



NASAA

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Mr. William T. Pound
National Conference of State Legislatures
444 North Capitol Street, N.W., Suite 515
Washington, D.C. 20001

Dear Mr. Pound:

On behalf of the North American Securities Administrators Association,¹ I am writing to call your attention to recent state legislative efforts to adopt state crowdfunding exemptions. NASAA does not support or oppose state efforts to craft a state crowdfunding alternative, but wants to make sure your members are aware of some preliminary concerns emanating from the bills that have been introduced or passed to date,² most notably state bill conflicts with federal securities laws.

To the extent your members are interested in pursuing their own state crowdfunding bills, NASAA would like to offer a few key recommendations for you to share in an effort to protect your state's small businesses and crowdfunding intermediaries from unanticipated federal securities law violations and to protect their investors, particularly mom and pop retail investors, from undue risk and loss in this emerging space.

I. BACKGROUND

Title III of the Jumpstart Our Business Startups Act ("JOBS Act"), enacted on April 5, 2012, created a federal exemption for equity crowdfunding or offerings conducted through trading platforms known as intermediaries, including a new breed of securities firms known as funding portals. Crowdfunding is typically done on-line with fundraisers collecting relatively small amounts from large numbers of donors, i.e., the crowd. In recent years, crowdfunding has become a popular tool for artistic ventures and start-ups to receive public donations of money through online websites such as Kickstarter and indiegogo. Through the JOBS Act, businesses will be able to raise money by crowdfunding for investors through the internet. Issuers can raise no more than \$1,000,000 per year through the new crowdfunding exemption and individual investors may

¹ The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for investor protection and efficient capital formation.

² References to the word "bill" include state exemptions adopted by legislation, regulation or order.

generally invest no more than \$2,000 or 5-10% of their annual income, whichever is greater, per year based on applicable net worth and income thresholds.³

Prior to enactment of the JOBS Act, states such as Kansas and Georgia had already enacted their own securities offering exemptions pursuant to the federal intrastate exemption found in Section 3(a)(11) of the Securities Act of 1933 and further interpreted by SEC Rule 147, 17 CFR § 230.147, in an effort to stimulate local, community-based offerings.⁴ Due to the federal overlay of general solicitation prohibitions and federal licensing requirements, however, the states were restrained from allowing broad, commission-based internet offerings.

While much of the new federal crowdfunding structure and compliance requirements were articulated by Congress in the JOBS Act itself, the U.S. Securities and Exchange Commission (SEC) was given 270 days to promulgate rules to implement the new offering exemption. Due to competing priorities, the SEC did not meet the established deadline, but has since released the rule proposal. SEC Release Nos. 33-9470; 34-70741 (October 23, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>. NASAA will be providing its formal comments regarding the rule proposal by the February 3, 2014 deadline, but expects it will take several months for the SEC to release a final rule that will finally authorize exempt crowdfunding deals in the U.S. markets.

Due to the SEC's delay in rule implementation and, in some cases, industry dissatisfaction with the federal crowdfunding exemption itself, several states have proposed or enacted their own state crowdfunding bills as an alternative. All bills except for a discussion draft currently being considered in Maine contemplate a state crowdfunding exemption from registration that parallels the federal exemption in some fashion. The alternative approach being considered in Maine is to allow a short-form state crowdfunding registration that is tied to the federal exemption found in Rule 504 of Regulation D, 17 CFR § 230.504. Two bills, those coming out of the states of Michigan and Wisconsin, have already been signed into law.

State securities regulators are not always consulted in the drafting of these exemptions. As a result, some provisions of these state-level crowdfunding exemptions do not align with federal securities requirements and may create unanticipated registration violations for both the small business issuers and internet platforms who utilize the new state exemptions. In view of the complicated interplay between state and federal securities law in the crowdfunding context, NASAA respectfully requests that state legislatures interested in pursuing a state crowdfunding alternative to the federal exemption carefully consider the following policy issues.

³ The United States Securities and Exchange Commission has proposed further restricting the five percent (5%) and ten percent (10%) individual investor limitation to a \$100,000 total cap in its crowdfunding rule proposal. See SEC Release Nos. 33-9470; 34-70741 (October 23, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>. The SEC proposed expanded the restriction in another sense, however, by allowing investors to utilize the higher of either net worth or income standards in applying the 5% and 10% limitations. *Id.*

⁴ Section 3(a)(11) of the Securities Act of 1933 provides: "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 business within or, if a corporation, incorporated by and doing business within, such State or Territory." 15 USC § 77c(a)(11). SEC Rule 147 provides a "safe harbor" that guarantees compliance with Section 3(a)(11) if the conditions set forth in the rule are met. 17 CFR § 230.147.

