



Arizona State Senate Issue Brief

July 28, 2016

Note to Reader:

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CROWDFUNDING, CAPITAL RAISING AND SECURITIES

INTRODUCTION

Crowdfunding is a recent development in fundraising involving a large number of people contributing a relatively small amount of money to a combined fund. Examples of the crowdfunding platform include raising funds for startup companies, blockbuster movies and medical treatment for sick patients.

While crowdfunding has become increasingly popular, it has primarily been used as a form of fundraising with individual contributions given as donations to specific beneficiaries with donors receiving no return on their investment. In recent years, however, the use of crowdfunding has become prevalent in the offering and sale of securities, allowing contributors to invest their money in private equity rather than simply donating to a cause of their choice. Federal and state laws, however, currently require the registration of many types of securities and regulate the types of investors who can purchase them in offerings exempt from registration.

Generally speaking, a security is any type of tradable financial asset, such as a stock or bond, which is sold by an issuer to an investor for capital raising purposes. Prior to 1933, there were no federal restrictions placed on the offering or sale of securities. States began enacting securities laws beginning in 1911 in order to protect investors from fraud. Arizona enacted its first securities law in 1912. The stock market crash of 1929 along with the Great Depression, however, called into question the issue of consumer protection with respect to these kinds of transactions on a nationwide scale. This concern led to the passage of the federal Securities Act of 1933 (Securities Act), which was intended to ensure that prospective purchasers receive accurate information about the securities they choose to invest in. The U.S. Securities and Exchange Commission (SEC), established by the Securities Exchange Act of 1934 (Exchange Act), is currently responsible for enforcing the Securities Act and other federal laws pertaining to the registration, offering and sale of securities.

THE SECURITIES AND EXCHANGE COMMISSION (SEC)

The SEC, which is comprised of five members appointed by the President of the United States, was established by the Exchange Act. Along with the Securities Act, the Exchange Act was designed to reestablish investor confidence in the financial markets.

The registration of securities allows investors access to important financial data by requiring issuers to disclose certain information. This includes a description of the company's assets, business and the securities to be offered for sale, as well as information about the management of the company and financial statements certified by independent accountants. Registration also creates a traceable securities market and allows the SEC to carry out rules designed to promote market stability and protect investors.

Since the creation of the SEC, Congress has passed several laws governing the agency and its purpose. These include:

- **Securities Act of 1933:** *Required issuers of securities to provide complete and accurate information to investors.*
- **Securities Exchange Act of 1934:** *Established the SEC and set laws governing the secondary trading of securities.*
- **Trust Indenture Act of 1939:** *Supplemented and clarified the Securities Act in order to protect bond investors.*
- **Investment Company Act of 1940:** *Regulated mutual funds, closed-end funds, hedge funds, private equity funds and holding companies.*
- **Investment Advisers Act of 1940:** *Regulated investment advisers.*
- **National Securities Markets Improvement Act of 1996:** *Amended federal securities laws to promote efficiency and capital formation in the financial markets, and created the bifurcated regulation of investment*

advisers between the states and federal government. The law also preempted the application of state registration requirements for covered securities.

- **Sarbanes-Oxley Act of 2002:** *Regulated public corporations and their boards of directors and added criminal penalties for certain misconduct.*
- **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010:** *Passed in response to the Great Recession, the law was a sweeping overhaul of the U.S. financial regulatory system designed to promote transparency and accountability.*
- **Jumpstart Our Business Startups Act of 2012:** *Aimed at promoting the funding of small businesses through the easing of several securities regulations.*
- **Other Rules and Regulations:** *Various internal rules, regulations and policies that govern the SEC.*

ACCREDITED VERSUS UNACCREDITED INVESTORS

While securities registration typically allows for unrestricted sales, registration can be expensive and time-consuming. In some exemptions from registration, the SEC has restricted the purchasing of securities to accredited investors only. Those who are considered to be unaccredited investors are not eligible to purchase these securities. The SEC has set forth certain criteria which must be met in order to qualify as an accredited investor (See 17 C.F.R. § 230.501). These include:

