Texas Opens its Doors to Crowdfunding

By Lee Polson and Alana Parker

In the race between states vying for startup businesses, Texas proposes to sweeten the deal with a new proposal that exempts crowdfunding initiatives from state securities laws.

For those new to the concept, crowdfunding refers to a method of raising money from a large number of small investors, typically through an online portal or platform, in order to finance a new business venture. Entrepreneurs who raise money through crowdfunding often use social media to share their efforts, which increases traffic to their crowdfunding page. Certain crowdfunding sites, such as Kickstarter, operate on a donations-based model. That is, individuals contribute to their preferred startups and causes without receiving any equity or interest in return. Consequently, Kickstarter campaigns are not considered securities offerings.

Other platforms, such as AngelList and CircleUp, restrict participation to accredited investors. While this allows them to comply with federal securities laws, the limited access to such offerings goes against the appeal of crowdfunding as a more open, egalitarian, and small-business friendly platform for raising capital. Therefore, proponents of crowdfunding have advocated for an exemption to the federal securities laws that would allow them to raise relatively small amounts of capital from the general public while avoiding the burdens of current regulations.

This goal appeared to be within reach after Title III of the JOBS Act prompted the SEC to draft a new exemption making it easier for small businesses to raise money from non-accredited investors via online portals. While observers in the startup community were initially optimistic about the potential for crowdfunded offerings on a national scale, they have lowered their expectations after the SEC took a year and a half to release proposals for its crowdfunding rules. It is not yet known when those rules will go into effect.

The Texas State Securities Board Publishes Proposal for Crowdfunding Exemption

The Texas State Securities Board recently released its own proposed crowdfunding rules for public comment. As with the proposals in other states, the Texas rules rely on the intrastate offering exemption set forth in Section 3(a)(11) of the Securities Act.

This exemption provides that any issue of securities offered only to investors residing within one state, where the issuer is a resident of the same state, is exempt from registration under the federal securities laws. Each state has its own intrastate offering regulations, and exemptions for crowdfunding proposals must generally fall under this exemption or they are preempted by federal securities laws.

The key provisions of the proposed crowdfunding exemption in Texas are as follows:

<u>Eligible businesses may raise up to $1 million per 12-month period.</u>

An issuer must be a Texas entity to be eligible for the crowdfunding exemption, and it may only offer securities in Texas. The eligibility and residency requirements mirror those set forth in Rule 147, enacted pursuant to the federal intrastate offering exemption.

Key Provisions

1

Eligible businesses may raise up to $1 million per 12-month period.

2

Non-accredited investors may contribute up to $5,000 per offering.

3

Offerings must be carried out online through a registered dealer or crowdfunding portal.

4

Issuers are required to submit limited disclosures.

In order to meet the residency requirements, an issuer must be able to demonstrate the following:

- The issuer must be organized in and have its principal place of business in Texas;
- at least 80% of the issuer's gross revenues during its most recent fiscal year prior to the offering must be derived from the operation of a business in Texas;
- at least 80% of the issuer's assets at the end of its most recent semiannual period prior to the offering are located in Texas; and
- at least 80% of the net proceeds of the offering must be used in connection with the operation of the issuer's business within Texas.

While the exemption is designed to benefit startup companies, the company must have a defined business plan and investment goals. Finally, customary bad actor disqualifications also apply, and the issuer may not be an investment company or an SEC reporting company.

Once an issuer meets these requirements, it may raise up to $1 million within each 12-month period (including offerings by control persons).

<u>Non-Accredited investors may contribute up to $5,000 per offering.</u>

Investments pursuant to the proposed crowdfunding exemption are limited to $5,000 per investor, unless the investor is an accredited investor as defined in Rule 501 under the Securities Act of 1933. If an issuer wishes to raise larger amounts from accredited investors, it must verify the investor's accredited status first. Investor funds must be placed in escrow until the specified minimum offering amount has been raised.

In addition, only investors resident in the State of Texas may participate in crowdfunding offerings. Investors will be required to submit a Texas driver's license number, voter registration card or property tax records to prove that they are Texas residents. Before purchasing any securities, prospective investors must confirm their acknowledgment of certain customary disclaimers.

<u>Offerings must be carried out online through a registered dealer or crowdfunding portal</u>.

The responsibility for verifying eligibility of investors lies with each online dealer or crowdfunding portal. Each site must review any documents submitted by a prospective investor and confirm the investor's residency in Texas before allowing access to the portal. In addition, crowdfunding portals must conduct background and regulatory checks on each issuer and each of the issuer's directors, officers, and other control persons to determine eligibility with the crowdfunding exemption and the potential risk of fraud.

Those establishing crowdfunding portals may register by filling out a form, completing a background check and paying the standard registration fee for securities dealers in Texas. Principals are not required to pass the General Securities Registered Representative (Series 7) Exam or the Uniform Securities Act State Law (Series G5) Exam. Instead, new procedures have been proposed to allow such portals to register as restricted dealers. Crowdfunding portals operating under the proposed rules must limit their access and trading activity to Texas, and may not offer investment advice, manage investor funds, or facilitate secondary market transactions, among other prohibited activities.

