



**November 24, 2015**

**CLIENT ALERT**

**SEC Adopts Final Crowdfunding Rules**

On October 30, 2015, the Securities and Exchange Commission (“SEC”) voted to adopt final rules – Regulation Crowdfunding<sup>1</sup> – to implement the crowdfunding provisions of Title III of the Jumpstart our Business Startups Act of 2012 (the “JOBS Act”). Regulation Crowdfunding relates to new section 4(a)(6) of the Securities Act of 1933, as amended (the “Securities Act”), which was adopted pursuant to the JOBS Act and which sets forth the crowdfunding exemption from the registration requirements of the Securities Act.<sup>2</sup>

Crowdfunding as contemplated by the JOBS Act refers to *securities* crowdfunding as a method for raising limited amounts of capital from a potentially large pool of investors over the Internet. Regulation Crowdfunding permits securities crowdfunding and is intended to help startups and small businesses raise capital by making low dollar offers of securities less costly and enabling smaller (“non-accredited”) investors to invest in such offerings of securities.

Regulation Crowdfunding follows, in most significant respects, the crowdfunding rules proposed by the SEC in October 2013 (the “Proposed Rules”) and permits small businesses to raise a maximum aggregate amount of \$1 million in any 12-month period by offering securities in crowdfunding transactions on the Internet through SEC-registered intermediaries called funding portals.

Regulation Crowdfunding will become effective May 16, 2016, except that the forms enabling funding portals to register with the SEC will become effective January 29, 2016.

---

<sup>1</sup> The full text of Regulation Crowdfunding is available at <https://www.sec.gov/rules/final/2015/33-9974.pdf>.

<sup>2</sup> Regulation Crowdfunding does not apply in situations in which securities are not being offered.

## Overview of Regulation Crowdfunding

Regulation Crowdfunding sets forth certain specified requirements regarding the dollar amount an issuer can raise and the dollar amount a person can invest. Under Regulation Crowdfunding:

- an issuer is permitted to raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period
- individual investors, over the course of a 12-month period, are permitted to invest in the aggregate across all crowdfunding offerings up to:
  - if *either* their annual income *or* net worth is less than \$100,000, then the greater of:
    - \$2,000 or
    - 5 percent of the lesser of their annual income or net worth
  - if *both* their annual income *and* net worth are equal to or more than \$100,000, then 10 percent 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 may not exceed \$100,000.

In addition, Regulation Crowdfunding sets forth rules regarding use of intermediaries (brokers or funding portals) through which crowdfunding offerings must be conducted, disclosure requirements, holding periods for the securities offered and who may rely on the exemption, including the following:

- an issuer must use only one intermediary to conduct an offering and the offering must occur over the Internet
- issuers are required to provide disclosures, including financial information, to the SEC, investors and intermediaries
- purchasers of securities sold in crowdfunding offerings generally will be required to hold such securities for one year and may not resell them (except to the issuer, an “accredited 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)
- only U.S. companies are eligible to rely on the crowdfunding exemption. Ineligible companies include non-U.S. companies, reporting companies under the Securities Exchange Act of 1934, as amended (“Exchange Act”), certain investment companies, companies that are disqualified under Regulation Crowdfunding’s disqualification rules (“bad actor” disqualification), companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement, 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.

Also, holders of securities offered pursuant to the crowdfunding rules do not count toward the threshold number of holders that would require a company to register under the SEC under Section 12 (g) of the Exchange Act, provided certain conditions are met.

### Requirements for Issuers

Issuers offering or selling securities under Regulation Crowdfunding must file certain information with the SEC and provide the information to investors and relevant intermediaries. The disclosures include:

- name, legal status, physical address and website address 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 its anticipated business plan;
- description of the financial condition of the issuer;
- description of the stated purpose and intended use of the proceeds of the offering;
- target offering amount, the deadline to reach the target and regular updates about the issuer's progress in meeting the target;
- price to the public of the securities or the method for determining price; and
- description of the ownership and capital structure of the issuer.

These disclosures, and any additional disclosures the SEC requires for the protection of investors and in the public interest, are required to be filed with the SEC via EDGAR on Form C. An issuer must amend its disclosures to reflect any material changes in the offer terms or in disclosures previously provided to investors. The amended disclosures also must be filed with the SEC on Form C.

