ARTICLES

CROWDFUNDING OFFERS ATTRACTIVE FINANCING ALTERNATIVE, BUT SEC MUST GIVE MORE CLARITY

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Due to the financial crisis and prolonged economic downturn, the credit market has contracted considerably. In this cautious investment climate, a start-up company's ability to secure seed financing from venture-capital firms and angel investors that have scaled back lending to many yet-unproven, entrepreneurial endeavors, has become increasingly difficult. One form of financing has seen exponential growth over the past few years to help these companies surmount its hurdles: crowdfunding. New federal crowdfunding legislation and implementing rules due by the end of the year, will set the stage for the financing method to grow in the United States.

Generally, crowdfunding is a form of financing by which a company raises capital through relatively small contributions from a large pool of individuals using a website intermediary. In this economic environment, crowdfunding is gaining prominence as an alternative form of financing. With a focus on the interests of start-up and emerging businesses, this article explores the advantages and drawbacks of crowdfunding financing, and discusses the recently-enacted statutory structure to facilitate and regulate investment crowdfunding.

AN INTRODUCTION TO CROWDFUNDING

By means of crowdfunding, an entrepreneur can pitch an idea to, and solicit funding from, anyone with internet access and an interest in wanting success for the venture. The entrepreneur simply uploads to a crowdfunding website a description of his or her idea or product, explains the business plan, states the amount of capital sought, and proposes what, if anything, contributors will receive in return for the funds they provide, such as a gift, repayment, or, in the case of equity crowdfunding, a stake in the venture.

Potential funders can then visit the crowdfunding website, peruse the listings, and contribute to attractive ventures, whether motivated by a return on investment or by philanthropy. Contributions can range from a few dollars to the total amount sought by the venture. The crowdfunding website typically facilitates the entire transaction, transferring the financial contribution to the entrepreneur and any returns back to the contributor.

Crowdfunding came to the forefront in approximately 2005, and initially was developed as an online means to raise capital for small projects, such as films, books, music recordings, and charitable ventures. The use of crowdfunding (outside of the United States) as a means of financing more profit-oriented ventures has since exploded. While the average project remains relatively small, international crowdfunding efforts have connected millions of entrepreneurs and investors and raised billions in capital for emerging businesses.

Crowdfunding can be categorized into three general models, based on the return promised to investors. First, there is the donation model, under which contributors simply donate funds to projects in which they have a charitable interest. The contributors receive no monetary value in return, though the donations may be tax deductible. Second, there is the reward model, under which contributors receive a gift in return for the contribution. The rewards are often small, such as one of the products the venture seeks to produce, the opportunity to pre-purchase a product, a phone call from the entrepreneur, or credits on a film or music album. Third, there is the investment model.

Through investment crowdfunding, investors can either loan money to the entrepreneur with the expectation of interest plus repayment of principal, or the investor can receive shares evidencing a partial stake in the venture. Because investment crowdfunding offers investors a financial return on their investment, it involves the purchase and sale of securities and therefore falls under the enforcement jurisdiction of the Securities and Exchange Commission (SEC).

In June 2011, the SEC took action to stop an investment crowdfunding effort that sought to raise $300 million for the purchase of the Pabst Brewing Company. The SEC charged the individuals behind the venture with improperly advertising a securities offering and soliciting investors while no registration statement was on file with the SEC. That matter ultimately was resolved when the individuals behind the venture agreed to stop their efforts and be subject to an SEC cease and desist order. Due to regulatory issues, investment crowdfunding has been uncommon in the United States. However, there will likely be an expansion of this model in the United States in light of new crowdfunding legislation.

CROWDFUNDING AS A CAPITAL-RAISING STRATEGY

Advantages of crowdfunding financing

One of the most obvious advantages crowdfunding offers start-up companies is convenience and simplicity in obtaining seed capital. Crowdfunding allows entrepreneurs to access large numbers of potential investors electronically. Entrepreneurs need not go to bank offices or meet with venture-capital investors, but instead can simply upload their idea to a crowdfunding website and instantly solicit financing from investors worldwide. Additionally, crowdfunding websites have traditionally offered a simple platform for submitting proposals, and have typically used simple, standardized agreements, so novice entrepreneurs can navigate the crowdfunding process.

Perhaps the most significant benefit to crowdfunding is cost savings. Crowdfunding's internet base and its streamlined processes reduce transaction costs and, depending on the crowdfunding model, offer cheap and unsecured financing options.

