

Date of Hearing: April 17, 2017

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Matthew Dababneh, Chair

AB 1517 (Muratsuchi and Chui) – As Amended April 5, 2017

**SUBJECT:** Securities transactions: qualifications by permit: liability

**SUMMARY:** Creates a new qualification by permit under California's Corporate Securities Law of 1968 to allow equity-crowdfunding. Specifically, **this bill:**

- 1) Provides that any offer or sale of any security that meets the following criteria may be qualified by permit:
  - a) An applicant may file an application for a "crowdfunding" permit if the applicant meets the following conditions:
    - i) Is a California corporation or a foreign corporation, as specified; is not issuing fractional undivided interests in oil and gas rights, or a similar interest in other mineral rights; is not an investment company subject to the Investment Company Act of 1940; and is not subject to the reporting requirements, as specified, in the Securities Exchange Act of 1934.
    - ii) Provides that the total offering of securities by the applicant to be sold in a 12-month period, within or outside this state, is limited to \$2 million, less the aggregate offering price for all securities sold within the 12 months before the start, and during the offering of the securities.
    - iii) Current offers and sales cannot be integrated with prior offers or sales of securities or subsequent offers or sales of securities, as specified.
    - iv) Prohibits the securities sold during a 12-month period to any investor from exceeding the lesser of \$5,000 or 10% of the net worth of that natural person or such amount as the Commissioner of the Department of Business Oversight (DBO) may provide by rule or order.
    - v) Requires the applicant to take reasonable steps to ensure that each investor who is a natural person who is not an accredited investor has knowledge and experience in financial business matters that he or she is capable of evaluating the merits and risks of the prospective investment.
    - vi) Requires the applicant to file with the Commissioner and provide to investors a disclosure document, as defined, and a Small Company Offering Registration (SCOR) disclosure document on Form U-7, or any other disclosures and documents deemed necessary or desirable by the Commissioner.
    - vii) Provides a three day right of rescission.
    - viii) Prohibits an applicant from direct solicitation.

- (1) Defines "direct solicitation" as any in person face to face conversation between the applicant or any of its founders, promoters, officers, directors, controlling persons, agents, or other persons acting directly or indirectly on behalf of the applicant and any investor or prospective investor or any person acting directly or indirectly on behalf of, or in regular communication with, the investor.
  - ix) Requires the applicant to set aside in a separate third-party escrow account all funds raised as part of the offering to be held in escrow until that time of minimum offering amount is reached. The issuer shall return all funds if the minimum offering amount is not reached within one year.
  - x) Prohibits an applicant from conducting unsolicited telephone calls.
  - xi) Requires the transaction be conducted through an intermediary that complies with the requirements in the Federal Securities Act, as specified.
  - xii) Requires the applicant to comply with state law regarding advertisements, as specified.
  - xiii) Places a fiduciary obligation on the applicant to any investor or prospective investor.
  - xiv) Prohibits an applicant and others, as specified, from being disqualified as a "bad actor" under federal regulations.
  - xv) Prohibits stock splits, stock dividends, spinoffs, or mergers for a period of two years from the close of the offering.
  - xvi) Prohibits the applicant from requiring or imposing an obligation on any investor with respect to the arbitration of any claim or dispute, or the waiving of rights, as specified.
- 2) Requires DBO to either issue or deny the permit within 60 days of receipt of the application otherwise the applicant can demand a hearing with DBO to explain why the permit has not been granted.
  - 3) Imposes a filing fee of \$200 plus one-fifth of 2% of the aggregate value of the securities sought to be sold in California for qualification of the sale of securities by permit.
  - 4) Requires the court to award reasonable attorney's fees and costs, and authorizes the award of treble and punitive damages, to a prevailing purchaser in an action brought against any person who violates conditions of qualification by permit.
  - 5) Provides that a plaintiff is not required to plead or prove that the defendant acted with scienter.

**EXISTING FEDERAL LAW:**

- 1) Authorizes, pursuant to the Jumpstart Our Business Startups (JOBS) Act (Public Law 112-106), the use of general solicitation and general advertising in certain circumstances not previously authorized. Title II of the JOBS Act, operative September 23, 2013, lifted the restriction against use of general solicitation and general advertising, when sales are made only to accredited investors

and other requirements are met. Title III of the JOBS Act, otherwise known as the CROWDFUND Act, lifted the restriction against use of general solicitation and general advertising to both accredited and non-accredited investors.

