SMALL BUSINESS ADVISORY

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 recently been promoted as a way of assisting 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," that advertises the investment opportunities and facilitates the payment from the investor to the issuer. Some portals advertise 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.

CROWDFUNDING CONCERNS FOR SMALL BUSINESSES AND ENTREPRENEURS

- **Don't rush in.** Do not start using any Internet resources to raise capital for your business under the crowdfunding exemption until the SEC rulemaking is complete, which won't be for at least several months. Until that time, federal and state securities law prohibitions remain in place against publicly accessible Internet securities offerings.

- **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, remains in place.

  If you do not comply with these disclosure requirements, you and your business can be liable for securities fraud and subject to private lawsuits as well as administrative enforcement actions. 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 huge 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 multi-million dollar civil and criminal fraud claims simply because those businesses were no longer prompted on the need to disclose the risks typically associated with start-ups.

- **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.

  Because the CROWDFUND Act is not implemented yet, such offers could be a scam, preying upon those entrepreneurs less familiar with the Act's requirements. A premature offer could also indicate that the individual making the offer is unfamiliar with the intricacies of the new laws and is perhaps less sophisticated than would be desired.

  If your broker or funding portal does not comply with the SEC's rules on the CROWDFUND Act, your exemption may be voided, subjecting you to liability for an unregistered offering. When you do select one, 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 thoroughly familiar with the act and is motivated to see that your business properly and legally get off the ground. 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 general federal and state securities laws. During the time until you can use the crowdfunding exemption, 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.** 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 your state securities regulator to learn the different options for raising capital.

THE BOTTOM LINE

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 disreputable crowdfunding platforms. For more information on offering securities and raising capital, contact the Hawaii Securities Branch at (808) 586-2740.

(Source: North American Securities Administrators Association (NASAA) Investor Education Program. For more information visit the website at nasaa.org)