

Reproduced with permission from Securities Regulation & Law Report, 45 SRLR 1128, 06/17/2013. Copyright © 2013 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

CAPITAL FORMATION

States Pilot Crowdfunding Initiatives to Increase Funding for Small Business



BY CAROLYN P. MEADE

Recognizing the role of small business in economic growth, certain U.S. states are speeding access to capital for local companies by authorizing equity-based crowdfunding. While most states await implementation of the federal Jumpstart Our Business Startups Act (the “JOBS Act”) (P.L. 112-106) enacted April 5, 2012, or actively caution investors against equity-based crowdfunding,¹ two states have instead embraced this new form of fundraising and two additional states are currently considering authorizing legislation. Leading this movement, Georgia and Kansas in 2012 adopted new securities exemptions which permit

¹ See, e.g., Press Release, Tex. State Sec. Bd., Securities Commissioner Warns Entrepreneurs About Potential Hazards of Rushing Into Crowdfunding (June 27, 2012), available at http://www.ssb.state.tx.us/News/Press_Release/06-27-12_press.php.

Carolyn Meade is a member at Moore & Van Allen PLLC, headquartered in Charlotte, North Carolina. She represents companies, stockholders, entrepreneurs, private equity groups, sponsors and institutional investors, acting as outside general counsel and assisting both financial and strategic acquirers and targets in their M&A, leveraged buyouts and recapitalization transactions.

Georgia-based and Kansas-based companies, respectively, to advertise to the public their need for investment and to raise money from state citizens.² Similar legislation is now pending in both North Carolina and the state of Washington.³ Title III of the JOBS Act, coupled with Title II of the JOBS Act, which will lift the prohibition on general advertising of an offering, should enable equity crowdfunding on a national scale, but federal implementation is trailing state efforts, and the law itself imposes significant requirements on the businesses that would seek to take advantage of this new fundraising approach. This article therefore examines the more business-friendly approaches Georgia, Kansas, North Carolina and Washington (for purposes of this article, the “Crowdfunding States”) are piloting or considering now.

Crowdfunding – the concept of raising money through small contributions from a large number of investors – can provide access to capital to new business ventures which are too small to be of interest to angel investors and venture capitalists. Equity-based crowdfunding describes the action of raising money from a large number of investors who, in exchange, receive equity in the company raising those funds. For businesses, and a nation that experienced the capital freeze that accompanied the recent recession, crowdfunding provides a new avenue for a capital raise outside of the traditional financial markets.

Permitted Investment

Where current state and federal securities regulations in practice limit small equity raises to accredited investors – persons making more than \$200,000 per

² Invest Georgia Exemption, Ga. Rule 590-4-2-.08; Invest Kansas Exemption, Kan. Rule 81-5-21.

³ N.C. House Bill 680 (introduced April 9, 2013); Wash. House Bill 2023 (introduced April 2, 2013); see also Cal. Assembly Bill No. 783 (introduced Feb. 21, 2013) (permitting general advertising of securities offerings not exceeding \$1,000,000. California is not yet opening offerings to the crowd, however, so California securities law is not discussed here).

year or whose net worth is at least \$1,000,000 - new Crowdfunding State exemptions allow entities formed in-state to offer the opportunity to invest to any citizen in the state. Furthermore, that investment may, but does not have to, be offered through an intermediary website (similar to Kickstarter or Indiegogo but for equity-based funding instead of donor-funding). In most cases, even if the offering is through such a website, the website does not have to register with, or wait for pre-clearance from, the State.

State legislatures in Crowdfunding States have intentionally limited requirements for new start-ups and provided access to the in-state “crowd” in the hopes that capital access will help industry grow in-state. Acknowledging that those initiatives mean less information may be available to an investor pool that now includes less sophisticated persons, the implementing states have adopted investment caps, setting as a matter of public policy the amount an individual should be entitled to put at risk. The maximum permitted investment by an individual who is not an accredited investor is \$10,000 in Georgia, \$1,000 in Kansas and, as legislation is currently drafted, \$2,000 in each of North Carolina and Washington.⁴ The bills pending in North Carolina and Washington would require a plain English statement of risk be signed by each funder: “I acknowledge that I am investing in a high-risk, speculative business venture, that I may lose all of my investment and that I can afford the loss of my investment.”

