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Crowdfunding In Colorado Is About To Be Legal

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Representatives Pete Lee and Daniel Pabon in the House and Senators Mark Scheffel and Owen Hill in the Senate were the primary sponsors of H.B. 15-1246 (the "Colorado Crowdfunding Act" or the "Act"). It was passed by the House on third reading on March 17, 2015, by the Senate on third reading on March 30, and signed by Governor Hickenlooper on April 13. Although the law becomes effective on August 5, 2015 (assuming that the legislature adjourns as scheduled on May 6), the availability of crowdfunding as an alternative tool for capital formation in Colorado is dependent upon rulemaking by the Colorado Division of Securities.

Background

Crowdfunding has been a buzzword for a significant period of time, but not involving equity or debt securities in Colorado. Crowdfunding made national headlines when it was authorized by Title III of the Jumpstart Our Business Startups Act (JOBS) Act of 2012, but three years later the Securities and Exchange Commission has not yet adopted rules to implement the JOBS Act requirements for crowdfunding.

Capital raising has been misunderstood by the popular press and other media. An example appeared in the February 8, 2015, Denver Post Business Section where the author described Corbeaux Clothing of Aspen, Colorado, having "raised more than $45,000 through Indiegogo last fall." While that is true, it was not the full story. Corbeaux did not sell securities-- it sold clothing-to-be-manufactured. The Indiegogo site reports that they did raise $45,422 by September 13, 2014, but each contributor was entitled to a perk for the contribution:

- For $62, the contributor was entitled to a "Women's Smuggler Tank."
- For $65, a "Capitol Tee"
- For $3,000, "A Full M's/W/s Collection 1+"

Thus there should have been no expectation by any contributor that they would share in the future profits of the business – only that they will receive the perks if and when available. Kickstarter and other similar sites offer similar rewards-based funding opportunities. Kickstarter avoids securities implications by describing the support given to projects as follows:

> Backers are supporting projects to help them come to life, not to profit financially. Instead, project creators offer rewards to thank backers for their support. Backers of an effort to make a book or film, for example, often get a copy of the finished work. A bigger pledge to a film project might get you into the premiere — or land you a private screening for you and your friends. One artist raised funds to create a wall installation, then gave pieces of it to her backers when the exhibit ended.

None of these methods, when operating pursuant to legal requirements, constitute an offering of equity or debt securities where the contributor expects a future interest in being repaid or making a profit. Especially given the prohibitions in the federal and state securities laws for public advertising or general solicitation for anything but a registered offering (and for certain private offerings under amended Rule 506), small business capital formation in Colorado and much of the United States has been lacking. The choices have been a private placement, most of which prohibit public advertising or general solicitation, or pursuing an expensive process to register securities.

Crowdfunding In Colorado

Colorado has long had a crowdfunding alternative through its limited offering registration process found in C.R.S. § 11-51-304(6). This was the subject of an article in August 2014 entitled: "*Is Crowdfunding In Colorado Effective Yet? Maybe*" and another article published in November 2014, "*More On Crowdfunding In Colorado*". Whether because of time delays or cost, there have been few limited offering registrations filed in Colorado since 2008. In fact, the first one since 2008 is currently pending.

Many states have adopted state crowdfunding acts which permit residents to raise a limited amount of equity funding pursuant to the federal exemption for the offer and sale of securities – SEC Rule 147. The North American Securities Administrators Association ("NASAA") has established an intrastate crowdfunding directory which provides links to specific intrastate crowdfunding exemptions adopted at the state level. As stated by NASAA in the directory introduction:

> A growing number of jurisdictions have adopted crowdfunding provisions in their rules or statutes recognizing that equity crowdfunding, done responsibly, with appropriate disclosure and safeguards, may be another valuable tool that small companies can use to raise capital.

Of course, there is always the risk of fraud, as well. This is of course a significant concern to state regulators especially because investors are unlikely to bring litigation to protect themselves given the small amount of their investment. As stated by Professor J. Robert Brown in February 2015, "with the mean pledge amount at about $64, . . . many backers may not think litigation is worth the cost and the hassle."

