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The JOBS Act and crowdfunding: Harnessing the power—and money—of the masses

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Abstract On April 5, 2012, President Barack Obama signed into law the Jumpstart Our Business Startups (JOBS) Act, dramatically changing the landscape for many companies raising capital. One of the most interesting sections of the Act is Title III, the CROWDFUND Act, which enables entrepreneurs and small business owners to sell limited amounts of equity in their companies to a large number of investors via social networks and various Internet platforms. Prior to the CROWDFUND Act, selling equity interests in companies via crowdfunding was for all practical purposes illegal under United States securities laws. The Act attempts to exempt crowdfunding from expensive registration requirements and allow crowdfunding websites to avoid the classification of broker, which would impose substantial registration costs on such sites. Through the CROWDFUND Act, equity-based crowdfunding has the potential to open funding opportunities to countless underfunded entrepreneurs and small businesses. In addition, it can provide investors with new ways to diversify their portfolios. However, the benefits of crowdfunding do not come without substantial risks. Given the combination of unsophisticated investors, inherently risky businesses, and the zeitgeist that changed regulations quickly, crowdfunding must be approached with caution.

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“‘The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.’”—President Franklin D. Roosevelt in his message to Congress concerning the eventual Securities Act of 1933 (Lusk, 1930-1934, p. 1163)

1. Crowdfunding and the JOBS Act

On April 5, 2012, President Barack Obama signed into law the Jumpstart Our Business Startups Act—also known as the JOBS Act—dramatically changing the landscape for many companies raising capital. One of the most interesting sections of the Act is Title III, the ‘Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012,’ more simply known as the CROWDFUND Act. The Act enables entrepreneurs and small business owners to sell limited amounts of equity in their companies to a large number of investors via social networks and various Internet platforms (Belleflamme, Lambert, & Schwienbacher, 2011).

In the past 15 years, crowdfunding has become a popular source of capital formation for design, filmmaking, music, and photography projects via
websites such as Kickstarter (www.kickstarter.com) and IndieGoGo (www.indiegogo.com). Through these sites, businesses or individuals who need financing for a project/venture publish an appeal for funds and typically offer a token reward (e.g., music CD, framed photo) to those who make contributions. Because small amounts of money from a large number of people can add up quickly, these sites have experienced tremendous success. For example, since its inception, Kickstarter has raised over $370 million for 72,317 projects (Kickstarter Stats, 2012). Indeed, one project collected a remarkable $10 million from multiple donors, which enabled the entrepreneur to produce a water-resistant watch that syncs with smartphones (Twose, 2012).

Crowdfunding is uniquely positioned to assist two groups of people in securing the money and support they need: (1) entrepreneurs trying to turn their ideas into viable businesses, and (2) small business owners trying to keep their businesses afloat or get them to grow. Both face enormous challenges in today’s financial environment. Due to their lack of credit, operating history, and proven track record, fledgling companies often have a hard time pursuing financing through traditional avenues, such as bank loans (Fink, 2012). Furthermore, private equity and venture capital firms provide capital to only a very select slice of U.S. companies (Fisch, 1998). For example, of the approximately six million companies in the United States, only three thousand or so received any venture capital in 2010 (“Statistics about Business Size,” n.d.; National Venture Capital Association, n.d.). Similarly, small businesses have limited access to capital markets and instead must rely on bank financing. This has become harder to get following the 2008 financial crisis, and even when attainable has come at higher interest rates. The potential for raising capital through equity-based crowdfunding could thus greatly assist these cash-starved companies with otherwise limited capital access.

While equity-based crowdfunding appears to be a simple and powerful solution for raising capital, current crowdfunding sites are unable—in most instances—to offer equity stakes in companies. This is because equity interests, as opposed to token rewards and such, are likely to be classified as securities under the Securities Act of 1933 (Securities Act) and subsequent legislation. The Securities Act originally was enacted in response to the Great Depression, and it was designed to ensure full disclosure of truthful information regarding the character of securities offered to the public (Keller, 1988). Additional purposes include market stability, market integrity, and preventing and repairing damage caused by free market failures (Martin, 2012).

To advertise and sell securities to the general public under the Securities Act, a company must fully comply with the complex registration requirements. Registration under the Act is prohibitively expensive for most small businesses; legal accounting, filing, and other fees for an underwritten public offering typically range from $300,000 to $500,000 (Sjostrom, 2001).

