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# Crowd-Funding for Small Businesses

The Jumpstart Our Business Startups (JOBS) bill was signed into law on April 5, 2012. The bill authorizes small companies to raise equity capital through what's commonly known as crowd-funding. The purpose is to offer small businesses—*often not candidates for traditional investment or bank financing*—access to investment dollars in the hopes that some of them will create jobs.

**What is crowd-funding?**

Generally speaking, crowd-funding describes the collective cooperation by people who network and pool their money together to support efforts initiated by other people or organizations—from nonprofit organizations to small businesses and other groups. There are many online sites where one can post the project they are looking to fund, set a minimum dollar amount to be raised, and a date by which the money needs to be pledged; if the goal is not met, the credit cards used to make the pledges are not charged. Research shows that the most active time in the cycle is the very beginning and the very end, much like an e-Bay auction. Most sites will charge a commission of 1%—10% of the funds raised if the funding round closes. Crowd-funding has taken many forms since gaining popularity in 2007. Prior to the recent JOBS Act, crowd-funding was used to:

1. Access donations
2. Raise non-equity funds for projects
3. Secure loans

**Why crowd-funding?**

***1. Access donations***

Non-profits use crowd-funding to increase donations. The playful nature of crowd funding allows donors and benefactors to follow the progress of the campaign; creating an addictive attraction to the success of this "community" that the donor now feels connected to.

***2. Raise funds for a project***

Historically, crowd-funding has been used as a conduit for arts-related, community related and micro-business project funding. To date, crowd-funding has taken the form of either a prepayment for goods or services or effectively, a donation to fund a project where the donor receives various gifts in return.

***3. Secure a loan***

Online crowd-funding loan platforms such as Prosper and Lending Club have been connecting lenders and borrowers since 2006. These platforms gather information from potential borrowers, access credit reports and rate the borrowers based on information gleaned from the reports. The interest rate (APR) charged to the borrower depends on their rating and the duration of the loan and varies from 6%—36%. The lender is currently realizing a 5.2%—20% net annualized return with the overall average being approximately 10% (According to Prosper and Lending Club). Loans on the two sites range from $2,000—$35,000. There are closing fees associated with borrowing the money which are taken from the loan amount; they range from 0.5%—5% based on the rating and duration of the loan. In addition, both companies charge a service fee to lenders at an annual rate of 1% on the outstanding principal of the loan.

In actuality, participants are not lending directly to the borrowers rather they are lending the money to the company facilitating the loan (Prosper or Lending Club). WebBank, a Utah registered bank then loans the money to the borrower and Prosper or Lending Club buys the loan from WebBank with the "crowd-funds". The loan payments to the lender are contingent on the loan payments from the borrower.

The two sites reviewed allow individual lenders to trade notes they have purchased through a company called FOLIO Investing, which is registered with the Financial Industry Regulatory Authority (FINRA). Lending

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Club is registered with the SEC .

At this point Vermont residents can borrow but can not lend through either Prosper or Lending Club.

**The JOBS Bill—equity investment**
Existing regulations limit investment opportunities to accredited investors. To qualify as an accredited investor, an investor has to have individual (or joint) net worth in excess of $1 million, excluding the value of his primary residence, or a minimum annual income of $200,000 ($300,000 for a couple) for each of the past two years and a reasonable expectation of this year's income matching or exceeding those levels.

The new bill allows companies to sell up to $1,000,000 of equity in a 12 month period to two distinct non-accredited investor groups. Individuals with less than $100,000 in income or net worth can now invest the greater of $2,000 or 5% of annual income or net worth in a single company. For those with over $100,000 in income or net worth the cap is $100,000 or 10% of income or net worth.

An investor merely has to attest that he/she understands the risks involved in investing in a start-up and the risks of illiquidity (strict restrictions are placed on the transfer of shares) and has read the investor education information.

Companies seeking to raise less than $100,000 simply need to have their principal executive officer certify that the internal financial statements are correct and provide copies of income tax returns. Companies seeking to raise between $100,000 and $500,000 are required to have a public accountant review the financial statements. Audited financial statements are not required unless the offering amount is above $500,000. All companies are required to provide investors with the results of operations "no less than annually."

**What it means for start-ups and business owners**
It's always friends and family that will be the initial funders and companies will need this type of "social proof" before strangers will fund them. Companies are limited to 2,000 investors, 500 of which can be non-accredited so there is a tremendous amount of opportunity here, but choose the minimum investment wisely.

***"Lawyer Up"***
The investments received through crowd-funding will be for equity in the company, therefore companies will need to have a lawyer structure the deal and set up the necessary funding documents in compliance with SEC regulations. It would be ideal to include a "Private Placement Memo" disclosing all of the risks to an investor.

**Seek Financial Advice**
There are tax considerations for those raising money and those investing. The entity type (S-Corp, LLC, C-Corp...) will be crucial in relation to tax consequences. Keeping track of the investments, fees, dividends, gains, losses and capital expenditures to name a few may be challenging. The calculations necessary to value the company and divide ownership (particularly in the event of a later capital raise) can be complicated when dealing with up to 2,000 small investors. Seek the advice of a financial professional prior to raising (or investing) funds to ensure the company knows what it's getting into and to identify it's responsibilities and those of the investor.

**Costs**
Companies seeking funding could potentially spend $10,000 to $15,000 on audited financials, legal fees, and paying to hold the money in escrow before they raise their first dollar. Companies may be required to register with the SEC as well, adding direct costs and indirect costs in manpower. If the goal is to raise a small amount of money, the cost might not be worth it. Or, if it's a startup, the company might not have the funds to set up crowd-funding at all!

**Risks**
The Security and Exchange Commission (SEC) will post regulations by January 1, 2013; to be clear, one cannot receive investment (or invest in a company) under the rules of the recently passed JOBS ACT prior to January 1, 2013. Startups that accept equity crowd-funding may have difficulty raising additional funds from venture capital firms and other sophisticated investors if they have thousands of small investors. Be very carful in choosing the funding platform; funding sites will need to be registered with the SEC, if they are not they are either illegal or outside the US regulatory environment. There is definitely an opportunity for fraud and the crowd-funding sites will not guarantee any investments. Business owners and investors alike need to be prepared to lose the entire investment!

Davis & Hodgdon Associates entrepreneurial advisory services include assistance for business owners to capitalize on the types of opportunities presented here. This is just one in a unique brand of services focused squarely on the needs of growing businesses. For more information call 802-878-1963 (Williston) or 802.775.7132 (Rutland).