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Crowdfunding is Coming, One Way or Another

Are you ready for a client asking you about investing in a start-up solar energy company, an organic farm, a microbrewery or a new chain of coffee houses? Or simply informing you that he or she has already made that investment?

If not, it's probably time to start thinking about just what your advice will be. The investment under consideration is likely to carry a high risk of failure. Beyond that, there are more prosaic advisory firm business questions to consider, including what kinds of fees can be charged for providing this kind of advice.

The issue is crowdfunding, and it's "coming to your state or a state near you," said **Leech Tishman** partner **Steven Irwin** at the 2014 IA Compliance Fall Conference last month. Depending on who you listen to, that's a good thing or a bad thing. But most agree advisers need to get ready for it.

"Your clients are going to be pressured and given many opportunities to invest their hard-earned assets into really risky schemes, legally," warned Irwin.

On the other hand, crowdfunding done on a state or local level may be a good thing, said **Armstrong Teasdale** partner **Matt Kitzi**, former state securities commissioner for Missouri. While crowdfunding efforts on a national level, as well as some on a state or local level, may carry high risks, more often local crowdfunding may take the form of "outreach efforts" to friends, family and other longtime associates to start small businesses, such as opening a community market, he said.

Types and levels of crowdfunding

The SEC is considering a crowdfunding rule, but a number of states are not waiting for it to act. Twelve states to date have adopted intrastate crowdfunding laws, according to the **North American Securities Administrators Association**. These statutes, some of which still require rules for implementation, allow companies to solicit investments online within their respective state boundaries. Other states are in the process of considering rules.

There are several crowdfunding paths, including:

- **Expected SEC rule.** A proposed rule, mandated by JOBS Act Title III, was issued in October 2013. Among other requirements, it would limit the aggregate amount of securities sold to all investors during a 12-month period to $1 million, place limits on the dollar amount of securities that investors can purchase within 12 months, and require that the transaction be conducted through an approved intermediary and on the intermediary's platform. The SEC is expected to issue an adopting release, possibly before the end of the year.
- **State-based.** Most of these are based on the federal offering exemption under Regulation D's Rule 504, which provides an exemption from the registration requirements for some companies when they offer and sell up to $1 million of their securities in any 12-month period. Some states provide higher aggregate sales and/or different individual investment ceilings than allowed in the SEC proposed rule. States that have approved intrastate crowdfunding so far are Alabama, Georgia, Idaho, Indiana, Kansas, Maine, Maryland, Michigan,

Nebraska, Tennessee, Washington and Wisconsin, according to NASAA, which tracks state crowdfunding activity. The number of states with crowdfunding may grow, as California, Connecticut, New Jersey, Texas and others are currently considering intrastate crowdfunding.

- **Rule 506(c).** This rule, which was adopted last year by the SEC, provides an exception to the longtime prohibition on general solicitation of private offerings. It is in many ways simply a private placement that raises money online, said Kitzi. While private issuers may not be flocking in droves to use this rule, it does seem to be attracting some real estate ventures seeking to raise money or recapitalize, he said.
- **Non-equity, non-securities, charities or for-profit ventures.** This involves parties contributing money without expecting a return. Crowdfunding might be used to build a new wing for a church, to start a philanthropic foundation or to start a for-profit venture for which there is no investor return. Those who provide money are not investors, but supporters, Kitzi said, adding that because there are no investments to be protected, there are no securities regulations at either the federal or state level. Should fraud occur, it would need to be handled by the appropriate attorney general , consumer protection official or other official with appropriate responsibilities.

The role of the adviser

Clients in most cases will be able to access crowdfunding portals directly, bypassing advisers and traditional broker-dealers. Many clients, however, may seek adviser guidance before investing. Some questions to be considered, according to Kitzi, are:

- For advisers that will manage the investment, where should it be placed in the portfolio?
- To what extent does an adviser's fiduciary duty apply, particularly if the adviser is not asked for advice?
- What kind of fee, if any, can an adviser charge with respect to the investment?

"Each adviser is going to have to assess the offering the same way they would any high risk, illiquid investment," said Maine securities administrator **Judith Shaw**.

"It is very, very important that the adviser do the due diligence," she said. "Is the business legitimate? Does it meet state requirements? One of my biggest concerns is that small businesses are going to be taken in by some scam artists offering to set up crowdfunding portals or offerings for well-intentioned entrepreneurs."

Advisers should also check into the nature of the financial investment – will investors be putting their money into equity investments, which represent an ownership interest, or debt investments, which essentially are a loan, asked **Ginsberg Jacobs** partner **Anthony Zeoli**, who publishes a blog on crowdfunding. ☙