

PUBLICATION

SEC Adopts Long-Awaited Crowdfunding Rules [Ober|Kaler]

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A periodic bulletin keeping small businesses informed about current developments in securities law and related matters.

By way of background, pursuant to Section 5 of the Securities Act of 1933 (Securities Act) and state securities laws, any offer and sale of a security must be registered with the Securities and Exchange Commission (SEC) and any applicable state securities regulators, or exempt from such registration. Just over two years after they were proposed, the SEC has adopted rules that exempt from registration certain sales of securities via “crowdfunding” pursuant to Sections 4(a)(6) and 4A of the Securities Act, as added by the Jumpstart our Business Startups (JOBS) Act in 2012. According to the adopting release, available [here \[PDF\]](#), “[c]rowdfunding is a relatively new and evolving method of using the Internet to raise capital... The crowdfunding provisions of the JOBS Act were intended to help provide startups and small businesses with capital by making relatively low dollar offerings of securities, featuring relatively low dollar investments by the ‘crowd,’ less costly.” While the crowdfunding rules were pending, a number of states adopted their own crowdfunding rules, many modeled on the SEC proposal, which allow companies to conduct securities-based crowdfunding campaigns limited solely to investors in their home state, which could take advantage of the Federal exemption for intrastate offerings. Absent the new rules, securities-based crowdfunding campaigns, other than those intrastate offerings in compliance with a state crowdfunding provision, were impermissible under Federal and State securities laws as there was no available exemption for securities sold over the Internet in the manner common of crowdfunding campaigns. Securities sold pursuant to the new crowdfunding exemption will also be exempt from state registration, subject to any state requirements to file any documents submitted to the SEC with the state regulator, including required annual reports.

Under the final rules, in order to qualify for the crowdfunding exemption issuers must (i) comply with specified requirements, including limits on the amounts raised from any one investor and by an individual issuer in any 12-month period, (ii) conduct the offering through a registered intermediary, (iii) comply with the rule's disclosure requirements, and (iv) comply with other requirements as set forth in the final rules.

The new crowdfunding rules will be effective May 16, 2016, except that Form Funding Portal, discussed below, and amendments to Form ID to add “Funding Portal” as a filer type will be effective January 29, 2016.

This Bulletin discusses the requirements of the new crowdfunding exemption in more detail below.

Offering Limit

Consistent with the proposal, an issuer may raise a maximum of \$1 million in any 12-month period in securities-based crowdfunding offerings; amounts raised through other methods, such as an exempt private placement conducted under Regulation D of the Securities Act or through non-securities based crowdfunding efforts, do not count towards the \$1 million limit. Any amounts sold in reliance on the exemption by entities controlled by or under common control with the issuer, or any predecessor of the issuer, within the prior 12 months do, however, count towards the \$1 million limit. Crowdfunding offerings will not be integrated with other exempt offerings by the issuer, assuming that each offering complies with the requirements of the applicable exemption being relied upon. Issuers will need to take care, however, to ensure that persons investing in an

exempt offering that does not permit general advertising and general solicitation that is conducted concurrently with a crowdfunding offering were not solicited by means of the crowdfunding offering.

Investment Limits

The final rules tweak the individual investor limits in crowdfunding offerings from what was proposed. Under the final rules individual investors may invest in *all* crowdfunding offerings of all issuers in any 12-month period an aggregate of (i) the greater of (A) \$2,000 or (B) 5% of the lesser of (instead of the greater of) the investor's annual income or net worth, if the investor's annual income *or* net worth are below \$100,000 or (ii) 10% of the lesser (instead of the greater) of the investor's annual income or net worth, not to exceed an aggregate of \$100,000, if the investor's annual income *and* net worth are at least \$100,000; under the proposal investors were subject to the higher limit if either their annual income or net worth was \$100,000 or more. Income and net worth are calculated consistent with the definition of an accredited investor in Rule 501 of Regulation D under the Securities Act and, therefore, may be considered alone or with the investor's spouse (provided that the aggregate investment of the spouses may not exceed the limit that would apply to an individual investor at the same income and net worth levels), and the investor's primary residence must be excluded from the net worth calculation. Further, as proposed issuers may rely on efforts that an intermediary must take in order to determine that the aggregate amount of securities purchased by an investor will not cause the investor to exceed the investment limits, as long as the issuer has no knowledge of the contrary. As discussed below, however, these limits are basically self-enforced by investor representations to the funding portal. There are no other purchaser requirements; for example, investors need not be accredited investors or have any knowledge or experience in business or financial matters.

In accordance with the statutory requirements, these investments limit, as well as the \$1 million offering limit discussed above, will be subject to periodic adjustment for inflation.

