A SOLARI REPORT: CROWD FUNDING BILL, "Entrepreneur Access to Capital Act," HR 2930

HOUSE PASSES CROWDFUNDING BILL

On November 3, 2011, the House of Representatives passed the Entrepreneur Access to Capital Act (H.R. 2930). This law is intended to facilitate "**crowd-funding**" for financing small business entrepreneurship. Wikipedia describes crowd funding as "the collective cooperation, attention and trust by people who network and pool their money and other resources together, usually via the Internet, to support efforts initiated by other people or organizations". Sponsor of the bill Congressman Patrick McHenry (R. NC) explains crowdfunding on his **website** :

> "The basic idea is to raise money through relatively small contributions from a large number of people - combining the best of microfinance and crowdsourcing"

Under the current federal and state securities laws, crowd funding as a means to raise capital to finance small businesses is cumbersome and expensive (see below). The bill would create a new federal exemption from securities and broker-dealer registration requirements for offerings up to $2 million, would relieve "crowd funded" companies from public company reporting requirements, and would preempt state law to prevent state securities regulators from imposing additional requirements at the state level.

The North American Securities Administrators Association ("NASAA"), the organization of state securities administrators, opposed the law in a **letter** to House leaders, stating that the bill is well intended but "structurally flawed" because, in preempting state laws that require disclosures or reviewing of exempted investment offerings before they are sold to the public, it would:

(1)prohibit states from enforcing laws designed to minimize the risks to investors;
(2)only allow states to address investor losses after they occur; and
(3)place unnecessary limits on the ability of state securities regulators to protect retail investors from the risks associated with smaller, speculative investments.

NASAA's position is a $2 million cap on the size of an exempt offering a is too high, since "[a] company that is sufficiently large to warrant the raising of $2 million in investment capital is also a company that can afford to comply with the applicable registration and filing requirements."

The Obama Administration supports the bill **(H.R. 2930 – Entrepreneur Access to Capital Act**) as broadly supportive of President's "Startup America" initiative.

REASONS FOR A CROWD FUNDING LAW

Congressman McHenry's site provides the following explanation of the need for a method to facilitate crowd funding in the small business funding context, which is a good short summary of why a bill such as this should be enacted into law, we think, *to wit*:

- Entrepreneurs, startups, and small businesses are overlooked by conventional lenders (local banks or venture capitalists, angel investors) and have a hard time accessing credit in today's marketplace. As a result, United States capital formation and entrepreneurs suffer.
- Today in the United States, internet-based crowdfunding is utilized to raise millions of dollars for charitable organizations and non-profits.
- Other nations - such as Great Britain, Hong Kong, and the Netherlands - already offer equity-based crowdfunding opportunities to investors and startups to spur capital formation.
- Entrepreneurs and investors in the United States that communicate through internet-based platforms and offer securities are subject to costly SEC registration requirements.
- Compliance with each individual state's securities laws and rules - known as "Blue Sky Laws" - is prohibitively costly if companies are seeking to raise only small amounts of money.
- The SEC's general solicitation ban restricts companies from using modern communications to inform and connect to investors.

SUMMARY OF ENTREPRENEUR ACCESS TO CAPITAL ACT ("ACT")

The Act would create a new Section 4(6) of the Securities Act of 1933 exempting from federal securities law registration requirements offerings by an issuer of securities under the following conditions:

(1) Maximum offering within 12 months: $1 million or, if the issuer provides audited financial statements, $2 million (adjusted going forward by changes in the Consumer Price Index);

(2) Minimum investor limits: the lesser of $10,000 or 10% of the investor's annual income (adjusted going forward by changes in the Consumer Price Index);

(3) The issuer or an intermediary offering the securities must:

(a) warn investors, including on its website, of the speculative nature generally of investments in startups, emerging businesses, and small issuers, including risks in the secondary market related to illiquidity;

(b) warn investors that they are subject to the restriction on sales requirement;

(c) take reasonable measures to reduce the risk of fraud in the transaction;

(d) provide the Securities Exchange Commission ("SEC") with the intermediary's/issuer's physical address, website address and the names of the intermediary/issuer and employees of the intermediary/issuer, and keep such information up-to-date;

(e) provide the SEC with continuous investor-level access to its website;

