

HOUSE OF REPRESENTATIVES STAFF ANALYSIS

BILL #: CS/CS/HB 275 Offer or Sale of Securities
SPONSOR(S): Insurance & Banking Subcommittee; Santiago
TIED BILLS: **IDEN./SIM. BILLS:** SB 914

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Insurance & Banking Subcommittee	12 Y, 0 N, As CS	Bauer	Cooper
2) Government Operations Appropriations Subcommittee	11 Y, 1 N, As CS	Keith	Topp
3) Regulatory Affairs Committee			

SUMMARY ANALYSIS

Crowdfunding describes an evolving method of raising funds for a variety of innovative projects, artistic endeavors, and non-profit political and charitable causes, typically through small individual contributions from a large number of people through the Internet. Most crowdfunding projects are *donation-based* or *rewards-based*, where the donor does not receive anything or may receive a free token of gratitude for funding the project. Under this model, the donation is akin to a gift, not a security. In recent years, there has been a growing interest in the use of *equity crowdfunding* to provide start-up or seed capital for small businesses and other ventures that are promoted on the basis of a potential economic return to the donors. Equity crowdfunding implicates state and federal securities laws, which require registration of securities and market participants by the U.S. Securities & Exchange Commission and state securities regulators, unless an applicable exemption applies. These laws also contain disclosure requirements and civil remedies for investors.

In 2012, Congress enacted the Jumpstart Our Business Startups (JOBS) Act in an effort to ease regulatory burdens faced by startups and small businesses in connection with capital formation, especially for relatively small-dollar amounts. Title III of the JOBS Act created a new registration exemption from federal securities law to permit the issuance, offer, and sale of up to \$1 million of crowdfunding securities per year, subject to specified requirements for issuers and intermediaries, and is not limited to accredited investors. However, national equity crowdfunding under Title III is not permitted until the SEC implements Title III by final rule, which has not yet been completed. In response to the delay, a number of states have recently enacted intrastate crowdfunding exemptions, which combine some elements of Title III of JOBS with §3(a)(11) of the 1933 Act, which exempts issuers from federal registration if the issuer, purchaser, and securities offering are all contained within the same state.

The bill creates an intrastate crowdfunding exemption within the Florida Securities and Investor Protection Act, ch. 517, F.S., which is administered by the Florida Office of Financial Regulation (OFR). The issuer, intermediary, investor, and transaction must all be in Florida in accordance with the federal intrastate exemption. Like Title III of JOBS, the bill exempts an issuer and the offering for a 12-month offering up to \$1 million of securities, requires registration for the intermediary, and mirrors the federal law's investment limitations for investors. The bill requires issuer notice filings and intermediary registration with OFR, initial and periodic disclosures to investors, an escrow agreement for investor funds, a right of rescission, and financial reporting to investors and to the OFR. The bill also gives authority to the Financial Services Commission to adopt rules relating to notice-filing and registration forms, books and records, and investor protections.

The bill appropriates \$120,000 in nonrecurring funds from the Regulatory Trust Fund within the OFR to implement provisions of the bill. The bill has an indeterminate positive fiscal impact on state revenues deposited into the Regulatory Trust Fund within the OFR.

The bill is effective on October 1, 2015.

FULL ANALYSIS

I. SUBSTANTIVE ANALYSIS

A. EFFECT OF PROPOSED CHANGES:

Crowdfunding – Donation/Rewards vs. Equity Models

Crowdfunding describes an evolving method of raising funds for a variety of projects, typically through small individual contributions from a large number of people through the Internet. These projects often involve innovative product ideas or artistic endeavors like movies or music, as well as political, charitable, and non-profit causes. Currently, the most popular forms of crowdfunding are *donation-based*, where the donor does not receive anything in exchange, or *rewards-based*, where the donor may receive a free item (such as a t-shirt or movie ticket) as a token of gratitude for funding the project. These projects are increasingly facilitated online through platforms such as Kickstarter, Indiegogo, and Fundable. Under this model, the donation is akin to a gift, not a security.

In recent years, there has been a growing interest in the use of *equity crowdfunding* to provide start-up or seed capital for small businesses and other ventures that are promoted on the basis of a potential economic return to the donors. As discussed in further detail below, equity crowdfunding has been particularly attractive for small or emerging businesses since the 2008-2009 recession and the resulting constriction in the credit markets, although borrowing conditions for small businesses have been gradually improving.

Unlike donation- or rewards-based crowdfunding, *equity crowdfunding* triggers the application of the federal and state securities laws. Both federal and Florida securities law broadly define “security” to include, among other things: notes; stocks; bonds; debentures; certificates of deposit; evidence of indebtedness; and investment contracts.¹ In 1946, the U.S. Supreme Court interpreted “investment contract” to include the purchase of a real estate interest in a Lake County, Florida citrus grove that included an optional management package. The Court articulated the following test (sometimes referred to as the *Howey* test) that is widely used at the state levels to determine the existence of a security:

1. An investment of money due to
2. an expectation of profits arising from
3. a common enterprise
4. which depends solely on the efforts of a promoter or third party.²

Securities Regulation

Federal Securities Regulation

The federal Securities Act of 1933 (“’33 Act”), often described as a “truth in securities” act, requires every offer or sale of securities using the means and instrumentalities of interstate commerce to be registered with the U.S. Securities & Exchange Commission (SEC), unless an exemption (such as the intrastate exemption, discussed below) is available.³ The ’33 Act’s emphasis on disclosure of important financial information through the registration of securities enables investors to make informed judgments about whether to purchase a company’s securities. While the SEC requires that the information provided be accurate, it does not guarantee it. Investors who purchase securities and suffer losses have important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.⁴ Once a company is registered under the ’33 Act or becomes publicly traded, it becomes subject to periodic reporting requirements under the federal Securities

¹ 15 U.S.C. § 77b(a)(1) and s. 517.021(21), F.S.