Most companies interested in pursuing crowdfunding are also unable to resort to one of the registration exemptions under the Securities Act and subsequent regulations. The exemptions are either cost-prohibitive or limit investing pools to an insufficient number of investors (Fink, 2012). Currently, Regulation A exempts public offerings that do not exceed $5 million over a 12-month period (Securities Lawyer’s Deskbook, 1998-2009). This exemption still requires an issuer to file a disclosure with the Securities and Exchange Commission (SEC), and is therefore sometimes referred to as a “mini-registration” (Bradford, 2012a). With Regulation A, a business may make general solicitations to investors, but it still may be prohibitively expensive to register under the exemption (Cox, 2009). By some estimates, Regulation A disclosure costs range from $40,000 to $60,000 (Fink, 2012).

Regulation D, a popular set of exemptions for certain non-public companies, is also very limiting. It caps the number of unaccredited investors, meaning those who lack certain sophistication or net-worth standards, at 35. In addition, before the JOBS Act, the exemption restricted the way companies could solicit investments. With the limits on the number of unaccredited investors, companies wanting to crowd source using Regulation D are not able to truly “source from the crowd” because they are limited on the types of investors they can have. Furthermore, prior to the JOBS Act, companies were not allowed to make general solicitations. While not specifically defined under SEC regulations, the sanctioning body determined that permissible solicitation of investment required a preexisting substantive relationship between the issuer and the potential investor (Sigar, 2012). Rarely was this the case; therefore, true crowdfunding was impossible under Regulation D.

2. Enter the JOBS Act

At the behest of many entrepreneurs and crowdfunding proponents, both Congress and President Obama took action. In September 2011, Representative Patrick McHenry (NC) called a congressional hearing to discuss crowdfunding and introduced a bill promoting the idea (Fink, 2012). During
that same month, President Obama unveiled his American JOBS Act, which included crowdfunding provisions. Subsequent bills presented in the Senate furthered the debate, and the JOBS Act—which entailed the CROWDFUND Act—was eventually passed with bipartisan support.

The JOBS Act is a remarkable shift away from the principles underlying U.S. securities laws in favor of a largely unregulated system. The JOBS Act increases by tenfold the amount of funds businesses can raise under Regulation A, to $50 million. In addition, the JOBS Act allows businesses using Regulation D to solicit broadly for investors (i.e., use general advertising) and to sell to an unlimited number of accredited investors.

Under the crowdfunding section of the JOBS Act, entrepreneurs and small business owners may utilize the crowdfunding exemption to raise up to $1 million within a 12-month period without registering the sales with the SEC. Any investor, whether accredited or unaccredited, may invest in companies relying on the crowdfunding exemption. However, the maximum dollar amounts they may invest depend on their income or net worth:

- If the investor has an annual income or net worth under $100,000, she can invest the greater of $2,000 or 5% of her annual income or net worth.
- If the investor has an annual income or net worth over $100,000, she can invest up to 10% of her annual income or net worth.

The CROWDFUND Act protects investors in additional ways. To comply with the Act, businesses will be required to file some documents with the SEC; make enhanced disclosures (financial, business, and risk) at the time of the offering; and provide annual updates thereafter, with the extent of disclosure dependent on the size of the offering. In addition, the Act imposes civil liability on businesses for material misstatements or omissions in connection with a crowdfunding offering and expressly permits rescission claims by investors.

Businesses wishing to use crowdfunding must, in most instances, rely on websites called “funding portals.” The CROWDFUND Act helps these portals avoid the classification of broker, which would impose substantial registration costs on such sites; however, they still have many “gatekeeper” requirements to prevent fraud and abuse, including ensuring that investors understand investing and its risks and monitoring investor compliance with individual investment limits. Furthermore, funding portals are prohibited from offering investment advice and from actively pushing securities on investors.

Moreover, the CROWDFUND Act prohibits funding portals from compensating their employees on commissions, which destroys the incentive for employees to push investors into making certain investment decisions.

3. Waiting on the SEC

While the CROWDFUND Act was signed into law during the first quarter of 2012, as of the time this article is being written, the SEC has yet to adopt rules to implement the Act. Until it does so, funding portals are prohibited from issuing securities under the crowdfunding exemption (SEC, 2012b). While the Commission has established a public comments section related to rulemaking for crowdfunding and a Crowdfunding FAQ on its website, it is quite possible that the rules necessary for the actual use of the exemption may not be in place until sometime in 2013 (SEC, 2012a).

