

# JOINING THE CROWD: SEC ADOPTS FINAL CROWDFUNDING REGULATIONS - PART I

Date: 10 November 2015

## Investment Management Alert

By: C. Todd Gibson, Jessica L. Dickerson, Kenneth G. Juster, Michael W. McGrath

On October 30, the U.S. Securities and Exchange Commission ("SEC") adopted its long-anticipated Regulation Crowdfunding, as mandated by Title III of the Jumpstart Our Business Startups Act ("JOBS Act").<sup>[1]</sup> Regulation Crowdfunding governs the offer and sale of securities pursuant to Section 4(a)(6) of the Securities Act of 1933, as amended ("1933 Act"), and includes provisions relating to the regulation of "funding portals" and brokers that facilitate the offer and sale of securities in a crowdfunding effort. The rules establish a framework under which a large number of investors (the "crowd") can invest in the securities of, and provide capital to, issuers particularly startups and small businesses, using the Internet. The new crowdfunding rules and related forms will be effective 180 days after they are published in the Federal Register. The forms enabling funding portals to register with the SEC will be effective Jan. 29, 2016. The full text of the adopting release can be found [here](#).

This is the first of a three-part client alert providing information regarding Regulation Crowdfunding and its expected impact on U.S. capital markets. Parts II and III will provide a more in-depth analysis of issuer and intermediary (including funding portal) requirements under the new rules.

## CROWDFUNDING OVERVIEW

Section 4(a)(6) exempts from registration under the 1933 Act a securities offering of less than \$1 million on an aggregate basis during a 12-month period, provided that the offering is conducted through a broker or funding portal.

Certain issuers are not eligible to engage in crowdfunding transactions under the new rules, including:

- Non-U.S. companies;
- Companies that are disqualified under Regulation Crowdfunding disqualification rules (modeled on, and substantially similar to, the Rule 506(d) "bad actor" rules under Regulation D);
- Investment companies and private funds;<sup>[2]</sup>
- Companies that are reporting companies under the Securities Exchange Act of 1934, as amended ("1934 Act");
- Companies that are delinquent in filing the ongoing reports required by Regulation Crowdfunding; and
- Companies that have no specific business plan or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Virtually any other type of enterprise can raise capital through crowdfunding, and there are no restrictions limiting the type of securities that may be offered and sold in reliance on Section 4(a)(6). Offerings may take the form of common stock, preferred stock, another form of equity interest in the issuer, or debt. Securities purchased in a crowdfunding transaction cannot be transferred for one year, subject to certain exceptions, and issuers do not need to count the holders of these securities when determining whether they meet the 1934 Act thresholds for registration, as long as the issuer is current in its annual reporting obligations, has less than \$25 million in assets, and retains the services of a registered transfer agent for shareholder recordkeeping. Section 4(a)(6) also imposes the following limitations on the aggregate amount of securities that can be sold to any single investor during a 12-month period in reliance on the exemption:

Financial Position of Investor	Aggregate Limits on <u>All</u> Crowdfunding Investments by Investor
Annual income or net worth < \$100,000	Greater of: <ul style="list-style-type: none"> <li>▪ \$2,000 or</li> <li>▪ 5 percent of the lesser of the investor's annual income or net worth</li> </ul>
Annual income and net worth ≥ \$100,000	Lesser of: <ul style="list-style-type: none"> <li>▪ 10 percent of the investor's annual income</li> <li>▪ 10 percent of the investor's net worth</li> <li>▪ \$100,000</li> </ul>

## CROWDFUNDING REQUIREMENTS FOR ISSUERS

**Disclosure Obligations.** Issuers engaged in crowdfunding activities will be required to file specific disclosures with the SEC (and provide such disclosures to the issuer's intermediary to make them available to investors) on new SEC Form C, including certain disclosures that must be provided in the standard format of eXtensible Markup Language (XML). The required disclosures include:

- The name, legal status, physical address and website address of the issuer;
- The names of each director and officer of the issuer (and any person occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer;
- A description of the business of the issuer and the anticipated business plan of the issuer;
- A description of the financial condition of the issuer, which must be certified by the issuer's principal executive officer, reviewed by an independent public accountant, or audited by an independent public

account, depending on the size of the offering and whether the issuer has previously made an offering in reliance on Section 4(a)(6);

- A description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
- The target offering amount, the deadline to reach the target offering amount and regular updates about the progress of the issuer in meeting the target offering amount
- The price to the public of the securities or the method for determining the price; and
- A description of the ownership and capital structure of the issuer.

