HANDLER THAYER, LLP
ATTORNEYS AND COUNSELORS AT LAW

CROWD FUNDING BILLS STALL IN CONGRESS

JANUARY 26, 2012

By: Christine E. McKillip

The growth of social media websites over the last ten (10) years has led many entrepreneurs to seek opportunities to access capital through their online networks, such as Facebook and LinkedIn. This "crowd funding" model of raising capital has had some limited success in the form of gift giving to the issuer; however, crowd funding in exchange for an economic interest in the issuer is currently impermissible under federal and state securities laws. As a result of these legal limitations, crowd funding has failed to grow as a capital raising strategy. In order to provide greater access to capital available through the crowed funding method, three (3) bills were introduced in the Senate in the fourth quarter of 2011 aimed at expanding the exemptions available to issuers under Section 4 of the Securities Act of 1933 (the "Act").

The House Bill

In November, the Entrepreneur Access to Capital Act was read in the Senate after passing in the House of Representatives (the "House") by a 407-17 vote margin (the "House Bill").[1] The House Bill has several features that are intended to provide small businesses with access to capital, without significant regulatory and cost burdens on the issuer. Notably, the House Bill provides the most generous caps on the amount issuers may raise and the bill pre-empts state securities regulators from requiring registration.[2] The House Bill also provides a generous offering cap, allowing issuers to raise up to $1 million (or $2 million, if the issuer provides investors with audited financial statements) through individual investments of the lesser of $10,000 or ten percent (10%) of the investor's annual income.

Significantly, the House Bill allows any social networking site, such as Facebook or LinkedIn, to be used as an intermediary without the site registering as a Broker-Dealer with the Securities and Exchange Commission (the "SEC"). However, although crowd funding intermediaries are not required to register with the SEC, the House Bill does place substantial burdens on these intermediaries, which ultimately may have a chilling effect on the crowd funding model. In order to act as an intermediary, the House Bill requires the intermediary to:

(i) Issue a warning for investors regarding the speculative nature of investing in small businesses;

(ii) Issue a warning notifying investors that the offered securities have restricted resale provisions that would allow for resale only to accredited investors and the issuer for the first year;

(iii) Take reasonable measures to reduce the risk of fraud;

(iv) Make a notice filing with the SEC regarding background information for the intermediary;

(v) Provide the SEC with investor level access to the intermediary's website;

(vi) Require investors to fill out a sophistication questionnaire;

(vii) Require the issuer to state a target offering amount, a deadline to reach the target, and a third-party custodian to hold the raised capital until the issuer raises at least 60% of the target offering;

(viii) Conduct a background check of the issuer;

(ix) Provide potential investors and the SEC a notice filing of the offering no later than the first day of the offering;

(x) Maintain books and records for the offering;

(xi) Allow investors to communicate with the issuer on its website;

(xii) Provide the SEC notice of the closing of the offering; and,

(xiii) Avoid providing advice to investors.[3]

The required disclosures to investors and the SEC, the mandatory reporting and recordkeeping compliance, and the significant liability that the House Bill imposes on the intermediary may prevent existing social networking sites, such as Facebook, from entering into crowd funding intermediary relationships with issuers. However, the House Bill may give ample opportunities to sites such as Kickstarter, whose business model has been developed explicitly to act as an intermediary.

The Senate Bills

Despite overwhelming support by the House, small businesses, and the Obama Administration, the House Bill stalled in the Senate due to concerns of potential fraud and abuse of online funding models. In response to these concerns, Senate Scott Brown introduced an alternative crowd funding bill, the Democratizing Access to Capital Act of 2011, which would allow a company to raise up to $1 million in a 12 month period (the "Brown Bill").[4] Deviating from the

House Bill, the Brown Bill would limit individual investments to $1,000; thereby, reducing the monetary exposure that investors have to the company and, as a result, the potential individual risk.[5] In addition, the Brown Bill adopts Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly called the "Bad Boy Rule," to increase investor protection.[6] Specifically, the Bad Boy Rule disqualifies issuers, officers, directors, and shareholders who have been convicted of a felony or are subject to court or administrative sanctions from participating in certain exempt transactions.[7]

As in the House Bill, intermediaries under the Brown Bill must provide disclosures and restrictions on resale. Additionally, the Brown Bill mandates intermediaries to: (i) provide a website that is open and accessible to the general public; (ii) prohibit employees from investing in an offering in which the intermediary is participating, or to have a financial interest in the issuer posting an offering through the intermediary; and (iii) define a process for filing a complaint with the intermediary and methods for dispute resolution if the intermediary is unable to satisfy the investor's complaint.[8] Furthermore, the Brown Bill prevents registration, notice filing, and filing fee requirements at the state level, except in (i) the issuer's state of organization, or (ii) the state where fifty percent (50%) or more of the investors reside. This relieves issuers of the significant regulatory hassle created by state notice filings under Regulation D of the Act.[9]

Although proponents believe that a crowd funding bill will provide increased access to capital for small entrepreneurs, while minimizing bureaucratic cost, both the Brown Bill and the House Bill have met significant opposition from the North American Securities Administrators Association ("NASAA"). Significantly, NASAA is concerned that fundraising efforts over the internet will leave investors open to fraud and disproportionately places the risks of speculative business ventures on unsophisticated investors unable to financially handle the potential loss of their investment.

