

## SEC Finally Adopts “Regulation Crowdfunding”

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*The SEC’s final crowdfunding rules, which are largely consistent with the proposed rules, provide broader access to capital for startups and small businesses, though concerns over cumbersome disclosure and regulatory requirements persist.*

On October 30, 2015, the Securities and Exchange Commission (SEC) voted to adopt final rules implementing Title III of the Jumpstart Our Business Startups Act (JOBS Act), known as “crowdfunding”. The final rules, to be codified as “Regulation Crowdfunding” in furtherance of Section 4(a)(6) of the Securities Act of 1933, are expected to become effective in May 2016. A copy of the final rules can be found [here](#).

Regulation Crowdfunding will allow smaller, non-public U.S. companies to raise up to \$1 million in any 12-month period by selling securities over the Internet (including through apps and other technologies) to individual investors who are not required to meet any sophistication or wealth standards, but will be subject to relatively small investment limits.

### Notable Changes from the Proposed Rules

The SEC’s vote on the final crowdfunding rules occurred just over two years from the date the SEC issued the proposed crowdfunding rules. Notwithstanding the long delay and almost 500 comment letters, the final rules were largely consistent with the proposed rules. Notable modifications to the proposed rules are set forth below.

- **Audited Financial Statements.** The final rules include a one-time exception to the requirement that issuers provide audited financial statements for a proposed crowdfunding offering in excess of \$500,000. As a result, issuers may provide reviewed financial statements instead of audited financial statements the first time they launch such a crowdfunding offering if audited financial statements are not available. While this accommodation will provide a measure of relief for some first-time issuers, it remains to be seen whether it goes far enough and whether small businesses and startups will be able to bear the expense of obtaining audited financial statements for additional crowdfunding offerings.

- **Ongoing Reporting Requirements.** The final rules add two circumstances in which an issuer may terminate its obligation to file annual reports otherwise required by Regulation Crowdfunding: (i) the issuer has filed at least one annual report and it has fewer than 300 holders of record; and (ii) the issuer has filed annual reports for at least the three most recent years and it has total assets of \$10 million or less. This change will be a source of relief for many issuers in light of the significant costs and burdens ongoing reporting requirements will have on most small businesses and startups.
- **Intermediary Compensation.** The final rules eliminate the restriction on intermediaries (i.e., the funding portals and broker-dealers who will manage crowdfunding offerings) from receiving stock or other financial interests in issuers as compensation for services provided. This modification will allow issuers to pay intermediaries in stock, which will be important to issuers that do not have sufficient available funds to pay intermediary fees in cash. Issuers may report compensation paid to intermediaries as either a dollar value or percentage of the offering amount and may use a good faith estimate if the parties are unable to identify an exact amount at the time of filing the offering statement on Form C.
- **Intermediary Curation.** The final rules allow funding portals and broker-dealers to use their discretion in determining whether to let an issuer use their platforms. This change is designed to allow intermediaries to better perform their intended “gate-keeping” function and should allow intermediaries to establish targeted or branded platforms, which should assist investors in selecting suitable intermediaries and issuers.
- **Disclosure Obligations.** The final rules impose an affirmative requirement on issuers to disclose any material information “necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.” This modification will require issuers to disclose all material information not specifically enumerated in the required disclosure items of Regulation Crowdfunding.
- **Tax Return Requirement.** The final rules eliminate the requirement that issuers provide copies of their federal income tax returns when conducting offerings of \$100,000 or less and instead add a less-burdensome requirement to disclose, with the principal executive officer’s certification, the issuer’s amount of total income, taxable income and total tax as set forth in its filed tax returns.

### Broad Overview of Crowdfunding Framework

**Eligibility:** All companies other than the below listed categories of companies will be eligible to use Regulation Crowdfunding.

- non-U.S. companies
- public reporting companies
- blank check companies and special purchase acquisition companies (SPACs)
- certain investment companies
- companies that fall under Regulation Crowdfunding’s disqualifying provisions (e.g., bad actors)
- companies that have failed to file their annual report required by Regulation Crowdfunding for the past two years

**Issuer Offering Cap:** Issuers may raise a maximum aggregate amount of \$1 million through crowdfunding offerings on a 12-month rolling basis. Other non-crowdfunding capital raising options will not count toward this limit. The offering cap includes offering expenses and intermediary fees.

**Resale Limitations:** Investors who purchase securities in a crowdfunding offering may not resell those securities within one year of their initial issuance other than to an accredited investor, third parties in a registered offering, an investor's family member, or the issuer.

**Investor Limitations:** The overall amount an individual investor may invest in crowdfunded securities (whether in one or more investments) over a 12-month period is limited to \$100,000. Investors will be further limited in the amount they may invest based on their annual income and net worth (which are each calculated in accordance with Rule 501 of Regulation D under the Securities Act of 1933):

Investor Annual Income or Net Worth	Amount that may be Invested over 12-Month Period
If <b>either</b> annual income or net worth is less than \$100,000	Investor may invest the greater of \$2,000 or 5% of the lesser of their annual income or net worth
If <b>both</b> annual income and net worth are \$100,000 or more	Investor may invest 10% of the lesser of their annual income or net worth (i.e., at least \$10,000)

It is unclear, however, how well these wealth requirements and investment limits will work because, under the final rules, the only check on investor limitations will be by intermediaries who in turn may rely on investor representations to the extent such reliance is reasonable.