In contrast to Georgia, Kansas, North Carolina and Washington, the proposed regulations for the federal JOBS Act would require the offering entity (through the intermediary used for the offering, discussed below) to determine how much an intended funder could invest. This means determining the income or net worth of prospective investors and ensuring that those investors do not exceed the allowable limits of their investments. The formula is complex: An investor whose annual income or net worth is less than \$100,000 per year could invest the greater of \$2,000 or 5 percent of his or her income or net worth. For investors whose income or net worth each year is \$100,000 or more, the permitted investment would increase to 10 percent of annual income or net worth.

As alluded in the preceding paragraph, the proposed JOBS Act regulations would permit a crowd-funded offering to be made only through an intermediary website or a registered broker and, in the first case, only through those websites previously certified and approved by the Securities and Exchange Commission (“SEC”). The website (or broker) hosting the offering would, in turn, have to (i) conduct a background and securities enforcement regulatory history check on each officer, director and person holding more than 20 percent of the outstanding equity of the issuer, (ii) deliver to each participant investor education information, (iii) receive from each investor a statement acknowledging risk of loss and (iv) ensure that offering proceeds go to

⁴ Washington’s proposed legislation uses \$2,000 as a threshold, but the actual permitted investment is based upon the investor’s annual income: The investor may invest the greater of \$2,000 or 5 percent of investor annual income if he or she makes/has a net worth of <\$100,000 per year, but the permitted investment amount increases to 10 percent of investor annual income if earnings/net worth are/is \$100,000 per year.

the issuer only when the aggregate raised capital is at least equal to the target offering amount.

Offering Size

Using either the federal JOBS Act exemption or one of the Crowdfunding State exemptions, an offering entity may raise up to \$1,000,000 in any 12 month period; of course, in the case of the Crowdfunding State provisions, those funds could come only from state citizens. North Carolina’s proposed “Jump Start Our Business Start-Ups Act” would go one step further for more established businesses; entities with audited GAAP (generally accepted accounting principles) financials for the prior year of operations would be entitled to raise up to \$2,000,000 in any 12 month period.

Required Paperwork

Another hallmark of most of the Crowdfunding State exemptions is the minimal burden imposed on new entities in terms of required filings with the state securities commission.⁵ In Georgia and Kansas, and, if pending legislation passes, in North Carolina and Washington, an offering may begin without notice to the state securities commissioner. A one page notice does have to be submitted to the securities commissioner before any general solicitation or the 25th sale of the security, whichever comes first. Furthermore, the issuer does not have to provide audited financials, removing the barrier to a securities raise that would otherwise exist for many brand new businesses. Post-offering reporting requirements are frequent but flexible, allowing companies to point investors to a website that includes management comments and quarterly (unaudited) financials.

The federal JOBS Act exemption is less user-friendly. A business wishing to issue securities using this exemption would have to provide an offering memorandum or prospectus to the SEC, investors, and the broker or funding portal used for the offering. That offering memorandum must include, depending on offering size, certified, reviewed or audited financials.⁶ Additional required information for the offering memorandum (or to be distributed by the broker or funding portal to potential investors) would include:

- the name, legal status, physical address and website address of the issuer;
- the names of the issuer’s directors and officers and each person holding more than 20% of its shares;
- a description of the issuer’s business and anticipated business plan;

⁵ Note that, while securities laws in the Crowdfunding States may not require filings at the state levels or dictate certain disclosures, it is anticipated that “the crowd” will reward companies which provide significant information and anticipate investor questions at the time of the offering. The absence of a legal requirement to disclose does not mean that disclosure will not occur.

⁶ For target offerings \$100,000, financials certified by the principal executive officer of the issuer as true and complete plus income tax returns filed for the most recently completed year of the issuer (if any); for target offerings >\$100,000 but \$500,000, financial statements reviewed by an independent public accountant; and for target offerings >\$500,000, audited financial statements.

- a description of the financial condition of the issuer;
- if the target offering is for more than \$100,000, reviewed or audited financial statements;
- if the target offering is for \$100,000 or less, certified financial statements and the issuer's most recent income tax returns (if any);
- regardless of offering size, a description of the purpose and intended use of the proceeds of the offering;
- the target offering amount, the deadline to reach the target offering amount and periodically, updates on progress towards that target;
- the price to the public for the securities (or the method for determining that price); and
- a description of the ownership and capitalization of issuer.

