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### CROWDFUNDING

## BNA Insights: Regulation Crowdfunding and Small Businesses: A Match Made in SEC-Regulated Heaven?



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### *The Dawn of a New Era in Capital Formation*

**T**he need for crowdfunding regulation became apparent after the Securities and Exchange Commission issued a cease and desist order to stop a crowdfunding effort by two men seeking funds to purchase the Pabst Brewing Company in 2011. Two men set up a website, [BuyaBeerCompany.com](http://BuyaBeerCompany.com), and raised more than \$200 million in an unregistered offering between November 2009 and February 2010 from more than five million people. [In the Matter of Michael Migliozi II and Brian Williams Flatow, Securities Act of 1933 Release No. 33-9216, (June 8, 2011), <https://www.sec.gov/litigation/admin/2011/33-9216.pdf>]. Each individual received a “crowdsourced certificate of ownership” and were promised beer in an amount commensurate with their investment. However, [\*Tom Sporkin is a Partner in the Washington, DC office of BuckleySandler LLP. Prior to entering private practice he spent more than 20 years with the SEC's Enforcement Division. Stephen M. LeBlanc is Counsel and Loyal T. Horsley is an Associate, both in the Washington, DC office of BuckleySandler LLP.\*](http://BuyaBeerCom-</a></p></div><div data-bbox=)

pany.com never registered the transaction with the SEC and did not limit its solicitation to accredited investors. Nor did the offering fit within any exemption from the SEC's registration rules.

On May 16, 2016, the microcap financing landscape is set to change when the SEC's new rules governing equity crowdfunding take effect. Equity crowdfunding is a form of financing by which companies can raise capital through relatively small contributions from large pools of individuals with the expectation that the investor will receive a financial reward if the company is profitable. This approach should not be confused with websites such as Kickstarter or DonorsChoose, which provide a tangible product, service, or other type of benefit to those who pledge money in support of the venture.

The SEC's final rules, Regulation Crowdfunding, which were mandated by the Jumpstart Our Business Startups (JOBS) Act of 2012, were informed by nearly 500 comment letters and reflect a set of principles that attempt to balance investor protection with access to capital. The essential part, however, is that those businesses that can most benefit from the new rules are aware of their existence and the relevant requirements in order to take proper advantage of this new opportunity. Regulation Crowdfunding applies only to equity crowdfunding, otherwise known as “SEC-Regulated Crowdfunding.” The stated goal of the JOBS Act is to “allow Main Street small businesses and high-growth enterprises to raise capital from investors more effi-

ciently, allowing small and young firms across the country to grow and hire faster.” [Press Release, The White House, President Obama to Sign Jumpstart Our Business Startups (JOBS) Act, Apr. 5, 2012, <https://www.whitehouse.gov/the-press-office/2012/04/05/president-obama-sign-jumpstart-our-business-startups-jobs-act>]. Soliciting capital from everyday investors via the internet is ostensibly an integral means for smaller businesses to more efficiently and cost-effectively raise capital.

### *Who Should Consider Crowdfunding*

Certain businesses, such as local retail stores, restaurants, and speculation builders might be the most appropriate candidates for SEC-Regulated Crowdfunding. Such companies may not qualify for bank loans due to their risk profile or the owner’s creditworthiness and may not have the finances or expertise to raise capital through a traditional securities offering. However, these companies may be exactly the type that attracts individuals who want to directly invest in businesses at the heart of their local economies. There are few restrictions on the type of company that can leverage the SEC’s Crowdfunding rules. The business must be American and cannot be an investment company (as defined by the Investment Company Act of 1940). [17 C.F.R. § 227.100(b)(3).] Further, the entity cannot be a development stage company that does not have a business plan or defined purpose. [17 C.F.R. § 227.100(b)(6).] In addition, the entity must be relatively small: it must not be subject to the reporting requirements of the Securities Exchange Act of 1934, it cannot have its stock listed on an exchange, and it cannot have more than \$10 million in assets. [Securities Exchange Act of 1934, 48 Stat. 881 §§ 12(b), 12(g), 15(d) (codified at 15 U.S.C. § 78a (1934)).] Finally, the issuer cannot be a disqualified “bad actor,” meaning that the company, its direct owners, officers, and directors do not have criminal convictions or regulatory orders against them. [17 C.F.R. § 230.506(d), (e).]

