

SEC Proposes New Regulatory Framework for Crowdfunding

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On October 23, 2013, the Securities and Exchange Commission (the “SEC”) proposed long-awaited rules that would implement Title III of the Jumpstart our Business Act (the “JOBS Act”), known as “crowdfunding.” Congress envisioned that allowing crowdfunding would provide small businesses and startups with an alternative source of capital by allowing them to raise small amounts of money from a large number of investors over the Internet. To date, the sale of securities through crowdfunding has been illegal in the United States, so that companies that wish to engage in crowdfunding have been relegated to in-kind and other non-equity crowdfunding such as providing cash investors with products or subscriptions. The SEC’s proposed rules, which are open for public comment for 90 days from their release and which could still change significantly at adoption, will when adopted support and advance the JOBS Act framework.

The proposed rules create an opportunity for eligible companies to raise up to \$1 million on a 12-month rolling basis from a large pool of individual investors over the Internet. Investors will not need to meet any sophistication or wealth thresholds, although they will be limited in the amount of money they will be permitted to invest in any 12-month period. Crowdfunded offerings will need to be conducted through a registered broker or a registered funding portal (a new type of entity envisioned by the JOBS Act). Crowdfunding also will be restricted to online-only platforms, such as Internet sites, smartphone apps or other electronic mediums. To engage in a crowdfunded offering, an issuer will need to make substantial disclosure in its offering materials about its business, key personnel and financial condition, including furnishing complete financial statements that will need to be certified by an officer, reviewed by independent accountants or audited depending on the issuer’s target offering amount. After successfully completing a crowdfunded offering, the issuer will be required to file annual reports with the SEC until it becomes a public company, no longer has any shareholders who purchased securities through the crowdfunding exemption, or dissolves or liquidates.

This advisory highlights significant requirements in the crowdfunding regulatory framework, as currently contemplated by the proposed rules. It does not provide a complete description of each step and requirement to engage in crowdfunding.

Fundamentals of the Crowdfunding Exemption

Eligible Issuers

The JOBS Act created a new issuer transactional exemption from registration for crowdfunding, codified as Section 4(a)(6) of the Securities Act of 1933 (the “Securities Act”). The exemption is designed for use by startups and small businesses. The following types of entities are specifically ineligible to engage in crowdfunding:

- non-US issuers;
- public reporting companies;

- registered investment companies;
- private equity funds and hedge funds; and
- blank check companies and special purpose acquisition companies (SPACs).

Offering Cap

Eligible issuers will be able to offer and sell securities (including debt securities, subject to applicable requirements of the Trust Indenture Act of 1939) under Section 4(a)(6) of the Securities Act just as they sell securities under other applicable registration exemptions. They will, however, be restricted from raising more than \$1 million in the aggregate from crowdfunded offerings on a 12-month rolling basis. Issuers will be free to raise funds through other transaction exemptions, e.g., Regulation D, without those funds counting toward the \$1 million crowdfunding cap. Similarly, capital raised through donations or other contributions will not count against the \$1 million cap.

Issuers will be able to launch individual crowdfunded offerings for any amount, up to the \$1 million cap, but they will need to disclose in advance the target offering amount, the offering deadline and whether they will accept funds beyond the target number (and, if so, how much). If the target offering amount is not met by the offering deadline, all committed investments received to that point will need to be returned to investors. The proposed rules also allow an issuer to conduct a minimum-maximum (or min-max) offering, where the minimum would serve as the target offering amount. All crowdfunded offerings must be open for at least 21 days.

Non-crowdfunded offerings would be permitted to occur simultaneously with, or immediately preceding or following, a crowdfunded transaction without being integrated with the crowdfunded offering, so long as each offering complies with applicable exemption requirements. Even a private offering under Rule 506(b), which does not permit general solicitation or general advertising, could occur simultaneously with a crowdfunded offering so long as the issuer can show that the purchasers in the Rule 506(b) offering were not directly solicited by any of the publicity materials related to the crowdfunded offering and did not first discover the issuer through the crowdfunding solicitation.

