
November 4, 2015

SEC Adopts Final Rules for Crowdfunding

On October 30, 2015, the Securities and Exchange Commission (the “SEC”) adopted final rules under Title III of the Jumpstart Our Business Startups (“JOBS”) Act. These rules relate to a new exemption under the Securities Act of 1933 (the “Securities Act”) that will permit securities-based crowdfunding by private companies without registering the offering with the SEC. The crowdfunding proposal (“Regulation Crowdfunding”) follows the 2013 crowdfunding rule proposal in most significant respects and represents a major shift in how small U.S. companies can raise money in the private securities market.

Crowdfunding is a term used to describe an evolving method of raising money through the Internet, typically through small individual contributions from a large number of people. Regulation Crowdfunding permits small businesses to raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period from any interested person, not just investors who meet specific qualifications, such as accredited investors (i.e., investors with a net worth of at least \$1 million, excluding the value of their homes, or annual income of more than \$200,000). It also creates a new entity – a funding portal – to allow Internet-based platforms or intermediaries to facilitate the offer and sale of securities without having to register with the SEC as brokers.

Crowdfunding emerged in the final version of the JOBS Act with a relatively extensive set of regulatory, filing and disclosure requirements. Some commentators expressed concerns that, as a consequence, the crowdfunding exemption would do little to help start-ups raise capital because it would not be economically feasible for them to comply with these requirements. As with other provisions of the JOBS Act, the SEC has struggled in its rulemaking process to strike an appropriate balance between the removal of barriers to raising capital and the protection of investors.

Regulation Crowdfunding

Regulation Crowdfunding prescribes rules governing the offer and sale of securities under new Section 4(a)(6) of the Securities Act. Title III of the JOBS Act established the foundation for the crowdfunding regulatory structure in significant detail; the final rule closely follows these provisions, as described below.

Regulation Crowdfunding will become effective 180 days after its publication in the Federal Register (with the exception of Form Funding Portal and the amendments to Form ID, which are effective January 29, 2016).

For a copy of Regulation Crowdfunding, see <http://www.sec.gov/rules/final/2015/33-9974.pdf>.

Limitation on capital raised. Under Regulation Crowdfunding, an issuer is able to raise a maximum aggregate amount of \$1 million through crowdfunding offerings over the course of a rolling 12-month period. Any amounts raised pursuant to other Securities Act exemptions during that period would not count toward this \$1 million limit.

Investment limitation. The aggregate amount sold to any one investor during the 12-month period preceding the date of a transaction is capped at a specified level based on the annual income or net worth of the investor. Investors with annual income or net worth of less than \$100,000 are permitted to invest up to the greater of (i) \$2,000 or (ii) 5% of the lesser of their annual income or net worth. Investors with annual income and net worth each equal to or more than \$100,000 are permitted invest up to 10% of the lesser of their annual income or net worth. During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings cannot exceed \$100,000.

By comparison, the proposed rule had sought to allow investors to refer to the greater of their annual income or net worth when determining their maximum crowdfunding investment amount.

Issuer eligibility. The crowdfunding exemption is not available to certain issuers, including foreign companies, companies that are subject to reporting requirements under the Securities Exchange Act of 1934 (the “Exchange Act”), certain investment companies, companies that are disqualified under the disqualification rules (modeled on the “bad actor” rules under Rule 506 of Regulation D), companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offerings statement, and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies. SPACs and other blind pool arrangements are excluded because the SEC believes that the exemption is intended to provide access to capital by issuers with an early stage project, idea or business.

Issuer disclosure requirements. In connection with an offering under Regulation Crowdfunding, issuers are required to provide disclosure, including financial information, to the SEC, investors and the relevant brokers or funding portals. These disclosures are required to be filed with the SEC via EDGAR on new Form C.

Although significantly more limited than the disclosure that would be required in connection with a registered offering of securities, the offering document still needs to include a variety of disclosures about the issuer and the offering. This includes a description of the company’s business and financial condition, the use of proceeds from the offering, information about officers, directors and owners of 20% or more of the company, information about certain related-party transactions, the price to the public of the securities being offered, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount.

In addition, the offering document is required to contain a complete set of financial statements of the issuer prepared in accordance with U.S. generally accepted accounting principles covering the shorter of the two most recently completed fiscal years or the period since the inception of the business. Depending on the amount offered and sold during a 12-month period, the financial statements are required to be accompanied by information from the company's tax returns, reviewed by an independent public accountant, or audited by an independent auditor.

Under the proposed rules, for issuers offering more than \$500,000 over a 12-month period, the financial statements would have been required to be audited by an independent public accountant or auditor. In a significant accommodation, the final rules permit issuers offering more than \$500,000 but not more than \$1 million of securities while relying on Regulation Crowdfunding for the first time to provide financial statements reviewed, rather than audited, by an independent public accountant (unless financial statements of the issuer are otherwise available that have been audited by an independent auditor).