Should an entity decide to conduct an exempt offering under Regulation Crowdfunding, there are several disclosure requirements and a few new user-friendly forms that the entity will need to file. Form C, the initial disclosure form, provides information relevant to potential investors. Form C/A allows the issuer to amend Form C, and Form C-U updates investors as to the status of the funding efforts. Form C-AR is the issuer’s annual report to shareholders, which must include certified financial statements. Finally, an issuer files Form C-TR to terminate its filing obligations under the Exchange Act. Termination can be triggered by a variety of factors, including when a business is listed on a securities exchange or accumulates more than \$10 million in assets. After filing, these forms are made publicly available on EDGAR, the SEC’s electronic filing system, making it easy for investors and potential investors to review the information.

### *Investment Limitations May Provide Challenges*

The most daunting parts of Regulation Crowdfunding from a compliance standpoint are making sure individuals do not breach the personal investment thresholds (which can differ from person to person based upon wealth and income metrics) and making sure an entity using SEC-Regulated Crowdfunding does not

raise more than \$1 million in a twelve-month period. Complying with the \$1 million limit should not be difficult; however, limiting investor funds to the required levels and monitoring their total investments in all entities utilizing the Regulation Crowdfunding exemption may prove challenging for those intermediaries that manage the crowd-funded offerings. For example, an investor with an annual income or net worth less than \$100,000 may only invest the greater of \$2,000 or 5% of his or her annual income or net worth to any and all issuers conducting SEC-Regulated Crowdfunding offers. Conversely, an investor with an annual income or net worth over \$100,000 may only invest 10 percent of his or her annual income or net worth, whichever is less, and must comply with the \$100,000 cap on total individual investment. It is the intermediary’s responsibility to then track the investors’ finances and investments to ensure they have not breached these limits. Regulation Crowdfunding mandates that the intermediary of any offer be either a registered broker/dealer or a funding portal. [Funding portals must be members of FINRA. The SEC recently approved FINRA’s proposed funding portal rules. See FINRA Regulatory Notice 16-06, Jan. 29, 2016, <http://www.finra.org/sites/default/files/Regulatory-Notice-16-06.pdf>.]

### *Intermediaries Must Be Present and Responsible*

The intermediary must take on several responsibilities. Monetizing the role may be ambitious as the numbers and any associated fees in an SEC-Regulated Crowdfunding offering are relatively small. The broker/dealer or funding portal must (i) reasonably believe that the issuer is in compliance with relevant laws and regulations [The intermediary may rely on the issuer’s representations as to its compliance as long as the intermediary does not have “reason to question the reliability of those representations.” 17 C.F.R. § 227.301.]; (ii) open accounts for any investor prior to accepting any funds [Funding portals cannot hold funds so any investor accounts must be held at a bank, credit union, or broker. 17 C.F.R. § 227.303.]; (iii) distribute all required educational materials to investors [17 C.F.R. § 227.303(a).]; (iv) provide the issuer’s information to the SEC and all investors for a minimum of 21 days before any securities are sold [17 C.F.R. § 227.303(a)(2).]; (v) monitor and comply with limitations of investments [17 C.F.R. § 227.303(b)(1).]; (vi) receive and record positive acknowledgement from all investors that they have read and understood the provided educational materials and the associated risks [17 C.F.R. § 227.303(b)(2).]; and (vii) provide an online forum for investors to discuss their investments and ask any questions, to which the issuer can respond. [17 C.F.R. § 227.303(c).] Ensuring that all investors receive the necessary documentation and abide by the regulation may be challenging, as doing so will require a fair amount of communication between various intermediaries if the investor supports several entities raising capital through SEC-Regulated Crowdfunding.

### *What A Successful Crowdfunding Scenario May Look Like*

Suppose a local entrepreneur decides to open a restaurant, a notoriously risky endeavor. The bank may reject his application for a small business loan for several

