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Will You Join the Crowd?

A Radical New Way to Finance Your Business

On April 6, President Obama signed the CROWDFUND Act into law as part of the bigger JOBS Act ("Jumpstart Our Business Startups"). "Crowdfunding," or the pooling of funding resources, is not new. In the United States, internet Crowdfunding has been used primarily for "contributions" to projects rather than for equity investments in businesses. Prior to the enactment of the JOBS Act, using Crowdfunding to solicit equity investments in business ventures was illegal under the U.S. securities laws. While there is still a lot of ground to cover before the public understands exactly how Crowdfunding will work, the passage of the JOBS Act brings with it major changes in how start-up, venture and other capital is raised in the United States.

Since major investors such as venture capitalists can receive thousands of investment proposals for relatively limited funding, Crowdfunding may allow more startups to thrive than in the past. The CROWDFUND Act allows businesses to raise capital from a much larger pool of investors than was previously available. The Act essentially eliminates the distinction between "accredited investors" (those considered to be "sophisticated investors") and unaccredited investors (people whose net worth and annual income did not hit certain statutory minimums).

The Act creates a new exemption that would permit private companies to raise up to $1 million in any 12-month period by selling stock to individuals regardless of their financial status. To participate in Crowdfunding, companies will need to comply with regulations that the SEC will develop over the next nine months. There will be protections in place for investors. For example:

♦ The maximum investment per investor will be:

- The greater of $2,000 or 5 percent of the investor's annual income or net worth within any 12-month period (if either the investor's annual income or net worth is less than $100,000); and

- 10 percent of the investor's annual income or net worth, not to exceed a maximum amount of $100,000 (if either the investor's annual income or net worth is greater than or equal to $100,000).

♦ Companies will be required to provide disclosure about itself and the offering including risks of investing in the securities; the company's business and business plan; the intended use of the capital that is raised; information about company officers, directors and significant shareholders; and details about the capital structure of the company (such as terms of the stock offered, how the price has been determined, and how the rights of investors could be affected by future corporate actions such as additional offerings, the exercise of rights belonging to larger shareholders, or even a sale of the company).

♦ Companies will have to release financial information based upon the amount of money they want to raise as follows:

- ♦ For offerings of $100,000 or less, a company must provide investors with its most recent income tax return;

- ♦ For offerings between $100,001 and $500,000, a company must provide investors with its financial statements that have been reviewed by an independent CPA; and

- ♦ For offerings above $500,000, a company must provide investors with audited financial statements.

♦ Companies will not be permitted to raise funds directly; they will need to conduct transactions through a broker or "funding portal" that will be regulated by the SEC and will serve as an intermediary between a company and its potential investors.

♦ There will be civil liability for material misstatements in, or material omissions from, an offering document or oral communications involved in the offer or sale of securities.

A protection for the companies issuing stock is that individuals who buy stock offered through Crowdfunding will not be able to sell or transfer any shares for one year except through a registered offering, or to a family member, a traditional accredited investor, or the company itself.

Entrepreneurs should view Crowdfunding as one of many options available to it to raise capital. It may not be the right option for a company that will need several rounds of financing and many millions of dollars to execute its business plan, but it may be the right choice for a company that, though not seeking venture capital, does need a smaller amount of money to get its business up and running.
