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SEC Proposes Crowdfunding Rules

On October 23, 2013, the Securities and Exchange Commission (SEC) proposed rules to implement the crowdfunding provisions in the Jumpstart Our Business Startups Act of 2012 (the JOBS Act).[1] Title III of the JOBS Act added new Section 4(a)(6) to the Securities Act of 1933 (the Securities Act), which provides a registration exemption for crowdfunding transactions. The proposed crowdfunding rules are subject to a 90-day comment period and will not take effect until sometime in 2014, at the earliest.

Crowdfunding involves an entity or individual raising funds through the Internet for a project, business or other venture, typically by seeking small individual contributions from a large number of people. Crowdfunding usually is open to the public so that any interested person can contribute. Another key attribute of crowdfunding in the SEC's view is that individuals interested in a crowdfunding campaign can share information about the venture with each other and use the information to decide whether or not to fund the venture based on the collective "wisdom of the crowd."

Crowdfunded offerings under Title III of the JOBS Act are not permitted until the SEC's final rules are effective. Until such time, offers and sales of securities through what is typically called crowdfunding would almost certainly violate the registration requirements of the Securities Act. Some media sources and others have mistakenly believed that crowdfunded securities offerings are currently permitted. Current crowdfunding through websites like Indiegogo, Kickstarter and RocketHub provides funding for projects, ideas or businesses through means other than sales of securities. These often involve contributions or donations in exchange for a product or service relating to the project (such as a pre-purchase of a music album or tickets or other memorabilia relating to a film project). They do not involve offers of a share in any financial return or profits that may constitute a security, which would need to be registered under the Securities Act or qualify for an exemption. Existing exemptions prohibit general advertising or solicitation and/or limit the number or type of investors, which would be incompatible with crowdfunding, and registration is generally not practical for early stage ventures.[2] In addition, under current law, a third party that operates a website to effect the purchase and sale of securities would likely be required to register with the SEC as a broker-dealer.

The SEC's proposed crowdfunding rules will be contained in new Regulation

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Crowdfunding. Once the SEC's crowdfunding rules are effective, Section 4(a)(6) of the Securities Act will provide an exemption for crowdfunded offerings that satisfy the requirements of Regulation Crowdfunding. Consistent with Title III of the JOBS Act, the SEC's proposed rules contain a number of provisions designed to limit crowdfunded offerings and protect investors. They also address the requirements for intermediaries through which crowdfunded offerings may be conducted.

General Requirements for Crowdfunding

Proposed Regulation Crowdfunding would impose a number of requirements applicable to all crowdfunded offerings.

- **Limitation on Offering Size**. The aggregate amount of all securities sold by an issuer to all investors in reliance on the crowdfunding exemption in Section 4(a)(6) during the 12-month period preceding the date of the transaction, including the securities offered in such transaction, may not exceed $1 million. The SEC proposed that amounts raised through other means (including private placements under Regulation D) would not be counted toward the $1 million limit and that an offering under Section 4(a)(6) should not be integrated with another exempt offering, provided that each offering complies with the requirements of its applicable exemption.
- **Individual Investment Limitation**. The aggregate amount that may be sold to any investor under the crowdfunding exemption during the 12-month period preceding the transaction (including the securities sold to the investor in the transaction) is limited as follows: (1) if both annual income and net worth of the investor are less than $100,000, then the limit is the greater of $2,000 or 5% of annual income or net worth of the investor, whichever is greater; or (2) if either annual income or net worth is $100,000 or more, the limit is 10% of annual income or net worth of the investor, whichever is greater, up to a maximum of $100,000. Annual income and net worth for natural persons would be calculated in accordance with the determination of accredited investor status under Rule 501(a), and may be calculated jointly with the income and net worth of the investor's spouse. An issuer may rely on an intermediary to determine that an investor will not exceed the investment limit as long as the issuer does not have knowledge that the investor has exceeded or would exceed the limit as a result of purchasing securities in the issuer's offering.
- **Transaction Conducted Through an Intermediary**. An issuer must use a single intermediary to conduct an offering or concurrent offerings in reliance on Section 4(a)(6). Intermediaries for crowdfunded offerings are limited to

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registered broker-dealers and registered funding portals, a new broker registration category created for the crowdfunding exemption. The offering must be conducted through an Internet website or other similar electronic platform through which a registered broker-dealer or registered funding portal acts as an intermediary.