Crowdfunding Platforms

As noted above, to qualify for the crowdfunding exemption, a crowdfunded securities offering must be conducted solely through an online platform operated by a registered intermediary that complies with Section 4A of the Securities Act and otherwise complies with the requirements of the new rules, although limited off-line advertising is permitted. Issuers may not use more than one intermediary to conduct a crowdfunding offering or concurrent offerings.

Pursuant to Sections 4(a)(6) and 4A of the Securities Act, an intermediary must be a registered broker or a new type of SEC registrant called a "registered funding portal." Funding portals are limited to acting as intermediaries in crowdfunding offerings and cannot offer investment advice, solicit purchases, hold or handle investor funds or securities, or take certain other prohibited actions in connection with securities offerings, although they are permitted to advise issuers about the structure of content of an offering and help prepare offering documents. The rules set forth the requirements and means for such funding portals to register with the SEC through new Form Funding Portal; funding portals must also register with a registered national securities association (FINRA, currently the only national securities association, proposed its rules applicable to funding portals last month) and comply with any requirements implemented by the association. Funding portals will be subject to the examination and enforcement authority of the SEC and the national securities association, must implement policies and procedures designed to achieve compliance with the federal securities laws and applicable regulations thereunder, and comply with certain recordkeeping and other ongoing requirements as set forth in the rules. The new rules set forth additional requirements applicable to and permissible and prohibited activities by funding portals, a discussion of which is beyond the scope of this Bulletin. In addition, intermediaries are required to deny access to their platforms if they have a reasonable

basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection or if a statutory disqualification, as discussed below, exists. In addition, in a change from the proposal, intermediaries also have discretion to determine whether, and under what terms, it will “allow an issuer to offer and sell securities” through its platform, as long as it does not offer investment advice or otherwise violate the new rules. The proposed rules allowed for no such discretion on the part of the intermediaries, who would have been required to allow all offerings that were not fraudulent or in violation of the rules applicable to crowdfunding offerings.

Consistent with Section 4A of the Securities Act and the proposed rules, the final rules set forth actions intermediaries must take with respect to their role in crowdfunding offerings. Among other things, intermediaries must: (i) provide investors (including potential investors) with investor education materials (that explain, among other things, the process for investing on the platform, the types of securities offered on the platform and the risks associated with each type of security and of investing in crowdfunding offerings generally, resale restrictions, investment limits and the right to cancel their investment); (ii) make the disclosure the issuer is required to provide, discussed below, available to investors and the SEC on its platform at least 21 days before any securities are sold; (iii) take steps to reduce the risk of fraud with respect to crowdfunding transactions, including having a reasonable basis to believe that the issuer is in compliance with requirements applicable to conducting an offering under the crowdfunding exemption and has the means to keep accurate records regarding its security holders, and conducting background checks to ensure that the issuer and its related persons are not subject to disqualification; (iv) before accepting an investment commitment, have a reasonable basis to believe (including through the investor's representation to that effect) that the investor does not exceed the investment limitations discussed above; (v) before accepting an investment commitment, obtain from the investor (A) a representation that he or she has reviewed the educational materials, understands that the entire amount of his or her investment may be lost and is in a financial condition to bear such loss, and (B) a questionnaire demonstrating that the investor understands there are restrictions on the investor's right to cancel his or her commitment, that it may be difficult to resell the securities purchased and the risks involved in the investment; (vi) provide on its platform communication channels through which potential investors can communicate with each other and with representatives of the issuers offering securities through the intermediary's platform; (vii) comply with rules for the maintenance and transmission of investor funds (funding portals cannot hold or handle funds and must direct investors to transmit funds to a qualified third party including banks, credit unions and registered broker-dealers); (viii) provide a notice of investment commitment upon receipt of an investment commitment from an investor; and (ix) provide investors with confirmation of the transaction, including the identity, price and number of securities purchased by the investor and sold in the entire offering, the purchase price, and the source, amount and form of any remuneration received by the intermediary in connection with the transaction. All information an intermediary provides to or receives from investors must be communicated electronically and the intermediary must obtain investors' consent to electronic delivery.

With respect to communication channels, an intermediary that is a funding portal is prohibited from participating in any communications via these channels, apart from establishing guidelines for communication and removing abusive or potentially fraudulent communications.

Issuer Requirements; Disqualification

As proposed, only U.S. issuers that are not required to file reports with the SEC under the Securities Exchange Act of 1934 (Exchange Act) may conduct an offering under the new crowdfunding exemption. Investment companies, companies excluded from the definition of an investment company pursuant to certain exclusions from the definition (including hedge funds and other private funds), companies that previously used the crowdfunding exemption but have failed to file an annual report with the SEC that was due in the prior two

years and companies with no specific business plan or whose business plan is to merge with or acquire an unidentified company or companies, are also ineligible to use the new exemption.