- *Earning an individual income of more than \$200,000 per year;*
- *Having a net worth of over \$1 million, either alone or together with a spouse (excluding the value of the person's primary residence);*
- *Being an entity such as a bank, partnership, corporation, nonprofit organization or trust with total assets in excess of \$5 million not formed to*

specifically purchase the subject securities;

- *Being any trust with total assets in excess of \$5 million not formed to specifically purchase the subject securities, the purchase of which is directed by a sophisticated person; or*
- *Being any entity with total assets in excess of \$5 million.*

It is estimated that roughly three percent of Americans meet at least one of the criteria listed above, thus qualifying them as accredited investors. The remaining 97 percent of individuals are considered unaccredited and are, in most cases, unable to purchase unregistered securities or invest with the companies of their choosing. The SEC states that such restrictions are in place in order to identify persons who are able to withstand the level of financial risk typically associated with purchasing unregistered securities in return for equity in a company.

THE JOBS ACT AND EQUITY CROWDFUNDING

Over the last decade, crowdfunding has become a popular avenue for small business startups to raise capital. A number of websites have become internet portals where entrepreneurs can exhibit their merchandise or idea and present their business plan to potential donors. The rules governing the offering and sale of securities, however, limited capital-raising to donations only, thus leaving out those individuals seeking a return on their investment. This quickly became an issue for those donors who saw many small companies that they invested in become large multi-million dollar enterprises under no legal obligation to share their profits. In response, on April 5, 2012, the Jumpstart Our Business Startups Act (JOBS Act) was signed into law by President Barack Obama. The JOBS Act includes several parts that permit equity crowdfunding and allow unaccredited

investors to participate where they previously could not.

Titles II and III of the JOBS Act specifically address exemptions for crowd-funded securities offerings. Title II lifts the SEC's ban on general solicitation for private securities offerings, allowing for advertising of capital raising activity. Title III authorizes the offering and sale of securities through crowdfunding, including to unaccredited investors. These exemptions are available provided certain conditions and requirements are met.

The implementation of certain portions of the JOBS Act was contingent upon SEC approval. Title II went into effect September 23, 2013. Approval of Title III, however, did not formally occur until October 30, 2015, when the SEC voted 3-1 to adopt final rules for Title III, allowing companies nationwide to offer and sell securities through equity crowdfunding, subject to certain limitations. The JOBS Act originally directed the SEC to adopt rules implementing Title III within 270 days of the law's enactment. The delay in adopting rules has been attributed to leadership changes within the agency and debate among SEC members over how best to protect unaccredited investors that participate in equity crowdfunding transactions.

The new SEC rules allow a company to raise a maximum aggregate amount of \$1,000,000 through crowd-funded securities offerings within a 12-month period. An individual investor whose annual income or net worth is less than \$100,000 may invest either \$2,000 or 5 percent of his or her annual income or net worth, whichever is greater. An individual investor whose annual income and net worth are \$100,000 or more may invest 10 percent of his or her annual income or net worth, whichever is less. The aggregate amount of securities that is sold by a company to an investor through all crowd-funded

offerings within a 12-month period may not exceed \$100,000. All crowdfunding transactions must be conducted through an intermediary that is either a broker-dealer or a funding portal registered with the SEC, and a company that relies on the new rules must conduct its offering exclusively through one intermediary at a time. Securities purchased in a crowdfunded offering generally may not be resold for a period of one year after purchase, at which point they become freely tradable.

The forms enabling funding portals to register with the SEC became effective January 29, 2016. The new rules became effective May 16, 2016.