- **Excluded Issuers**. The following types of issuers would be excluded from relying on Section 4(a)(6) to conduct a crowdfunding transaction: (1) a non-U.S. issuer; (2) an issuer subject to reporting requirements under the Securities Exchange Act of 1934 (the Exchange Act); (3) an investment company as defined under the Investment Company Act of 1940 or a company excluded from the definition of investment company under Section 3(b) or 3(c) of the Investment Company Act (this would include any hedge fund or other private fund); (4) an issuer that has sold securities in reliance on the Section 4(a)(6) exemption if the issuer has not filed with the SEC and provided to investors, to the extent required, the ongoing annual reports required by Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement for the new offering; (5) an issuer with no specific business plan or who has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies; and (6) an issuer who is (or certain of whose related parties are) subject to a disqualification event similar to the bad actor provisions for Rule 506 offerings.

Requirements for Issuers

A number of specific requirements would apply to issuers under the proposed rules.

- **Disclosure Requirements**. An issuer relying on the crowdfunding exemption in Section 4(a)(6) must electronically file certain required disclosures with the SEC through an Offering Statement on Form C. Some of the disclosure would need to be presented in a specified format while the other disclosures could be customized and filed as exhibits to the Form C. The filing would be due prior to the commencement of the offering. The filing must also be posted on the intermediary's platform and made available to potential investors (which can be done by referring potential investors to the intermediary's platform). The Form C Offering Statement would include the following disclosure:
  - General information about the issuer, its officers and directors, and beneficial owners of 20% or more of the issuer's outstanding voting equity securities.
  - A description of the issuer's business, business plan and number of

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employees.
    - A description of the purpose and intended use of the proceeds of the offering.
    - The target offering amount and deadline, as well as how oversubscribed offerings would be allocated. It must also include clear disclosure about an investor's right to cancel.
    - The offering price or method for determining the price.
    - A description of the issuer's ownership and capital structure, including the terms of the securities being offered, as well as a description of the material terms of any outstanding indebtedness.
    - Risk factors.
    - Information about the intermediary, including its compensation.
    - Disclosure of exempt transactions conducted by the issuer within the past three years.
    - Disclosure of certain related-party transactions.
    - Financial statement disclosure. If the issuer is offering $100,000 or less, the issuer would need to provide tax returns for the most recently completed year and financial statements certified by the principal executive officer. Issuers offering more than $100,000 but not more than $500,000 must provide financial statements reviewed by an independent public accountant. Issuers offering more than $500,000 must provide financial statements audited by an independent public accountant. All of these dollar amounts include the current offering and any amount sold in a crowdfunded offering within the past 12 months. The financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP) and cover the shorter of the two most recently completed fiscal years or the period since the inception of the business.
    - Narrative discussion of the issuer's financial condition, similar to MD&A required for public companies under Item 303 of Regulation S K.
- **Progress Updates**. An issuer would be required to provide updates on its progress in meeting the target offering amount. In particular, an issuer would be required to file a Form C no later than five business days after raising 50% and 100% of the target offering amount. Like the original Offering Statement, the updates would need to be filed with the SEC, posted with the intermediary and made available to potential investors.
- **Amendments to the Offering Statement**. An issuer would be required to amend its Offering Statement for any material change in the offering terms or disclosure previously provided to investors. Investors would have five business days to reconfirm their investment commitments or the investment

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commitments would be cancelled.

- **Ongoing Reporting Requirements**. An issuer that has sold securities in reliance on Rule 4(a)(6) would be required to file a report with the SEC annually, not later than 120 days after the end of the most recent fiscal year covered by the report, and to also post the report on its website. The annual report would also be filed on Form C and would include similar disclosure as the original Offering Statement. The financial statement requirements would be based on the highest level required in any of its crowdfunded offerings. An issuer would be required to continue filing annual reports until one of the following events occurs: (1) the issuer becomes an Exchange Act reporting company; (2) the issuer or another party purchases or repurchases all of the securities issued pursuant to Section 4(a)(6); or (3) the issuer liquidates or dissolves its business in accordance with state law.
- **Prohibition on Advertising Terms of the Offering**. An issuer would be prohibited from advertising the terms of the offering, except that it could publish a notice of the offering that includes the address of the intermediary's platform on which additional information about the issuer and the offering may be found. These permitted notices would be similar to "tombstone ads" in public offerings under Securities Act Rule 134. An issuer could also communicate with investors through communications channels provided on the intermediary's platform as long as the issuer identifies itself in all such communications.
- **Compensation of Persons Promoting the Offering**. The proposed rules would prohibit an issuer from compensating, or committing to compensate, directly or indirectly, any person to promote the offering through communications channels provided by the intermediary unless the issuer takes reasonable steps to ensure that the person clearly discloses the compensation each time the person makes a promotional communication.

