Crowdfunding: Weighing the Opportunities, Risks

The federal JOBS Act makes it easier for investors and qualifying businesses to hook up, but there are plenty of risks to go along with the rewards

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On April 5, 2012, President Obama signed into law the "JOBS Act." The acronym (for "Jumpstarting Our Business Startups") is a little misleading, as the Act has less to do with jobs, per se, than with easing regulatory restrictions on small businesses that need to attract investment capital. For business owners, the most interesting features of the JOBS Act include approval of (a) "crowdfunding" and (b) public marketing of Rule 506 (accredited investor) offerings.

Predictably, most of the publicity has focused on crowdfunding, which is also the focus of this article. Crowdfunding is a form of microfinance that for some time has been popular among charities, artists, filmmakers, etc., in raising money (often via the Internet) to fund causes and projects. After the SEC's 270-day rule-making period (which started April 5) has run its course, the JOBS Act will:

- let business startups solicit investment from the general public, something that until now has been prohibited, and
- make it easier for individuals to identify growing companies in which they might wish to invest.

PROS AND CONS

The White House and the law's supporters in Congress have touted the JOBS Act's potential for stimulating business formation and job creation and, eventually, encouraging domestic innovation in business and technology. Less enthusiastic are observers who view the JOBS Act as a good-news-bad-news item; whether it is mostly good or mostly bad depends largely on what you are trying to accomplish and your tolerance for venturing into the unknown.

On the plus side, the JOBS Act will generally let a new company raise money from anyone, at any time in its development cycle. Also, doing away with the "general solicitation" ban for investments allows new companies to publicize the fact that they are in fund-raising mode and to attract the attention of would-be investors. Third, proponents argue that the JOBS Act will cause the startup economy to become more "transparent," prompting more investors of all sizes to support companies that are in their infancy, in some cases moving their capital from static or institutional investments to more dynamic, "real economy" opportunities.

The downside of the JOBS Act includes predictions that the new law will provide new opportunities for scammers and fraud artists. One can assume that, while the SEC is writing its rules to protect the public, rip-off artists are using the same time period to hatch crooked schemes directed at unwary investors.

Scams aside, crowdfunding dollars invested in legitimate start-up companies are invariably at risk. The reason: Most businesses fail. Many investors who are lured into the marketplace by the ease and excitement of crowdfunding will guess wrong, and they will lose money that would not have been put at risk in the pre-JOBS Act era. As is described below, there are limits to the amounts that an individual can invest; still, many investors will be ill-prepared to lose even modest sums.

In addition, while crowdfunding might be just what the doctor ordered for a startup company, its directors and officers need to be more careful than ever. The Act's definition of "issuer" includes any person who offers or sells a security in a crowdfunding transaction; that definition could pose a significant expansion of personal liability for directors and officers if things go sour for a crowdfunded company.

Finally, investment opportunities might not be as "transparent" as the JOBS Act's champions content. Publicity of crowdfunding opportunities will be very limited with respect to the quality and quantity of information, since they will be barred from making investment recommendations.

EXEMPTION REQUIREMENTS

Under the Act, the offer and sale of securities is exempt from SEC registration if it meets these basic requirements:

- The issuer may not be a public company, investment company or foreign private issuer.

- There is a $1 million limit on the aggregate amount sold to all investors under the crowdfunding exemption in any 12-month period.
- An investor who has an annual income or net worth of less than $100,000 can invest (in a 12-month period) no more than $2,000 or 5% of his or her annual income or net worth (whichever is more).
- An investor who has an annual income or net worth of $100,000 or more can invest (in a 12-month period) up to 10% of his or her annual income or net worth, with a cap of $100,000.
- The intermediary and issuer both must comply with SEC disclosure and reporting requirements.
- The transaction must be conducted through a broker or a funding portal.

A “funding portal” is a person who acts as a crowdfunding intermediary and does not (a) offer investment advice, (b) solicit purchases of the securities displayed on its website or pay others to do that, or (c) handle investor funds or securities.

ASK FOR HELP

The relative merits of crowdfunding, both for business owners and for investors, will likely become clearer as the JOBS Act's effective date (circa January 2013) nears. Whether the net effect of crowdfunding is positive for you or your company can be determined only after doing your homework and getting professional guidance from an experienced attorney and accountant.

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