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The Trouble With Crowdfunding

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It's about one year since President Obama signed the Jumpstart Our Business Startups Act (<http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>) (the "JOBS Act"), designed to help new companies raise capital and go public. For individual investors the most troublesome provisions of the law relate to crowdfunding—a term not defined in the law, but popularly used to mean raising money online for a variety of purposes. Since the JOBS Act passed, crowdfunding has been on a roll. But don't believe the hype; it is far from a start-up fundraising panacea. In the guest post below, Brian Korn

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http://www.pepperlaw.com/LegalStaff_Preview.aspx?LegalStaffKey=957), a securities lawyer with Pepper Hamilton, explains why crowdfunding is not all it's cracked up to be.

By Brian Korn



The SEC has not yet released crowdfunding rules for public comment, but many folks aren't waiting for that. At last count there were nearly 200 public comment letters and staff meetings about the subject on record with the Securities and Exchange Commission. That's the highest of any provision of JOBS Act.



Photo: Getty Images

Meanwhile, the LinkedIn group "CrowdSourcing and CrowdFunding" has over 19,000 members and is brimming with minute-by-minute activity, eclipsing the roughly 1,400 members of the "IPO" group. It is impressive that a concept barely in the investor lexicon two years ago has captured the imagination and attention of so many.

Unfortunately, crowdfunding perception does not align with crowdfunding reality. Crowdfunding will not be able to deliver the grassroots fundraising ease for which so many seem to be hoping. After reviewing the enthusiastic postings of entrepreneurs and discussing the concepts in detail with financial and venture industry insiders, many observers believe there is a fundamental disconnect between the promise of crowdfunding, and the system that the SEC will put in place exercising its authority under the JOBS Act. Put another way, the risks, burdens and limitations of crowdfunding render it almost completely useless. And since crowdfunding targets individual investors, maybe that's a good thing.

Social Media Meets Corporate Finance

The promise of social media has made it possible for unknown people and ideas to become viral sensations overnight without spending money on traditional media or promotion. We've all seen the Facebook posting of some puppy or kitten video that has managed to garner over 1 million "Likes." We have become a society of direct engagement through social media, including Facebook, Twitter, Instagram, LinkedIn, Spotify and Pinterest. In early April, the staff of the SEC's Division of Corporation



Finance endorsed social media as a bona fide corporate disclosure tool under certain conditions. But until the JOBS Act, social media could not be used as an effective capital-raising tool without violating securities laws.

Crowdfunding Gains Political Traction

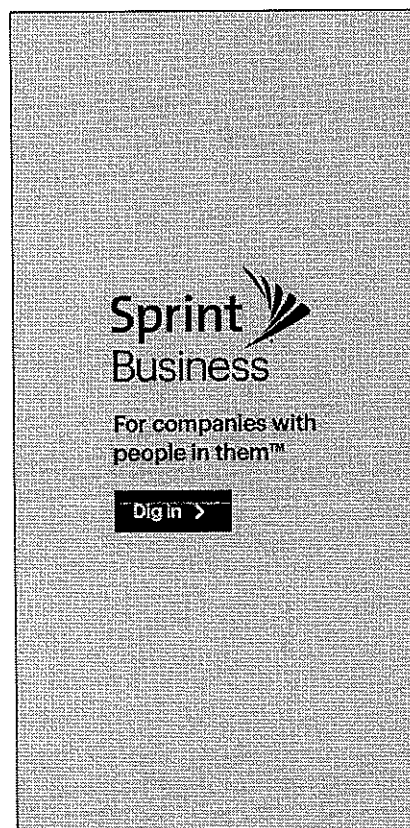
Crowdfunding began with the concept of small enterprises engaging in online capital-raising through social media and raising funds from people they did not previously know (and were not likely to meet). The notion that small individual investors could have the same access to early-stage investment as large venture capital funds, combined with the enhanced ability of start-up companies to raise money beyond their “friends and family” group was a compelling reason for Congress to add crowdfunding to the JOBS Act. Congress even cleverly fashioned Title III of the JOBS Act as the “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012.”

Despite its detractors, including then-SEC Chairwoman Mary Schapiro, Title III added a new exemption from the registration provisions of the Securities Act of 1933 for crowdfunding transactions. The JOBS Act was signed into law by President Obama on April 5, 2012, following a 73-26 Senate vote. Unlike some of the other provisions of the JOBS Act, before crowdfunding is lawful the SEC must propose and finalize additional rules. Despite a December 31, 2012 deadline, no rules have been proposed.

Here's The Problem

As a result of significant amendments on the Senate floor, crowdfunding emerged in the final version of the JOBS Act with a much heavier set of regulatory, legal and procedural burdens than what had been originally proposed. Regardless of the SEC's upcoming rulemaking process, these statutory requirements effectively weigh it down to the point of making the crowdfunding exemption under the JOBS Act utterly useless. When compared to other forms of private placements, crowdfunding is not a feasible option. Here are ten reasons why:

1. Crowdfunding caps an amount an issuer can raise to \$1 million in any 12-month period.
2. Shares issued in crowdfunding transactions are subject to a one-year restricted period.
3. Non-U.S. companies, public-reporting companies (other than “voluntary filers”) and investment companies (mutual funds, for example) are not eligible to crowdfund.
4. Crowdfunding caps the amount a person can invest in all crowdfunding over a 12-month period at 10% of annual income or net worth (incomes of \$100,000 or more) or the greater of \$2,000 or 5% of annual income or net worth (incomes of less than \$100,000).



