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July 28, 2015

Intrastate Crowdfunding Legislation Has Passed in Florida

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Florida Has Passed Intrastate Crowdfunding Legislation

As the country waits for the SEC to publish final Title III crowdfunding rules as required by the JOBS Act, states continue to enact and introduce state-specific crowdfunding legislation. As of today, it is unclear when the final federal rules will be released and passed into law though SEC Chair Mary Jo White has publicly stated on several occasions that it will be this year. Upon passage of the final rules, there will be a period of ramping up time in which crowdfunding portals complete the process of registering with the SEC, becoming members of FINRA and completing the necessary steps to ensure that their portal operates in compliance with the final rules. Federal crowdfunding is coming, but it is a slow process.

Florida is the newest state to pass intrastate crowdfunding legislation. The new Florida Intrastate Crowdfunding Exemption takes effect October 1, 2015. As a Florida resident, I have a personal interest in this bill and as a crowdfunding proponent, I support its passage.

The Florida Intrastate Crowdfunding Exemption

In May 2015, Florida passed new crowdfunding legislation through both the House and Senate allowing equity crowdfunding offerings up to $1 million in any 12-month period. The Florida Intrastate Crowdfunding Exemption will allow crowdfunding by Florida entities, using social media and other forms of advertising, where all investors are Florida residents and all raises are conducted through Florida-registered intermediaries.

The Florida Intrastate Crowdfunding Exemption creates a new crowdfunding exemption codified in Section 517.0611 of the Florida Statutes and makes conforming changes throughout Section 517.

The new exemption exempts the offer or sale of securities from the Florida registration requirements found in Section 517.07, if the offer or sale is conducted in accordance with all of the following requirements:

(a) The issuer is a for-profit business entity formed under the laws of the state of Florida and registered with the Secretary of State;

(b) The issuer maintains its principal place of business in Florida and its revenues primarily come from its activities in Florida;

(c) The issuer is not a blank check company (i.e., it does not lack a defined business operation, business plan, or stated investment goal for the raise, or it has plans to engage in a merger or acquisition with an unspecified business);

(d) The issuer, directors, offers and 20% shareholders must not be subject to a "bad actor" disqualification as set out in new Florida Statute section 517.1611 or Rule 506(d) of the Securities Act of 1933, as amended ("Securities Act");

(e) The transaction meets the requirements of the federal exemption for intrastate offerings under Section 3(a)(11) of the Securities Act of 1933 and Rule 147 promulgated thereunder;

(f) The issuer files a notice with Florida's Office of Financial Regulation ("OFR") and pays a $200 filing fee at least 10 days prior to commencing the offering or displaying any offering materials on the issuer's website. The notice contains information regarding the issuer, its officers and directors and the offering which information is also contained in the disclosure document;

(g) All offerings must be conducted through a registered broker-dealer or registered intermediary;

(h) The dealer or intermediary for the offering must provide a disclosure statement to potential investors and the issuer must file this disclosure statement with the OFR at the same time it files its notice of offering;

(i) The offering disclosure statement must be provided to potential investors and must contain certain delineated information including issuer information and background, financial disclosures, descriptions of the business plan, identity and information related to officers, directors, owners and control persons, risk factors, the offering amount and the price of the securities including how such price and valuation were determined, the name of the escrow agent, and the capital structure and ownership information;

(i) The financial statement disclosure is tiered based on the offering amount as follows: (x) for offerings below $100,000, the most recent income tax return must be described and the financials certified by the principal executive officer; (i) for offerings between $100,000 and $500,000, the financial statements must be prepared in accordance with GAAP and reviewed by an independent public accountant; and (z) for offerings over $500,000, the financial statements must be prepared in accordance with GAAP and audited by an independent public accountant. Offering amounts are aggregated with all offerings within the preceding 12-month period;

(j) The issuer must execute an escrow agreement with a federally insured financial institution authorized to conduct business in Florida, and must deposit all investor funders into such account. Proceeds may only be released when the aggregate funds raised are equal to or greater than the target offering amount;

(k) The issuer is not an investment company under the Investment Company Act of 1940 or subject to the reporting requirements of the Securities Exchange Act of 1934;