In addition, as proposed an issuer may not conduct an offering under using the new crowdfunding exemption if (i) the issuer, (ii) an affiliated or predecessor issuer, (iii) its officers, directors, general partners, managing members or stockholders owning 20% or more of its voting securities, (iv) any promoter connected with the issuer at the time of sale, or (v) any person that has or will be compensated in the offering (or its directors, officers, general partners or managing members), have been convicted of certain felonies and misdemeanors, are subject to certain court or regulatory orders, bars, judgments or decrees, or filed or was named as an underwriter in any registration statement or Regulation A offering statement with the SEC that was subject to a refusal order, stop order or order suspending the Regulation A exemption. For criminal convictions and certain orders, judgments and decrees, the look-back period for such events is either five or ten years, but others will result in a disqualification if the applicable person or entity remains subject to the order, etc. at the time of sale. Disqualification will not apply, however, if the triggering event took place before May 16, 2016, although such events must be disclosed in the offering statement. In addition, the disqualification will not apply if the authority issuing the relevant judgment, order or other triggering directive advises the SEC, either in such order, judgment, etc. or by direct communication to the SEC, that disqualification should not be a consequence of the order, judgment or other action. The disqualification also will not apply if waived by the SEC (by delegation to the Director of the Division of Corporation Finance) “upon a showing of good cause” or “[i]f the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed.” Therefore, an issuer conducting a crowdfunding offering will need to make factual inquiries to confirm that no disqualification exists. Similar disqualification provisions also apply to intermediaries.

Disclosure Requirements

Consistent with Section 4A of the Securities Act and the proposed rules, issuers conducting an exempt crowdfunding offering must prepare an offering statement disclosing certain information about the issuer and the offering on new Form C. The offering statement must be filed with the SEC through its EDGAR filing system and provided to the intermediary, which must then make it available to investors and potential investors through the intermediary's platform. Form C requires an issuer conducting a crowdfunding offering to disclose prescribed information about: (i) the issuer and its officers, directors and persons that beneficially owns 20% or more of its outstanding voting securities; (ii) the issuer's business and anticipated business plan; (iii) the address of the issuer's Web site (which is must create if it does not have one prior to the offering) and where on such Web site and by what date it will post its annual report; (iv) the purpose of the offering including the intended use of proceeds; (v) the target offering amount, the deadline to reach such target, the amount above the target the issuer will accept subscriptions for, if any, and how it will allocate the securities if the offering is oversubscribed; (vi) the offering price or how the offering price will be determined; (vii) information regarding the issuer's ownership and capital structure, including the terms of the securities offered and each other class of the issuer's securities; (viii) a discussion of the material factors that make an investment in the issuer speculative or risky; (ix) material terms of any indebtedness of the issuer; (x) other exempt offerings conducted by the issuer in the past three years; (xi) certain related-party transactions; (xii) whether the issuer or any of its predecessors previously failed to comply with the ongoing reporting requirements of the crowdfunding rules; and (xiii) similar to the Management's Discussion and Analysis required for registered offerings, a description of the issuer's financial condition “including, to the extent material, liquidity, capital resources and... historical results of operations.” Issuers must also disclose that investors may cancel an investment commitment until 48 hours prior to the deadline disclosed in the offering materials, that the intermediary will notify investors when the target offering amount has been reached, that it may close the offering early with five business days' notice if the target amount is reached, the need for an investor to reconfirm its investment after a material change to

the offering, and that the offering will be canceled if the target amount is not reached by the offering deadline. Issuers must further disclose that the securities purchased will be restricted from resale or other transfer for one year, as well as a description of the intermediary's financial interest in the issuer and the transaction (or arrangement to acquire such interest), including the amount of compensation paid or to be paid to the intermediary in the offering. Certain legends must also be included in the offering statement.

In addition, issuers must provide certain financial statement information in the Form C, depending on the amount of capital being raised in the current offering and raised in all other crowdfunding offerings under Section 4(a)(6) in the prior 12 months, as follows: (i) up to \$100,000 - disclosure of the amount of total income, taxable income and total tax as reflected in the issuer's federal income tax return and financial statements, both certified by its principal executive officer to be true and complete, provided that if financial statements are available that have been reviewed or audited by an independent certified public accountant (CPA), those financial statements are required instead; (ii) greater than \$100,000 but no more than \$500,000, or greater than \$500,000 but the issuer is using the exemption for the first time (in each case, assuming audited financial statements are not otherwise available) - financial statements reviewed by an independent CPA; and (iii) greater than \$500,000 and not the issuer's first time using the exemption - financial statements *audited* by an independent CPA. Such financial statements must cover a two-year period or, if shorter, the period since inception. The independent CPA need not be registered with the Public Company Accounting Oversight Board, and the CPA's signed review or audit report must accompany the financial statements. An issuer will be required to file a Form C/A to amend its disclosure for any material changes to the terms of the offering or the disclosure previously provided, and to provide this information to investors and the intermediary.

