THE PEW CHARITABLE TRUSTS

The Pew Charitable Trusts / **Research & Analysis** / **Stateline** / States Clear Way for Crowdfunding

STATELINE

States Clear Way for Crowdfunding

August 21, 2014

By Jenni Bergal

© AP

Matthew Marcus works at his desk in the basement of Kansas City Startup Village in Kansas City, Kansas. Kansas is one of a dozen states that have made it easier for startups to use crowdfunding to raise money from investors. (AP)

Creating a startup company takes a lot of time and effort. It also takes money, which is something that entrepreneurs like Henry Schwartz know all too well.

Schwartz is co-founder and president of MobCraft Beer, a craft brewery in Madison, Wisconsin. His company recently became the first in his state to get approval from regulators to use crowdfunding to raise money from a large number of small investors online. It's allowed under a new state law aimed at helping startup ventures.

"I think it's awesome the state passed this law," said Schwartz, 26. "There's such a capital crunch in Wisconsin and people are a little apprehensive to invest in startups. So this is a great way for companies to start the first round, and then be able to attract some higher dollar-amount investors down the road."

In the last three years, Wisconsin and 11 other states plus the District of Columbia have passed laws or regulations allowing startups to use crowdfunding to raise money from investors, without having to jump through all the regulatory hoops that companies with shareholders usually do.

Anya Coverman, deputy policy director for the North American Securities Administrators Association, which represents state securities regulators, said startups in the states where the laws have been changed still have to fill out some paperwork, disclose information to investors and pay a small fee. But it's not considered a full-blown securities registration, which can be expensive and time-consuming. The business also must operate in and sell shares to investors only within that state.

"This is a relatively new phenomenon that's happening on a state level," Coverman said. "States are really attuned to what local businesses need."

Indiana passed its law allowing intrastate crowdfunding earlier this year. The goal was to give startups an opportunity to get funding in an easier way, said Republican state Sen. Travis Holdman, the bill's sponsor.

"I'm very pro-business in supporting entrepreneurship," Holdman said. "This helps small businesses get going, with the assistance of folks here in Indiana. There's a homespun twist to it."

The Indiana law is about "expanding investment choice" for people who ordinarily wouldn't be able to put money into a private offering, said Carol Mihalik, the state's securities commissioner, who joined Holdman to speak about crowdfunding at a panel this week at the National Conference of State Legislatures annual summit in Minneapolis.

"Right now, I can sit on a couch at home on my laptop in the middle of the night and log onto a registered website in Indiana and look at the offerings and choose to invest," Mihalik said.

Other states that have similar laws or regulations allowing intrastate crowdfunding include Alabama, Georgia, Idaho, Kansas, Maine, Maryland, Michigan, Nebraska, Tennessee and Washington.

Two Kinds of Crowdfunding

Until recently, there was only one type of crowdfunding – the donation model, which focuses on creative ventures or causes. Entrepreneurs with an idea put it out on the Web and solicit funding. Donors usually get a perk such as a T-shirt or pre-released CD or other product in exchange for helping a good cause or a cool new venture, but they have no stock or ownership in the company.

If an entrepreneur decided to use crowdfunding to open a doughnut shop, for example, those who donated $25 might get a free doughnut every month for a year. For $100, they'd get a doughnut named after them. And for $1,000, they could get doughnuts for life.

One of the best known donor-based ventures is Kickstarter, a crowdfunding site that bills itself as a home for everything from film and music to design and technology ventures. Since its 2009 launch, the company says that nearly 7 million people have pledged $1 billion and funded 67,000 projects.

The other concept is called "equity crowdfunding." It uses a similar approach by asking the "crowd" to fund a business or project. But the entrepreneur is selling shares – an ownership stake in the business. Financial backers aren't donors getting free doughnuts; they're investors hoping for a return. That means that like other companies that issue stock, these startups must register with state regulators under securities laws or apply for an exemption.

"Securities laws and registration are designed to protect issuers and investors by making sure they have materials and important information about a company they're investing in," said Coverman, of the securities regulators organization. "It's also to prevent fraud and misrepresentation in those investments."

But the normal securities registration process can be costly and cumbersome, making it too difficult for small-time entrepreneurs.

