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Securities Regulation

New SEC Rules May Undercut Equity Crowdfunding Potential

BY ALEXIS KRAMER

Companies thinking that crowdfunding by selling stock online is a good proposition may want to reconsider their optimism.

Securities and Exchange Commission rules allowing companies to raise funds by selling stock over the Internet that are set to take effect May 16 are limited and restrictive. The rules would enable individuals to invest a small amount of money in a business venture through a funding method called equity crowdfunding. But securities regulatory attorneys told Bloomberg BNA they aren't yet convinced on how popular the method will become.

The rules permit, among other things, a company to raise no more than $1 million through crowdfunding in a 12 -month period. Professional fees necessary to comply with the rest of the requirements may outweigh the benefits in some situations, David C. Fischer, a corporate and securities law and mergers and acquisitions partner at Loeb & Loeb LLP in New York said.

Equity crowdfunding is different from the kind popularized by Kickstarter and other sites, in which people contribute to an artistic project or other undertaking but receive no equity. The globally famous Kickstarter platform funded 22,252 projects in 2014, with over $500 million from 3.3 million backers, according to a report by the Financial Crimes Enforcement Network (FinCEN).

''Crowdfunding portals are akin to e-commerce sites though for investing in small businesses,'' Jordan R. Bernstein, a food startup and entrepreneur partner at Michelman & Robinson LLP in Los Angeles said. ''But I'm not sure businesses are going to think it is that useful due to the limitations.''

Fischer said the financial costs and limitations stipulated by the new rules may make it unattractive for companies to raise money through equity crowdfunding.

Companies will need to retain counsel, a certified public accountant, possibly pay broker fees, and funding portals may take a piece of the equity. Bernstein said that companies could spend between $25,000 to $50,000 just in preparation for equity crowdfunding offering.

Stephen P. Wink, a partner in Latham & Watkins LLP's Financial Institutions Group in New York, said the requirements for filing documents with the SEC would still cost less than a company is likely to raise, but companies don't know ahead of time that they will successfully raise money.

Once companies look at the requirements, they are going to think more carefully and consider the costs and benefits, Wink said. ''I'm not seeing companies rushing to go ahead and do this,'' he said.

Niche Applications. Andrew J. Foley, a Corporate Department partner at Paul Weiss Rifkind Wharton & Garrison LLP in New York said that equity crowdfunding can generate real capital formation in the right situation. For example, Foley said it may give smaller projects the ability to attract capital to get themselves off the ground. However, the limitations on both the investors and the recipient may limit its utility, he said.

Equity crowdfunding under Title III of the Jumpstart Our Business Startups (JOBS) Act requires companies to use a website of a registered broker or a funding portal. It permits individual investors whose annual income or net worth is less than $100,000 to invest the greater of $2,000 or 5 percent of the lesser of their annual income or net worth. Investors whose annual income and net worth are more than $100,000 can invest 10 percent of the lesser of their annual income or net worth. Investors may not invest in more than $100,000 in a 12-month period.

The company must file with the SEC, among other things:

- the price of the securities and how it reached this amount;
- the company's financial condition; and
- a description of the business venture and use of proceeds.

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JORDAN R. BERNSTEIN, MICHELMAN & ROBINSON LLP

Fischer said it is unclear whether equity crowdfunding is going to become a common way of raising money. It requires a very niche situation in which companies want to raise no more than $1 million and are willing to

make filings with the SEC and pay for an attorney, he said.

Bernstein said the potential applications for equity crowdfunding under Title III could be for those who want to raise capital from people in the local area to spread the word in a new community. Potential restaurant franchisees may also choose to raise money under Title III rules as they may not need that much capital for a franchise unit depending on the level of capital expenditure required per unit.

Bernstein said he didn't see that many other applications for Title III offering that were practical given the limitations prescribed by the rules and the high costs of setting up a business. ''Unfortunately, $1 million doesn't get you very far these days,'' he said.

Companies seeking to raise more than $1 million do have alternatives to Title III crowdfunding. For example, Regulation D under Title II of the JOBS Act, 7 C.F.R. § § 230.504–230.506, permits entrepreneurs to raise from $1 million to an unlimited amount in private offerings from accredited investors (21 ECLR 728, 5/11/16).

Many Owners.

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David C. Fischer, Loeb & Loeb LLP

Thomas A. Sporkin, a partner at BuckleySandler LLP in Washington, said that equity crowdfunding under Title III is a great way for people to invest in their local community and see how their investment grows. But those community members will want to know that the business venture they are investing in is vibrant and profitable, he said. As such, companies may face scrutiny from a vast number of individuals who have a vested interest in the venture.

Bernstein said equity crowdfunding may be practical for initial funding, but companies likely aren't going to fully fund their business via this method due to the large amount of investors. Funding a $1 million business venture by selling $1,000 investments to 1,000 in-

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dividuals could be ''administratively difficult.'' It would require, among other things, communication and reporting to 1,000 investors, which for a small business could be taxing.

Foley echoed Bernstein's comment. The method may be a good initial step for launching a business idea, but it wouldn't be sufficient to continue this way, Foley said.

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Full text of the rules at https://www.sec.gov/rules/final/2015/33-9974.pdf.