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BILL ANALYSIS

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House Bill 4996 (Substitute H-4 as passed by the House)
Sponsor: Representative Nancy Jenkins
House Committee: Commerce
Senate Committee: Banking and Financial Institutions

Date Completed: 12-5-13

CONTENT

The bill would amend Article 2 of the Uniform Securities Act to provide an exemption from securities registration requirements for a Regulation A offering under the Federal Securities Act, and sales or offers that would qualify for a Federal exemption for interstate offerings and met other criteria established in the bill.

Under Section 301 of the Act, a person may not offer or sell a security in Michigan unless one or more of the following are met: 1) the security is a "federal covered security"; 2) the security, transaction, or offer is exempted from registration under Sections 201 to 203; or c) the security is registered under the Act. Sections 302 to 306 include provisions relating to securities, including registration, notices, statements, suspension, and revocation. Provisions in Section 504 relate to filing sales and advertising literature.

Article 2 governs exemptions from registration requirements for securities. Section 202 exempts certain types of transactions from Sections 301 to 306 and 504. The bill would provide two additional exemptions under Section 202, which are described below.

Federal "Regulation A" Exemption

The bill would exempt any offer or sale of a security that met the requirements for the Federal exemption for a Regulation A offering under Section 3(b) of the Federal Securities Act, and Securities and Exchange Commission (SEC) Rule 251, if the offer or sale met certain requirements. (A Regulation A exemption generally applies to small public offerings of securities. Section 3(b) of the Securities Act generally allows the SEC to add any class of securities to securities exemptions. Rule 251 exempts a public offer or sale of securities from registration requirements if certain criteria are met.)

To qualify for the exemption, the offer or sale would have to meet the following requirements.

The issuer would have to have filed an SEC Form 1A with the SEC with respect to the Regulation A offering, in a manner acceptable to the SEC, that satisfied the requirements in 17 CFR 230.251 to 230.263, including the filing of the Regulation A offering circular required under 17 CFR 230.253. (The Federal regulations in 17 CFR 230.251 to 230.263 govern Regulation A offerings. An offering circular is a document that offers securities for sale, and must include the narrative and financial information required in Form 1A.)

At least 10 days before commencing an offer in reliance on this exemption, or the use of any publicly available website in connection with an offering in reliance on the exemption, the issuer would have to file written or electronic notice with the Department of Licensing and Regulatory Affairs (LARA). The notice would have to contain the following: 1) a notice of claim of exemption from registration, specifying that the issuer intended to conduct an offering in reliance on a Regulation A exemption; 2) a nonrefundable filing fee of $100, which LARA would have to use to pay the costs of administering and enforcing the Act; and 3) a copy of the completed SEC Form 1A and all accompanying documents filed with the SEC, including the final Regulation A offering circular to be provided to prospective purchasers in connection with the offering.

Before filing SEC Form 1A with LARA, the issuer could advertise its intent to make a Regulation A offering within Michigan and to solicit interest from prospective purchasers under 17 CFR 230.254 (which allows for solicitation to prospective purchasers through publication of a written document or making scripted radio or television broadcasts).

The sum of all cash and other consideration to be received for all sales of the security in reliance on the exemption could not be greater than the amount set forth in 17 CFR 230.251(b), less the aggregate amount received for all sales of securities by the issuer within the 12 months before the first offer or sale made in reliance on the exemption. (Under 17 CFR 230.251(b), the sum of all cash and other consideration for the securities may not be greater than $5.0 million, including not more than $1.5 million offered by all selling security holders, less the aggregate offering price for all securities sold within the 12 months before the start of and during the offering of securities in reliance on a Regulation A exemption.)

The issuer could not accept more than $10,000 from any single purchaser unless the purchaser was an accredited investor under Rule 501 of SEC Regulation D. In determining whether a purchaser was an accredited investor, an issuer could rely on confirmation from a licensed broker-dealer or another third party. Every fifth year, LARA would have to cumulatively adjust the $10,000 limit to reflect the change in the Consumer Price Index (CPI) for all urban consumers published by the Federal Bureau of Labor Statistics, rounded to the nearest $100.

(Rule 501 defines "accredited investor" as any person who comes within certain categories, or whom the issuer reasonably believes comes within any of the categories, at the time of the sale of securities to that person. Generally, the categories include: a bank or other financial institution; a broker or dealer; an investment company; a plan established and maintained by a state, political subdivision, or state or political subdivision agency; an employee benefit plan; a private business development company; a 501(c)(3) organization; a director, executive officer, or general partner of either the issuer or a general partner of the issuer; a natural person with a net worth of over $1.0 million; a natural person with income in excess of $200,000, or with joint income with a spouse in excess of $300,000, in the previous two years; a trust with assets in excess of $5.0 million; and an entity in which all of the equity owners are accredited investors.)