In addition, the Form C filing must include the following information:

- The name, SEC file number and CRD number (as applicable) of the funding portal or broker-dealer through which the offering will be conducted;
- The amount of compensation paid to the intermediary to conduct the offering, including the amount of referral and other fees associated with the offering;
- Any other direct or indirect interest in the issuer held by the intermediary, or any arrangement for the intermediary to acquire such an interest;
- Risk factors;
- Information about indebtedness, prior exempt offerings and related-party transactions;
- Whether oversubscriptions will be accepted and, if so, how they will be allocated;
- Maximum offering amount (if different from the target offering amount);
- Current number of employees of the issuer;
- Selected financial data for the prior two fiscal years; and
- The jurisdictions in which the issuer intends to offer the securities.

Form C includes an optional Question and Answer format that issuers may elect to use to provide the disclosures that are not required to be filed in XML format. Issuers opting to use this format will need to prepare their disclosures by answering the questions provided and filing that disclosure as an exhibit to the Form C.

**Reporting Obligations.** Crowdfunding issuers will be subject to ongoing reporting requirements under Section 4A(b)(4) of the 1933 Act and Rule 202 of Regulation Crowdfunding. Issuers will need to file a report with the SEC annually, no later than 120 days after the end of the most recently completed fiscal year covered by the report, and the report also must be posted to the issuer's website. The annual report must contain information similar to that required in the offering statement, including disclosure about the issuer's financial condition. However, in the adopting release, the SEC modified its original proposal requiring that an audit or review of the financial statements be included in the annual report. The final rules require financial statements of the issuer included in the annual report to be certified by the principal executive officer as true and complete in all material respects,

although an issuer that has financial statements that have been reviewed or audited by an independent certified public accountant must provide them.

*Advertising by a Crowdfunding Issuer.* Section 4A(b)(2) of the 1933 Act prohibits issuers from advertising the terms of an offering, "except for notices which direct investors to the funding portal or broker." Regulation Crowdfunding describes the acceptable content of such notices, which can include no more than:

- A statement that the issuer is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the investor to the intermediary's platform;
- The terms of the offering<sup>[3]</sup>; and
- Factual information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and website of the issuer, the e-mail address of a representative of the issuer and a brief description of the business of the issuer.

The SEC stated in the adopting release that the permitted notices will be similar to "tombstone ads" under Securities Act Rule 134, except that the notices are intended to direct an investor to the intermediary's platform through which the offering is being conducted, such as through a link directing the investor to the platform.

## CROWDFUNDING REQUIREMENTS FOR INTERMEDIARIES

Crowdfunding transactions are required to be conducted through an intermediary, which must be either a broker or a funding portal. Issuers relying on the crowdfunding rules would be required to conduct their offerings exclusively through one intermediary platform at a time.

Regulation Crowdfunding places specific restrictions on funding portals consistent with their more limited activities and regulatory status than that of a fully registered broker-dealer. For example, the regulation prohibits funding portals from, among other activities:

- Offering investment advice or making recommendations (even if incidental to the execution of a transaction);
- Soliciting purchases, sales or offers to buy securities offered or displayed on their platforms;
- Compensating promoters and other persons for solicitations or based on the sale of securities; and
- Holding, possessing, or handling investor funds or securities.

Funding portals<sup>[4]</sup> must register with the SEC on the new Form Funding Portal, and become a member of a national securities association (currently, FINRA).<sup>[5]</sup> Although the types of activities in which funding portals will be engaged bring them within the definition of a "broker" under Section 3(a)(4) of the 1934 Act, Regulation Crowdfunding exempts funding portals that meet certain requirements from registration as a broker-dealer.<sup>[6]</sup> All funding portals will be required to have in place policies and procedures reasonably designed to prevent violations of federal securities laws.

Regulation Crowdfunding also requires intermediaries (including funding portals) to, among other things:

- Provide investors with educational materials that explain, among other things, the process for investing on the platform, the types of securities being offered, and the information a company must provide to investors, resale restrictions, and investment limits;
- Take certain measures to reduce the risk of fraud, including having a reasonable basis for believing that a company complies with Regulation Crowdfunding and that the company has established means to keep accurate records of securities holders;
- Make an issuer's required disclosures available to the public on its platform for a minimum of 21 days before any security may be sold in the offering, and throughout the offering period;
- Provide communication channels to permit discussions about offerings on the platform;
- Provide disclosure to investors about the compensation the intermediary receives;
- Refrain from accepting an investment commitment from an investor until after that investor has opened an account with the intermediary;
- Have a reasonable basis for believing an investor complies with the annual individual investment limitations;
- Provide investors notices once they have made investment commitments and confirmations at or before completion of a transaction;
- Comply with maintenance and transmission of funds requirements; and
- Comply with completion, cancellation and reconfirmation of offering requirements.

