New Rules Governing Crowdfunding Activities Under the Colorado Crowdfunding Act

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On July 29, 2015, the Colorado Division of Securities (the “Division”) released rules governing crowdfunding activities (the “Rules”) under the Colorado Crowdfunding Act (the “Act”). The Act provides a state exemption from registration for securities offered by a Colorado entity (an “Issuer”) and sold to Colorado residents and entities, subject to the condition that at least 80% of the funds raised by the Issuer be used within Colorado. The Rules, which became effective August 5, 2015, clarify and expand the Act.

For certain startup and emerging growth companies with limited access to traditional sources of growth capital, crowdfunding provides an alternative way to raise up to $1 million, or up to $2 million with submission of audited financial statements to the Division. However, Issuers should carefully consider the implications of certain of the Act's requirements before commencing a crowdfunding offering, such as additional disclosure and recordkeeping requirements, filings with the state, the requirement that at least 80% of the offering proceeds be used within Colorado, and in the case of online intermediaries (“Intermediaries”), assistance with the enforcement of Issuer's compliance with the Act.

The Rules set out notice, disclosure, and recordkeeping requirements for Issuers under the Act. The Rules also specify how Issuers must verify investor credentials, handle funds, and determine which acts may disqualify an Issuer from fundraising under the Act.

Intermediaries, or online funding platforms, that assist in the crowdfunding process are also subject to the Act. An Intermediary must collect certain data from its users, avoid certain activities, disclose its compensation to the Division, maintain records, and supervise Issuers' compliance with the Act's recordkeeping and anti-fraud provisions. An Intermediary acting as a solicitor may also be subject to disqualification based on prior bad acts.

Exemption Requirements

The following requirements, among others, apply to Issuers seeking to conduct an offering that is considered an exempt transaction under the Act:

- the Issuer must be a Colorado business entity that is authorized to do business in Colorado;
- the offering must qualify as an intrastate offering conducted in Colorado that meets the requirements of Section 3(a)(11) of the

Securities Act of 1933, as amended (the “Securities Act”);

- the aggregate amount sold to any purchaser by the Issuer during any twelve-month period must not exceed $5,000, unless the purchaser is an accredited investor as defined under Rule 501(a) of Regulation D under the Securities Act;
- the Issuer must file certain notice filings, disclosure documents, and escrow agreements with the Division and pay a $50 registration fee;
- the Issuer must maintain all records with respect to the offering; and
- the Issuer must establish both a minimum and maximum offering amount and deposit funds raised from purchasers in an escrow account.

The new rules adopted by the Division implement these requirements and provide additional requirements necessary for an offering to be considered an exempt transaction under the Act.

Additional Notices and Disclosure

The Issuer must file a disclosure document with the Division prior to providing it to all prospective investors at the time of the offering. The disclosure document must provide detailed information about:

- the offering;
- the Issuer;
- risk factors associated with the offering and the Issuer;
- the Issuer's business and properties;
- the use of proceeds from the offering;
- distribution arrangements between the Issuer and any selling Intermediaries;
- the Issuer's management; and
- the Issuer's finances.

In addition to the information in the disclosure document, Issuers must provide financial statements from the previous year, which must be audited if the offering seeks to raise more than $1 million. Given the time and costs associated with obtaining audited financial statements, this requirement may have the effect of limiting most offerings under the Act to $1 million.

Issuers are also required to enter into an escrow agreement with a qualifying financial institution and file a copy of such agreement with the Division. Under the escrow agreement, the financial institution must accept and hold investor funds in escrow, disbursing proceeds from the offering to the Issuer only after receiving a minimum threshold amount of proceeds, equal to and no less than 50 percent of the maximum offering amount. Escrowed funds are not immediately accessible, however. Any disbursement from escrow requires filing an escrow release request with the commissioner (“Commissioner”) and a seven-day waiting period for the

Commissioner's approval.

Reporting

Issuers will be required to provide a free quarterly report to investors within 45 days of the end of each fiscal quarter. The report must include information about compensation received by each of the Issuer's directors and officers, including cash, stock options, bonuses, and other compensation. The report must also contain an analysis by the Issuer's management of the business operations and financial condition of the Issuer. Issuers may satisfy the reporting requirement by making the quarterly reports available online.

