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# Crowdfunding In Colorado Is Now Available

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House Bill 2015-1246 (the "Colorado Crowdfunding Act") became effective August 5, 2015. The Colorado Crowdfunding Act added C.R.S. § 11-51-308.5 to the Colorado Securities Act[2] to establish an exemption from registration under the Colorado Securities Act for capital formation for small businesses seeking up to $1 million ($2 million if audited financial statements are available) from a crowd of prospective investors in what looks much like a public offering of securities. H.B. 1246's primary sponsors were Representatives Pete Lee and Dan Pabon and Senators Mark Scheffel and Owen Hill, and it passed through the 2015 Colorado General Assembly almost unanimously. According to the legislative declaration:

- Start-up companies play a critical role in expanding economic opportunities, creating new jobs, and generating revenues; and

- Lack of access to capital is an obstacle to starting and expanding small business, inhibits job growth, and has negatively affected the state's economy.

The General Assembly also determined that, in its judgment, costs and complexities of compliance with the existing registration or exemption requirements of the federal and state securities laws "can outweigh the benefits to Colorado businesses seeking to raise capital by small securities offerings" and that "crowdfunding . . . raising money on-line through small contributions from a large number of investors . . . will enable Colorado businesses to obtain capital, democratize venture capital formation, and facilitate investment by Colorado residents in Colorado start-ups, thereby promoting the formation and growth of local companies and the accompanying job creation."

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[2] COLO. REV. STAT §§ 11-51-101 *et seq*.

***The Colorado Crowdfunding Act***[3]

The Colorado Crowdfunding Act requires that the issuer and the offering be exempt from the registration requirements of federal law pursuant to the intrastate exemption set forth in § 3(a)(11) of the Securities Act of 1933 (the "1933 Act")[4] and Rule 147[5] adopted by the Securities and Exchange Commission (the "SEC"). The Colorado Crowdfunding Act was not self-implementing. Although effective August 5, 2015, the Colorado Crowdfunding Act required rulemaking from the Colorado Division of Securities (the "Division") to be implemented.

In order to be adopted before the effective date of the Colorado Crowdfunding Act, on July 29, 2015, the Division acted on an emergency basis to adopt Rules 3.20 through 3.30 after publishing draft rules and receiving public input.[6] The final rules were adopted under the Colorado Administrative Procedure Act[7] on September 2, 2015.

It is important to note that no issuer may use the Colorado Crowdfunding Act "in conjunction with any other exemption pursuant to section 11-51-307, 11-51-308, or 11-51-309 during the immediately preceding twelve-month period."[8] The precise meaning of this statutory language is not clear. Does it mean that an issuer that has issued securities pursuant to one of those Colorado exemptions in the prior twelve months is unable to raise funds under the Colorado Crowdfunding Act? Or does it mean that the prior offering and the crowdfunding offering somehow have to be related, part of a "single plan of financing"?

***The Rules.***

The rules, as adopted, are intended to implement the legislative intent as expressed in the statute and to make crowdfunding a feasible alternative to the normal methods of capital formation by small businesses in Colorado—receiving capital from "friends and family," a

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[3] This is an expanded version of articles that appeared in the Colorado Bar Association, Business Law Section's newsletter issued in April 2015 and August 2015 (available at http://www.cobar.org/index.cfm/ID/22954/subID/29329/CORP//).

[4] Securities Act of 1933, 15 U.S.C. § 77a *et seq*.

[5] 17 C.F.R. § 230.147.

[6] The rules are found in the Code of Colorado Regulations available through the Secretary of State's website at 3 COLO. CODE REGS. 704-1:51-3.20 *et seq.*, www.sos.state.co.us/CCR/NumericalDeptList.do, hereinafter the "Rules."

[7] COLO. REV. STAT § 24-4-101 *et seq.*; COLO. REV. STAT § 24-4-103(6)(a) (providing that emergency rules are effective for no more than 120 days after adoption).

[8] COLO. REV. STAT § 11-51-308.5(3)(a)(XI).

private placement pursuant to federal Regulation D,[9] venture capital financing, or a state- or federally-registered public offering.

Because the Colorado Crowdfunding Act is based on the federal intrastate exemption, it can only be used by Colorado businesses soliciting funds from Colorado residents, primarily for use in Colorado. The securities offered and sold pursuant to the Colorado Crowdfunding Act must "come to rest" in Colorado – meaning that there have to be transfer restrictions imposed under Rule 147 to ensure that, for at least nine months following the completion of the offering, the securities sold in a crowdfunding offering are not transferred to persons who are not Colorado residents.

***The Issuer and Disclosure.*** As a result of the federal intrastate offering being the basis for the Colorado Crowdfunding Act, the issuer must be organized or incorporated under Colorado law. The issuer must have its principal place of business in Colorado, and the issuer must derive at least 80 percent of its gross revenues (and those of its subsidiaries on a consolidated basis) from operations in Colorado. At least 80 percent of the issuer's assets (on a consolidated basis with its subsidiaries) must be located in Colorado. Finally, the issuer must intend to use at least 80 percent of the proceeds of the offering in Colorado.

The Colorado Crowdfunding Act is not a private placement. The Act contemplates, and the rules provide for, the issuer giving a broad public notice to persons who may be interested in the offering. The notice may be in print format or in electronic format (through email, social media, or otherwise), but must be limited to Colorado residents. Following the guidance of SEC Compliance and Disclosure Interpretation 141.04, Colorado Rule 3.24.I provides that where an electronic-based notice "sent by or on behalf of the issuer" has appropriate legends and warnings, the public notification is permitted, even where it may be accessible to non-Colorado residents.

The Colorado Crowdfunding Act and the rules[10] impose the obligation for full and fair disclosure on the issuer seeking to raise funds from the crowd. The rules include Form CF-2[11]

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[9] 17 C.F.R. § 230.501 *et seq.*

[10] RULE 3.22.B.

