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## The SEC's Final Crowdfunding Rules: Still May Not Be a Crowd Pleaser

On October 30, 2015, the Securities and Exchange Commission (the "SEC") released the final rules under the Jumpstart Our Business Startups ("JOBS") Act to permit companies to offer and sell securities through crowdfunding. These new rules are designated as "Regulation Crowdfunding." The SEC had proposed the rules in October 2013 with a 90-day comment period. That comment period turned into over two years with close to 500 comment letters. Companies have been able to use crowdfunding to raise money through small contributions from a large number of individuals without issuing securities (but often by providing a product or a gift) through popular websites such as Kickstarter and Indiegogo. However, because of federal and state securities laws, crowdfunding has not been available to companies seeking to raise capital through the issuance of securities. Regulation Crowdfunding will change that and allow such capital raising beginning six months after publication of the rules in the Federal Register.

Under the Securities Act of 1933 (the "Securities Act"), an offer or sale of securities must be registered with the SEC unless an exemption from such registration is available. Title III of the JOBS Act amends the Securities Act to provide a new exemption from the SEC's registration requirements for crowdfunding, but it was subject to the SEC adopting final rules. Under the SEC's final rules, which are substantially similar to the proposed rules, a new registration exemption (Section 4(a)(6)) would be available from the SEC registration requirements under certain conditions described below.

### **Issuer and Investor Eligibility**

For issuers to be eligible to make a crowdfunding offering and for investors to invest in those offerings, the following rules apply:

- An issuer is permitted to raise a maximum aggregate amount of \$1 million through crowdfunding offerings in a 12-month period (other non-crowdfunding offerings made by the issuer are not integrated - combined - with crowdfunding offerings to determine the maximum, but crowdfunding offerings by affiliates of the issuer will be counted).
- Individual investors, over the course of a 12-month period, are permitted to invest in the aggregate across all crowdfunding offerings (of all issuers) up to:
  - o If either their annual income or net worth is less than \$100,000, then the greater of:
    - > \$2,000 or
    - > 5% of the lesser of their annual income or net worth.

- o If both their annual income and net worth are equal to or more than \$100,000, then 10% of the lesser of their annual income or net worth.
- During the 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed \$100,000.
- The issuer must be a domestic company that is not subject to the reporting requirements under the Securities Exchange Act of 1934, cannot be a company that is disqualified under Regulation Crowdfunding's disqualification ("bad actor") rules, cannot be a company that has failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement, and may not be an investment company, a private investment or hedge fund, a shell company or a blank check company.
- The securities purchased may not be transferred for a one-year period after the purchase (other than transfers to the issuer, accredited investors or family members or transfers effected in connection with a registered offering or the death or divorce of the investor).
- The issuer need not count the holders of crowdfunded securities toward the threshold that requires an issuer to register its securities with the SEC under Section 12(g) of the Securities Exchange Act if the issuer is current in its annual reporting obligation, retains the services of a registered transfer agent and has less than \$25 million in assets.

### **Issuer Disclosure**

Issuers will need to provide fairly substantial disclosure about the business and the offering and will need to provide progress updates and disclosure amendments for material changes in the offering or prior disclosure. The disclosure requirements include the following:

- The issuer will provide the SEC (through the EDGAR public filing system), investors and the relevant broker-dealer or funding portal with certain information on a new Form C, including:
  - o a description of the material risks of the investment;
  - o a description of the business of the issuer and its business plan;
  - o a reasonably detailed description of the purpose of the offering and the use of proceeds from the offering;
  - o information about the directors and officers (including names and three-year employment history) and each person holding more than 20 percent of the shares of the issuer;
  - o the target offering amount, the deadline to reach the target offering amount, and whether the issuer will accept investments in excess of the target offering amount;

