

"CROWDFUNDING: REGISTRATION EXEMPTION FOR SECURITIES UNDER UNIFORM SECURITIES ACT

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House Bill 4996 (Substitute H-3)
Sponsor: Rep. Nancy Jenkins
Committee: Commerce

Complete to 10-31-13

A SUMMARY OF HOUSE BILL 4996 AS REPORTED FROM COMMITTEE

The Uniform Securities Act (2002) is based on a model act from the Uniform Law Commission of the National Conference of Commissioners on Uniform State Laws (NCCUSL) and is designed to coordinate federal and state securities legislation. The purpose of such regulation is to prevent fraudulent sales of securities to investors.

Under the act, a person cannot offer or sell a security in this state unless one or more of the following are met: (a) The security is a federal covered security; (b) the security, transaction, or offer is exempted from registration under Sections 201 to 203; or (c) the security is registered under the act.

House Bill 4996 would amend the act to provide additional exemptions from registration for securities when certain specified criteria are met. The exemptions take two forms:

- (1) An offer or sale of a security that meets the requirements for the federal exemption for a Regulation A offering under Section 3 (B) of the federal Securities Act of 1933, if the offer also meets certain requirements spelled out in the bill. This is found in an amendment to existing Section 202.
- (2) An offer or sale of a security based on new statutory criteria listed in a new Section 202a that forms the bulk of the bill.

In both cases, an exempt issuer could not accept more than \$10,000 from any single purchaser unless the purchaser is an accredited investor under federal regulations,

There would also be a limit on the sum of all cash and other consideration to be received for all sales of the security relying on the exemptions, with the amount depending on which form of exemption relied upon.

These provisions are described in more detail later.

BACKGROUND INFORMATION:

The bill addresses what has come to be called *investment crowdfunding*.

According to the federal Securities and Exchange Commission, in an October 23rd press release on new crowdfunding regulations:

Crowdfunding is a term used to describe an evolving method of raising money through the Internet. For several years, this funding method has been used to generate financial support for such things as artistic endeavors like films and music recordings, typically through small individual contributions from a large number of people.

While crowdfunding can be used to raise funds for many things, it generally has not been used as a means to offer and sell securities. That is because offering a share of the financial returns or profits from business activities could trigger the application of the federal securities laws, and an offer or sale of securities must be registered with the SEC unless an exemption is available.

Congress created an exemption to permit securities-based crowdfunding when it passed the JOBS Act last year. Among other things, the JOBS Act was intended to help alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses in connection with raising capital in relatively low dollar amounts.

Title III of the JOBS Act established the foundation for a regulatory structure that would permit these entities to use crowdfunding, and directed the SEC to write rules implementing the exemption. It also created a new entity – a funding portal – to allow Internet-based platforms or intermediaries to facilitate the offer and sale of securities without having to register with the SEC as brokers. Together these measures were intended to facilitate capital raising by small businesses while providing significant investor protections.

DETAILED SUMMARY:

Federal-based Exemption

An offer or sale of a security by an issuer would be exempt from registration requirements under the Uniform Securities Act if it met the requirements for the federal exemption for a Regulation A offering under Section 3 (B) of the federal Securities Act of 1933, if the offer also met the following requirements.

** The issuer has filed SEC Form 1A with the federal Securities and Exchange Commission with respect to the offering in a manner acceptable to the SEC and, in that filing, has satisfied certain federal requirements, including the filing of the Regulation A offering circular.

**At least 10 days before beginning an offering of securities in reliance on the exemption or the use of any publicly available website in connection with such an offering, the issuer files a notice with the state administrator (the Department of Licensing and Regulatory Affairs, or LARA) in writing or in electronic form, as specified by LARA, that contains all of the following:

-- A notice of claim of exemption from registration, accompanied by a nonrefundable filing fee of \$100.

-- A copy of the completed SEC form 1A and all accompanying documents filed with the SEC, including the final Regulation A offering circular. Before filing the form, the issuer could advertise its intent to make a Regulation A offering within the state and solicit interest from prospective purchasers.

** The sum of all cash and other consideration to be received for all sales of the security in reliance on the exemption does not exceed the amount set forth in federal rules (Subsection B of 17 CFR minus the aggregate amount received for all sales of securities by the issuer within the 12 months before the first offer or sale made while relying on the exemption. (This appears to be \$5 million, including no more than \$1.5 million offered by all selling security holders, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities in reliance upon Regulation A.)

** The issuer does not accept more than \$10,000 from any single purchaser unless the purchaser is an accredited investor under federal regulations. (This limit would be cumulatively adjusted every fifth year by LARA based on an inflation measure.)

An issuer that sells securities in the state while relying on this exemption could advertise the offering in any manner, including advertising on website platforms owned and controlled by nonissuer third parties, if no commissions are paid to either employers of the issuer or to the third parties, unless the third parties are licensed broker-dealers.

State Statute-based Exemption

House Bill 4996 would exempt from registration an offer or sale of a security that meets all of the following requirements:

** The issuer of the security is an entity that is incorporated or organized under Michigan law and is authorized to do business in Michigan.

** The transaction meets the requirements of the federal exemption for intrastate offerings (under the Securities Act of 1933). The bill provides criteria for determining that an individual is a state resident. If an exempt purchaser resells the security to a person who is not a state resident within nine months after the closing of the particular offering, the original investment agreement would be void. If an agreement is voided, the issuer could recover damages from the misrepresenting offeree or purchaser.

** The sum of all cash and other consideration to be received for all sales of the security in reliance on this exemption does not exceed the following amounts: (1) \$2 million if the issuer has undergone and made available documentation from a financial audit with respect to its most recently completed fiscal year certified by an independent certified public accountant; or (2) \$1 million, if the issuer has not undergone and made available

such a financial audit. (In both cases, these amounts would be reduced by the aggregate amount received for all sales of the security by the issuer within the 12 months before the first offer or sale made in reliance on the exemption.)

