

Starting Your Own Mail-Order Artisan Bon-Bon Company: Crowdfunding Connects Dollars to Your Next Great Idea.

Written By: Laura Horton

Edited By: Lindsay Landstrom

Researcher: Amanda Klimczak

Managing Editor: Dave Smith

So you have an idea! Maybe it's a [pirate-vampire-zombie-graphic novel](#) or perhaps it's [hand-crafted-vegan doughnuts](#). But you have this idea and it's occupying all of your time. You keep thinking about how well it would work, the profits you'd most definitely make, and how your friends and family would find you impressive when you put together a traveling exhibition of the global [dispersion of your family over 100 years from a small village in Lithuania](#). The problem is, what do you do with this great idea? How do you turn an idea into a financed project? A business? [A movement](#)? Whether the 99% Movement inspires you, or you just want to [sculpt filigree skulls](#), a new way of raising money is quickly becoming the hipster's Wall Street. These platforms are connecting people with cool ideas to those who want to pledge money to the idea.

And if I Share With You My Story, Would You Share Your Dollar With Me?

These platforms are part of a new movement that is growing in popularity, "[crowdfunding](#)." Crowdfunding is a means of raising money from numerous investors through existing Internet social media platforms. By facilitating relationships through Web 2.0, entrepreneurs can tap this resource when seeking capital to start a new business. [Crowdfunding](#) is a way of generating smaller dollar investments from numerous investors. Crowdfunding has long been a source of investment dollars in the entertainment industry for movie projects, documentaries, and bands on tour. As credit remains scarce, crowdfunding has increasingly provided small business owners with new sources of capital. Currently, the money raised through crowdfunding is completed as a contribution only with rewards limited to cool perks and merchandise to avoid any violation of Federal Securities Regulations.

In a speech given by the President last month, the White House released the [American Jobs Act](#). The American Jobs Act covers a variety of proposals meant to stimulate the economy, some even have bipartisan support. One of the proposals is to create policies that support entrepreneur and small business access to capital. In this economic climate, where traditional financing is hard to come by because of increased restrictions on loans, entrepreneurs have turned to creative sources for gathering capital. As funding sources have evolved for small businesses, investors and entrepreneurs have faced hurdles in existing regulations that have not kept up with the dynamic nature of investing. As part of the [job-boost](#) outlined by the President, the Obama Administration indicated that it would work with the Securities and Exchange Commission (SEC) to review securities regulations from the perspective of small business with the aim of reducing regulatory burdens and increasing access to capital.

Regulators, Mount Up.

While crowdfunding has [bi-partisan support from Congress](#) and support from the business community, the laws that regulate securities remain a hurdle. The [Securities Act of 1933](#) (the Securities Act) requires those selling securities publicly to register a particular offering with the SEC, which includes providing certain financial information and documentation in the form of a registration statement and detailed prospectus. [Section 5](#) of the Securities Act prohibits promotion or solicitation of securities without registering an offering. This registration process can be extremely costly to small business owners. Congress recognized this burden and provided exemptions from registration including private offerings under §4(2) of the Securities Act. The exemption was clarified in the safe harbor rule under [Regulation D](#). Congress never explicitly provided parameters for determining the difference between a private and public offering. The Supreme Court has said that the [important factors in determining if an offer is private](#) are the sophistication of the investors and their access to all relevant information rather than any limit on the number of investors or dollar amount. These private offerings also have definite prohibitions against general solicitations. Another provision within Regulation D, [Rule 504](#), provides an exemption for an issuer to raise up to \$1 million. By falling within certain parameters, a company can sell freely tradable public securities through general solicitations. In order to do so, the company must be a fully operating company, beyond the development stage, and must maintain current filings under a state registration system.

