

LEGAL UPDATE: ATTRACTING INVESTORS THROUGH CROWDFUNDING

Entrepreneurs encounter a number of challenges when starting a new business in today's economy. One such hurdle is securing funds through bank financing, angel investors and venture capital funds. With that in mind, the Jumpstart Our Business Startups Act (JOBS Act) was signed into law on April 5, 2012. Among other things, the JOBS Act creates a new type of transaction called "crowdfunding" that permits issuers to raise small amounts of money from numerous investors.

Securities offerings must either be registered with the SEC or exempt from registration. Issuers conduct private placements by employing safe harbor exemptions such as SEC Rule 506. However, crowdfunding does not fit under Rule 506 or other exemptions for private placements because it targets individuals who lack the wherewithal to be considered accredited investors and seeks relatively small individual investments from a large number of investors rather than limiting the offering to a small group.

Although startups cannot use the crowdfunding exemption at this time (the SEC will issue crowdfunding guidelines before the end of the year), entrepreneurs and potential investors are educating themselves now so they will be ready once the exemption is in place. For its part, the JOBS Act has already established certain important provisions:

- An issuer may sell up to \$1 million of securities in any 12-month period to an unlimited number of investors. However, the maximum amount of securities that an issuer may sell per year to any particular investor is (a) the greater of \$2,000 or 5% of the investor's annual income or net worth if the annual income or net worth is less than \$100,000; or (b) the lesser of \$100,000 or 10% of the investor's annual income or net worth if the annual income or net worth is \$100,000 or more.
- An issuer must disclose certain information, including its business plan, target offering amount, planned use of proceeds, and financial statements reviewed by an independent accounting firm. Investors may rescind their subscriptions until the target offering amount is met.
- Offerings must be conducted through a registered broker or an SEC-registered Internet funding portal. A broker or funding portal must disclose information to investors, educate investors about risks, obtain background checks on certain individuals associated with the issuer, and more.
- Issuers may not engage in unrestricted general solicitation and advertising, but may provide notices directing investors to a registered broker or funding portal.

- With limited exceptions, securities issued must be held for at least one year before they can be transferred.

Issuers may find crowdfunding to be appealing, but it has certain drawbacks as well. For example:

- Issuers have an ongoing obligation to file annual financial statements with the SEC.
- Issuers and their directors and officers face potential liability if required disclosures contain material misstatements or omissions.
- Venture capital firms may be hesitant to invest in companies with an abundance of shareholders due to corporate governance and other considerations.

Despite being exempt from federal registration, issuance of securities through crowdfunding must comply with state securities laws. Because failure to comply with securities laws can result in severe financial implications, entrepreneurs interested in raising capital via crowdfunding or traditional means of funding should consult with a knowledgeable attorney to ensure the transaction is properly structured to protect the company, its management team and investors.

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