

CLIENT ALERT



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Crowdfunding Regulations

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On October 30, 2015, the Securities and Exchange Commission (SEC) adopted final crowdfunding rules (available at <http://www.sec.gov/rules/final/2015/33-9974.pdf>). More than two years after the publication of the proposed crowdfunding rules, the SEC approved regulations that permit companies to raise capital through the sale of equity or other securities by means of Internet funding portals. The new rules, conveniently named

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“Regulation Crowdfunding,” mark one of the final steps required of the SEC under the JOBS Act, which was enacted in 2012. The new rules will be effective 180 days after their publication in the *Federal Register*, which should result in an effective date in early May 2016, although the funding portal registration procedures are effective January 29, 2016.

Summary of the Rules

The JOBS Act added a new section 4(a)(6) to the Securities Act of 1933 (Securities Act), which provides for an exemption from the otherwise onerous registration requirements of the Securities Act for crowdfunding offerings by eligible issuers. The new regulations implement that statutory mandate. To qualify for the exemption, crowdfunding transactions for any issuer must, among other things, meet the following criteria:

- the total amount raised by an issuer via crowdfunding transactions must not exceed \$1 million in any 12-month period
- the amount an investor may invest in any issuer’s crowdfunded securities in any 12-month period cannot exceed:
 - if annual income or net worth of the investor is less than \$100,000, the greater of \$2,000 or 5 percent of the lesser of such investor’s annual income or net worth
 - otherwise, 10 percent of the lesser of such investor’s annual income or net worth
- the total amount an investor may invest in crowdfunded securities (of all issuers) in any 12-month period cannot exceed \$100,000
- all crowdfunding transactions must be conducted through an intermediary that is either registered as a broker-dealer or registered as a funding portal.^[1]

Pepper Point: It will be up to the intermediary (the broker-dealer or the funding portal running the offering online) to confirm that the investors have not exceeded their annual limitations. The intermediary may rely on self-certifications from investors concerning their net worth, income and compliance with the investment limitations; the issuer, in turn, is allowed to rely on the suitability information it receives from the intermediary. Not surprisingly, the issuer and the intermediary are not entitled to rely on an investor’s representation if the issuer or the intermediary, in fact, knows that the investor has exceeded the investor limits or would exceed the investor limits as a result of purchasing the issuer’s securities.

Not all companies are eligible to participate in crowdfunding offerings. Non-U.S. companies, public companies that file periodic reports with the SEC, certain investment companies, companies with no specific business plan, companies that have a history of noncompliance with the new annual crowdfunding reporting requirements, and companies (and/or the control persons or promoters of which) that have a history of securities law-related violations (similar to existing “bad actor” provisions under other SEC offering exemptions) may not take advantage of the crowdfunding exemption.

The transferability of crowdfunded securities is restricted. Any securities purchased under the crowdfunding exemption may not be publicly resold for one year after the date of purchase. Until that time, such securities may only be transferred to the investor’s family members, to an accredited investor, or to the issuer or may be sold to the public in an SEC-registered offering.

Crowdfunding issuers that are current in the new reporting requirements under the crowdfunding rules, retain the services of a registered transfer agent, and have less than \$25 million in assets will not be required to count the purchasers of the crowdfunded securities towards the thresholds required for companies to become subject to the SEC’s standard periodic reporting requirements.

Pepper Point: The adopting release to the new rules states explicitly that an issuer that is engaging in a crowdfunding offering is not precluded from also engaging in an exempt offering under Regulation D, Regulation A, Regulation S (offshore offerings) or Rule 701 (employee benefit plans). Even a Rule 506(c) “general solicitation within the context of a private placement” is also allowed, provided that such other offering complies with the requirements of the applicable exemption that is being relied on for the particular offering, and, further, in the context of the 506(c), the offering under 506(c) could not include in any such general solicitation an advertisement of the terms of an offering made in reliance on Section 4(a)(6), unless that advertisement otherwise complied with Section 4(a)(6) and the final rules. As such, a concurrent offering would be bound by the more restrictive solicitation requirements of Regulation Crowdfunding, *unless the issuer can conclude that the purchasers in the Regulation Crowdfunding offering were not solicited by means of the offering made in reliance on Rule 506(c).*

See Release 33-9974 at 19, n.28 and the text accompanying (emphasis added).

Pepper Point: That means concurrent offerings could taint the crowdfunding offering unless precautions are taken and strictly followed. Most importantly, the issuing company may not solicit generally under Rule 506(c) and shunt non-accredited investors to a simultaneous crowdfunding offering. The offerings will be integrated, and both will fail under their respective rules.

In addition to meeting the requirements of the exemption noted above, issuers under the new crowdfunding rules must also provide certain disclosures to investors and comply with certain ongoing reporting requirements and filings. In its offering documents, an issuer under the crowdfunding rules must, among other things, disclose:

- information about its officers, directors and beneficial owners of more than 20 percent of the issuer
- a description of the issuer's business (including a business plan and the current number of employees) and how the proceeds from the offering will be used
- the price of the securities being offered, the target and range of the amount being raised, and the deadline of the offering
- certain related-party transactions
- the issuer's financial condition
- financial statements, including audited financials, depending on the amount of securities sold by the issuer during a 12-month period.

