The President Favors Crowdfunding, But Is It Good Enough?

February 13, 2012 By Joe Wallin and Christina Chan

The President is in favor of crowdfunding, and is "calling for a national framework that allows entrepreneurs and small businesses to raise capital through crowdfunding. (See the President's proposal here). This is exciting news to crowdfunding enthusiasts. Crowdfunding would allow early stage and small businesses to raise small amounts of money from the public at large.

Why can't startups use crowdfunding now?

Under current securities law, crowdfunding is not possible for a couple of different reasons. First, Rule 506 of Regulation D, the securities law exemption most commonly used by startups to raise capital, precludes the use of general solicitation, which generally means companies cannot use the Internet or broadcast or similar media to advertise the fact that they are raising money.

Second, Rule 506 offerings disallow non-accredited investors from participating without the company having to comply with very detailed and comprehensive disclosure obligations. In contrast, if you are raising money from only accredited investors, there are no specific disclosure obligations required.

> ***Rule 502(b) states,*** *"The issuer is not required to furnish the specified information to purchasers when it sells . . .to any accredited investor." Whereas non-accredited investors require "disclosure documents that are generally the same as those used in registered offerings." (See the rules and regulations here: http://taft.law.uc.edu/CCL/33ActRls/rule502.html; and a reference to the second quote here: http://www.sec.gov/answers/rule506.htm.)*

This is one of the reasons why most startups limit their fundraising to all accredited investor offerings (that and the fact that federal law preempts state securities regulation in Rule 506 offerings except for Form D notice filings). What this means as a practical matter is that if you are not an "accredited investor," it is generally not possible for you to invest in startups. (The income test to qualify as an "accredited investor" is at least $200,000 in income or $300,000 in income with your spouse in each of the last 2 years with the expectation of the same in the current year, or $1M net worth excluding your primary residence.)

To give you an idea of how prevalent the Rule 506 exemption is relative to other securities law exemptions in private securities offerings, in its most recent proposed "bad actor" regulations, the SEC reported:

> *"Rule 506 is…by far the most widely used Regulation D exemption, accounting for an estimated 90-95% of all Regulation D offerings and the overwhelming majority of capital raised in transactions under Regulation D."*

See here: http://sec.gov/rules/proposed/2011/33-9211.pdf

But think about it, wouldn't it be great if startups could advertise for small amounts of funds from hundreds or even thousands of people in exchange for a small stake in the business, without the business having to spend tens of thousands of dollars preparing disclosure documents or limiting the offering to only accredited investors? Crowdfunding is gaining traction among lawmakers. The U.S. House of Representatives has already passed a crowdfunding bill by an overwhelming bipartisan majority with 407 votes in favor (H.R. 2930). The House has also passed a separate bill repealing the ban on general solicitation in all accredited Rule 506 offerings (H.R. 2940). The Senate is currently considering the two separate bills, and now the President has weighed in in favor of crowdfunding.

The Million-Dollar Question (Literally)

Will any of the various legislative proposals, if passed, be practical and usable by small companies?

I think crowdfunding is a great idea in concept, but I am afraid that crowdfunding enthusiasts are going to be sorely disappointed when Congress ultimately passes a bill. Why? Because I think all the bills being considered are critically flawed.

As various crowdfunding proposals are considered in Congress, I think they all ought to be measured by reference to Rule 506 and how Rule 506 works. Why make reference to Rule 506? Because Rule 506 has been wildly successfully. Rule 506 works, unlike many other securities law exemptions that are already on the books.

What then are the problems with the various crowdfunding proposal being considered? All of them contemplate a fundraising process that involves a significant amount of complexity (which is odd, given the small amounts that can be raised from each investor, and the small aggregate caps proposed). So, what it looks like to me is that Congress is going to pass a securities law exemption that won't be used very often because it is not going to be practical to use it. All of this excitement about crowdfunding will have been for nothing (or very little).

There are already several securities law exemptions on the books that are rarely used because of their impracticality.

> ***For example**: Rule 504 of Regulation D theoretically allows companies to raise up to $1M from non-accredited investors, but it is rarely used. Why? Because Rule 504 offerings require an advance filing with state securities regulators who have the authority to review the content and quality of offering materials. Filing with state regulators is time consuming and costly in terms of legal and accounting fees. Understandably, many companies just don't want to go through this. They would rather raise the money solely from accredited investors.*

So, if we really want to allow companies to raise money through a new securities law exemption for crowdfunding, the rules must be simple and practical.

The current proposals on the table, including the President's, fail at what I am calling the "simplicity test." Almost all contemplate fairly complex statutory and regulatory schemes. Despite all of the hoopla, the securities law pathway being cleared could turn out to be mostly unusable and ultimately lightly traveled. Below I critique some of the President's proposals for creating a crowdfunding exemption and offer some suggestions:

Proposal	Reaction
The President is calling for a national framework that allows entrepreneurs and small businesses to raise capital through "crowdfunding" -- relatively small investments from many individuals through regulated online platforms.	I like the language about a "national framework," but for crowdfunding to work, we need the federal law to preempt all state law. Otherwise, companies will have to comply with the laws of each state in which each investor resides. This will add considerable cost and expense to their offerings, making the crowdfunding exemption much less useful. Recall that Rule 506 offerings are commonly used because they preempt state regulation.
Require all crowdfunding offerings to be conducted through registered platforms or portals	How many years will it be until we have "regulated online platforms" up and running? In my opinion, Rule 506 should be our model, and since Rule 506 does not require offerings to be conducted through registered portals or platforms; it doesn't make sense to have this requirement for crowdfunding.
In order to create an efficient and transparent marketplace, businesses should be allowed to raise up to $1 million per year through crowdfunding offerings and should be required to provide financial and other disclosures to investors.	The key here is ensuring that the required disclosures remain simple. We should strive to create a usable exemption for startups and small businesses. Again, I believe we should use Rule 506 as our model. Rule 506 has no specific information delivery requirements.

Conclusion

As I have written before and elsewhere, I think the easiest thing to do to make crowdfunding a reality would be to amend Rule 506 to do two simple things:

1. Allow general solicitation in Rule 506 offerings.

2. Allow non-accredited investors to invest in Rule 506 offerings up to a max of $1M and an individual investor cap of $10,000 without triggering Rule 506's onerous disclosure obligations.

In other words, we don't need a new, complex statutory and regulatory regime, or registered "portals" or intermediaries.