[11] Form CF-2 and the other forms under the Colorado Crowdfunding Act are available on the Securities Division's website at https://www.colorado.gov/pacific/dora/forms-11#Forms (last visited September 1, 2015). Form CF-1 is the issuer's notification of intention to issue securities in a crowdfunding offering; Form CF-3 is the Notification of Intention to Act as On-Line Intermediary; and Form CF-4 is the annual financial disclosure requirement for an on-line intermediary. In each case, the forms must be timely filed with the securities commissioner. When filed, the forms subject the filing party to potential liability for misleading filings under C.R.S. § 11-51-502, potential liability for fraud and other prohibited conduct under C.R.S. § 11-51-501, and investigations, enforcement actions, civil and criminal actions, and cease and desist proceedings under C.R.S. § 11-51-601 through 607.

which forms the basis for disclosure, although it is expected that many issuers will also use a memorandum format or a business plan for disclosure which they will incorporate by reference into the Form CF-2. It is likely that prospective investors will want to perform further due diligence and make inquiries of the issuer. Where the discussions with prospective investors lead the issuer to disclose material information not already contained in the Form CF-2 disclosure, the issuer must amend the Form CF-2 disclosure within five business days.[12] Where material events occur after the filing of the initial Form CF-2 (or after the filing of any amendment), the issuer must appropriately amend the disclosure within five days.

***The Investors.*** The investors must be Colorado residents. In fact, using language similar to SEC Rule 506(c),[13] the Colorado Crowdfunding Act requires that before making any sales, "the issuer shall obtain documentary evidence from each prospective purchaser that provides the seller with a reasonable basis to believe that the purchaser meets the [Colorado residency] requirements."[14] This arguably requires more than a simple investor affirmation as to residency since it requires "documentary evidence." This language suggests that the issuer must review and maintain copies of the investor's driver's license, state voting registration, utility bills, or other documentary evidence to establish residency in addition to the investor's affirmation.

No person may invest more than $5,000 in a crowdfunding offering unless that person is an "accredited investor" as that term is defined by the SEC. If a person is an accredited investor, there is no statutory limitation on the investment amount (subject to the maximum limits of the crowdfunding offering). In determining whether a person is an accredited investor, Rule 3.24.A.1 requires the issuer to have a "reasonable basis" for establishing the accredited investor status. This is language that is similar to Rule 506(c)(2)(ii) (which requires that the issuer "take reasonable steps to verify that purchasers" are accredited investors). It is not likely that an investor self-certification will be sufficient if challenged.

In any crowdfunding offering in Colorado, the prudent issuer will require the purchaser to provide documentary evidence as to residency,[15] and (if applicable) as to accredited investor status.[16] In addition, the issuer will require the investor to sign (electronically or on paper) a subscription agreement or investment letter warranting residency and acknowledging the restrictions on ownership and further transferability of the security. The subscription agreement or investment letter will also likely follow the normal form for such documents and include warranties by the purchaser that:

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[12] RULE 3.22.D.

[13] 17 C.F.R. § 230.506(c).

[14] COLO. REV. STAT §§ 11-51-308.5(3)(a)(I), (VIII).

[15] COLO. REV. STAT §§ 11-51-308.5(3)(a)(I), (VIII).

[16] RULE 3.24.A.1.

- he/she has been fully informed about the transaction, the risks, and the issuer;

- the purchaser is acquiring the securities for investment purposes only and without a view toward further distribution;

- the purchaser is aware of the transferability restrictions to which the crowdfunding securities are subject; and

- the purchaser has consulted with legal counsel and other advisors as the purchaser has determined to be necessary or appropriate in the circumstances.

These investor representations and supporting documentation are information the issuer and the on-line intermediary must maintain for at least five years.[17]

***The On-Line Intermediaries.*** The Colorado Crowdfunding Act contemplates, and the rules provide for, crowdfunding offerings being accomplished through broker-dealers, sales representatives, or on-line intermediaries. Where broker-dealers or sales representatives are involved, the Colorado Crowdfunding Act and the rules defer to FINRA which regulates broker-dealers and sales representatives that are affiliated with FINRA-member broker-dealers.[18] The Colorado Securities Act was amended to define "on-line intermediary"[19] and to describe certain prohibited activities.[20] As set forth in the statute and the rules (and especially Rule 3.29.A):

- On-line intermediaries cannot handle or possess funds or securities in the offering process.

[17] RULES. 3.23, 3.25.

[18] Under federal, state, and FINRA guidelines, a sales representative associated with a FINRA-member broker-dealer cannot act independently in this manner without the prior written authorization of the broker-dealer. See FINRA Rule 3270. Most FINRA member broker-dealers will not provide this consent because of the risk of its own liability as well as its desire to keep opportunities in-house.

Colorado law does contemplate a sales representative acting for an issuer that is not associated with a broker-dealer, whether or not a FINRA member. C.R.S. § 11-51-201(14). Any such sales representative is subject to the licensing requirements of C.R.S. § 11-51-402. While technically permitted by the statute to be involved in a crowdfunding offering independently of an on-line intermediary, Rule 3.24.H prohibits such activity by a sales representative who is not associated with or acting on behalf of a broker-dealer that is a FINRA member.

[19] COLO. REV. STAT § 11-51-201(11.5).

[20] COLO. REV. STAT § 11-51-308.5(3)(c)(III).

- On-line intermediaries cannot own a financial interest in any crowdfunding participant or receive compensation that is based on the amount raised.

- On-line intermediaries cannot be affiliated with or under common control with an issuer conducting a crowdfunding offering through that intermediary.

- On-line intermediaries cannot offer investment advice or recommendations or solicit purchases or sales of securities displayed on its website (an on-line intermediary is merely a repository for the information displayed).

- On-line intermediaries must post the disclosure documents, and likely will have extensive terms and conditions, risk warnings, and investor acknowledgements that must be accepted as a condition precedent to the investor continuing to the funding site.

- On-line intermediaries have specific record-keeping obligations, and must take steps to ascertain that the persons viewing crowdfunding offerings through their website are in fact Colorado residents.

