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The Crowdfunding Catch: Government Regulations

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Pop quiz: Your college roommate wants to start a restaurant and puts up a post on her Facebook page asking friends to contact her if they're interested in providing startup cash in exchange for a share of the profits.

Remembering the great meals she whipped up in your apartment, you eagerly offer to invest.

The question is: Was any of this illegal?

The answer's yes.

Your friend conducted an unregistered public offering of securities and now could face an enforcement action by the Securities and Exchange Commission (SEC), as well as other liability.

Crazy? Some people thought so and lobbied Congress to create an exemption under the securities laws to allow small-scale offerings like your friend's. And they were successful. In 2012, President Barack Obama signed into law the Jumpstart Our Business Startups Act, or JOBS Act, which includes a securities crowdfunding provision.

Like other crowdfunding efforts, the JOBS Act allows companies to solicit small amounts of money online from a number of individuals. Unlike other types of crowdfunding, such as campaigns conducted on sites like Kickstarter, this new type would allow companies to actually offer a return on investment.

(This is a key bit of securities law. If you and some other people give money to someone for them to use in a way that you hope will result in getting a return on your investment, the law views that as a sale of securities, no matter what you may have called it.)

This is important because registering an offering of securities with the SEC is more than just filing a simple form. There are a number of disclosures, financial and other, that a company must make and a complex filing process a company must follow that has been estimated to cost in the millions of dollars.

For this reason, few companies register a first public offering of securities—an initial public offering or IPO—unless they need to raise tens or even hundreds of millions of dollars.

Starting today, May 16, 2016, four years after the JOBS Act was signed into law, this type of crowdfunding will finally become legal. Does that mean your friend will be able to solicit investment on Facebook? Not really.

Despite the fact that securities crowdfunding was intended to be a vehicle for this kind of grassroots capital raising, and despite the fact that it was supposed to be a no-frills, low-cost way for small businesses to leverage the internet, the final version that came out of Congress, and the final set of rules that came out of the SEC have created a very different process than its proponents initially envisioned. And asking for investment directly on Facebook is still not allowed.

To raise capital using the new crowdfunding rules, a business must provide a number of disclosures both at the time it sells its securities and on an ongoing basis. If it misses a filing, it might have to register the offering (that is, do a very expensive IPO) or risk violating the securities laws.

Given that a company can only raise $1 million under this new rule, this means taking on a big risk for what is not a very big amount of capital. It also can't use social media to directly solicit investment; it can only direct investors to a special online platform designed to list offerings.

The reason that securities crowdfunding looks the way it does is that it's built into an old and complex set of laws and regulations that were designed for large companies, and that were designed in the 1930s, long before the internet ever existed.

There is an easier way. Why not just say that the registration requirement does not apply to very small offerings, like the restaurant owner?

The 1933 law states that its registration requirements should not apply to offerings where registration is not in the public interest. It seems that an entrepreneur asking a few people she knows for investment in her very small business would be just such an offering.

If regulators are concerned about such an offering getting out of hand, they could limit the amount an entrepreneur can raise to $500,000 and limit investors to those personally known to the entrepreneur.

People trying to start a business with a little help from their friends shouldn't have to hire a lawyer and jump a raft of legal hurdles just to get the company off the ground. The crowdfunding law was supposed to do this but fell far short.

Instead of getting tied up in knots trying to make an old law do new things, the better solution is to use the law as it was intended and leave out these very small transactions that pose no risk to our economy or our stability. Anything else limits the growth of (job-producing) small businesses and exposes Americans to unnecessary risk of bureaucratic entanglements.

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