The Colorado Crowdfunding Act-In General

The Colorado Crowdfunding Act differs from the limited offering registration because it is an exemption from registration under the Colorado Securities Act. It is important to note that the Act is subject to rulemaking by the Colorado Division of Securities. Although the Division will likely use the limited offering registration process and forms as a model for the crowdfunding rules, the Colorado Crowdfunding Act will only require various filings with the Division by the issuer and the online intermediary, and will not require Division review. The

Act will also require that both the issuer and the online intermediary maintain certain records and make them available to the Securities Commissioner and his staff for inspection.

Practitioners should note that the Colorado Crowdfunding Act is designed to implement the suggestion from NASAA: "that equity [and debt] crowdfunding, done responsibly, with appropriate disclosure and safeguards, may be another valuable tool that small companies can use to raise capital." Hopefully, the Act will become a useful tool in the capital formation toolbox that should be discussed between entrepreneurs, their legal counsel, and other advisors.

The Colorado Crowdfunding Act-Specifics

The Colorado Crowdfunding Act adds a new section to the Colorado Securities Act, § 11-51-308.5, which will become effective August 5, 2015, assuming that the legislature adjourns as scheduled on May 6, 2015.

Subsection (1) of the Act establishes the Colorado Crowdfunding Act, which creates an exemption from registration under Colorado law, and piggy-backs off of the federal intrastate exemption from registration in 1933 Act § 3(a)(11) and Rule 147. The Colorado Crowdfunding Act repeats some of the requirements of federal law, but the legislators wanted to ensure that the Colorado-centric nature of the bill was front-and-center even to someone who did not understand the federal intrastate exemption.

Subsection (2) of the Act is a rather lengthy legislative declaration that describes the intent of the General Assembly in enacting the legislation.

Subsection (3) is the meat of the Act, and is divided into three paragraphs:

a. Paragraph (3)(a) sets forth the issuer requirements which generally tracks SEC Rule 147 for the intrastate character of the issuer and the purchaser.

b. Paragraph (a)(II) limits the amount of the crowdfunding offering in any twelve month period to $1,000,000 unless audited financial statements of the issuer are provided, in which case there is a $2,000,000 limit. This was a focus of debate between the Securities Commissioner and the legislators. The limit in the federal JOBs Act is $1 million, and the majority of the 17 states which have adopted crowdfunding have a $1 million limit or less. The Securities Commissioner pointed out that in Idaho, Indiana, Michigan, Mississippi, North Carolina, Vermont, and Wisconsin, the limit is $1 million, unless the company provides "audited" financials. Then the limit is $2 million. This is the approach adopted in the Act.

c. Paragraph (a)(III) also limits the amount of any individual's investment to $5,000 unless the individual is an accredited investor (under the federal definition), in which case the individual amount is unlimited.

d. Paragraph (a)(IV) also requires that the issuer file a notice and consent to service with the Commissioner, pay a fee to be established by the Commissioner, and prepare and file the disclosure document with the Commissioner (although it is only a notice filing and will not be reviewed).

e. The minimum offering can be no less than one-half of the maximum offering, and an escrow has to be established. Paragraphs 3(a)(IV)(D) and (F).

f. The exemption is subject to the bad actor provisions of federal Rule 506(d) (Paragraph 3(a)(XII)), and the issuer must provide certain reports to the owners (Paragraph 3(a)(XIII)).

g. In order to advertise the crowdfunding offering, the issuer may distribute a notice within Colorado about the offering including a link to the website for the offering maintained by the online intermediary or broker-dealer. § 11-51-308.5(3)(b)(XIV).

2. Paragraph (3)(b) is rather simple. It says that the crowdfunding offering may be made through a licensed broker-dealer, a licensed sales representative, or through an online intermediary. If made through an online intermediary, the new definition of "online intermediary" and Paragraph (3)(c) are important.

3. Paragraph (3)(c) imposes various obligations on an online intermediary. A new section (§ 11-51-201(11.5) at page 13 of HB 15-1246) is added to the Colorado Securities Act to define the new term, "online intermediary."

a. The online intermediary must make a filing with and pay a fee to the Commissioner. § 11-51-308.5(3)(c)(I).

b. The online intermediary must maintain certain records. Paragraph 3(c)(II).

c. Perhaps most importantly, the online intermediary may only post information and make offers on behalf of a crowdfunding issuer – the online intermediary may not accept investments, give investment advice, or engage in securities transactions. § 11-51-201(11.5)(b).