(1) Compliance with applicable federal offering exemptions

While most of the state crowdfunding bills introduced to date exempt the securities offering from state registration, the approaches taken to address federal registration requirements vary. The majority of states include an explicit reference to the federal intrastate offering exemption found under Section 3(a)(11) of the Securities Act and the corresponding Rule 147. Inclusion of this reference is helpful as it indicates sophistication from a drafting standpoint as well as recognition that compliance with federal securities requirements is necessary. For bills that do not refer to federal statutes directly, quoting the applicable language of Section 3(a)(11) would suffice.

Even where a state bill, explicitly or implicitly, references the federal intrastate exemption, it is critical that the bill complies with the substantive requirements associated with the applicable federal exemption. Bills referencing Section 3(a)(11), for example, can only be offered intrastate to residents of the member jurisdiction. SEC guidance suggests that internet-based offerings would be deemed interstate, not intrastate, in nature if out-of-state investors are given access to such offerings.⁵ At a minimum, a state would be well advised to require issuer implementation of basic precautionary measures that would avoid targeting and sales to out-of-state residents.⁶ Such measures could include prominent disclaimer text that the offering is limited to home state residents, password access upon residency verification, or other attestations or certifications of investor residency prior to sale. State crowdfunding bills that purport to allow unrestricted offerings via the internet would not appear to comply with Section 3(a)(11) and Rule 147. Under such circumstances, all sales made by issuers pursuant to the unrestricted internet solicitation would constitute illegal, unregistered transactions under federal law.

(2) Compliance with federal broker-dealer licensing requirements

Generally, any person acting as a “broker” or “dealer” as defined by Section 3(4), and 3(a)(5) of the Securities Exchange Act of 1934, respectively, must be registered with the SEC and join a self-regulatory organization—the Financial Industry Regulatory Authority (FINRA), a national securities exchange, or both. Broker-dealers must also comply with state law registration requirements. Broker-dealers that conduct their business on a purely intrastate basis are not

⁵ The SEC Guide to Broker-Dealer Registration, available at <http://www.sec.gov/divisions/marketreg/bdguide.htm> states that “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.” That guidance is consistent with SEC pronouncements going back as far as 1937 in which the SEC’s General Counsel stated: “In any consideration of the exemption it is essential to appreciate that its application is . . . expressly limited to cases in which the entire issue of securities is offered and sold exclusively to residents of the state in question.” Sec. Act. Rel. 1459 (1937); *accord* Louis Loss, Joel Seligman & Troy Paredes, *Fundamentals of Sec. Reg.*, Vol. 1, at 520-25 (6th ed. 2011); Sec. Act Rel. 4434 (1961).

⁶ In evaluating its own jurisdiction regarding U.S. investors’ exposure to foreign offerings posted on the internet, the SEC has indicated foreign issuers and financial service providers would need to implement precautionary measures reasonably designed to ensure U.S. investors are not being targeted and that no sales to U.S. investors are ultimately made. See SEC Release no. 33-7516 (March 23, 1998), available at <https://www.sec.gov/rules/interp/33-7516.htm>.

required to register at the federal level,⁷ but applicable SEC guidance is clear that the intrastate exemption is narrowly construed and offerings advertised through the internet are deemed interstate, not intrastate, in nature:

The exception provided for intrastate broker-dealer activity is very narrow. To qualify, all aspects of all transactions must be done within the borders of one state. This means that, without SEC registration, a broker-dealer cannot participate in any transaction executed on a national securities exchange or NASDAQ. Also, 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.⁸

Most of the state crowdfunding bills introduced to date fail to address these overarching federal broker-dealer registration requirements, relying perhaps on the faulty premise that an intrastate label on the offering alone is enough to bypass federal licensing requirements. For example, bills enacted in Wisconsin and New Jersey purport to allow unregistered internet platforms to be compensated for facilitating the sale of securities without a broker-dealer license. As defined, the activity requires registration with the SEC and FINRA. Unregistered internet platforms relying on the state exemption will be engaging in unlicensed sales subject to SEC action and potentially other adverse consequences.

