

Crowdfunding, or Raising Capital over the Internet - Wave of the Future?

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On September 11, 2011, as part of President Obama's Startup America initiative, the White House announced that it will pursue efforts to reduce the regulatory burdens on capital formation by small businesses. This initiative includes working with the Securities and Exchange Commission (the "SEC") to establish a "crowdfunding" exemption from SEC requirements for companies raising less than \$1 million (with individual investments limited to \$10,000, or 10% of the investor's annual income), as well as raising the cap on "mini-offerings" (under Regulation A) from \$5 million to \$50 million.

What is Crowdfunding?

Crowdfunding is the enterprise of raising small amounts of money from a large number of investors, typically over the internet. Over the years, various crowdfunding websites have sprung up, such as Kickstarter, Lending Club, Prosper, Profounder, IndieGoGo, and Kiva.

Pabst Beer Securities, Anyone?

Recently, two advertising executives, Michael Migliozzi II and Brian William Flatow tried to raise \$300 million over the internet to buy Pabst Brewing Co. Investors were promised "Certificates of Ownership" and beer with a value equal to the amount invested. As an example of the power of crowdfunding, the two men reportedly received over \$200 million in pledges from more than 5 million people in a six-month period, before the SEC shut them down for offering to sell securities without filing a registration statement or qualifying for an existing exemption from registration.

Meshing Securities Laws with Crowdfunding

The Pabst Brewing Co. example demonstrates that the existing securities laws do not easily accommodate internet capital raising. Unresolved issues are myriad, such as:

- Are crowdfunding investments securities? The SEC considered the solicitation of pledges to raise capital for a tender offer for Pabst Brewing Co. to be an offer to sell securities. Although crowdfunding investments may be structured in different ways, equity investments (and, more generally, investments where an expectation of profits arises primarily from the efforts of others) clearly count as securities.

- If crowdfunding investments are securities, are offerings of them currently exempt from registration? Crowdfunding investments are offered through general solicitations to a large number of investors, who may not be "accredited" or sophisticated. As a result, crowdfunding investments do not fit well under existing exemptions, yet registered offerings are not economically feasible for them, which is the main impetus for a new exemption.
- Are crowdfunding sites exchanges? Exchanges, which provide a marketplace for bringing multiple buyers and sellers of securities together, need to be registered. But crowdfunding sites bring together multiple buyers for particular securities, so the multiple-sellers requirement for an exchange would not be met.
- Are crowdfunding sites broker-dealers? Brokers are engaged in the business of effecting securities transactions for the account of others. Because crowdfunding sites publicly advertise securities and are compensated based on securities transactions, they may be considered brokers, in which case they would have to register as brokers unless a new exemption is created.
- Are crowdfunding sites investment advisors? Investment advisors, for compensation, engage in the business of advising others about investing in securities or of issuing reports or analyses about securities. Even if crowdfunding sites do not provide investment advice, the information they provide could be considered reports, so SEC clarification is needed.

What Comes Next?

On September 15, 2011, Meredith Cross, the Director of the SEC's Division of Corporation Finance, testified before the House of Representatives' Oversight and Government Reform Committee that she believes the SEC will consider crowdfunding "in the near future." In addition to the White House's proposal, a crowdfunding bill (H.R.-2930) has already been introduced in the House by Patrick McHenry (R.-N.C.), who chaired the committee hearing. There seems to be support for amending securities laws and regulations to permit crowdfunding as a jobs-creation measure, while continuing to protect investors.

As developments occur, we will issue additional updates. To discuss this client alert or any securities law matter, please contact your Lathrop Gage attorney or any of the attorneys listed on this alert.