An issuer that sold securities in Michigan in reliance on the exemption could advertise the offering in any manner, including advertising on website platforms that could be owned and controlled by nonissuer third parties. However, no commissions could be paid to either employees of the issuer for the sale of the securities or to third parties that facilitated the sale of the securities, unless those third parties were licensed broker-dealers authorized to conduct the transactions described above.

State Statutory Exemption

The bill would add Section 202a to the Uniform Securities Act, which would exempt an offer or sale of a security by an issuer from Sections 301 to 306 and 504 if the offer or sale met certain requirements, which are described below.

An issuer would have to be an entity that was incorporated or organized under Michigan law and was authorized to do business in the State.

The transaction would have to meet the requirements for the Federal exemption for intrastate offerings under Section 3(a)(11) of the Securities Act, and SEC Rule 147, including the requirements for determining whether an offeree or purchaser is a resident of the State. (Under Section 3(a)(11) of the Securities Act, if the issuer and the purchaser of a security are residents of the same state, certain registration requirements do not apply to the transaction. Rule 147 pertains to intrastate sales, and includes criteria for determining the residency of a party to a transaction.)

Each of the following would constitute prima facie evidence that an individual was a resident of the State:

-- A valid operator's license, chauffeur's license, or official personal identification card issued by the State.
-- A current Michigan voter registration.
-- A signed affidavit filed for a principal residence exemption under the General Property Tax Act, that indicates that the purchaser owns and occupies property in the State as his or her principal residence.
-- Any other record or documents issued by the State that establishes that the purchaser's principal residence is in Michigan.

(Prima facie evidence is evidence sufficient to establish a rebuttable presumption of fact.)

The bill would apply the provisions of SEC Rule 147 in determining the residency of an offeree or purchaser that was a corporation, partnership, trust, or other form of business organization.

A person's agreement to purchase, or the purchase of, a security that was exempt under Section 202a would be considered a representation that the person was a State resident at the time that agreement was made. If the representation later were found to be false, the agreement would be void.

If a purchaser of a security that was exempt under Section 202a resold the security to a person who was not a State resident within nine months after the closing of the particular offering in which the purchaser obtained the security, the original investment agreement between the issuer and the purchaser would be void.

If a purchase or an agreement to purchase were void due to the provisions described above, the issuer could recover damages from the misrepresenting offeree or purchaser. These damages would include the issuer's expenses in resolving the misrepresentation, but could not exceed the amount of the person's investment in the security.

The sum of all cash and other consideration to be received for all sales of the security in reliance on the exemption could not exceed a certain amount, less the aggregate amount received for all sales of securities by the issuer within the 12 months before the first offer or sale made in reliance on the exemption. The maximum amount would be $2.0 million if the issuer made audited financial statements or reviewed financial statements for the issuer's most recently completed fiscal year, prepared by a certified public accountant in accordance

with the statements on auditing standards of the American Institute of Certified Public Accountants or the statements on standards for accounting and review services of the American Institute of Certified Public Accountants, as applicable, available to prospective purchasers and LARA. If the issuer did not make such statements available to prospective purchasers and LARA, the maximum amount would be $1.0 million.

An issuer could not have accepted more than $10,000 from any single purchaser unless the purchaser was an accredited investor as defined by Rule 501 of SEC Regulation D (described above). The issuer could rely on written or electronic confirmation from an independent third party that the purchaser was an accredited investor, if the confirmation came from a qualified source, including a licensed broker-dealer or investment advisor, a lawyer, and accountant, a bank, an angel investor group, or any other person qualified to attest to the purchaser's accredited status, including an organization that was established specifically to provide confirmation that purchasers are accredited investors pursuant to Rule 501.

Every fifth year, LARA would have to cumulatively adjust both of the limitations described above to reflect the change in the CPI for all urban consumers. With regard to the limitation on the sum of all cash and other consideration received for securities sales, the amount would have to be rounded to the nearest $50,000. With regard to the $10,000 cap per single purchaser, the amount would have to be rounded to the nearest $100.