² *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

³ 15 U.S.C. §§ 77a-77aa.

⁴ U.S. SECURITIES & EXCHANGE COMMISSION, *The Laws That Govern the Securities Industry*, <http://www.sec.gov/about/laws.shtml> (last visited February 10, 2015).

Exchange Act of 1934, which also requires registration of market participants like broker-dealers and exchanges.⁵

State Securities Regulation

In addition to federal securities laws, “Blue Sky Laws” are state laws that protect the investing public through registration requirements for both broker-dealers and securities offerings, merit review of offerings, and various investor remedies for fraudulent sales practices and activities.⁶ In Florida, the Securities and Investor Protection Act, ch. 517, F.S. (“the Act”), regulates securities issued, offered, and sold in the state of Florida. The Florida Office of Financial Regulation (the OFR)’s Division of Securities regulates and registers the offer and sale of securities in, to, or from Florida by firms, branch offices, and individuals affiliated with these firms in accordance with the Act and Chapter 69W, Florida Administrative Code.⁷ As of December 2014, the OFR oversees:

- 2,789 dealers
- 5,182 investment advisers
- 10,373 branch offices
- 296,271 stockbrokers.⁸

The Act prohibits dealers, associated persons, and issuers from offering or selling securities in this state unless registered with the OFR or specifically exempted.⁹ Additionally, all securities in Florida must be registered with the OFR unless they meet one of the exemptions in ss. 517.051 or 517.061, F.S., or are federally covered (i.e., under the exclusive jurisdiction of the SEC).¹⁰ Failure to meet the precise requirements of these exemptions, can subject the issuer to civil, criminal, and administrative liability for the sale of unregistered securities, which is a third-degree felony in Florida.¹¹ Civil remedies under the act include rescission and damages.¹² In addition, issuers must comply with disclosure requirements in state and federal laws that provide potential investors with full and fair disclosures regarding the security.

In 2009, the Legislature amended the Act to expand the jurisdiction of the statewide grand jury and the Office of Statewide Prosecution to consider and prosecute violations of the Florida Money Laundering Act and the Act. Additionally, the 2009 legislation expanded the investigative and enforcement authority of Office of the Attorney General for commodities, antifraud, and boiler room telephonic sales violations, in coordination with OFR.¹³

Currently, no Florida exemption permits the advertising or solicitation for the offer or sale of unregistered securities to the general public, or for securities sold to the general public to be sold by an unregistered dealer.

⁵ *Id.*

⁶ U.S. SECURITIES & EXCHANGE COMMISSION, *Blue Sky Laws*, <http://www.sec.gov/answers/bluesky.htm>

⁷ Pursuant to s. 20.121(3)(a), F.S., the Financial Services Commission (the Governor and Cabinet) serves as the OFR’s agency head for purposes of rulemaking and appoints the OFR’s Commissioner, who serves as the agency head for purposes of final agency action for all areas within the OFR’s regulatory authority.

⁸ Office of Financial Regulation, *Fast Facts* (2nd ed., Dec. 2014), at <http://lofr.com/StaticPages/documents/FastFacts2015.pdf>

⁹ s. 517.12, F.S.

¹⁰ s. 517.07, F.S. If a security is registered with the SEC, s. 517.082, F.S., requires the broker or issuer to notify OFR that the security is registered with the SEC.

¹¹ s. 517.302(1), F.S.

¹² s. 517.211(3-5), F.S.

¹³ Ch. 2009-242, Laws of Fla.; see s. 517.191(5), F.S.

Self-Regulatory Organizations

The Financial Industry Regulatory Authority, Inc. (FINRA) is the largest private self-regulatory organization for all securities firms doing business in the United States.¹⁴ FINRA was formed as a result of a 2007 merger between its predecessor, the National Association of Securities Dealers, and certain operational arms of the New York Stock Exchange. In addition to operating the largest securities arbitration forum in the U.S., FINRA operates the Central Registration Depository and the Investment Adviser Registration Depository, which are central databases for registration, reporting, and disclosure information for the securities industry.

Funding Sources for Startups and Small Businesses

According to the U.S. Small Business Administration (SBA), the most common startup sources are owners' savings, family contributions, and external credit (i.e., bank or finance company loans, credit cards, credit lines).¹⁵ A 2012 study by the National Small Business Association found that 43% of small business owners surveyed could not obtain the financing they needed.¹⁶ The SBA reported that small businesses (meaning an independent business having fewer than 500 employees) make up over 99% of employer firms in the U.S. Below are funding options for small and startup businesses, and trends following the 2008-2009 recession.