While crowdfunding portals will be required to maintain certain offering-related records for at least five years following an offering, they are not required to monitor individual offerings on an ongoing basis. Portals are, however, subject to certain post-registration reporting requirements and renewal fees.

<u>Issuers are required to submit limited disclosures</u>.

Issuers raising money through crowdfunding must claim an exemption from registration by filing new Form 133.17 with the State Securities Board. Issuers must post a summary of the offering and an offering disclosure on a registered crowdfunding portal or dealer site at least 21 days before any securities may be sold. The disclosure must include risk factors, a description of the issuer's business, operations, and management, a description of the securities and other material information. However, the required disclosure will be brief compared to disclosures required for larger offerings. The State Securities Board expects to release guidance for crowdfunding disclosures simultaneously with the rules' enactment.

All communications with investors must occur on the portal via open message boards accessible to other prospective investors. Issuers are permitted to distribute a limited notice stating that the issuer is conducting an offering and providing a link to the crowdfunding portal that will host the offering, but the notice may only be distributed to investors located in Texas. This provision limits the possibility of advertising crowdfunding offerings through social media.

Notably, issuers relying on the crowdfunding exemption will not be required to provide reviewed or audited financial statements unless audited financial statements are already available for any of the three years prior to the offering. Issuers may instead have their CEO certify that the issuer's financial statements are accurate and complete as of the date of the offering.

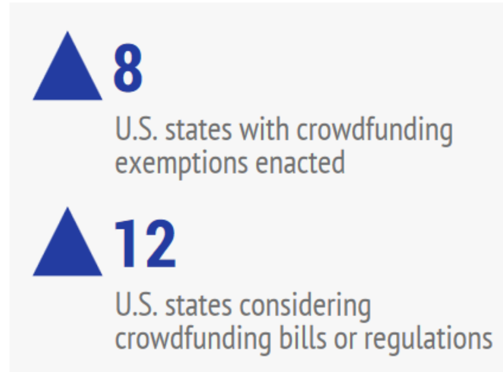
SEC's Crowdfunding Exemption Seen as Flawed

The SEC's proposed rules have been widely criticized by analysts for being overly burdensome and costly. In particular, the proposal requires issuers raising $500,000 or more to submit audited financial statements on an annual basis, and all issuers must be prepared to submit financial statements in accordance with GAAP. Companies raising $100,000 or less must submit a tax return for the most recent fiscal year. Furthermore, issuers are subject to annual filing requirements.

As a result of these and other regulatory burdens, the SEC estimates the cost of compliance for raising capital at up to 40% of the proceeds raised, while some analysts have noted that the cost can be even higher for offerings at the lower end of the scale. Furthermore, the SEC's proposal requires funds to be held in escrow during a review period, even after the target minimum amount has been raised.

These federal-level obstacles have led several states to propose new rules or legislation that rely on the intrastate offering exemption under the Securities Act. All of these initiatives would allow small businesses within each state to tap into crowdfunding as an innovative way to raise capital from the general public.

Texas’ Recipe for Crowdfunding Success



What makes the Texas proposal unique is the sheer size of the state. With a population of 26 million, Texas offers a business-friendly regulatory environment and a sufficiently large market for small- and medium-sized businesses to raise financing through crowdfunding. At present, Texas is the second largest state to support a crowdfunding initiative. California, the largest state, has pending a Crowdfunding proposal which would require action by the state legislature. Michigan, the next largest state to enact a crowdfunding exemption, has less than half the population of Texas.

The Texas proposal also has a few advantages over the proposed exemptions in other large states. For example, the Texas proposal was initiated by and enjoys the support of the Texas State Securities Board. By contrast, Florida recently saw its legislation die in committee following reported opposition from the Florida Office of Financial Regulation.

Furthermore, while issuers in Texas would be subject to the customary rules related to fraud, nothing in the proposed rules would create additional liabilities for small businesses raising capital through crowdfunding. California’s crowdfunding bill, however, contains potential pitfalls for the unwary small business issuer and has not yet left the sponsor’s committee in the State Assembly. In particular, the California legislation entails greater risks of litigation for issuers by authorizing courts to award treble or punitive damages to purchasers of securities where the issuer violates certain qualification provisions of the crowdfunding exemption. Indeed, Texas’ proposal is focused on striking the balance between protecting investors and encouraging small businesses to thrive.

Next Steps for Crowdfunding in Texas

The rules proposed by the Texas State Securities Board were published in the Texas Register on May 9, 2014 and are subject to a 30-day public comment period before they may be adopted. After the comment period ends, the State Securities Board may adopt the proposal as published, adopt it with amendments, or revise it and republish it for public comment. Strasburger & Price will keep you apprised of developments, and our attorneys are always open for discussion about how these changes can affect your business.

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