

# LEGAL UPDATE

December 2013

By: Michael T. Campoli

## HERE COMES THE CROWD: SEC PROPOSES CROWDFUNDING RULES

On October 23, 2013, the U.S. Securities and Exchange Commission (the “SEC”) proposed long-awaited rules – known as “Regulation Crowdfunding” – that would implement a new exemption under the federal securities laws for equity crowdfunding transactions.<sup>1</sup> Equity crowdfunding is a means for issuers to raise capital by selling their securities to a large number of investors in small increments, generally through the Internet. Partly as a result of the tight financing environment that has persisted over the past several years, many of those in the start-up and emerging company community have identified equity crowdfunding as an attractive potential option for raising capital to fund promising ventures. With the proposal of Regulation Crowdfunding, that potential is now much closer to being realized.

The SEC proposed Regulation Crowdfunding to fulfill the mandate set forth in Title III of the Jumpstart Our Business Startups Act (the “JOBS Act”). The JOBS Act added a new Section 4(a)(6) to the Securities Act of 1933 (the “Securities Act”) that exempts equity crowdfunding transactions from the registration requirements of the Securities Act. Throughout the proposing release, the SEC clearly attempts to strike a balance between creating a viable new financing opportunity that would benefit issuers, while at the same time ensuring that sufficient safeguards exist to protect a new group of largely unsophisticated investors.

Comments on the proposing release can be submitted to the SEC until February 3, 2014, though given the extensive number of requests for comment that are included throughout the lengthy release, it is likely that the comment period will be

extended. Until final rules are adopted and become effective, equity crowdfunding will remain prohibited under the federal securities laws.

### Application to Issuers

The proposed rules permit an issuer to sell up to \$1,000,000 of securities using the crowdfunding exemption during any 12-month period. Capital raised using another registration exemption would not be counted in determining the aggregate amount sold in reliance on Section 4(a)(6).

The following issuers would not be eligible to utilize the crowdfunding exemption:

- non-US issuers;
- publicly reporting issuers;
- entities that either are registered under the Investment Company Act of 1940, or that are exempt from registration under Section 3(b) or Section 3(c) of such act;
- issuers that have completed crowdfunding offerings but have failed to comply with the post-offering reporting requirements applicable to them; and
- issuers that either have no specific business plan or that have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

In addition, an issuer would be disqualified from utilizing the crowdfunding exemption if such issuer and/or certain of its associated persons engaged in specified securities violations or other similar bad acts. These disqualification provisions are substantially similar to the “bad actor” provisions

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<sup>1</sup> The proposing release for Regulation Crowdfunding can be found here: <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>.

that apply to offerings conducted pursuant to Rule 506 of Regulation D.

Purchasers of securities issued using the crowdfunding exemption would not be counted toward the limitation on the number of record holders that an issuer may have before it is required to register a class of securities under Section 12(g) of the Exchange Act.

#### Application to Individuals

Regulation Crowdfunding limits the amount that individual investors can invest in crowdfunding offerings during any 12 month period. If both an investor's annual income and net worth are less than \$100,000, then such investor could purchase securities in a crowdfunding transaction in an amount of up to the greater of \$2,000 or 5% of such investor's annual income or net worth. If either the annual income or net worth of an investor exceeds \$100,000, then a limit of 10% of annual income or net worth, whichever is greater, but not to exceed \$100,000, would apply. Investors would have the right to cancel their investment commitment until 48 hours prior to the deadline identified in the offering materials.

Investors who purchase securities in a crowdfunding transaction would be restricted from transferring such securities for a period of one year after the date of purchase. However, such securities may be transferred: (i) to the issuer; (ii) to an accredited investor; (iii) as part of a registered offering; (iv) to a family member of the purchaser or the equivalent, or in connection with certain events, including death or divorce of the purchaser; or (v) in certain estate planning contexts.

#### Disclosure Requirements

To utilize the crowdfunding exemption, issuers must file specified disclosures with the SEC, provide these disclosures to investors and the relevant broker or funding portal for the offering, and make these disclosures available to potential investors. These disclosures – which would be made by filing a new Form C with the SEC via EDGAR – would include:

- general identifying and biographical information about the issuer, its officers

and directors, and the holders of 20% or more of its voting equity securities;

- a description of the issuer's business and business plan;
- a description of the intended use of the offering proceeds;
- the target offering amount and the deadline to reach the target offering amount;<sup>2</sup>
- the offering price (or the method for determining the offering price);
- a description of the issuer's ownership and capital structure;
- risk factors regarding the issuer and the offering;
- a description of the material terms of any indebtedness;
- a description of recent exempt offerings of securities;
- a description of related-party transactions; and
- a narrative discussion of the issuer's financial condition.

Amendments to the required disclosures would be necessary whenever any material changes occur in an offering.

As indicated above, not only must these disclosures be filed with the SEC on Form C, they also would have to be made publicly available on the applicable intermediary's platform for a minimum of 21 days before any securities are sold in the offering, and remain publicly available on such platform until the completion or cancellation of the offering.

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<sup>2</sup> Issuers would also be required to disclose whether they will accept investments in excess of the target offering amount and, if they will, such issuers would be required to disclose, at the commencement of the offering, the maximum amount that they will accept.

