A New Era for Small Business Capitalization or Funding for the Future: Crowd Funding and Small Business Online Offerings

By: Joe Donnini[1]

FIRST PUBLISHED IN ORANGE COUNTY LAWYER, May 2013, Vol. 55 No. 5, page 14

The views expressed herein are those of the Author(s). They do not necessarily represent the views of the Orange County Lawyer magazine, the Orange County Bar Association, The Orange County Bar Association Charitable Fund, or their staffs, contributors, or advertisers. All legal and other issues must be independently researched.

Imagine that an entrepreneur needs to raise $100,000 for their business. With limited options, the entrepreneur seeks the internet as source of funds. The entrepreneur places a campaign on a third party website that allows them to reach infinite amounts of people, who may want to donate to their cause in exchange for different types of creative gifts they offer in return. A California based company, Pebble Technology, did just that and surpassed its $100k goal to set an incredible record of securing over $10 million dollars in just thirty days![2] Granted, this is probably the highest campaign to date; however, it begs the questions: How did they do it and what are the rules of the game?

JUMPSTART OUR BUSINESS START UPS (JOBS ACT): TITLE III on CROWDFUNDING

As most entrepreneurs know, access to capital has been increasingly difficult for small businesses, which in turn affects jobs, tax revenues, and a host of related areas. Fortunately, on April 5, 2012, the Jumpstart Our Business Startups Act (JOBS Act) was signed into law, allowing crowd funding to exist as a way to infuse much needed capital into the business sector.[3] Crowd funding is a way for the "crowds" to invest online in ventures of their choosing in exchange for equity. This does not comport with historical securities laws; however, the SEC is actively setting forth rules that implement the JOBS Act provisions on crowd funding, so that the balance between access to capital and reduction/prevention of fraud can effectively be realized. One of the key issues in promulgating regulations relates to third party intermediaries that serve as a conduit between the entrepreneur and the investor. These entities or funding portals are the subject of debate in terms of how their role will be shaped to effectuate that balance of providing access to capital and protecting from investor fraud. While websites currently exist under the donative (gift) model, where causes, business, and various projects have sought funds in exchange for gifts, this area of business and law is about to propel to new levels, particularly once the SEC and FINRA rules are established.

KEY PROVISIONS OF THE LAW[4]

First, in order to understand how crowd funding will work, it's imperative to know the basic framework of the JOBS Act, Title III. This title incorporates changes into the staple U.S.

---

[1] Joe Donnini is a practicing business attorney and Visiting Assistant Law Professor at Whittier Law School. Additionally, Joe is a member of Crowdfund Intermediary Regulatory Advocates ("CFIRA"), an organization working with the Securities & Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), and other affected governmental and quasi-governmental entities to help establish industry standards and best practices.

[2] See http://www.kickstarter.com/projects/597507018/pebble-e-paper-watch-for-iphone-and-android

[3] JOB Act, Title III, PUBLIC LAW 112–106—APR. 5, 2012

[4] Note: This is intended to provide a basic framework of the law and is not intended to address every single provision. Please review the law carefully so as to ascertain all elements of it.

securities laws that have shaped offerings since its inception: Securities Act of 1933 and the Securities Exchange Act 1934.[5]

Investors[6]: This legislation provides that the aggregate amount sold by an issuer to investors, within a twelve month period, shall be the greater of $2,000.00 or 5% of their annual income or net worth, if the annual income or net worth is less than $100,000.00. If an investor's net worth or annual income is over $100,000.00, then that investor may invest, within a twelve month period, 10% of their annual income or net worth, but not more than $100,000.00 total.

Basically, there is no need for an investor to be accredited, as the intent to truly allow the crowds the opportunity to connect with opportunities. Of course, due to concerns of fraud and/or misrepresentation, these opportunities do come with limitations. Most of the risk minimization for investors is placed upon the intermediaries, which can be registered broker dealers[7] or funding portals[8], as defined under the Securities Exchange Act of 1933.

Intermediaries[9]: A basic summary of the law pertaining to intermediaries includes that they must:

- register with the SEC and a self-regulating organization (currently FINRA is the only one); and
- provide various disclosures (rules to be determined by the SEC)
- make sure investors review education and understand total risk of loss of investment (rules to be determined by SEC); and
- conduct a background check and securities enforcement regulatory history check on all officers, directors and persons owning more than 20% of the stock of an issuer; and
- ensure a 21 day cooling off period prior to a sale execution; and
- ensure that issuers only get money if target amount is met and allow investors to cancel (rules to be determined by SEC); and
- ensure that investors haven't exceeded the limitations of amounts they can invest within a twelve month period (rule to be determined by SEC); and
- ensure privacy of investors' information (rules to be determined by SEC); and
- not compensate promoters, finders or lead generators for providing them with any personal identifying information of a potential investor; and
- not allow any officers, directors or partners to have any financial interest in any issuer they are servicing; and
- abide by anything else the SEC sets forth.