- On-line intermediaries may generally advertise their website but may not "identify, promote, or otherwise refer to a security offered by it."[21]

The Colorado Crowdfunding Act amended the Colorado Securities Act to exempt on-line intermediaries acting within the limitations of the Colorado Crowdfunding Act from the registration requirements for broker-dealers and sales representatives.[22] Where an on-line intermediary reaches beyond the narrow scope of permissible actions described in the statute and the rules, the on-line intermediary may venture into broker-dealer territory. Unless registered as a broker-dealer, an on-line intermediary may not accept transaction-based compensation and may not engage in a general solicitation on behalf of a specific issuer.

There are a number of rules that govern on-line intermediaries, with the intention that the on-line intermediary be a bulletin board-like posting service with certain record keeping obligations.

- Rule 3.25.A defines a number of rules that the on-line intermediary must keep regarding its own actions, including "all records of compensation received for acting as an on-line intermediary" and "records of all communications that occur on or through the on-line intermediary's website." Rule 3.25 also requires that the on-line

[21] COLO. REV. STAT § 11-51-308.5(3)(c)(V).

[22] COLO. REV. STAT § 11-51-402(1)(c).

intermediary maintain all agreements and contracts with issuers and "written supervisory procedures or policies" of the on-line intermediary as required by the statute[23] and Rule 3.27.

- Rule 3.26 requires that on-line intermediaries make annual filings with the Securities Commissioner on Form CF-4.

- Rule 3.28 defines very important aspects of the on-line intermediary's responsibility which differentiate the on-line intermediary from a passive bulletin board.

    - Before permitting any person to access any Colorado offerings, the on-line intermediary needs to gather the individual's contact information and "information to establish Colorado residency."[24] This may be voting records, Department of Motor Vehicle records, or other records that provide the necessary "documentary evidence."[25]

    - Before permitting any person to access any Colorado offerings, the on-line intermediary must ensure that each such person acqknowledges the information set forth in Rule 3.28B.

- The rules contemplate that an issuer may contract with an on-line intermediary to collect residency information and preserve records for the benefit of the issuer, but this remains the issuer's responsibility.[26]

- The rules also provide that an on-line intermediary that "does nothing more than collect information regarding the purchase of securities" and "provides a link to transmit funds to the escrow agent," is not conducting a prohibited act.[27]

Rule 3.28.C imposes substantive obligations on the on-line intermediary. Rule 3.28.C requires that the on-line intermediary affirmatively "deny access" to an issuer where the on-line intermediary has a "reasonable basis for believing":

    - that the issuer is not in compliance with C.R.S. § 11-51-308.5;

[23] COLO. REV. STAT § 11-51-308.5(3)(c)(II)(C).

[24] RULE 3.28.A.

[25] COLO. REV. STAT §§ 11-51-308.5(3)(a)(I), (VIII).

[26] RULE 3.23.B.

[27] RULE 3.29.B.

- that the issuer has not established a means to keep accurate records; or

- that the issuer or offering presents the potential for fraud or otherwise raises concerns regarding investor protection.

The use of the phrase "reasonable basis" in the context of Rule 3.28.C does not necessarily impose a due diligence obligation on the on-line intermediary; it does not permit the on-line intermediary to ignore facts that would come to its attention that might suggest the negatives set forth in the Rule. The wording of this rule creates an affirmative obligation to "deny access" only when the intermediary reasonably believes wrongdoing is occurring. This prohibits "willful blindness" on the part of the on-line intermediary; however, it does not require the same level of due diligence as (for example) the rule requiring the issuer to reasonably believe that the investor is a Colorado resident,[28] which requires documentary confirmation, or Rule 3.24.A.1, which requires an affirmative "reasonable basis" for determining that a purchaser is an "accredited investor" in order to take advantage of that provision.

With experience, the on-line intermediary may become the driving force behind crowdfunding in Colorado. Where the on-line intermediary has established a successful track record of relationships with escrow agents and investors, they may attract issuers. Where the on-line intermediary has offered record retention services and other permitted services at a reasonable cost, the on-line intermediaries will be instrumental in the success of the offering and compliance with the Colorado Crowdfunding Act. Because an investor may use an on-line intermediary for more than one crowdfunding investment, the on-line intermediaries will likely look at the investors as their clients—not the issuers. Hopefully this will assist in the goal of investor protection which is the focus of the Colorado Securities Act.

***All Crowdfunding Offerings Must Be Through Escrow.*** Importantly, the Colorado Crowdfunding Act requires that all crowdfunding offerings be funded through an escrow at a depository institution, such as a bank or savings and loan.[29] The maximum amount of the offering to be raised can be no more than twice the minimum amount of the offering, and funds cannot be released from escrow until at least the minimum offering is raised.

The Colorado Crowdfunding Act provides that the escrow agent must be "a bank, regulated trust company or corporate fiduciary, savings bank, savings and loan association, or credit union authorized to do business in Colorado."[30] This is somewhat different than the

[28] COLO. REV. STAT. §§ 11-51-308.5(3)(a)(I), (VIII).

[29] COLO. REV. STAT §§ 11-51-308.5(3)(a)(IV)(D); COLO. REV. STAT 11-51-308.5(3)(a)(IV)(F); COLO. REV. STAT 11-51-308.5(3)(a)(IX).

[30] COLO. REV. STAT § 11-51-308.5(3)(a)(IV)(D).

Colorado Securities Act's definition of "depository institution,"[31] but hopefully will be interpreted similarly.

When the issuer has raised at least the minimum offering in the escrow and desires the release of the offering proceeds (whether or not the issuer wishes to continue the offering), the issuer must file a Form ES-CF with the Securities Commissioner and wait seven days before having the funds released from escrow. As a condition to the release from escrow, the issuer must also provide for the delivery of the securities and certain notices to the persons participating in the crowdfunding offering as defined in the rules. It is likely that many of the crowdfunded securities will be uncertificated. With regard to specific entities:

- Corporate stock may be certificated or uncertificated. If uncertificated, the Colorado Business Corporation Act (the "CBCA") [32] sets forth the information that must be included in a written statement that (according to the Colorado Crowdfunding Act and the rules) must be sent to the purchaser at or before the release of the escrow funds. The CBCA[33] also sets forth the information that must be included on certificates for corporate stock.