Requirements for Intermediaries

The requirements for an intermediary to participate in an exempt crowdfunding transaction would include the following:

- **Registration and SRO Membership**. A crowdfunding intermediary under Section 4(a)(6) must be either a registered broker-dealer or a registered funding portal and be a member of a self-regulatory organization, which currently would be the Financial Industry Regulatory Authority (FINRA). A funding portal would essentially be a broker with a limited registration that allows it to

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conduct activities in connection with crowdfunding transactions. A funding portal generally would be prohibited from: (1) offering investment advice or making recommendations; (2) soliciting purchases, sales or offers to buy securities offered or displayed on its platform; and (3) compensating people for promoting offerings through its platform subject to certain exceptions.

- **Prohibition on Financial Interests in the Issuer**. A crowdfunding intermediary would be prohibited from having any financial interest in an issuer using its services, including receiving any financial interest as compensation for services provided to, or for the benefit of, the issuer in connection with the offering.
- **Reduce Risk of Fraud**. An intermediary must have a reasonable basis for believing that the issuer is in compliance with Regulation Crowdfunding and has established means to keep accurate records of the securities it offers. An intermediary is also required to deny an issuer access to its platform if it believes the issuer or its offering would provide a potential for fraud.
- **Educational Materials**. An intermediary must deliver to investors, at account opening, educational materials that are in plain language and otherwise designed to effectively communicate certain specified information.
- **Communications Channels**. An intermediary must establish channels to provide required communications to investors to facilitate the offer and sale of crowdfunded securities. An intermediary also must set up a communications channel to facilitate discussions about offerings on the platform.

Additional Provisions

Proposed Regulation Crowdfunding includes a safe harbor allowing an issuer to still rely on the exemption if there are insignificant deviations from the requirements of the rule. To qualify for the safe harbor, the issuer relying on the exemption would have to show that: (1) the failure to comply with a term, condition or requirement was insignificant with respect to the offering as a whole; (2) the issuer made a good faith and reasonable attempt to comply with all applicable terms, conditions and requirements of Regulation Crowdfunding; and (3) the issuer did not know of the failure to comply, where the failure to comply with a term, condition or requirement was the failure of the intermediary to comply with the requirements of the rule, or such failure by the intermediary occurred solely in offerings other than the issuer's offering.

Investors in an offering under the crowdfunding exemption will have a private right of action against an issuer and its directors, principal executive officer,

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principal financial officer and principal accounting officer if the disclosure in connection with the offering contains material misstatements or omissions. The defendants would have the burden to show that they did not know and, in the exercise of reasonable care, could not have known, of the false or misleading statement.

Sales of securities purchased under the crowdfunding exemption would be prohibited for one year, except for transfers (1) to the issuer, (2) pursuant to a registered offering, (3) to an accredited investor, or (4) to certain family members or in connection with the death or divorce of the purchaser or other similar circumstance. Holders of securities sold pursuant to Section 4(a)(6) would not count toward the threshold that requires a company to register with the SEC under Section 12(g) of the Exchange Act.

Securities sold under the crowdfunding exemption would be "covered securities" under Section 18(b)(4) of the Securities Act, which would not be subject to state registration requirements.

Given the limits on the size of crowdfunded offerings under Section 4(a)(6) and the potential costs to issuers to comply with the disclosure requirements, including legal and accounting costs as well as the intermediary's fees, it is not clear whether crowdfunding will be a practical alternative for most issuers. In the proposing release, the SEC estimated costs of up to $152,000 for offerings over $500,000, including up to $112,500 for compensation to the intermediary, $11,000 for preparation of disclosure documents and $28,700 for audited financial statements. These estimated expenses are likely too low, but even at the SEC's estimated levels they would be a significant portion of the proceeds. The SEC also estimated significantly lower intermediary compensation for smaller offering sizes (as low as $2,500 for offerings under $100,000). Given that many of an intermediary's obligations apply regardless of offering size, such low fees seem unlikely for smaller offerings.

An early stage company seeking financing will need to consider whether there are superior alternatives to the crowdfunding exemption. An offering under Rule 506(c) seems to be an attractive alternative, as it permits general solicitation and general advertising as long as all sales are to accredited investors. The tradeoff would be losing access to non-accredited investors through crowdfunding in exchange for the potential of significantly lower costs and regulatory burdens.

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[1] The SEC's release proposing the rules is Crowdfunding, SEC Release No. 33-9470 (October 23, 2013).

[2] Effective September 23, 2013, pursuant to the JOBS Act, Rule 506 was amended to permit general solicitation and general advertising in private placements under Rule 506(c) provided that all of the purchasers of the securities are accredited investors. *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, SEC Release No. 33-9415 (July 24, 2013). Because crowdfunding is premised on permitting sales to any interested person, Rule 506 offerings using general solicitation under the new rules are not consistent with crowdfunding as it is generally understood.

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