(l) The issuer must file with the OFR and provide all investors with an annual report containing information about the issuer including disclosures related to any material changes, within 45 days of the end of the fiscal year. The issuer must continue to do this as long as there remain outstanding securities purchased by shareholders in the offering;

(m) The sum of all cash and other consideration received from all sales of the security under this exemption does not exceed $1 million, less the aggregate amount received from all sales of securities by the issuer within the 12 months before the offering

is made; offers and sales to officers, directors, or 20% or greater shareholders do not count in the calculation;

(n) The offering may be advertised but only if the securities are being sold by a broker-dealer or intermediary registered with the OFR (note that all offerings must be completed through a broker-dealer or intermediary);

(o) Investors must be given the right to cancel the investment up to 3 business days before the offering deadline as set forth in the disclosure document;

(p) Issuer must refund all investor funds if the target amount is not reached by the offering deadline;

(q) All offering materials prominently and in bold conspicuous print contain the state-required disclosure legend;

(r) Unless the purchase is an accredited investor as defined by Rule 501 of Regulation D of the Securities Act of 1933, the aggregate amount sold by an issuer to an investor under this exemption during a 12-month period does not exceed: (i) if the investor's annual income or net worth is less than $100,000, the greater of $2,000, 5% of the annual income of the investor, or 5% of the net worth of the investor; or (ii) if the investor's annual income or net worth is $100,000 or more, the greater of $100,000, 10% of the annual income or 10% of the net worth of the investor;

(g) Before the use of any general solicitation or the 25th sale of the security, whichever occurs first, the issuer files a notice with the commission in writing or in electronic form through the office's Regulatory Enforcement and Licensing System that: (i) indicates that the issuer is conducting an offering in reliance upon this exemption; (ii) contains the names and addresses of the issuer, all persons who will be involved in the offer or sale of securities on behalf of the issuer, and the bank or other depository institution in which investors' funds will be deposited; and (iii) includes documentation verifying that the issuer is organized under the laws of the state and is authorized to conduct business in this state; and

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(i) Each security purchaser is notified by the issuer or the selling agent that the security is not registered under this chapter and that the securities are subject to the resale limitations set forth in Rule 147 promulgated under the Securities Act of 1933.

Under the Florida Intrastate Crowdfunding Exemption, an "Intermediary" is defined as a natural person residing in Florida or a corporation, trust, partnership, association or other legal entity registered with the Florida Secretary of State to conduct business in Florida and which facilitates the offer or sale of securities under the new Crowdfunding Exemption. Intermediaries must be registered with the OFR. To register an intermediary must file an application, pay a $200 fee and be subject to a criminal background check.

An Intermediary has certain affirmative duties, including (i) take measures, as set forth in the rules, to reduce the risk of fraud, including verifying issuer compliance with the requirements of the Florida Intrastate Crowdfunding Exemption; (ii) provide basic information on its website regarding the risk of investments and limitations on the resale of the securities and the potential for loss of the entire investment, and a description of the escrow agreement; (iii) obtaining from each purchaser evidence showing that the purchaser is a resident of this state; (iv) monitoring the offering and deposit and release of escrow funds; (v) provide a monthly update for each offering; and (vi) obtain a certification from each investor as specifically set forth in the statute which certification includes acknowledgment of residency and an understanding of the risks.

An intermediary that is not also a licensed broker-dealer may not: (i) offer investment advice or recommendations (an intermediary's refusal to post or rejection of an offering may not be construed as advice or a recommendation); (ii) solicit purchases, sales or offers to buy securities offered or displayed on its website or portal; (iii) compensate employees, agents, or other persons for the solicitation of purchases, sales, or offers to buy the securities offered on its website or portal; (iv) compensate promoters, finders or lead generators for providing the intermediary with the personal identifying information of any potential investor; and (v) hold, manage, possess, or otherwise handle investor funds or securities.

Like the federal statute, Florida Intermediaries will be exempt from registration as a broker-dealer. In the Florida Intrastate Crowdfunding Exemption, a funding portal will be required to provide basic information on its website regarding the high risk of investment and limitation on the resale of exempt securities and the potential for loss of an entire investment in order to qualify from the broker-dealer registration requirements. In

addition, the intermediary is required to maintain records of the offers and sales of securities made through its website and provide access to such records to the SEC and/or OFR. Like the federal statute, Florida Intermediaries are subject to "bad boy" disqualification provisions, which provisions reference federal Rule 262 promulgated under the Securities Act of 1933, as amended.