5. Crowdfunding must be done through a registered broker-dealer or registered "funding portal." Broker-dealers and funding portals may not solicit investments, offer investment advice or compensate employees based on sales. Traditional investment banks have not yet registered for crowdfunding, leading to speculation that crowdfunding will be facilitated by lesser-known financial institutions with little or no retail investment track record.

6. Crowdfunding requires a disclosure document to be filed with the SEC at least 21 days prior to first sale, and requires scaled financial disclosure, including audited financial statements for raises of over \$500,000.

7. Unlike Regulation D Rule 506 private placements to accredited investors following the JOBS Act, crowdfunding does not allow advertising except solely to direct investors to the appropriate broker/funding portal.

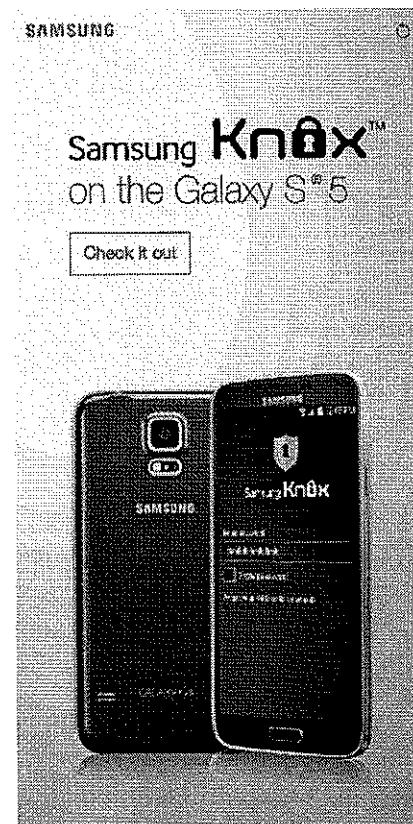
8. Annual reports and possibly more frequent reports (depending on SEC rulemaking) must be filed with the SEC by a company which completes a crowdfunding round.

9. Legal prospectus liability will apply to disclosures, with a "knowledge" exception for misstatements or omissions.

10. Extensive due diligence is required, including background checks on management and large stockholders.

Better Ways To Raise Money

Despite the sound and fury, the crowdfunding exemption will do little to help small start-ups raise capital. That's because it will not be economically feasible for most companies to comply with the filing and disclosure requirements; take on the risk of legal liability; and undertake annual reporting obligations to raise a maximum of \$1 million in a 12-month period. A company might as easily consider filing for an IPO and raise enough to cover its offering costs. As demonstrated by the chart below, it is difficult to imagine why a company would opt for crowdfunding instead of other, less burdensome, forms of private placements – for example, a Regulation D Rule 506 raise or a Regulation A+ raise (another creation of the JOBS Act).



Feature	Crowdfunding	Regulation A+	Regulation D Rule 506
Maximum Amount Allowed to be Raised	\$1 million per 12-month period	\$50 million per 12-month period	Unlimited
Number of Investors	Unlimited but subject to maximum total raised	Unrestricted	Unlimited accredited investors; up to 35 non-accredited investors
Maximum Investment Per Investor	Restricted by income/net worth	Unrestricted	Unrestricted
Investor Disclosure	Required, must be filed with SEC	Required, must be filed with SEC	Not required if all accredited investors
Intermediary Required?	Yes - broker/dealer or funding portal	No	No
Subject to ongoing SEC reporting following raise?	Yes, at least annually, possibly more frequently	Yes; at least audited financials filed annually	No
Disclosure Liability?	Yes, full disclosure liability with a knowledge exception	Yes, full disclosure liability with a knowledge exception	Only anti-fraud liability
Is Resale of Shares Restricted?	Yes, for one year	No	Yes, for public companies most can sell under Rule 144 after six months
State filing Required?	Possibly, depends on future rules by state	No, if securities sold are listed on a national securities exchange or if sold only to "qualified purchasers"	Yes
Advertising and General Solicitation	Not allowed	Allowed	Allowed if sales are made only to accredited investors
Can Public Companies, Foreign Issuers, Investment Companies and Exempt Investment Companies use this Exception?	No	Yes	Yes

http://b-i.forbesimg.com/deborahljacobs/files/2013/04/CrowdfundingArticlechart_BrianKorn4.jpg

The reason many firms may not be able to complete a traditional private placement is that they cannot find enough accredited investors. Many fear that crowdfunding will push the least desirable and riskiest investments that cannot attract mainstream investor support out to the retail investor base, essentially passing on the riskiest slice of investments to those who can least afford the risk.

Whether you're a company or an investor, don't try this without legal advice either. The myth of easy capital raising through crowdfunding has overtaken the social media start-up marketplace. Compliance with the crowdfunding rules is harder than it may look.

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