SENATE JUDICIARY COMMITTEE
Senator Thomas Umberg, Chair
2021-2022 Regular Session

AB 511 (Muratsuchi)
Version: June 24, 2021
Hearing Date: July 6, 2021
Fiscal: Yes
Urgency: No
AWM

SUBJECT

Securities transactions: qualification requirements, exemptions, and liability

DIGEST

This bill creates an exemption to California's securities qualification requirement certain crowdfunded equity offerings, subject to certain conditions.

EXECUTIVE SUMMARY

Crowdfunding platforms have become a popular way for small and new businesses to raise capital in exchange for equity. These sites allow businesses to pitch their ideas directly to members of the public, who generally pledge small amounts of money toward the business so that the business can raise "seed capital," or early stage funding. Crowdfunding occupied a legal gray area until 2012, when the federal government authorized the United States Securities and Exchange Commission (SEC) to adopt regulations governing crowdfunding offerings. The resulting regulations, known as Regulation CF, took effect in 2016, and permit crowdfunding operations within certain parameters to operate without registering the offering with the SEC. Current California law, however, does not have any crowdfunding-specific provisions, meaning certain California companies seeking to raise capital via crowdfunding offerings within the state must comply with the qualification requirements of the Corporations Law of 1968. There have been numerous attempts to establish a crowdfunding exemption, but none has passed both houses of the Legislature.

This bill creates a more modest crowdfunding exemption than prior bills. Specifically, the bill exempts from the state qualification requirement crowdfunding offerings that comply with Regulation CF, with a few variances, and ensures that shareholders cannot be required to waive their right to a jury trial, litigate under law other than California law, or litigate in a forum other than California. The bill also awards reasonable attorney fees to a prevailing investor for specified violations of state securities laws, including the new crowdfunding provisions.

This bill is sponsored by Small Business California and is supported by a number of chambers of commerce and other small business groups. There is no known opposition. This bill passed out of the Senate Banking and Financial Institutions Committee with a 9-0 vote.

PROPOSED CHANGES TO THE LAW

Existing federal law:

1) Under the Securities Act of 1933, makes it unlawful for any person to make an interstate offering of securities without registering the offering with the SEC, unless the offering is specifically exempted. (15 U.S.C. § 77e.)

2) Preempts state securities laws for, and exempts from state qualification requirements, interstate securities that are covered by the Securities Act of 1933. (15 U.S.C. § 77r.)

3) Exempts from the requirements of the Securities Act of 1933 crowdfunded offerings, subject to SEC regulations. (15 U.S.C. §§ 77d(a)(6) & 77d-1(b).)

4) Establishes Regulation CF (Reg CF), which provides requirements for crowdfunding offerings exempt from the registration requirement, including:
    a) The aggregate amount of securities offered in a subject to the crowdfunding exemption shall not exceed $5,000,000.
    b) For purchasers who are not accredited investors, as defined, the aggregate amount sold to an investor shall not exceed (1) the greater of $2,200 or 5 percent of the greater of the investor's annual income or net worth, if either the investor's annual income or net worth is less than $107,000; or (2) 10 percent of the greater of the investor's annual income or net worth, not to exceed an amount sold of $107,000, if both the investor's annual income and net worth are equal to or more than $107,000.
    c) The transaction is conducted through an intermediary that complies with the SEC's requirements and is conducted exclusively through the intermediary's platform.
    d) The issuer is not otherwise ineligible for the crowdfunding exemption as a result of, e.g., not being organized under the laws of a state or the District of Columbia; being disqualified from offering securities by the SEC; or has failed to file with the SEC a disclosure statement and annual report relating to the crowdfunding issuance. (17 C.F.R. § 227.100; *see generally* 17 C.F.R. § 227.100 et seq.)

Existing state law:

1) Establishes the Corporate Securities Law of 1968, which is administered by the Department of Financial Protection and Innovation (DPFI) and governs the issuance and sale of securities in California. (Corp. Code, tit. 4, div. 1, §§ 25000 et seq.)

