Prepare for a Capital Raise with Crowd Funding

Small businesses and entrepreneurs have been given a very big opportunity. On April 5, 2012, President Obama signed into law the JOBS (Jumpstart Our Business Startups) Act. Among its aims: to permit small businesses to use the Internet to solicit investments and raise capital.

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VIEWPOINT

Title III of the JOBS Act is entitled the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" or CROWDFUND Act. The act gives small businesses and startups access to a vast amount of capital resources available online by exempting certain limited offerings of their equity from the registration requirements of federal securities laws. About 98 percent of businesses, which until now had no real access to large-scale capital raises, are now permitted to publicly solicit certain equity investments without being subject to U.S. Securities & Exchange Commission (SEC) registration and reporting requirements.

For the past 79 years, the capital-raising landscape of the United States has been dominated by the Securities Act of 1933, which prohibits a company from selling securities that are not registered with the SEC. Before the CROWDFUND Act, there were exceptions to the registration requirement, but none that were particularly helpful to small businesses or startups looking to harness the power of online marketing. The exceptions included:

1) Section 4(2), which exempts transactions in securities not involving a public offer or sale;

2) Rule 504, which allows a capital raise of up to $1 million to an unlimited number of investors provided there is no public solicitation or advertisement; and,

3) Rule 505, which allows a capital raise of up to $5 million to an unlimited number of "accredited investors," and up to 35 unaccredited investors, again provided there is no public solicitation or advertisement and provided that the unaccredited investors are given the same type of information as provided in an SEC registration statement; and

4) Rule 506, which allows an unlimited capital raise to an unlimited number of accredited investors and up to 35 "sophisticated investors," again provided that there is no public solicitation or advertisement and that the sophisticated investors are given the same type of information as provided in an SEC registration statement.

The exceptions themselves are complicated and their lines are in some cases blurry. Each exception, however, has the same drawback — no public solicitation is allowed. Thus, under those exceptions, while a business owner could offer friends or relatives the opportunity to invest in his or her business, that same business owner could not place a general solicitation on a website, on message boards, on a Twitter feed, Facebook account, or LinkedIn profile. That type of broad advertisement would be tantamount to a public solicitation for the sale of securities and would require a full-fledged SEC registration process which, for a small business, would be cataclysmically expensive.

Consequently, prior to the CROWDFUND Act, the only businesses able to acquire new equity capital were those which could afford to pay for it. This put small businesses at a severe competitive disadvantage. And, in an economy where small businesses are responsible for more than half of new job growth, a lack of access to capital was not only devastating to the small businesses, but also to the economy as a whole.

The CROWDFUND Act is the remedy. It doesn't go so far as to permit unfettered solicitation through Facebook, but it does allow a small or start-up business to publicly solicit investment and raise capital on a previously unprecedented scale. A business may now present its business plan not just to a single lender or small group of well-funded investors, but to the entire online community, through a broker or a registered "funding portal." Individuals in the online community can then decide whether they want to invest in the business. If 1,000 individuals contribute $50 each, a business raises $50,000 in new equity capital. Ostensibly, convincing a multitude to make a small investment is easier than convincing a few individuals to make a large one.

Because the CROWDFUND Act amends the Securities Act of 1933 and the Securities Exchange Act of 1934, its core purpose must be to protect investors. Therefore, it places caps on the capital raise available under the CROWDFUND exemption. During any 12-month period, a business would be limited to raising $1 million via crowd funding, and each individual investor's contribution would also be limited. An individual with an annual income or net worth of less than $100,000 would be limited to investing the greater of $2,000 or 5 percent of such income or net worth. An individual with an annual income or net worth greater than $100,000 could invest 10 percent of such net worth or annual income, up to $100,000.

Quite literally, the CROWDFUND Act will allow funding by the crowd or money from the masses. It will stand in contrast to the traditional small-business model of relatively few, well-capitalized owners contributing large sums, a model that prohibited a start-up company or entrepreneur from infusing a business with adequate capital unless he or she was independently wealthy or had connections who were wealthy. The prior registration exemptions will still exist and will continue to be utilized on a large scale. The CROWDFUND Act, however, will go a long way toward leveling the playing field for small businesses and will clear the way for growth, jobs, and increased market competition. ❑

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