

ALERTS

Business of Law Update

CORPORATE AND SECURITIES UPDATE

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05.06.2013

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Equity-Based Crowd Funding – Federal and State

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the “JOBS Act”), whose intent, among others, was to enable small businesses and start-ups to raise money through equity-based crowd funding. This article follows our April 2012 client update on the JOBS Act and provides an overview of the movement among states to adopt their own equity-based crowdfunding legislation in the face of delayed implementation of the JOBS Act provisions.

Crowd funding – 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 even to angel investors and venture capitalists. Donor-based crowd funding sites like Kickstarter, IndieGoGo and RocketHub match potential donors to entrepreneurs’ projects; in exchange for a donor’s funds, the donor receives a “reward” but does not become an equity holder in the business they’ve funded. Donor-based crowd funding has been a creative solution to raising money from friends, family and the common man in an era where the desire to protect investors from harm has led to a regulatory environment under the Securities Act of 1933 (the “Securities Act”) and the Securities Exchange Act of 1934 (the “Exchange Act”) whose practical effect has been to close off the equity markets to true start-ups and to limit private offerings – equity offerings exempt from registration under the Securities Act – to accredited investors. Equity-based crowd funding describes the action of raising money from a large number of investors who, in exchange, receive equity in the business raising those funds.

Federal Statute (P.L. 112-106)

Title III of the JOBS Act, once implemented, will create a new exemption (the “Federal Crowd Funding Exemption”) which would allow a business, without registration under the Securities Act, to raise up to \$1,000,000 in any 12 month period from a wide variety of individuals, including those making less than \$100,000 per year. (Such investors could invest a maximum of the greater of \$2,000 or 5% of their annual income.[1]) The requirements around this new exemption may seem onerous to start-up businesses, however. A business wishing to issue securities using the Federal Crowd Funding Exemption would have to provide an offering memorandum or prospectus to the Securities and Exchange Commission (“SEC”), investors and the broker or funding portal used for the offering, including, depending on offering size, certified, reviewed or audited financials.[2] The broker or funding portal through which the new equity would be offered would have

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to be one registered with the SEC and, 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. The funding portal would also have the responsibility of determining the income or net worth of its prospective investors and ensuring that those investors do not exceed the allowable limits of their investments.

The complexity of writing the regulations on those requirements has delayed implementation of the JOBS Act. Over 1 year after the law's passage, a business still cannot offer its securities to the crowd using this intended exemption.

State Statutes & Proposed Bills (GA, KS, NC & WA)

Some state legislatures and securities commissions have tried to expedite equity-based crowd funding for entrepreneurs and small businesses within their states through the introduction or passage of laws creating exemptions for in-state only offerings of securities to accredited and unaccredited investors. Georgia and Kansas have both successfully enacted and implemented such crowd funding securities exemptions (the "Invest Georgia Exemption" - GA Rule 590-4-2-.08 and the "Invest Kansas Exemption - KS Rule 81-5-21). State representatives in North Carolina and Washington State introduced bills in April, 2013 similarly designed to facilitate investment by state residents in state start-ups.[3] The North Carolina bill has been hailed by commentators[4] as "bringing the crowd back to crowdfunding" by taking the best of the Georgia and Kansas legislation and providing an exemption that is much easier to understand and implement for both small investors and small businesses than the Federal Crowd Funding Exemption.[5]

Generally demanding less than the JOBS Act from the companies offering equity through the exemptions, all state initiatives permit, or would permit, entities formed in the applicable state to raise up to \$1,000,000 in any 12 month period without requiring them first to have audited financials. (North Carolina's "Jump Start Our Business Start-Ups Act anticipates the involvement not only of the masses but also of some accredited investors and would permit businesses with audited financials to raise up to \$2,000,000 using this exemption.) The offering can begin without notice to the state securities commissioner, but 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. Post-offering reporting requirements are generally more frequent but more flexible than under the Federal Crowd Funding Exemption, allowing companies to point investors to a website that includes management comments and quarterly (unaudited) financials. Although there are far fewer investor protections in the forms of disclosure than under the Federal Crowd Funding exemption, the maximum allowable investment for an unaccredited individual is limited to a low dollar amount (ranging from \$1,000 in Kansas to \$10,000 in Georgia.) Each state decides as a matter of public policy how to balance the amount an individual should be entitled to put at risk against the burden it will impose on the small businesses it is trying to advance through the exemption.

The obvious limitation on these state exemptions is the very intrastate nature of them. Entrepreneurs do not have the ability to reach outside their own states for their planned capital raises, which limits them to an in-state network. Nevertheless, for many small businesses, the ability to do a public solicitation in their local area may be enough to raise the needed level of capital. In addition, these state programs can serve as small-scale test cases, helping to prove whether a federal exemption could be even more flexible than what the

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JOBS Act currently envisions without endangering investors.

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. Similarly, please note that other states not discussed in this article may also be considering exemptions to assist small business. We encourage clients to contact their legislators or to speak with MVA directly if they have a question about a state bill or law not addressed here.