In The News

Texas Rule Tweaks Could Help Grow Crowdfunding Market

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Law360, Dallas (July 8, 2016, 9:11 PM ET) -- Texas securities regulators this month are considering tweaks to state crowdfunding rules that would lift escrow requirements for smaller investments, changes that attorneys say demonstrate the state's continued eagerness to fine-tune crowdfunding requirements and help expand the fundraising method's use among small businesses.

The proposed changes to escrow requirements for offerings of $100,000 or less, which could be adopted as early as July 31, come on the heels of relaxed restrictions for crowdfunding portals run by nonprofit housing and community development groups, community development financial institutions and small business development entities.

Lawyers say since Texas enacted its equity crowdfunding rules in November 2014, state lawmakers and regulators have shown a willingness to fine-tune the regulations in line with market needs. The state's quick reaction time and overall issuer-friendly crowdfunding structure are two elements that could help Texas' instrastate crowdfunding market thrive even as federal rules that took effect in May open up the market for national fundraising.

“I think it's a good thing,” Nathan Roach of Moster Wynne & Ressler PC, who is also the CEO of crowdfunding portal MassVenture, said of the recent Texas rule changes. “I think it's something we probably can expect to see periodically as the crowdfunding market matures.”

Under changes proposed July 1, crowdfunding portals would be permitted to handle investor funds in a segregated account instead of a designated escrow account for offerings under $100,000. Portals would still need to disclose the segregated account to the Texas securities commissioner but wouldn't need to engage an escrow agent.

Roach said that change is important because maintaining funds in escrow is a “significant burden” on portals. Using an escrow provider does add a layer of cost, but the true burden comes in finding the escrow agent in the first place, he said.

“What we saw is that there were not a lot of banks that wanted to be an escrow agent for crowdfunding transactions,” Roach said. “It's not in their core competency and they're all very risk-averse after recent financial regulatory changes, so there haven't been a lot of escrow providers available to do the work.”

In proposing the rules, the Texas State Securities Board noted the change would “allow Texas crowdfunding portals to handle investor funds for certain small securities offerings where engaging an escrow agent may be difficult or cost prohibitive.”

Texas also recently implemented rules for nonprofit and community development crowdfunding portals, after that provision was added to the Texas Securities Act in the 2015 legislative session. Under Section 44 of the act, certain small business development entities can register to offer crowdfunding through a simplified process with fewer regulatory requirements.

The lesser regulatory burden for those entities does comes with restrictions: Section 44 portals can't handle investor funds, make recommendations or provide investment advice, but are instead required to be passive and neutral. Section 44 portals also can only raise funds in their geographic service area — not the whole state.

"I think that's interesting because it could increase people's knowledge of crowdfunding by having the ability to have more portals available in Texas," Drew Palmer of Munsch Hardt Kopf & Harr PC said. "I think if you're an average investor, you don't know you can invest in a small business within your area — my understanding is people feel like they have to be 'in the know.' But you can invest in anyone you want through a portal as long as you meet the requirements."

The overall effect of these minor but important tweaks to the state's crowdfunding rules is that securities issuers and crowdfunding portal operators have more confidence that regulators are tracking the market and are able to respond quickly to market needs, lawyers say.

That adaptiveness to the market is enabled by a regulatory structure that gives the TSSB the authority to prescribe new exemptions by rule instead of waiting for legislative direction, Roach said. And in turn, the ability to quickly tweak rules can help stoke the still-fledgling market for equity crowdfunding as investors and small businesses get more comfortable with the relatively novel approach to raising cash, Roach said.

Texas, one of about 30 states with equity crowdfunding rules, stands out for more than just its market awareness.

Texas regulations focus on the portal through which crowdfunding opportunities are offered, instead of putting the burden of due diligence on the securities issuer. Portals are required to investigate the issuer, screening out fraudsters, and also verify investor information, like that they are actually Texas residents.

That's a different approach from many states that impose stricter requirements directly on the issuer, Palmer said. And it's less burdensome on issuers than federal rules that require due diligence from both the crowdfunding portal being used and the issuers, he said.

Distinctions like that are something capital raisers will consider as they decide whether to limit their crowdfunding to just one state, and operate under state rules, or if they want to draw from the whole country and operate under federal rules, Roach said.

"What's really going to be interesting as the federal crowdfunding rules move forward is how the states continue to attract offerings to their state rules when there is a national rule set available," he said. "There has to be some competitive advantage for someone to go to a Texas portal instead of opening it up nationwide. I think the states are going to have to work to make sure their rules are attractive to businesses."

On Roach's wish list for changes to crowdfunding rules would be a lifting of escrow requirements for offerings of up to $500,000, instead of the proposed $100,000 limit. And he said the difficulty of finding a willing escrow agent could be addressed by allowing attorneys with Interest on Lawyers Trust Accounts to fulfill that role.

And crowdfunding's utility for industries like commercial real estate and oil and gas would be vastly improved if Texas increased the offering cap from its current $1 million-per-12-month limit, he said. For those industries, $1 million often doesn't go very far because of high capital costs, meaning crowdfunding isn't an attractive means of raising equity.

“Raising the limit is something that would be discussed if crowdfunding doesn’t take off the way they wanted it to,” Palmer said. “There would be discussion of finding ways to relax the limits so more companies would be willing to use crowdfunding as a means of raising funds.”

Palmer said the dream among many stakeholders in the crowdfunding sphere as state and federal regulations continue to take shape is to make the process as easy and streamlined as “rewards-based crowdfunding” like Kickstarter and IndieGoGo, which are exempt from securities rules because they aren’t selling interests in a company but rather tend to offer tangible goods or experiences in exchange for investment.

Roach said Texas has an “enormous opportunity” to lead the country in crowdfunding, given its large and growing population, nimble securities regulator and strong state economy.

“It’s really our game to lose,” Roach said. “We have an amazing opportunity in front of us here. How that develops is entirely going to depend on how the market is regulated and whether it winds up being an attractive environment for capital raising or winds up being overly restrictive compared to other options out there.”

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