At least 10 days before an issuer made an offer of securities in reliance on the exemption or used any publicly available website in connection with a securities offer in reliance on the exemption, the issuer would have to file a written or electronic notice with LARA. The notice would have to be in a form as specified by LARA and include the following:

-- A notice of claim of exemption from registration, specifying that the issuer intended to conduct an offering in reliance on the exemption, accompanied by a $100 filing fee.
-- A copy of the disclosure statement to be provided to prospective investors in connection with the offering.
-- An escrow agreement with a bank or other depository institution located in the State in which the purchaser funds would be deposited.

The disclosure statement would have to include the following:

-- A description of the issuer, including its type of entity, the address and phone number of its principal office, its formation history, its business plan, and the intended use of the proceeds, including payments to any owner, executive officer, director, managing member, or similar personnel.
-- The identity of each person who owned more than 10% of the ownership interests of any class of securities of the issuer.
-- The identity of the executive officers, directors, managing members, and similar personnel, including their titles and prior experience.
-- The terms and conditions of the securities offered and of any outstanding securities of the issuer.
-- The minimum and maximum amount of securities being offered.
-- Either the percentage ownership of the issuer represented by the offered securities or the valuation of the issuer implied by the price of the offered securities.
-- The identity of any person whom the issuer had retained or intended to retain pertaining to the offer, including website owners, but excluding anyone acting solely as an accountant or attorney and any employee who was primarily involved in operating the business rather than raising capital.
-- A description of the consideration being paid to any person identified under the preceding requirement.
-- A description of any litigation or legal proceedings involving the issuer or its management.

-- The name, address, and URL of any website that the issuer intended to use regarding the offering.

If an issuer did not engage a website at the time it filed the disclosure statement, but later did so in connection with the offering, it would have to notify LARA via a supplemental notice.

The escrow agreement would have to provide that all offering proceeds would be released to the issuer only when the aggregate capital raised from all purchasers was equal to or greater than the minimum target offering amount specified in the disclosure statement as necessary to implement the business plan. The agreement also would have to provide that all purchasers would receive a return of their subscription funds if the target offering amount were not raised by the time stated in the disclosure. The escrow agent could contract with the issuer to collect reasonable fees for its services regardless of whether the target was reached.

All payments for the purchase of securities would have to be directed to and held by the bank or depository institution.

An issuer could not be an investment company, either before or as a result of the offering, or an entity that would be an investment company but for the exclusions in 15 USC 80a-3(c) of the Federal Investment Company Act, or subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act. ("Investment company" would mean that term as defined in the Investment Company Act, which is generally any issuer that: 1) holds itself out as being engaged primarily in the business of investing; 2) is engaged in the business of issuing face-amount certificates; or 3) is engaged in the business of investing, reinvesting, owning, holding, or trading securities.)

An offer or sale of a security could not be made through an internet website unless the website had filed a written notice with LARA. If an offer were made through an internet website, all of the following requirements would have to be met. Before making an offer through a website, the issuer would have to give the website and LARA evidence that the issuer was organized under Michigan law and that it was authorized to do business in the State. The issuer would have to obtain from each purchaser evidence that the purchaser was a resident and, if applicable, an accredited investor. The website operator would have to file with LARA a written notice that included the website operator's name, business address, and contact information and stated that it was authorized to do business in the State and was used to offer and sell securities under the exemption. Beginning 12 months after the date of the website operator's written notice, the operator would have to annually notify LARA in writing of any changes in the information. The issuer and the website would have to keep and maintain records of the offers and sales made through the website and provide ready access to the records to LARA on request. The Department could gain access to, inspect, and review any website described in these provisions.

A website through which an offer or sale of securities was made would not be subject to the broker-dealer, investment adviser, or investment adviser representative registration requirements under Article 4 if the website met all of the following conditions:

-- It did not offer investment advice or recommendations.
-- It did not solicit purchases, sales, or offers to buy securities offered or displayed on the website.
-- It was not compensated based on the amount of securities sold and did not hold, manage, possess, or otherwise handle purchaser funds or securities.
-- It did not engage in any other activities that LARA by rule determined were inappropriate for an exemption from registration under Article 4.

(Although the bill refers to "chapter 4", Article 4 of the Act provides for the registration of broker-dealers, agents, and investment advisers.)

An issuer could not pay any commission or remuneration to an executive officer, director, managing member, or similar personnel, for offering or selling securities unless he or she was a registered broker-dealer, investment adviser, or investment advisor representative under Article 4. Any of these parties would be exempt from registration requirements under Article 4 if he or she did not receive commission or remuneration for offering or selling securities of the issuer that were exempt under Section 202a.

The issuer also would have to provide a copy of the disclosure statement to each prospective purchaser at the time the offer was made. The statement would have to include additional information material to the offering, including, where appropriate, a discussion of significant factors that made the offering speculative or risky. The discussion would have to be concise and organized logically and should not present risks that could apply to any issuer or any offering.