In addition to the items listed above, the required disclosures would include financial statements of the issuer, prepared in accordance with GAAP, the type and extent of which would depend upon the size of the offering. Specifically:

- an issuer that is conducting an offering of \$100,000 or less must provide its filed income tax returns for the most recently completed fiscal year, if any, and its financial statements certified by its principal executive officer;
- an issuer that is conducting an offering of more than \$100,000, but not more than \$500,000, must provide financial statements reviewed by an independent public accountant; and
- an issuer that is conducting an offering of more than \$500,000 must provide audited financial statements.

#### Ongoing Reporting Requirements

An issuer that completes a crowdfunding offering would be required to file an annual report via EDGAR on Form C-AR no later than 120 days after the end of each fiscal year of the issuer that contains information – including financial statements – similar to the information required in the offering statement. This requirement would continue until either: (i) the issuer becomes a reporting company under the Exchange Act; (ii) the issuer or another party purchases or redeems all of the securities issued pursuant to the crowdfunding exemption; or (iii) the issuer liquidates or dissolves its business.

#### Intermediaries Generally

Regulation Crowdfunding contemplates that all crowdfunding transactions be conducted through either a registered broker-dealer or a “funding portal” that complies with the requirements of the Securities Act<sup>3</sup>. The rules establish a streamlined registration process whereby a funding portal could register with the SEC by filing a new Form Funding Portal that contains information that is consistent

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<sup>3</sup> The term “funding portal” is defined in new Section 3(a)(80) of the Exchange Act.

with, but less extensive than, the information required for broker-dealers on Form BD.

Although the SEC makes clear that funding portals are brokers under the federal securities laws, a registered funding portal would be exempt from the broker registration requirements of the Exchange Act so long as it limits its activities to those permitted for funding portals under Regulation Crowdfunding.

To provide guidance regarding the activities in which funding portals may engage without having to register as brokers, Regulation Crowdfunding provides a non-exclusive safe harbor that covers certain permitted activities. These activities relate to:

- limiting offerings made on or through the funding portal’s platform based on eligibility requirements, rather than on an assessment of the merits or shortcomings of a particular issuer or offering;
- highlighting and displaying offerings on the platform in a manner so as not to recommend or implicitly endorse one issuer or offering over another;
- providing communication channels for potential investors and issuers;
- providing search functions on the platform based upon objective criteria;
- advising issuers on the structure or content of offerings;
- compensating others for referring persons to the funding portal and for other services; and
- advertising the existence of the funding portal.

Although funding portals would be exempt from the broker registration requirements, they would remain subject to the full range of the SEC’s examination and enforcement authority. They also would be required to be members of a registered national securities association, such as FINRA. Funding portals also must maintain a fidelity bond having

minimum coverage of \$100,000.

As per the proposal, issuers can only use one intermediary for a particular offering or concurrent offerings made in reliance on rule 4(a)(6). All crowdfunding offerings must be conducted online only through an intermediary's platform.

### Advertising Requirements

Regulation Crowdfunding generally prohibits issuers from engaging in advertising in connection with any crowdfunding offering. However, issuers could publish a notice that contains limited information about the issuer and the offering, provided that the notice includes the address of the intermediary's platform on which additional information about the issuer and the offering may be found. Issuers could also communicate with investors about the offering through communication channels provided by the intermediary on its platform, so long as the issuer identifies itself as the issuer in all communications. The proposals would not restrict an issuer from engaging in regular business communications that do not refer to the offering.

### Further Requirements Regarding Intermediaries

#### *Financial Interests*

The directors, officers or partners of an intermediary would be prohibited from having any financial interest in any issuer that such intermediary services, as well as from receiving any financial interest in such issuer as compensation for services provided to, or for the benefit of, such issuer, in connection with the offer and sale of such issuer's securities<sup>4</sup>.

#### *Background Checks*

Under Regulation Crowdfunding, an intermediary must have 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. Each intermediary would be required to deny access to its

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<sup>4</sup> A "financial interest" in an issuer means a direct or indirect ownership of, or economic interest in, any class of the issuer's securities.

platform if it has a reasonable basis for believing that an issuer is disqualified from utilizing the crowdfunding exemption or if the intermediary believes that the issuer or the offering presents the potential for fraud or otherwise raises investor protection concerns. Intermediaries must conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered by the intermediary, as well as on each of its officers, directors and 20% holders.

### *Educational Materials*

Intermediaries would be required to deliver to investors, at account opening, educational materials that are designed to communicate specified information regarding the offering process and the risks and restrictions applicable thereto, to make such materials available on their platforms, and to make revised materials available to all investors before accepting any additional investment commitments or effecting any further transactions in securities offered and sold in reliance on Regulation Crowdfunding.

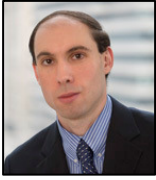
Before acceptance of each investment commitment, intermediaries must obtain from each investor a representation that he or she has reviewed the educational materials, understands that the entire amount of his or her investment may be lost, and is in a financial condition to bear the loss of the investment.

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If you would like to learn more about crowdfunding or how Pryor Cashman LLP can serve your legal needs, please contact Michael T. Campoli at [mcampoli@pryorcashman.com](mailto:mcampoli@pryorcashman.com), or any Pryor Cashman attorney with whom you are working.

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Michael Campoli devotes his practice to counseling public and private companies of all sizes and at all stages of development on a broad range of corporate matters, including securities law compliance, Securities Exchange Act reporting, corporate formation and governance, M&A, public and private financing transactions (including early-stage financing initiatives), joint ventures, and limited liability company and partnership counseling.

Mr. Campoli is a 2000 graduate of New York University School of Law, and a 1997 Phi Beta Kappa graduate of Columbia College.