

Date of Hearing: April 21, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Roger Dickinson, Chair

AB 2096 (Muratsuchi) – As Amended: April 9, 2014

SUBJECT: Securities transactions: qualification requirements: notification.

SUMMARY: Creates a form of crowdfunding in California by means of qualification of notification for any offer or sale of a security. Specifically, this bill:

- 1) Provides that the aggregate amount of securities sold to all investors by the issuer within a 12- month period cannot exceed \$1,000,000.
- 2) Provides that the aggregate amount of securities sold to any investor by the issuer including any amount sold during the 12-month period preceding the date of the transaction cannot exceed \$5,000.
 - a) Allows the commissioner of the Department of Business Oversight (DBO) to increase that amount by rule or order; and,
 - b) Provides that the limit does not apply if the investor is an accredited investor as defined under federal law.
- 3) Requires the offering to meet the requirements of the federal exemption for limited offerings and sales of securities not exceeding \$1,000,000.
- 4) Requires the issuer to file with the administrator, provide to investors and make available to potential investors the following:
 - a) A Small Company Offering Registration disclosure document on Form U-7, as adopted by the North American Securities Administrators Association (NASAA), prior to the commencement of the offering of securities.
 - b) Income tax returns filed by the issuer for the most recently completed year, if any; and, financial statements of the issuer certified by the principal executive officer of the issuer to be true and complete on all material respects, for offerings that, together with all other offerings of the issuer within the preceding 12-month period, have, in the aggregate offering amounts of \$100,000 or less.
 - c) All financial statements reviewed by a public account who is independent of the issuer, using professional standards and procedures for the review or standards and procedures established by the commissioner of the DBO by rule, for offerings, that together with all other offering of the issuer within the preceding 12-month period, have, in the aggregate, offering amounts of more than \$100,000, but no more than \$500,000.
 - d) Audited financial statements, for offerings that together within the preceding 12 month period have in aggregate, offering amounts of more than \$500,000.

- 5) Requires the issuer to set aside in a separate bank account all funds raised as part of the offering to be held until the time that minimum offering amount is reached.
- 6) Provides that if the minimum offering amount is not reached within one year of the effective date of the offering, the issuer shall return all funds to investors.
- 7) Provides an issuer, a predecessor of the issuer, an affiliated issuer, a director, executive officer, or other officer participating in the offering, among others specified in the measure would not be disqualified as a "bad actor" under federal regulations.
- 8) Requires a court to award attorney's fees and costs to a prevailing purchaser and would authorize the court to award treble and punitive damages.

EXISTING FEDERAL LAW:

- 1) Establishes the Securities Act of 1933 and the Securities and Exchange Act of 1934 administered by the Securities and Exchange Commission (SEC).
- 2) Establishes the National Association of Security Dealers that helps define the national behavior standards for member and minimum standards for listed securities which is regulated by the Securities and Exchange Commission.
- 3) Provides a "bad actor" disqualification that states no exemption shall be available for a sale of securities if the issuer; any predecessor of the issuer; any affiliated issuer; any director, executive officer, other officer participating in the offering, general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; any promoter connected with the issuer in any capacity at the time of such sale; any investment manager of an issuer that is a pooled investment fund; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; any general partner or managing member of any such investment manager or solicitor; or any director, executive officer or other officer participating in the offering of any such investment manager or solicitor or general partner or managing member of such investment manager or solicitor:
 - a) Has been convicted, within ten years before such sale (or five years, in the case of issuers, their predecessors and affiliated issuers), of any felony or misdemeanor, as specified;
 - b) Is subject to any order, judgment or decree of any court of competent jurisdiction, entered within five years before such sale that, at the time of such sale, restrains or enjoins such person from engaging or continuing to engage in any conduct or practice, as specified; or,
 - c) Is subject to a final order of a state securities commission (or an agency or officer of a state performing like functions); a state authority that supervises or examines banks, savings associations, or credit unions; a state insurance commission (or an agency or officer of a state performing like functions); an appropriate federal banking agency; the U.S. Commodity Futures Trading Commission; or the National Credit Union Administration that, as specified. [Title 17 of Code of Federal Regulations (CFR),

Section 230.506, subdivision d]

- 4) Provides an exemption for limited offerings and sales of securities not exceeding \$1,000,000. [Section 230.504 of Title 17 of CFR]
- 5) Defines an "accredited investor" as any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:
 - a) Any bank or any savings and loan association or other institution whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company, any investment company registered under the Investment Company Act of 1940 or a business development company, any Small Business Investment Company licensed by the U.S. Small Business Administration, any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;
 - b) Any private business development company;
 - c) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
 - d) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
 - e) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;
 - f) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
 - g) Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person, and;
 - h) Any entity in which all of the equity owners are accredited investors. [17 C.F.R. 230.501] [Rule 501, Regulation D]