Issuers[10]: Last but not least to this triune are issuers. They too must follow various elements of the statute to minimize investor fraud or misrepresentation. Specifically, issuers must:

---

[5] Securities Act of 1933: 17 U.S.C §77 et. seq. and Securities Exchange Act of 1934: 17 U.S.C §78 et. seq.
[6] Id at Section 302.
[7] Securities Act of 1933: Section 2(a)(12)
[8] Securities Exchange Act of 1934: Section 3(a)(80)
[9] JOBS Act, Title III, Section 302 (b)(a) as redefined at Section 4(a) under the Securities Act of 1933.
[10] JOBS Act, Title III, Section 302 (b)(b) as redefined at Section 4(a) under the Securities Act of 1933.

- not raise more than $1 million dollars with a twelve month period; and
- file with the SEC and provide broker dealers or funding portal, and investors, and make available to potential investors:
    - a business plan and information on the company and the names of its officers, directors and those owning more than 20% of the stock; and
    - information on the financial condition of the company, including tax returns (if any) if raising less than $100,000.00. If raising more than $100,000.00, financial statements need to be reviewed by a public accountant, and if raising more than $500,000.00, issuers need to provide audited financial statements for the previous year; and
    - the target amount to be raised, use of those proceeds, deadlines for raising and regular updates regarding progress on raising such funds; and
    - the price of the securities and method of calculation; and
    - various details on the terms, valuations, modifications to such securities, particularly all ways in which an investor's rights and investment may be at risk; and
- not advertise, but can direct investors to the broker dealer or funding portal; and
- not compensate or attempt to, anyone to promote its offering through communication channels provided by a broker dealer or funding portal unless it follows rules set forth by the SEC, which haven't yet been adopted; and
- file report with the SEC (rules to be determined by the SEC); and
- abide by anything else the SEC sets forth.

OTHER GENERAL PROVISIONS[11]

Issuers will be liable for any material misstatements or omissions.[12] No resale of securities is permitted for a one year period, unless to the issuer, an accredited investor, in connection with a registered offering, or to family member in connection with death or divorce. [13] Further, funding portals (as opposed to broker dealers) cannot offer investment advice nor can they handle any of the investor funds.[14] Finally, federal law preempts state law with respect to registrations, and no filing fees can be required except if the state is where the principal place of business is for the issuer and if 50% or more of the investors reside in a particular state[15]. States in general are not preempted for enforcement of matters involving fraud, deceit or unlawful conduct.[16]

SO WHAT DOES ALL THIS MEAN?

Based upon sites like kickstarter.com, rockethub.com, indiegogo.com and several others, we have seen a proliferation of the donative model. Anecdotal evidence supports that over $1.5 billion dollars was raised in 2011.[17] This is just the tip of the proverbial iceberg. Once the equity model is up and running, there's strong indication that this number will be significantly higher.

---

[11] See Note 3.
[12] JOBS Act, Title III, Section 302 (b)(c) as redefined at Section 4(a) under the Securities Act of 1933.
[13] JOBS Act, Title III, Section 302 (b)(c) (1) (e) as redefined at Section 4(a) under the Securities Act of 1933.
[14] JOBS Act, Title III, Section 304.
[15] JOBS Act, Title III, Section 305.
[16] Id.
[17] http://techcrunch.com/2012/05/08/crowdfunding-state-of-the-union/

Granted, much of the detail in terms of pending regulations by the SEC and FINRA needs to be worked out, presumably by year's end; however, Congress has created a strong platform for a new ecosystem that is positioned to fundamentally change the landscape of small business access to capital. As this system evolves there will be challenges, but they will be far outweighed by the benefits of providing small businesses the capital they need to create jobs, expand our economy and add to the tax base.

I suspect that some of the areas that will need further attention by the legal community include:

- educating entrepreneurs (issuers) on this major change in securities law;
- advising funding portals and issuers on compliance with forthcoming regulations;
- protection of issuer's intellectual property, particularly if they haven't yet protected various technologies or other patentable, copyrightable, or trademarkable assets;
- implementation of various documents/agreements required by the JOBS Act, in terms of issuer disclosures, stock (or unit) purchase agreements, and related transactional documents;
- advising investors on any issues that arise in connection with their investments; and
- representing parties in connection with any possible litigation that arises between any of the regulatory agencies (federal or state), issuers, funding portals, and/or investors.

This cutting edge industry is just evolving and the timing couldn't be better. Small businesses are the engine which drives our economy. Equity crowd funding will soon provide that engine with the necessary power to drive the economy forward, creating opportunity for entrepreneurs, employees, and investors.