

EXPERT ANALYSIS

A Balancing Act: Sec Adopts Final Crowdfunding Rule

By Meryl E. Wiener, Esq.
Warshaw Burstein LLP

On Oct. 30, the Securities and Exchange Commission voted to adopt final rules known as Regulation Crowdfunding. These rules implement the crowdfunding provisions of Title III of the Jumpstart Our Business Startups Act of 2012, 15 U.S.C.A. § 77d(a)(6).

Regulation Crowdfunding relates to new Section 4(a)(6) of the Securities Act of 1933, which was adopted pursuant to the JOBS Act and sets forth the crowdfunding exemption from the registration requirements of the Securities Act.

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 by enabling smaller (non-accredited) investors to invest.

The SEC is involved in securities crowdfunding only.

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

It will become effective May 16, 2016, while the forms enabling funding portals to register with the SEC will become effective Jan. 29, 2016.

ORIGIN OF CROWDFUNDING

Crowdfunding has its origin in "crowd-sourcing," a type of participatory online activity in which a company, such as Wikipedia, proposes to a group of individuals the voluntary undertaking of a task.

Crowdfunding differs from crowdsourcing in that the "crowd" wants to contribute capital rather than 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. Small individual contributors receive a "reward" in the form of the fruits of the project, such as a book or a CD.

Before Section 4(a)(6) of the Securities Act and its implementing rules, crowdfunding was not available as a means to offer or sell securities because it would have triggered the registration requirements of the Securities Act. Section 4(a)(6) and Regulation Crowdfunding creates an exemption that enables crowdfunding.



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OVERVIEW OF REGULATION CROWDFUNDING

Regulation Crowdfunding sets specific requirements regarding the dollar amount an issuer can raise and the dollar amount a person can invest. An issuer may raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period.

Over the course of a 12-month period, individual investors whose annual income or net worth is less than \$100,000 may invest — in the aggregate and across all crowdfunding offerings — up to either \$2,000 or 5 percent of the lesser of their annual income or net worth (whichever is greater). If annual income *and* net worth are at least \$100,000, then the allowable amount is 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.

Regulation Crowdfunding sets forth rules regarding disclosure requirements, holding periods for the securities offered, and the use of intermediaries, such as brokers or funding portals through which crowdfunding offerings may be conducted. The rules provide that only U.S. companies are eligible for the crowdfunding exemption. They specifically exclude, among others, non-U.S. companies, reporting companies under the Securities Exchange Act of 1934 (15 U.S.C.A. § 78a), certain investment companies and 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, are also ineligible.

Holders of securities offered pursuant to the crowdfunding rules do not count toward the threshold number of holders that would require SEC registration 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 information to investors and relevant intermediaries.

The required disclosures include descriptions about the issuer and information about its directors, officers and persons holding more than 20 percent of its shares; a description of its business and financial condition; the use of the proceeds from the offering; target offering amount and the deadline to reach the target; and the price of the securities offered to the public.

These disclosures, and any additional disclosures the SEC requires for the protection of investors and in the public interest, must be filed with the SEC via EDGAR on Form C. Issuers must amend disclosures to reflect any material changes in the offer terms or in previous investor disclosures. The amended disclosures also must be filed with the SEC on Form C.

Financial statements must be prepared in accordance with the U.S. Generally Accepted Accounting Principles for the shorter of the issuer's two most recent fiscal years or the period since the issuer's inception.

The required level of financial statement review depends on the amount offered in the preceding 12-month period. For issuers offering up to \$100,000, 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 and relying on Regulation Crowdfunding for the first time, financial statements must be reviewed by an independent public accountant. For issuers that previously sold securities in reliance on Regulation Crowdfunding, financial statements must be audited by an independent public accountant. In each of these cases, audited financial statements of the issuer must be provided if they are available.

Issuers of securities under Regulation Crowdfunding must 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 also limited. Specifically, issuers may not advertise the terms of an offering other than via a notice that includes 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
- Terms of the offering
- Certain limited factual information about its business.

The permitted notice will be similar to "tombstone ads," which are ads written by investment bankers for public offerings under Rule 134 of 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 can conduct its offering through only one intermediary at a time. The overall regulatory burdens for funding portals will be somewhat less onerous than those placed on brokers. Nevertheless, funding portals will be required to register with the SEC and a national securities association such as the Financial Industry Regulatory Authority Inc.