Bank Lending

Bank lending data from 2006-2013 shows that small business loans (under \$1 million) declined from a lending peak in 2008, with a decline of 18% from 2008-2013.¹⁷ However, small businesses have experienced gradually improving borrowing conditions, although at an uneven and slower pace than those for large firms. The SBA estimated that total small business borrowing amounted to almost \$1 trillion in 2013.¹⁸

Surveys from mid-2013 indicate that the net portion of small businesses having difficulty obtaining credit has declined, and approval rates for small business loans has increased at credit unions and at large banks (i.e., those with \$10 billion or more in assets). Many commercial banks reported easing their lending conditions and terms, although not to pre-recession levels. However, bank lending growth has been weaker for small business loans, partly due to regulatory demands such as increased bank capital requirements as well as increased collateral and underwriting requirements for borrowers.¹⁹ According to a 2014 Federal Reserve study, most banks expect a moderate increase in retail small business lending in 2015.²⁰ The Federal Reserve recently reported that for its Atlanta district (which includes Florida), "while large businesses had easy access to credit, small businesses were experiencing small improvements in their ability to access credit."²¹ This reflects the greater risk in lending to smaller businesses, as the latter are more sensitive to economic swings and have fewer collateral.

¹⁴ About FINRA, <http://www.finra.org/AboutFINRA/>

¹⁵ SEC Proposed Regulation Crowdfunding, pp. 325-326; Small Business Administration Office of Advocacy, *Small Business Finance: Frequently Asked Questions* (Feb. 2014), at: <https://www.sba.gov/category/advocacy-navigation-structure/frequently-asked-questions-about-small-business-finance>

¹⁶ NATIONAL SMALL BUSINESS ASSOCIATION, *Small Business Access to Capital Survey* (July 11, 2012), p. 4, <http://www.nsba.biz/wp-content/uploads/2012/07/Access-to-Capital-Survey.pdf>.

¹⁷ U.S. SECURITIES & EXCHANGE COMMISSION, Proposed Regulation Crowdfunding, pp. 325-326, citing Federal Deposit Insurance Corporation, *Statistics on Banking*, available at: <http://www2.fdic.gov/SDI/SOB/>

¹⁸ SBA Small Business Finance FAQ, p. 1

¹⁹ Victoria Williams, *Small Business Lending in the United States 2013*, OFFICE OF ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION, Dec. 2014, at: <https://www.sba.gov/advocacy/small-business-lending-united-states-2013>

²⁰ THE FEDERAL RESERVE BOARD, *The October 2014 Senior Loan Officer Opinion Survey on Bank Lending Practices* (Oct. 2014), at: <http://www.federalreserve.gov/BoardDocs/snloansurvey/201411/default.htm>

²¹ FEDERAL RESERVE, *Summary of Commentary on Current Economic Conditions by Federal Reserve District* (Jan. 14, 2015), available at <http://www.federalreserve.gov/monetarypolicy/beigebook/default.htm>)

Additionally, some bank loans may be federally guaranteed, such as SBA loans or the U.S. Treasury's Small Business Lending Fund, which may increase availability of bank credit for small businesses.²²

Other Lending Options

- *Peer-to-peer (P2P) lending*, which matches interested lenders with borrowers over the Internet and offers an alternative to bank financing due to some flexibility in pricing terms.²³
- Personal and business *credit card debt*, which the SBA reports makes up roughly 7% of all startup capital.²⁴
- *State-administered business assistance programs*, such as those administered by the Department of Economic Opportunity.²⁵

Capital Markets

- *Registered offerings*, which are cost-prohibitive for small or startup businesses. Recent surveys estimated the average initial regulatory costs for an initial public offering (IPO) averaged \$2.5 million, with ongoing annual compliance costs of \$1.5 million.²⁶
- *Exempt offerings* (such as private placements, Rule 504, Rule 505, Rule 506), although varying restrictions on general solicitation and advertising, resale, and investor quantity and experience, significantly limit the offerings and may also not be suitable for startups and small businesses.²⁷
- The *angel investment* market, which has been on a gradual upward trend since 2012 and has been shifting to later-stage investments.²⁸
- *Venture capital (VC)*, which has remained relatively flat since 1999-2001, and is almost evenly split in terms of early-stage, expansion, and later-stage investments.²⁹ VC tends to be selective as to geography and industry niche (e.g., Silicon Valley tech firms), and often expects significant control rights over the startup company and specific growth benchmarks.³⁰ The research findings on the failure rate of VC-backed businesses in the U.S. vary, ranging from industry estimates of 25-30%, to as high as 75% by one business academic.³¹

Title III of the Jumpstart Our Business Startups (JOBS) Act – Equity Crowdfunding

In 2012, Congress enacted the Jumpstart Our Business Startups (JOBS) Act in an effort to ease the funding gap and regulatory burdens faced by startups and small businesses in connection with capital formation, especially for relatively small-dollar amounts.³² In particular, Title III of the JOBS Act (Title III) created a new registration exemption from the '33 Act to permit the issuance, offer, and sale of up to \$1 million of crowdfunding securities in a 12-month period, subject to specified requirements for issuers and intermediaries and investor limitations. Title III provides that individual investments are limited to 1) the greater of \$2,000 or 5% of the investor's annual income or net worth, if annual income or net worth

²² U.S. DEPARTMENT OF THE TREASURY, *SBLF Helps Lenders Increase Small Business Loans by \$14 Billion*,

[http://www.treasury.gov/connect/blog/Pages/SBLF-Helps-Lenders-Increase-Small-Business-Loans-by-\\$14-Billion.aspx](http://www.treasury.gov/connect/blog/Pages/SBLF-Helps-Lenders-Increase-Small-Business-Loans-by-$14-Billion.aspx)

²³ The SEC generally requires P2P lenders to register their offerings under the '33 Act. Additionally, P2P lending may be subject to oversight by other federal and state financial regulatory agencies. See Karen Gordon Mills and Brayden McCarthy, *The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game*, Harvard Business School Working Paper 15-004 (Jul. 22, 2014), at http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf

²⁴ SBA Small Business Finance, p. 1.

