CAPITOL RESEARCH

Intrastate Equity Crowdfunding Exemptions

Crowdfunding has been used to finance a vast assortment of projects in recent years, from video games and smart watches to kitchen gadgets and children's television programs.[1] These campaigns generally start with little more than a well-produced YouTube video and a proposal for a product, service or charity event.

Crowdfunding is a relatively new funding vehicle for entrepreneurs, promising capital infusions with fewer strings attached than more traditional venture capital or angel investment funding rounds, which often afford the investors extensive rights and privileges.[2] Federal regulators are concerned about the possibility of fraud in crowdfunding campaigns, however, which is not unwarranted.[3] Delays are common even in campaigns that are ultimately successful, and there is no guarantee that a delivered product will be commercially viable. There also have been instances in which project creators have made false promises about products, fabricated entire companies, failed to deliver products or simply walked off with backers' cash.[4]

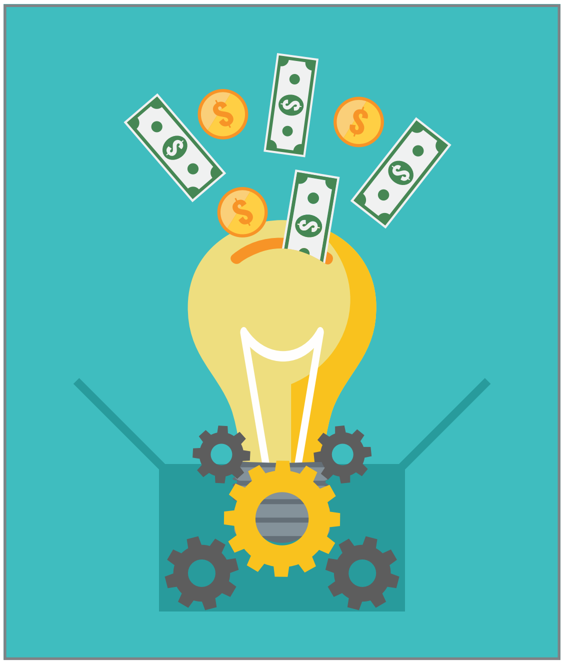
Federal regulatory authorities have struggled to create rules that address the need for investor protection while preserving the ease of investment that has defined the nascent crowdfunding industry, which is projected to reach $34 billion in 2015.[5]

There are three primary types of crowdfunding:

The most well-known type is token crowdfunding, in which a company promises to bring a desired product to market and their customer-investors—or backers—are willing to pre-purchase the product months, or even years, before the company is able to deliver.

- Backers contribute smaller amounts than traditional investors—usually just the cost of the product—and receive no stake in the company.
- Backers sometimes contribute more than the cost of the product, usually in exchange for exclusive or limited edition merchandise.

Token crowdfunding campaigns are almost always conducted online using platforms such as Kickstarter and Indiegogo, which facilitate the interactions between projects and backers.



In equity crowdfunding, businesses raise money from a large number of small investments in lieu of, or in conjunction with, the large lump-sum investments received from venture capitalists or angel investors. Investors receive equity rather than goods.

- Investors must be accredited according to the standards established by the Securities Act of 1933, which requires either an individual income of $200,000 or a net worth of more than $1 million.[6]
- Individual contributions tend to be larger than in token crowdfunding because the overall number of investors is more limited.
- Dedicated platforms such as Crowdfunder and Equitynet allow businesses to interact with investors online using tactics similar to those employed by token crowdfunding campaigns.

The final type is crowd lending, also known as peer-to-peer lending. In peer-to-peer lending, businesses advertise their debt and, similar to a conventional bond market, investors receive a monthly return rather than a product or stake in the company.[7]

- Popular platforms for peer-to-peer lending include Prosper and Lending Club.
- In the United States, lending platforms are required to register with the SEC.
- There is considerable variance in state regulation of crowd lending. For instance, California places limits on investors seeking to engage in peer-to-peer lending, while Texas bans the practice outright.[8]

The U.S. Jumpstarting Our Business Startups, or JOBS, Act provides a number of regulatory exemptions for businesses and investors involved in equity crowdfunding. Rollout of the JOBS Act has been slow, with the SEC struggling to finalize regulations.

- Although companies are allowed to advertise for investment, only accredited investors may participate in interstate equity crowdfunding.[9]
- A company can collect up to $1 million per year through crowdfunding.
- Investors who make less than $100,000 can invest $2,000 or 5 percent of their income per year, whichever is higher.
- Investors who make more than $100,000 can invest up to 10 percent of their income yearly.
- Like all investments, equity crowdfunding is regulated by the Securities and Exchange Commission.

Many states have taken advantage of federal intransigence, with 24 states and the District of Columbia implementing laws that create regulatory exemptions for intrastate crowdfunding. Intrastate crowdfunding tends to be more community-based, although some states mandate the use of online fundraising platforms.[10]

- These laws are derived from states' authority to regulate intrastate commerce, and the key challenge for state regulators is to allow general solicitation of small investments without violating federal law.
- Regulations for intrastate crowdfunding tend to be broadly similar. They allow non-accredited individuals and investors to invest in companies that engage in crowdfunding within their state.
- Key differences among state laws include a cap imposed on funding, with $2 million being the standard. These laws generally require projects that raise more than $1 million to undergo an audit, although some states—notably Texas—omit this requirement.
- State-specific crowdfunding platforms exist to facilitate intrastate transactions. Some are general purpose, like MichiganFunders. Other platforms are focused on specific project types, such as EquityEats, which was used to fund Prequel, the first crowdfunded restaurant in Washington, D.C.[11]
- Adoption of these platforms has generally been slow[12] compared to token crowdfunding, despite attempts to create a stable regulatory environment.

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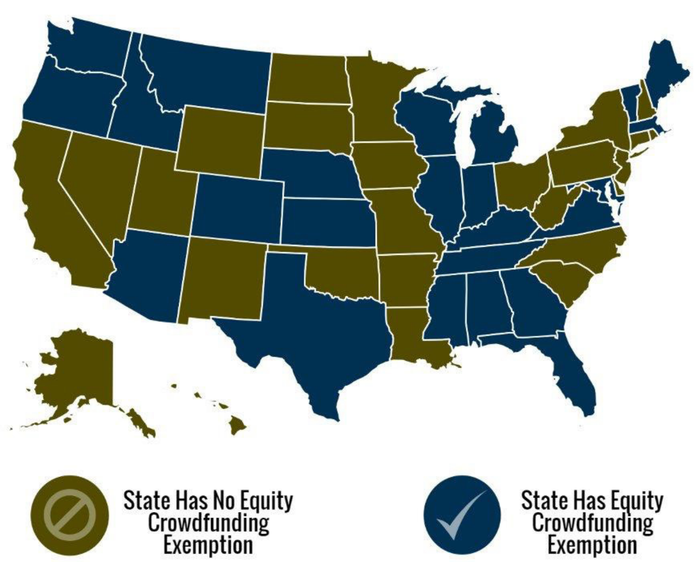
Equity Crowdfunding Exemptions by State



Source: Crowdfunding Legal Hub, 2015

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