An issuer relying on Regulation Crowdfunding is required to file annual reports with the SEC and provide them to investors. The annual report is required to contain information similar to the information required in the offering document. This reporting obligation continues until the issuer becomes a reporting company under the Exchange Act, has filed at least one annual report and has fewer than 300 holders of record, has filed at least three annual reports and has total assets that do not exceed \$10 million, all of the issuer's shares issued pursuant to the crowdfunding exemption are repurchased, or the issuer liquidates or dissolves its business.

Restrictions on resales. Regulation Crowdfunding imposes a one-year lock-up on the securities sold, subject to certain limited exceptions, including resales to the issuer, to an accredited investor, to a member of the family of the purchaser, or as part of a registered offering.

Crowdfunding platforms. An offering of securities under Regulation Crowdfunding is required to be conducted through an intermediary—either a broker or a “funding portal.” A “funding portal” is a new type of intermediary that performs limited functions in connection with the offer and sale of securities under the crowdfunding exemption.

Intermediaries are tasked with a variety of duties and obligations in connection with a crowdfunding offering. For example, intermediaries are required to: provide investors with certain information, such as materials that explain, among other things, the process for investing on the platform and the types of securities being offered; take measures to reduce the risk of fraud, have a reasonable basis for believing that an issuer complies with Regulation Crowdfunding; make available to the SEC and potential investors the disclosure required to be provided by issuers at least 21 days prior to any sale; and provide communication channels to permit discussions about offerings on the platform.

Intermediaries are not permitted to provide access to their platforms to companies that they have a reasonable basis for believing have the potential for fraud or other investor protection concerns, and are required to have a reasonable basis upon which to believe that the issuer has established methods to keep accurate records of its security holders. Significantly, the rule allows intermediaries to rely on investors' representations concerning compliance with investment limits.

Additional requirements for funding portals. Funding portals are required to register with the SEC by filing a form ("Form Funding Portal") with information consistent with, but less extensive than, the information required for broker-dealers on Form BD. They are also required to be a member of FINRA or any other national securities association registered under Section 15A of the Exchange Act. They are, however, exempt from the requirement to register as a broker-dealer under the Exchange Act.

Funding portals are permitted to engage only in limited activities necessary in order to effect an offering under the crowdfunding exemption. They are prohibited from offering investment advice, making recommendations, soliciting purchases, sales or offers to buy securities offered or displayed on its website, compensating promoters and other persons for solicitations or based on the sale of securities, and from holding, possessing, or handling investor funds or securities. However, in a change from the proposed rules, funding portals will be able to accept shares of a crowdfunding offering as payment for services, subject to certain conditions.

Regulation Crowdfunding provides for a safe harbor under which funding portals can engage in certain activities deemed consistent with the restrictions described above. Among other things, this safe harbor permits funding portals to advise issuers on the structure of their offerings, limit access to issuers engaged in a particular type of offering, and highlight the offerings of certain issuers.

Limitation on advertising terms of offering. Under the final rule, an issuer can publish a notice advertising the terms of an offering pursuant to the crowdfunding exemption and certain factual information about the issuer (similar to the "tombstone ads" permitted under Rule 134 of the Securities Act), provided that the notice includes the address of the intermediary's platform on which additional information about the issuer and the offering may be found. Other advertising is not permitted.

Liability. Securities Act Section 4A(c) provides that an issuer will be liable to a purchaser of its securities in a transaction exempted by Section 4(a)(6) if the issuer, in the offer or sale of the securities, makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, provided that the purchaser did not know of the untruth or omission, and the issuer does not sustain the burden of proof that such issuer did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. In the adopting release, the SEC specifically declined to exempt funding portals (or any intermediaries) from the statutory liability provision of Section 4A(c) or to interpret the provision as categorically excluding such intermediaries, and noted that the determination of

“issuer” liability for an intermediary under Section 4A(c) will turn on the facts and circumstances of the particular matter in question.

Exemption from Section 12(g). Holders of securities offered pursuant to the crowdfunding exemption do not count toward the threshold number of holders that would require a company to register with the SEC under Section 12(g) of the Exchange Act if the issuer is current in its annual reporting obligations, retains the services of a registered transfer agent and has less than \$25 million in total assets at the end of its most recently completed fiscal year.

Staff report regarding use of crowdfunding exemption. The SEC staff has undertaken to study and submit to the SEC a report no later than three years following the effective date of Regulation Crowdfunding on the impact of the regulation on capital formation and investor protection.

Proposed Amendments to Facilitate Intrastate and Regional Offerings

On October 30, 2015, the SEC also proposed amendments to existing Securities Act Rule 147 to modernize the rule for intrastate offerings to further facilitate capital formation, including through intrastate crowdfunding provisions. The proposal also would amend Securities Act Rule 504 to increase the aggregate amount of money that may be offered and sold pursuant to the rule from \$1 million to \$5 million and to apply bad actor disqualifications to Rule 504 offerings to provide additional investor protection.

For a copy of the proposed amendments to facilitate intrastate and regional offerings, see <http://www.sec.gov/rules/proposed/2015/33-9973.pdf>.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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