

4 Things To Know As Equity Crowdfunding Rules Take Effect

By Tom Zanki

Law360, New York (May 13, 2016, 5:43 PM ET) -- Four years after Congress passed the landmark Jumpstart Our Business Startups Act to expand capital-raising tools for small companies, rules governing equity crowdfunding — enabling mom-and-pop businesses to sell securities to unaccredited investors — go live Monday, ushering in a new era eagerly watched by enthusiasts and skeptics alike.

Equity crowdfunding, whereby privately held businesses can raise capital from the public through digital platforms, marks the final piece of the JOBS Act to take effect. The long-awaited arrival follows extensive deliberation by the U.S. Securities and Exchange Commission, which took three years to craft rules that seek to balance the capital needs of small business with investor protections.

While fans and critics of the fundraising method continue to debate whether SEC rules went too far or are adequate — allowing stocks or bonds to be sold to large numbers of ordinary investors without a registration process that has been a hallmark of securities laws since the 1930s is a huge step — capital markets experts are eager to see what happens once the idea meets reality.

“As securities lawyers, we’re all excited,” Mitchell Silberberg & Knupp LLP partner Nimish Patel said. “This is sort of revolutionary, considering that for the last 80 years we couldn’t do anything like this. But I think the jury is out. I don’t know if this is going to open up the floodgates or whether this is going to be too cumbersome for people to take advantage of.”

Here are four things to know about equity crowdfunding.

Expect a ‘Slow Burn’ to Start

For all the anticipation, few observers are expecting equity crowdfunding to storm out of the gates. For one, the SEC requires issuers conduct their offerings through a middleman registered with the Financial Industry Regulatory Authority, and few funding portals are up and running.

Six online portals designed to run websites that connect investors with issuers had gained regulatory approval as of Friday, though attorneys note they are working with many more applicants and expect that number to rise. Portals must comply with comprehensive rules in their own right, attorneys say, creating a time-consuming approval process. Issuers can also conduct crowdfunding campaigns through licensed broker-dealers.

Experts say that word about crowdfunding is still getting out to the wider public. Portals will have to

convince issuers to sign up with them and issuers will have to persuade investors of modest means that their enterprise is worth backing.

“I expect this to be a slow burn,” said Sara Hanks, an attorney and CEO of CrowdCheck, a disclosure and compliance company that seeks to protect investors from fraud. “Securities are sold and not bought, as they say, and companies are going to have to reach out to their networks and convince investors to give up their hard-earned cash.”

Attorneys also note that other JOBS Act innovations already in effect, including a provision that lets issuers advertise their private placements online through so-called 506(c) offerings, which are limited to accredited investors, are only just beginning to **gain market acceptance**.

Likewise, the JOBS Act's expansion of Regulation A, which allows exempt offerings of up to \$50 million, sometimes called “mini-IPOs,” just went into effect last year, and it is showing **moderate results** so far. New rules and regulations take time to absorb, according to Covington & Burling LLP partner Keir Gumbs, who expects the same of equity crowdfunding.

“It will be probably years, not months, before we really have a good sense for what exactly these rules hold in terms of opportunities for a new form of capital raising,” Gumbs said.

Rules Could Limit Crowdfunding’s Appeal

The SEC, seeking to combat potential fraud, crafted elaborate rules for participants in crowdfunding, including issuers, investors and intermediaries. Attorneys are closely watching whether those parties will put up with necessary requirements and whether the SEC will ease up regulations if evidence suggests it is necessary.

“It appears they might have overregulated this just because they were afraid of potential fraud that could result from it,” Patel said. “They would rather take measured steps, first trying it this way, and then perhaps relaxing it several years down the road.”

For instance, issuers are limited to raising \$1 million over a 12-month span, must submit annual reports to the SEC and provide financial statements reviewed by an accountant, and can potentially be audited if a company seeks to raise more than \$500,000 more than once, among other things.

Regulators also limited how much investors can provide crowdfunding campaigns, for fear that vulnerable supporters squander more than they can bear on a money-losing business. If someone’s annual income or net worth is less than \$100,000, they can only contribute 5 percent of the lesser of either figure, or \$2,000, whichever is more. If both their personal income and net worth is more than \$100,000, then they can invest 10 percent of whichever figure is less.

