

Regulation Crowdfunding

Recently, the Securities and Exchange Commission (“SEC”) voted 5-0 to approve the release of proposed Regulation Crowdfunding (the “Proposed Rule”) under the JOBS Act.¹ Crowdfunding is the process of raising money with relatively small contributions through the Internet. The contributions typically solicited in this manner take the form of donations or pre-purchases of a resulting product with no expectation of investment return on the part of those who contribute. The use of this approach is due to the fact that a general solicitation offering the public an opportunity to make an investment would usually involve the time and expense of complying with the requirement to register a public offering under the Securities Act of 1933 (the “Securities Act”), as well as compliance with state securities, or Blue Sky, laws. As part of the JOBS Acts enacted in April 2012, Congress sought to expand crowdfunding to “provide startup companies and other small businesses with a new way to raise capital from ordinary investors.”²

Under the Proposed Rule, crowdfunding securities offerings would be exempt from Securities Act registration and result in less stringent reporting requirements compared to those required of public companies under the Securities Exchange Act of 1934 (the “Exchange Act”), depending on the size of the offering and the status of the investors. The maximum amount an issuer and related entities could seek to raise through this exemption in a twelve-month period would be \$1 million. Crowdfunding transactions would be required to go through a single registered broker intermediary, and brokers participating solely in the sale of crowdfunding securities could register as a new category of broker, a “funding portal,” which would have reduced approval and ongoing supervisory standards compared to other registered broker-dealers.³

Qualifying as a Crowdfunding Issuer

Certain categories of issuers may not issue securities using the crowdfunding exemption. Issuers that already report to the SEC under the Exchange Act and investment companies as well as the categories of companies specifically excluded from the definition of “investment company” by Section 3(b) and Section 3(c) of the Investment Company Act⁴ do not qualify for the exemption. The statute also excludes issuers organized outside of the United States and U.S. territories.

Disclosure Requirements

When making an offering relying on the Proposed Rule, an issuer must disclose certain information about its business and the offering itself. Disclosure requirements vary depending on the size of the offering, but in all cases are less extensive than the disclosures required in connection with a typical public securities offering registration with the SEC. The disclosures must be filed on EDGAR using a new Form C and, in some cases, must be posted on the company or broker intermediary’s website.

¹ Securities and Exchange Commission, Release Nos. 33-9470; 34-70741; File No. S7-09-13, *Crowdfunding* (October 23, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9470.pdf> (the *Crowdfunding Release*). The JOBS Act is available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

² *Crowdfunding Release* at 7, n.7, quoting Rep. Patrick McHenry.

³ See *infra*, “Requirements for Brokers and Funding Portals.”

⁴ Section 3(b) of the Investment Company Act provides an exemption, in appropriate cases, from the clause in the investment company definition that covers companies in which more than 40% of their assets are attributable to “investment securities.” Section 3(c) of the Investment Company Act provides exemptions for so-called “private funds” and a variety of other companies and investment pools that are subject to other regulatory schemes.

The required disclosures, include:

- 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;
- the various rights, including voting rights, of the offered securities, as well as a summary of how the rights of those securities differ from all other classes of securities of the issuer;
- the target offering amount and the deadline for reaching that amount; however, an issuer may seek to raise more than a target amount, provided that the issuer discloses its intention to do so along with the maximum amount it will raise;
- a description of any exempt securities offerings for the past three years;
- the material terms of any indebtedness;
- the general risks of crowdfunding investing and particular material factors that make an investment in the issuer risky or speculative;
- a description of the issuer's business, business plan and basic information about directors and significant shareholders;
- a description of the financial condition of the issuer, including its operating history, earnings, liquidity, and cash flows and whether those are representative of what investors should expect in the future;
- financial statements for the most recently completed fiscal year
 - for offerings of \$100,000 or less, certified as true and complete by the issuer's principal executive officer,
 - for offerings of more than \$100,000, but not more than \$500,000, reviewed by an independent public accountant, or
 - for offerings of more than \$500,000, audited by an independent public accountant in each case aggregating the amount of securities offered with the issuer's other crowdfunding securities offerings from the previous twelve months to determine the applicable dollar threshold; and
- certain related-party transactions from the last year between the issuer and significant shareholders, directors, or officers, based on the size of the related transaction relative to the size of the offering.

Information provided to the SEC or the broker intermediary with respect to a given offering, must be posted on the intermediary's portal at least 21 days before the first security sale.

