

Securities Law News

# States Pilot Crowdfunding Initiatives to Increase Funding for Small Business

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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,<sup>1</sup> *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](http://www.ssb.state.tx.us/News/Press_Release/06-27-12_press.php). 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 Georgia-based and Kansas-based companies, respectively, to advertise to the public their need for investment and to raise money from state citizens.<sup>2</sup> Invest Georgia Exemption, Ga. Rule 590-4-2-.08; Invest Kansas Exemption, Kan. Rule 81-5-21. Similar legislation is now pending in both North Carolina and the state of Washington.<sup>3</sup> 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). 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 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. <sup>4</sup>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 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 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.<sup>5</sup>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. 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 25<sup>th</sup> 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.<sup>6</sup>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. 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;
- 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.

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