

SEC Adopts Proposed Crowdfunding Rules to Permit Online Sales of Securities: Releasing the Kraken or Unleashing the Wisdom of the Crowd?

On October 23, 2013, the Securities and Exchange Commission ("SEC") proposed rules under the Jumpstart Our Business Startups Act (the "JOBS Act") to permit companies to raise capital through online crowdfunding ("Regulation CF"). Crowdfunding generally refers to the practice of raising money by obtaining small investments from a large number of people over the Internet to help fund a project, business or other venture. To date, the sale of securities via crowdfunding has been illegal in the United States, so start-ups or small companies seeking crowd-funded investment dollars have been mostly relegated to exchanging token products or services (such as pre-purchased movie tickets or other memorabilia relating to an independent film project) for cash pledges.

Title III of the JOBS Act, enacted last year, created a new exemption from registration under Section 4(a)(6) of the Securities Act of 1933 ("Securities Act") to permit start-ups and small companies to offer and sell securities to the public over the Internet or through other similar electronic means (*e.g.*, mobile apps). For the first time, unregistered debt and equity securities can be issued to large numbers of investors (accredited and

non-accredited alike), easing capital formation for companies that otherwise would have found the costs associated with the registration requirements under existing federal securities laws too onerous.

The SEC itself has described crowdfunding as "a new and evolving method to raise money using the Internet" where individuals "interested in the crowdfunding campaign — members of the 'crowd' — may share information about the project, cause, idea or business with each other and use the information to decide whether or not to fund the campaign based on the collective 'wisdom of the crowd.'"

Although securities-based crowdfunding is a welcome development for many start-ups (which may be too small or risky to attract funding from banks or venture capitalists), Regulation CF (like the JOBS Act itself) imposes a number of conditions which companies should consider before deciding whether it makes sound business sense to seek investment dollars from the crowd.

The following summarizes key highlights of the SEC's 585-page proposal of particular relevance to investors and entrepreneurs alike.

Purchase Limits Requirements

While there are no income, net worth or sophistication requirements for investors to participate in crowdfunding offerings, Regulation CF imposes strict limits on the amount of money an investor may so invest, including the following:

- The aggregate amount of securities sold to all investors by the issuer in reliance on the crowdfunding exemption during the preceding 12-month period shall not exceed \$1,000,000. (Capital raised through other means or in reliance on other exemptions, such as Regulation D or Regulation S, does not count towards the \$1,000,000 cap.)
- The aggregate amount of securities sold to any investor by any issuer in reliance on the crowdfunding exemption during the preceding 12-month period shall not exceed the greater of: (i) \$2,000 or 5% percent of the investor's annual income or net worth, whichever is greater, if both the annual income and net worth are less than \$100,000; and (ii) 10% percent of the investor's annual income or net worth, whichever is greater, not to exceed an amount sold of \$100,000, if either the investor's annual income or net worth is equal to or more than \$100,000.

In both instances, the investor's annual income or net worth (exclusive of the investor's primary residence) may be calculated jointly with the income and/or net worth of the investor's spouse. Regulation CF would also allow individuals to self-certify their income and net worth and the amount of their other crowdfunding investments for purposes of the individual investor limits.

Eligibility Requirements

The crowdfunding exemption is specifically not available to issuers that:

- are organized outside of the U.S.
- are publicly traded and subject to the reporting requirements of the Securities and Exchange Act of 1934 ("Exchange Act")
- are registered investment companies, private equity funds or hedge funds
- are disqualified "bad actors" (*e.g.*, have been convicted of a felony or misdemeanor; are the subject of a final order of a state securities commission that bars the person from engaging in the business of securities; or have been suspended or expelled from FINRA)
- fail to comply with the annual reporting requirements of the proposed rules during the

immediately preceding two years

- do not have a business plan or whose business plan is to enter into a merger or acquisition with unidentified targets

Disclosure Requirements

Under proposed Regulation CF, an issuer seeking to rely on the crowdfunding exemption must file with the SEC on EDGAR (using a new SEC Form C), provide to investors and the relevant intermediary, and make available to potential investors the following information:

Issuer Information: Issuer's name, legal status, form of organization, physical address and website.

Business Plan: A description of the issuer's business and anticipated business plan.

Officers, Directors and Shareholders: Basic information regarding the issuer's officers, directors, and significant shareholders (*i.e.*, those holding at least 20% of the issuer's outstanding equity securities), including name, principal occupation and employment, and business experience for the past three years.

Offering Information: The target offering amount and the deadline to reach the target offering amount, including a statement that if the sum of the investment commitments does not equal or exceed the target offering amount at the offering deadline, no

securities will be sold in the offering, investment commitments will be cancelled and committed funds will be returned.

Maximum Amount Investor Will

Accept: Whether the issuer will accept investments in excess of the target offering amount and, if so, the maximum amount that the issuer will accept and whether oversubscriptions will be allocated on a pro-rata, first come-first served, or other basis.

Intended Use of Proceeds: A description of the purpose and intended use of the offering proceeds.

