Washington Post, March 8, 2012, at [www.washingtonpost.com](http://www.washingtonpost.com).

<sup>2</sup> Access to Capital for Job Creators Act, H.R. 2940, 112<sup>th</sup> Congress, §§ 2(a) and (b) (2011).

<sup>3</sup> Small Company Capital Formation Act, H.R. 1070, 112<sup>th</sup> Cong., § 2 (2011).

<sup>4</sup> Small Company Capital Formation Act, H.R. 1070, 112<sup>th</sup> Cong., § 2 (2011).



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<sup>5</sup> Entrepreneur Access to Capital Act, H.R. 2930, 112<sup>th</sup> Cong. (2011).

<sup>6</sup> Entrepreneur Access to Capital Act, H.R. 2930, 112<sup>th</sup> Cong. (2011).

<sup>7</sup> Ed O'Keefe, *House Pass Jobs Bill with Wide Bipartisan Margins*, Washington Post, March 8, 2012, at [www.washingtonpost.com](http://www.washingtonpost.com).

<sup>8</sup> United States Securities and Exchange Commission, Strategic Plan For Fiscal Years 2010-2015.

<sup>8</sup> Entrepreneur Access to Capital Act, H.R. 2930, 112<sup>th</sup> Cong. (2011).

<sup>9</sup> Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. Pa. J. Bus. L. 973, 979 (2010).

<sup>10</sup> *Id.*