²⁵ DEO administers several loan programs under ch. 288, F.S., designed to stimulate business activity and to expand economic opportunity, including the Rural Community Development Revolving Loan Program, the Economic Gardening Business Loan Pilot Program, and the Microfinance Loan Program, which the Legislature created in 2014 (ch. 2014-218, Laws of Fla.).

²⁶ See IPO Task Force, *Rebuilding the IPO On-Ramp*, at 9 (Oct. 20, 2011), available at http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf.

²⁷ SEC Proposed Regulation Crowdfunding, pp. 319-324.

²⁸ SBA Small Business Finance (Feb. 2014), p. 2.

²⁹ *Id.*

³⁰ SEC Proposed Regulation Crowdfunding, p. 331.

³¹ Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail*; THE WALL ST. JOURNAL (Sept. 20, 2012),

<http://www.wsj.com/articles/SB10000872396390443720204578004980476429190>

³² The JOBS Act was signed into law on April 5, 2012. Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at various sections of 15 U.S.C.).

is less than \$100,000; and 2) 10% of the investor's annual income or net worth (not to exceed a total investment of \$100,000), if annual income or net worth is over \$100,000.

Unlike other securities exemptions, Title III permits the fundraiser (*issuer*) to advertise and solicit sales of securities from the general public and to sell the securities to non-accredited investors without first registering with the SEC or other regulatory authority. Title III also allows *intermediaries* - either registered broker-dealers or a new Internet-based platform entity (funding portals) – to facilitate the online offer or sale of securities, subject to certain requirements, including registering with “with any applicable self-regulatory organization” as defined as in the 1934 Securities Exchange Act. The SEC’s proposed rule provides that this self-regulatory organization is FINRA, which is the only registered national securities association.³³ If the Title III conditions are met, funding portals are exempt from having to also register with the SEC.

Certain companies are not eligible to use the Title III exemption, such as non-U.S. companies, companies that already are SEC reporting companies, certain investment companies, and as determined by SEC rule. Title III also includes a disqualification provision under which the exemption is unavailable if the issuer or related persons were subject to certain disqualifying events, such as being subject to a state financial regulatory final order barring the individual from the financial industry or a criminal conviction involving the purchase or sale of securities or false filings with the SEC.

Intermediaries (whether broker-dealers or funding portals) are required to comply with certain due diligence requirements and Title III’s investor protections, including:

- Providing investors with disclosures and education materials,
- Conducting background checks on the issuer and related persons to ensure they are not subject to disqualification;
- Ensuring investor funds are escrowed, and released only when the target offering amount is reached, and
- Protecting the privacy of information collected from investors, and ensure that promoters and finders are not compensated for providing potential investors’ personal identifying information,

Title III is a brief federal statutory framework, and requires the SEC to write significant implementing rules and to issue studies to facilitate capital formation, disclosure, and registration requirements.

SEC Rulemaking for Title III National Equity Crowdfunding

Many of the Title III requirements must be implemented by SEC rule. Title III directed the SEC to write rules within 270 days of enactment, i.e., by December 31, 2012. However, it was not until October 23, 2013 that the SEC published proposed rules (“Regulation Crowdfunding”) and sought public comment.³⁴ Since the notice and comment period of the proposed rules, the SEC has not yet finalized them. Recently, the SEC released a rulemaking agenda indicating a target date of October 2015 to adopt final rules to implement Title III.³⁵ The federal rules will then require an additional 60 days of publication in the Federal Register before becoming law, which means it is more likely that national equity crowdfunding will not legally begin until early 2016.

The SEC has advised that no Title III (interstate) crowdfunding is permitted until the SEC’s rules are finalized; specifically, one cannot operate a crowdfunding intermediary or funding portal unless registered in accordance with the final rules.³⁶

³³ SEC Proposed Regulation Crowdfunding §227.400.

³⁴ SEC Release No. 33-9470; 34-70741 (Oct. 23, 2013) (Proposed Regulation Crowdfunding), available at <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>

³⁵ EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF INFORMATION AND REGULATORY AFFAIRS, RIN 3235-AL37, at: <http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201410&RIN=3235-AL37>

³⁶ U.S. SECURITIES & EXCHANGE COMMISSION, Information Regarding the Use of Crowdfunding Exemption in the JOBS Act, at <http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm>. See also JOBS Act Frequently Asked Questions About Crowdfunding Intermediaries, at <http://www.sec.gov/divisions/marketreg/tmjjobsact-crowdfundingintermediariesfaq.htm>

Currently, the only legally authorized national equity crowdfunding is under Title II of the JOBS Act, which is limited to accredited investors.³⁷ “Accredited investors” are defined in Rule 501 of Regulation D to include banks, insurance companies, or individuals and entities with specified income and net worth levels. A natural person with an individual net worth of over \$1,000,000 (not including the value of a primary residence), an individual income in excess of \$200,000 in each of the two most recent years, or a joint income of \$3,000,000 in each of those two years, is considered an accredited investor.³⁸

The Intrastate Exemption & State Crowdfunding Legislation

In light of the SEC’s significant delay in implementing Title III national equity crowdfunding, a number of states have crafted *intrastate* crowdfunding exemptions, based on the federal intrastate exemption in §3(a)(11) of the ’33 Act.³⁹ Section 3(a)(11) exempts “any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State or Territory.” This exemption recognizes that state, not federal, regulation is more appropriate for an issuer that only offers and sells securities within one state and does most of its business within that state.