An issuer would have to inform each prospective purchaser that the securities were not registered under Federal or State securities laws and that the securities were subject to limitations on transfer or resale. The issuer would have to include the following text conspicuously on the disclosure statement:

> In making an investment decision, purchasers must rely on their own examination of the issuer and the terms of the offering, including the merits and risks involved. These securities have not been recommended by any federal or state securities commission or regulatory authority. Furthermore, the foregoing authorities have not confirmed the accuracy or determined the adequacy of this document. Any representation to the contrary is a criminal offense. These securities are subject to restrictions on transferability and resale and may not be transferred or resold except as permitted by subsection (e) of SEC Rule 147, 17 CFR 230.147(e), as promulgated under the Securities Act of 1933, as amended, and the applicable state securities laws, pursuant to registration or exemption therefrom. Purchasers should be aware that they will be required to bear the financial risks of this investment for an indefinite period of time.

An issuer would have to require each purchaser to certify in writing, including his or her signature, and his or her initials next to each paragraph of the certification, the following:

> I understand and acknowledge that:
>
> I may lose all of my investment, and I can afford the loss of my investment.
>
> This offering has not been reviewed or approved by any State or Federal securities commission or other regulatory authority and that no regulatory authority has confirmed the accuracy or determined the adequacy of any disclosure made to me relating to this offering.
>
> The securities I am acquiring in this offering are illiquid, that the securities are subject to possible dilution, that there is no ready market for the sale of those securities, that it may be difficult or impossible for me to sell or otherwise dispose of this investment, and that, accordingly, I may be required to hold this investment indefinitely.
>
> I may be subject to tax on my share of the taxable income and losses of the issuer, whether or not I have sold or otherwise disposed of my investment or received any dividends or other distributions from the issuer.
>
> By entering into this transaction with the issuer, I am affirmatively representing myself as being a Michigan resident at the time that this contract

is formed, and if this representation is subsequently shown to be false, the contract is void.

If I resell any of the securities I am acquiring in this offering to a person that is not a Michigan resident, within 9 months after the closing of the offering, my contract with the issuer for the purchase of these securities is void.

The term of the offering could not exceed 12 months after the date of the first offer.

If an offer were exempt under Section 202a, the issuer would have to provide a quarterly report to the issuer's purchasers until no securities remained outstanding. The issuer could satisfy this requirement by making the information available on an internet website if the information were made available within 45 days after the end of each fiscal quarter and remained available until the next quarterly report was issued. The report would have to meet the following requirements:

-- The issuer would have to provide the report free of charge to the purchasers.
-- The report would have to include the compensation received by each director and executive officer of the issuer, including cash compensation since the previous report, and any bonuses, stock options, rights to securities, or other compensation.
-- The report would have to include an analysis by management of the issuer of the business operations and financial condition of the issuer.

The exemption under Section 202a could not be used in conjunction with any other exemption under Article 2, except offers and sales to controlling persons would not count toward the $10,000, $1.0 million, and $2.0 million limitations discussed above. ("Controlling person" would mean an officer, director, partner, or trustee, or another individual who has similar status or performs similar functions, of or for the issuer or to a person that owns 10% or more of the outstanding shares of any class or classes of securities of the issuer.)

The exemption would not apply if an issuer or person who was affiliated with an issuer or offering were subject to any disqualification established by LARA by rule or contained in Rule 262 as promulgated under the Securities Act. However, the exemption still would apply if both of the following were met: 1) on a showing of good cause and without prejudice to any other action by LARA, the Department determined that it was not necessary to deny an exemption; and 2) the issuer established that it made factual inquiry into whether any disqualification existed under these provisions but did not know, and in the exercise of reasonable care could not have known, that a disqualification existed. The nature and scope of the inquiry would vary based on the circumstances of the issuer and the other offering participants.

The Department could adopt rules to implement Section 202a and to protect purchasers of exempt securities.

The Department would have to charge a nonrefundable filing fee of $100 for filing an exemption notice. The fees would have to be used to pay the costs incurred in administering and enforcing the Uniform Securities Act.

Except for Section 504, which pertains to filing sales and advertising literature, Article 5, which governs fraud and liabilities in securities, would apply to a violation of Section 202a, including a violation concerning website operation.

MCL 451.2202 et al. Legislative Analyst: Glenn Steffens

FISCAL IMPACT

The bill would have no fiscal impact on State or local government.

Fiscal Analyst: Josh Sefton

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