As noted previously, the broker or funding portal through which the new equity would be offered would have to be one registered with the SEC. No issuance could commence without that initial registration step. Following the offering, the issuing entity would have to

file with the SEC and provide to investors annual reports containing the results of operations and its financial statements.

Access to Capital

Once implemented or enacted, both the federal and state crowdfunding exemptions will offer businesses a new way to raise capital. However, the business that chooses to take advantage of the federal exemption is likely to be more established and therefore different from the in-state issuer who avails itself of, for example, Georgia's "Invest Georgia" exemption. True start-ups and "Mom and Pop" businesses may be forced to look at intrastate offerings if only because they cannot produce the financial statements, income tax returns and more fulsome information necessary to be eligible to take advantage of the federal exemption. Lessons learned in both approaches may drive further changes in this new securities space.

The chart on the following pages highlights the key terms of the federal JOBS Act Exemption and the Crowdfunding State exemptions summarized here. Please keep in mind that the North Carolina and Washington exemptions have yet to be enacted and thus may change during the process of consideration.

Requirement	Federal (JOBS Act)	GA	KS	NC (not yet enacted)	WA (not yet enacted)
Business & Investors Located in state	N/A	Issuer a for-profit entity formed in GA and registered with GA Secretary of State; sold only to State residents <i>NOTE: All funds received from investors must be deposited into a bank authorized to do business in Georgia.</i>	Issuer a business or organization formed in KS and registered with the KS Secretary of State; sold only to State residents.	Issuer a business entity formed in NC and registered with the NC Secretary of State; sold only to State residents <i>NOTE: if the sale of securities is by an Internet web site, the web site must require as a condition of investor registration on the site evidence or certification that the investor is a North Carolina resident.</i>	Issuer is an entity formed in WA and doing business within WA; sold only to State Residents.
Maximum Raise	\$1,000,000	\$1,000,000 <i>NOTE: sales to “controlling persons” (officers, directors, partners, trustees, persons holding 10% of outstanding equity) do not count towards \$1,000,000 limit.</i>	\$1,000,000 <i>NOTE: sales to “controlling persons” (officers, directors, partners, trustees, persons holding 10% of outstanding equity) do not count towards \$1,000,000 limit.</i>	\$2,000,000 if issuer has audited financials; otherwise, \$1,000,000 <i>NOTE: sales to “controlling persons” (officers, directors, partners, trustees, persons holding 10% of outstanding equity) do not count towards \$1,000,000 (or \$2,000,000) limit.</i>	\$1,000,000
Investor Cap (maximum from each investor)	Greater of \$2,000 or 5% of investor annual income if make/net worth is <\$100,000 per year. 10% of investor annual income if make/net worth is \$100,000 per year.	\$10,000 (unless the investor is an accredited investor).	\$1,000 (unless the investor is an accredited investor).	\$2,000 (unless the investor is an accredited investor).	Greater of \$2,000 or 5% of investor annual income if make/net worth is <\$100,000 per year. 10% of investor annual income if make/net worth is \$100,000 per year.
Notice to Investors	Intermediary must ensure that each investor reviews investor education information, positively affirms that the investor is risking the loss of the entire investment and could bear the loss, answers questions demonstrating an understanding of the risk applicable to start-up investments, of illiquidity and such other matters as SEC deems appropriate by rule. <i>NOTE: the intermediary also has to have conducted a background and securities enforcement regulatory history check on each officer, director and person</i>	Must inform all purchasers that the securities have not been registered under Georgia’s securities act and are subject to a limitation on resales (cannot sell for 9 months after completion of offering).	Must inform all purchasers that securities have not been registered under Kansas’ securities act and therefore, cannot be resold unless the securities are registered or qualify for an exemption from registration under the Kansas securities act. Must also make disclosures required by SEC Rule 147 (related to intrastate offerings).	All purchasers must submit to issuer in writing a separate document, signed, which reads: “I acknowledge that I am investing in a high-risk, speculative business venture, that I may lose all of my investment and that I can afford the loss of my investment. I understand this offering has not been reviewed by the State and no authority has expressed an opinion on the merits of the offering.”	All purchasers must sign the following statement at the time of sale: “I acknowledge that I am investing in a high-risk, speculative business venture, that I may lose all of my investment and that I can afford the loss of my investment.”