Issuers may also rely on the SEC’s Rule 147, known as the “safe harbor” rule, which provides specific guidance on §3(a)(11) offerings.⁴⁰ For example, Rule 147 specifies that at least 80% of the gross revenues and its subsidiaries (on a consolidated basis) be derived from the subject state in order to be deemed “doing business within a state or territory.” Rule 147 states that the legislative history of §3(a)(11) suggests that “the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing to local industries, carried out through local investment.”

Unlike the Title III crowdfunding exemption, §3(a)(11) does not limit the size of the offering, and unlike several other exemptions, §3(a)(11) does not limit the number of investors or require that they be accredited. However, it is noted that §3(a)(11) is strictly and narrowly construed, and if any of the securities are offered or sold to even one out-of-state person, the exemption may be lost and the company could be in violation of the ’33 Act.⁴¹ It is also important to note that §3(a)(11) only provides an exemption from federal registration, but does not provide immunity from the antifraud or civil liability provisions of the federal securities laws, including investor rescission. States may still require registration for purely intrastate offerings involving a general solicitation of investors.

Currently, seventeen states and the District of Columbia have some form of intrastate crowdfunding law in place (whether by statute, regulation, or administrative order), to exempt the issuer and offering from state registration, if certain regulatory requirements are met. Many of these exemptions were only recently enacted or became effective in the latter half of 2014, and intrastate crowdfunding legislation or rulemaking has been introduced and pending in more than a dozen other states.⁴² While these intrastate exemptions are based on §3(a)(11) of the ’33 Act, they also appear to be based Title III’s goals of easing regulatory burdens and promoting small business growth. Accordingly, these “hybrid” intrastate crowdfunding exemptions incorporate elements of Title III to varying degrees; for example, while most states have capped the total offering amount at \$1 million to match Title III of JOBS, some

³⁷ Title II of the JOBS Act was implemented by final SEC rule on July 10, 2013. SEC Release No. 33-9415, at: <http://www.sec.gov/rules/final/2013/33-9415.pdf>

³⁸ 17 CFR § 230.501(a)(5-6). Issuers may be exempt from the ’33 Act if they sell securities to only accredited investors in accordance with Rules 505 or 506 of Regulation D.

³⁹ 15 U.S.C. §77c(a)(11).

⁴⁰ 17 CFR §230.147.

⁴¹ U.S. SECURITIES & EXCHANGE COMMISSION, *Small Business and the SEC*, <http://www.sec.gov/info/smallbus/qasbsec.htm#intrastate>

⁴² NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, *Intrastate Crowdfunding Resource Center*, <http://www.nasaa.org/industry-resources/corporation-finance/intrastate-crowdfunding-resource-center/> (last viewed Feb. 10, 2015).

have allowed issuances up to \$2 million, or have income or net worth requirements for investors different than those found in Title III.⁴³

The cost of raising capital under an intrastate crowdfunding campaign of identical offering amount is unknown, given the infancy and wide variation of existing state intrastate crowdfunding exemptions. However, the SEC has estimated that the cost of raising capital under Title III of JOBS is approximately \$39,000 (in fees for accountants, attorneys, and funding portal) for a \$100,000 national equity crowdfunding campaign, and more than \$150,000 to raise \$1 million. The SEC estimates that initial development of an intermediary platform could cost an additional \$250,000 to \$600,000, and would likely include establishing functionalities such as investor account opening procedures, electronic delivery, and the maintenance and transmission of investor funds.⁴⁴

Additionally, data on the success of these intrastate offerings or regarding regulatory or enforcement trends is not yet available.⁴⁵

The Internet and Intrastate Offerings

Questions have arisen as to the applicability of the intrastate exemption to crowdfunding offers and sales conducted through the Internet, which can be accessed across state lines. SEC guidance from 2008 has suggested that internet-based offerings would be deemed interstate, not intrastate, in nature if out-of-state investors are given access to such offerings.⁴⁶ Some securities law experts have questioned the appropriateness and effectiveness of using §3(a)(11) for internet-based offerings, stating that the intrastate exemption is “fraught with both technical and subtle traps for issuers”⁴⁷ and may not be useful to issuers making a broad solicitation over the Internet.⁴⁸

Issuers and intermediaries conducting online crowdfunding issuances, even under the auspices of an state law referencing the federal exemption, must ensure they comply with the substantive requirements of the federal exemption, or risk running afoul of the federal securities law for illegal, unregistered transactions.⁴⁹ The North American Securities Administrators Association (NASAA) recently suggested minimum safeguards, such as password access upon residency verification, or other attestations or certifications of investor residency prior to sale.⁵⁰

⁴³ Indiana, Michigan, and Wisconsin permit up to a \$2 million offering of crowdfunding securities if the issuer has audited financial statements. The D&O Diary, *Some States have Sidestepped the JOBS Act’s Burdensome Crowdfunding Rules* (May 15, 2014), at <http://www.dandodiary.com/2014/05/articles/securities-litigation/some-states-have-sidestepped-the-jobs-acts-burdensome-crowdfunding-rules/>

⁴⁴ SEC Proposed Regulation Crowdfunding, pp. 442-454.