- Neither the Colorado LLC Act nor the partnership acts contemplate certificates representing ownership interests. Even an issuer-made certificate would not constitute a "certificate" in the corporate sense unless the election contemplated under Article 8 of the Uniform Commercial Code is made in the operating agreement or partnership agreement.[34]

- Where the securities consist of a debt instrument (such as a promissory note), the debt instrument should be in writing and delivered at or before the release of the escrow funds.

In any case, it is important that the issuer maintain records accurately reflecting the ownership of the securities issued in the crowdfunding offering and any other outstanding securities of the issuer. The issuer may choose to do this directly or by retaining a transfer agent to do so.

While the issuer may continue the crowdfunding offering after obtaining the release of funds from escrow, all funds must still go through the escrow account, and releases from the

[31] COLO. REV. STAT § 11-51-201(5).

[32] COLO. REV. STAT § 7-106-207.

[33] COLO. REV. STAT § 7-106-206.

[34] *See* COLO. REV. STAT § 4-8-202.

escrow must be accomplished in accordance with the rules. Furthermore, any release of funds from the escrow is likely a material event for which the issuer would be obligated to update its disclosure; the expenditure of those funds after release from escrow may also be a material event requiring updated disclosure.

***Data Collection, Record-Keeping, and Reporting.*** The on-line intermediary may provide a method of collecting data from investors who deposit funds into escrow, and may provide a portal to the escrow agent for the transfer of funds by ACH. These are among the records that the issuer must obtain and retain, although the rules provide that the issuer may contract with the on-line portal to maintain the records retention on the issuer's behalf.

During and following the offering, the issuer has certain reporting obligations to all of its owners, including the new investors. These reports are defined in the Colorado Crowdfunding Act and the rules, and the obligation continues indefinitely. Wise issuers will report more frequently to their owners and investors than the quarterly report required by the Colorado Crowdfunding Act[35] and the rules.[36] The Colorado Crowdfunding Act does set forth the minimum requirements for these reports, however, including an obligation to report the compensation being paid to the directors and executive officers and to provide a management's analysis of the issuer's business operations and financial condition.

***Bad Actors Are Prohibited.*** Certain persons are prohibited from using the exemption from registration provided by the Colorado Crowdfunding Act. These are referred to as "bad actors," and the definition is similar to the similar definition found in SEC Rule 506(d).[37] The Colorado Crowdfunding Act has provisions that the "bad actor" prohibition applies to both issuers[38] and on-line intermediaries,[39] but Rule 3.30 expands the disqualification for issuers well beyond the SEC Rule 506(d) definition of "bad actors."

The rules provide that where an issuer is subject to a bad actor disqualification, the Securities Commissioner can waive certain of the bases for disqualification. The Securities Commissioner will not waive a disqualification based on certain felony convictions and certain final orders issued by the SEC or state securities administrators. Before issuing a waiver, the Commissioner must make the following finding:

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[35] COLO. REV. STAT § 11-51-308.5(3)(a)(XIII).

[36] RULE 3.24.D ("Notice of Completion of the Transaction"); RULE 3.24.H ("Quarterly Report Timing").

[37] 17 C.F.R. § 230.506(d).

[38] COLO. REV. STAT § 11-51-3-8.5(3)(a)(XIII).

[39] COLO. REV. STAT. § 11-51-308.5(3)(c)(VII).

> In balancing all relevant factors, granting the waiver is consistent with the objective of the Colorado Securities Act to protect investors and maintain public confidence in securities markets while avoiding unreasonable burdens on participants in capital markets.

***Liability Risk From Crowdfunding***

Unlike the rewards-based crowdfunding models of Kickstarter, Indiegogo, and other similar sites, crowdfunding under the Colorado Crowdfunding Act involves the offer and sale of securities, which is subject to regulation under and compliance with federal law (the 1933 Act and the Securities Exchange Act of 1934[40]) and (in Colorado) the Colorado Securities Act.[41] Strict compliance with the Colorado Crowdfunding Act and the rules does not exempt the issuer or the other participants in the offering from potential liability; a failure to comply strictly with the Colorado Crowdfunding Act and the rules will likely lead to potential administrative civil, or even criminal liability.

***Federal Compliance.*** The first issue under the Colorado Crowdfunding Act (as under the crowdfunding legislation adopted in more than 20 other states) is compliance with SEC Rule 147[42] which provides an exemption from the registration requirements of § 5 of the 1933 Act. A failure to comply with Rule 147 leads to a violation of the registration requirements of the 1933 Act and the risk of issuer liability for rescission[43] and the liability of the persons controlling the issuer.[44]

Even strict compliance with the requirements of Rule 147 does not preclude the risk of future liability. Like all exemptions from registration, Rule 147 merely exempts the offering from the registration requirements of the 1933 Act; it does not provide an exemption from the disclosure and anti-fraud requirements.

- Where the disclosure in the Colorado Form CF-2 is inadequate, incomplete, or inaccurate in any material respect, the issuer[45] and persons controlling the issuer[46] are potentially liable, as are (potentially) other participants in the offering.

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[40] Securities Act of 1934, 15 U.S.C. § 78a *et seq*.

[41] COLO. REV. STAT § 11-51-101 *et seq.*

[42] 17 C.F.R. § 230.147.

[43] 1933 Act, § 12(a)(1).

[44] 1933 Act, § 15.

[45] *See* 1933 Act § 12(a)(2); *see also* 1934 Act, Rule 10b-5 (17 C.F.R. § 240.0-10b-5).

[46] 1933 Act, § 15; 1934 Act, § 20.

- Where the issuer or its controlling persons take actions (such as spending the proceeds raised) contrary to the disclosure, they have significant risk of liability.

