



CORPORATE

ALERT

SEC PROPOSES CROWDFUNDING RULES

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On October 23, 2013, the Securities and Exchange Commission (SEC) released much anticipated proposed rules regarding crowdfunding. The proposed rules provide a framework for the sale of securities under Section 4(a)(6) of the Securities Act of 1933 (Securities Act), as directed by Title III of the Jumpstart Our Business Startups Act (JOBS Act), and come on the heels of the SEC's recent issuance of final rules to remove the ban on general solicitation in private placements under Regulation D of the Securities Act.

While crowdfunding offers smaller issuers the promise of increased access to capital, the proposed rules contain significant restrictions and compliance requirements, which have already generated substantial critical commentary from market participants. The SEC has requested comment on a host of issues relating to the proposed rules. The public comment period ends on February 3, 2014.

Title III of the JOBS Act created Section 4(a)(6) under the Securities Act, which exempts from Section 5 of the Securities Act the sale of securities in crowdfunding offerings. Section 4(a)(6) sets forth a number of criteria required to satisfy the exemption, including:

- \$1 million limitation on the amount raised in any 12-month period;
- \$100,000 limitation on the amount an investor may invest in an issuer's crowdfunding offerings during a 12-month period based on the investor's annual income or net worth;
- requiring offerings to be conducted through a broker or a newly registered funding portal;
- requiring certain mandatory disclosures to potential investors; and
- limiting the exemption to issuers organized in the US that are not already subject to the reporting requirements of the Securities Exchange Act of 1934 (Exchange Act).

Unless and until final rules are adopted by the SEC, crowdfunding remains unavailable.

The Proposed Rules

The 500-plus-page release sets forth a number of detailed requirements to satisfy the crowdfunding exemption. These include:

Limitation on Amount Raised. An issuer may not raise in excess of \$1 million pursuant to crowdfunding offerings in any 12-month period. The proposed rules

would not aggregate sales by issuers in other private placements during any 12-month period. This means that an issuer could raise \$1 million in a private placement under Rule 506 of Regulation D, and still undertake crowdfunding offerings within 12 months of such private placement. Importantly, crowdfunding offerings will not be integrated with other private placements, which would allow an issuer to simultaneously conduct a crowdfunding offering and a traditional private placement. Issuers relying on an exemption that does not permit general solicitation (for example Rule 506(b)) should take extra precaution to ensure that investors participating in such private placement were not solicited by means of general solicitation.

Limitations on Individual Investor's Investment. An investor may not invest more than \$100,000 in securities sold by an issuer in crowdfunding offerings during any 12-month period. More specifically, during any 12-month period, an investor:

- with net worth and annual income of less than \$100,000 may only invest up to a maximum of \$2,000 or 5 percent of the investor's net worth or annual income, whichever is greater; and
- with net worth or annual income of more than \$100,000 may only invest 10 percent of the investor's net worth or annual income, whichever is greater, but not in excess of the \$100,000 limit.

An issuer may rely upon an intermediary's efforts to ensure that an investor does not violate these investment limitations, as long as the issuer does not have actual knowledge that an investor had, or would, violate the investment limitations.

Use of Broker or Funding Portal. Section 4(a)(6)(C) of the Securities Act requires crowdfunding offerings to be conducted through a broker or funding portal registered with the SEC. Each crowdfunding offering by

an issuer may utilize only one intermediary and must be conducted via the Internet through an intermediary's platform. The proposed rules contemplate that an intermediary's platform may utilize mobile Internet devices, such as iPhones and other smartphones.

Disclosures, Disclosures ... and More Disclosures.

The proposed rules require issuers to provide significant disclosure to investors in a crowdfunding offering including:

- information regarding directors, officers and 20 percent or more beneficial owners;
- description of business plan;
- the target offering amount, the deadline to reach the target offering amount and regular updates regarding progress in meeting the target offering amount;
- use of proceeds;
- price to the public of the securities and the method for determining the price;
- a description of the issuer's ownership and capital structure;
- risk factors; and
- related party transactions.