Basic Background on Crowdfunding

Crowdfunding generally is where an entity or individual raises funds by seeking small contributions from a large number of people. The crowdfunder sets a goal amount to be raised from the crowd, with the funds to be used for a specific business purpose. In addition, a crowdfunding campaign allows the crowd to communicate with each other, thus adding the benefit of the "wisdom of the crowd." Small businesses can particularly benefit from crowdfunding as they are not limited by restrictions on general solicitation and advertising or purchaser qualification requirements.

Title III of the JOBS Act, called the Crowdfunding Act, amends Section 4 of the Securities Act of 1933 (the Securities Act), adding new Section 4(a)(6) to create a new exemption to the registration requirements of Section 5 of the Securities Act. The new exemption allows issuers to solicit "crowds" to sell up to $1 million in securities in any 12-month period as long as no individual investment exceeds certain threshold amounts.

The threshold amount sold to any single investor cannot exceed (a) the greater of $2,000 or 5% of the annual income or net worth of such investor if the investor's annual income or net worth is less than $100,000; and (b) 10% of the annual income or net worth of such investor, not to exceed a maximum of $100,000, if the investor's annual income or net worth is more than $100,000. When determining requirements based on net worth, an individual's primary residence must be excluded from the calculation. Clearly there is a conflict in the language determining threshold amounts; an investor could fall within both categories. The conflict has been pointed out in numerous letters to the SEC and will presumably be addressed in the rule making.

Section 302 of the Crowdfunding Act requires that all crowdfunding offerings be conducted through an intermediary that is a broker-dealer or funding portal that is registered with the SEC and a member of a registered self-regulatory organization (SRO). Currently that SRO is the Financial Industry Regulatory Authority (FINRA). Although funding portals will have to register with the SEC and become a member of FINRA, they

will not have to register as a broker-dealer. FINRA has already published proposed rules to regulate funding portals.

In addition, the Crowdfunding Act requires that issuers and intermediaries provide certain information to investors, potential investors and the SEC. The ability to utilize crowdfunding will be subject to bad boy restrictions and other disqualifying events. All crowdfunding issuers must be United States entities. Crowdfunding issuers cannot be subject to the reporting requirements of the Securities Exchange Act of 1934 or an investment company as defined by the Investment Company Act of 1940.

The finalization and implementation of Regulation Crowdfunding is in the hands of the SEC. Many proponents are concerned that Regulation Crowdfunding as promulgated by the SEC will be cumbersome for small businesses, and the draft of proposed rules has done nothing to alleviate that concern.

The states are cognizant of this concern and the immediate need for a method for small businesses to raise local funds for local businesses using social media and other general solicitation and advertising without accredited investor restrictions. Accordingly, many states have recently either enacted or introduced state-specific crowdfunding legislation. Georgia, Kansas, Michigan and Idaho have already enacted legislation. California has granted at least one permit to allow for a crowdfunded offering. Washington and North Carolina have pending crowdfunding bills, and Nebraska and Maine are drafting bills.

Potential Positive Impact of Crowdfunding

In a study completed by Crowdfund Capital Advisors based on a review of entities completing crowdfunding capital raises either in the U.S. on a rewards basis or in Europe on an equity or debt basis, the following facts were reported:

- Crowdfunded companies increased quarterly revenues by an average of 24% post offering
- 39% of companies hired an average of 2.2 new employees
- Within 3 months of the crowdfunding campaign, 28% of the companies had closed an angel investor or venture capital round
- Every hour invested in a successful crowdfunding campaign returned $813

Federal Authority for State Crowdfunding Legislation

Both the federal government and individual states regulate securities, with the federal provisions often preempting state law. When federal provisions do not preempt state law, both federal and state law must be complied with. On the federal level, every issuance of a security must either be registered under Section 5 of the Securities Act, or exempt from registration. Section 3(a)(11) of the Securities Act of 1933, as amended (Securities Act) provides an exemption from the registration requirements of Section 5 for "[A]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." Section 3(a)(11) is often referred to as the Intrastate Exemption. Rule 147 promulgated under Section 3(a)(11) provides for further details on the application of the Intrastate Exemption.

