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The Wisdom of Crowdfunding? The SEC's New Rules

By *Jerry J. Burgdoerfer, William L. Tolbert, Elaine Wolff and Matthew Carter*

On October 23, 2013, the Securities and Exchange Commission (the "SEC") unanimously proposed new crowdfunding rules (the "Rules") under Title III of the JOBS Act[1] ("the Act"). Eagerly awaited by the crowdfunding investment community, the proposed Rules will now face what is sure to be an extensive comment process before their final adoption. Comments will be due within 90 days after publication of the proposed Rules in the Federal Register.

I. Why are the Proposed Rules a Big Deal?

Crowdfunding enthusiasts have predicted a democratizing game-change in how start-ups and small businesses raise capital. Within certain limits described below, unregistered debt and equity securities can, for the first time, be issued to large numbers of unaccredited investors. But others remain wary. "The thing about crowdfunding is that it brings together unsophisticated issuers with unsophisticated investors," said Barbara Roper of the Consumer Federation of America. "What could possibly go wrong?"

The crowdfunding Rules, which allow small businesses and start-ups to raise up to $1 million in a 12-month period, have the potential to tap into an immensely broad—albeit rather shallow—lake of capital. Nevertheless, the risks and costs of compliance described in this Client Alert—drafting the required disclosures and business plans, obtaining two years[2] of audited financial statements for larger offerings, filing annual reports and updates with the SEC, restrictions on advertising, and caps on investor purchases—may mean that for many small businesses, equity crowdfunding will be the funding of last resort.

II. Crowdfunding 1.0 versus Equity Crowdfunding: What's the Change?

Crowdfunding has not hitherto involved the issuing of securities. Instead, the rewards for backers of projects on platforms such as Kickstarter or Indiegogo have been limited to non-monetary ones—psychic satisfaction, or perhaps a copy of the finished artwork or product. Crowdfunders have avoided the equity or profit-sharing model: sales such as these to non-accredited investors would have triggered costly registration requirements. In an attempt to lower this capital-raising hurdle, Congress created a new exemption to the Securities Act's registration requirement: Section 4(a)(6) ("4(a)(6)"). Under Title III of the Act, 4(a)(6) offerings will be exempt from registration—provided the amount raised in reliance on the exemption does not exceed $1 million within a 12-month period.[3] Companies raising capital through crowdfunding would be required to prepare an offering document and file it with the SEC on the Commission's new Form C. The issuing company would then provide its crowdfunding intermediary with copies of this filing, to be made available online to investors. Both the SEC filing and the copy on the intermediary's website must be completed and available at least 21 days prior to the first day on which securities are sold in the offering.

To further incentivize crowdfunding, the proposed Rules do not mandate aggregation of the amounts raised by an issuer[4] in reliance on different exemptions. This preserves issuers' access to other funding sources—issuers may raise capital under other exemptions, so long as the amount raised *using 4(a)(6)* does not exceed $1 million. Similarly, there is no integration of 4(a)(6) offerings with offerings under other exemptions. In addition, the Rules "neither limit the type of securities that may be offered…nor prescribe a method for valuing them."

III. Issuers: Caps on the Exemption, Restrictions on Resale

Certain issuers are ineligible for the 4(a)(6) crowdfunding exemption, including non-U.S. companies, companies that are already SEC reporting companies, and investment companies. For issuers that *are* eligible, the Rules place caps on the amount that may be sold to any unaccredited investor:

- If the investor (and any spouse) has an annual income AND net worth of less than $100,000, then an annual limit of $2,000 or 5% of income or net worth, whichever is greater, would apply.

- If either the investor's annual income OR net worth exceeds $100,000, then an annual limit of 10% of either figure, whichever is greater, would apply—as well as an overall cap of $100,000.

There is however an important safe-harbor for issuers. Provided that issuers do not have *knowledge* that these caps have been exceeded, they may rely on the efforts that an intermediary makes to determine these aggregate annual figures.

For their part, investors have restrictions on their power to resell 4(a)(6) securities. Securities issued in reliance on the crowdfunding exemption may not be transferred by the purchaser for one year, unless (i) to a family member, (ii) to a trust controlled by the purchaser or for the benefit of a family member,[5] (iii) to an accredited investor, (iv) in a registered offering, or (v) to the issuer.

Importantly, crowdfunding issuers are exempt from registration under 12(g) of the Exchange Act. One widely-held concern was that the sale of a security by an issuer (with total assets exceeding $10,000,000) to more than 500 unaccredited investors, would force that issuer to register the class of securities with the SEC. Proposed Rule 12g-6 removes this apprehension by providing that purchasers and transferees of 4(a)(6) offerings would be permanently excluded from the record holder count. Further, the SEC declined to condition this exemption from 12(g) on any particular size of crowdfunding issuer.

IV. Issuers: Disclosure Requirements

The Rules propose a tiered disclosure system based on the aggregate 4(a)(6) target amounts offered within the preceding 12 months. If issuers have raised:

- **$100,000 or less:**[6] they must file with the SEC—and provide to the intermediary—income tax returns for the most-recently completed year;

- **$100,000-$500,000:** they must file and provide U.S. GAAP-compliant financial statements covering the period since the business' inception, or two years (whichever is shorter), that have been reviewed by an independent public accountant;

- **More than $500,000:** they must file and provide *audited* financial statements covering the period since the business' inception, or two years (whichever is shorter).

The Commission has proposed that for each offering, issuers must file its new Form C. This fillable online form would store key information on the SEC's EDGAR database. The Form C offering statement (and thus, the data on the intermediary's website) must include:

- information about officers and directors, as well as owners of 20 percent or more of the company;
- a description of the company's business;
- a description of the company's intended use of proceeds;
- the price of securities being offered, the target amount of the offering, the deadline to reach the target amount and whether the company will accept investments in excess of the target amount;
- certain related-party transactions; and
- a narrative discussion of the company's financial condition. If an issuer does not have a prior operating history, the discussion of the issuer's financial condition should focus on financial milestones, operations, liquidity and other challenges. The SEC anticipates that these discussions will look much like the MD&As required in registered offerings—though rather more flexible, and less lengthy or detailed.

Issuers must also provide:

- progress updates on meeting their target offering amounts. These should be filed on EDGAR no later than five business days after reaching the 50% and 100% marks. (The concept is to allow investors to gauge the fluctuating levels of interest in an offering); and
- amended disclosures after any material change to its prior disclosures, or to the offer's terms. This triggers cancellation of the commitments of any investors who do not reconfirm within 5 days. Investor funds would then be returned from the bank escrow accounts mandated by the Rules.

Finally, any issuer who has sold an offering in reliance on 4(a)(6) must file an annual report on EDGAR no later than 120 days after the end of the fiscal year covered by the report. This ongoing duty to report is only suspended by an issuer's:

- liquidation;
- repurchase of all securities; or
- change in status to a reporting company under the Exchange Act.

V. Issuers: Restrictions on Advertising

Advertising and general solicitation by issuers is not permitted under the Rules. An issuer is only permitted to publish a notice (somewhat similar to the "Tombstone Ad") that may include no more than the following:

- That the issuer is conducting an offering;
- The name of the intermediary, with accompanying link;

- The terms of the offering, such as price, amount, and closing date; and
- Bare factual information about the issuer's legal identity, a brief description of the issuer's business, and business location.

To promote one of the central tenets of crowdfunding—allowing members of the crowd to share information and decide whether to fund an issuer—each issuer will be permitted to communicate through their intermediary's channels with investors about the offering's terms. The issuer must disclose its identity, however. Similarly, issuers may not compensate persons to promote an offering through the intermediary's channels, unless the issuer takes reasonable care to ensure that these persons clearly disclose the fact of their compensation.

VI. Intermediaries

Crowdfunding must take place through SEC-registered intermediaries, which fall into two categories: broker-dealers and funding portals. Under the rules, offerings would be conducted exclusively through online platforms operated by a registered broker or a registered funding portal.[7] A funding portal is any person acting as an intermediary in a transaction involving the offer or sale of securities, for the account of others, pursuant to 4(a)(6). Funding portals may not:

- offer investment advice or recommendations;
- engage in secondary market transactions in securities;
- solicit purchases or sales;
- compensate employees, agents, or other persons for such solicitation; or
- hold or handle investor funds or securities.

The Rules make clear that funding portals are brokers for the purposes of the federal securities laws, but conditionally exempts them from registration as broker-dealers under the Exchange Act. All persons acting as intermediaries must register with the Commission as a broker (under the Exchange Act) or as a funding portal (under the Securities Act and Regulation Crowdfunding Rule 400). All broker-dealers and funding portals must also be members of a national securities association (i.e. FINRA).

Intermediaries must also:

- disclose the manner in which they will be compensated by the issuer;
- prohibit their directors, officers or partners from having any financial stake in an issuer that uses the intermediary's services;
- give investors a reasonable opportunity to rescind commitments to purchase, up to a cutoff 48 hours prior to the issuer's deadline;
- provide investors with educational materials that describe the process of an offer, the types of securities offered, the risks associated with crowdfunding securities, the restrictions on resale, the types of information in annual reports, the limitations on the investor's purchases, the circumstances in which an issuer may cancel an offering, the need to carefully consider investing, the fact that there may not be an ongoing relationship between the intermediary and the investor, and the risk of subsequent voting power

dilution;

- make available information about the issuer and the offering on its website;
- provide communication channels to permit discussions about offerings on its online platform; and
- take measures to reduce the risk of fraud and fraud liability by (i) obtaining a background and securities enforcement regulatory history check on each officer, director and 20 percent holder of the outstanding equity of each issuer, (ii) having a reasonable basis for believing that the issuer is in compliance with relevant regulations and has established means to keep accurate records of holders of the securities it offers, and (iii) by denying access if it believes that the issuer or its offering would present a potential for fraud.

This last responsibility is especially important for intermediaries, for they may face the same fraud liability to investors as issuers do under §17 and §12(a)(2) of the Securities Act, and §10(b) of the Exchange Act. Under the JOBS Act, issuers remain liable to purchasers for material misstatements or omissions. But the SEC also considers it “likely” that, given the definition of “issuer” in section 4A(c)(3), intermediaries and funding portals would be liable, too. This suggests that intermediaries need, at a minimum, to establish policies and procedures designed to achieve compliance by issuers, and that intermediaries should review issuers’ offering documents before posting them to their platform.

Intermediaries will also be tasked with policing the investor exposure limits of §4(a)(6)(B). This duty should not prove onerous, however: all that the Rules require is that the intermediary has a “reasonable basis to believe” that the investor has invested less than their cumulative annual limit. And what is required to check on these tiered caps? “An intermediary may rely on *an investor’s representations* concerning compliance with investment limitation requirements….” Thus, a key investor protection of the Act—investment caps that limit the exposure of low and middle-income investors—could be sidestepped. While the proposal does invite public comment on this unresolved point, one hears faint echoes of the stated-income “liar loans” that contributed so fatefully to the Housing Bubble of the mid-2000s.

VII. Intermediaries: Publicity and Communication

To improve transparency and better harness the “wisdom of crowds,” intermediaries must make communication channels available on their online platforms. But apart from monitoring and recording these channels in order to “track the origins of any abusive or potentially fraudulent comments,” intermediaries themselves are barred from participating. Further, any person who is an insider or who is compensated by an issuer or intermediary must disclose this fact before posting a comment in the communication channels.

Under the Rules, intermediaries may not compensate “promoters, finders, or lead generators for providing the personal identifying information of any potential investor.” Congress’ goal in this provision was to deter high-pressure or abusive tactics. However, an intermediary *can* pay for more general promotional activity that does not attempt to personally identify or target potential investors.

To steer clear of broker-dealer registration requirements, a funding portal may not make investment advice or recommendations. “Investment advice” could be construed very broadly, however, so the SEC has created several safe harbors to protect legitimate portal functions.

VIII. Conclusion

Overall, the SEC has worked to balance the Act’s goal of capital creation with its own mandate to protect investors. In so doing, it has carved out safe harbors for intermediaries and issuers, and has granted issuers some leeway with regards to disclosure format. Yet despite Congress and the SEC's attempts to give crowdfunding room to grow, doubts remain over its promise. It is unclear whether the relatively small, capped amounts available from each investor justify the substantial compliance costs of disclosure and monitoring. True, in some cases crowdfunding may have compensating advantages—such as assessing market demand or generating consumer buzz. But even with these liberalizing Rules, crowdfunding may prove to be one of the riskiest and most expensive forms of corporate finance.

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[1] In a marvel of the legislative arts, the Crowdfund Act—like the JOBS Act that encompasses it—is shoehorned into a handy acronym: Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure.

[2] Or since the inception of the business.

[3] The Commission is undecided about whether this figure will be net of fees charged by an intermediary.

[4] However, 4(a)(6) amounts by the same issuer *are* aggregated. Here, "issuer" includes any predecessor entity, and any entity under the issuer's "common control." This latter term's definition is adopted unchanged from Rule 405 of the Securities Act.

[5] The definition of "family member" tracks the existing use in the Exchange Act, with a minor change in the Rules for the "spousal equivalent" definition.

[6] Aggregated to include the current offering, together with only those previous offering amounts *actually sold*.

[7] Investors will be directed to intermediaries' websites through Tombstone-style ads.

CONTACT US

Corporate Practice

Jerry J. Burgdoerfer, Partner, Jenner & Block LLP

Phone: 312 923-2820 Email: jburgdoerfer@jenner.com Download V-Card

Practice Groups: Corporate, Japan Practice, Mergers & Acquisitions, Private Equity/Investment Funds, Securities

William L. Tolbert, Jr., Partner, Jenner & Block LLP

Phone: 202 639-6038 Email: wtolbert@jenner.com Download V-Card

Practice Group: Corporate, Mergers & Acquisitions, Securities

Elaine Wolff, Partner, Jenner & Block LLP

Phone: 202 637-6389   Email: ewolff@jenner.com   Download V-Card

Practice Group: Corporate, Corporate Finance, Real Estate Securities, Securities

Matthew C. Carter, Associate, Jenner & Block LLP

Phone: 212 909-0872   Email: mcarter@jenner.com

Practice Group: Corporate