2) Provides that it is unlawful for any person to offer or sell any security in this state, unless such offering or sale has been qualified by the DPFI, as specified, or unless the offering or sale is covered by an express exemption. (Corp. Code, §§ 25005, 25110.)

3) Provides exemptions to the qualification requirement, including for securities covered under certain sections of the federal Securities Act of 1933 and the Investment Company Act of 1940. (Corp. Code, § 25100.1.)

This bill:

1) Establishes a crowdfunding exemption to the qualification requirement for securities under the Corporate Law of 1968, when specified criteria are met.

2) Provides that, to be eligible for the crowdfunding exemption, the issuer must meet all of the following criteria:
   a) Is a California corporation or a foreign corporation doing a majority of its business in California.
   b) Is not a "blind pool" company as defined by the DPFI.
   c) Is not an investment company subject to the Investment Company Act of 1940.
   d) Is not subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934.

3) Provides that, to be eligible for the crowdfunding exemption, the offering must be conducted in accordance with the federal statutory crowdfunding exemption and specified portions of Reg CF, except that:
   a) The aggregate amount of securities that may be sold by the issuer in the 12 months prior to the offering shall not exceed $300,000.
   b) If the issuer has raised less than $300,000 in the preceding year, the issuer may file financial statements including total income, taxable income, and total tax, as specified, and financial statements of the issuer, certified by the principal executive officer of the issuer to reflect accurately the issuer's financial condition; this is higher than the $107,000 federal ceiling for executive-certified financial statements. An issuer opting to provide certified statements must promptly provide a statement that financial information has been certified by the principal executive officer of the issuer.

4) Provides that integration of offers and sales made in reliance on the state crowdfunding exemption shall be governed by federal regulations set forth at section 230.152 of Title 17 of the Code of Federal Regulations.

5) Requires the issuer, in connection with a crowdfunding offering, to take certain actions to protect potential investors:
    a) The issuer must take reasonable steps to ensure that each purchaser who is a natural person and not an accredited investor within the meaning of federal securities regulations, either alone or with their purchaser representative or representatives, has knowledge and experience in financial and business matters and that they are capable of evaluating the merits and risks of the prospective investment.
    b) The issuer must give the purchaser a three-day right to rescind any investment made in any security offered under this subdivision. The three-day period shall end at 11:59 p.m. Pacific Standard Time on the third business day after the date on which the issuer's confirmation of its acceptance of the purchaser's investment is communicated in writing and received by the purchaser.
    c) The issuer must set aside in a separate third-party escrow account all funds raised as part of the offering, to be held in escrow until the time that the minimum offering amount, if any, is reached. 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 purchasers.

6) Prohibits the issuer, through itself or a third party not licensed as a broker-dealer, from conducting any direct solicitation of the securities offered under the crowdfunding exemption.

7) Prohibits the issuer from imposing specified terms on an investor in a crowdfunding offering covered by the exemption, as follows:
    a) The issuer may not require a purchaser to waive the right to a jury trial in a court action.
    b) The issuer may not require a purchaser to be bound by or subject to any law other than California law.
    c) The issuer may not require a purchaser to file or resolve any claim or dispute in any forum other than California.

8) Requires the issuer to file, on a form approved by the Commissioner of the DPFI (Commissioner), a notice of transactions under at least 15 days prior to the publication of an initial offer of the securities subject to the crowdfunding exemption, with the following provisions for when an issuer fails to do so:
    a) Any issuer that fails to file the notice as described shall, within 15 business days after discovery of the failure to file the notice or after demand by the Commissioner, whichever occurs first, file the notice and pay a fee equal to

the fee payable had the transaction been qualified (i.e., not subject to the crowdfunding exemption). If the issuer satisfies these steps, the initial failure to file shall not affect the issuer's eligibility for the crowdfunding exemption.

b) Neither the filing of the notice nor the failure by the Commissioner to comment thereon precludes the Commissioner from taking any action that the Commissioner deems necessary or appropriate under this division with respect to the offer and sale of the securities.

