

## The SEC's Crowdfunding Rules Finally Arrive

On October 30, 2015, the Securities and Exchange Commission ("SEC") adopted final rules implementing the crowdfunding provisions in the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act").<sup>1</sup> 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 final crowdfunding rules take effect 180 days after their publication in the Federal Register (which should result in an effective date in the first half of May 2016), except that the form for the registration of funding portals takes effect on January 29, 2016. Crowdfunding involves an entity or individual raising funds via 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."

Crowdfunding under Title III of the JOBS Act will be true crowdfunding in the sense of opening an offering to any interested investor in the United States. Crowdfunding under Title III should not be confused with other types of fundraising activities that may also be called "crowdfunding":

- **Product/Donation-Based Crowdfunding.** Websites like Kickstarter and Indiegogo raise funds to support a project, product or company based on a donation model. These fund-raising campaigns often give donors recognition by providing them with a product or service. These sites do not involve raising capital by selling an economic interest in a business (i.e., securities).
- **Regulation D/Rule 506 Crowdfunding.** Pursuant to the JOBS Act, the SEC has amended Rule 506 to eliminate the prohibition on general advertising and general solicitation if all sales are made to accredited investors.<sup>2</sup> This change has allowed accredited investor-only crowdfunding sites to emerge. Because the "crowd" is limited to accredited investors, this is not true crowdfunding as envisioned by Title III of the JOBS Act, where anyone is eligible to invest.
- **State Crowdfunding.** A number of states have adopted exemptions for crowdfunding where the offering is made solely to residents of the applicable

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state. These offerings generally rely on the federal exemption in Section 3(a)(11) and Rule 147 for intrastate offerings.<sup>3</sup>

- **Peer-to-Peer Lending.** Some people have described peer-to-peer lending via websites like LendingClub and Prosper as crowdfunding.

The SEC's crowdfunding rules are contained in new Regulation 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 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

Regulation Crowdfunding imposes a number of requirements applicable to all offerings relying on the exemption.

- **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. This \$1 million cap includes sales under the crowdfunding exemption by affiliates of an issuer. Amounts raised through other means (including private placements under Regulation D) are not counted toward the \$1 million limit and an offering under Section 4(a)(6) will 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 in all offerings under the crowdfunding exemption during the 12-month period preceding a particular transaction (including the securities sold to the investor in the transaction) is limited as follows: (1) the limit is the greater of \$2,000 or 5% of the lesser of the investor's annual income or net worth if annual income or net worth is less than \$100,000; or (2) the limit is the lesser of \$100,000 or 10% of the lesser of the investor's annual income or net worth if both annual income and net worth are \$100,000 or more. 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. The intermediary is required to have a reasonable basis to believe that each investor satisfied these investment limitations, and may rely on the investor's representations for this purpose unless the intermediary has reason to question the reliability of the representations.

- **Transaction Conducted Through an Intermediary.** An issuer must use a single intermediary to conduct an offering or concurrent offerings. Intermediaries for crowdfunded offerings are limited to registered broker-dealers and registered funding portals, a new registration category created for the crowdfunding exemption. The offering must be conducted via the intermediary's Internet website or other similar electronic platform.
- **Excluded Issuers.** The following types of issuers would be excluded from relying on Regulation Crowdfunding: (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 which 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 apply to issuers under Regulation Crowdfunding.

- **Disclosure Requirements.** An issuer relying on the crowdfunding exemption 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 provided to potential investors (which can be done by referring potential investors to the intermediary's platform). The Offering Statement includes 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 employees.
  - A description of the purpose and intended use of the offering proceeds.
  - 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.
  - All issuers must provide financial statements prepared in accordance with U.S. GAAP covering the shorter of the last two completed fiscal years or the period from the issuer's inception. Financial statements for interim periods are not required. If the issuer is offering \$100,000 or less, the financial statements must be certified to be true and correct in all material respects by the principal executive officer and the principal executive officer must also

certify that the disclosure of the amount of the issuer's total income, taxable income and total tax reflects accurately the information in the issuer's federal income tax returns. Issuers offering more than \$100,000 but less 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, except that if the issuer has not previously sold securities in reliance on Regulation Crowdfunding, the financial statements only need to be reviewed and not audited. All of these dollar amounts include the current offering and any amount sold in a crowdfunded offering within the past 12 months. If an issuer otherwise has audited financial statements available, it must provide such financial statements even if not otherwise required (and the same applies where reviewed financial statements are available in an offering of \$100,000 or less).

- Narrative discussion of the issuer's financial condition, similar to MD&A required for public companies under Item 303 of Regulation S-K.
- Any material information necessary to make the statements made, in light of the circumstances under which they were made, not misleading.
- **Progress Updates.** An issuer must provide updates on its progress in meeting the target offering amount. In particular, an issuer must file a Form C-U no later than five business days after raising 50% and 100% of the target offering amount and no later than five business days after the offering deadline where the issuer will accept proceeds in excess 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 provided to potential investors. The requirement to file updates does not apply where frequent updates are made publicly available on the intermediary's platform, provided that the issuer still must file a Form C-U no later than five business days after the offering deadline.
- **Amendments to the Offering Statement.** An issuer must 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 commitments would be cancelled.
- **Ongoing Reporting Requirements.** An issuer that has sold securities in reliance on Regulation Crowdfunding will 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 statements only need to be certified by the principal executive officer to be true and correct in all material respects rather than reviewed or audited by an independent public accountant unless the issuer otherwise has reviewed or audited financial statements available. 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 has filed at least one annual report and has fewer than 300 holders of record; (3) the issuer has filed at least three annual reports and has total assets that do not exceed \$10 million; (4) the issuer or another party purchases or repurchases all of the securities issued pursuant to Section 4(a)(6); or (5) the issuer liquidates or dissolves its business in accordance with state law.

