

## Equity Crowdfunding Struggles To Gain Steam At 1-Year Mark

By Tom Zanki

*Law360, New York (May 11, 2017, 8:39 PM EDT)* -- One year since federal regulations authorizing equity crowdfunding went live — launching a novel method of capital raising that lets tiny startups raise money online from ordinary investors without completing the standard registration process that defines securities law — the idea is struggling to gain traction.

Early data show a limited number of companies dabbling with the new approach, and lawyers advising small startups say the concept has not generated momentum in the marketplace. Things could pick up over time, but attorneys say crowdfunding is moving slowly so far, largely because participants are still unfamiliar with the idea or are put off by various strings attached to what many consider a modest level of financing.

“It hasn’t been the floodgates opening as we thought,” Mitchell Silberberg & Knupp LLP partner Nimish Patel said. “It’s more of a drip, and we are just seeing a small handful of companies utilizing it.”

The coming Tuesday marks one year since U.S. Securities and Exchange Commission rules governing crowdfunding took effect. Passed as part of the landmark Jumpstart Our Business Startups Act of 2012, or JOBS Act, crowdfunding lets essentially mom-and-pop businesses sell stocks or bonds online to nonaccredited investors subject to certain limits, as part of a broader attempt to modernize capital raising for the internet age.

Such businesses can do so without filing a formal registration statement and can publicize their offerings on the internet, departing from traditional rules governing most securities offerings. Capital raisings are capped at \$1 million annually, and contribution limits apply to investors. Issuers can sell securities only through licensed intermediaries, who are also subject to rules.

The SEC, which took more than three years to develop crowdfunding rules after the JOBS Act's passage in an effort to ensure adequate safeguards for investors, said in a white paper published in February that the market is seeing the “gradual adoption” of crowdfunding. SEC data show that 33 deals were completed through Jan. 15 — more recent data were not available — raising \$10 million with a median fundraising amount of \$171,000.

Around that time, data show, 163 offerings were submitted, seeking to raise \$18 million total, for a median amount of \$53,000. The numbers are seen as small, but some attorneys say that is expected

given a steep learning curve that comes with a nontraditional way of raising money.

“There is a lot of risk involved, so I think to have a slow incubation period is actually very good,” said Mark Roderick, a crowdfunding attorney at Flaster/Greenberg PC.

The majority of crowdfunding companies are new to the process of soliciting investments. SEC data show most issuers are prerevenue, have yet to generate a profit and have no prior experience with capital raising.

The idea behind the law was to provide early-stage businesses with loyal customers — but not necessarily the same access to venture capital as flashier startups — the ability to tap into their following on social media and elsewhere for equity-raising purposes.

Successful examples include Ellison Eyewear, a seller of handmade sunglasses made in Greece, which raised \$55,000 through crowdfunding. Beta Bionics Inc., a maker of a bionic pancreas that autonomously manages blood sugar levels in people with diabetes, raised a full \$1 million last year.

Companies of similar ambition will need considerable resources to comply with crowdfunding rules. Patel noted there are many “bells and whistles” attached to crowdfunding, something that attorneys say could scare off potential issuers.

“The rules were a step in the right direction, but there are so many hoops that have to be jumped through both in terms of the companies doing the fundraising but also the investors,” Covington & Burling LLP partner Keir Gumbs said.

Apart from the fundraising limit, companies must file annual reports with the SEC; issuers raising \$100,000 to \$500,000 must provide financial statements reviewed by an independent accountant, and repeat issuers seeking to raise beyond \$500,000 must provide audited financial statements.

Regulators also limit how much investors can provide crowdfunding campaigns for fear that vulnerable supporters may lose their shirts on a risky enterprise.

If someone’s annual income or net worth is less than \$100,000, they can contribute only 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.

And intermediaries, such as online funding portals or broker-dealers, have responsibilities too, including vetting issuers to ensure they comply with disclosure rules and providing investors education materials so they understand risks of the security being sold.

Given the requirements, crowdfunding can be a hard sell in light of alternatives that allow unlimited fundraising such as traditional Regulation D private placements, albeit those offerings are mostly limited to accredited investors. Traditional Regulation D offerings also don’t allow “general solicitation,” or advertising, though the JOBS Act added a new Regulation D option that permits advertising so long as the offering is strictly limited to accredited investors.

“Why would I invest through a portal in one of these crowdfundings, as opposed to just doing a Reg D investment without the limitations?” Gumbs asked. “I get the investor protection part. I think that’s important. But the bottom line is I think maybe the statute went a little far in that regard.”

Various proposals have floated in Congress to ease rules on crowdfunding, including one last year to raise the annual funding limit to \$5 million that was dropped by a House committee out of concern that it was too soon to start loosening limits on an untested fundraising method. The Financial CHOICE Act, which is more broadly a rewrite of Dodd-Frank financial regulations, also eases certain regulations on crowdfunding.

Patel said that lifting the cap to \$5 million could provide crowdfunding a boost. Given that the expenses of complying with crowdfunding rules tend to be fixed, such as hiring lawyers and accountants, a higher funding limit would make those costs easier to bear, according to Patel.

"You could really raise a significant amount of money and reduce your transaction costs as a percentage," Patel said. "I think that would create a lot more momentum."

Roderick agreed that raising the limit would increase interest in crowdfunding though he also noted the view that \$1 million doesn't go far tends to be a "bi-coastal elitist perception" on the East and West coasts near Manhattan and Silicon Valley. The money goes much farther in regions with lower cost-of-living scenarios, especially for real estate issuers, who Roderick said form a large chunk of early participants in crowdfunding.

The longer-term hope for crowdfunding is that internet-based finance levels the playing field nationwide, Roderick said, spreading opportunities for issuers and investors around the country. Current SEC data show that California, New York and Texas account for a huge portion of crowdfunding offerings.

"Gradually, someone in South Dakota will be able to raise money just as easily as someone in Mountain View [California]," Roderick said. "And also ... an investor in South Dakota will have access to the same deals as the guy in Mountain View."

The SEC cautioned against reading too much into the early results, given the nascent nature of crowdfunding and the likelihood that its market will evolve over time. Attorneys saw the next year or two will provide a fuller picture.

"We all wanted to hit the ground running, but I think it's going to be a more two- or three-year process, not just six months to a year," Patel said. "Hopefully then we will see a more robust equity crowdfunding come alive."

--Editing by Christine Chun and Edrienne Su.

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