House of Representatives passes Crowdfunding Bill

Is this the future of startup financing? The House of Representatives overwhelmingly passed HR 2930, the McHenry Crowdfunding Bill, in a 407-17 vote. First proposed in September of 2011, the McHenry Crowdfunding Bill went through just one revision in committee and is now in front of the Senate. If the Senate approves, crowdfunding looks to join venture capital, private equity, and angel investing as a new way for startups to acquire financing.

Crowdfunding, for those that are unfamiliar –also referred to as crowd financing or crowd sourced capital – allows new ventures to acquire financing through collective efforts. Such collective efforts are usually formed via third-party platforms on the Internet, such as Kickstarter or Indiegogo. These platforms empower entrepreneurs to showcase their projects and ideas to people everywhere and seek financial support.

Obstacles to crowdfunding

Challenges to crowdfunding, however, rest largely in legal rules. Both federal and state laws preclude crowdfunding through a variety of obstacles. For instance, federal rules under Regulation D provide special exemptions for investors to fund new ventures. But these exemptions still preclude investment by non-qualified investors, place limits on the public solicitation of investment in new companies, impose caps on the amount of investment new ventures can acquire, and cap the number of shareholders for exempt companies. States often have similar laws for those companies that operate strictly within state borders.

Because of these obstacles, entrepreneurs have been unable to leverage crowdfunding to raise capital in return for equity. Instead, entrepreneurs have been limited to seeking financing on a project-by-project basis. For example, a company might require a certain amount of capital to develop a t-shirt they want to sell; the company will showcase the t-shirt on a crowdfunding website and seek capital to produce just that product. As a result, crowdfunding does not currently provide the long-term working capital many businesses require to grow.

HR 2930 changes the rules

HR 2930 addresses these challenges by removing the obstacles currently faced by crowdfunding platforms, thereby enabling crowdfunding platforms to provide working capital for new ventures. As Representative McHenry's website notes, HR 2930 provides three key changes to support crowdfunding:

1. HR 2930 creates a crowdfunding exemption from SEC regulations for firms raising up to $2

million, with individual investments limited to $10,000 or 10 percent of an investor's annual income.

2. HR 2930 excludes crowdfunding investors from counting as shareholders for purposes of calculating the 499-shareholder cap under 12(g) of the Securities Exchange Act

3. HR 2930 preempts state law and exempts the ban on general solicitation for the new crowdfunding exemption.

Impact on startup funding

For the startup, HR 2930 makes two critical changes to support crowdfunding. First, the bill increases the pool of potential investors by (1) removing the high threshold of personal net wealth or high income required to be a qualified investors under Regulation D for crowdfunding; and, (2) by removing the SEC cap on the number of shareholders to allow crowdfunding, thus allowing a large community of investors. Second, the bill creates uniformity by preempting state law; in so doing, the bill allows crowdfunding websites need only conform to federal law, not 50 different state laws.