EXISTING STATE LAW

- 1) Provides under the Corporate Securities Law of 1968 exemptions from qualification for certain securities transactions. [Corporations Code, commencing with Section 25000]
- 2) Provides that the Commissioner of DBO shall approve all securities offered or sold in California. [Corporation Code, Section 25100]
- 3) Prohibits any person from offering or selling in this state any security in an issuer transaction whether or not by or through underwriters, unless such sale has been qualified under Section 25111, 25112 or 25113 or unless such security or transaction is exempted or not subject to qualification. The offer or sale of such a security in a manner that varies or differs from, exceeds the scope of, or fails to conform with either a material term or material condition of qualification of the offering as set forth in the permit or qualification order, or a material representation as to the manner of offering which is set forth in the application for qualification, shall be an unqualified offer or sale. [Corporations Code, Section 25110]
- 4) Provides any security issued by a person which is the issuer of any 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, and which is not eligible for qualification under Section 25111, may be qualified by notification under this section. An application for qualification under this section shall contain such information and be accompanied by such documents as shall be required by rule of the commissioner, in addition to the information specified in Section 25160 and the consent to service of process required by Section 25165. For this purpose, the commissioner may classify issuers and types of securities. [Corporations Code, Section 25112]
- 5) Requires all purchasers to have either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors or controlling persons, or managers (as appointed or elected by the members) if the offeror is a limited liability company, or by reason of their business or financial experience or the business or financial experience of their professional advisers who are unaffiliated with and who are not compensated by the issuer or any affiliate or selling agent of the issuer, directly or indirectly, could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction. [Corporations Code, Section 25102 (f)]
- 6) Defines "issuer" as any person who issues or proposes to issue any security, except that:
 - a) With respect to certificates of deposit, voting trust certificates or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or persons performing similar functions or of the fixed, restricted management or unit type, "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the security is issued. However, with respect to equipment-trust certificates or like securities, "issuer" means the person by whom the equipment or property is or is to be used.

- b) With respect to certificates of interest or participation in oil, gas or mining titles or leases or in payments out of production under those titles or leases, "issuer" means the person or persons in active control of the exploration or development of the property who sell those interests or participations or payments or any person or persons who subdivide and sell those interests or participations or payments. The determination of the person or persons in active control of the exploration or development of the property shall be made on the basis of the actual relationship of the parties and not on the basis of the legal designation of a person's interest.
- c) With respect to a fractional or pooled interest in a viatical or life settlement contract, "issuer" means the person who creates, for the purposes of sale, the fractional or pooled interest. In the case of a viatical or life settlement contract that is not fractionalized or pooled, "issuer" means the person effecting the transactions with the investors in those contracts.
- d) In the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity. [Corporations Code, Section 25010]

FISCAL EFFECT: Unknown.

COMMENTS:

Based on the April 9, 2014 amendments to AB 2096, this measure is closely modeled after the recent enacted equity crowdfunding exemption established in Maine without the Governor's signature. AB 2096 will allow small businesses to raise up to \$1,000,000 in capital by selling small amounts of equity to individual investors. Small businesses will need to register with DBO, as well as, set a fundraising goal and deadline. AB 2096 will allow individual investors to purchase up to \$5,000 in equity from a single business. AB 2096 provides three significant differences from Maine which includes:

- 1) Instead of laying out a unique offering document, the measure uses an existing document established by the NASAA, Form U-7;
- 2) The measure includes a "bad actor" provision as provided under subdivision (d) of Section 230.506 of Title 17 of the CFR; and,
- 3) The measure provides attorney's fees and costs to a prevailing purchaser, as well as, treble and punitive damages.

While the goal of this measure is admirable, providing increased access to capital for small businesses, the risks associated with the measure could be at the expense of those most vulnerable, un-sophisticated non-accredited investors. AB 2096 does have a cap of \$5,000 which weakens the ability for an issuer to take an investors lifesavings but small business investments have even greater risk than normal. About 50 percent of all small businesses fail within the first five years according to a crowdfunding warning document issued by the NASAA.

This document can be found at: http://www.nasaa.org/wp-content/uploads/2012/05/NASAA_Advisory_Crowdfunding.pdf

Under existing state law, all securities offered or sold must either be qualified with the commissioner of DBO or exempted from registration by the commissioner. AB 2096 would add an additional way of qualification of notification rather than a pure exemption under the Corporate Securities Act of 1968.

BACKGROUND:

On April 5, 2012, President Obama signed landmark legislation, H.R. 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. As far as, AB 2096 is concerned, Title III of the JOBS Act requires the SEC to develop new rules permitting capital raising by “crowdfunding.” SEC is still in the rule-making process and is due to publish final regulations before non-SEC accredited investors can start financing small businesses.

In October of 2013, the SEC issued the proposed crowdfunding rules in a 585 page document. The JOBS Act creates an exemption from the registration requirements of the Securities Act of 1933 that provides for a form of securities crowdfunding. The SEC has not taken lightly the role of establishing a brand new type of financial intermediary and a whole new regulatory process which is why it is estimated the final rules will not be released until Summer, 2014 or as late as Winter, 2014. The SEC has struggled to create a set of 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.