On the federal level, issuers relying on state crowdfunding statutes rely upon the Intrastate Exemption together with Rule 147 promulgated thereunder. The Intrastate Exemption is only available for bona fide local offerings. That is, the issuer must be a resident of, and doing business within, the state in which all offers and sales are made, and no part of the offering may be offered or sold to non-residents. Because of the strict rules against any sales or offers to non-residents, issuers conducting concurrent or consecutive offerings need to be extra careful to avoid the integration of any non-intrastate transactions with the Intrastate Exemption.

Avoiding Integration While Using the Intrastate Exemption

The determination of whether two or more offerings could be integrated is a question of fact depending on the particular circumstances at hand. Rule 502(a) and SEC Release 33-4434 set forth the factors to be considered in determining whether two or more offerings may be integrated. In particular, the following factors need to be considered in determining whether multiple offerings are integrated: (i) are the offerings part of a single plan of financing; (ii) do the offerings involve issuance of the same class of securities; (iii) are the offerings made at or about the same time; (iv) is the same type of consideration to be received; and (v) are the offerings made for the same general purpose.

In addition, Rule 147(b)(2) provides an integration safe harbor. That is, offerings made under Section 3 or Section 4(2) of the Securities Act or pursuant to a registration statement will not be integrated with an Intrastate Exemption offering if such offerings take place six months prior to the beginning or six months following the end of the Intrastate Exemption offering. To rely on this safe harbor, during the six-month periods, an issuer may not make any offers or sales of securities of the same class as those offering in the Intrastate offering. Rule 147(b)(2) is merely a safe harbor. Issuers and practitioners may still conduct their own analysis in accordance with the five-factor test enumerated above.

Determining Whether an Issuer is a "Resident" of and Doing Business in a Particular State

For purposes of the Intrastate Exemption, an issuer shall be deemed to be a resident of the state in which: (i) it is incorporated or organized, if it is an entity requiring incorporation or organization; (ii) its principal office is located, if it is an entity not requiring incorporation or organization; or (iii) his or her principal residence is located, if an individual.

For purposes of the Intrastate Exemption, an issuer shall be deemed to be doing business within a state if: (i) the issuer, together with its subsidiaries, derived at least 80% of its gross revenues in the most recent fiscal year or most recent six-month period from that state, whichever is closer in time to the offering; (ii) the issuer had 80% of its assets located in that state in the most recent semiannual fiscal year; (iii) the issuer intends to use and uses at least 80% of the net proceeds from the Intrastate offering in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services in that state; and (iv) the principal office of the issuer is located within that state.

Determining Whether the Investors and Potential Investors are Residents of a Particular State

All offers, offers to sell, offers for sale and sales of securities in an Intrastate-exempted offering must be made to residents of the state in which the offering is conducted. For the purpose of determining the residence of an offeree or purchaser: (i) a corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state if, at the time of the offer and sale, it has its principal office within such state; (ii) an individual shall be deemed to be a resident of a state if, at the time of the offer and sale, his or her principal residence is within that state; and (iii) a corporation partnership,

trust or other form of business organization formed specifically to take part in an Intrastate offering will not be resident of the state unless all of its beneficial owners are residents of that state.

Resale Restrictions

Even though securities issued relying on the Intrastate Exemption are not restricted securities for purposes of Rule 144, Rule 147(e) prohibits the resale of any such securities for a period of nine months except for resales made in the same state as the Intrastate Offering. Moreover, market makers or dealers desiring to quote such securities after the nine-month period must comply with all of the requirements of Rule 15c2-11 regarding current public information. Moreover, Rule 147 specifically requires the placing of a legend on any securities issued in an Intrastate offering setting forth the resale restrictions. In the case of an allowable in-state resale, the purchaser must provide written representations supporting their state of residence.

Advertising and Solicitation

There is no prohibition in Section 3(a)(11) or Rule 147 regarding general advertising or general solicitation as long as such general advertising or solicitation complies with applicable state law and does not result in an offer or sale to non-residents of such state.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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