

Corporate Finance and Securities and Canada Practice Law Update

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Coming Soon to a Start-up Near You: Crowdfunded Capital

When small business clients learn about the barriers to sourcing capital imposed by U.S. securities laws, perhaps the most consistent theme is one of frustration. The prohibition on general solicitation of investors imposed by Rule 506 of the Securities Act of 1933, as amended (the “Securities Act”), means that unless the business has a pre-existing relationship with a potential investor, it can be difficult to make the right connection to bring in critical funding. And while other avenues to capital permit general solicitation in private offerings, they generally come at the price of lengthy, and potentially expensive, merit review by state securities administrators. Soon, this may all change.

Having passed both houses of Congress, the Jumpstart Our Business Startups Act (the “JOBS Act”) is on the cusp of receiving President Obama’s signature. With those few strokes of a pen, U.S. law in this area will dramatically change. Crowdfunding, or the practice of raising capital online from a large number of small investors, will become a practical option for businesses wishing to source capital in the states in the U.S. While there are still a few details to iron out in the form of new rules to be crafted by the Securities and Exchange Commission, the basic framework is clear:

- Issuers of the securities will be permitted to source up to \$1 million in funding during any 12-month period;
- Investors will not be required to be so-called “Accredited Investors,” but the amount of any single investor’s purchase of securities during any 12-month period will be limited to either: (i) the greater of \$2,000 or five percent of the investor’s net worth or annual income (if the investor’s annual income or net worth is less than \$100,000); or (ii) ten percent of the annual income or net worth of the investor (if the investor’s annual income or net worth is greater than \$100,000);
- Offerings must be conducted through a broker or a funding portal that meets the requirements of the JOBS Act; and
- The issuer complies with certain information requirements, including the requirement to provide financial statements that are either simply attested to by management (for offerings of less than \$100,000 during any 12-month period), reviewed by an outside accounting firm (for offerings within the \$100,000 to \$500,000 range during any 12-month period), or audited by an independent registered public accounting firm (for offerings of \$500,000 or more in any 12-month period).

Because securities sold under this exemption will be deemed “covered securities” for purposes of the Securities Act, crowdfunded offerings will not be subject to state merit review. As with other private placement exemptions, state anti-fraud rules will continue to apply. But unlike other private placement exemptions, state filing fees may be preempted as well depending on the geographic dispersion of the investors in the offering.

What remains to be seen is the extent to which third parties — so called “funding portals” — will step up to provide the infrastructure necessary to conduct these offerings. Currently, there are a small number of such portals operating primarily as gateways for issuers to reach accredited investors. However, with the floodgates opening to participation by non-accredited individuals, it is unclear whether these existing market players will have the capacity to handle this new influx of investors, the obligations imposed on funding portals by the JOBS Act, and the costs that may be imposed upon issuers by those funding portals for accessing their platforms.

**For more information, please contact the Corporate Finance and Securities
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