9) Requires the issuer to submit all state, federal, and other filings related to the crowdfunding offer or sale to DPFI in a form prescribed by the Commissioner.

10) Provides that, to the extent allowable, any inconsistency between state and federal law shall be interpreted to the benefit of investors or potential investors.

11) Authorizes the Commissioner to adopt other rules establishing requirements for the crowdfunding exemption.

12) Provides that a court shall award reasonable attorney fees and costs to a prevailing purchaser or seller who succeeds in establishing that a seller or purchaser made a material misrepresentation or omitted material facts necessary to make the statements true in the course of offering or purchasing a security in this state, in addition to other available remedies.

13) Provides that a court shall award reasonable attorney fees and to a prevailing purchaser in an action against a seller for violating the state's qualification requirements or selling in violation of a trading suspension by the Commissioner, in addition to other available remedies.

14) Establishes filing fees for filing for the crowdfunding exemption.

COMMENTS

1. Author's comment

According to the author:

> Small businesses, accounting for over two-thirds of new jobs nationally, often lack access to capital and rely heavily on credit card debt, home equity and limited personal assets for financing. Crowdfunding enables entrepreneurs to prove a concept, build infrastructure necessary to support a business model and take other steps necessary to attract capital investment. For small businesses and start-ups, however, raising capital frequently can be an overwhelming challenge.

> AB 511 would allow start-up and emerging small businesses to find investors who can provide capital to help them grow and create jobs, while providing greater protections to California investors participating in crowdfunding. This bill offers both entrepreneurs and investors a safer means of filling the "capital gap" that exists for smaller early-stage seed capital offerings while helping to jumpstart companies so that they can become candidates for larger rounds of financing.

2. Background on the scope of state and federal securities laws

The Senate Banking and Financial Institutions Committee's analysis of this bill—incorporated herein by reference—provided a useful background on securities law in general and the range of offerings subject to California's Corporate Securities Law of 1968:

> At the most general level, a security is an investment in a business. Securities can take a variety of forms – stocks, bonds, bundled mortgages, or certain digital assets, for example. A securities offering is the process whereby a company issues or sells its securities to investors, such as when a company issues shares via an initial public offering (IPO). One feature of American capital markets is investors' trust in the offering process – that representations made by an issuer are reasonable and based in fact and that fraudulent or deceptive behavior can be remedied through the judicial system.
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> Federal law provides the regulatory foundation of securities offerings. Congress passed the Securities Act of 1933 in response to the bad behavior that fueled the run-up and ultimate crash of the stock market in the 1920s. Prior to the Securities Act, a patchwork of state level "blue sky laws" provided some protections to investors but proved insufficient for the exuberance of the Roaring Twenties. Among other things, the Securities Act requires a company to file a registration statement containing information about itself, the securities it is offering, and the offering, unless the offering qualifies for an exemption. Federal and state law worked in parallel for several decades, layering requirements on the securities offerings process. In 1996, Congress passed the National Securities Market Improvement Act (NSMIA), which preempted state law for many large and interstate offerings.
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> Today state securities law related to offerings is largely focused on fraud prevention and qualification requirements for relatively smaller offerings. Examples of offerings exempt from federal registration requirements, but potentially required to qualify by permit at the state level include:
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> - Offerings of less than $5 million that meet the exemption specified in Rule 504 or Regulation D.

- Offerings of less than $20 million that meet the exemption requirements of a Regulation A – Tier 1 offering.
- Intrastate offerings where the company is organized in California, carries out a significant amount of its business in California, and makes offers and sales of its securities only to residents of California.

The qualification-by-permit process requires an issuer to submit a lengthy questionnaire and all offering documents to DFPI for review before money is raised from investors. Except for certain small offerings, DFPI may review the fairness of the offering and impose additional restrictions on the offering. For small offerings to bypass the fairness review, the law provides minimum investment standards related to a potential investor's income and/or net worth.