That's why lawmakers have been amending their securities statutes or rules to exempt small startups from many of the standard registration requirements and allow them to raise money through crowdfunding, as long as it's only in their state. Start-ups still have to register, but the process is much simpler and cheaper.

States also cap the amount that can be raised. In Wisconsin and Indiana, for example, a startup using crowdfunding can collect a maximum of $1 million from investors or $2 million if the company is audited.

While both models of crowdfunding are growing increasingly popular, state officials say that they also want to ensure that the companies are doing right by donors and investors.

In Washington state, Attorney General Bob Ferguson in April filed what may be the nation’s first consumer protection lawsuit against a company that was using traditional donor-based crowdfunding. Washington alleges the company failed to deliver decks of horror-themed playing cards created by a Serbian artist and similar items promised to people who donated a total of $25,146 for the project through Kickstarter.

Some states have decided to take a more cautious approach to crowdfunding.

In Minnesota, legislators tweaked state securities laws to allow equity crowdfunding and to give state officials the authority to regulate and set rules. But Minnesota didn’t institute a blanket exemption from all the legal hurdles as some other states have done.

“It’s an exciting area and one that we want to promote,” said Minnesota Democratic state Rep. Joe Atkins. “But we have to be cognizant of the potential for fraud and abuse of investors. They could fall prey to scams and certain unsavory characters who might want to take advantage of them. It’s an area that is fraught with potential perils.”

Frustrated with the Feds

Many states that have changed their securities laws to allow equity crowdfunding acted after they heard from disgruntled small business owners.

Entrepreneurs initially had been thrilled when the federal Jumpstart Our Business Startups (JOBS) Act was signed by President Barack Obama in 2012. It's supposed to allow small startups to use equity crowdfunding nationwide and be able to raise up to $1 million a year from investors. But two years after the law's passage, the Securities and Exchange Commission is still working on creating the rules that are necessary to move ahead. That means that the process is in limbo and companies can't raise money through equity crowdfunding on a national scale.

So entrepreneurs started turning to the states for help.

"A lot of them have become frustrated with the SEC at the federal level and they've gone to the state legislatures, and have been successful, to a degree, in getting bills passed or rules allowing intrastate crowdfunding," said Bob Webster, communications director for the securities regulators group.

This year, lawmakers in at least 21 states introduced legislation dealing with crowdfunding exemptions, according to the National Conference of State Legislatures.

"These state bills are focused on the local doughnut shop, the local movie theater, a new startup that two young kids at the local university are trying to get off the ground, and help them crowdfund to local investors," said Coverman, of the securities regulators group.

Schwartz, the craft beer entrepreneur from Wisconsin, said that he paid the $50 online fee to register, provided the necessary documents and got approval from state regulators to begin crowdfunding in June. But he hasn't been able to start because he's still waiting to find a Wisconsin bank that will agree to be the company's escrow agent, as required by law.

In the meantime, MobCraft Beer is continuing to use old-fashioned crowdsourcing to come up with ideas for its beers, such as Chocolate Peanut Butter Coffee Porter and Whisky Old Fashioned Berliner Weiss.

Schwartz, who describes the company as a “fully crowdsourced brewery,” said people submit ideas for new beers on the company’s website and customers vote for their favorites. The winning beers are brewed every month and sold at the brewery or through online retailers in more than 30 states. Winners get their names on the label.

Schwartz said that while the company has been successful because of its customer interaction, investor-based crowdfunding could bring it to a whole new level.

“We want to be like the Green Bay Packers, where the people own the team,” he said. “I wouldn’t say equity crowdfunding is great for all products, but for those businesses like us that people feel an attachment to and a sense of ownership of, it should be pretty effective.”

NEWER
Editor's Picks From Around the Web

OLDER
Editor's Picks From Around the Web

PLACES
United States

TAGS
Business of Government, Economy

Explore

By Tag

By State

STATELINE

ABOUT STATELINE

Stateline provides daily reporting and analysis on trends in state policy.

About ›

MEDIA CONTACT

Jeremy Ratner
Director, Communications,
202.540.6507
jratner@pewtrusts.org

SIGN UP

Sign up for our daily update —original reporting on state policy, plus the day's five top reads from around the Web.

Email Address

SUBMIT