d. The online intermediary may not hold a financial interest in any issuer or be affiliated with a crowdfunding issuer for which the online intermediary is posting information or "be an owner of any issuer offering [crowdfunding] securities" pursuant to the Colorado Crowdfunding Act. § 11-51-308.5(3)(c)(III).

e. The online intermediary may not charge a transaction-based fee, but only a fixed fee for presenting the crowdfunding offering information – although that fee may vary but only by the length of time the information is posted. § 11-51-308.5(3)(c)(IV).

f. The online intermediary is also subject to the federal bad actor provisions. § 11-51-308.5(3)(c)(VII).

g. Finally, the online intermediary is exempted from the broker-dealer/sales representative licensing requirements of § 11-51-40(1). (New § 11-51-402(1)(c) proposed to be added by HB 15-1246 at page 16 of the bill.)

Future Rulemaking Required

When it becomes effective, the Colorado Crowdfunding Act will not be self-executing. Section 11-51-308.5(4) makes it clear that the Securities Commissioner may adopt rules to implement or enforce the Colorado Crowdfunding Act and to conform it to federal law. In addition, the Act requires that the Commissioner adopt rules to implement various portions of the Act:

(i) Section 11-51-308.5(3)(a)(IV)(A) requires that, not less than ten days before commencing an offering, the issuer must make a notice filing and file a consent to service of process "on a form prescribed by the Securities Commissioner."

(ii) Section 11-51-308.5(3)(a)(IV)(B) requires that the issuer pay fees to be established by the Commissioner.

(iii) Section 11-51-308.5(3)(a)(IV)(C) requires that the issuer file a disclosure document with the Commissioner containing the information "that the Securities Commissioner requires by rule" (Section 11-51-308.5(3)(a)(X)).

(iv) Section 11-51-308.5(3)(a)(IV)(E) requires that the issuer maintain all records with respect to any crowdfunding offering "as the Securities Commissioner may be rule require."

(v) Section 11-51-308.5(3)(c)(I)(A) and (E) require that the online intermediary make a filing with the Securities Commissioner and pay a fee as the Securities Commissioner may require.

(vi) Section 11-51-308.5(3)(c)(II) requires that the online intermediary "file with the Securities Commissioner specified financial and other information."

(vii) Section 11-51-308.5(3)(c)(II) requires that the online intermediary "not engage in any other activities that the Securities Commissioner, by rule, determines are prohibited by the on-line intermediary.

Now That I Own It, What Do I Do With It?

Crowdfunding and H.B. 15-1246 do not solve that problem of investors holding closely-held and privately-placed securities – "now that I own these, what do I do with them?" The traditional private placement requires purchasers to acquire securities "for investment purposes

only." While crowdfunded securities under federal Rule 147 do not bear the characteristics of "restricted securities," there is no easy mechanism for resale, and because of the restrictions found in Section 15 of the Securities Exchange Act of 1934, a state "crowdfund securities exchange" will have significant legal restrictions.

In a March 4, 2015, speech to the Advisory Committee on Small and Emerging Companies, SEC Commissioner Luis A. Aguilar discussed "*The Need for Greater Secondary Market Liquidity for Small Businesses*." (This was also the subject of testimony of Stephen Luparello, Director of the SEC's Division of Trading and Markets to the Senate Subcommittee on March 10, 2015.) In his speech, Commissioner Aguilar noted that the result of recent federal and state initiatives, including Regulation A+ (final rules issued on March 25, 2015) and state crowdfunding, is that a broader group of people will be invested in illiquid investments without, perhaps, fully appreciating the investment restrictions.

Under current federal and state regulation, it is unlikely that exchanges can develop; rather companies will basically have to act as introducing agents and control disclosure and investment opportunities. Commissioner Aguilar proposed a "venture exchange," but nothing like that exists at the present time and the current legal requirements under the 1934 Act will be significant. More discussion and perhaps action is likely coming.

Conclusion

Thus there will be plenty of opportunity for rulemaking by the Securities Commissioner, but the General Assembly, in testimony and questioning, clearly expressed their hope that the rule-making occur expeditiously, balancing the need for small business capital formation against the need for investor protection.

Crowdfunding as adopted in Colorado and elsewhere will not likely be a panacea for what is lacking in capital formation for small businesses, but properly used can provide an alternative to entrepreneurs.