4. Guidance for businesses wishing to use crowdfunding to raise capital

If you own a business or want to start one, but have limited assets and are struggling to secure funding from traditional sources such as banks, family, and venture capital firms, crowdfunding may be the perfect avenue for you. With it, your business will be able to collect small amounts from a large number of people to get it off the ground and in the green. However, your business will have to wait until the SEC publishes its guidance on the CROWDFUND Act before you can legally start raising capital by selling equity to the crowd (unless you register your securities with the SEC or pursue one of the aforementioned exemptions). When the SEC does publish its guidance, you should explore the available funding portals and select a portal that is in compliance with all SEC rules and provides you with wide exposure to interested investors. Following is a list of equity-crowdfunding sites that are preparing to be funding portals once the SEC publishes its rules:

- Early Shares (www.earlyshares.com)
- The Funders Club (www.thefundersclub.com)
- InCrowd Capital (www.incrowdcapital.com)
- Crowd Funder (www.crowdfunder.com)
- StartupValley (www.startupvalley.com)
While awaiting the SEC, you can prepare for equity-based crowdfunding by taking the steps described next:

- Develop a well-researched, detailed, and clear set of documents that explain your market, your strategy, your financials, and how your business makes money. Also be sure to present your business in a way that will allow future flexibility. Only make promises you intend to keep and statements that are true. There are harsh penalties under the CROWDFUND Act for making untrue statements of material fact, intentionally or unintentionally.

- Remember that first impressions count. Develop materials (text, video) that clearly explain your business to investors in a professional and well-thought out manner. Also ensure that your website is accurate and sharp-looking. Investors want to feel confident about the companies in which they make financial commitments. By displaying a professional image, investors will experience more trust and confidence in your business.

- Make sure that your business is organized in a way that allows you to issue the type of shares you hope to promise crowdfunding investors. You may need to amend your articles of incorporation, bylaws, or operating agreement, or change your business’ corporate form completely. For example, if your business is organized as an S-corporation, it can have no more than 100 shareholders; therefore, you must reorganize the corporation to form either a C-corporation or a limited liability company (LLC). Consider procuring advice on the tax consequences of any change in choice of entity.

5. Guidance for investors wishing to purchase securities using crowdfunding

Once the SEC publishes its rules, investors will be able to purchase equity in companies through crowdfunding. Even though the SEC rules will attempt to protect investors, crowdfunded investments will still come laden with many risks. Investing in small businesses, especially those in startup stages, is inherently risky. Small businesses and startups are much more likely to be poorly organized, to be understaffed and resourced, and to fail than established companies (Bradford, 2012b). Perform due diligence on companies in which you intend to invest by gathering information and asking such questions as:

- Who are the major competitors? What makes the product or service unique? How does the company protect its intellectual property?

- Who are the company’s targeted customers? Is the target market sufficiently large enough to make the company profitable?

- What is the company’s marketing strategy?

- Who are the entrepreneurs/owners/managers? What skills and experiences do they have to lead the business?

- What will your stake in the company be and what form will it take?

- What is the company’s exit strategy? Does the entrepreneur/owner have plans to grow the company indefinitely? Could the business be sold to a larger company?

Some critics do not like the new crowdfunding rules, sensing that naive investors will be swindled through slick-looking websites and unscrupulous “entrepreneurs.” While these risks associated with crowdfunding and deregulation should not be discounted, crowdfunding portals do play certain gatekeeper functions to protect and inform investors, and amounts that investors can spend on crowdfund investments are relatively small. However, the rule of caveat emptor still applies and investors must make smart decisions to avoid losing their hard-earned money.

6. Final thoughts

Risk is necessarily inherent in all new ventures and worthwhile business endeavors; someone either decides to bear this risk and our economy grows, or we remain stagnant. There is no way to eliminate completely the risk associated with startups and small business financing, but the CROWDFUND Act attempts to mitigate some of those risks by helping investors make informed decisions and limiting the amounts they can put at risk.

Equity-based crowdfunding has the potential to open funding opportunities to countless underfunded entrepreneurs and small businesses. Additionally, it can provide investors with new ways to diversify their portfolios. However, the benefits of crowdfunding do not come without substantial risks.
Given the combination of unsophisticated investors, inherently risky businesses, and the zeitgeist that changed regulations quickly, crowdfunding must be approached with caution.

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References