reasons. These might include his past failed small businesses, the absence of a need for a new restaurant in the town, or simply because the risks of the enterprise outweigh the possibility of a return to the bank. Instead of accepting failure, the entrepreneur can now turn to SEC-Regulated Crowdfunding for the required startup funds. He must first contract with a funding portal or broker/dealer and file Form C with the Commission. Assuming the entrepreneur is not disqualified due to any criminal convictions or regulatory orders and has a valid business plan, the funding portal will then set up the website for the restaurant and invite people to invest in the venture. In this scenario, the entrepreneur has decided to raise \$250,000. Potential investors must disclose their income or net worth in order to determine how much they can invest. The funding portal or broker/dealer will work with a bank to hold the investors' deposits. If the venture goes well and the entrepreneur reaches \$125,000 and files Form C-U with the SEC, the funding portal or broker/dealer will then notify the investors that they have commitments amounting to 50 percent of the offering. As part of the process, the funding portal must make the required educational materials available and obtain the investors' acknowledgment and understanding of such. The investors will also be provided with an online forum on the funding portal's website, which the entrepreneur consistently monitors to answer questions and provide any unofficial updates. When the offering is fully subscribed, the entrepreneur will file another Form C-U to inform the Commission and his investors that the offering is 100 percent subscribed and closed, and that he will not be accepting subscriptions in excess of the offering amount. At this point, the funds are released to the entrepreneur whose restaurant now has shareholders. He must keep his shareholders informed by filing his annual report on Form C-AR with the Commission and posting it on his website. It is likely the entrepreneur will have more shareholder interaction than the average company, and therefore must respond promptly to his shareholders' questions and concerns. However, as a result of the opportunity made possible by SEC-Regulated Crowdfunding, he can now open his dream restaurant — and maybe serve some of his new shareholders.

### *Companies Should Always Consider Their Other Options: Regulation A+ and Regulation D*

Regulation D provides registration exemptions for entrepreneurs seeking to raise varying amounts of capital in so-called private offerings. [Depending on the type of offering, the entrepreneur can raise from \$1,000,000 to an unlimited amount. 17 C.F.R. §§ 230.504–230.506.] Depending upon the amount desired and the audience from whom the capital is being sought, Regulation D permits the entrepreneur to reach out in varying iterations to so-called accredited investors, [The definition of accredited investor boils down to either an individual with an annual income of over \$200,000 or a net worth of over \$1,000,000, or a com-

pany with more than \$5,000,000 in total assets. For the full definition, see 17 C.F.R. § 230.501(a).] sophisticated investors, [“Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.” 17 C.F.R. § 230.506(b)(2)(ii).] as well as, in limited circumstances, unsophisticated investors. [17 C.F.R. § 230.505(b)(2)(ii)] The drawbacks to using Regulation D are that the entrepreneur must know the sophistication of his audience, will not be able to advertise the offering in most instances, and similar to crowdfunding, any shares purchased through a Regulation D offering are restricted and therefore cannot be sold until after one year from date of purchase. [17 C.F.R. § 230.502(d).]

Similarly, new Regulation A+ presents opportunities for entities to conduct “mini” IPOs to raise as much as \$50 million. [There are two tiers from which an entrepreneur may choose: Tier One that allows him to raise up to \$20,000,000 and Tier Two, which allows him to raise up to \$50,000,000. 17 C.F.R. § 230.251(a).] The benefit of using Regulation A+ is that the shares are not restricted and can be publicly traded immediately. It also allows the offeror to test the waters prior to filing his offering statement. The primary drawback to Regulation A+ is that a comprehensive mini registration statement must be filed and qualified with the SEC.

Both Regulation A+ and Regulation D might appeal to companies with more name recognition and bigger aspirations than those who turn to SEC-Regulated Crowdfunding. However, a small business could use SEC-Regulated Crowdfunding to raise \$1,000,000 in its infancy and then turn to a different exemption, such as Regulation D, as it becomes more successful, since the two offerings would not likely be integrated. [The Commission has stated “issuers may conduct other exempt offerings without having those offerings integrated with the offering made in reliance on Section 4(a)(6), provided that each offering complies with the applicable exemption relied upon for that particular offering.” Commentary to final rule, p. 391, Crowdfunding, SEC Release Nos. 33-9974, 34-76324, 17 C.F.R. §§ 200, 227, 232, 239-40, 249, 269, 274 (Oct. 30, 2015).]

### *Conclusion*

The idea of harnessing the power of the internet to facilitate the financing of a business that might not otherwise see the light of day is just as exciting and promising today as it was when the JOBS Act was enacted more than five years ago. If equity crowdfunding can successfully provide the avenue to match investors willing to take a leap of faith on entrepreneurs who are on the verge of creating the next Microsoft or Google, then crowdfunding will be a smashing success. Small business entrepreneurs will be happy to be given the chance to make their dreams a reality, and investors will be happy that they are no longer being paid back in beer.