In relief of some of these concerns, a second Senate bill, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, was introduced on December 8, 2011, by Oregon Senator Jeff Merkley (the "Merkley Bill"). The Merkley Bill is significantly more restrictive than the House Bill or the Brown Bill.[10] First, the Merkley Bill caps an investor's investment at: (i) $500; (ii) one percent (1%) of an investor's income, if the investor's annual income is greater than $50,000, but less than $100,000; or (iii) two percent (2%) of an investor's income, if the investor's annual income is greater than $100,000.[11] In addition, the total capital raised under the Merkley Bill is capped at $500,000 or $1 million for issuers providing audited financial statements.[12] Investors under the Merkley Bill will also be restricted to selling their interest in the issuer to accredited investors or the issuer for two (2) years, rather than the one (1) year prohibition under the House and Brown Bills.[13]

Furthermore, the Merkley Bill limits the use of intermediaries to registered Broker-Dealers or "funding portals," defined as individuals or entities engaged in the business of effecting securities transactions that does not (i) recommend securities; (ii) offer advice to investors or solicit sales; (iii) pay employees commission-based fees for the sale of securities; or (iv) hold, manage, possess, or otherwise handle investor funds or securities.[14] These funding portals are required to:

(i) Register with any applicable self-regulatory organization;

(ii) Provide proper disclosures regarding risks of investment;

(iii) Ensure each investor has the requisite sophistication for the investment;

(iv) Obtain a background check on the issuer and each officer, director and person holding more than twenty percent (20%) of the shares of the issuer;

(v) Provide information on the issuer to the SEC and potential investors in writing at least one (1) month prior to the first day of the offering;

(vi) Ensure proceeds of the offering go to the issuer and allow investors to cancel investment commitments, as appropriate;

(vii) Take steps to protect investor privacy;

(viii) Prohibit commission or finder's based compensation for employees or other persons; and,

(ix) Prohibit directors, officers, partners or employees from having any financial interest in an issuer.[15]

The Merkley Bill also puts onerous restrictions on the issuer, including requiring the issuer to file a notice filing with the SEC prior to the offering and providing quarterly reports containing the results of operations and financial statements with the SEC and investors.[16] Finally, the Merkley Bill uniquely provides for a private right of action against the issuer's officers and directors for misstatements and fraudulent acts.[17]

In summary, the following is an overview summary and comparison of the three (3) crowd funding bills that are currently under consideration by the Senate:

	House Bill	Brown Bill	Merkley Bill
Cap on Total Offering	$1 million ($2 million if issuer provides audited financial statements)	$1 million	$500,000 ($1 million if issuer provides audited financial statements)
Cap on Individual Investment	Less of $10,000 or 10% of annual income	$1,000	$500 if the investor's annual income is less than $50,000 If the investor's annual income is more than $50,000, but less than $100,000, then 1% of investor's annual income If the investor's annual income is more than $100,000, then 2% of investor's annual income
Intermediary	Disclosure requirements and notice filing with SEC on the first day of offering	Disclosure requirements and notice filing with SEC on the first day of offering	Disclosure requirements and notice filing to SEC and investors due 1 month prior to offering
Restrictions on Resale	1 year	1 year	2 years
Disqualification	Yes	Yes, Section 926 of the Dodd-Frank Act	Yes, Section 926 of the Dodd-Frank Act
State Filings	None	Filings with state of incorporation and state where more than 50% of investors reside	None

Although the Senate is seeking a more restrictive bill than the House has passed, it is clear that Congress and the President support instituting a new exemption allowing for funding through online social networks. Once a law is passed, issuers and intermediaries accessing capital through crowd funding will be required to ensure compliance with the provisions of the exemption, which will differ significantly from the current exemptions under Section 4 of the Act. Consequently, issuers and intermediaries will need to reconsider compliance methods and processes for due diligence that will allow issuers to reasonably rely on the representations of online investors and take advantage of the forthcoming exemption.

Handler Thayer, LLP is one of the premier private client law firms in the U.S. Its national and international practice, based out of Chicago, Illinois and Washington, D.C., utilizes interdisciplinary teams of advanced planning attorneys. Handler Thayer is dedicated to providing distinctive, technologically-current and

responsive services to affluent families, family businesses and family offices. The firm's practice is concentrated in Corporate, Real Estate and Securities Law, Sports & Entertainment Law, Federal, State and International Taxation, Trusts & Estates, and Financial & Estate Planning. Firm clientele include foundations, multinational corporations, professional athletes, prominent entrepreneurs, celebrities and family offices. See WWW.HANDLERTHAYER.COM.

---

[1] Entrepreneur Access to Capital Act, H.R. 2930 (as read in the Senate on November 7, 2011), 112th Cong. § 2(a)(2011).
[2] Entrepreneur Access to Capital Act, H.R. 2930 (as read in the Senate on November 7, 2011), 112th Cong. § 4(2011).
[3] Entrepreneur Access to Capital Act, H.R. 2930 (as read in the Senate on November 7, 2011), 112th Cong. § 2(b)(2011).
[4] Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. § 2.
[5] Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. § 2.
[6] Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. § 2.
[7] The Dodd Frank Wall Street Reform Act and Consumer Protection Act § 926, 15 U.S.C. 5301 (2011).
[8] Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. § 7.
[9] Democratizing Access to Capital Act of 2011, S. 1791, 112th Cong. §§ 7 and 8.
[10] According to Section 2 of the Capital Raising Online Deterring Fraud and Unethical Non-Disclosure Act, the "Bad Boy" Rule would also apply under this legislation.
[11] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 2.
[12] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 2.
[13] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 2.
[14] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 4.
[15] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 2.
[16] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 2.
[17] Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2011, S. 1970, 112th Cong. § 2.

"Crowd Funding Bills Stall In Congress," Business Law Today, Vol. 21, February, 2012 Issue.