While there are many exemptions to the state's securities qualification requirement, there is currently no exemption for crowdfunding equity offerings.[1]

3. This bill provides an exemption to the state securities qualification requirement for crowdfunding offerings

Crowdfunding equity offerings—which generally allow small or startup companies to raise capital through small-value equity investments from the public[2]—long occupied a gray area in securities law. While crowdfunding is usually achieved through small payments from many members of the public, which theoretically limits the possible damage to investors on an individual basis, unregulated equity offerings can still pose substantial risk to the public. In particular, in the absence of regulations relating to what information the issuer must provide or restricting crowdfunding to "accredited," i.e., sophisticated, investors, there was still a high risk that investors could be misled by overly optimistic (or downright fraudulent) promises.

In 2012, the federal government enacted legislation that included an "equity crowdfunding" exemption to federal securities laws.[3] The exemption, and the SEC's subsequently adopted Reg CF, do the following:

- Require all transactions issued pursuant to Reg CF to take place online through an SEC-registered intermediary, either a broker-dealer or a funding portal.
- Permit a company to raise a maximum aggregate amount of $5 million through crowdfunding offerings in a 12-month period.[4]

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[1] *See* Corp. Code, §§ 25100-25105.
[2] This bill addresses equity-based crowdfunding, which is legally distinct from rewards-based crowdfunding wherein the consumer (the "backer") makes a donation to a company in exchange for a product or other perk from the company.
[3] 15 U.S.C. §§ 77d(a)(6) & 77d-1(b).
[4] The original rule permitted a maximum offering of $1.07 million. The SEC increased the limit by rule in November 2020 to $5 million. (*See* 17 C.F.R. § 227.100.)

- Limit the amount individual investors can invest across all crowdfunding offerings in a 12-month period, as specified, based on the investor's income or net worth.
- Require disclosure of information in filings with the SEC and to investors and the intermediary facilitating the offering.[5]

Over the past decade, Small Business California, the sponsor of this bill, has sponsored several bills intended to ease the costs of crowdfunding offerings in California that are regulated by state, rather than federal, securities law. Previous efforts, including AB 2081 (Allen, 2012), AB 2096 (Muratsuchi, 2014), AB 722 (Perea, 2015), and AB 2178 (Chiu, 2016), proposed a variety of exemptions to state securities law that brought opposition from PIABA, an international bar association whose members represent investors in disputes with the securities industry. Whether due to policy concerns or fiscal effects of the bills, none of the bills made it through both houses of the Legislature.

This bill is another attempt to implement a crowdfunding exemption to California's securities qualification requirement for crowdfunding offerings that are exempt from federal regulations. This bill is more modest than prior legislative efforts and is modeled after the federal Reg CF and expressly adopts most of its terms. As with Reg CF, the bill exempts offerings only if they are made through an SEC-registered portal and the issuing company provides certain information and financial data. Unlike Reg CF, the state exemption allows the issuer to self-certify its financial statements if it raised up to $300,000 in the prior year; Reg CF allows self-certification only up to $107,000 in the prior year. The bill also provides investor protections not available under Reg CF, including:

- Providing investors with a three-day right to rescind a purchase of an investment.
- Requiring purchase funds to be deposited into an escrow account and, if the issuer's target is not met within one year of the effective date of the offering, requiring the issuer to return the funds to the purchasers.
- Prohibiting the issuer from requiring investors to waive the right to a jury trial.
- Prohibiting the issuer from requiring investors to be bound by law other than California law.
- Prohibiting the issuer from requiring investors to file or resolve a claim or dispute in a forum other than California.
- Awarding reasonable attorney fees and costs to investors who successfully prove that the issuer knowingly made a material statement or omission of material facts in connection with the offering, or if the shares were sold in violation of qualification requirements or an order suspending trading. (The bill's attorney fee and cost provisions are not limited to crowdfunding offerings, and are discussed in greater detail in Part 4 of this analysis.)

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[5] U.S. Securities and Exchange Commission, *Regulation Crowdfunding* (Mar. 17, 2021), https://www.sec.gov/smallbusiness/exemptofferings/regcrowdfunding [last visited Jul. 2, 2021].