⁴⁵ A recent notable example of a state enforcement action against a *rewards-based* crowdfunding project is the State of Washington’s Attorney General’s lawsuit against a Kickstarter campaign promising, but failing to deliver, a deck of cards and other promotional gifts, in return for cash donations. The complaint alleged a violation of Washington State’s unfair and deceptive trade practices law. Ángel González, *AG sues Kickstarter project that didn’t deliver*, THE SEATTLE TIMES (May 1, 2014), <http://www.seattletimes.com/business/ag-sues-kickstarter-project-that-didntdeliver/>

⁴⁶ U.S. SECURITIES & EXCHANGE COMMISSION, *The SEC Guide to Broker-Dealer Registration* (Apr. 2008), <http://www.sec.gov/divisions/marketreg/bdguide.htm> (last viewed Feb. 10, 2015), stating “information posted on the Internet that is accessible by persons in another state would be considered an interstate offer of securities or investment services that would require Federal broker-dealer registration.”

⁴⁷ Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433 (2012). Available at: <http://scholarship.law.ufl.edu/flr/vol64/iss5/9>

⁴⁸ Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C.L. REV. 1735 (2012). Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1954040

⁴⁹ As noted above, national crowdfunding to unaccredited investors is not permitted until the SEC’s Title III rules are final.

⁵⁰ Letter from NASAA to the National Conference of State Legislatures (Jan. 17, 2014), on file with the Insurance & Banking Subcommittee staff. NASAA is the oldest international organization devoted to investor protection and consists of the securities regulators in the 50 states, the District of Columbia, Mexico, Puerto Rico and the U.S. Virgin Islands.

On April 10, 2014, the SEC issued interpretive guidance regarding §3(a)(11) and the Internet.⁵¹ The SEC indicated that use of a third-party Internet portal to promote an offering to residents of a single state would not violate the intrastate exemption, if the portal implemented “adequate measures,” such as disclaimers, restrictive legends, and limited access to information about specific investment opportunities to persons who confirm they are residents of the relevant states by way of zip codes or address verification. Although the SEC’s interpretive ruling is not conclusive, issuers generally would not be able to use popular social media platforms (such as Facebook, Twitter, or LinkedIn) to promote an intrastate crowdfunding offering, because these sites can be indiscriminately accessed by non-Florida residents. In addition, the issuer would likely need to ensure that an investor does not continue to use the portal after moving out of state.⁵²

Investor Protections

A primary investor protection concern regarding equity crowdfunding is that investors may not adequately appreciate the high risk of loss when investing in a startup company. According to U.S. Department of Labor statistics, almost half of all new businesses do not survive after their fifth year of operation.⁵³ Survival rates have changed little over time, even before, during, and after the recent recession.

An offering under several other securities exemptions, such as Regulation D, requires investors to be accredited in order to invest in a start-up company. On the other hand, Title III and almost all current intrastate crowdfunding exemptions allow all types of investors to participate in crowdfunding offerings, including individuals with modest incomes or net worth who may not have the financial sophistication or means to avoid or absorb a loss of investment.

Because non-accredited, intrastate equity crowdfunding is only in its infancy in several states, no data exists for average rates of return or loss. However, one study reviewed return rates in angel investments, finding a “kind of feast-or-famine universe,” where only the top 10% of angel investors garnered 75% of the total returns. Even where angel investors spread their risk through a portfolio strategy, the top 10% of angel investors still earned 50% of the total gains. However, the strategies and resources (time, due diligence, legal and accounting advice, etc.,) necessary for such investments are mostly unavailable for non-accredited investors, leaving the possibility that rates of return could be even less favorable in equity crowdfunding offerings.⁵⁴ Additionally, investments in these startup companies are illiquid, and investors cannot resell their investments until such investments are executed on an exchange or in a public market. It is unknown the extent to which a secondary market for intrastate crowdfunding securities will be readily available.

NASAA has identified internet fraud (including social media and crowdfunding) as a persistent threat facing investors in 2015.⁵⁵ NASAA and the OFR have issued investor alerts regarding crowdfunding and investment scams, respectively.⁵⁶ The SEC has also issued an investor alert regarding social media and investing.⁵⁷

⁵¹ See Questions 141.03-141.05 (issued April 10, 2014), available at <http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>

⁵² Elizabeth J. Chandler, *SEC Staff Releases Compliance and Disclosure Interpretations Related to Intrastate Crowdfunding*, THE NATIONAL LAW REVIEW (Apr. 14, 2014), <http://www.natlawreview.com/article/sec-securities-and-exchange-commission-staff-releases-compliance-and-disclosure-inte>

⁵³ U.S. DEPARTMENT OF LABOR, BUREAU OF LABOR STATISTICS, *Business Employment Dynamics, Chart 3: Survival rates of establishments*, at: <http://www.bls.gov/bdm/entrepreneurship/entrepreneurship.htm>

⁵⁴ Michael B. Dorff, *The Siren Call of Equity Crowdfunding* (Sept. 13, 2013). Available at SSRN: <http://ssrn.com/abstract=2325634>

