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Proposed Crowdfunding Rules: The Storm Before the Calm?

Almost a year and a half after Congress passed the Jumpstart Our Business Startups (JOBS) Act in April 2012, and following scores of subsequent comment letters, the SEC finally released its proposed rules regarding equity-based crowdfunding on October 23, 2013. The SEC's press release heralding the proposed rules seemed both hopeful and hesitant, describing crowdfunding as an "evolving method of raising capital" and eliciting further comments on the rules for an additional 90 days after the proposed rules have been published in the *Federal Register*.

At first glance, the proposed crowdfunding regulations follow the road map created for the SEC in the original Title III of the JOBS Act. (For a refresher on the crowdfunding provisions of the JOBS Act, see our 2012 Alert here.) Upon closer inspection, however, there are some subtle and not-so-subtle provisions that, if adopted in their present form, could impair the effectiveness and affect the widespread adoption of crowdfunding that many proponents hoped to achieve.

Broadly put, the crowdfunding provisions contained in the JOBS Act and the SEC's proposed rules providing for an exemption from the existing SEC registration requirements for sales of securities by issuers, are (theoretically) supposed to offer a more streamlined process for private securities offerings and a method for nonaccredited investors who have been shut out by existing investor qualifications to participate in the growing investment market in startups. There is no limit on the number of investors in a crowdfunded offering.

The SEC's proposed rules, referred to by the SEC as "Regulation Crowdfunding," address only equity-based crowdfunding. Non-equity-based crowdfunding (in which sponsors receive products and other rewards instead of securities) has been thriving for some time on websites such as Kickstarter.

The crowdfunding process established by the JOBS Act and followed by the proposed rules provides that issuers can sell securities to investors only through intermediaries, which will be regulated entities. Following that basic premise triggers many additional requirements, including the following:

- ***Issuers.*** The proposed rules impose numerous restrictions on issuers of crowdfunded securities:
    - Issuers cannot use the crowdfunding exemption to sell more than $1 million in securities in a 12-month period.
    - Any shares sold are subject to transfer restrictions for one year.
    - Issuers must be organized under the laws of a U.S. state or territory or the District of Columbia. Non-U.S. entities, investment companies or companies that already file under the Securities Exchange Act of 1934 cannot use the crowdfunding exemption.
    - Issuers can also be disqualified from using crowdfunding by the involvement of "bad actors," failure to provide annual reports required under crowdfunding rules or lack of a specific business plan.
    - Issuers can do a limited kind of advertising, essentially a very short notice in print or electronic media that directs potential investors to the intermediary platform hosting the offering.
- ***Investors.*** The investors themselves are limited as to how much they can invest in all crowdfunding ventures in a 12-month period?- from the greater of $2,000 or 5 percent of the investor's annual income or net worth (if either annual

income or net worth is less than $100,000) up to $100,000 (if either annual income or net worth is greater than $100,000). Here is where the fine print matters. In the proposed instructions to the rules, the SEC notes that annual income and net worth are calculated the same way these values are calculated for "accredited investors." That means that the value of an individual's primary residence is not included in the net-worth calculation. Because the net worth of many individuals is tied to their homes, this may eliminate a number of prospective investors or demote them to the lower investment tier.

- ***Intermediaries.*** The crowdfunding intermediaries can be either registered broker-dealers or "funding portals" and, in either case, must be registered with the SEC and be a member of the Financial Industry Regulatory Authority, which also just released its own notice regarding proposed funding portal rules. It's worth noting that crowdfunding transactions must take place exclusively online through platforms operated by the intermediaries. Precisely how intermediaries will be compensated is not yet clear, but it is clear that intermediaries cannot receive securities in the issuers whose crowdfunding offerings they host. Intermediaries that are funding portals (as opposed to registered brokers) are not allowed to offer investment advice or recommendations, solicit purchases, pay for solicitations, or actually hold any investor funds. The proposed rules also require the intermediaries to perform a sort of gatekeeper function. Depending on a whole host of beliefs formed on a "reasonable basis" or otherwise, intermediaries are expected to exercise their judgment in denying access to issuers that are perceived to be tilting toward the fraudulent. Ominously for potential future intermediaries, the discussions in the proposed rules suggest that intermediaries could be held liable for misrepresentations made in crowdfunding offerings.
- ***Disclosure Requirements.*** Issuers will be required to provide certain information to both prospective investors and the intermediary that will be the conduit for their crowdfunding offering on a new filing form?- Form C, which must be filed prior to the offering. The JOBS Act provided a list of disclosure requirements, and the SEC has elaborated upon these. The information will have to be filed on the SEC's EDGAR electronic filing system and on the intermediary's website and includes, among other things:

    - (i) the names of officers, directors and 20 percent beneficial owners of the issuer;
    - (ii) the issuer's business plan;
    - (iii) risk factors;
    - (iv) use of proceeds;
    - (v) a description of the securities being offered and the ownership structure of the issuer and how the securities are, and may in the future be, valued;
    - (vi) description of the issuer's debt situation;
    - (vii) related party transactions;
    - (viii) a description of the financial condition of the issuer plus financial statements in accordance with U.S. generally accepted accounting principles (the type of which depends on the amount of the offering?- offerings over $500,000 require audited financial statements, for example, whereas offerings over $100,000 but less than $500,000 require that the financials be reviewed only); and
    - (ix) any "bad actor"-related events that did not actually trigger disqualification.

The issuer also needs to describe the conditions for the offering?- the amount of money sought, any minimum investment requirements and the deadline for investment. A reminder that investors can cancel their commitment to invest up to 48 hours prior to the investment deadline is also required.

- ***Form C.*** Form C itself has a number of permutations. The following additional forms are provided:

    - Form C-A (Form C: Amendment), to be filed if there are any material changes to the information included in the original Form C prior to the offer closing.

- Form C-U (Form C: Progress Update), to be filed no later than five business days after the issuer reaches the halfway point in the offering and again once the issuer has achieved 100 percent of the offering target.
- Form C-AR (Form C: Annual Report), to be filed annually (see below).

- ***Ongoing Reporting.*** Once the offering is completed, the issuer becomes subject to ongoing reporting requirements. It has to provide an annual report to the SEC, posted on its website, that includes updates to its original information disclosure and updated financial statements. This obligation continues until the issuer becomes a reporting public company, all of the originally issued crowdfunding securities are repurchased, or the issuer is liquidated or dissolved.

This summary is not intended to be a complete or comprehensive review of the proposed rules, which include many other provisions and conditions not addressed above. In addition, no crowdfunding offering may be made by anyone until the rules are finalized. At that point, prospective issuers and intermediaries would be well-advised to consult with counsel before proceeding.

The proposed rules reflect the difficult balancing act faced by the SEC in the past 18 months with respect to crowdfunding?-trying to balance the desire to make these smaller securities offerings efficient and accessible with the fulfillment of the SEC's historic charge (echoed by state securities regulators) to protect investors from fraud and abuse. The question is whether the structure that eventually emerges after the comment period will be, from a practical standpoint, too burdensome and fraught with liability for issuers and intermediaries to gain traction and effect the change in financing for businesses that the JOBS Act envisioned.