Financial statements are to be prepared in accordance with the U.S. GAAP for the shorter of the issuer's two most recent fiscal years or the period since the issuer's inception. The level of financial statement review is based on the amount offered within the preceding 12-month period:

- for issuers offering \$100,000 or less: financial statements must be certified by the principal executive officer to be true and complete in all material respects
- for issuers offering more than \$100,000 but not more than \$500,000: financial statements

must be reviewed by an independent public accountant

- for issuers offering more than \$500,000 but not more than \$1 million relying on Regulation Crowdfunding for the first time: financial statements must be reviewed by an independent public accountant<sup>3</sup>
- for issuers that previously sold securities in reliance on Regulation Crowdfunding: financial statements must be audited by an independent public accountant.

In each of the above cases, if audited financial statements of the issuer are available, they must be provided.

Issuers of securities under Regulation Crowdfunding would be required to file an annual report with the SEC no later than 120 days after the end of the fiscal year covered by the report.

An issuer's ability to advertise is limited. An issuer may not advertise the terms of the offering except that it may provide a notice that can include no more than (i) 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; (ii) terms of the offering; and (iii) certain limited factual information about its business. The permitted notice will be similar to "tombstone ads" under Rule 134 under the Securities Act.

### Requirements for Intermediaries

Crowdfunding transactions must be conducted through an intermediary, meaning a broker, as defined in the Exchange Act, or a new limited type of entity, called a "funding portal." An issuer relying on Regulation Crowdfunding would be required to conduct its offering through one intermediary at a time. The overall regulatory burdens for a funding portal will be somewhat less than those of a broker. Nevertheless, funding portals will be required to register with the SEC and a national securities association (such as FINRA). Directors and officers of a funding portal may *not* have a financial interest in the issuer using its services. However, the intermediary, itself, *may* receive compensation for services provided to the issuer, including shares of the securities being offered under the crowdfunding offering.<sup>4</sup>

Under Regulation Crowdfunding, intermediaries are required to:

- provide disclosures related to risk and other investor education materials (these include, among other things, the process, types of securities being offered, restrictions on resale, limits on investment amount, manner of intermediary compensation and circumstances for cancellation of investment)

---

<sup>3</sup> This represents a significant change from the Proposed Rules, which required that companies offering \$500,000 or more provide audited financial statements.

<sup>4</sup> Permitting intermediaries to receive a financial interest in the issuer is a departure from the Proposed Rules, which prohibited intermediaries from receiving stock or other financial interest in the issuer as compensation.

- take measures to reduce the risk of fraud (this requires the intermediary to have a “reasonable basis” for believing the issuer is complying with the crowdfunding rules and Regulation Crowdfunding, although the intermediary may reasonably rely on the representations of the issuer, unless the intermediary has reason to question the reliability of those representations)
- make available information required to be provided by the issuer not later than 21 days prior to sale of securities
- take measures to ensure that investors do not exceed their investment limitations
- take measures to ensure that investors understand the risks associated with an investment
- provide on its platforms channels through which investors can communicate with one another and with the issuer about the offerings (the intermediary that is a funding portal would be prohibited from participating in these communications).

Pursuant to Regulation Crowdfunding, a funding portal may not:

- offer investment advice or recommendations
- solicit purchases, sales or offers to buy the securities offered or displayed on its portal
- compensate persons for such solicitation or based on the sale of securities on its portal
- hold or manage investor funds or securities.

Despite the foregoing restrictions, Regulation Crowdfunding provides a non-exclusive safe harbor under which funding portals could engage in certain limited actions consistent with the foregoing restrictions. A funding portal, among other things, may highlight offerings on its platform, provide communication channels, advise issuers on the structure or content of its offerings, compensate others for referring (*not soliciting*) persons to the funding portal, pay compensation to or receive compensation from a registered broker-dealer (provided such compensation is permitted under Regulation Crowdfunding and otherwise is not prohibited), and advertise the existence of the funding portal and the offering. Most importantly, under Regulation Crowdfunding, a funding portal may determine whether and under what terms to allow an issuer to offer or sell securities through its platform.

### Liability

An issuer will be liable to a purchaser in a crowdfunding transaction if, in connection with the offer or sale of securities, it makes an untrue statement of a material fact or omits to state a material fact, provided 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. For purposes of liability, the issuer includes “any person who offers or sells the security in such offering.” The SEC

recognized that based on that definition, an intermediary *would* be considered an issuer for purposes of liability and specifically declined to preclude investors from bringing a private right of action against funding portals. The SEC stated that the determination of “issuer” liability for an intermediary would turn on the facts and circumstances of the particular matter.

