The Troubles With The New Crowdfunding Law

Posted on May 21, 2012 by Joe Wallin

Everyone is very excited about the new crowdfunding-for-securities law. Crowdfunding is a great idea–in concept. And now we have a new law which is about to make crowdfunding for securities a reality, at least in *some* sense. The trouble? The law is onerous. It is going to be difficult and expensive to comply with. The burdens of the new law are plenty, but the benefits of the new law are capped. In short, the crowdfunding law as currently written is, in my opinion, needs to be fixed.   I don't mean to be just negative here. Crowdfunding enthusiasts should take their enthusiasm back to Congress to try to get the law fixed. Here are a few of my complaints about the law as it currently stands and recommendations for improvements.

1) The Law Is Too Limiting, Too Constrictive

Under the law, companies can't raise more than $1M during a 12-month period.

> *Contrast this with Reg D Rule 506 all accredited investor offerings–there is no limit on the amount companies can raise.*

A $1M cap during any 12-month period is not per se wrong or inappropriate–but weighed against the costs of raising this $1M (see paragraph immediately below), $1M is too little. For the amount of money it is going to cost companies to raise $1M under the law, the $1M cap doesn't make sense. The law's burdens are disproportionate to its capped benefits.

2) Compliance With The Law Is Too Expensive For The Amounts Allowed To be Raised

- To raise up to $1M, companies are going to have to incur substantial expense. For example, if you plan to raise more than $500,000, you will have to have audited financial statements. The cost of obtaining audited financial statements is likely to be a significant percentage of your total fundraising proceeds.

Contrast this with Reg D Rule 506 applicable to accredited investor-only offerings–you can raise an unlimited amount of money from accredited investors and no audited financial statements are required.

- Companies will have to file not less than annually with the SEC and provide investors reports of the results of operations and financial statements of the issuer, as the SEC by rule determines appropriate. Preparing and filing annual reports with the SEC are likely to be expensive and, over the years (reporting will be an ongoing obligation, presumably for years into the future), could amount to a significant percentage of the funds raised.

Contrast this with Reg D Rule 506 applicable to accredited investor-only offerings–there is no annual report filing obligation with the SEC.

- To raise money, a company will have to prepare comprehensive offering materials to protect not only the company but also its directors and certain of its officers from liability. This will be expensive. Expect to incur multiples of thousands of dollars of expenses in preparing private placement-style offering documents.

Contrast this with Reg D Rule 506 applicable to accredited investor-only offerings–as long as you are selling securities only to accredited investors, no PPM is required.

- Because of personal liability risks to directors and officers, companies will want to obtain D&O insurance. Tack on several more thousand dollars of D&O premium expense per year.

3) The Law Forces Companies To Use Intermediaries

The law forces startups to use intermediaries to raise the funds. This is fundamentally different from what typically happens with startups. Most startups raise funds without the help of intermediaries. In fact, this is the prevailing norm for startup companies. The typical advice to a startup is–don't use an intermediary! Founders, do it yourself!   But here the law forces companies into the arms of either registered broker-dealers or registered funding portals. These entities are subject to numerous requirements, and their compliance with those requirements will make the process much more difficult and costly for companies.

Conclusion

Crowdfunding enthusiasts should go back to Congress and get the law fixed. Recommended law fixes:

- Allow companies to raise more than $1M. Again, right now the law's burdens are disproportionate to the law's allowed benefits.
- Don't force companies to use intermediaries. Allow startups to continue to raise money like startups have traditionally raised money–by themselves.
- If Congress really wants to unleash the creative genius of startups throughout America, allow investors to gamble with small amounts of money. For example, allow people to invest $1,000 without any recourse if they lose their money except in cases of clear and demonstrable fraud.

Crowdfunding is a great idea, but we need a better law than the one we've gotten.