Ongoing Reporting by Issuer

Issuers of crowdfunding securities would be required to make disclosures on an annual basis similar to those made at the time of the initial offering. A Form C would be filed on EDGAR, with an “Annual Report” selection marked on the cover page. The issuer would not need to provide the offering specific information again, but most of the financial and general business disclosures would need to be updated in the filing. The obligation to report would continue until the securities are no longer publicly held, the issuer begins reporting under the Exchange Act, or the issuer liquidates or dissolves. The statute requires an issuer to provide the report to investors, in addition to the SEC, and the issuer could satisfy this requirement by posting the report on its website.

Purchase Limits for Investors

The amount of securities an investor could purchase annually through crowdfunding would be limited based on the investor’s income and net worth. The Proposed Rule would impose on the broker intermediary and the issuer the obligation to confirm that an investor is within the investor’s annual limit. The crowdfunding securities would only qualify for the exemption from full SEC registration if all of the investors are within their annual aggregate purchase limit following the transaction. However, the issuer can rely on the efforts that the broker intermediary is required to undertake to ensure that the aggregate amount of securities purchased by an investor will not cause the investor to exceed the annual limit.

The higher an investor’s annual income and net worth, the more securities that investor is permitted to purchase annually under the crowdfunding exemption as set forth in the following table.⁵

Investor’s Annual Income or Net Worth	Permitted Annual Crowdfunding Purchases
< \$100,000	the greater of: i) \$2,000 ii) 5% of annual income iii) 5% of net worth
≥ \$100,000	the greater of the following, not to exceed \$100,000: i) 10% of annual income ii) 10% of net worth

Resale Restrictions

Resale of crowdfunding securities would be restricted for the year following the initial purchase. During that initial year, investors could sell the securities freely to the following persons, among others: (i) to the issuer of the securities; (ii) to an accredited investor as defined in Regulation D; (iii); to a family member of the purchaser; or (iv) to any investor as part of an SEC registered offering. After the first year, the securities would be freely transferrable.

⁵ For purposes of Regulation Crowdfunding, an individual’s annual income and net worth are calculated in the same manner as they are in determining whether a person is an “accredited investor” for Regulation D. For both Regulation D and the proposed regulation, annual income is calculated on a household basis and the value of a person’s primary residence is excluded from the calculation of net worth. *Crowdfunding Release at 24-25.*

Requirements for Brokers and Funding Portals

Crowdfunding offerings would have to be made through a single broker and the proposed regulation would create a new category of broker, a funding portal, that would have relaxed registration and oversight standards.

Under Exchange Act Section 3(a)(4), a broker is a person that effects transactions in securities for the account of others. A funding portal would be a broker that only effects transactions in reliance on the crowdfunding exemption and does not: (i) offer investment advice; (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. In addition to registering with the SEC, funding portals would need to be a member of Financial Industry Regulatory Authority, FINRA.

In accordance with the guidance provided by the SEC, FINRA has limited the broker registration and ongoing supervisory standards to reflect the more limited function of brokers serving as funding portals.⁶ Compared to other broker-dealer members, FINRA has reduced the standards for being approved as a funding portal, from fourteen standards to five, and significantly reduced the turnaround time for approval decisions.⁷ FINRA has also provided more flexibility for funding portals with respect to their ongoing supervisory obligations.

The SEC also directly imposes some obligations on funding portals or any other broker serving as an intermediary for crowdfunding securities. The intermediary must:

- have a reasonable basis to believe an issuer complies with the Proposed Rule, but can rely on reasonable representations by the issuer;
- perform background and securities enforcement regulatory history checks on each issuer as well as on each of its officers, directors, and significant shareholders; and
- have a reasonable basis for believing an investor is within the annual purchase limits, but the intermediary may rely on reasonable representations by the investor.

State Blue Sky Laws Preempted

The crowdfunding provisions of the JOBS Act and the regulations effecting those provisions, including the Proposed Rule, preempt state law.⁸ Therefore, state Blue Sky laws would not apply to offerings under the Proposed Rule and those offerings would be exempt from state registration.

⁶ FINRA, Regulatory Notice 13-34, *FINRA Jumpstart Our Business Startups (JOBS) Act: FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms*, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p370743.pdf>.

⁷ For instance, an applicant for funding portal membership should have a decision within 60 days, as opposed to 180 days under the broker-dealer membership application process. *Id.* at 3.

⁸ JOBS Act § 305.

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Request for Public Comment

The Proposed Rule is currently open for comment through the SEC website until 90 days from the time the proposal is published in the Federal Register; the comment period will likely end in late January.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com.

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