Requirement	Federal (JOBS Act)	GA	KS	NC (not yet enacted)	WA (not yet enacted)
	<i>holding >20% of the outstanding equity of the issuer; get all disclosures to the investors and ensure that offering proceeds only go to the issuer when the aggregate raised capital is the target offering amount.</i>				
Intermediary	Must use a broker or funding portal registered with the SEC to conduct crowd-funding.	None required; may use funding portal (affirmatively stated).	None required.	None required; may use funding portal (affirmatively stated).	None required; may use funding portal (affirmatively stated). Department of financial institutions may inspect and review such web site and the web site operator must previously have informed the director of the existence of the web site and have given the department access to the site.
Other Issuer Restrictions		Cannot be an investment company (as defined in Section 3 of the Investment Company Act of 1940).	Cannot be an investment company (as defined in Section 3 of the Investment Company Act of 1940).	Cannot be an investment company (as defined in Section 3 of the Investment Company Act of 1940).	Silent.
Filings required by SEC/State	<p>Issuer must file with the SEC and provide to investors and the broker or funding portal:</p> <ul style="list-style-type: none"> ■ Name, legal status, physical address, website address of issuer; ■ Names of directors & officers and each person holding >20% of shares; ■ Description of issuer's business and anticipated business plan; ■ Description of the financial condition of the issuer incl. financial statements and if, target offering is \$100,000, most recent income tax returns; ■ Description of the purpose and intended use of the proceeds of the offering; ■ Target offering amount, deadline to reach target offering amount and updates 	<p>Before general solicitation or 25th sale of security (whichever 1st), notice to Securities Commissioner stating that the issuer is conducting an offering in reliance upon the Invest Georgia Exemption and containing the names and addresses of the following:</p> <ul style="list-style-type: none"> ■ The issuer; ■ All persons involved with the offer or sale of securities on behalf of the issuer; and ■ The bank or other depository institution where funds will be deposited. 	<p>Before general solicitation or 25th sale of security (whichever 1st), notice to Securities Commissioner stating that the issuer is conducting an offering in reliance upon the Invest Kansas Exemption and containing the names and addresses of the following:</p> <ul style="list-style-type: none"> ■ The issuer; ■ All persons involved with the offer or sale of securities on behalf of the issuer; and ■ The bank or other depository institution where funds will be deposited. 	<p>Before general solicitation or 25th sale of security (whichever 1st), notice to Securities Commissioner stating that the issuer is conducting an offering in reliance upon the Invest North Carolina Exemption and containing the names and addresses of the following:</p> <ul style="list-style-type: none"> ■ The issuer; ■ All persons involved with the offer or sale of securities on behalf of the issuer; and ■ The bank or other depository institution where funds will be deposited. 	<p>Within 15 days of 1st sale, file a notice in a form required by the department or on SEC Form D + a consent to service of process and a fee of \$300.</p>

Requirement	Federal (JOBS Act)	GA	KS	NC (not yet enacted)	WA (not yet enacted)
	<p>on progress;</p> <ul style="list-style-type: none"> ■ Price to the public for the securities or method for determining such price; and ■ Description of ownership and capitalization of issuer. 				
Post-Offering Reporting	<p>Not less frequently than annually, file with the SEC and provide to investors reports of the results of operations and financial statements of the issuer as the SEC determines by rule are appropriate.</p>	Not addressed.	Not addressed.	<p>Quarterly reports to equity holders, which requirement may be satisfied by making reports publicly accessible, free of charge, at issuer's internet web site with a user name and password within 45 days of the end of each fiscal quarter and be available for at least 60 days. Reports to contain the following information:</p> <ul style="list-style-type: none"> ■ Executive officer and director compensation, including cash compensation earned by executive officers since previous report and on an annual basis + any bonuses or other compensation (e.g. stock options or rights to receive equity securities of issuer or any affiliate thereof); and ■ Management analysis of business operations and financial condition of issuer. 	<p>Quarterly reports to equity holders by making reports publicly accessible, free of charge, at issuer's internet web site with a user name and password within 45 days of the end of each fiscal quarter. Reports to contain the following information:</p> <ul style="list-style-type: none"> ■ Executive officer and director compensation, including cash compensation earned by executive officers since previous report and on an annual basis + any bonuses or other compensation (e.g. stock options or rights to receive equity securities of issuer or any affiliate thereof); and ■ Management analysis of business operations and financial condition of issuer.