Investor Limitations

There are no income, net worth or sophistication requirements for investors to participate in crowdfunding. There are, however, strict limits on the amount of money an investor may invest via crowdfunding, which are as follows:

| Investor Status: | Investment Limit (per 12 months): |
|--|--|
| If both annual income <u>and</u> net worth are less than \$100,000 | Limit of \$2,000 or 5% of annual income or net worth, whichever is greatest |
| If either annual income or net worth are greater than \$100,000 | Limit of 10% of annual income or net worth, whichever is greater, up to a maximum of \$100,000 |

Furthermore, in all cases, an investor's annual income and net worth may be calculated jointly with such investor's spouse's income and net worth.

The SEC has acknowledged that monitoring and independently verifying these investor limits may be difficult. Under the proposed rules, an issuer would be entitled to rely on the efforts of its intermediary to determine whether a sale to an investor would exceed that investor's maximum investment limit, so long as the issuer does not have actual knowledge that the investor has exceeded or would exceed his or her limit as a result of taking part in the issuer's crowdfunded offering. To satisfy their oversight responsibility, however, intermediaries would be entitled to rely on investor representations as to compliance with the investor limitation requirements.

Restrictions on Resale

The customary six-month holding period of Rule 144 of the Securities Act will not apply to securities purchased through the crowdfunding exemption. Rather, investors will also be restricted from reselling securities purchased through a crowdfunded offering for one year from the date of purchase. The only exemptions to this one-year holding period are for transfers:

- to the securities issuer;
- to accredited investors;
- as part of an offering registered with the SEC;
- to a family member, or in connection with certain events (including the investor's death or divorce); and
- to a trust controlled by an investor or a trust created for the benefit of an investor's family member(s).

Intermediaries

Crowdfunded offerings may be conducted only over the Internet or through other similar electronic means (e.g., websites, smartphone apps, etc.). In addition, all crowdfunded offerings must be conducted through an intermediary that is either a registered broker or a new type of registered entity called a "funding portal" (which portal would be exempt from being registered as a broker or dealer), either of which must be a member of the Financial Industry Regulatory Authority, Inc., or "FINRA". A funding portal is an entity specifically designed to conduct crowdfunded offerings, and unlike brokers may not:

- offer investment advice or recommendations;
- solicit investors, sales or offers to buy the securities sold on its portal;
- compensate employees, agents or others for such solicitation; or
- hold, manage, possess or otherwise handle investor funds or securities.

To allay concerns that the restriction on offering investment advice would prohibit a funding portal from accepting or rejecting any offer an issuer seeks to list on the portal's platform, the SEC has proposed a non-exclusive safe harbor for funding portals that engage in certain limited activities, including limiting permissible offerings based on publicly posted and consistently applied objective criteria (e.g., funding

portals that focus their platform on issuers in certain industries or geographic locations or by the type of security being offering).

An issuer would be restricted to using only one intermediary for its offerings at any one time. Intermediaries would also have substantial disclosure and oversight requirements when conducting crowdfunded offerings on behalf of issuers, independent of issuer requirements, as discussed further below.

Penalties for Non-Compliance

An issuer would be barred from conducting a crowdfunded offering if it has failed to file annual reports for a previous crowdfunded offering during the two years immediately preceding the filing of a new offering statement. Once any delinquent reports have been filed, the issuer will be permitted to launch a new crowdfunded offering.

Crowdfunding Investors Not Counted Toward Record Holder Count

Under the proposed rules, investors purchasing securities through a crowdfunded offering would not count toward an issuer's record holder list for the purpose of determining whether the issuer is required to register as a public company. Currently, Section 12(g) of the Securities Exchange Act of 1934 requires an issuer with total assets of \$10 million and a class of securities held by either 2,000 persons or 500 persons who are not accredited investors to register with the SEC.

Disclosure Requirements

Issuer Initial Disclosure

Issuers engaging in crowdfunding would be required to provide substantial disclosure to investors, potential investors and the SEC at the time of the offering's launch, through an offering statement on a new SEC Form C which would be filed with the SEC on EDGAR. In brief, the initial offering statements would include information related to:

- **Issuer Information:** Issuer's name, legal status, form of organization, physical address and website.
- **Offering Information:** The price of the securities being offered, the target offering amount, the deadline to reach the target offering amount, whether investments in excess of the target amount will be accepted, and, if so, the maximum amount the issuer will accept as well as how shares in oversubscribed offerings will be allocated.
- **Directors and Officers:** Director and officer information, including name, principal occupation and employment, and business experience for the past three years.
- **20 Percent Beneficial Owners:** Names and ownership levels of the beneficial owners of more than 20% of the issuer's outstanding voting securities.
- **Business Plan:** A description of the issuer's business and its anticipated business plan, although there would be no required format for the business plan and no information that is specifically required to be contained in the plan.