Key features of the SEC’s proposed rules:

- A company will only be able to raise a maximum aggregate amount of \$1 million through crowdfunding offerings per 12-month period.
- Companies raising less than \$500,000 through crowdfunding within any 12-month period will need to share financial statements and income-tax returns with their investors and those raising more than \$500,000 will be obligated to provide audited financial statements to investors.
- Investors with an annual income or net worth of less than \$100,000 will be permitted to invest a maximum of \$2,000 or 5% of their annual income or net worth (whichever is greater) per 12-month period.
- Investors with an annual income or net worth equal to or greater than \$100,000 will be permitted to invest up to 10% of their annual income or net worth (whichever is greater) per 12-month period up to a total maximum of \$100,000 in securities.

- Companies conducting a crowdfunding offering will need to file certain information with the SEC, the relevant intermediary facilitating the crowdfunding offering and potential investors.
- Private crowdfunding offerings will be conducted exclusively online through a registered broker or funding platform (portal). Funding platforms will be required to register with the SEC. Non-US crowdfunding platforms will be able to register with the SEC, subject to an on-site examination.
- Registration rules for crowdfunding platforms, which were developed in partnership with the Financial Industry Regulatory Authority (FINRA). FINRA released its set of proposed rules, the Funding Portal Rules.

CROWDFUNDING

Crowdfunding is a collective cooperation of people who network and pool their money and resources together, usually 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 a business, real estate investments, projects or ideas and has become popularized online by sites such as Kickstarter, Wefunder, Crowdfunder and RockthePost.

Crowdfunding is a means to raise money by attracting relatively small individual contributions from a large number of people. In recent years, crowdfunding websites have proliferated to raise funds for charities, artistic endeavors and businesses. These sites did not offer securities, such as an ownership interest or share of profits in a business; rather, money was contributed in the form of donations, or in return for the product being made. Through AB 2096 and when the final rules are issued by the SEC, crowdfunding will expand to securities.

NASAA

AB 2096 requires an issuer to file with the administrator (commissioner of DBO) a small company offering registration disclosure document on Form U-7. The form is found at the NASAA website: <http://www.nasaa.org/industry-resources/corporation-finance/scor-overview/scor-forms/>. The form goes into detail, among other things, the type of investment, potential risks to the investor, the offering amount, and the deadline to reach the offering.

OTHER STATES

A number of other states have enacted crowdfunding in a variety of forms. These states include: Georgia, Kansas, Michigan, Idaho, Washington, Wisconsin and Maine.

QUESTIONS & CONCERNS:

- 1) Should California enact intrastate crowdfunding or should the Legislature wait until after the SEC finalizes the federal crowdfunding rules? The SEC proposed rules have been touted as being too stringent which may hinder those who actually use it. Some would say this is intentional to deter fraud and scams under this new framework. Ultimately, the question is

whether or not California needs to establish its own crowdfunding framework which may be more lax and/or conflict and if so, is that good?

- 2) The economy is recovering, the unemployment rate is down, the federal government acted, is there still a need to act on a statewide level to produce more ways to raise capital? In addition, the U.S. Treasury just gave the California State Treasurer \$55,218,250 in federal funds from the JOBS Act to provide access to capital to small businesses through the California Pollution Control Financing Authority and the California Infrastructure and Economic Development Bank. This is the second of three disbursements. Are small businesses capitalizing on these funds?
- 3) As noted above in "other states," the states that have adopted a crowdfunding framework are states that are desperately trying to attract and lure in new businesses. California is known as the start-up epicenter. According to a recent study by Radius, a San Francisco technology company that collects small business data in the U.S. of the top 12 places to establish a start-up in 2014, California had three cities which included: San Diego as number 1, San Francisco as number 6 and San Jose as number 12. Are small businesses really struggling to establish themselves in California? The small businesses that would need to use crowdfunding may be the types of businesses that have exhausted all other options and if so, are these the type of businesses we want established in California soliciting to potentially vulnerable unsophisticated investors?

PREVIOUS LEGISLATION:

AB 783 (Daly) (2013 Legislative Session) Provides 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) (2012 Legislative Session) Provides 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) (2010 Legislative Session) 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.

AB 1644 (Campbell & Briggs) (2001 Legislative Session) 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.

SUGGESTED AMENDMENT:

On page 3, line 12, delete "administrator" and insert "commissioner"

REGISTERED SUPPORT / OPPOSITION:

Support

Small Business California (SB-Cal)
California Artisanal Distiller Guild (CADG)
California Asian Pacific Chamber of Commerce
California Association of Competitive Telecommunications Companies (CALTEL)
California Association of Micro-economic Opportunity (CAMEO)
California Chapter of American Fence Association (AFA)
California Disabled Veteran Business Alliance
California Fence Contractors' Association (CFCA)
California Metals Coalition (CMC)
Coalition of Small and Disabled Veteran Businesses (CSBDVB)
Flasher Barricade Association
Greater Geary Boulevard Merchants & Property Owners Association
Marin Builders Association
National Federation of Independent Business (NFIB)
North East Mission Business Association (NEMBA)
San Francisco Builders Exchange
San Francisco Chamber of Commerce
San Francisco Council of District Merchants Association (SFCDMA)
Small Business Majority
SouthBay Entrepreneurial Center (SBEC)

Concern

Consumer Attorneys of California

Opposition

Public Investors Arbitration Bar Association (PIABA)

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