- o the price to the public of the securities or the method for determining the price provided that, prior to the actual sale, the issuer must disclose the final price in writing to the investors, and the issuer must provide the investors with a reasonable opportunity to rescind the commitment to purchase the securities;
  - o a description of the ownership and capital structure of the issuer, including (1) the terms of the securities being offered and each other class of securities of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including how the rights of the securities being offered may be materially limited, diluted, or qualified by the rights of any other class of securities of the issuer; (2) 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; (3) the name and ownership level of each existing shareholder who owns more than 20 percent of any class of the securities of the issuer; (4) 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, including during subsequent corporate actions; and (5) the risks to purchasers of the securities relating to minority ownership in the issuer, and the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties;
  - o whether the issuer or any of its predecessors previously has failed to comply with the ongoing reporting requirements of Regulation Crowdfunding; and
  - o a description of related party transactions.
- Issuers will also be required to provide a description of the financial condition of the issuer, which must include, to the extent material, a discussion of liquidity, capital resources and historical results of operations. In addition to this narrative disclosure, issuers will have to provide financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) for the shorter of the two most recently completed fiscal years or the period since the issuer's inception in accordance with the following:
    - o For issuers offering \$100,000 or less: disclosure of the amount of total income, taxable income and total tax as reflected in the issuer's federal income tax returns certified by the principal executive officer to reflect accurately the information in the issuer's federal income tax returns (in lieu of filing a copy of the tax returns), and financial statements certified by the principal executive officer to be true and complete in all material respects. If, however, financial statements of the issuer are available that have either been reviewed or audited by a public accountant that is independent of the issuer, the issuer must provide those financial statements instead and need not include the information reported on the federal income tax returns or the certification of the principal executive officer.
    - o For issuers offering more than \$100,000 but not more than \$500,000: financial statements reviewed by a public accountant that is independent of the issuer. If, however, financial statements of the issuer are available that have been audited by

a public accountant that is independent of the issuer, the issuer must provide those financial statements instead and need not include the reviewed financial statements.

- o For issuers offering more than \$500,000:
  - > For issuers offering more than \$500,000 but not more than \$1 million of securities in reliance on Regulation Crowdfunding for the first time: financial statements reviewed by a public accountant that is independent of the issuer. If, however, financial statements of the issuer are available that have been audited by a public accountant that is independent of the issuer, the issuer must provide those financial statements instead and need not include the reviewed financial statements.
  - > For issuers that have previously sold securities in reliance on Regulation Crowdfunding: financial statements audited by a public accountant that is independent of the issuer.
- The issuer cannot advertise the terms of the offering but may issue notices of the terms of the offering, including (1) the amount of securities offered; (2) the nature of the securities; (3) the price of the securities; and (4) the closing date of the offering period, and such notices must direct investors to the funding portal or broker-dealer.
- The issuer must clearly disclose all compensation paid directly or indirectly to all persons that have promoted the offering through the channels of the broker-dealer or funding portal.
- The issuer must file an annual report of the results of its operations and financial statements with the SEC after the offering and provide that to investors. The annual report will contain basically the same type of information required in the original disclosure documents. However, the required financial statements need only be certified by the principal executive officer of the issuer to be true and complete in all material respects. However, issuers that have available financial statements that have been reviewed or audited by an independent certified public accountant because they prepare them for other purposes must provide them and will not be required to have the principal executive officer certification.

## **Crowdfunding Platforms**

Under Regulation Crowdfunding, each offering must be conducted exclusively through one platform operated by a registered broker or a funding portal, which is a new type of SEC registrant. The rules require these intermediaries to:

- provide investors with educational materials;
- take measures to reduce the risk of fraud;



- make available information about the issuer and the offering;
- provide communication channels to permit discussions about offerings on the platform; and
- facilitate the offer and sale of crowd-funded securities.

The rules prohibit funding portals from:

- offering investment advice or making recommendations;
- soliciting purchases, sales or offers to buy securities offered or displayed on its platform;
- compensating promoters and others for solicitations or based on the sale of securities; and
- holding, possessing, or handling investor funds or securities.

The rules provide a safe harbor under which funding portals can engage in certain activities consistent with these restrictions.

While the funding portals would not be required to be registered as broker-dealers as such, they would be required to register with the SEC using a modified Form BD (called a Form Funding Portal) and would be required to become a member of a registered national securities association (the Financial Industry Regulatory Authority (FINRA) is currently the only such association).

### **Conclusion**

While the SEC's final rules, which liberalized some of the proposed rules, are intended to make it easier for start-up companies to raise capital, the financial and compliance burdens imposed on crowdfunding offerings may make it impractical and prohibitively expensive for start-up companies to benefit from them. In addition to the costs that start-up companies will incur to prepare disclosure materials, engage and compensate a broker-dealer or funding portal and prepare financial statements, these companies will be required to regularly file financial and informational reports that will be available to the general public (including competitors, customers and strategic partners) to review. A company will need to weigh the benefits of raising a limited amount of capital through crowdfunding against the financial and compliance obligations associated with Regulation Crowdfunding, especially if the company is otherwise able to raise capital from "accredited investors" under Regulation D, which now permits general solicitation and general advertising.

### **Questions?**

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