Verification

Prior to any sale of securities, Issuers must obtain documentary evidence from each prospective purchaser that provides a reasonable basis for believing that the purchaser is a resident of the state of Colorado. For individual purchasers, an Issuer can meet this verification requirement by obtaining documentation that the purchaser's primary residence at the time of the offer and sale is in Colorado. For entity purchasers, the residency verification process is more involved. Issuers will be required to document that an entity purchaser's principal office is located in Colorado, or that the entity is organized under the laws of Colorado.

However, if an entity has been formed for the specific purpose of acquiring securities from an Issuer's crowdfunding offering, the Issuer must “look-through” the entity and verify that all of the entity's beneficial owners meet the residency requirements for individuals. Consequently, Issuers will likely need to take additional steps to determine whether an entity is a “look-through” entity in order to comply with residency verification requirements.

In addition to verifying purchasers' residency, Issuers, before accepting any investment, must either (i) verify that a prospective investor has not purchased more than $5,000 of the Issuer's securities during the preceding year, or (ii) take “reasonable steps” to verify that the investor is an “accredited investor” as defined in Regulation D of the Securities Act of 1933. Although the language of the Rules tracks the “reasonable steps” language of Rule 506(c) of Regulation D, Rule 506(c) provides several “safe harbors” for satisfying the “reasonable steps” verification requirement, whereas the Rules do not contain similar safe harbor provisions. In the absence of further guidance from the Division, prospective Issuers should proceed with caution regarding accredited investor verification requirements.

Disqualification

The Rules specify certain bad acts which, if committed [or perpetrated] by an Issuer or its affiliates, will disqualify the Issuer from relying on the exemption provided by the Act. These acts largely mirror the SEC's Rule 506(d) “bad actor” disqualification rule, including, among others, certain convictions, orders, judgments, or decrees related to the purchase or sale of securities. However, Colorado's Rules have added as disqualifying

events: (i) being subject to a final stop order under any state's securities law within five years before the offering, and (ii) being subject to any final state administrative enforcement order or judgment within five years before the offering. The Rules also lay out a process for requesting a waiver from the Commissioner to conduct an offering in spite of certain disqualifying acts.

Intermediary Requirements

Recordkeeping and Disclosure

The Rules expand recordkeeping requirements for Intermediaries set forth in Section 3 of the Act. An Intermediary must preserve a broad range of information, in non-alterable format, for five years after the completion or termination of an offering, including:

- compensation received for acting as an Intermediary, including the amount of compensation, the name of the payor and the Issuer, and the date of payment;
- information collected during the operation of the Intermediary's platform, including investors' and Issuers' personal information, accredited investor information (if received), and information used to establish Colorado residency;
- all communications that occur on or through the platform;
- all agreements between the Intermediary and Issuers or investors, in addition to the Intermediary's own corporate legal documents;
- all notices provided to the Issuer and investors, including notices of site malfunctions, changes in procedures, platform maintenance, and denials of access;
- any written procedures of the Intermediary reasonably expected to prevent and detect violations of the Act, given the Intermediary's limited role under the Act.

Intermediaries are also required to disclose to the Division the amount of compensation received for each offering during the year, though the Division has yet to fix a date for that filing.

Access to the Intermediary: Prohibited Activities

The Act requires that an Intermediary file a notice, consent to service, and a 60 dollar registration fee with the Division prior to operating under the Act.

Before an Intermediary may allow any person to access offerings on its platform, it must collect his or her name, physical and email address, phone number, date of birth, and information sufficient to establish Colorado residency. The Rules also specify click-through language for each prospective investor outlining the risks of investing via crowdfunding.

In a significant addition to the Act, the Rules state that an Intermediary must deny an Issuer access to its platform if the Intermediary has a

reasonable basis to believe that the Issuer:

- is not in compliance with the Act;
- has not established means to keep accurate records as required by the Act; or
- presents the potential for fraud or otherwise raises concerns regarding investor protection.

If an Intermediary denies access based upon these grounds, it must report such denial to the Division. Failure to comply with any of the Rules or the Act subjects the Intermediary to potential enforcement action from the Commissioner. In other words, this rule appears to require Intermediaries to monitor Issuers' compliance with the Act without setting a standard for the thoroughness of an Intermediary's review.

Finally, the Rules prohibit Intermediaries from acting as broker-dealers or investment advisors, offering investment advice, receiving equity securities in an Issuer as compensation for Intermediary services, and handling securities or purchaser funds. The prohibition on handling purchaser funds is particularly important because it effectively bars an Intermediary from providing the escrow services discussed above.