- **Financial Condition:** A narrative discussion of the issuer’s financial condition that, among other points, addresses the issuer’s historical results of operations, its liquidity and capital resources, and whether the offering proceeds are necessary for the business’s viability.
- **Financial Statements:** Based on the sum of the target offering amount plus the total amount of capital raised through crowdfunding in the 12 months prior to the offering, the issuer must provide two years of GAAP-compliant financial statements as follows:

| Aggregate Target Offering Amounts in Current and Previous Completed Offerings in the Trailing 12-Month Period | Disclosure Requirement |
|---|---|
| \$100,000 or less | Financial statement certified by the principal executive officer, and an income tax return for the most recently completed year |
| More than \$100,000, up to \$500,000 | Financial statement reviewed by an independent public accountant |
| More than \$500,000, up to \$1,000,000 | Audited financial statements |

- **Use of Proceeds:** A sufficiently detailed description of the intended use of the offering proceeds (including the amount of proceeds that will be used to compensate the intermediary), and, if the issuer does not have a specific use of proceeds (or a range of possible uses of proceeds), then a description of each proper use and factors impacting the selection of each particular use.
- **Description of Investors’ Rights:** Issuers must include the following statements to make clear to investors their rights relative to their investment commitments:
 - 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, then the issuer will be permitted to close the offering early, so long as it notifies investors of the new closing date at least five business days in advance thereof and investors retain the ability to cancel their investment commitment up to 48 hours prior to the new closing date;
 - 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; and
 - if the issuer does not raise the full target offering amount by the stated deadline, then all funds committed to that point will be returned to investors and no securities will be sold.
- **Capital Structure:** A description of the issuer’s ownership and capital structure, including the differences in the rights of the securities being offering from the existing classes of securities, risks of capital dilution, risks associated with minority ownership, description of transfer restrictions of the securities, and the ownership level of existing 20% beneficial owners.

- **Related Party Transactions:** Disclosure of related party transactions that occurred within the 12 months prior to the crowdfunded offering that were in excess of 5% of the aggregate amount of capital raised by the issuer through crowdfunding in the previous 12 months.
- **Additional Disclosure:** The issuer would also be required to disclose the following information:
 - the amount of compensation paid to the intermediary;
 - its current number of employees;
 - the material terms of any indebtedness;
 - all of its exempt offerings conducted within the past three years; and
 - material risk factors that make an investor's investment risky or speculative.

Issuer Ongoing Disclosure

- **Progress Reports:** An issuer must provide notice to the SEC, its intermediary, and investors within five business days of reaching 50% and then 100% of the target offering amount. If the issuer accepts investments beyond the originally stated target offering amount, it must file another notice within five business days after the offering deadline so as to disclose the total amount of securities sold. To satisfy the notice requirements with regard to the SEC, an issuer must file a Form C-U on EDGAR; and to satisfy the notice requirement with regard to investors, an issuer may refer investors to the intermediary's platform through a post on the issuer's own website (among other options).
- **Annual Reports:** An issuer that has successfully sold securities under the crowdfunding exemption must file an annual report with the SEC on EDGAR and post the report to its website. The annual report must disclose information similar to the issuer's initial offering statement, including disclosure about its financing condition and the applicable financial statement requirement. This reporting requirement would continue until:
 - the issuer becomes a reporting company;
 - the issuer no longer has any shareholders who purchased securities through the crowdfunding exemption; or
 - the issuer liquidates or dissolves.

Intermediary Disclosure

Intermediaries also would have significant disclosure obligations to investors and potential investors who use their portals. Below are some of the key intermediary disclosure obligations.

