

President Obama signed the Jumpstart Our Business Startups Act (the JOBS Act) on April 5. Part of this Act authorizes crowdfunding for the first time. (Up until now, crowdfunding could only be done legally by a company effectively pre-selling its goods or services at a discount.)

That does not mean the crowdfunding provisions go into effect immediately, though. The Act gives the Securities & Exchange Commission 270 days to issue regulations for the crowdfunding offerings. No crowdfunding can be done prior to the SEC issuing those regulations. Still, the Act is expected to open up crowdfunding for a number of smaller companies.

The crowdfunding exemption applies to issuers who do not sell more than \$1 million to investors under any exemption during any 12-month period. Companies that want to raise more than \$1 million in 12 months will not be able to use crowdfunding.

To summarize, the amounts investors may invest is limited by their income and net worth. The crowdfunding must be done through "Conduits" registered with the Securities & Exchange Commission (SEC). Issuers may not advertise except for notices which direct investors to the Conduit. Issuers must also file annual reports with the SEC. In terms of financial disclosures, offerings of less than \$100,000 in a year need only provide income-tax returns and financials certified by their CEO. With offerings between \$100,000 and \$500,000 in a year, the financials must be reviewed by a public accountant. For offerings between \$500,000 and \$1 million, the financials must be audited.

### **Investor Amount Restrictions**

There are some restrictions on how much investors may invest. Investors who have either annual income of less than \$100,000 or whose net worth (presumably excluding the principal residence) is less than \$100,000 may only invest in any 12-month period the greater of \$2,000 or 5 percent of the investor's annual income or net worth. One thing companies using crowdfunding will need to consider is whether they want to set higher minimums for investment, given that the administrative time for a small investor is often as much as for a large investor. If \$1,000,000 were raised by having 500 people invest \$2,000 each, the administrative time per investor could be a substantial part of the \$2,000 contributed by each investor.

If either the annual income or net worth (again, presumably excluding the principal residence) of the investor is equal to or more than \$100,000, then the investor may invest 10 percent of the investor's annual income or net worth in any 12-month period, not to exceed a maximum amount of \$100,000.

(There is an inconsistency in the wording of the statute on these two categories. Presumably to fit within the second category the investor must have both income in excess of \$100,000 AND (not Aor@) net worth of more than \$100,000. Expect the SEC to address this in its regulations.)

### **Use of Registered Conduits Required**

For better or worse, the transaction must be conducted through a licensed securities broker or funding portal (either or which we'll call a "Conduit") that has registered with the SEC for crowdfunding. The Conduit must also register with any self-regulatory organization that is applicable, such as FINRA. (There are non-brokers who are required to register with FINRA.) Part of the Conduit's duties are to: provide disclosures to investors related to risks; ensure that each investor reviews investor-education information; and confirm that the investor understands that the investor is risking the loss of the entire investment, that the investor could bear such a loss, that the investor understands the level of risk applicable to investments in startups, emerging businesses, and small issuers, and understands the risk of illiquidity.

The Conduit must also obtain a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered. In addition the Conduit must ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest. (There are other requirements as well.)

### **Actions Required of Issuers**

Issuers using crowdfunding have requirements to meet also. The issuer is required to make a filing with the SEC.

Further, an issuer using the crowdfunding exemption may not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker, and not less than annually file with the SEC and provide to investors reports of the results of operations and financial statements of the issuer. This is unusual in that most private placement offerings do not require annual filings with the SEC.

### **Non-Financial Disclosures**

In terms of non-financial disclosures to investors, the issuer must provide, among other things: a) the names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer; and b) the anticipated business plan of the issuer. There's not much surprise there.

The issuer must also disclose, among other things, 1) the target offering amount, the deadline to reach the target offering amount, and regular updates regarding the progress of the issuer in meeting the target offering amount; and 2) a description of the ownership and capital structure of the issuer. The latter must include, in addition to other matters, (a) the terms of the securities of the issuer being offered and each other class of security of the issuer; (b) a description of how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered; and (c) how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the

future.

## **Financial Disclosures**

The financial description requirements depend on the amount being raised. For offerings that, together with all other crowdfunding offerings of the issuer within the preceding 12-month period, total \$100,000 or less the issuer must provide: (i) the income tax returns filed by the issuer for the most recently completed year, if any, and (ii) financial statements of the issuer, which must be certified by the principal executive officer of the issuer to be true and complete in all material respects (but which do not need to be audited).

Where the current offering plus other crowdfunding offerings by the issuer total more than \$100,000 but less than \$500,000, the issuer must provide financial statements reviewed (but not audited) by a public accountant who is independent of the issuer.

When the total of the current offering and the crowdfunding offerings within the last 12 months total more than \$500,000, audited financial statements are required. Given the expense of audited financial statements and the \$1,000,000 limit on offerings, some issuers may decide not to take the crowdfunding approach.

## **Preemption of State Law**

Thankfully, the crowdfunding provisions appear to preempt state law regarding state registration, documentation, and offering requirements. The provisions still allow the states to take enforcement actions. States are allowed to require notice filings (as is done with Rule 506 offerings) but not to charge filing fees. (Section 305.)

Much will depend on the regulations the SEC issues.

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