Every fifth year, LARA would adjust these amounts to reflect the change in the consumer price index for all urban consumers, rounded to the nearest \$50,000.

** The issuer has not accepted more than \$10,000 from any single purchaser unless the purchaser is an accredited investor (under Securities and Exchange Commission rules). Every fifth year, LARA would also adjust this amount to reflect inflation, rounded to the nearest \$100.

** At least 10 days before the beginning of an offering of securities in reliance on the exemption or the use of any publicly available website in connection with an offering of securities in reliance on the exemption, the issuer files a notice with the administrator in writing or in electronic form containing:

- a notice of claim of exemption from registration, specifying that the issuer will be conducting an offering in reliance on the exemption, accompanied by the specified filing fee.

- a copy of the disclosure statement to be provided to prospective investors in connection with the offering. (The bill details what must be contained in this disclosure statement.)

- an escrow agreement with a bank or other depository institution in the state, in which purchaser funds will be deposited, that provides that all offering proceeds will be released to the issuer only when the aggregate capital raised from all purchasers is equal to or greater than the minimum target offering amount specified in the disclosure statement as necessary to implement the business plan, and that all purchasers will receive a return of their subscription funds if the target offering amount is not raised by the time stated in the disclosure document.

** The issuer is not an investment company under federal law.

** The issuer informs each prospective purchaser that the securities are not registered under federal or state securities law and that the securities are subject to limitations on resale and displays specified language on the cover page of the disclosure document. This language must include, among other things, a statement that in making an investment decision, purchasers must rely on their own examination of the risks and that the securities have not been recommended by any federal or state securities commission or state regulatory authority.

** The issuer requires each purchaser to certify an extensive list of statements in writing, including among other things: "I am investing in a high-risk, speculative business venture. I may lose all of my investment, and I can afford the loss of my investment."

** If the offer and sale of the securities is made through an Internet website, all of the following requirements are met: the issuer provides to the website and LARA evidence that the issuer is organized under the laws of Michigan and that it is authorized to do business in the state; the issuer obtains from each purchaser of a security evidence that the purchaser is a resident of the state and, if applicable, an accredited investor; the website operator registers with LARA and describes its role; and the issuer and the website keep and maintain records of the offers and sales of securities through the website and provide ready access to the records to LARA on request. The website registration is valid for 12 months and can be renewed.

** All payments for the purchase of securities are directed to and held by the bank or depository institution, subject to the escrow account requirements cited earlier.

** Offers or sales of a security are not made through an Internet website unless the website is registered with LARA.

** The issuer does not pay, directly or indirectly, any commission or remuneration to an executive officer, director, managing member, or other individual with similar status or who performs similar functions in the name of and on behalf of the issuer for offering or selling the securities unless registered as a broker-dealer, investment adviser, or investment adviser representative. Such persons are exempt from registration requirements if they do not receive, directly or indirectly, any commission or remuneration for offering or selling securities of the issuer that are exempt from registration under the bill.

** The issuer provides a copy of the disclosure statement provided to LARA to each prospective purchaser at the time the offer of securities is made to the prospective purchaser.

** The term of the offering does not exceed 12 months after the date of the first offer.

If the offer and sale of a security of an issuer is exempt, the issuer must provide a quarterly report to the issuer's investors until none of the securities issued are outstanding. The report must be provided free of charge to investors, and each report must be filed with the administrator and the issuer must provide a copy to any investor on request.

The report must include: the compensation received by each director and executive officer of the issuer, including cash compensation earned since the previous report and on an annual basis, and any bonuses, stock options, other rights to receive securities of the issuer or an affiliate, or other compensation received; and an analysis by management of the issuer of the business operations and financial condition of the issuer.

The exemption would not apply if the issuer or a person affiliated with the issuer or offering is subject to any disqualification established by the administrator by rule or contained in Rule 262 promulgated under the federal Securities Act of 1933. However, this would not apply if, on a showing of good cause and without prejudice to any other

action by LARA, the department determines it is not necessary to deny an exemption; or if the issuer establishes that it made factual inquiry into whether any disqualification existed but did not know, and in the exercise of reasonable care could not have known, that a disqualification existed. The nature and scope of the requisite inquiry will vary based on the circumstances of the issuer and other offering participants.

The administrator could adopt rules to implement provisions of the bill and to protect investors that purchase securities that are exempt from registration under the bill.

LARA would charge a nonrefundable filing fee of \$150 for filing an exemption notice. Fees paid to LARA would be used to pay the costs incurred and administering the Uniform Securities Act.

A website through which an offer or sale of securities is made is not subject to the broker-dealer, investment advisor, or investment advisor representative if the website meets certain specified conditions, including that it does not offer investment advice or recommendations; it does not solicit purchases, sales, or offers to buy the securities offered or displayed on the website; it does not compensate employees, agents, or other persons for the solicitation, or based on the sale of, securities displayed on the website; it is not compensated based on the amount of securities sold and it does not hold, manage, possess, or otherwise handle investor funds or securities; and it does not engage in any other activity that LARA by rule determines are inappropriate for an exemption from registration requirements.

FISCAL IMPACT:

House Bill 4996 would have an indeterminate, but likely nominal, fiscal impact on the Corporations, Securities, and Commercial Licensing Bureau (CSCLB) within the Department of Licensing and Regulatory Affairs (LARA); because there are few enforcement responsibilities under HB 4996, the CSCLB anticipates that the \$150 filing fee for exemption notices would be sufficient to cover CSCLB administrative costs.

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.