When broker-dealers or sales representatives are involved in the offering, they have the risk of liability under both federal law and the rules of their governing organization, the Financial Industry Regulatory Authority ("FINRA"). When an on-line intermediary is involved, the liability of the on-line intermediary is less as long as the on-line intermediary does not participate in the offering beyond merely posting the disclosure documents and perhaps gathering information and maintaining certain records as described above.

Of course, where the on-line intermediary (or any other participant in the offering) knows, or reasonably should know, that the disclosure is inadequate, incomplete, or inaccurate in any material respect, such persons have significantly increased their risk of liability in an administrative, civil, or even criminal forum.

***Colorado Compliance.*** Strict compliance with the Colorado Crowdfunding Act and the rules also creates an exemption from the registration requirements of the Colorado Securities Act.[47] Disclosure in the Form CF-2 that is accurate and complete in all material respects also limits the risk of liability for securities fraud. Where there is a failure to comply with the exemption or the disclosure requirements in any material respect, issuers and persons controlling the issuer are potentially liable in a state administrative, civil, or even criminal forum.

In Colorado, it is unlawful for any person (issuer, broker-dealer, sales representative, or investment advisor)[48] or controlling person[49] to "employ any device, scheme, or artifice to defraud" an investor, to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading," or to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." Where the Securities Commissioner suspects a violation of the registration requirements, the broker-dealer licensing requirements, or the disclosure requirements, he may initiate an investigation[50] or seek

[47] COLO. REV. STAT § 11-51-301.

[48] COLO. REV. STAT § 11-51-501.

[49] COLO. REV. STAT § 11-51-604(5).

[50] COLO. REV. STAT § 11-51-601.

enforcement by an administrative cease-and-desist proceeding,[51] injunction,[52] civil action,[53] or through a criminal proceeding.[54] Investors may also seek civil damages against the issuer and controlling persons for violations of the anti-fraud rules.[55]

***Escrow Agent Exoneration.*** Escrow agents are the key to the success (and even the ability to conduct) an offering under the Colorado Crowdfunding Act. The Act[56] provides that the escrow agent "does not have any duty or liability, contractual or otherwise, to any purchaser or other person." Most escrow agreements will provide contractual exoneration of the escrow agent except in the case of bad faith or willful misconduct by the escrow agent.

***The Risk of Fraud.*** Fraud is one of the principal risks of a crowdfunding offering as it is with any capital raising transaction involving the offer and sale of securities. It is likely that offerings under the Colorado Crowdfunding Act will follow the national trend—where purchasers invest from $100 to $300 in equity or debt securities. In most cases, this will be "pocket change" or "slot machine money." Where the purchaser loses her investment either through a bad business decision or even fraud, it likely will not be worth the purchaser's time and expenditure to take legal action. Perhaps the purchaser will file a complaint with the Colorado Division of Securities, but it is unlikely that the purchaser will take any more extensive action to recover his or her investment.

Thus, purchasers of crowdfund securities seeking to protect themselves should follow the typical mantra of investor advocates—know and trust your management. This again leads to the most-likely-to-be-successful crowdfunding offering—those within affinity groups where the investors know management or have other bases to trust management.

***Now That You Are An Owner of Crowdfund Securities, What Can You Do With Them?***

The short answer to the question is: be prepared to hold the crowdfund securities indefinitely and hope that the issuer is successful to generate dividends, distributions, or to repay debt securities. There is likely to be no secondary market for crowdfund securities after the initial issuance; it is also unlikely any efficient market will develop.

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[51] COLO. REV. STAT § 11-51-606(1.5).

[52] COLO. REV. STAT § 11-51-602.

[53] COLO. REV. STAT § 11-51-604.

[54] COLO. REV. STAT § 11-51-603.

[55] COLO. REV. STAT § 11-51-604.

[56] COLO. REV. STAT § 11-51-308.5(3)(a)(IV)(D).

It is important to note that even after the sale of crowdfunded securities, the third-party resale is a process that must be controlled by the issuer. If the issuer fails to keep control of the market, the original transaction may fail for lack of compliance with Rule 147. Furthermore, any sale of a security by any person (even if not the issuer) must be registered or exempt from registration under federal and Colorado law, and the issuer has an obligation to maintain the integrity of any market for its securities. In any transfer of securities, the exemption used by the transferor must be established to the satisfaction of the issuer. In addition, the issuer has an obligation to keep track of all transfers on its records or to contract with a transfer agent to do so. Otherwise the issuer will be unable to identify or communicate with its owners.

***Availability of Information.*** As discussed below, there are a number of requirements that must be met before an owner of an issuer's securities can transfer the securities to another person. One of the principal conditions precedent is the availability to the secondary market of adequate information about the issuer. The transferee must have access to information about the investment that the transferee proposes to make. Generally, the transferor holder of the security does not have access to the type and amount of information that the transferee would need—the information has to come from the issuer.

Hopefully, the issuer's reporting requirements mandated by the Colorado Crowdfunding Act[57] and the rules will provide sufficient information to meet the disclosure requirements. Issuers should consider going beyond the limited disclosure requirements in the quarterly reports required by the statute and the rules. Where broker-dealers are involved in the transaction, they will insist on the availability of information meeting the requirements of SEC Rule 15c2-11,[58] which prohibits brokers and dealers from initiating or resuming quotations of securities unless there is adequate public information available "to prevent fraudulent, deceptive, or manipulative acts or practices." Rule 15c2-11 provides a good model for an issuer's continuing disclosure.

***Limitations of Rule 147 On Resales.*** In addition to the disclosure and other requirements discussed above, the issuer of crowdfunded securities must place appropriate transferability restrictions on any certificates or other writings representing crowdfunded securities to ensure that any quotation or trading system limits transferability to meet the requirements of Rule 147(f). Issuers must also place stop transfer restrictions against the transfer of any crowdfunded securities and take other precautions to ensure that crowdfunded securities are not transferred to persons who are not Colorado residents for at least "nine months from the date of the last sale by the issuer of such securities" in the crowdfunding offering.[59]

[57] COLO. REV. STAT § 11-51-308.5(3)(a)(XIII).