- **Prohibition on Advertising Terms of the Offering.** An issuer is prohibited from advertising the terms of the offering, except that it can publish a notice of the offering that directs investors to intermediary's platform on which additional information about the issuer and the offering may be found. These notices would be similar to "tombstone ads" in public offerings under Securities Act Rule 134 that permit only limited information regarding the offering and the issuer. An issuer may 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.** An issuer is prohibited 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 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 must be a member of a self-regulatory organization, which currently would be the Financial Industry Regulatory Authority ("FINRA"). A funding portal has a limited registration that allows it to conduct limited activities in connection with crowdfunding transactions. A funding portal is 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 and its directors, officers and partners are prohibited from having any financial interest in an issuer that is offering or selling securities on the intermediary's platform in reliance on the crowdfunding exemption. However, the intermediary itself can have a financial interest in an issuer if it receives the financial interest as compensation for its services and the financial interest consists of securities of the same class and having the same terms as the securities being offered through the intermediary's platform. • **Reduce Risk of Fraud.** An intermediary must have a reasonable basis for believing that an issuer is in compliance with Regulation Crowdfunding and that the issuer 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 has a reasonable basis to believe that the issuer or any of its officers, directors or 20% shareholders is subject to the disqualification provisions under the rule. The intermediary must conduct a background check and securities enforcement regulatory check on each issuer as well as its officers, directors and 20% shareholders. In addition, an intermediary must deny access to the platform if it has a reasonable basis to believe that the issuer or its offering presents the potential for fraud or otherwise raises concerns.
- **Educational Materials.** An intermediary must deliver to investors, at account opening, educational materials that are in plain language and otherwise designed to communicate effectively certain specified information. An intermediary must also receive from an investor at the time of investment (1) a representation that the investor has reviewed the intermediary's educational materials, understands that the entire investment may be lost, and is in a financial condition to bear the loss of the investment; and (2) a completed questionnaire demonstrating an understanding of the risks of any potential investment and other required elements.

- **Communications Channels.** An intermediary must establish channels to provide required communications to investors to facilitate the offer and sale of crowd-funded securities. An intermediary also must set up a communications channel to facilitate discussions about offerings on the platform.

## Additional Provisions

**Right to Cancel Investment Commitments.** An investor may cancel an investment commitment by following the procedures that are set forth in the issuer's offering materials at any time until 48 hours prior to the deadline identified in the offering materials.

**Safe Harbor for Insignificant Deviations.** 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.

**Statutory Liability.** Investors in an offering under the crowdfunding exemption will have a private right of action against an issuer and its directors, principal executive officer, principal financial officer and principal accounting officer if the disclosure in connection with the offering contains material misstatements or omissions. This private right of action includes any person who offers or sells a security under the exemption, which could be interpreted to include an intermediary. 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.

**Restrictions on Resale.** 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





similar circumstances. These restrictions on resale apply both to the initial purchaser and any person who subsequently purchases the securities during the one-year period.

**Exemption from Section 12(g).** Holders of securities sold pursuant to the crowdfunding exemption will not count toward the threshold that requires a company to register with the SEC under Section 12(g) of the Exchange Act, provided that the issuer (1) is current in its ongoing annual report filing requirements under Regulation Crowdfunding; (2) has total assets as of the end of its last fiscal year not in excess of \$25 million; and (3) has engaged the services of a registered transfer agent.

**Blue Sky Preemption.** 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.

## Final Thoughts

The crowdfunding exemption attempts to balance the desire to provide early-stage businesses with an innovative way to raise capital and the need to protect investors, particularly inexperienced investors who do not have a high net worth and invest as part of the crowd. Given the limits on the size of crowdfunding offerings under the exemption and the potential costs to issuers to comply with the rule, there has been a concern that crowdfunding may not be a practical alternative for most issuers. The final rules include a few changes from the SEC's original proposal that may ease the cost for issuers, including providing that financial statements may not need to be reviewed or audited by an independent public accountant for an initial offering under the exemption even if the offering size is over \$500,000, providing that financial statements in ongoing annual reports generally will not need to be reviewed or audited by an independent public accountant and permitting an issuer to cease ongoing reporting at some point if the issuer has fewer than 300 holders of record or less than \$10 million of total assets. Still, an offering under the crowdfunding exemption will involve significant expenses, including legal expenses to comply with the disclosure and other requirements under the rules and the fees of the intermediary. The rules place a number of burdens on intermediaries, and intermediaries may potentially face liability to investors if the disclosure in an offering contains material misstatements or omissions. It remains to be seen how the market for funding portals will grow and how much an offering will cost.



An early-stage company seeking financing should 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 nonaccredited investors through crowdfunding in exchange for the potential of significantly lower costs and regulatory burdens.

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