The reward model allows entrepreneurs to raise capital in return for future gifts of the products the venture produces or intangible tokens of appreciation, in either event a low-cost price to secure seed capital. The investment model often provides interest-free or low-interest loans, another cheap source of financing compared to traditional bank loans. In the equity context, crowdfunding also provides entrepreneurs the opportunity to raise cheap capital, but there are more nuances to this strategy. For a start-up company with little if any capital, offering investors a stake in the venture is a means to raise much-needed early-stage capital without having to provide anything in return during the formative stages of the venture. Of course, depending on how the equity is structured, this model could prove costly later if the venture is successful and investors were given a large stake in the venture.

Another advantage to crowdfunding is the ability for an entrepreneur to finance a project without ceding control of the venture. Venture-capital firms, and in some cases influential angel investors, typically want a controlling stake in a company. Crowdfunding can obviate controlling investors and thereby protect entrepreneurs' creative and operational autonomy. The donor and reward models are most advantageous in this respect, as the company can raise start-up capital without risking outside interference in the direction of the project. Autonomy is less protected, however, with equity crowdfunding, as influential shareholders may seek to influence decisions or direction.

Crowdfunding also provides the opportunity, and in certain cases the only chance, for unproven start-ups to attract investors and raise capital. Venture capital firms focus on larger companies with an established market or which are in high-growth areas. Traditional bank lending imposes stringent credit-history and ability-to-repay hurdles or collateralization, with even tighter requirements in the current economy. With crowdfunding, entrepreneurs can connect to the general public to solicit investments, in some cases obtaining financing based on the creative or philanthropic aspects of the venture, while in other cases obtaining financing based on the expectation of profits.

This is not to imply that crowdfunding, in its current iterations, involves no credit screens, as many crowdfunding websites conduct credit-history investigations, but compared to venture capital firms or bank lending, crowdfunding certainly provides emerging businesses a less rigorous avenue to obtain early-stage capital.

Considerations and potential drawbacks to crowdfunding financing

While crowdfunding offers a viable alternative to traditional financing options, there are important considerations businesses must consider before embarking on the crowdfunding route. First, crowdfunding works best for smaller projects that require relatively small amounts of start-up capital. While there are instances in which non-investment crowdfunding has raised millions for emerging businesses, such success is rare. Accordingly, crowdfunding alone is likely an inadequate capital-raising strategy for a large venture or rapidly expanding business.

Entrepreneurs also should consider the impact that crowdfunding may have on future financing options. Investment crowdfunding may result in many unsophisticated investors having fractional shares of the venture. Such a business model may deter future financing from professional venture capitalists or angel investors wary of involvement with a business owned by thousands of inexperienced lenders or shareholders.

Additionally, the recently enacted JOBS Act -- discussed more thoroughly below -- provides an exemption to certain federal securities regulations for equity crowdfunding only where the aggregate amount sold to all investors in a 12-month period does not exceed $1 million. Consequently, an entrepreneur who raises $1 million through equity crowdfunding cannot seek further financing for one year without complying with costly and onerous securities-registration requirements.

The litigation implications of crowdfunding also must be considered. As with any investment financing, investor lawsuits in the wake of failed business ventures -- for fraud, rescission, breach of contract or fiduciary duties, to name a just few potential causes of action -- are commonplace. Given the low success rate for start-up companies, this is not a small concern. Although most crowdfunding investments are small, likely making private litigation cost prohibitive, investors may still file complaints with federal or state enforcement agencies, creating the possibility of government investigations and enforcement actions.

Emerging businesses considering investment crowdfunding also should understand the potential administrative burdens of hundreds or thousands of investors joining the venture. These investors will expect a return and may become increasingly demanding if the business fails to generate early profits. Managing the concerns and demands of thousands of investors-turned-critics is an onerous task for a struggling entrepreneur. Large investors may seek to influence the business, a potentiality that undercuts one of the key advantages of crowdfunding -- autonomy.

A related concern, with respect to equity crowdfunding, is the eventual need for a secondary market for the venture's securities. Without an external liquid market for issued shares, shareholders seeking an exit strategy likely will look to the business itself for redemption. And under the new JOBS Act regime, within one year of the issue date, securities issued through crowdfunding may be transferred only to the issuing company, accredited investors, a family member of the purchaser, or as part of an offering registered with the SEC.