While prior versions of legislation creating a crowdfunding exemption included prohibitions on mandatory arbitration clauses and class action waivers, this bill does not include those prohibitions. Committee staff is unaware of any opposition to the bill or these omissions specifically.

4. This bill authorizes the award of reasonable attorney fees and costs to a party that successfully proves specified securities violations

As noted above, this bill allows a crowdfunding investor to recover reasonable attorney fees and costs from an issuer in actions where the investor successfully shows that (1) the issuer knowingly makes material misstatements of fact, or omissions of material fact, in connection with the offering, or (2) the issuer sold the securities in violation of qualification requirements or in violation of an order suspending trading. The bill's fee and cost provisions are not limited to crowdfunding offerings, but are instead being added to the existing enforcement provisions that apply to all offerings regulated under the Securities Act of 1968.

The specific provisions for which reasonable attorney fees and costs may be awarded are as follows:

- In an action for a violation of Corporations Code section 25401, which prohibits making untrue statements of material fact or omissions of material fact necessary to make the statements not misleading, a seller or purchaser who establishes the violation would be entitled to recover attorney fees and costs. While the provision applies to fraud in connection with the purchase or sale, the attorney fee provision is *not* a prevailing party fee-shifting provision. Instead, the provision applies so that a purchaser who proves that a seller committed fraud is entitled to attorney fees from the seller, and a seller who proves that a purchaser committed fraud is entitled to attorney fees from the purchaser.[6] In either type of suit, if the seller or purchaser alleging fraud does not prevail in the lawsuit, there is no fee-shifting—the parties simply pay their own fees.
- In an action to recover damages for sales of securities made in violation of certain qualification requirements or in violation of an order to suspend trading,[7] a prevailing purchaser would be able to recover attorney fees and costs from the seller. As with the above provision, the fee-shifting provision is not mutual: if a purchaser fails to prove the violation, each party bears its own fees and costs.

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[6] While the statute authorizes lawsuits against both a seller and a purchase for fraud in connection with a securities transaction, the sponsors were unable to think of an instance in which a shareholder has been sued under this provision, and there is no obvious circumstance in which shareholder could be liable under this bill. Instead, the provision appears most likely to apply in circumstances in which a corporation makes misstatements in connection with a stock buyback or in connection with a purchase that harms minority shareholder rights.

[7] *See* Corp. Code, §§ 25110, 25130, 25133, 25141, 25129.

According to the sponsors, allowing prevailing purchasers—and, in the case of the fraud provision, a prevailing seller—to recover attorney fees and costs will permit more parties to bring meritorious lawsuits. They state that, for the most part, the potential recovery for any individual purchaser will not justify the cost of a lawsuit, so the best chance of bringing a purchaser suit is via a class action; and in order to retain competent class action counsel without unduly eating into the class's recovery, it is necessary to allow the purchasers to recover reasonable attorney fees and costs in addition to their damages. Overall, it appears that the addition of the fee-and-cost-shifting provisions will make it easier for purchasers of securities to retain counsel to vindicate their rights, without unnecessarily increasing the risk of bringing a shareholder suit. At a time when many corporations are amending their bylaws to require *shareholders* to pay the *corporation* if the shareholders do not prevail in a shareholder suit,[8] providing shareholders with attorney fees in securities fraud and sales-violation suits could help shareholders bring meritorious lawsuits that are otherwise unaffordable.

5. Arguments in support

According to a coalition of the bill's sponsor, Small Business California, and the bill's supporters:

> Small businesses, accounting for over two-thirds of new jobs nationally, often lack access to capital. As a result, owners of small businesses must rely heavily on credit card debt, home equity, and limited personal assets to start and grow businesses. Seed and later-stage growth capital enable entrepreneurs to prove a concept, build infrastructure necessary to support a business model and take other steps necessary to attract later-stage capital investment. For small businesses and startups, however, raising capital to get started can frequently be an overwhelming challenge…
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> AB 511 creates an exemption from qualification to enable a business in California to conduct an offering pursuant to SEC Regulation Crowdfunding, but be exempted from the requirement to provide reviewed financial statements for seed offerings of up to $300,000. However, companies would be required to adopt the investor protections afforded by AB 511, which are presently absent from the federal JOBS Act. The investor protections present in the bill are:
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> - Attorneys' fee provisions for prevailing investors
> - Prohibitions on jury trial wavers
> - Prohibitions on choice of law provisions other than California
> - Prohibitions on forum selection outside of California

[8] *See* Sjostrom, *The Intersection of Fee-Shifting Bylaws and Securities Fraud Litigation*, 93 Wash. U. Law. Rev. 379 (2015).