[58] 17 C.F.R. § 240.0-15c2-11.

[59] SEC Rule 147(e).

Where the crowdfunding offering continues after the initial closing, the restricted period continues until nine months after the crowdfunding offering is completed.

***Rule 144 As An Exemption Available For Resales.*** SEC Rule 144 is an unlikely exemption for resales of crowdfund securities since one of the requirements is that the transaction be either a "broker's transaction," a transaction "directly with a market maker," or a "riskless principal transaction" as those terms are defined in Rule 144(f) ("Manner of Sale"). In any event, the Rule 147 restrictions continue to apply until nine months after the crowdfunding offering is completed.

Where a person not affiliated with the issuer holds the securities for more than a year after purchase and the issuer is not and was not a "shell company," Rule 144 does not impose any further limitations on transferability—although the issuer may do so. Where, however, the crowdfunding issuer is a "shell company" as defined in Rule 144(i) at the time of the offering (that is, one with no or nominal operations, among other requirements), Rule 144(i) imposes a perpetual restriction on future transfers of the ownership interests. If the one-year holding period falls within the Rule 147 nine-month residency requirement because the offering continued after the selling shareholder acquired his or her securities, the issuer must continue to enforce the Rule 147 residency limitations.

***Section 4(1½).*** First, it is important to note that the Section 4(1½) does not exist in the federal securities laws. Section 4(a)(1) of the 1933 Act provides the normal secondary market exemption for transactions by persons who are not issuers, underwriters, or dealers.[60] Section 4(a)(2) provides an exemption for issuers for transactions not involving a public offering.[61] Section 4(1½) arguably splits the difference, and constitutes a judicially accepted exemption from registration for private placements of securities by security holders who are not the issuer. Generally the requirements are similar to the rules under 1933 Act § 4(a)(2) which, briefly stated:

- Prohibit public advertising or general solicitation;
- Require individual negotiations among the parties; and
- Require that the purchasers have available information, sophistication, and take the securities for investment purposes only.

[60] 1933 Act, 15 U.S.C. § 4(a)(1).

[61] 1933 Act, 15 U.S.C. § 4(a)(2).

Even in connection with a section 4(1½) transaction, the issuer must ensure compliance with the Rule 147(f) transferability restrictions until more than nine months after the completion of the offering.

***The On-Line Intermediary Cannot Be Involved.*** The Colorado Crowdfunding Act specifically prohibits the on-line intermediary from acting "as an exchange or listing or quotation service for the offer or sale of securities by third parties."[62] Thus, the on-line intermediary that assisted the issuer in the crowdfunding cannot participate in any secondary market. In many cases, an entity creating the secondary market for securities would result in that person being classified as an exchange subject to the registration requirements of § 17 of the 1934 Act.

***Alternative Trading Systems.*** It is possible under existing law that alternative trading systems or electronic communications networks can be established to facilitate transactions in crowdfunded securities when a purchaser of the crowdfunded securities wants to sell. In 1998, the SEC adopted Regulation ATS for alternative trading systems. Alternative trading systems include "any organization, association, person, group of persons, or system . . . that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange."[63] Alternative trading systems must be licensed as a broker-dealer, file certain reports with the SEC, and maintain an open and fair quotation system for the securities quoted, all as set forth in Regulation ATS.

Regulation ATS goes on to provide that an alternative trading system must comply with applicable state law "relating to the offer or sale of securities or the registration or regulation of persons or entities effecting transactions in securities." That will generally require broker-dealer licensing in Colorado unless the alternative trading system is an exempt broker-dealer as set forth in the Colorado Securities Act.[64]

Regulation ATS also provides that the alternative trading system "must comply with the antifraud, antimanipulation, and other applicable provisions of the federal securities laws," and the requirements of Regulation ATS "are in addition to any requirements applicable to broker-dealers registered under Section 15 of the Exchange Act."

Once again, however, the ability of any alternative trading system to permit the quotation of securities is dependent upon disclosure. Because alternative trading systems must be registered as a broker-dealer, they are subject to SEC Rule 15c2-11 which prohibits brokers and dealers from initiating or resuming quotations of securities unless there is adequate public

[62] COLO. REV. STAT § 11-51-201(b)(V).

[63] Regulation ATS, 17 C.F.R. § 242.300(a).

[64] COLO. REV. STAT § 11-51-402.

information available "to prevent fraudulent, deceptive, or manipulative acts or practices." Where the issuer is not making the required information available, alternative trading systems cannot quote crowdfunded (or any other) securities. Even in the case of an alternative trading system, the issuer must ensure compliance with the Rule 147(f) transferability restrictions until more than nine months after the completion of the offering.

***Future IPO.*** Where the issuer of crowdfunded securities accomplishes an initial public offering in the future, the crowdfunded securities may gain much greater liquidity. Offerings through new (June 2015) Regulation A+[65] or a traditional registration statement under the 1933 Act may result in broker dealers making a market for the securities in the OTC Markets or an exchange listing. In both cases, the marketability of crowdfund securities will be enhanced, although where applicable the restrictions of SEC Rule 144(i)[66] will continue to apply.

***Future Acquisition.*** Where the issuer of crowdfunded securities develops the better mousetrap and becomes an acquisition target for a much larger company, the owners of the issuer will likely gain liquidity—either through a cash buy-out or through the issuance of registered shares.

***Transferability Summary.*** Where investors wish to resell the crowdfunded securities they have acquired, the rules governing transferability are complex and the availability of adequate disclosure about the issuer (over which the investors have no control) may be the most problematic. Holding the securities for investment purposes only and hoping for a future return is the most likely expectation to create.

***Is There a Role for Attorneys?***

Although crowdfunding is intended to be a simple concept for small businesses and startups in Colorado to raise capital (as described by Representative Lee in his press release issued August 5, 2015), and even though the rules and the forms are written in a step-by-step nature anticipating that most issuers will proceed without sophisticated legal counsel, there remain sophisticated legal issues that each issuer will have to address. Crowdfunding issuers proceeding without legal counsel will be well-advised to understand the rules and the statute. On-line intermediaries and other advisors need to consider issues surrounding the unauthorized practice of law before assisting prospective issuers in their efforts to comply with the Colorado Crowdfunding Act.