Regulation of securities was born out of a demand for federal protection of investors after the stock market crash of 1929. The [purpose of the Securities Act](#) was to provide investors with sufficient information to make informed investment decisions and to prevent fraud on the part of issuers. Following the Securities Act, the Securities Exchange Act of 1934 (the Exchange Act) provided further regulation regarding disclosure by publicly traded companies. The Exchange Act provides registration requirements in [§12\(g\)](#) based on a company's number of shareholders and total assets. A company with more than 500 shareholders and assets exceeding \$10 million must register with the SEC under the Exchange Act. This registration imposes periodic disclosure requirements on a company including filing of an annual report, a quarterly report, and periodic reports.

Crowdfunding, as a source of investors rather than contributors, would not currently fall under any exemption to the Securities Act because it is not limited on the sophistication of purchasers, it is not private by nature, and the call to invest is a general solicitation. In addition, there is no limit on the number of investors, so the company would be required to register under the Exchange Act. Because raising investment capital through crowdfunding is not an exempted offering, an entrepreneur is required to meet the hurdles of registration.

The current guidelines of these crowdfunding forums provide for how a contributor can be rewarded. To avoid any implications of pledges being considered investments, the rules of the game are that you can offer [rewards that are not financial incentives](#). The sites provide guidance on how to offer [perks](#) while making it clear that all funds are contributions rather than investments. With the changes in securities regulation being proposed, these sites would now be available to [entrepreneurs seeking actual investors](#) to buy a financial interest in the company. These crowdfunding forums would become investment domains to buy a security interest in startups.

The next obvious question is what is a security and how do I know that I am selling one? The 1933 Act defines a security in [§2\(a\)\(1\)](#) and includes under this definition, the investment

contract. The [Supreme Court adopted the Howey test](#) for determining what constitutes an investment contract, and therefore, a security under the 1933 Act. In *SEC v. W.J. Howey Co.*, the Court looked at four factors in identifying transactions as those dealing in securities: “(1) an investment of money (2) in a common enterprise and (3) is led to expect profits (4) solely from the efforts of others.” Based on these definitions, for example, it is highly likely that selling shares of interest through an open invitation on the Internet in order to raise money for starting a new food-cart would fall under the 1933 Act Registration Requirements.

The Times, They Are a’Changin.

As part of the American Jobs Act, the Obama Administration indicated that it supported changes in securities regulations to provide for a crowdfunding exemption. The [legislation](#), originally proposed by Representative Patrick McHenry, would provide an exemption from SEC registration requirements for businesses seeking to raise capital through lots of small investors. The [exemption](#) would cover businesses or entrepreneurs who raise up to \$5 million in capital, with a limit on individual investments of the lesser of \$10,000 or ten percent of an individual investor’s income. The limits on the numbers of unaccredited investors would be erased in favor of this dollar limit. These changes, called the Entrepreneur Access to Capital Act, would allow businesses to access capital through crowdfunding without having to meet the rigorous requirements of Federal Securities Regulations. On October 5, 2011, the House subcommittee responsible for the Entrepreneur Access to Capital Act forwarded the bill to the full committee for approval.

While the benefit of these changes would be increased access to capital, the [potential danger](#) would be exposure to precisely what securities regulations aim to protect against. By not requiring companies to disclose certain financial information, investors may be left in the dark as to the actual viability of a company. [There is concern](#) that by allowing unaccredited investors the ability to invest large amounts of capital without the protection that securities regulation requirements provide, there is room for fraud and impropriety. In response, those in favor of crowdfunding find that investor protection rests on a fundamental aspect of this financing, opening it to lots of people for investment. This “crowd” aspect creates transparency, which may temper the effects of deregulation. There is also a [stronger sense of community](#) support through this style of investing. Crowdfunding makes [venture capital accessible](#) to small-scale business owners.

The Obama Administration has indicated that a key component of its economic recovery policy will be supporting small business. Beyond making capital accessible to small enterprises, the Administration has announced new programs including [public-private partnerships](#), [mentorship programs](#), and [increased lending](#) to small businesses. The hope is that these programs combined will serve as a launching pad for economic growth and, in turn, fuel the economic recovery. Crowdfunding has already skyrocketed in popularity with numerous websites dedicated to providing this platform. With deregulation allowing the scope of these platforms to expand to providing investment opportunities, crowdfunding could revolutionize financing as we know it.