> This bill offers both entrepreneurs and investors a safer means of filling the "capital gap" that exists for smaller early-stage seed capital offerings while helping to jumpstart companies so that they can become candidates for larger rounds of financing.

SUPPORT

Small Business California (sponsor)
California African American Chamber of Commerce
California Asian Pacific Chamber of Commerce
California Association of Micro-economic Opportunity
California Chamber of Commerce
California Disabled Veteran Business Alliance
California Hispanic Chambers of Commerce
California Metals Coalition
Flasher Barricade Association
Innovation Incubator—California State University, Dominguez Hills
National Association Women Business Owners—California
National Association of Women Business Owners—Sacramento Valley Chapter
National Federation of Independent Business
Small Business California
Small Business Majority
South Bay Entrepreneurial Center

OPPOSITION

None known

RELATED LEGISLATION

Pending Legislation:

AB 283 (Chen, 2021) creates a qualification exemption for certain securities issued by cooperative corporations as part of their annual membership distributions. AB 283 is pending before the Senate Appropriations Committee.

Prior Legislation:

AB 2069 (Muratsuchi, 2020) would have created a crowdfunding exemption to the qualification requirement that is similar to the one in this bill, except the exempt offering could have been up to $3,000,000. AB 2069 died in the Assembly Banking and Finance Committee.

AB 2577 (Muratsuchi, 2018) would have created a crowdfunding exemption to the qualification requirement that is similar to the one in this bill, but with broader advertising permissions and no certification of the issuer's finances. AB 2577 died in the Assembly Banking and Finance Committee.

AB 1517 (Muratsuchi, 2017) would have authorized crowdfunding offerings to be qualified with a permit from the Commissioner; the bill authorized offerings of up to $2,000,000 under the permitting, and had a higher per-investor cap than this bill. AB 1517 died in the Assembly Appropriations Committee.

AB 2178 (Chiu, 2016) would have authorized crowdfunding offerings to be qualified with a permit from the Commissioner, as specified; the bill authorized a higher per-investor cap than this bill, permitted certain advertisements of the offering, and did not impose limitations on jury trial waivers or choice of law and forum provisions. AB 722 died in the Assembly Appropriations Committee.

AB 722 (Perea, 2015) would have authorized crowdfunding offerings to be qualified with a permit from the Commissioner; the bill authorized a higher per-investor cap than this bill, and did not impose limitations on jury trial waivers or choice of law and forum provisions. AB 722 died in the Assembly Appropriations Committee.

AB 2096 (Muratsuchi, 2014) would have created a crowdfunding exemption to the qualification requirement that would have, among other things, created a two-tiered financial disclosure system, and lacked lawsuit-related protections for investors. AB 2069 died in the Senate Appropriations Committee.

AB 783 (Davies, 2013) would have created a crowdfunding exemption to the qualification requirement that would have, among other things, required the issuer to verify that each purchaser was an accredited investor and had a net worth, or joint net worth with their spouse, of $1,500,000. AB 783 died in the Assembly Banking and Finance Committee.

AB 2081 (Allen, 2012) would have created a crowdfunding exemption to the qualification requirement for sales to accredited investors only. AB 2018 failed passage on the Senate floor.

PRIOR VOTES:

Senate Banking and Financial Institutions Committee (Ayes 9, Noes 0)
Assembly Floor (Ayes 78, Noes 0)
Assembly Appropriations Committee (Ayes 16, Noes 0)
Assembly Banking and Finance Committee (Ayes 12, Noes 0)

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