Among the legal questions that issuers and on-line intermediaries will need to address in each crowdfunding offering will be:

[65] 17 C.F.R. § 230.251 *et seq.*

[66] 17 C.F.R. § 230.144(i).

- What is a "single plan of financing" under Rule 147 and how is that interpreted with the limitations of C.R.S. § 11-51-308.5(3)(a)(XI)? Does any prior securities offering by the issuer restrict the issuer's ability to conduct a crowdfunding offering?

- Where do the actions of the on-line intermediary become the actions of an unlicensed broker-dealer? Where does the advice provided to the issuer by the on-line intermediary become the unauthorized practice of law?

- Who drafts the escrow agreement and the agreement with the on-line intermediary, and interprets it for the issuer? This is unlikely to be an off-the-shelf form and will have to be tailored to each issuer, on-line intermediary, and offering.

- What is "adequate disclosure" for the purposes of Form CF-2? What subsequent events are "material" requiring an amendment within five business days?[67]

- What level of due diligence and documentation will be sufficient to meet the issuer's and on-line intermediary's obligations when determining residency of investors and whether they are accredited?

- How does the issuer manage the future transferability of the securities issued under the Colorado Crowdfunding Act, and what in fact are the limitations?

- Does the "reasonable basis" requirement for on-line intermediaries under Rule 3.28.C require that the on-line intermediary take affirmative steps, or does it merely prohibit willful blindness?

- Does the issuer's notice to the crowd meet the requirements of being "within Colorado" as defined in Rule 3.24.I?

These legal questions and others that may arise have to be considered based on a specific set of facts—facts that likely change from issuer to issuer, on-line intermediary to on-line intermediary, and offering to offering. Those issuers and on-line intermediaries who proceed without competent legal assistance will be taking risks. Unfortunately, lawyers usually want to be paid whether or not the offering is successful, or even commenced. This may be a significant investment for the prospective crowdfunding issuer.

Another consideration for prospective crowdfunding issuers is how to deal with the resulting investors. Assuming that the crowdfunding offering is successful, the issuer may have

[67] RULE 3.22.D.

several hundred to perhaps several thousand new security holders.[68] The Colorado Crowdfunding Act[69] requires quarterly reporting to these owners. The larger the number of owners, the more difficult reporting will be. Furthermore, experience in the public company world indicates that these owners will be seeking information from the issuer on a regular basis, lodging complaints where performance is not as expected, and trying to develop a trading market. Each security holder is likely to have a different, personalized agenda that may result in significant management time and expense to resolve.

***Thoughts on Crowdfunding in Colorado***

If the risks can be managed to the satisfaction of the participants, the Colorado Crowdfunding Act may become an extremely useful tool in capital formation for small businesses. It is new, the rules and the Act itself are untested, and there will undoubtedly be many issues that develop. One of the biggest may be whether any depository institution[70] will be willing to act as an escrow agent in a crowdfunding offering at a reasonable cost, recognizing that many investments are likely to be small—$100 or so per person. In brief discussions with certain local banks, they have expressed reluctance to participate in these untested offerings, even though the Colorado Crowdfunding Act specifically provides that the escrow agent "does not have any duty or liability, contractual or otherwise, to any purchaser or other person."[71]

It is likely that crowdfunding offerings will be targeted to affinity groups by the issuers—perhaps a broader version of a "family and friends" offering. Professor Karl Dakin[72] has written a number of blogs that relate to crowdfunding including one entitled "Characteristics of a Crowd" (May 11, 2015). As Professor Dakin indicates, "any message within a crowdfunding campaign must address the perspective of the investor."[73] Included in the perspective of the investor is whether the investor is considering investing "pocket change" or an investment that

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[68] Experienced counsel would likely warn prospective crowdfunding issuers to limit the number of investors in the offering to the maximum extent possible, while still being able to raise the necessary capital. Lawyers who deal with public companies know the difficulties that result from a large number of owners.

[69] COLO. REV. STAT § 11-51-308.5(3)(a)(XIII).

[70] COLO. REV. STAT § 11-51-101 (defining depository institution).

[71] COLO. REV. STAT § 11-51-308.5(3)(a)(IV)(D).

[72] *See* COLORADO CAPITAL CONGRESS, http://www.coloradocapitalcongress.com (last visited Aug. 5, 2015).

[73] *Id.*

could be characterized as "a major life decision."[74] As Professor Dakin advises with respect to the issuer's disclosure and other communications with prospective investors:

> Too often, entrepreneurs fail to address the perspectives of the investors. They either assume that all investors are alike or that their deal is so good that all investors will invest. This is not true for classical investments based upon seeking a return on investment. And, it will represent a greater error in thinking with regard to crowdfunding.

As a result, Professor Dakin notes that too many issuers are "looking for money in all the wrong places," "pitching to the wrong people," "pitching too early" before the issuer is ready, "not knowing the investor," and considering "investors as ATMs."[75] This is further explained in a blog post that derived from a Kickstarter campaign for *Gluten Free Forever*[76] where the principals said, when raising money from the crowd, one should "formulate[] a marketing and promotion strategy prior to launching the [] campaign" and come to the campaign with your own crowd.[77] The principal provided the following recommendations to consider before launching a crowdfunding campaign – applicable to the sale of securities through crowdfunding as it is to rewards-based crowdfunding:[78]

> (1) Have a marketing and promotion plan in place;
> (2) Consult with legal counsel;
> (3) Form the legal structure;
> (4) Weigh the cost of the transaction fee [as well as the other transaction costs], and the amount of time you will spend developing a crowd; and
> (5) Consider realistic objectives for your project to ensure a sustainable business model after the initial crowdfunding period.

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[74] *Id.*

[75] *See* Karl Dakin, *10 Mistakes in Raising Capital* Series, COLORADO CAPITAL CONGRESS (June 22, 2015—July 01, 2015), www.coloradocapitalcongress.com/page-1819601.