A Description of Investor's Rights: A description of the process to complete the transaction or cancel an investment commitment, including a statement that:

- Investors may cancel an investment commitment until 48 hours prior to the stated offering deadline
- The intermediary will notify investors when the target offering amount has been met
- If an issuer reaches the target offering amount prior to the deadline, it may close the offering early if it provides notice about the new offering deadline at least five business days prior to such new offering deadline (absent a material change that would require an extension of the offering and

reconfirmation of the investment commitment)

- If an investor does not cancel his or her investment commitment before the 48-hour deadline, the funds will be released to the issuer at closing and the investor will receive the purchased securities in exchange for his or her investment.

Material Change to Offering: A statement that if an investor does not reconfirm his or her investment commitment after a material change is made to the offering, the investor's investment commitment will be cancelled and the committed funds will be returned.

Offering Price and Valuation: The offering price of the securities, or at least the method for determining the price, the method for valuing the securities and examples of how the securities might be valued in the future.

Capital Structure: A description of the ownership and capital structure of the issuer, including:

- The terms of the securities being offered and each other class of security of the issuer, including the number of securities being offered and/or outstanding, whether or not such securities have voting rights, any limitations on such voting rights, how the terms of

the securities being offered may be modified and a summary of the differences between such securities and each other class of security of the issuer, and how the rights of the securities being offered may be materially limited, diluted or qualified by the rights of any other class of security of the issuer

- A description of how the exercise of the rights held by the principal shareholders of the issuer could affect the purchasers of the securities being offered
- The name and ownership level of each person, as of the most recent practicable date, who is the beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power
- How the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions
- The risks to purchasers of the securities relating to minority ownership in the issuer and the risks associated with corporate actions including additional issuances of securities, issuer repurchases of securities, a sale of the issuer or of assets of the

issuer or transactions with related parties

- A description of the restrictions on transfer of the securities

Compensation to Intermediary: The amount of compensation paid to the intermediary for conducting the offering, including the amount of referral and any other fees associated with the offering.

Material Terms of Indebtedness: A description of the material terms of any indebtedness of the issuer, including the amount, interest rate, and maturity date.

Exempt Offerings: A description of exempt offerings conducted within the past three years.

Related Party Transactions: A description of any transaction since the beginning of the issuer's last full fiscal year, or any currently proposed transaction, to which the issuer or any entities controlled by or under common control with the issuer was or is to be a party and the amount involved exceeds 5% of the aggregate amount of capital raised by the issuer through crowdfunding during the preceding 12 months, inclusive of the amount the issuer seeks to raise in the current crowdfunding offering, in which any of the following persons had or is to have a direct or indirect material interest: (i) any director or officer of the issuer; (ii) any person who is, as of the most recent practicable date, the beneficial owner

of 20% or more of the issuer's outstanding voting equity securities; (iii) if the issuer was incorporated or organized within the past three years, any promoter of the issuer; or (iv) any immediate family member of any of the foregoing persons, which means any child, stepchild, parent, stepparent, spouse/spousal equivalent, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of the person, and any persons (other than a tenant or employee) sharing the household of the person.

Financial Condition: A description of the financial condition of the issuer.

Financial Statements: Financial statements for the most recently completed fiscal year which are: (i) certified as true and complete by the issuer's principal executive officer (for offerings of \$100,000 or less); (ii) reviewed by an independent public accountant (for offerings of more than \$100,000, but not more than \$500,000); or (iii) audited by an independent public accountant (for offerings of more than \$500,000).

Issuers that have sold securities under the crowdfunding exemption will also be required to file an annual report with the SEC no later than 120 days after the end of its fiscal year, as well as post such annual report on the issuer's website. The annual report is generally required to include updated information that was disclosed in the initial offering statement, in conjunction with the filing of the

issuer's prior completed year's tax return or financial statements, as applicable. This obligation will continue until: (a) the issuer becomes a reporting company required to file reports under the Exchange Act; (b) the issuer or another party purchases all of the securities issued pursuant to the crowdfunding exemption; or (c) the issuer liquidates or dissolves its business in accordance with applicable state law.

Intermediary Requirements

Under proposed Regulation CF, all crowdfunding must be conducted through a single, online-only intermediary, either a registered broker-dealer or a newly-created registered entity, a "funding portal" (defined below), either of which must be a member of a national securities association (*i.e.*, currently only FINRA). By limiting the crowdfunding exchange to a single, "online-only" platform, Regulation CF is designed to ensure that individual investment decisions regarding any particular crowdfunded offering are never made without the benefit of the crowd's (that is, the public's) full participation and collective wisdom.

A funding portal is defined as a broker that only effects transactions in reliance on the crowdfunding exemption and does not: (i) offer investment advice or recommendations; (ii) solicit, directly or through agents, purchases, sales, or offers to buy the securities offered or displayed on its platform or portal;

or (iii) hold, manage, possess, or otherwise handle investor funds or securities.