## Conclusion

Regulation Crowdfunding clearly reflects an attempt by the SEC to strike a balance between facilitating capital formation (making securities crowdfunding accessible to smaller investors and smaller issuers), while at the same time protecting investors from fraud. Regulation Crowdfunding imposes substantial requirements on issuers and intermediaries to maintain an appropriate balance while providing new opportunities to smaller investors. Notwithstanding, or perhaps because of the attempt at reaching a balance, concerns persist:

- On the one hand, crowdfunding will provide a boost to startup companies and small businesses looking to raise small amounts of capital; on the other hand, the smaller investors from whom they will raise the capital likely are unsophisticated, and therefore more vulnerable.
- On the one hand, investment limitations likely will have a negative impact on capital formation, making it more difficult for issuers to reach their funding target; on the other hand, the limitations will reduce the inherent risk of loss for investors that accompanies the high failure rates associated with investments in startup companies and small businesses.
- On the one hand, access to high risk/reward investments now will be open to smaller investors; on the other hand, it is not clear that these smaller investors will be able to sustain losses in the full amount of their investments, albeit as low as \$2,000.
- On the one hand, crowdfunding will provide a potential source of funding to startup companies and small businesses that lack the business experience necessary to obtain conventional financing; on the other hand; this very lack of business experience suggests that many of these potential issuers are likely to fail after receiving funding.<sup>5</sup>
- On the one hand, crowdfunding will enable small issuers to raise small amounts of capital in a relatively short period of time; on the other hand, investors generally will not be able to sell the securities purchased in a crowdfunding offering for a period of one year and perhaps even longer than that, as there may not be a reliable secondary market, which would leave smaller investors holding illiquid investments in securities.
- On the one hand, some of the restrictions placed on issuers, such as requiring them to

---

<sup>5</sup> Failure rates documented in various studies of startup companies and small businesses that cover the period 1980 through 2010 are high, despite involvement of sophisticated investors, such as venture capital investors. Because issuers engaging in securities crowdfunding will be in an even earlier stage of development than of the studies conducted, it would appear that issuers relying on Regulation Crowdfunding will have an even higher failure rate.

provide reviewed or audited financial statements and to retain and pay an intermediary will offer protection to smaller investors; on the other hand, those requirements make the limited capital raising process (maximum of \$1 million in any 12-month period) disproportionately expensive, which and could deter issuers from the crowdfunding process.

- On the one hand, an issuer raising \$1 million at the rate of \$2,000 per investor allows 500 new smaller investors to participate in a crowdfunding offering; on the other hand, 500 shareholders is a lot of shareholders for an issuer with a relatively small capital structure to manage.
- On the one hand, crowdfunding provides issuers that cannot get bank loans or venture capital with an avenue to raise capital; on the other hand, that leaves smaller investors prey to the most risky of opportunities.
- On the one hand, intermediaries will be able to deny issuers access to use their platforms; on the other hand, intermediaries will be liable to investors as “issuers” for material misstatements and omissions of fact, although it remains unclear as to what degree they will be liable for an issuer’s misstatements and omissions.

It remains to be seen whether the SEC has struck the right balance and whether Regulation Crowdfunding will prove to be a useful tool to enable smaller issuers to raise capital and at the same time to protect smaller investors. We continue to monitor the situation.

\*\*\*\*\*

Please contact Meryl Wiener, the undersigned or your regular Warsaw Burstein attorney for assistance in connection with any issues you may have concerning crowdfunding. We can assist you in your capacity as an issuer, an intermediary or an investor.

|                            |  |                |
|----------------------------|--|----------------|
| Frederick R. Cummings, Jr. | <a href="mailto:FCummings@wbcsk.com">FCummings@wbcsk.com</a> | (212) 984-7807 |
| Thomas Filardo             | <a href="mailto:TFilardo@wbcsk.com">TFilardo@wbcsk.com</a>   | (212) 984-7806 |
| Marshall N. Lester         | <a href="mailto:MLester@wbcsk.com">MLester@wbcsk.com</a>     | (212) 984-7849 |
| Murray D. Schwartz         | <a href="mailto:MSchwartz@wbcsk.com">MSchwartz@wbcsk.com</a> | (212) 984-7701 |
| Stephen W. Semian          | <a href="mailto:SSemian@wbcsk.com">SSemian@wbcsk.com</a>     | (212) 984-7764 |
| Kyle A. Taylor             | <a href="mailto:KTaylor@wbcsk.com">KTaylor@wbcsk.com</a>     | (212) 984-7797 |
| Meryl E. Wiener            | <a href="mailto:MWiener@wbcsk.com">MWiener@wbcsk.com</a>     | (212) 984-7731 |