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CLIENT ALERT

SEC PROPOSES NEW CROWDFUNDING RULES

The Securities and Exchange Commission (“SEC”) voted unanimously on October 23, 2013 to propose new rules to implement the crowdfunding provisions of Title III of the Jumpstart our Business Startups Act of 2012 (the “JOBS Act”) and permit companies to offer and sell securities through “crowdfunding” (the “Proposed Rules”).¹ Title III of the JOBS Act created an exemption so that this type of funding method--crowdfunding--could be used to offer and sell securities without requiring registration under the Securities Act of 1933, as amended (the “Securities Act”). The SEC is seeking comments to the Proposed Rules, which may be submitted on or before February 3, 2014.

Note: Until the Proposed Rules are adopted, the crowdfunding exemption may not be relied on.

Background

Crowdfunding has its origins in “crowdsourcing,” which is a type of participatory online activity in which a company proposes to a group of individuals the voluntary undertaking of a task (such as *Wikipedia*). Crowdfunding differs from crowdsourcing in that the “crowd” is asked to contribute capital (as opposed to labor) to the project. “Early-stage” crowdfunding called “reward crowdfunding” has been used (on websites such as *Kickstarter*) to generate financial support for various artistic endeavors, such as books and music recordings through small individual contributions, where the contributors received a “reward,” in the form of the fruits of

¹ The Proposed Rules are available at <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>.

the project, such as a book or a CD. Crowdfunding, as contemplated by the JOBS Act, refers to securities crowdfunding and is a method for raising limited amounts of capital from a potentially large pool of investors over the Internet. The SEC is involved in securities crowdfunding only. Crowdfunding previously has *not* been available as a means to offer or sell securities because it would have triggered the application of the federal securities laws, which require that the offering or sale of securities be registered under Section 5 of the Securities Act, unless an exemption is available.

Title III of the JOBS Act

Title III of the JOBS Act created a new Section 4(a)(6) of the Securities Act, which exempted certain crowdfunding transactions from the registration requirements of Section 5 of the Securities Act and established the foundation for a regulatory structure that would permit smaller entities to use crowdfunding to raise capital. Title III of the JOBS Act was designed to help provide start-ups and small businesses with capital by making relatively low dollar offerings of securities less costly and to enable smaller (“non-accredited”) investors to invest in such offerings.

It also created 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. These measures were intended to facilitate capital raising by small businesses while providing significant investor protections, although at this juncture, it is unclear how much capital raising will be facilitated or how significant investor protection will be. Title III of the JOBS Act directed the SEC to write rules implementing the exemption. The Proposed Rules are the response to that directive.

The Proposed Rules

Consistent with Title III of the JOBS Act, the Proposed Rules, among other things, would limit the amount of money an issuer can raise, permit individuals to invest subject to certain thresholds, require that crowdfunding transactions be conducted through intermediaries, and require issuers to disclose certain information about their offers.

Pursuant to the exemption from registration provided by new Section 4(6) of the Securities Act, the Proposed Rules would make crowdfunding available under the following conditions:

- the amount raised by an issuer does not exceed \$1 million in a 12-month period²;
- investments by individual investors in a 12-month period are limited to:
 - the greater of \$2,000 or 5% of annual income or net worth², if the investor’s annual income or net worth is less than \$100,000²; or

² The calculation of a natural person’s net worth would exclude the value of the primary residence of such person. These amounts are subject to adjustment for inflation at least every five years.

- 10% of annual income or net worth, not to exceed \$100,000, if the investor's annual income or net worth is \$100,000 or more²;
- transactions are conducted through an intermediary that is a registered broker or is registered as a new type of entity called a "funding portal" (which does not have to register as a broker), subject to a regulatory framework that would facilitate crowdfunding transactions;
- issuers and intermediaries must provide certain information to investors and potential investors; and
- an issuer would not be able to avail itself of the Section 4(a)(6) exemption if it or its related parties were subject to certain "bad actor" disqualifying events³.

The crowdfunding exemption would *not* be available to non-U.S. companies, companies that already are SEC reporting companies, certain investment companies, companies that have failed to comply with annual reporting requirements of the Proposed Rules and companies with no business plan or whose business plan is to engage in a merger or acquisition with an unidentified company.

Under the Proposed Rules, to rely on the crowdfunding exemption, issuers and intermediaries must comply with certain requirements. A summary of those requirements is set forth below.

Requirements for Issuers

An issuer offering or selling securities in reliance on the Section 4(a)(6) exemption must file certain specific disclosures with the SEC, provide these disclosures to investors and intermediaries, and make these disclosures available to potential investors. These disclosures, among other things, include:

- name, legal status, address and website of the issuer;
- names of the directors and officers and each person holding more than 20% of the shares of the issuer;
- description of the business of the issuer and the anticipated business plan of the issuer;
- financial statements of the issuer that, depending on the amount offered and sold during a 12-month period, are certified by the principal executive officer or reviewed or audited by an independent public accountant or auditor and accompanied by a copy of the issuer's tax return;
- description of the financial condition of the issuer;

³ The Proposed Rules apply the disqualification to the issuer, any director, officer or 20% beneficial owner of the issuer, any promoter connected with the issuer at the time of sale, any person paid for solicitation of purchasers in connection with sales of securities ("Compensated Solicitor") and any director or officer of such Compensated Solicitor.

- description of the intended use of the proceeds of the target amount of the offering;
- target offering amount, deadline to reach the target offering amount and regular updates regarding the progress of the issuer in meeting the target offering amount;
- price of the securities or the method for determining the price; and
- description of the ownership and capital structure of the issuer.