To reduce the likelihood of investor fraud, intermediaries for crowdfunding securities must:

- Have a reasonable basis to believe an issuer complies with Regulation CF but may rely on representations by the issuer (unless the intermediary has reason to question the reliability of those representations).
- Have a reasonable basis for believing that the issuer has established means to keep accurate records of the holders of the securities it would offer and sell through the intermediary's platform. Again, an intermediary may rely on the representations of the issuer concerning compliance with this requirement unless the intermediary has reason to question the reliability of those representations.
- Deny access to its platform to an issuer if the intermediary: (a) has a reasonable basis for believing that the issuer or any of its officers, directors or 20% holders is subject to a "bad actor" disqualification; or (b) believes that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection. (In satisfying the

first requirement, an intermediary must deny access if it believes that it is unable to adequately or effectively assess the risk of fraud of the issuer or its potential offering. Likewise, in satisfying the second requirement, an intermediary must, at a minimum, conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered by the intermediary and on each officer, director or qualifying beneficial owner. Additionally, if an intermediary becomes aware of information after it has granted access that causes it to believe that the issuer or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection, the intermediary must promptly remove the offering from its platform, cancel the offering, and return (or, for funding portals, direct the return of) any funds that have been committed by investors in the offering.)

The following additional requirements would also apply for an intermediary to participate in a crowdfunding transaction:

Prohibition on Financial Interests in the Issuer: A crowdfunding intermediary (including its directors, officers or partners) 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 offer and sale of its securities. (The proposed rules would interpret “any financial interest in an issuer” to mean a direct or indirect ownership of, or economic interest in, any class of the issuer’s securities.)

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, including:

- the process for the offer, purchase and issuance of securities through the intermediary
- the risks associated with investing in securities offered and sold in reliance on the crowdfunding exemption
- the types of securities that may be offered on the intermediary’s platform and the risks associated with each type of security, including the risk of having limited voting power as a result of dilution
- the restrictions on the resale of securities offered and sold in reliance on the crowdfunding exemption

- the types of information that an issuer is required to provide in annual reports, the frequency of the delivery of that information, and the possibility that the issuer's obligation to file annual reports may terminate in the future
- the limitations on the amounts investors may invest
- the circumstances in which the issuer may cancel an investment commitment
- the limitations on an investor's right to cancel an investment commitment

Communications Channels: An intermediary must provide, on its platform, channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary's platform.

Restrictions on Resales

Securities sold in crowdfunding exempt offerings may not be transferred by the purchaser for one year after the date of purchase, except when such securities are transferred:

- to the issuer
- to an accredited investor (as defined in Rule 501(a) of Regulation D)

- as part of an offering registered with the SEC
- to a family member of the purchaser or the equivalent, to a trust controlled by the purchaser, to a trust created for the benefit of a member of the family of the purchaser or equivalent or in connection with the purchaser's death or divorce or other similar circumstance

Further, regarding the sale of securities to accredited investors during the one-year lock-up period, the seller need only reasonably believe that the person acquiring the securities is an accredited investor. No verification of income or net worth is required.

Restrictions on Advertising

Proposed Regulation CF would permit an issuer to publish a notice advertising the terms of the crowdfunding offering provided that the notice was limited to the following:

- A statement that the issuer is conducting an offering, the name of the intermediary (funding portal or broker) through which the offering is being conducted, and a link directing potential investors to the intermediary's platform through which additional information about the issuer and the offering may be found

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- The terms of the offering (*i.e.*, the amount of securities offered, the nature of the securities, the price of the securities, and the closing date of the offering period)
 - Factual information about the legal identity and business location of the issuer

Aside from this notice, an issuer would otherwise not be permitted to advertise, directly or indirectly, the terms of a crowdfunding offering. These proposed limitations are intended to ensure that investors are directed to the intermediary's platform, where crowd-based discussions and disclosures would help engender informed investment decisions.

Although the advertising notices themselves are limited in scope, companies would be allowed to distribute such notices to investors and potential investors in a variety of means, including in newspapers and social media sites.

Looking Ahead

The SEC's proposed rules are intended to facilitate start-up access to a larger pool of potential investors, regardless of their income or net worth. But this greater access may come with greater costs and regulatory compliance burdens than starts-ups and early-stage ventures can reasonably be expected to bear, most notably in the form of reviewed/audited financial

statements, ongoing reporting requirements, and funding portal fees. Indeed, as one commentator observed, the costs associated with the securities-based crowdfunding option may well approach \$100,000, making crowdfunding "the worst 'bang for your buck' in all of corporate finance."

Whether Congress's and the SEC's proposed rules strike the correct balance between promoting capital growth through crowdfunding and protecting investors from fraud remains to be seen. Fortunately, interested parties may weigh in on the preferred course securities-based crowdfunding should follow as proposed Regulation CF is currently open for comment through the SEC's website until February 3, 2014. In the meantime, start-ups, small businesses and other issuers may not rely on the crowdfunding exemption until the SEC adopts final rules for such offerings.

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