[76] *Gluten Free Forever* founded and edited by Erika Lenkert, www.gffmag.com.

[77] It is, of course, likely that on-line intermediaries will lead crowdfunding issuers to believe that the intermediary itself has a crowd of investors waiting for the next good deal. That may develop over time, but is unlikely to be the case in the early years and may not be the case for all prospective issuers. A crowdfunding issuer can increase its chances for success by bringing its own crowd of potentially interested investors.

[78] *See* Shannon Moran, "*Special Projects Segment: Rewards-Based Crowdfunding, Gluten Free Forever Magazine*," www.TheRaceToTheBottom.org (August 6, 2015).

In his paper *Teenage Crowdfunding*,[79] Professor Andrew A. Schwartz of the University of Colorado Law School predicts that younger entrepreneurs will take advantage of crowdfunding because of their social media and networking skills. Chris Tyrell of *Crowdfund Insider* suggests that "Crowdfunding is Changing the Female Entrepreneurial Landscape."[80] Crowdfunding may in fact become the capital formation tool that the Colorado legislature and the U.S. Congress envisioned, but expectations have to be moderated to fit within reality.[81]

***Crowdfunding Under the Federal JOBS Act.***

In 2012, when national unemployment exceeded 9%, the U.S. Congress enacted, and President Obama signed, the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"). Title III of the JOBS Act (the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act") added § 4(a)(6) to the 1933 Act to permit federal crowdfunding. As Jackie Benson wrote in the May 2012 CBA Business Law Section newsletter,[82] § 4(a)(6) was not to be effective until the issuance of final SEC regulations. Although the JOBS Act mandated that those regulations be issued within 270 days, we are still waiting for those regulations. Rules were first proposed in a 585-page release in October 2013[83] and have not been further addressed by the SEC. At the SEC's April 10, 2015 Investor Advisory Committee, Chair White forecast adoption of the federal crowdfunding rules by the end of 2015 (although she stated it was also a priority for 2014).[84]

The proposed federal rules are significantly more complicated than the Colorado rules and the rules adopted to implement crowdfunding in more than 20 other states. A benefit of federal crowdfunding, however, will be that a federal crowdfunding offering under § 4(a)(6) can be of interstate nature since securities issued would be "covered securities" as defined in the 1933 Act[85] and therefore exempt from state regulation. The crowdfunding rules implemented by

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[79] Andrew A. Schwartz, *Teenage Crowdfunding*, 83 UNIV. CINCINNATI L. REV. 515 (2014), available at http://ssrn.com/abstract=2605518.

[80] Christ Tyrell, *Crowdfunding is Changing the Female Entrepreneurial Landscape,* CROWDFUNDINSIDER (Jul. 15, 2015), http://www.crowdfundinsider.com/2015/07/71191-crowdfunding-is-changing-the-female-entrepreneurial-landscape/

[81] The New York State Bar Association Comm. On Prof'Ethics has even issued an opinion (Op. 1062, 6/29/2015) which concluded in certain limited cases, even a law firm could engage in crowdfunding financing – although not where the investor is receiving equity or a royalty (and therefore "sharing fees").

[82] http://www.cobar.org/repository/Inside_Bar/Business/Business_May_Web.pdf.

[83] SEC Rel. 33-9470.

[84] http://www.crowdfundinsider.com/2015/04/65924-sec-chair-mary-jo-white-on-jobs-act-final-crowdfunding-rules-is-our-last-major-rulemaking-to-complete/.

[85] 1933 Act, § 18(b)(4)(C).

the states that have adopted it are all based on the federal intrastate exemption in 1933 Act[86] and therefore must be intrastate in character.

***Conclusion***

Because of the lesser formality of the crowdfunding process, abuse and fraud are possible. Because of the smaller amounts raised, it is hoped that such abuse will be nominal. Nevertheless, prospective investors and attorneys who advise them must be alert for warning signs. Knowing your principals is your best protection, which is why affinity crowdfunding offerings are more likely to succeed than blind offerings to unknown investors. On the other hand, there has been plenty of affinity fraud in the annals of the Securities and Exchange Commission.[87]

Properly used and constructed, however, crowdfunding in Colorado may be a very successful tool for smaller businesses seeking to raise capital within their sphere of influence – customers, clients, vendors, friends, family, and others. Although contemplated in the Colorado Crowdfunding Act, it is unlikely that broker-dealers or sales representatives will be involved in the offerings because of their due diligence obligations under their regulatory rules (and the related cost which would be passed on to the crowdfunding issuer). It is also unlikely that issuers will use sophisticated legal guidance, again because of the cost which can quickly make a smaller offering unaffordable.

The best advice for an issuer looking for a crowdfunding offering is to be familiar with the statute and the rules. The issuer should also seek an on-line intermediary that will be competent and provide competent assistance in accordance with the rules.[88] Escrow agents will be key, and an experienced on-line intermediary may have relationships that the issuer can use. On-line intermediaries that are not broker-dealers are operating in other states that have already authorized crowdfunding;[89] as the Colorado crowdfunding market develops, on-line intermediaries can be expected to appear in Colorado. This may be sooner; this may be later; and it will depend on the market. There will likely be competent on-line intermediaries, and unfortunately there will likely be incompetent on-line intermediaries; issuers should make all relevant inquiries to be comfortable that they are dealing with the correct on-line intermediary.

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[86] 1933 Act, § 3(a)(11) and Rule 147 thereunder.

[87] *See* "*Affinity Fraud: How To Avoid Investment Scams That Target Groups*" available at http://www.sec.gov/investor/pubs/affinity.htm (last visited July 15, 2015).

[88] As of September 5, 2015, four entities have filed Form CF-3 to act as an on-line intermediary under the Colorado Crowdfunding Act. The information about those entities and future filings is available at www.colorado.gov/pacific/dora/equity-crowdfunding.

[89] *See, e.g.*, www.hoosiercrowd.com.

Let the offerings roll!