- 2) Provides for the Securities Act of 1933, which establishes a framework for regulating the offer and sale of securities and ensuring the protection of investors that purchase those securities. Generally speaking, the Securities Act of 1933 requires the offer or sale of all securities to be registered with the Securities and Exchange Commission (SEC) and to be structured as prescribed in federal law and regulation, unless the offer or sale is covered by an exemption. This federal act also requires those who offer (i.e., market) and sell securities to be licensed as investment advisers or broker-dealers, unless either the transaction or the activity being undertaken is exempt.
- 3) Provides for Regulation D, one of the regulations promulgated by the SEC to implement the Securities Act of 1933. Regulation D authorizes a series of exemptions from the registration requirements of the Securities Act of 1933.

**EXISTING STATE LAW:**

- 1) Provides that it is unlawful for any person to offer or sell any security in this state, unless such offering or sale has been qualified by the commissioner, as specified, or unless the offering or sale is covered by an express exemption. [Corporations Code (CC) Section 25110]
- 2) Authorizes the qualification by notification of any security issued by a person that is the issuer of a security registered under Section 12 of the Securities Exchange Act of 1934 or issued by an investment company registered under the Investment Company Act of 1940. [CC Section 25112]
- 3) Establishes "qualification by permit" which states all securities, whether or not eligible for qualification by coordination under CC Section 25111 or qualification by notification under CC Section 25112, may be qualified by permit under this section. An application for a permit under this section shall contain any information and be accompanied by any documents as shall be required by rule of the commissioner, in addition to the information specified in CC Section 25160 and the consent to service of process required by CC Section 25165. For this purpose, the commissioner may classify issuers and types of securities. [CC Section 25113]
- 4) Contains several exemptions from the requirement immediately above. Two of the most relevant exemptions for purposes of this bill include CC Sections 25102(f) and 25102(n).

**FISCAL EFFECT:** Unknown

**COMMENTS:** This bill is sponsored by Small Business California, to allow small businesses and start-ups to more readily access capital. According to the Author's office:

Small businesses, accounting for over two-thirds of new jobs nationally, often lack access to capital and rely heavily on credit card debt, home equity and limited personal assets for financing. Crowdfunding enables entrepreneurs to prove a concept, build infrastructure necessary to support a business model and take other

steps necessary to attract capital investment. For small businesses and start-ups, however, raising capital frequently can be an overwhelming challenge.

[This bill] would allow start-up and emerging small businesses to find investors who can provide capital to help them grow and create jobs, while providing greater protections to California investors participating in crowdfunding. This bill would add to the California Corporate Securities Laws specific conditions under which [DBO] will review and issue a permit for a crowdfunding offering in California. This bill offers both entrepreneurs and investors a safer means of filling the “capital gap” that exists for smaller early-stage seed capital offerings while helping to jumpstart companies so that they can become candidates for larger rounds of financing.

This measure allows applicants to “qualify by permit” under which applicants also known as issuers can use general solicitation and general advertising with the exception of direct solicitation and unsolicited telephone calls to attract both accredited and non-accredited investors. The bill also creates a process where an applicant turns in a permit application to offer securities. The DBO has 60 days to approve or deny a permit; otherwise, the applicant can ask for a hearing from the DBO.

**Crowdfunding:** Crowdfunding is a collective cooperation of people who network and pool their money and resources together, via the internet, to support efforts initiated by other organizations. Crowdfunding literally attracts a “crowd” of people, each of whom takes a small stake in a business idea by contributing towards an online funding target. Crowdfunding has become a popular and alternative method of raising finance for businesses, real estate investments, projects or ideas and has become popularized online by sites such as Kickstarter, Wefunder, Crowdfunder and RockthePost.

**Background:** On April 5, 2012, President Barack Obama signed landmark legislation, House Resolution 3606, the Jumpstart Our Business Startups Act (the “JOBS Act”). The JOBS Act makes it easier for startups and small businesses to raise funds. This legislation passed Congress through a 73-26 Senate vote and a 380-41 House vote. Title III of the JOBS Act required the SEC to develop new rules permitting capital raising by “crowdfunding.”

In October of 2013, the SEC issued the proposed crowdfunding rules in a 585 page document. The SEC struggled to create the final rules that respected the flexible and democratic nature of crowdfunding (which makes it so appealing to very small and early stage start-up companies) while also implementing sufficient regulation to satisfy consumer and investor protection critics who fear that investment crowdfunding is far too open to abuse and fraud.

