Small Business Advisory: Crowdfunding

The Jumpstart Our Business Startups (JOBS) Act, a series of legislative provisions intended to facilitate capital formation in the United States, was signed into law in 2012. This legislation included the CROWDFUND Act, which made significant changes to current federal and state securities laws. The CROWDFUND Act allows entrepreneurs to raise capital by offering to sell interests in their businesses over the Internet. Under the CROWDFUND Act, a small business is allowed to raise $1 million in a 12-month period by selling its securities to investors without registering that offering with federal or state securities regulators. However, the Act places limitations on how and to whom a small business can sell its securities. In May 2016, the Securities and Exchange Commission (SEC) issued rules to implement this new exemption to allow securities sales through crowdfunding.

What is Crowdfunding?

Crowdfunding is an online money-raising strategy that began as a way for the public to donate small amounts of money, often through social networking websites, to help artists, musicians, filmmakers and other creative people finance their projects.

The concept has been promoted as a way to assist small businesses and start-ups looking for investment capital to help get their business ventures off the ground. Traditionally, investment opportunities are offered by professionals, such as broker-dealer firms and investment advisers, who must recommend investments that are based on their clients' investment objectives and levels of sophistication.

Through crowdfunding, individuals will be able to invest in entrepreneurial start-ups through an intermediary, such as a broker-dealer or a "funding portal." A funding portal is a website, also called a "platform," through which investors may invest in crowdfunding offerings. Companies using crowdfunding may not make investment opportunities directly to individual investors. The funding portal or platform facilitates the investment including the payment from the investor to the issuer. Some portals may list a variety of investment opportunities on one website, allowing investors to select one or more projects. By law, "funding portals" are not allowed to provide investment advice and must be registered with the SEC.

Crowdfunding Considerations

Don't discount disclosure. The crowdfunding exemption is only an exemption from securities law registration requirements. It does not change the securities law disclosure requirements. The requirements of federal and state securities laws regarding disclosures, including disclosures of all material facts and risks to investors, remain in place.

If you do not comply with these disclosure requirements, you and your business could be liable for securities law violations and subject to private lawsuits as well as enforcement actions by state and federal regulators. Existing federal and state registration laws are specifically designed to protect small businesses soliciting investments by ensuring that the key terms and risks of their offerings are disclosed on brief, short-form filings. This is a significant benefit for entrepreneurs and other unsophisticated businesses that may be unaware of the legal pitfalls that await them when such disclosures are not made.

In light of statistics showing that roughly 50 percent of all small businesses fail within the first five years, the next generation of small businesses could quickly find themselves facing civil and criminal legal claims simply because those businesses were no longer prompted on the need to disclose the risks typically associated with start-ups.

To learn more, contact:
CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT
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- **Carefully choose a broker or funding portal.** Be aware of unscrupulous persons offering to take fees from you now to help you raise capital over the Internet. If your broker or funding portal does not comply with the SEC's rules under the CROWDFUND Act, your exemption may be voided, subjecting you to liability for an unregistered offering. When you do select an intermediary, be sure that the broker or funding portal thoroughly complies with the requirements of the CROWDFUND Act and its rules. It is your business, after all, so ask questions to ensure that the broker or funding portal is compliant with applicable laws and rules. For example, since small businesses will be held responsible for making misrepresentations to investors or failing to disclose important information, you should be wary of crowdfunding platforms that seem careless about making adequate disclosures to investors.

- **Don't go it alone.** The crowdfunding exemption is meant to lower your capital-raising costs by exempting $1 million or less capital formation efforts from registration. However, a small business using this exemption still needs legal guidance as to how to comply with the CROWDFUND Act's requirements as well as the other federal and state securities laws. Consider speaking with a licensed and experienced securities law attorney to help you in your offering.

- **Avoid distractions.** Having hundreds of "owners" may distract the company's management from devoting the time and energy that is necessary to run a successful business. Venture capital companies or private equity funds may be less inclined to invest in a company that already has a crowd of small investors.

- **Consider your funding alternatives.** Consider your funding alternatives. Crowdfunding may be less expensive than doing a public offering of securities, but it will be more expensive than other alternatives. Federal and state laws provide other ways for a company to raise money from limited numbers of investors with little or no cost. Contact the California Department at Business Oversight, your state or provincial securities regulator to learn the different options for raising capital.

The Bottom Line

Do your due diligence and get advice from a competent professional to determine the appropriate course of action for your particular circumstances. Be sure to guard your company's reputation by avoiding crowdfunding platforms and other intermediaries that appear unconcerned about compliance.

For more information on offering securities and raising capital, contact the California Department at Business Oversight at1-866-275-2677 or online at www.dbo.ca.gov.

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