The rules also prohibit intermediaries from engaging in certain activities, such as:

- Providing access to companies that they have a reasonable basis to believe have the potential for fraud or other investor protection concerns;
- Having a financial interest in a company that is offering or selling securities on its platform unless the intermediary receives the financial interest as compensation for the services rendered in connection with the offering made in reliance on Section 4(a)(6); and
- Compensating any person for providing the intermediary with personally identifiable information of any investor or potential investor.

## OTHER ISSUES

*Integration.* Issuers making concurrent offerings under Regulation Crowdfunding, Regulations A and/or Regulation D (either a 506(b) or 506(c) offering) or other exemption will need to have robust procedures and ongoing compliance monitoring processes in place to ensure that the multiple offerings are indeed kept "separate" and that the requirements of each exemption are continually met.<sup>[7]</sup>

*Insignificant Deviations.* Regulation Crowdfunding includes a safe harbor for insignificant deviations from a term, condition or requirement of Regulation Crowdfunding. To qualify for the safe harbor, an issuer must show that:

- The failure to comply with a term, condition or requirement was insignificant with respect to the offering as a whole;
- The issuer made a good faith and reasonable attempt to comply with all applicable terms, conditions and requirements of the rules; and
- The issuer did not know of the failure to comply, where the failure to comply was the result of the failure of the intermediary to comply with certain requirements, or such failure by the intermediary occurred solely in offerings other than the issuer's offering.

Notwithstanding the safe harbor, failure to comply with Regulation Crowdfunding remains actionable by the SEC.

*State preemption.* Section 305 of the JOBS Act amended Section 18(b)(4) of the 1933 Act to preempt the ability of states to regulate certain aspects of crowdfunding conducted pursuant to Section 4(a)(6). Under this preemption, issuers will not need to register crowdfunding offerings or sales made pursuant to Section 4(a)(6) with the states. Section 305 of the JOBS Act also amended Section 15(i) of the 1934 Act such that intermediaries, including funding portals, will not have to comply with state registration or other requirements applicable to broker-dealers with respect to their crowdfunding activities.

\*\*\*\*\*

With the SEC's adoption of Regulation Crowdfunding, the United States has "joined the crowd" of foreign and domestic (at the state level) jurisdictions that already provide for securities-based crowdfunding transactions.

## NOTES:

[1] Pub. L. No. 112-106, 126 Stat. 306 (2012).

[2] Under Section 4A(f) of the 1933 Act and Rule 100(b) of Regulation Crowdfunding, excluded issuers include investment companies as defined in Section 3 of the Investment Company Act of 1940 ("1940 Act") and companies that are excluded from the definition of investment company under Sections 3(b) or 3(c) of the 1940 Act.

[3] "Terms of the offering" is defined in Instruction to Rule 204 of Regulation Crowdfunding to include: (1) the amount of securities offered; (2) the nature of the securities; (3) the price of the securities; and (4) the closing date of the offering period.

[4] Section 3(a)(80) of the 1934 Act defines a "funding portal" as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(a)(6) of the 1933 Act, that does not: (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the SEC, by rule, determines appropriate.

[5] FINRA has issued proposed rules and fees for registration of funding portals as FINRA member firms.



[6] Section 3(h)(1) of the 1934 Act, which was added by Section 304(a) of the JOBS Act, directed the SEC by rule to exempt, conditionally or unconditionally, a registered funding portal from the requirement to register as a broker or dealer under Exchange Act Section 15(a)(1), provided that the funding portal: (1) remains subject to the examination, enforcement and other rulemaking authority of the SEC; (2) is a member of a national securities association registered under Section 15A of the 1934 Act; and (3) is subject to other requirements that the SEC determines appropriate.

[7] The SEC clarified its view that issuers may conduct other exempt offerings without those offerings being integrated with crowdfunding transactions made in reliance on Section 4(a)(6), provided that the issuer fully complies with the applicable exemption relied upon for each particular offering. This is consistent with the SEC's prior guidance with respect to offerings under Regulations A and S.

## KEY CONTACTS



**C. TODD GIBSON**  
PARTNER

BOSTON, PITTSBURGH  
+1.617.261.3140  
TODD.GIBSON@KLGATES.COM

---

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.