Other state crowdfunding bills provide that crowdfunding transactions be conducted through an “intermediary” as is required by the JOBS Act, but may not appreciate the federal registration requirements associated with the intermediary status. Intermediaries are required to first register with the SEC as either a broker or “funding portal” and with any applicable SRO before they engage in crowdfunding occurring over the internet. The SEC has issued guidance that no intermediaries, not even registered broker-dealers, should be engaging in crowdfunding transactions pursuant to the exemption created in the JOBS Act until the SEC’s crowdfunding rules are finalized:

Please keep in mind that the SEC still has to write rules to implement the crowdfunding provisions of the JOBS Act. Until the SEC has completed this rulemaking, you cannot act as a crowdfunding intermediary, even if you are already a registered broker.⁹

Even once SEC rules are finalized, it is not clear that registered intermediaries will be able to complete intrastate crowdfunding offerings given the JOBS Act directive that a broker-dealer

⁷ Section 15(a)(1) of the Exchange Act provides an exemption from broker-dealer registration for a broker-dealer whose business is “exclusively intrastate and who does not make use of any facility of a national securities exchange.” 15 U.S.C. 78o(a)(1).

⁸ SEC Guide to Broker-Dealer Registration, available at <http://www.sec.gov/divisions/marketreg/bdguide.htm> (emphasis added).

⁹ SEC FAQs About Crowdfunding Intermediaries (Division of Trading and Markets May 7, 2012), available at <https://www.sec.gov/divisions/marketreg/tmjjobsact-crowdfundingintermediariesfaq.htm>.

exemption is available only where the business is conducted solely in compliance with the federal crowdfunding rules.¹⁰ Moreover, at this time, there are no registered crowdfunding intermediaries approved at the federal level because the SEC rules are still not finalized. Unregistered internet portals or other intermediaries who complete intrastate crowdfunding offerings on a commission or other transactional basis over the internet will be doing so illegally. A better state legislative approach may be to prohibit transaction-based compensation unless the intermediary is a registered broker-dealer.

(3) Investor Protection

Given the potential for large numbers of unsophisticated and unaccredited investors¹¹ to participate in state-level crowdfunding offerings, NASAA recommends a balanced approach that reflects smarter regulation when consulted on state crowdfunding bills. We encourage state legislatures to employ a maximum annual offering limit as well as an individual investor limit that takes into account the type of investors participating in these offerings. The first state to adopt an exemption targeted at community investors, Kansas, set the limits at \$1 million and \$5,000 (unless the investor is accredited), respectively. The JOBS Act crowdfunding provisions also utilized a \$1 million offering limit and imposed similar individual limits of \$2,000 or 5-10% of applicable net worth or income.

NASAA discourages state legislatures from pursuing bills that do not take into account the unsophisticated nature of many of these investors. For example, the Wisconsin law creates a new classification of “certified investors” who are allowed to invest unlimited sums in these high-risk offerings without sufficient income or net worth to meet even the outdated accredited investor definition. Creating new investor classes that conflict with the federal standards may also result in unanticipated registration violations for both small business issuers and crowdfunding intermediaries.

NASAA encourages state legislatures to consider other investor protection provisions that have been included in some state crowdfunding bills, including a short notice filing to states that includes information about the company, its officers, directors and agents involved in the offering, and the amount being raised. A few states have also required that a basic disclosure document be provided to investors with information about the use of proceeds, financial condition of the issuer,

¹⁰ Section 3(a)(80) of the Exchange Act states that the term “funding portal” means any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6) of the Securities Act, or the federal crowdfunding rules. Section 3(h) sets forth the limited exemption for funding portal registration as broker-dealers. In order to be exempt from broker-dealer registration, funding portals must be subject to SEC authority and be a member of a registered national securities association (i.e., FINRA). It also states that the national securities association “shall only examine for and enforce against a registered funding portal rules of such national securities association written specifically for registered funding portals.” The practical effect of these provisions is that a registered funding portal is exempt from broker-dealer registration if it conducts its business solely in compliance with the federal crowdfunding rules.

¹¹ The definition of an “accredited investor” includes “[a]ny natural person whose individual net worth, or joint net worth with that person’s spouse [exclusive of the person’s primary residence], exceeds \$1,000,000” and “[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.” 17 CFR § 230.501.

risk profile of the offering. Another good addition in a few bills is a disqualification provisions for “bad actors.” Finally, a few bills contemplate investor attestations or certificates of acknowledgement regarding the risks disclosed in the offering. We caution states from limiting investor recourse against an issuer that fails to meet the standards set forth in the exemptions.

Thank you for your attention to these concerns. Should you or any of your members have questions or require additional information, please do not hesitate to contact myself, Anya Coverman, NASAA’s Deputy Director of Policy, or Rick Fleming, NASAA’s Deputy General Counsel, at (202) 737-0900.

Sincerely,

Russ Iuculano
NASAA Executive Director