Thus, to avoid the financial liability and administrative headache of valuing the securities and resolving the demands of investors looking to cash out, entrepreneurs considering equity crowdfunding should carefully consider the availability of accredited investors interested in the business's shares and the feasibility of establishing a secondary market one year from the issue date.

THE JOBS ACT OFFERS A NEW REGULATORY REGIME

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (JOBS Act), legislation intended to stimulate economic growth by making it easier for small businesses to raise capital. Title III of the JOBS Act, known as the CROWDFUND Act, provides an exemption to the registration requirements of the Securities Act of 1933, permitting start-ups to raise limited amounts of equity capital via crowdfunding without registering the securities with the SEC. While the JOBS Act represents a landmark step in facilitating equity crowdfunding through easing regulatory hurdles, issuers must meet important criteria to qualify for the exemption, and the statute itself imposes additional regulatory requirements.

To qualify for the CROWDFUND Act's registration exemption, the maximum amount of securities sold to all investors cannot exceed $1 million in any 12-month period. The aggregate amount sold to any one investor in any 12-month period may not exceed, (i) for investors with annual income or net worth under $100,000, the greater of $2,000 or 5 percent of the investor's annual income or net worth; and (ii) for investors with annual income or net worth of $100,000 or more, 10 percent of the investor's annual income or net worth with a $10,000 cap. Additionally, the crowdfunding must be conducted through a broker or funding portal, such as a website.

The CROWDFUND Act also imposes disclosure and registration requirements. A company issuing securities via crowdfunding must file with the SEC and provide to investors, potential investors, and the funding portal:

Basic information about itself, including name, legal status, address, website address of the issuer, and the names of directors, officers and each person holding more than 20 percent of the company's shares;

A description of the business and anticipated business plan;

A description of the financial condition of the company, including:

For offerings under $100,000, the company's most recent income tax returns and financial statements certified by its principal executive officer;

For offerings between $100,000 and $500,000, financial statements reviewed by an independent public accountant;

For offerings over $500,000, audited financial statements;

A description of the purpose and intended use of the financing;

The target offering amount and deadline to reach the target amount;

The public price of the securities or the method for determining the price; and

A description of the company's ownership and capital structure.

Additionally, companies issuing crowdfunding securities may not advertise the terms of the offering (except for notices directing investors to the funding portal), may not compensate anyone to promote the offerings, and must provide the SEC and investors annual operational and financial statements.

The CROWDFUND Act also imposes liability on an issuer for making an untrue statement of material fact or omitting a material fact in an equity crowdfunding transaction. The Act further provides a private right of action for misrepresentations or omissions against the issuer for any person who purchases a security under the Act. The Act preempts state regulation of crowdfunding transactions, but preserves state authority to take enforcement action for fraud or deceit.

RIGOROUS RULES ARE EXPECTED; FORMS WILL BE HELPFUL

The CROWDFUND Act requires the SEC to issue "necessary or appropriate" rules to implement the Act within 270 days -- by Dec. 31, 2012. Given the efforts undertaken by the SEC in the days leading to the passage of the JOBS Act, efforts designed to ensure that the SEC would have ample opportunity to write rules to protect investors from crowdfunding fraud, it is likely that the rules will be rigorous in several aspects and borrow concepts from pre-existing rules in analogous scenarios.

For instance, crowdfunding facilitators, whether broker-dealers or funding portals, could be held to a similar standard of review as broker-dealers wishing to initiate or resume the quotation of an over-the-counter security. That standard requires broker-dealers to certify that they have a reasonable basis for believing that the information provided by the issuer -- information similar to that required by the CROWDFUND Act -- is accurate in all material respects and that the sources of the information are reliable. Similarly, crowdfunding facilitators could be required to certify that they have reviewed financial statements and other information evidencing the financial condition of investors wishing to participate in crowdfunding.

Because crowdfunding facilitators may be required to perform this level of due diligence to qualify investors and investments, they might find themselves the targets of lawsuits in instances in which crowdfunded ventures turn out to be unsuccessful. Accordingly, the publication by the SEC of standardized forms with checklists to assist in this qualifying process would be of great value to the facilitating entities.

Crowdfunding provides a tremendous resource for start-up companies seeking an alternative means of financing an emerging business. With the passage of the CROWDFUND Act, equity crowdfunding, not yet prominent in the United States, will see tremendous growth. Consequently, the stakes are high for the SEC's forthcoming enabling rules.

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