The limits on individuals reflect concerns about expanding access to private investments beyond accredited investors, or those considered wealthier and more sophisticated and therefore able to fend for themselves, a big worry with regulators considering the high failure rate of startups. At the same time, those individual caps atop limits imposed on companies could severely limit the appeal of crowdfunding.

“At least, in the beginning, the SEC is taking a cautious approach and making this more highly regulated than a lot of people would like,” Day Pitney LLP counsel Eliza S. Fromberg said. “I think the hope is that

after some time when people get more comfortable with crowdfunding, perhaps some of these rules could be relaxed a bit. Perhaps the \$1 million limit could be increased. Starting from a more cautious position and incrementally expanding crowdfunding might be the way to go.”

Online funding portals, for their part, also have to comply with rigorous rules as well as pay the operating costs of running a platform. Such portals must be registered with FINRA, are prohibited from making false or misleading statements, cannot offer investment advice, must provide education materials to investors, and must weed out bad actors, among other requirements. Full-fledged broker-dealers are already mandated to comply with more rules.

No Secondary Market — Yet

SEC rules also bar securities sold through equity crowdfunding from being resold for at least one year. As it stands now, there is no secondary market established that would facilitate the resale of such securities even if investors desire it, potentially leaving them stuck with shares they no longer want.

“If there is no market for these securities, it will be difficult if not impossible to transfer them,” Fromberg said.

This lack of liquidity was a concern for SEC Commissioner Luis Aguilar, who last year urged the development of a viable **secondary market** for crowdfunded shares to protect investors and promote small-business growth. Yet certain crowdfunding followers don’t expect the absence of secondary trading to be a big problem.

They note crowdfunding campaigns, which have existed for years in nonequity formats through platforms like Kickstarter that compensate supporters with nonfinancial rewards, often have a local or familial connection to their backers, who are more prone to be emotionally invested in that venture’s long-term success. Hanks said if demand for secondary trading is strong enough, it will develop over time.

“A lot of these crowdfunding investments are going to be ‘passion plays,’” said Hanks, also a member of an SEC committee that advises small and emerging companies. “You invest because you love the idea or you know the team and want to give them a chance. You’re in it for the long run. You don’t invest to flip the shares.”

Crowdfunding Depends on Local Loyalty

The loyal connection that many backers have with crowdfunding campaigns — where companies often turn to support from customers they know — distinguishes them from large-scale securities offerings. But whether loyal customers turn out to be reliable shareholders is one of many uncertainties that attorneys following crowdfunding will be watching.

“Do good customers make good shareholders?” Morrison & Foerster LLP partner Anna Pinedo asked. “It will be interesting to see whether what motivates somebody to buy a doughnut is the same thing that motivates them to buy a share of the doughnut company.”

For now, experts expect crowdfunding to mostly remain a local phenomenon. High-flying Silicon Valley startups destined for an initial public offering, which can access venture and institutional funding, are considered less likely candidates for crowdfunding. Gumbs noted that such companies are apt to prefer

traditional private placements under the SEC's Regulation D, which doesn't limit how much can be raised but is mostly restricted to accredited investors.

"I am not sure whether it will ever grow to compete with private placements and Reg D offerings," Gumbs said of equity crowdfunding. "But it is something that was not there before."

However a small business with deep community roots and no aspirations to go public — say a coffeehouse, microbrewery or restaurant that needs to fund an expansion — just might find equity crowdfunding appealing, said Mark Roderick, a crowdfunding attorney with Flaster/Greenberg PC. But he expects the concept to take root slowly, noting that many business owners he talks to still don't know the option exists.

"As people become more aware, you are going to see a shift," Roderick said. "In my going around, anecdotally nobody knows about it. It's a secret. It's only when the secret starts to seep out that you are going to see it gain traction. Legally, it's the first time in history you can do this. It's going to take a lot for that to seep through."

--Editing by Jeremy Barker and Mark Lebetkin.

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