STATE LEGISLATION

In light of the prolonged delay in SEC rulemaking, many states began enacting their own intrastate crowdfunding exemptions. As of June 2016, at least 31 states and the District of Columbia have either passed some form of crowdfunding legislation or have accomplished the same goal through rulemaking. State crowdfunding laws have been characterized as generally being more permissive with respect to company disclosure, ongoing compliance and reporting requirements, and the solicitation of investors, among other features, than their federal equivalent. The maximum aggregate amounts that can be raised by a company or invested by an individual in that company also vary widely, depending on the limits and restrictions of each state's particular crowdfunding law. According to the North American Securities Administrators Association (NASAA), a company relying on an intrastate crowdfunding exemption may currently raise an aggregate amount of between \$100,000 and \$4,000,000 within a 12-month period, depending on the jurisdiction, with an individual investor being limited to investing anywhere between \$100

and \$100,000 in such a company, unless he or she falls into the accredited investor category. A company could thus potentially raise more capital through crowdfunding under some state laws than it would under federal law. Its pool of potential investors, however, would be limited to residents of the state where it chooses to initiate its securities offering.

ARIZONA'S CROWDFUNDING LAW

Arizona's crowdfunding legislation, H.B. 2591 (Laws 2015, Chapter 185), was signed into law by Governor Doug Ducey on April 1, 2015. The new law, A.R.S. § 44-1844(D), exempts issuers of securities from current state securities registration requirements, provided that certain criteria are met. Specifically, the law exempts the offering and sale of securities provided that the aggregate securities offering amount, without a financial audit, does not exceed \$1,000,000 over a 12-month period. In the event that a financial audit is provided, an aggregate amount of up to \$2,500,000 within a 12-month period may be exempted from registration. Unaccredited investors are limited to making a \$10,000 investment within a 12-month period per individual investor.

All issuers of crowdfunded securities must be business entities organized under the laws of Arizona, authorized to do business in the state, and conduct business in accordance with the Securities Act. All sales of the exempt securities must occur through a web portal or internet website operated by a registered dealer in Arizona, the issuer of the securities sold, or a person who does not receive a commission or remuneration, directly or indirectly, for the offer or sale of the securities. The funds must be held by an independent escrow agent authorized to do business within the state. Securities purchased in a crowdfunded offering may not be resold for a period of at least nine months from the date of the last sale of such securities by the

issuer to a resident of this state, at which point they become freely tradable.

THE CORPORATION COMMISSION AND CROWDFUNDING

The Arizona Corporation Commission (ACC) was established under Article 15 of the Arizona Constitution. The ACC is constitutionally and statutorily charged with the regulation of securities in this state and is responsible for all rulemaking associated with the registration, offering and sale of securities pursuant to Arizona law.

Similar to the SEC, the ACC states that it strives to preserve the integrity of the financial marketplace through investigative actions as well as the registration and oversight of securities, securities dealers and salespersons, and investment advisers and their representatives; to enhance legitimate capital formation and deter financial fraud; and to minimize the burden and expense of regulatory compliance by legitimate business. The ACC reviews prospective securities offerings and oversees dealers, investment advisers and their agents by investigating possible violations and initiating civil action when appropriate.

Pursuant to Laws 2015, Chapter 185, effective July 3, 2015, the ACC has oversight over all solicitations for funding carried out under the state's crowdfunding exemption. Companies wishing to participate must file a notice with the agency prior to the start of any crowdfunded securities offering.

ADDITIONAL RESOURCES

- **Arizona Corporation Commission (ACC)**
1200 W. Washington
Phoenix, AZ 85007-2996
(602) 542-4242
<http://www.azcc.gov/>
- **Arizona Securities Act:** Arizona Revised Statutes, Title 44, Chapter 12
- **North American Securities Administrators Association (NASAA)**
750 First Street NE, Suite 1140
Washington, DC 20002
(202) 737-0900
<http://www.nasaa.org/>
- **U.S. Securities and Exchange Commission (SEC)**
100 F Street, NE
Washington, DC 20549
(202) 942-8088
<http://www.sec.gov/>
Los Angeles Regional Office
444 South Flower Street, Suite 900
Los Angeles, CA 90071
(323) 965-3998
<https://www.sec.gov/page/sec-los-angeles-regional-office>
- **Investor Bulletin: Accredited Investors**
<http://www.investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors>