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SEC Adopts Regulation Crowdfunding to Facilitate Early Capital Raises

On Oct. 30, 2015, the Securities and Exchange Commission (SEC) adopted Regulation Crowdfunding by a 3-1 vote. The rules were adopted despite concerns expressed in comment letters to the SEC that capital raising through crowdfunding could lead to fraudulent activities, and thereby place unsophisticated investors at risk. Regulation Crowdfunding governs offers and sales of securities under Section 4(a)(6) of the Securities Act of 1933, as amended (Securities Act), which came into effect as part of the JOBS Act in 2012. Securities sold under the new rules are exempt from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934, as amended (Exchange Act). Regulation Crowdfunding will become effective May 16, 2016, except for certain provisions relating to funding portals, as discussed below. Under the new rules, an issuer may raise up to a maximum of $1 million in any rolling 12-month period from investors, including non-accredited investors. All offerings relying on Regulation Crowdfunding must utilize a SEC-registered broker-dealer or funding portal.

"Crowdfunding" has evolved in recent years as a method of raising capital through general solicitation, typically over the internet, for a variety of projects. The JOBS Act created an exemption under the U.S. federal securities laws to enable this funding alternative to be utilized for the offer and sale of securities, subject to certain investment size, and manner of offering limits. The provisions in the JOBS Act were designed to provide startup companies and small businesses with access to capital through relatively low dollar offerings of securities, featuring a less costly means of capital raising by relying on the "crowd." In recent years, the concept has been confused with capital raises under Rule 506(c) under the Securities Act of 1933, as amended (Securities Act), and Regulation A+, adopted by the SEC last summer. However, as discussed below, crowdfunding under the newly-adopted rules draws important distinctions from other available exemptions. Offerings made in reliance on Section 4(a)(6) will not be integrated with other exempt offerings that occur prior to, concurrently with, or subsequent to the offering, provided that all conditions for each exemption relied upon are satisfied.

Issuer Eligibility: For purposes of determining aggregate amounts offered and sold, including under prior offerings, the term "issuer" is defined broadly to include "all entities controlled by or under common control with the issuer and any predecessors of the issuer. Among other issuer requirements, in order to rely upon Regulation Crowdfunding, the issuer must not be:

- a non-U.S. company;
- an existing SEC reporting company under the Exchange Act;
- a company (or affiliates) that is disqualified as a "bad actor" under Rule 503 under Regulation Crowdfunding;
- an investment company (subject to certain limitations);
- a development stage company with no specific business plan or that has indicated its business plan is to engage in a merger or acquisition with an unidentified company; or
- a company that has sold securities in reliance on Regulation Crowdfunding and has not filed the requisite reports with the SEC and provided the required annual reports to investors during the two years immediately preceding the filing of the required offering statement.

Disclosure Requirements. In conducting an equity crowdfunding offering, companies must file certain information with the SEC and make certain disclosures available to investors and the broker-dealer, or to the funding portal facilitating the offering, in the interest of providing transparency. Initial disclosure about the offering must be filed with the SEC on new Form C, which the intermediary (i.e., the broker-dealer or funding portal through which the offering is being conducted) would then post on its website or provide a link for potential investors. The required disclosures are akin to those included in a Form 1-A qualification statement under Regulation A+. Issuers can opt to include a Q&A-style format to provide certain disclosures. Amendments to the Form C must be filed for any updates to the information, or for material changes that would affect an investment decision. Progress reports on Form C-U are required to be filed with the SEC within five days after completion of certain milestones, such as: investor commitments for at least 50% of the offering; commitments for 100% of the offering; acceptance of oversubscriptions; and closing of the offering.

Form C disclosures are not insubstantial and include information about officers, directors, and owners of 20% or more of the company, certain related party transactions, the price to the public of the securities being offered or the method for determining the price, the target offering amount, offer mechanics, whether the company will accept investments greater than the target amount, any deadline by which the company must reach the target amount, a description of the company's business, the intended use of proceeds from the offering, indebtedness, a description of other exempt offerings over the past three years, risk factors, transfer restrictions, a discussion of the financial condition of the company, and financial statements of the company. Information must also be provided about the intermediary, including compensation arrangements, and any other financial interests the intermediary may have in the offering or in the issuer. The discussion of offering mechanics must include a statement that the investor can cancel a subscription up to 48 hours prior to the identified deadline and that, if not cancelled, the investor's funds will be released to the issuer at closing.

The scope of the financial information that must be provided depends upon the amount of securities being offered and sold during a 12-month period, as set out below:

- for offerings up to $100,000: total income, taxable income, and total tax, or equivalent line items, as reported on the issuer's federal tax return for the most recently completed year, and certified by the principal executive officer. The issuer's financial statements must also be provided and certified by the same officer. Alternatively, if financial statements have either been reviewed or audited by an independent public accountant, this information must be provided instead;
- for offerings over $100,000 and up to $500,000: financial statements reviewed by an independent public accountant, unless audited financial statements are available;
- for offerings over $500,000 and up to $1 million: financial statements audited by an independent public accountant; however, first-time issuers may provide financial statements that have been reviewed by an independent public accountant if audited statements are not available.

Financial statements must be prepared in accordance with U.S. GAAP and, where required, audited in accordance with AICPA or PCAOB standard. Audited financial statements must include a signed audit report from the independent public accountant.

Ongoing Reporting. Companies that conduct an offering under the new rules are required to file an annual report with the SEC on Form C-AR within 120 days after the issuer's fiscal year-end. The report must include the information required in the Form C, as well as financial statements certified by the principal executive officer.

The ongoing reporting requirements can be terminated upon the first to occur of:

- the issuer becoming subject to the reporting requirements of the Exchange Act;
- after filing at least one annual report, the issuer has fewer than 300 record holders;
- after filing at least three annual reports, the issuer's assets do not exceed $10 million;
- all of the issuer's securities issued under Section 4(a)(6) have been repurchased or redeemed; or
- the issuer dissolves or is liquidated under state law.

Holders of securities sold in reliance on Section 4(a)(6) are excluded from the determination of the number of the issuer's "holders of record," for purposes of determining whether the issuer is required to register the class of securities under Section 12(g) of the Exchange Act. However, the issuer is required to maintain a method for tracking its shareholders, which may require engaging a transfer agent or similar third-party service provider.

Offering Communications: Rule 204 under Regulation Crowdfunding permits issuers to release a notice to the public similar to the tombstone-type information allowed for conventional public offerings under Securities Act Rule 134. The information is limited to: the name, address, phone number and website of the issuer, together with an email address for the issuer's representative; the name of the related intermediary for the offering, including a link to the intermediary's offering page; the amount, nature and price of offered securities; the closing date; and a brief description of the issuer's business. All other communications with investors must occur through the intermediary's platform. The issuer may, however, continue to release information about its business in the ordinary course, without mentioning the offering; such releases will not have the benefit of an express safe harbor.

Investor Requirements: Investors themselves are subject to significant limitations on the amount they may invest in crowdfunding offerings over a rolling 12-month period. For investors with annual income or net worth less than $100,000, the maximum investment in all offerings relying upon Regulation Crowdfunding is the greater of (x) $2,000, or (y) 5% of the lesser of the investor's annual income or net worth. If annual income and net worth each equal or exceed $100,000, then the investment limit is 10% of such annual income or net worth, whichever is less.

Unlike securities acquired in a Regulation A+ offering, securities purchased through crowdfunding are subject to a one-year restriction on resale or transfer, except to the issuer, an accredited investor, a family member, or in connection with estate transfers, or in connection with an offering registered under the Securities Act.

Platform Requirements: Section 4A under the Securities Act was adopted as part of the JOBS Act and sets out the statutory requirements for intermediaries participating in a crowdfunding offering under Section 4(a)(6). All issuers conducting offerings under Section 4(a)(6) and Regulation Crowdfunding are required to use a SEC-registered intermediary, either a broker-dealer or funding portal. The intermediary essentially functions as a gatekeeper to protect investors from fraudulent transactions. Only one such intermediary may be used for a particular offering. The offering must be conducted on and through the intermediary's platform. A "platform" is "a program or application accessible via the Internet or other similar electronic communication medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6) of the Securities Act." Funding portals must register with the SEC on new Form Funding Portal and must also become a member of FINRA. The proposed FINRA framework is not covered in this Alert. The new Form will become effective Jan. 29, 2016. Registration will become effective on the later of 30 days after the filing of Form Funding Portal with the SEC, or the date upon which the portal is approved for membership in FINRA.

Under the new rules, intermediaries must, among other things:

- provide investors that open accounts with educational materials in plain English by electronic link that explain the process for investing on the platform, the types of securities offered, investment limits, company information, resale/transfer restrictions, right to cancel a commitment, and post-transaction relationships with the issuer and the intermediary;
- adopt measures to reduce the risk of fraud, including having a reasonable basis for believing the company complies with the new rules and has established means to keep accurate records of securities holders. The intermediary must conduct background and securities regulatory enforcement checks on each issuer, as well as the issuer's officers, directors, and beneficial owners of at least 20% of the issuer's securities;
- make the company disclosure available on the platform throughout the offering period, and for at least 21 days prior to the sale of any security in the offering;
- provide communication channels on the platform to facilitate discussions among investors and issuers about offerings made available on the intermediary's site, without participation by the intermediary itself; and
- disclose to investors the intermediary's compensation relating to the offering, as well as that of any promoter.

Intermediaries must require investors to open an account on the platform before accepting any investment; however, the intermediary cannot require a potential investor to open an account in order to receive information about the offering or an issuer. The intermediary must have a reasonable belief that the investor meets and complies with the investment limitations under the rules. The issuer may rely upon the intermediary's calculation of the investment limits relative to an investor, provided that the issuer does not otherwise have knowledge that the limits would be exceeded as a result of participating in the offering. Upon receipt of a commitment from an investor, the intermediary must provide an electronic notice to the investor confirming the dollar amount of the commitment, price of the securities, name of the issuer, and deadline for cancellation of the commitment. Prior to acceptance of the investor's commitment, the intermediary must obtain confirmation from the investor that the investor understands the restrictions on cancellation of a commitment and the ability to secure a return of the investment, the restrictions on resale and transfer of the securities, and the potential for complete loss of the investment and the ability to withstand such loss. Once the investment has been accepted, the intermediary must provide electronic confirmations to each of the investors at or before completing the sale.

Intermediaries are prohibited under the rules from engaging in certain activities. Companies may not be permitted access to the platform if the intermediary has a reasonable belief that there is a potential for fraud, among other concerns. Intermediaries are prohibited from having a financial interest in a company offering on its platform, unless that interest was received as compensation for its services, subject to certain limitations. In addition, no person may be compensated by the intermediary for providing personally identifiable information of any investor or potential investor.

Crowdfunding portals are subject to additional restrictions on their activities, as distinguished from broker-dealers. Funding portals cannot offer investment advice, make investment recommendations, solicit purchases, sales, or offers to buy securities, compensate promoters or other persons for soliciting investors or based upon the sale of securities, or hold, possess or handle investor funds or securities.

State Securities Law Preemption: Section 305 of the JOBS Act amended Securities Act Section 18(b)(4) to preempt the ability of state securities commissions to regulate certain aspects of crowdfunding conducted in reliance upon Section 4(a)(6). Although preemption of state registration requirements will reduce the costs of these offerings for issuers, certain states and commentators have expressed concern that such preemption will remove a layer of protection for investors in preventing fraud. In the adopting release, the SEC noted that certain restrictions included in the statute and the final rules are intended to offset this concern, such as through public disclosure requirements, investment limits, the use of an intermediary, and the disqualification provisions. In addition, the antifraud provisions of the federal and state securities laws will apply to these offerings.

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Regulation Crowdfunding will not become effective until May 16, 2016. This time lag will enable funding portals to begin the registration process with the SEC, once the applicable forms become available at the end of January 2016. It will also allow funding portals the necessary time to apply for FINRA membership. Early stage companies will now be able to consider the viability of raising capital through the "crowd," as compared to Regulation A+, or more traditional forms of private placements, such as Regulation D. However, given all the "chatter" that has surrounded crowdfunding since the enactment of the JOBS Act, we anticipate that early stage companies will welcome these new rules and seek to be part of the expanding crowd. Notwithstanding this enthusiasm, participants in crowdfunding must carefully prepare to meet the extensive requirements and safeguards imposed under the JOBS Act and Regulation Crowdfunding, as well as the associated costs.

This *GT Alert* was prepared by **Barbara A. Jones**, **John K. Wells**, and **Ira N. Rosner**. Questions about this information can be directed to:

- Barbara A. Jones | +1 617.310.6000 | jonesb@gtlaw.com
- John K. Wells | +1 617.310.6000 | wellsj@gtlaw.com
- Ira N. Rosner | +1 305.579.0500 | rosneri@gtlaw.com
- Or your Greenberg Traurig attorney