(f) require each potential investor to answer questions demonstrating an understanding of the risks of this type of offering and such other matters as the SEC may require by rule or regulation;

(g) state a target offering amount and a deadline to reach the target offering amount and ensure that the required third party custodian withholds offering proceeds until aggregate capital raised from investors (other than the issuer) is at least 60% of the target offering amount;

(h) in the case of an intermediary, carry out a background check on the issuer's principals;

(i) provide the Commission and potential investors with notice of the offering, not later than the first day securities are offered to potential investors, including certain specified information demonstrating that the requirements have been satisfied;

(k) maintain such books and records as the SEC determines appropriate;

(l) make available on its website a method of communication that permits the issuer and investors to communicate with one another;

(m) provide the SEC with a notice upon completion of the offering that includes certain summary information about the offering;

(n) in the case of an issuer, disclose to potential investors, on its website, that the issuer has an interest in the issuance; and

(0) not offer investment advice.

Investors in crowd-funded offerings would not be permitted to resell their securities within one year of purchase except to the issuer or an accredited investor. An intermediary offering securities in a crowd-funded offering is relieved under the Act of the broker-dealer registration requirements under the Securities Exchange Act of 1934 ("Exchange Act").

The Act also would exempt offerings under the crowd funding rules from the public reporting requirements under Section 15 and 13(d) of the Exchange Act of 1934. This means that the issuer is not required to file annual reports, quarterly reports, proxy statements and other documents and notices with the SEC merely because it has 500 or more holders of common equity.

The Act requires the SEC to promulgate rules to facilitate these provisions within 180 days of enactment, including rules that would establish disqualification provisions under which issuers and intermediaries that have disciplinary histories would be ineligible.

Finally, the Act preempt state laws that would impose additional or different requirements for crowd-funded offerings but has no impact on any state's authority to take enforcement action under state law against issuers, intermediaries or custodians that engage in fraud or otherwise unlawful activity under state law.

CURRENT LAW

Common equity securities, limited partnership interests, limited liability company interests, notes sold for investment purposes and most other methods by which an entrepreneur might raise money to start a business or expand an existing business are "securities." Under current federal law, an issuer of securities engaged in interstate commerce (i.e., virtually any issuer these days, arguably) is required to register any securities it sells unless it qualifies for a federal exemption.

Most of the available transactional exemptions under the Securities Act:

- either limit the size of the offering or the number of non-accredited investors (i.e., those with incomes > $250,000 or assets of > $1MM) who can invest;
- place limits on or prohibit public advertising of the offering; and
- prohibit payment of sales commissions to intermediaries.

They call into question whether it is safe for an issuer to sell securities to anyone other than an investor who has a paid financial advisor to recommend the offering (who in turn is prohibited from being paid by the issuer to conduct a review of the offering) or who is obviously a financial expert or experienced in investing in similar securities. If the

issuer succeeds in establishing that interstate commerce is not implicated and, therefore, federal laws do not apply, then similar state restrictions on the offering generally apply.

Under current law, broker-dealer registration and other requirements under the Exchange Act make it virtually impossible for salesmen to become involved in the exempt offerings. Resale restrictions severely limit the liquidity of the securities offered under exempt transactions and make it difficult for investors to sell their securities in the secondary market.

The result? Legal fees required to comply with current exemptive provisions are prohibitive, making offerings of less than $2 million difficult. If the company ignores securities law requirements and provides investors with a good return on investment, then "no harm, no foul." However, if any investor is disgruntled, he or she effectively has a "put" to the issuer for the amount of the investment and state and/or federal enforcement authorities can be expected to descend upon the already-financially-strapped company.

LINKS

"Crowdfunding bill raises questions about investor protection," **http://www.stltoday.com/business/columns/david-nicklaus/crowdfunding-bill-raises-questions-about-investor-protection/article_c266825e-2a34-5c90-91f9-48ff520665c9.html**

Fund St. Louis site (referred to in "Crowdfunding" article above – an attempt at crowd-funding on a charitable basis) – www.fundstlouis.org

North American Securities Administrators Association (NASAA) letter to John Boehner and Nancy Pelosi in opposition to HR 2930 -- http://www.nasaa.org/wp-content/uploads/2011/11/NASAA-Letter-on-HR-2930.pdf