In addition to the above statutory disclosure requirements, the Proposed Rules would require an issuer, among other things, to provide:

- name, SEC file number and Central Registration Depository Number (“CRD”) number (as applicable) of the intermediary;
- disclosure of any compensation paid to the intermediary;
- certain legends to be included in the offering statement;
- number of employees of the issuer;
- discussion of risk factors;
- material terms of any indebtedness of the issuer;
- disclosure of exempt offerings conducted within the past three years; and
- disclosure of certain related-party transactions.

Issuers that have made crowdfunding offerings would have certain ongoing disclosure requirements. Among other things, these issuers would be required to amend their offering documents to reflect material changes and provide updates on their progress toward reaching their target offering amount. These issuers would also be required to file an annual report with the SEC and to provide it to its investors.

Issuers would *not* be allowed to advertise the terms of their offerings but could provide a notice containing limited information that directs potential investors to the intermediaries (brokers or funding portals).

Requirements for Intermediaries

Offerings under the crowdfunding exemption can only be made online through an intermediary that is registered with the SEC as a broker or as a “funding portal” and registered with an appropriate national securities association (e.g., FINRA). The intermediary and its directors, officers and partners *cannot* have a financial interest in the issuer.

The Proposed Rules, among other things, would require intermediaries to:

- provide investors with educational materials;
- take measures to reduce the risk of fraud;
- make available information about the issuer and the offering at least 21 days before any securities are sold;
- take measures to ensure that investors understand and acknowledge the risks associated with an investment;

- take measures to ensure that investors do not exceed their investment limitations;
- provide communication channels to permit discussions between investors and the issuer and among investors about offerings or its platform; and
- facilitate the offer and sale of crowdfund securities.

Under the Proposed Rules, funding portals, among other things, may not:

- offer investment advice or recommendations;
- solicit purchases, sales or offers to buy the securities offered or displayed on its platform or portal (website);
- compensate employees, agents or other person for solicitation of the purchase or sale of securities or its platform;
- hold, manage, possess or otherwise handle investor funds or securities; and
- engage in such other activities as the SEC, by rule, determines appropriate.

The Proposed Rules provide a non-exclusive safe harbor from broker-dealer registration for funding portals that comply with the foregoing restrictions. Consistent with these restrictions, under the Proposed Rules, a funding portal, among other things, may:

- limit offerings available on its platform based on criteria that it applies consistently;
- highlight and display offerings on its platform;
- provide communication channels among investors, prospective investors and issuers;
- provide search functions on the platform;
- advise issuers on the structure and content of offerings;
- compensate others for referring persons to the funding portal and for other services;
- pay, offer to pay compensation to or receive compensation from a registered broker or dealer for services, provided such compensation is permitted under the Proposed Rules and not prohibited by FINRA rules; and
- advertise the existence of the funding portal.

In addition, a funding portal may accept investment commitments, direct investors where to transmit funds, and direct a qualified third party to release proceeds to an issuer upon completion of an offering or return proceeds to an investor in the event an investment commitment or offering is cancelled. A funding portal may also deny access to or cancel an offering on its platform if it believes the offering presents a potential for fraud.

Liability to Investors

An issuer will be liable to an investor in a crowdfunding transaction if the issuer makes an untrue statement of a material fact or omits to state a material fact, provided the investor did not know of the untruth or omission, and the issuer did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. For purposes of liability, an issuer includes “any person who offers or sells the security in such offering.” Therefore, on the

basis of this definition, the Proposed Rules state that it appears likely that intermediaries would be considered issuers for purpose of this liability provision.

Under this liability provision, an investor who purchases securities in a crowdfunding transaction may bring an action against the issuer to recover the consideration paid for the security, with interest, or damages if the person no longer holds the security.

Miscellaneous

Under the Proposed Rules:

- Securities purchased in a crowdfunding transaction cannot be resold for a period of one year (except to the issuer, to an “accreditor investor,” as part of an SEC registered offering, or to a family member of the purchaser in connection with certain events, such as death or divorce);
- Holders of securities purchased in a crowdfunding transaction would not count toward the threshold number of shareholders that requires an issuer to register with the SEC under Section 12(g) of the Securities Exchange Act of 1934, as amended. (The JOBS Act raised this threshold from 500 to 2,000 shareholders).

FINRA has also proposed rules for funding portals and broker-dealers that participate in crowdfund offerings.

Conclusion

The Proposed Rules reflect an attempt by the SEC to strike a balance between facilitating capital formation and making crowdfunding accessible to smaller issuers and smaller investors, and protecting investors from fraud. The Proposed Rules impose substantial requirements on issuers and intermediaries to maintain this balance. Crowdfunding presents new opportunities and new concomitant regulations on participants in crowdfunding transactions. However, despite the best intentions of lawmakers to create the perfect balance between facilitating capital raising and protecting investors, concerns exist. Among other things, there are concerns about the high rate of failure of new ventures, the inability of small investors to properly diversify their investments and the lack of oversight over the small businesses of the issuers, making it fertile ground for fraud.

Please contact the undersigned or your regular Warsaw Burstein attorney to discuss any questions you may have about crowdfunding, in particular, on the issuer side, whether it is a viable option for you and your business, and on the investor side, whether it makes sense for you or your company to invest in a crowdfunding opportunity. These are issues you should begin thinking about at this time. As mentioned earlier, the crowdfunding exemption may not be relied on until the Proposed Rules are adopted, and the comment period continues to February 3, 2014.

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