⁵⁵ NASAA, *New Products in Classic Schemes Identified as Top Investor Threats* (Nov. 12, 2014), at <http://www.nasaa.org/33485/new-products-classic-schemes-identified-top-investor-threats/>

⁵⁶ NASAA Investor Advisory, <http://www.nasaa.org/12842/informed-investor-advisory-crowdfunding/>; OFR, *Consumer Alert: Common Investment Scam Red Flags*, <http://flofr.com/PressReleaseDetail.aspx?id=4371>

⁵⁷ U.S. Securities & Exchange Commission, *Updated Investor Alert: Social Media & Investing – Avoiding Fraud*, <http://www.investor.gov/news-alerts/investor-alerts/investor-alert-social-media-investing-avoiding-fraud>

Effect of the Bill

The bill amends the Act to create a new equity crowdfunding exemption from state securities registration. The bill requires the issuer to file a notice with the OFR before conducting an offering. These proposed securities may be generally advertised to the public (such as over the Internet), and may be sold through an intermediary, who is required to register with the OFR. The bill provides for the exempt offer and sale of up to \$1 million of unregistered securities per offering, and sets forth terms and conditions for issuers and intermediaries offering and selling such securities. The bill matches the income and investment caps set out in Title III, so that individual investments are limited to 1) the greater of \$2,000 or 5% of the investor's annual income or net worth, if annual income or net worth is less than \$100,000; and 2) 10% of the investor's annual income or net worth (not to exceed a total investment of \$100,000), if annual income or net worth is over \$100,000.

The bill clarifies that an offer or sale of a security under the crowdfunding exemption is exempt from the registration provisions of the Act, but like other exempt securities, crowdfunding securities remain subject to the Act's antifraud and boiler room provisions. The bill clarifies that *unlike* the other exempt transactions of s. 517.061, F.S., the crowdfunding exemption is not self-executing, so that crowdfunding issuers must demonstrate compliance with the requirements of this new exemption.

The securities must meet all of the requirements of the federal intrastate exemption, §3(a)(11), and the safe harbor rule, Rule 147, described above. The bill contains many similar or identical requirements of Title III of the JOBS Act.

*Issuer*⁵⁸

- The bill requires the issuer to be a for-profit business entity formed under Florida law, be registered with the Secretary of State, maintain its principal place of business in the state, and derive its revenues primarily from operations in the state.
- As with Title III of JOBS, the bill prohibits investment companies and certain companies that are required to report to the SEC.
 - The bill also disqualifies directors, officers, and 20% shareholders of the issuer based on s. 517.1611, F.S., or Rule 506(d) of the '33 Act.
 - The bill also prohibits issuers with undefined business operations, that lack business plans and stated investment goals, or that have plans to engage in a merger or acquisition with an unspecified business entity.⁵⁹
- The issuer must submit a \$200 filing fee and a notice-filing to OFR, containing specified information, and keep the notice-filing current with OFR. The bill requires the notice filing to contain certain information about the issuer, such as the amount of the offering and the intermediary's website address. The bill also specifies that fee revenue will be deposited into the Regulatory Trust Fund within the OFR.
- As with Title III of JOBS, the bill requires the issuer to execute an escrow agreement with a federally insured financial institution to deposit and hold investor funds.
 - The bill requires that escrowed funds be released only when the target offering amount is reached, and the issuer must allow an investor to cancel an investment within 3 days of the offering's deadline.
- Like Title III of JOBS, the bill requires issuers to provide a *disclosure statement* containing specified information to potential investors.
 - The issuer must also provide a copy of the disclosure statement to OFR at the time it files a notice with OFR.

⁵⁸ Current law defines "issuer" as "any person who proposed to issue, has issued, or shall hereafter issue any security. Any person who acts as a promoter for and on behalf of a corporation, trust, or unincorporated association or partnership of any kind to be formed shall be deemed an issuer." Section 517.021(14), F.S.

⁵⁹ These development-stage companies are known as "blank check companies" and often fall within the SEC's definition of "penny stocks" or are considered "microcap stocks." See U.S. SECURITIES & EXCHANGE COMMISSION, *Blank Check Company*, at

<http://www.sec.gov/answers/blankcheck.htm>

- The disclosure statement must include certain financial disclosures (depending on the target amount of the offering) and standard language that the investor must accept to affirm his or her knowledge and understanding of the risks involved with crowdfunding.⁶⁰

Intermediary

The intermediary may be either a natural person who resides in Florida or a legal entity registered with the Secretary of State to do business in Florida. The bill creates a definition of “intermediary” to mean a natural person residing in this state, or legal entity registered with the Secretary of State to do business in this state, that facilitates the offer or sale of securities under the crowdfunding exemption.

