SMALL-BUSINESS INVESTING

N.C. crowdfunding advocates say federal rules not enough

Federal rules allow private companies to raise up to $1M a year

Critics say rules too costly for small businesses

State bills failed to win legislative approval in 2013, 2015

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Even though new federal regulations hold out the promise of opening up crowdfunding to the masses, advocates of this new source of funding for start-ups and other small businesses say a state crowdfunding law is still needed.

The problem, said securities lawyer Jim Verdonik of Raleigh's Ward and Smith, is that "the new federal rules are flawed in many ways." Verdonik, who is among those pushing for a state crowdfunding law, has self-published a book on crowdfunding, "Crowdfunding Opportunities and Challenges."

Verdonik

White

New rules adopted by the U.S. Securities and Exchange Commission in October, which go into effect May 16, permit privately held businesses to raise up to $1 million a year from average investors, which previously was prohibited. The new rules represent the final phase of implementing the Jumpstart Our Business Startups Act that was passed by Congress and signed into law in 2012.

"There is a great deal of enthusiasm in the marketplace for crowdfunding, and I believe these rules ... provide smaller companies with innovative ways to raise capital and give investors the protections they need," SEC Chair Mary Jo White said in a statement issued when the rules were released.

Until now, federal securities law limited privately held companies to raising money from "accredited investors" who have an annual net income that exceeds $200,000 or a net worth in excess of $1 million.

Websites such as Kickstarter and Indiegogo already offer a form of crowdfunding, but companies who raise money on those sites aren't selling their backers an ownership stake.

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Instead, they offer a reward of some sort – such as the product whose development is being funded or, say, a T-shirt or dinner with the company's founder.

Attorney Mital Patel of Raleigh's Wyrick Robbins Yates & Ponton refers to this as "reward crowdfunding," as opposed to the "investment crowdfunding" enabled by the SEC rules that permits companies to sell stock or debt to investors.

The best things about the new SEC rules, said Jon Spinney, co-founder and CEO of Raleigh crowdfunding company Malartu Funds, is that they show that the federal government is being "proactive about using new technology to provide financing for companies."

Malartu has been taking advantage of a previously implemented provision of the federal JOBS Act that permits startups to solicit funds online from accredited investors. The new rules also permit online solicitation from non-accredited investors.

FALLING BEHIND

A key problem with the new rules, said Verdonik, is that "the expenses of the offering in many cases will not be justified by the amount of money raised."

For example, depending on the size of the offering, the company has to provide financial statements that are audited or reviewed by an independent accountant. That's a significant expense for a startup or small business.

It behooves North Carolina to follow more than two dozen states that have passed their own crowdfunding laws, said attorney Benji Jones of Raleigh's Smith Anderson.

North Carolina, she added, "is falling far behind" by not passing its own law.

The state House passed a crowdfunding bill in 2013 with overwhelming support from both parties – just a single dissenting vote was cast – but it stalled in the Senate the following year when unrelated economic development initiatives were tacked onto it. Bills also were introduced in 2015,

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Jim Verdonik, Raleigh securities lawyer, on what he sees as shortcomings in federal crowdfunding rules

but they failed to gain traction.

Jones is a proponent of S.B. 481, which was among last year's crop of bills. It would permit companies to raise up to $2 million, rather than the $1 million limit in the federal rules. It also wouldn't require reviewed or audited financials for offerings of less than $1 million.

That bill, which is restricted to North Carolina companies raising money from North Carolina investors, could be tweaked this year in light of an SEC proposal, not yet adopted, that was released in the fall.

That SEC proposal, said Verdonik, is designed to facilitate state crowdfunding laws.

"I personally think it is kind of an effort by the SEC to get critics (of the new rules that take effect in May) off the SEC's back," Verdonik said.

SLOW TO TAKE OFF

Although crowdfunding has generated a lot of media attention and a wave of supporters, it hasn't taken off in states that have passed laws.

The SEC, citing data from the North American Securities Administrators Association, notes that from December 2011, when the first state enacted a crowdfunding law, through September, just 118 crowdfunding offerings have been filed with state regulators.

Patel attributes that to "a lack of awareness" of the new fundraising procedure and the fact that, with many state laws, "the amount you can raise just doesn't make sense for the amount of hoops you have to jump through."

That said, Patel sees crowdfunding as the wave of the future.

"I think if we look into the long horizon, the idea of raising money from the crowd is going to be maybe the new norm," he said. "But it's not going to happen overnight."

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