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July 31, 2017

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 ("NASAA"),[1] I am writing to advise you of recent federal regulatory changes that impact state crowdfunding laws. These new federal rules provide states with more flexibility to account for advances in business practices and communications technology when drafting state crowdfunding laws. To fully realize the potential benefits of the new federal rules, modifications to existing state laws and/or regulations may be required.

In light of the NCSL's long-standing interest in state crowdfunding, I wanted to alert you and your membership about these new federal policies, and provide a short overview of how they could impact state crowdfunding laws.

I. Background

Crowdfunding is an online money-raising strategy. It began as a way for the public to donate small amounts of money, often through social networking websites, to help artists, musicians, filmmakers and others finance their projects. In return for these donations, donors received items such as t-shirts and CDs. The concept has expanded beyond the donation model. Small businesses and start-ups can now use crowdfunding to solicit investors who provide the capital necessary to help get their business ventures off the ground.

As of July 31, 2017, thirty-four states and the District of Columbia have enacted intrastate, or state-based, crowdfunding laws, through legislation, rulemaking and orders.[2] These laws allow small and emerging companies in these states to raise capital from local, in-state investors through the issuance of securities. In general, businesses can raise money from local investors directly or through an intermediary such as a broker-dealer or a state-based online

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[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. ("NASAA") 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] Alabama, Alaska, Arizona, Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Mississippi, Minnesota, Montana, Nebraska, New Jersey, North Carolina, Oregon, South Carolina, Tennessee, Texas, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

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platform or portal. The amount a business can raise, and individual investment limits, are determined by each state's crowdfunding laws.

State and federal securities laws govern a company's issuance of securities, including through state crowdfunding. Those laws require companies to either register their securities or find an available exemption from registration. Importantly, a business conducting state crowdfunding must meet both a state and federal exemption. Most state crowdfunding laws are linked to the federal "intrastate" offering exemption—Section 3(a)(11) of the Securities Act of 1933 ("Securities Act") and its corresponding Rule 147. A few state crowdfunding laws are tied to the federal exemption in Rule 504 of Regulation D.

Recent amendments to these federal regulations, discussed below, stand to directly impact the efficacy and potential of state crowdfunding laws. Specifically, by modernizing the federal securities exemptions that are referenced in state crowdfunding laws, small companies can make better use of state crowdfunding and other local offering exemptions to raise capital. Investors and small companies will also benefit from the rules which maintain important investor protections and preserve state authority.

II. Discussion

On October 26, 2016, in response to requests by NASAA and other stakeholders, the U.S. Securities and Exchange Commission ("SEC") unanimously voted to adopt final rules amending the federal rules that are referenced in state crowdfunding laws and other local state offering exemptions.[3]

The SEC's final rules update federal Rules 147 and 504, and create a new federal securities exemption, Rule 147A.[4] Amended Rule 147 and new Rule 147A are substantially similar, but Rule 147A contains some additional provisions. Discussed below are some of the important changes adopted in the final rules that impact state crowdfunding laws.[5]

General Solicitation and Advertising. New Rule 147A[6] allows a company to solicit and advertise its offering to out-of-state residents, so long as the ultimate investment or sale is made by in-state residents. This important change allows a company to conduct crowdfunding

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[3] Exemptions to Facilitate Intrastate and Regional Securities Offerings; 17 CFR PARTS 200, 230, 239, 240, 249, 270 and 275; Release Nos. 33-10238; 34-79161; File No. S7-22-15, *available at* https://www.sec.gov/rules/final/2016/33-10238.pdf.

[4] The amendments to Rule 504 took effect on January 20, 2017. The amendments to Rule 147 and new Rule 147A took effect on April 20, 2017. Finally, the SEC also repealed an additional exemption from registration in its final rules, Rule 505, effective May 22, 2017. The repeal of Rule 505 was based on its lack of relevance in light of the other available exemptions from registration and its nearly non-existent use by issuers.

[5] The final rules contain additional changes such as allowing a company to verify purchaser residency based on a "reasonable belief" standard, and allowing resales to out-of-state investors 6 months after the date of sale (instead of 9 months from the date of the last sale, as previously required). The rules also require a prominent and specific disclosure (i.e., disclaimer) on the security, allow verbal disclosure for verbal offers, and address issues such as integration (i.e., structuring a single transaction into multiple exempt offerings to avoid registration).