Directors and officers of a funding portal may **not** have a financial interest in the issuer using its services. However, the intermediary **may** receive compensation for services provided to the issuer, including shares of the securities being offered under the crowdfunding offering.

Under Regulation Crowdfunding, inter-mediarities must provide disclosures related to risk and other investor education materials. These include, among other things, disclosures relating to the investing process, types of securities being offered, restrictions on resale, limits on investment amount and intermediary compensation, and measures taken to reduce the risk of fraud. The intermediary must have a "reasonable basis" for believing the issuer is complying with Regulation Crowdfunding.

Funding portals must also make information required by the issuer available no later than 21 days before the securities sale. They must also provide the information on their platforms channels, through which investors can communicate with one another and the issuer about the offerings. 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; or hold or manage investor funds or securities.

Despite these restrictions, Regulation Crowdfunding provides a non-exclusive safe harbor under which funding portals can take certain limited actions consistent with the foregoing restrictions.

Most importantly, Regulation Crowdfunding permits funding portals to determine whether and under what terms it allows issuers to offer or sell securities through their platforms.

Issuers must amend disclosures to reflect any material changes in the offer terms or in previous investor disclosures. The amended disclosures also must be filed with the SEC on Form C.

While crowdfunding will provide a boost to startup companies and small businesses looking to raise small amounts of capital, the smaller investors from whom they will raise the capital likely are unsophisticated and therefore vulnerable.

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 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, the issuer includes “any person who offers or sells the security in such offering.” The SEC specifically declined to preclude investors from bringing a private right of action against funding portals and 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 the SEC’s attempt to strike a balance between facilitating capital formation and making securities crowdfunding accessible to smaller investors and smaller issuers on the one hand and protecting investors from fraud on the other. It 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 to reach this balance, concerns persist.

While crowdfunding will provide a boost to startup companies and small businesses looking to raise small amounts of capital, the smaller investors from whom they will raise the capital likely are unsophisticated and therefore vulnerable.

Investment limitations will likely have a negative impact on capital formation, making it difficult for issuers to reach their funding targets. Conversely, the limitations will reduce the inherent risk of investor loss 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 will be open to smaller investors. On the other, it is not clear that these smaller investors will be able to sustain losses in the full amount of their investments — even those as low as \$2,000.

Crowdfunding will also provide a potential source of funding to startup companies and small businesses that lack the business experience necessary to obtain conventional financing. But this lack of business experience suggests that many of these potential issuers are likely to fail after receiving funding.

Crowdfunding provides issuers that cannot get bank loans or venture capital an avenue to raise capital. The concern, however, is that it can leave smaller investors vulnerable to the risky opportunities. Although it will enable small issuers to raise small amounts of capital in a relatively short period of time, investors generally will not be able to sell purchased securities for at least a year. This is because there may not be a reliable secondary market. As a result, smaller investors may be left holding illiquid investments.

Some restrictions on issuers, such as requiring them to provide reviewed or audited financial statements and to retain and pay an intermediary, will provide a measure of protection to smaller investors. Those requirements, however, will make the limited-capital-raising process (maximum of \$1 million in any 12-month period) relatively expensive, which could deter issuers from engaging in the crowdfunding process.

An issuer raising \$1 million at the rate of \$2,000 per investor allows 500 new smaller investors to participate in a crowdfunding offering. But 500 shareholders is a lot of shareholders for an issuer with a relatively small capital structure to manage.

Intermediaries will also be able to deny issuers access to their platforms. The flip side is that intermediaries will be liable to investors as “issuers” for material misstatements and omissions of fact, although it remains unclear to what degree they will be liable for an issuer’s misstatements and omissions.

Whether the SEC has struck the right balance — and whether Regulation Crowdfunding will enable smaller issuers to raise capital while protecting smaller investors — remains to be seen.



Meryl E. Wiener is a partner at **Warshaw Burstein LLP** in New York City. She advises businesses on a broad range of regulatory, compliance and securities matters. Early in her career, she spent four years as trial counsel for the U.S. Securities and Exchange Commission in its division of market regulation, where she investigated and prosecuted enforcement actions under the federal securities laws.

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