On October 30, 2015, the SEC adopted final rules under Title III of the JOBS Act. The JOBS Act provided for a new exemption under the Securities Act of 1933 that will permit securities-based crowdfunding by private companies without registering the offering with the SEC. The final rules become effective in May 2016 except that the forms enabling funding portals to register with the SEC became effective on January 29, 2016. Additionally, the SEC staff must submit a report to the SEC no later than three years following the effective date of crowdfunding on the impact of the regulation on capital formation and investor protection.

***Questions and Concerns:***

- 1) The federal Crowdfunding rules became final in October, 2015. We now have a process set in place nationwide to conduct equity crowdfunding. Why does California need its own crowdfunding process? Considering that these final rules are so new, isn't it too early to cast a shadow on federal Crowdfunding? The SEC is required to issue a report in three years. Should California wait to reevaluate the success, or lack of success, of federal Crowdfunding after the first report is released?
- 2) This bill, if enacted, would allow and promote "regulation shopping." Issuers/Applicants can determine whether to register to adhere to federal regulations or state securities regulations. Even if California's crowdfunding has better investor protections, why would this point matter, since issuers would have the ability to choose the weaker regulations?
- 3) Although the Federal program is fairly new, what data is available to show that small, early stage start-up companies are taking advantage of the program?
- 4) This bill provides that the securities sold could be "within or outside California." Wouldn't anything outside California conflict with federal rules? Other states who have enacted state crowdfunding proposals only apply intrastate. How will DBO be able to enforce?

***Previous Legislation:***

AB 2178 (Chiu) of 2016 would have authorized a new form of securities offering in California to facilitate crowdfunding as an alternative to a similar authorization in federal law under the JOBS Act. *Died in the Assembly Appropriations Committee.*

AB 722 (Perea) of 2015 would have authorized a new form of securities offering in California to facilitate crowdfunding as an alternative to a similar authorization in federal law under the JOBS Act. *Died in the Assembly Appropriations Committee.*

AB 2096 (Muratsuchi) of 2014 would have created a new way in which a person seeking to offer or sell securities could qualify their offering, by authorizing the "qualification by notification" of offers or sales of securities advertised by means of general solicitation and general advertising, as specified. *Died in the Senate Appropriations Committee.*

AB 783 (Daly) of 2013 would have provided that an issuer can offer or sell securities using any form of general solicitation or general advertising. *Died in the Assembly Banking and Finance Committee.*

AB 2081 (Allen) of 2012 would have provided that an issuer can offer or sell securities using any form of general solicitation or general advertising. *Died on the Senate Floor.*

SB 875 (Price) of 2010 would have exempted from qualification offerings or sales of securities using a general solicitation or general advertising, provided the transaction meets specified requirements, including a requirement that the sales are made to accredited investors. *Died in Senate Banking and Financial Institutions Committee.*

AB 1644 (Campbell and Briggs) of 2001 would have exempted from qualification offerings or sales of securities using a general solicitation or general advertising, provided the transaction

meets specified requirements, including a requirement that the sales are made to accredited investors. *Failed passage in Assembly Banking and Finance Committee.*

**Double Referral:** This measure is double referred to the Assembly Judiciary Committee.

**REGISTERED SUPPORT / OPPOSITION:**

**Support**

California Asian Pacific Chamber Of Commerce  
California Association Of Competitive Telecommunications Companies  
California Association Of Micro-economic Opportunity  
California Black Chamber Of Commerce  
California Metals Coalition  
Flasher Barricade Association  
Golden Gate Restaurant Association  
Greater Geary Boulevard Merchants & Property Owners Association  
National Association Of Women Business Owners California - Sacramento Valley Chapter  
National Federation Of Independent Business  
North East Mission Business Association  
Northern California Independent Booksellers Association  
Opportunity Fund  
Pacific Coast Regional Small Business Development Corporation  
Plumbing-heating-cooling Contractors Association Of California  
San Francisco Chamber Of Commerce  
San Francisco Council Of District Merchants Association  
San Francisco Locally Owned Merchants Alliance  
San Francisco Small Business Network  
Sierra Business Council  
Small Business California  
Small Business Majority  
Small Manufacturers Association Of California

**Opposition**

None on file.

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