Issuers must also comply with modified reporting requirements, including annual reports and financial statements that, depending on the amount offered and sold during a 12-month period, must be either accompanied by information from the issuer's tax returns, reviewed by an independent public accountant, or audited by an independent auditor.

Funding Portals

The final rules also provide for a new type of registered entity that will act as the facilitator for crowdfunding transactions in which a registered broker-dealer is not involved. This new type of intermediary, called a "funding portal," must be registered with the SEC and comply with as-yet-unspecified requirements for membership in FINRA or another registered national securities association. These intermediaries are required to, among

other things, provide investors with educational materials, provide information about the issuer and provide ways for investors to discuss offerings. An intermediary must also, at a minimum, conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered by the intermediary and on each officer, director or beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power.

Funding portals and broker-dealers facilitating crowdfunding transactions are not allowed to give investment advice or recommendations, solicit purchases, compensate promoters based on the sale of securities, or hold any investor funds or securities. Issuers must disclose the name of the intermediary through which any offering is made, as well as any compensation paid to such intermediary and any ownership interest of the intermediary in the issuer.

Opportunities for Issuers

The new crowdfunding exemption can be useful to early-stage companies that are not able to take advantage of other exemptions from SEC registration to raise capital. Existing exemptions generally require that investors be "accredited," which requires (as to individual investors) that they have a substantial net worth or annual income, or that the issuer provide a substantial amount of SEC-mandated disclosures to the investors. Although the new crowdfunding rules require an issuer to prepare and file an offering statement containing prescribed information with the SEC, issuers may find it easier to comply with these disclosure requirements than the disclosure requirements under previously available exemptions.

Pepper Point: It is anticipated that all of this information will be made available online and be delivered online. Note, however, that the materials still must be prepared and delivered to the SEC via the EDGAR system on new SEC Form C. There is, of course, an expense associated with that process.

Issuers that offer and sell securities in a crowdfunding offering are exempt from compliance with state securities law, or "blue sky," registration requirements. This is a major benefit of the new crowdfunding rules that is not available to private companies under most other available SEC registration exemptions for offerings to investors that are not "accredited." The burden of complying with blue sky laws has historically led many companies to limit their private placement offerings to accredited investors, which also provides for the preemption of blue sky registration requirements.

One clear opportunity for the crowdfunding rules lies with early-stage companies and small businesses that are unable to attract investment from traditional angel investors or venture capitalists. Such issuers often want to avoid the costs and exit necessities that come with these investors and may want to use the crowdfunding exemption to sell equity or debt securities in early rounds to friends and family or other interested retail investors. Creating this access to capital for earlier-stage companies is a main objective of the crowdfunding regulation.

Pepper Point: Although the crowdfunding rules impose restrictions on the ability of a funding portal to solicit investors or compensate employees for such solicitation, issuers will be able to publicly advertise their offerings. Issuers may publish a general description of their business and the terms of the offering on their own website, through social media or otherwise, directing investors (which may be by hyperlink) to the intermediary's platform for additional information about the offering. In fact, subject to the integration issue noted above, it is anticipated that the offerings made under Regulation Crowdfunding will be the epitome of general solicitations over the Internet.

Pepper Point: However, careful attention is needed to the integration issue and what the **next** round of financing will need to look like for the crowdfunding issuer. Use of the Internet to solicit offers in close proximity to the next round of financing may prevent the issuer from using Rule 506(b), an exemption for a private placement offering to accredited or financially sophisticated investors that does not permit general advertising or general solicitation.

Pepper Point: Many issuers will find that the investment limitations of the new rules will limit the usefulness of a potential crowdfunding offering. If an investor's annual income or net worth is less than \$100,000, then the maximum amount that the investor may invest in one or more crowdfunding offerings in any 12-month period is the greater of \$2,000 or 5 percent of the lesser of such investor's annual income or net worth. In making the net worth calculation, the value of an investor's primary residence may not be included as an asset. Even the most well-heeled individual or institutional investor is limited in the aggregate amount that may be invested in all crowdfunding offerings in any 12-month period — \$100,000.

Pepper Point: An issuer can include any higher thresholds that it wants to for its offering. However, a person with a \$100,000 income and a \$100,000 net worth can still only invest up to a total of \$10,000 in all crowdfunding offerings in any 12-month period.

Although the new rules provide both early-stage company investors and issuers with significant incentives to use the crowdfunding exemption, they also include robust restrictions and anticipate SEC oversight, which is consistent with Congress' mandate in the JOBS Act and the SEC's stated interest in protecting investors. It is yet to be seen whether the final crowdfunding rules will have the intended impact of making it easier for companies to raise funds over the Internet.

Pepper Points:

- Issuers (especially more established issuers) should consider, in view of their own individual capital circumstances, the pros and cons of crowdfunding as opposed to more traditional SEC equity fundraising exemptions, such as Rule 506 under Regulation D.
- The new “funding portal” registered entity is a unique creature of the crowdfunding rules and may need to wait for further definition to the term. However, issuers can still use the broker-dealer model to issue securities under the exemption

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Endnotes

1. A funding portal is a new type of SEC-registered entity that also must become a member of the Financial Industry Regulatory Authority (FINRA) or an as-yet-to-be-formed securities regulatory intermediary that will perform a “self-regulatory organization” function similar to what FINRA does.