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PERSPECTIVE

California adopts equity crowdfunding exemption for seed capital

By Mark T. Hiraide

Since the start of the pandemic, the market for early-stage equity investments by retail investors has boomed. An August New York Times article, "Even Your Allergist Is Now Investing in Start-Ups," describes the heightened interest in startup investments by what the Securities and Exchange Commission calls "non-accredited investors."

Now, in addition to traditional sources of early-stage capital — wealthy friends and family, seed-stage funds, and family offices — entrepreneurs are tapping retail investors through "equity crowdfunding" made possible by the federal Jumpstart Our Business Startups Act, or "JOBS Act," of 2012. On Jan. 1, 2022, a new securities law, Assembly Bill 511, adds Section 25102(r) to the California Corporate Securities Law of 1968. It will significantly reduce the out-of-pocket cost of raising up to $300,000 in critical seed capital, which startups need to scale up their capital-raising activity to access larger early-stage investments through the federal JOBS Act regime. It is the first exemption for small offerings in California in nearly 30 years.

AB 511 reduces the cost of accessing seed capital in two ways. First, relying on a federal intrastate offering exemption — Section 3(a)(11) of the Securities Act of 1933 and Rule 147 (17 C.F.R. 230.147) or Rule 147A (17 C.F.R. 230.147A) under that act — AB 511 eliminates the federal requirement to obtain a financial statement review by an independent certified public accountant for offerings up to $300,000. Second, and perhaps more importantly, because the issuer need not rely on the federal crowdfunding offering exemption to raise its first $300,000 in seed capital, it will preserve for a post-seed, follow- on offering a federal exception applicable to first-time users of the federal crowdfunding offering exemption that allows an issuer to raise up to $1 million without incurring the cost of an audit.

Until the JOBS Act, federal and state securities law placed strict restrictions on raising capital from private sources. The Securities Act of 1933 and the Securities Exchange Act of 1934, well-intentioned in the aftermath of the 1929 stock market crash and the Great Depression, outlawed advertising private securities offerings that were not registered with the SEC. Consequently, entrepreneurs were relegated to raising startup financing from investors with whom they had a close "pre-existing relationship" (i.e., friends and family with means). Those 90-year-old laws also effectively restricted private unregistered offerings to "accredited investors" — individuals with at least $1 million in net worth, excluding home equity, or annual income of $200,000 ($300,000 joint annual income) for the past two and current years.

These systemic legal impediments to accessing capital determined who received early-stage capital, who created businesses and who accumulated wealth.

The JOBS Act established provisions for "equity crowdfunding," an exemption from registration for offerings conducted online to an unlimited number of non-accredited investors on SEC-sanctioned crowdfunding portals. Although the JOBS Act is almost 10 years old, it wasn't until online investing increased dramatically during the pandemic and, importantly, until this year when the SEC increased the equity crowdfunding offering limit from the original $1 million to $5 million, that the newly created regime jumpstarted startup financing.

Prior law also imposed significant restrictions on the intermediaries who sold securities to investors; most were required to register with the SEC as broker-dealers. For broker-dealers, who are subject to know-your-customer and suitability rules and strict oversight by the Financial Industry Regulatory Authority, aka FINRA, recommending and selling securities sold in unregistered offerings to non-accredited customers is often cost-prohibitive. The JOBS Act requires crowdfunding portals to become members of FINRA, but they are exempt from the broker-dealer registration requirements under the 1934 Act, and Regulation CF permits the portals to rely on representations by investors about their net worth and income level.

The portals' software takes information provided by the entrepreneur in response to an online questionnaire and generates a draft offering statement. To attract the attention of the ever- growing number of investors who register with the portal, in a manner similar to online sites that create websites, the portals' software creates a customized investment landing page for each offering that incorporates the entrepreneur's vision video and other collateral material.

There are presently approximately 80 crowdfunding portals licensed with FINRA: Republic, StartEngine, WeFunder and SeedInvest, to name a few. By design, the crowdfunding portals have become an important resource in the startup ecosystem. The JOBS Act requires the portals provide investor education, and the portals' agents serve to educate entrepreneurs about the basics of equity crowdfunding under Regulation CF. Most portals charge very little or nothing up front, as the portals are compensated on a percentage of the equity raised, usually between 6% to 8%. Historically, only registered broker-dealers were eligible to charge commissions to

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sell securities. In addition to the commission, some portals also receive a small percentage of the equity raised.

The requirements to conduct an equity crowdfunding offering pursuant to Regulation CF were designed to be straightforward. Regulation CF limits the amount an individual may invest based on the investor's annual income or net worth. The regulation also imposes certain requirements on advertising the offering, and it mandates specific disclosures be included in an offering statement on a prescribed form that must be filed with the SEC. For offerings greater than $107,000, the Offering Statement must include a review report by an independent certified public accountant. For offerings more than $535,000, the issuer is required to obtain an audit, unless the issuer has not previously sold securities in reliance on section 4(a)(6) of the Securities Act (15 U.S.C. 77d(a)).

An entrepreneur's most significant out-of-pocket expense for an equity crowdfunding campaign under Regulation CF is the cost of the independent certified public accountant's attest engagement. The risk premium associated with a review or audit for what is, in effect, a public offering of securities can be significant. *See Bily v. Arthur Young & Co.*, 3 Cal. 4th 370 (1992) (accountants may be liable in tort to third parties). For many, the cost of the CPA precludes access to the federal JOBS Act regime. AB 511 will enable a startup to raise up to $300,000 in seed capital without a review and later scale up to raising up to $1 million without incurring the cost of an audit.

Finally, to enhance investor protection, AB 511 brings California into line with most other states by providing statutory attorney fees for investors who prevail in obtaining relief in a civil action for rescission or damages under the California Corporate Securities Law of 1968. See Section 25501 and 25503.

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