- **Compensation:** An intermediary must disclose to an investor, at the time the investor opens an account with the intermediary, how the intermediary is compensated for its services.
- **Educational Materials:** Upon the opening of a new account by a potential investor, an intermediary must provide the investor with plain-language educational materials as well as keep current and post those educational materials on its website.

- **Material Changes:** Intermediaries must provide notice to committed investors as to any material changes to the term of an issuer's offering that occur during the offering period. In the event of a material change, an investor must reconfirm his or her investment commitment within five business days and if the investor fails to do so, that investor's investment commitment will be cancelled and the committed funds returned.

General Requirements for Intermediaries

The following is a description of certain key requirements applicable to brokers and funding portals to conduct crowdfunded offerings as an intermediary:

- **Registration:** Both brokers and funding portals would be required to register with the SEC to serve as crowdfunding intermediaries. The registration process for brokers would remain unchanged (they would complete the Form BD "Uniform Application for Broker-Dealer Registration"). Funding portals would be required to complete a new Form Funding Portal, which would be similar to the Form BD, but less extensive.
- **Financial Interests:** Neither the intermediary nor its directors and officers may own any securities of issuers that conduct offerings using its portal, and the intermediary may not accept securities as compensation for its services.
- **Antifraud Measures:** Intermediaries would be required to have a reasonable basis for believing that issuers have established an accurate method for the recordkeeping of securities and are in compliance with the requirements of Section 4(a)(6) of the Securities Act, although intermediaries would be allowed to rely on issuer representations, absent actual knowledge or other information that indicates that the representations are untrue. Intermediaries also would be required to conduct background checks and security enforcement regulatory history checks on issuers and their directors, officers and 20% beneficial holders.
- **Maintaining Funds:** Brokers that act as intermediaries must keep all investor funds segregated in a separate bank account. Funding portals, which are prohibited from handling investor funds, must arrange for investors to send funds directly to a bank to be held in escrow.

Conclusions

Crowdfunding represents a substantial departure in style and substance from the existing exemptions to securities registration. The JOBS Act reimagined investor protection, foregoing traditional measures and relying on open communication and the "wisdom of the crowd", in an effort to spur investment in startups and small businesses.

Congress may have envisioned crowdfunding as a streamlined and readily accessible way for small companies to access new sources of capital, but the emerging regulatory framework makes clear that there will be substantial hurdles for companies that want to raise capital through crowdfunding. Cost is likely to be the largest such hurdle for small issuers. The crowdfunding rules are complex, and proper compliance will cost issuers both time and money. In addition, for offerings over \$500,000, the cost of providing reviewed

or audited financial statements, as applicable, and filing annual reports may be prohibitive. The fee structure for intermediaries is still unknown, and the proposed rules' due diligence obligations for intermediaries will likely further increase their costs, which will likely flow down to issuers. Moreover, the restriction against compensating intermediaries with issuer securities will make paying an intermediary's fees all the more challenging.

The value of crowdfunding to investors is also uncertain. Investing always carries substantial risks, but crowd-funded offerings present several specific risks to investors. As SEC Commissioner Luis Aguilar noted in his remarks at the SEC's October 23rd meeting, not only do 70% of initial venture capital investments lose money, but small business investments are at relatively high risk for fraud, self-dealing and overreaching by controlling shareholders. Furthermore, under the crowdfunding exemption, issuers will be permitted to deliver less information and disclosure to investors that they would be required to provide under certain other private offering exemptions. Exit options may also be further limited for investors in crowd-funded offerings. Crowdfunding investors are subject to a one-year holding period, rather than the six-month holding period for non-affiliates under Rule 144 of the Securities Act, which governs restricted securities sold under other offering exemptions.

Companies wishing to fundraise by issuing equity or debt securities through internet solicitations may ultimately find that the costs of the new rules exceed the benefits, and that the existing regulatory framework for private placements is easier to use than the new crowdfunding rules. Many companies wish to raise funds through crowdfunding and have been eagerly anticipating the U.S. legalizing crowdfunding and the SEC issuing its rules implementing the JOBS Act mandate. While the JOBS Act's intent appeared to be to encourage a robust market for businesses and funders and to keep the U.S. capital market competitive, all while protecting investors against fraud, it is too soon to tell whether the JOBS Act-mandated rules will gain traction in the marketplace.

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