[6] Amended Rule 147 does not include this change as it is a "safe harbor" rule under a statutory provision—Section 3(a)(11) of the Securities Act. Section 3(a)(11) does not allow for out-of-state offers, including general solicitation and advertising.

over the Internet, including through the use of their publicly available website, or social media accounts such as Facebook or Twitter but sales are limited solely to in-state residents. This change protects the company for broadly advertising their offering without exposing it to liability for conducting an unauthorized interstate offer of securities.

State of Incorporation. New Rule 147A[7] allows a business to incorporate or organize out of state, so long as it has its "principal place of business" in state. "Principal place of business" is defined as the state in which the officers, partners or managers of the issuer (i.e., company) primarily direct, control and coordinate the activities of the business. This change allows an in-state business to incorporate in a different state for business or tax reasons, for example, but nonetheless remain a local, in-state business for all other purposes.

"Doing Business" Standard. Both new Rule 147A and amended Rule 147 relax a previous "doing business" standard to demonstrate a business's local residency (and thus availability of the exemption). Prior to the rule changes, a company had to meet three separate tests in order to prove they were a resident and doing business in the state.[8] Issuers and their counsel often had to engage in a difficult legal and financial analysis, prior to reliance on the exemption, to ensure compliance with each of the tests and some legitimate issuers found compliance impossible.[9] The new rule changes allow a company to meet only one of four tests to prove they are legitimately "doing business" in the state.[10]

Rule 504 Offering Limits. Rule 504 offers advantages to a company that registers their offering in a state. The company can generally solicit potential investors using any method of advertising and the securities are not restricted (i.e., are freely tradeable) upon issuance. Rule 504 also allows businesses to conduct an offering in multiple states, and provides an opportunity for a multi-state, coordinated review of the offering. The SEC increased the Rule 504 offering limit from $1 million to $5 million to capture a greater population of small businesses and increase the utility of this exemption. It also added a "bad actor" disqualification consistent with similar rules under the securities laws.

Intermediaries. The final SEC rules also provide additional federal guidance regarding the use of a publicly available website by an intrastate broker-dealer as defined in Section 15(a)(1) of the Securities Exchange Act of 1934.[11] The guidance may impact intrastate

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[7] Amended Rule 147 also does not include this change as it would not be permissible under Section 3(a)(11).

[8] The previous "doing business" standard required the issuer to: (1) derive at least 80% of its consolidated gross revenues in the state; (2) have at least 80% of its consolidated assets in the state; <u>and</u> (3) intend to use and use at least 80% of the net proceeds from the sale in-state.

[9] For example, an online business may derive a majority of sales from out of state customers and thus not be able to meet (1) above. If a business' cash is held at a national bank, it may be difficult to determine if compliance with (2) is met. An issuer may also intend to use 80% of their net offering proceeds in the state, but only be able to deploy 60% of those proceeds thus not meeting (3). Additionally, if a company uses the proceeds in state to expand its operations out of state, it may be difficult to determine if the proceeds were in fact used in state.

[10] The issuer may now satisfy the "doing business" requirement by meeting only 1 of 4 tests, the three existing tests in footnote 7 plus a new 4th test—a majority of the issuer's employees are based in the state or territory.

[11] The Release states "[w]e believe that a broker-dealer whose business otherwise meets the requirements of the intrastate broker-dealer exemption should not cease to qualify for the intrastate broker-dealer exemption solely because it has a website that may be viewed by out-of-state persons, so long as the broker-dealer takes measures reasonably designed to ensure that its business remains exclusively intrastate."

crowdfunding intermediaries or other state-registered broker-dealers that seek to qualify for the federal intrastate broker-dealer exemption.

III. **Conclusion**.

The SEC's final rules impact states that have adopted state crowdfunding laws and other limited offering exemptions tied to Rules 147 and/or 504. States may continue to reference those exemptions but may need to amend their laws to account for certain changes, such as the three-part "doing business" test. States may also wish to adopt new Rule 147A into their state crowdfunding laws. NASAA is also completing work on a multi-state, coordinated review program for Rule 504 offerings that can take advantage of the higher offering limit.

Thank you for your attention to these concerns. Please do not hesitate to contact me or Anya Coverman, NASAA's Deputy Director of Policy and Associate General Counsel at (202) 737-0900 with any questions regarding these matters.

Sincerely,

Mike Rothman
NASAA President
Minnesota Commissioner of Commerce