

Crowdfunding: Issues and Limitations



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You may have been interested in or may have contributed to funding campaigns on sites such as Kickstarter. There are a number of fundamental issues relating to crowdfunding – is your payment a gift to the fundee, an equity investment, a loan, or a purchase of an item? Funders don't often think about these issues and the law isn't always clear. Recently, the Securities and Exchange Commission (SEC) adopted final rules allowing private companies to sell securities (an equity investment) through internet-based crowdfunding. These rules will become effective on May 16, 2016 and will allow all investors (not just accredited investors) to buy private securities – i.e., to invest in crowdfunding ventures. There are limitations – see below:

- The amount the company can raise through crowdfunding is limited to \$1 million in any 12-month period.
- If an individual investor's annual income and net worth are both greater than \$100,000, he can invest up to 10% of his net worth.
- If an individual investor's annual income or net worth is less than \$100,000, he can invest the greater of \$2,000 or 5% of his annual income or net worth.
- Crowdfunding investors generally may not sell their securities for one year. Even without that limitation, crowdfunding investors should view their investments as highly illiquid.
- Funding portals will be required to register with the SEC.
- Those seeking this type of equity crowdfunding will be required to provide information about the offering and the financial condition of the company. These requirements are much less onerous than those associated with a public offering, but they are significant, and failure to comply may permit an unhappy investor to obtain a refund.

This is a significant improvement to the rules for small companies seeking to raise capital and for funders seeking an equity investment in such companies. We're not sure if it will bring a sea-change in Kickstarter type fundraising and so the confusion about the nature of such contributions will likely continue – is it a gift, a loan, or a purchase of an item? If it's an equity investment, it should comply with the new SEC rules.

Contact your Dean Dorton advisor if you have any questions or would like to learn more.