**Issuer Offering Statement:** An issuer must comply with various disclosure requirements and file certain information with the SEC in connection with a crowdfunding offering, including an offering statement on Form C. An issuer must disclose in its offering statement:

- the names of its directors and officers and their business experience for the three prior years
- risk factors, including an analysis of specific risks associated with the issuer and general risks associated with crowdfunded securities
- the issuer's current number of employees
- the identity of, and compensation paid to, the intermediary involved in the offering
- a description of the issuer's ownership and capital structure, including the terms of the securities offered (whether equity or debt) and the names of beneficial owners of 20% or more of its voting equity securities
- a description of its financial condition, including the material terms of any indebtedness, and a description of its business and anticipated business plan
- a reasonably detailed description of the purpose and intended use of the proceeds of the crowdfunding offering as well as other details of the offering, including disclosing the price to the public of the securities or the method for determining the price, the target offering amount, whether the target amount may grow, the deadline to reach the target amount and updates on efforts to reach the target amount at specified benchmarks
- certain related-party transactions

- financial statements prepared in accordance with U.S. GAAP for the issuer's two most recent fiscal years with the following financial statement review requirements:

Proposed Amount of Offering	Level of Financial Statement Review Required
\$100,000 or less	The financial statements must be certified by the issuer's principal executive officer to be true and complete in all material respects.
More than \$100,000 to \$500,000	The financial statements must be reviewed by an independent public accountant.
More than \$500,000	The financial statements must have an unqualified audit opinion (but a going concern opinion is acceptable) by an independent public accountant, except that first-time issuers may instead provide reviewed financial statements.

**Annual Reporting Requirements:** Issuers that complete a crowdfunding offering (irrespective of the size of the offering) are required to file annual reports with the SEC until they:

- are liquidated or dissolved
- become public companies
- no longer have any shareholders who originally purchased securities in their crowdfunding offering
- have filed at least three annual reports and have total assets that do not exceed \$10 million
- have filed at least one annual report and have fewer than 300 holders of record

These annual reports must contain financial statements certified by the issuer's principal executive officer to be true and complete in all material respects and other information similar to what the issuer had to include in its offering statement on Form C.

**Crowdfunding Platforms:** Intermediaries, through which every crowdfunding offering must be conducted, must be registered as either broker-dealers or funding portals. Each crowdfunding offering must be conducted through a single intermediary. While intermediaries will be able to accept issuer securities as compensation for services, intermediaries' directors and officers are barred from holding any securities of issuers on their portal. Intermediaries are required to:

- run background checks on an issuer's officers, directors and 20% beneficial holders and deny access to their platform to any issuer they reasonably believe is subject to any of Regulation Crowdfunding's bad actor disqualification provisions;
- have a reasonable basis for believing that issuers have complied with all requirements of Regulation Crowdfunding and that they have established accurate methods for record keeping, though intermediaries may reasonably rely on issuers' representations unless they have any reason to question the reliability of those representations; and
- have a reasonable basis for believing investors on their portals satisfy the investment limits established by Regulation Crowdfunding, though they may rely on investors' representations unless they have a reasonable basis to question the reliability of those representations.

**Statutory Liability:** Issuers and, most likely, intermediaries will have potential liability for material misstatements and omissions in an issuer's offering statement. The final rules provide that an issuer of crowdfunded securities will be liable to a purchaser if the issuer makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading. However, the final rules also

provide an affirmative defense to an issuer if the purchaser of such securities was aware of the untruth or omission or if the issuer can show that it did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. The SEC noted in the final rules that “it appears likely” that intermediaries will be considered to be an “issuer” in this context, and the SEC specifically declined to exempt intermediaries from liability.

### What Happens Next?

Significant questions remain as to whether crowdfunding will be a practical option for small businesses and startups to raise capital and whether the general public will be sufficiently protected.

**Challenges for Issuers.** Regulation Crowdfunding places substantial burdens and potential liabilities on issuers. Companies that sell securities through crowdfunding offerings will have to spend significant time and money preparing their offering statements, including financial statements. In addition, issuers that complete a crowdfunding offering will essentially become “mini-reporting companies” that are required to file annual reports with the SEC until they qualify for one of the stated exemptions. These ongoing reporting requirements will be burdensome and costly to issuers and, given the limited amount of offering proceeds permitted under the exemption, issuers will need to weigh the costs and benefits of conducting a crowdfunding offering.

**Burdens on Intermediaries.** Despite the fact that intermediaries may now determine their own criteria for allowing an issuer to use their platforms, the final rules impose significant obligations on intermediaries that facilitate crowdfunding offerings, including the gate-keeping responsibility to help reduce fraud – both from issuers and investors. Intermediaries likely will also face the risk of “issuer” liability for issuers’ material misstatements and omissions in offering statements. The fees intermediaries will charge to conduct crowdfunding offerings will likely take into account these risks and add to the total expenses issuers will incur in a crowdfunding offering.

**Risks for Investors.** Reports indicate that between 3-7% of Americans qualify as “accredited investors”, meaning that crowdfunding will be the first time over 90% of the country has a meaningful path to invest in startups and other small businesses. These new investors could suffer meaningful losses relative to their annual income and net worth, even when accounting for the investment limits, considering most small businesses and startups fail. (The SEC cites several studies that conclude approximately two-thirds of all startups fail in a few years’ time and/or after receiving venture capital funds.) In addition, the lack of any reliable secondary market for non-public company securities means that crowdfunding investors (even after their one-year holding period has passed) may have no practical opportunity to trade their newly acquired shares, leaving them with illiquid investments until the issuer fails, is acquired or completes an IPO.

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