

Raising Capital -- Crowdfunding vs. the New Reg D Offering

Much excitement surrounded the adoption of the Jumpstart Our Business Startups Act (the "JOBS Act") back in April 2012. Much of the source of excitement arose from the promise that under the legislation small companies and new ventures would finally be able to seek funding via the Internet and social media from small and first-time investors. Something akin to a public offering of securities that would certainly be beyond the reach of these small companies and investors without a change in the law.

While grand in concept, by the time the crowdfunding piece of the JOBS Act wound its way through the Senate, it had been loaded down with so many regulatory requirements that it has substantially lost its luster. Further the SEC has not even completed its task of drafting all the further rules and regulations to which crowdfunding companies, investors and crowdfunding platforms will become subject.

I have written and spoken before about new Rule 506(c) of Regulation D which now allows private companies to utilize "general solicitation" in their fundraising efforts. Among other things, when this type of offering is properly-structured:

1. A company is entitled to solicit accredited investors using social media, radio, Internet and traditional advertising.
2. Since the offering is to "accredited investors" only, there is no limitation on how much an investor can commit to the offering.
3. Similarly, there is no limitation on the amount of funds that can be raised.
4. There is limited ongoing reporting to the SEC regarding the offering and the investors in it.
5. The fundraising effort can be undertaken with or without the assistance of a FINRA broker-dealer.
6. If desired, a certain amount of funds raised can be allocated to a registration of the company's shares with the SEC, providing a clear path to liquidity for each investor.

Crowdfunding may still be a good possibility for many companies but a great number of them will have to think twice before going down that road. Unlike new Reg D, crowdfunding is still not legal and it's been one and a half years since the passage of the JOBS Act. The SEC has not yet completed final rules and regulations and there is no reliable estimate of when that may occur. When crowdfunding does become legal, some of its key provisions will include the following:

1. A company will not be entitled to solicit investors directly using social media, radio, Internet and traditional advertising. The only solicitation permitted will be notices to potential investors that they can go to a specific crowdfunding platform/website to find more information about the company.
2. Since the offering is to "non-accredited investors" as well as accredited, there are limitations on the amount that can be invested. Investors with incomes below \$100,000 will be limited to a maximum of \$5,000 (but in no event more than 5% of annual income or net worth), and those

with incomes above \$100,000 will be limited to a maximum of \$100,000 (but in no event more than 10% of annual income or net worth).

3. Unlike new Rule 506(c) of Reg D, companies raising money through crowdfunding can raise a maximum of \$1 million in a 12-month period.

4. There is significant ongoing reporting to the SEC regarding the offering and specifically regarding the investors in it.

5. Crowdfunding may only take place through a platform operated by a FINRA-licensed broker-dealer. Any efforts outside of this venue will be closely scrutinized.

6. Shares sold through crowdfunding are restricted for 12 months and thereafter will remain illiquid absent a sale of the company or an SEC registration. Given the relatively small amount of funds permitted to be raised and the cost of ongoing compliance, an SEC registration may be unlikely for most of these companies due to the expenses involved. Investors in many crowdfunding deals will have to be prepared to hold their shares for the long run.

The differences pointed out above between crowdfunding and the new Reg D offerings are just a sampling and, as is the case with so many laws, there are a great number of other factors and issues involved in compliance. It should also be noted that there are some more sophisticated Internet platforms out there that are structured and managed by investment banking firms. Unlike crowdfunding platforms, they allow entrance by accredited investors only and allow access to quality companies and alternative investments. The crowdfunding issues referenced above would not be relevant in this type of platform.

While it's not perfect and there are hoops to jump through, overall the new Rule 506(c) offering permitting general solicitation has turned out remarkably well. It is flexible enough so that a properly-drafted Reg D offering document can be used (i) in independent company-led fundraising efforts to accredited investors in the general public, or (ii) in an investment banking platform like the one described above, or (iii) with angel investors and VC firms. The same Reg D offering document can be used with any one of these investor venues, or with all three at the same time if desired. Not bad, right?

Crowdfunding did sound like a good idea at the time. It however appears to have fallen prey to over-regulation at the Senate level and it will take a further regulatory beating at the hands of the SEC. It's a shame. It should do well enough in some situations but it really could have been a contender...

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