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New Jersey Bill Will Authorize Intrastate Crowdfunding Securities Offerings

Crowdfunding has been a popular securities law topic since the 2012 JOBS Act required the Securities Exchange Commission (“SEC”) to implement a path to exempt internet offerings, but has come to a grinding halt while the SEC delays issuing regulations to implement it. It is about to gain a local toehold in New Jersey. Crowdfunding in general terms is the use of the internet by businesses to raise capital by offering and selling equity securities to a broad base of potential investors, including “non-accredited” investors, without registration of the offering either with the SEC or state securities regulators.

The New Jersey legislature has passed a crowdfunding bill that is waiting to be signed by the Governor. The new bill creates an exemption from New Jersey State “blue sky” registration for certain securities offerings by New Jersey businesses confined to New Jersey investors and meeting other limitations. It does not provide an exemption from registration under Federal securities law. It in fact requires that the offering and sales be exempt from federal registration under the so-called “intrastate offering” exemption of Section 3(a)(11) of the Securities Act of 1933, as amended.

What follows is a brief description of what will become permissible under the new law once signed and some observations about its potential applications and problem areas.

Exclusively New Jersey Intrastate Offerings

The exemption will be available for use only by business entities organized under New Jersey law and authorized to do business in New Jersey, for sales only to New Jersey residents. The offering must meet the requirements for a federal “intrastate offering” exemption. The intrastate offering exemption requires that not only sales of securities, but the offers of securities, be confined to a single state. Because “offers” includes a wide range of selling activities, the intrastate offering exemption has long been disfavored by securities lawyers because it is too easy to slip and make offers outside of state lines, imperiling the exemption. It remains to be seen whether internet solicitations are “offers” that can be confined within New Jersey lines. The issuer must have the substantial part of its business located in New Jersey, in addition to being formed under New Jersey law.

Limitations on Amounts Invested

“Accredited investors” are defined under the SEC’s Regulation D as meeting certain financial tests based on assets or income. Individuals must have a net worth (excluding their personal residence) of at least \$1 million, or income of at least \$200,000 for the two preceding years and an expectation of at least \$200,000 in the current year (\$300,000 in each case if measured jointly with their spouse).

The maximum amount that a business can raise from New Jersey non-accredited investors under the



new law is \$1,000,000 in the aggregate. No single non-accredited investor can invest more than \$5,000. Amounts invested by accredited investors are not subject to the \$5,000 individual cap, and are excluded from the \$1,000,000 aggregate maximum.

There is no mention in the new law as to how the issuer is to assure compliance with the accredited investor tests. Those familiar with federal Regulation D private placements know that it is often a vexing problem of how to establish whether an investor does or does not satisfy “accredited investor” tests. New federal rules in a slightly different context require not only self-certification by investors, but verification of the content. It remains to be seen how an offering to potentially dozens if not hundreds of responding investors can adequately identify and qualify “accredited investors” to assure compliance with the investment limitations.

Internet Site Operators

The offering must be made exclusively through a qualifying Internet site. To qualify, the Internet Site Operator must itself be a business organized under New Jersey law and authorized to transact business in New Jersey, and must itself file a registration with the New Jersey Bureau of Securities. The Internet Site Operator does not have to be a broker dealer registered in New Jersey, but if it is not, then it must satisfy some fairly rigorous requirements disavowing giving investment advice, and not being compensated based on securities sold, among other things, to assure that broker-dealer regulations are not being violated by its activities.

Issuer's Required Disclosure; Filing with the New Jersey Bureau of Securities

The issuer must post on the Internet site written disclosure materials relating to the offering and the business, such as the issuer's business plan, use of proceeds, identification of major equity holders, description of material agreements, pending legal proceedings, identification and qualifications of directors, officers and managers, capital structure and the terms of the securities offered. There is a requirement that financial statements be included, but no requirement of an audit report or other attestation from independent public accountants. The disclosure document is much the same in terms of required disclosure content as would be required for a New Jersey blue-sky registration of the securities.

The issuer must give a minimum offering amount sufficient to fund its business plan and specify a date and time by which the minimum must be raised. Investors' funds must be held in escrow with a third party bank or financial institution until the minimum offering amount is raised.

The issuer must file this information with the New Jersey Bureau of Securities at least 10 days before commencement of the Offering and pay a fee.

Experience with Other States' Crowdfunding Exemptions

The intrastate nature of the new exemption will no doubt be a limiting factor. The use of state lines to confine an internet-based solicitation seems counterintuitive.

A June 2015 article in The New York Times reports that 22 states besides New Jersey have adopted intrastate crowdfunding blue-sky laws since 2013. There are not a lot of published experiences in businesses actually having raised funds using these laws. The New York Times article described a microbrewery in Wisconsin that raised \$67,000 from 52 Wisconsin residents, and a Kansas grocery business in a rural locale



underserved by grocery chains that raised \$150,000, from 250 Kansas residents. These two examples show the true local nature of the investors attracted to the opportunity.

Other Crowdfunding-Style Opportunities

The JOBS Act made other substantial contributions to loosening the application of historical private placement restrictions on internet based offerings. The law and regulatory exemptions have historically prohibited the use of any “general solicitation” in claiming private placement exemptions. The JOBS Act and related regulations now allow the use of general solicitation in a private placement that otherwise satisfies the tests of an offering exemption under Rule 506 of Regulation D *if* all the investors meet the “accredited investor” tests. Thus, a qualifying internet-based offering confined to purchasers that are accredited can cross state lines. Internet sites maintained by registered broker-dealers have sprouted up to try to capitalize on this alternative, particularly in real estate investments. A recent article on Bloomberg.com describes completion of a Manhattan condominium building project funded partially by \$12 million in capital raised from 116 accredited investors investing at least \$20,000 apiece.

In addition, the SEC adopted rules to loosen the requirements of its existing Regulation A exemption, but the perception is that costs of compliance with this exemption will still be high, limiting its usefulness to small startups.

The New Jersey crowdfunding bill is part of a wave of state law attempts to liberalize private placement restrictions and permit, within limits, the use of the internet to match capital potentially available from the “crowd” with small startup businesses. Its limitation to intrastate offers and sales would seem to greatly limit its ability to unlock capital from the crowd. Further, there are costs of compliance to prepare disclosure documents and financial statements, have corporate legal documentation to accommodate a potentially large number of investors, monitor compliance with “accredited investor” tests, hire an Internet Site Operator, and engage a bank as escrow agent to hold investor funds pending completion, which may be limiting for small offerings. Further, if and when the SEC finally acts to adopt regulations required by the JOBS Act to implement crowdfunding at the federal level, the New Jersey intrastate exemption will be obsolete.

This *Securities Alert* was written by Douglas R. Brown, a Member of the firm. Please feel free to contact Doug at drbrown@nmmlaw.com if you have any questions regarding the information in this alert or any other related matters.

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