An issuer conducting a crowdfunding offering will also be required to provide regular updates on its progress in meeting the target offering amount. This information can be satisfied by relying on the intermediary to make this information available on its platform. If the intermediary does not provide this information, the issuer must file it with the SEC on Form C-U. In either case, a final Form C-U must be filed at the end of the offering to disclose the total amount of securities sold.

Advertising; Compensation

Under the final rules, advertising of crowdfunding offerings is limited to notices that provide very limited information about the offering and the issuer and that direct potential investors to the intermediary's platform. Issuers and persons acting on behalf of the issuer may also communicate with potential investors about the terms of the offering through communication channels provided by the intermediary, and persons acting on behalf of the issuer must identify themselves as such in each such communication. Compensation paid to any person to promote the offering through such channels must be clearly disclosed each time such person makes a promotional communication. The rules also provide guidance allowing funding portals to advertise their existence and identify offerings on their platform.

In addition, as proposed intermediaries may not compensate any person for providing it with "personally identifiable information" of any investor or potential investor. New rules provide that a funding portal may compensate persons for directing issuers or potential investors to the intermediary's platform if the person does not provide the intermediary with personally identifiable information of any potential investor and the compensation is not based on the purchase or sale of a security offered through the intermediary's platform, unless paid to a registered broker or dealer in compliance with the new rules (existing broker-dealer rules with respect to limits on the compensation paid to third parties will also apply to their role as intermediaries in crowdfunding offerings).

Finally, while the new rules prohibit the directors, officers or partners of an intermediary from having or receiving an economic interest in the securities of an issuer offering and selling securities through its platform, in a change from the proposal the final rules do allow the intermediary itself to have such an interest if received as compensation for the services it provides the issuer in connection with a crowdfunding offering and the securities are the same as those offered by the issuer in such offering.

Completion, Amendment, Cancellation and Reconfirmation

As proposed, under the final crowdfunding rules investors may cancel their commitments at any time until 48 hours before the expiration date of the offering disclosed in the offering materials. The issuer may close the offering early if the target investment is reached prior to the expiration date, provided the offering had remained open for at least 21 days, the intermediary provides at least five business days' notice of the new offering deadline, investors are given the opportunity to cancel their investment commitment until 48 hours before the new deadline, and the issuer continues to meet the target investment amount.

If there is a material change to the terms of the offering or the offering information, the intermediary must to give or send notice of the change to persons who have made investment commitments and inform them that their commitment will be cancelled unless they reconfirm their commitment within five business days of receipt of the notice.

If an issuer cancels an offering, the intermediary must send a notice of cancellation within five business days and direct the return of the investors' funds.

Restrictions on Resale

The final rules prohibit resales or other transfers of the securities purchased in a crowdfunding offering for one year from the date of issuance except for transfers: (i) to the issuer; (ii) to an accredited investor; (iii) as part of a registered offering; (iv) to a family member (as defined in the new rules) or to a trust controlled by the purchaser or created for the benefit of a family member; or (v) in connection with the death or divorce of the purchaser or other similar circumstance.

Ongoing Reporting Requirements

Issuers that sell securities pursuant to an offering under the new exemption will have to file annual reports on new Form C-AR with the SEC and post such reports on their Web site. Form C-AR includes the information required in the Form C offering statement, except the offering-specific information, including updated financial statements and a discussion of the issuer's financial condition. Unless audited or reviewed financial statements are otherwise prepared, however, the financial statements in the annual report must only be certified by the issuer's principal executive officer. Such an issuer will be required to file annual reports until (i) the issuer becomes an SEC reporting company, (ii) the issuer has filed at least one annual report since its most recent sale of securities under the exemption and has less than 300 holders of record, (iii) the issuer has filed at least three annual reports since its most recent sale of securities under the exemption and has total assets of \$10 million or less, (iv) all the securities issued under the exemption are repurchased, or (v) the issuer dissolves or liquidates.

Exchange Act Registration Exemption

Security holders of an issuer who own securities initially sold by the issuer solely under the new crowdfunding exemption will not count towards the number of record holders (2,000 or 500 who are not accredited investors, or 2,000 for banks and bank holding companies) that trigger SEC registration and reporting under Section 12(g) of the Exchange Act, but only if the issuer (i) is current in its annual report obligations, (ii) retains the services of a registered transfer agent and (iii) has no more than \$25 million in total assets as of the end of its most recently completed fiscal year.