With regard to financial information, issuers will be required to disclose a narrative description of their financial condition, including results of operations, liquidity and capital resources, similar to "Management's Discussion and Analysis" provided by public companies in their Exchange Act filings. As crowdfunding issuers may have little or no operating history, the proposed rules mandate that issuers discuss financial milestones and operational, liquidity and other challenges.

In addition to the narrative disclosures, issuers will also be required to disclose and file with the SEC, financial statements for the issuer's two most recently completed fiscal years prepared in accordance with Generally Accepted Accounting Principles (GAAP) as follows:

- for offerings seeking to raise \$100,000 or less, the issuer's tax returns for the most recently completed fiscal year, if available, and financial statements that are certified by the issuer's principal executive officer to be true and complete in all material respects;
- for offerings seeking to raise in excess of \$100,000 but not more than \$500,000, financial statements reviewed by a public accountant independent of the issuer; and
- for offerings seeking to raise in excess of \$500,000, audited financial statements.

The JOBS Act mandates that the SEC adjust these offering thresholds to account for inflation not less frequently than once every five years.

Filings, Filings ... and More Filings. The forgoing required disclosures must be filed with the SEC via EDGAR on a newly-created Form C. Information regarding material changes to the disclosed information prior to completion of the offering must be provided to investors and filed with the SEC on new Form C-A. In the event of material changes, investor funds must be returned unless the investor re-affirms the investment within five business days. Form C-U must be filed with the SEC and furnished to the investors and intermediary, to disclose progress in completing the offering amount no later than five business days after the issuer reaches 50 percent and 100 percent of the targeted offering amount. Finally, issuers will be required to file an Annual Report on Form C-AR within 120 days after the end of each fiscal year. The annual information disclosure is similar to the information required to be disclosed for the original offering, excluding information relating to the terms of the completed offering.

The annual filing requirements would terminate upon the earliest of:

- the issuer becoming a reporting company under the Exchange Act;

- the issuer, or another party, purchases or repurchases all of the securities sold in a crowdfunding offering; or
- the issuer liquidates or dissolves its business under state law.

Upon termination, an issuer would be required to file within five days of the terminating event, SEC Form C-TR.

Permissible Communications by Issuers. An issuer is permitted only to publish a notice of a crowdfunding offering by providing the website address of the intermediary's platform, the terms of the offering (i.e., amount of securities offered and the price) and factual information concerning the issuer's legal identity and business location. Such notices may be made or posted in a newspaper or via social media outlets. An issuer is prohibited from otherwise advertising a crowdfunding offering.

Issuers will, however, be permitted to communicate with investors by way of communication channels on the intermediary's platform, provided that the issuer identifies itself in all such communications. Such communications would include, among other things, responding to investor questions. Issuers would also be permitted to continue to communicate business information to the general public not related to the crowdfunding offering in accordance with historical practices, similar to Rule 169 under the Securities Act.

Additional Provisions. In addition to the above, it is worth noting that:

- although crowdfunding securities are not deemed "restricted securities" under Rule 144 of the Securities Act, they are subject to a one year holding period, with exceptions for transfers to the issuer, to an accredited investor, in connection with an SEC-registered offering, or to a family member in connection with death, divorce or under similar circumstances;

- purchasers in a crowdfunding offering will not count towards the security holder thresholds for registration under Section 12(g) of the Exchange Act;
- issuers may not compensate any third party to promote crowdfunding offerings through communication channels provided by an intermediary unless that intermediary complies with rules adopted by the SEC to ensure that the third party clearly discloses, in each promotional communication, that it is being compensated by the issuer;
- the proposed rules include “bad actor” provisions substantially similar to those set forth in Rule 506(d) under the Securities Act, which provide for disqualification of a crowdfunding offering under certain circumstances; and
- shell companies may not utilize the exemption.

Conclusion

Given the substantial disclosure and reporting requirements and the limited amount of funds that can be raised, many issuers may choose to avoid crowdfunding offerings in favor of other available private placement exemptions, particularly Rule 506(c) of Regulation D which permits general solicitation. We expect continued commentary from market participants and the final crowdfunding rules may vary from the proposed rules.

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