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Law Opens Investor Pool for Small Startups

By Finance New Mexico

A crowdfunding campaign to finance a movie about TV character Veronica Mars recently set a record — $2 million in 10 hours — on the Kickstarter platform. The backers were fans of the show and wanted to see a movie based on the character. In return for this donation, the contributors will get rewards, such as DVDs of the movie or other swag.

That's a far cry from the typical crowdfunding project, which usually aims at a smaller target. But it suggests the possibilities of micro-financing vehicles that use the global reach of the internet to support projects unable to secure more traditional loans.

Kiva is credited with being the first microlending website, though many have imitated its format. Investments in Kiva projects are loans — not donations — and investors expect to be repaid in full for their contributions to the small-scale ventures of entrepreneurs who don't qualify for traditional credit — often because they live in poor, isolated communities in underdeveloped countries.

Other businesses are taking crowdfunding to the next level, hoping to raise equity capital and essentially sell shares of stock or ownership in aspiring companies. A year ago, Congress moved to simplify this process.

New Paradigms

When Congress passed the Jobs Act in April 2012, it lifted restrictions on the type of investor who could legally invest in early stage businesses eager to raise money through crowdfunding.

The rules that will guide this new financing landscape haven't been written, but when they are, entrepreneurs will be able to raise money from anyone — not just "accredited investors" with a net worth of $1 million — though they can only do so through portals approved by the Securities and Exchange Commission.

Limits will be imposed on how much a single investor can contribute and how many securities a company can sell in a year. The companies are limited to $1 million in securities, and individual investors are limited to a certain dollar amount or a certain percentage of their annual income.

The new law gives high-growth companies more breathing room before an initial public offering than they would normally get from a more traditional equity investor, such as an angel investor or venture capitalist. While the law offers exemption from the registration requirements of securities law, disclosure requirements remain.

What It Means

Crowdfunding in its evolving incarnation means raising capital by selling small amounts of equity to many investors by way of a website operated not by the company but by a third party or "intermediary."

The Jobs Act requires that this intermediary be a registered broker/dealer or a portal recognized by the Financial Industry Regulatory Authority, or FINRA, to protect the investor from fraud. But much remains to be sorted out so the SEC and FINRA can maintain oversight without imposing so many requirements that companies decide the process is more time consuming and costly than it's worth.

Until such rules are promulgated, funding portals cannot legally act as crowdfunding intermediaries and can't sell securities to accredited investors through a general solicitation to the public.

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