The bill contains several requirements that are similar or identical to requirements in Title III. The bill:

- Prohibits intermediaries from engaging in crowdfunding transactions if certain affiliated persons are disqualified based on their regulatory and criminal backgrounds.
- Requires intermediaries to conduct a background check and regulatory enforcement history check on each officer, director, and persons holding more than 20% of the issuer’s outstanding equity.
- Requires intermediaries to provide specified basic information on its website, including its business plan, a description of the escrow agreement for investor funds, and whether its financial information has been audited by an independent certified public accountant.
- Requires intermediaries to conduct certain due diligence requirements, such as:
 - Verifying that potential investors are Florida residents in order to comply with the intrastate requirement,
 - Obtaining affidavits from investors stating their investments are consistent with the Act’s income requirements, and require investors to certify in writing that they acknowledge the risks of the investment,
 - Depositing and releasing investor funds in accordance with the Act’s escrow requirements,
 - Providing monthly updates to investors after the offering’s first full month,
 - Directing investor funds to the qualified third-party designated in the escrow agreement, and
 - Taking reasonable steps to protect investors’ personal information, as required by s. 501.171, F.S.⁶¹
- Prohibits an intermediary from:
 - Offering investment advice or recommendations;
 - Soliciting purchases, sales, offers (or compensate others to solicit) to buy the securities offered on its website;
 - Holding, managing, possessing, or otherwise handling investor funds or securities; and
 - Compensating certain third parties for providing personal identifying information of potential investors.

Intermediary Registration

- The bill requires intermediaries to be registered dealers or to register as an intermediary, and creates a new registration requirement for the latter within s. 517.12, F.S. The bill requires a \$200 filing fee, a consent to process, and information determined by commission rule as part of the application. The bill also specifies that fee revenue will be deposited into the Regulatory Trust Fund within the OFR.

Books and Records

The bill amends s. 517.121, F.S. to require intermediaries to be subject to the Act’s requirements to maintain books and records and OFR examinations.

B. SECTION DIRECTORY:

Section 1. Amends s. 517.021, F.S., relating to definitions.

Section 2. Amends s. 517.061, F.S., relating to exempt transactions.

⁶⁰ Similar or identical language appears in other state crowdfunding exemptions, e.g., Mich. Comp. Laws §451.2002a(1)(h).

⁶¹ Section 501.171, F.S., is the Florida Information Protection Act of 2014, which requires “covered entities” to give notice of a security breach to the Department of Legal Affairs. Ch. 2014-189, Laws of Fla.

Section 3. Creates s. 517.0611, F.S., relating to the Florida Intrastate Crowdfunding Act.

Section 4. Amends s. 517.12, F.S., relating to registration of dealers, associated persons, and investment advisers.

Section 5. Amends s. 517.121, F.S., relating to books and records requirements; examinations.

Section 6. Amends s. 626.9911, F.S., relating to definitions.

Section 7. Provides a nonrecurring appropriation for the 2015-2016 fiscal year.

Section 8. Provides an effective date of October 1, 2015.

II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

The bill has a positive, yet indeterminate, fiscal impact to state revenues. The bill requires issuers to pay notice-filing fees (\$200) and requires intermediaries to pay registration fees (\$200). However, the anticipated number of notice-filing and registration applications is unknown at this time.⁶²

2. Expenditures:

The bill appropriates \$120,000 in nonrecurring funds from the Regulatory Trust Fund within the OFR to implement provisions of the bill. The OFR indicates that it is difficult to anticipate the full impact of this program change, but that provisions of the bill are anticipated to create increased workload for the OFR. The OFR noted that additional IT support, increased storage, and modifications to the Regulatory Enforcement and Licensing (REAL) system would be necessary to implement provisions of the bill relating to the integration of notice-filings by issuers and applications by intermediaries. The OFR estimates the cost to perform the necessary IT upgrades to be approximately \$63,150. The bill also authorizes the Financial Services Commission to adopt rules creating electronic forms for notice-filings and applications.⁶³

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

Indeterminate. It is unknown how many issuers and intermediaries will utilize this exemption.

The bill may provide an additional source of capital for new businesses in Florida. As discussed above, however, the rates of return or loss for crowdfunding investors are also unknown.

D. FISCAL COMMENTS:

None.

⁶² Office of Financial Regulation, Agency bill analysis of 2015 House Bill 275. (March 18, 2015)

⁶³ *Id.* at pp. 5-6.

III. COMMENTS

A. CONSTITUTIONAL ISSUES:

1. Applicability of Municipality/County Mandates Provision:

Not applicable. This bill does not appear to: require counties or municipalities to spend funds or take an action requiring the expenditure of funds; reduce the authority that counties or municipalities have to raise revenues in the aggregate; or reduce the percentage of a state tax shared with counties or municipalities.

2. Other:

The OFR notes that the SEC has not yet promulgated final rules implementing interstate crowdfunding under Title III of the JOBS Act, and notes that such final rules could conflict with provisions of the bill or rules adopted under it.⁶⁴

B. RULE-MAKING AUTHORITY:

The bill grants authority to the Financial Services Commission to adopt rules for notice-filing and application forms, procedures, the deposit of notice-filing and registration fees, certain financial reporting requirements, intermediary requirements for reducing the risk of fraud, prohibited intermediary activities, and books and records requirements for intermediaries.

C. DRAFTING ISSUES OR OTHER COMMENTS:

None.

IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES

On March 31, 2015, the Government Operations Appropriations Subcommittee adopted three amendments and reported the bill favorably as a committee substitute. The amendments:

- Specify that fee revenue collected for issuer application filings shall be deposited into the Regulatory Trust Fund within the Office of Financial Regulation.
- Specify that fee revenue collected for intermediary application filings shall be deposited into the Regulatory Trust Fund within the Office of Financial Regulation.
- Provides a nonrecurring appropriation of \$120,000 from the Regulatory Trust Fund to implement provisions of the bill.

This analysis is drafted to the committee substitute as passed by the Government Operations Appropriations Subcommittee.

⁶⁴ *Id.* at p. 7.