Corporate

ALERT

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EQUITY CROWDFUNDING CLEARED TO BEGIN WITH SEC'S ISSUE OF LONG-AWAITED REGULATIONS

By Michael S. Harrington

The wait is over. Equity crowdfunding is now legal.

The option of harnessing the Internet to raise capital from "the masses" was promised in the JOBS Act, aka the Jumpstart Our Business Startups Act, passed in April 2012. But the equity crowdfunding provisions were delayed by years of haggling over the fine print in the implementing regulations.

Now "equity crowdfunding" or "Title III crowdfunding" is truly an option thanks to implementing regulations published by the Securities and Exchange Commission (SEC).

On October 30, 2015, the SEC issued final rules and forms implementing Title III of the JOBS Act. These regulations come more than three years after the enactment of the JOBS Act, and more than two years after the SEC was required by Congress to implement final rules legalizing Title III crowdfunding.

Why the long delay? The rulemaking process was plagued by years of disagreement focusing on the implementation of the difficult statutory scheme that Congress handed to the SEC in Title III, as well as concerns about the heightened opportunity for fraud and abuse that Title III potentially brings.

Title III was designed to unite the social networking world that we have become with the traditional and regulated capital raising world that has existed for many years. It does so by allowing companies seeking capital to reach non-accredited investors through offerings of equity on the Internet.

Previously, an offering over the Internet would have been illegal. Title III now creates a new exemption from registration under the Securities Act of 1933 for a new form of crowdfunding. This new form must be conducted through "crowdfunding intermediaries" – Internet portals that meet certain conditions in order to handle crowdfunding offerings. Any company utilizing Title III must follow a strict set of implementing rules in order to avail itself of this new exemption from registration.

Title III offerings must not exceed maximum amounts of capital raised per issuer and amounts invested per individual investor. Specifically, an issuer cannot raise more than $1 million in any rolling 12-month period. In terms of the per investor limits imposed by Title III, these depend on the net worth or annual income of each individual investor. For individuals with either an annual income or net worth that is less than $100,000, that investor cannot invest more than the greater of (i) $2,000 and (ii) 5 percent of the lesser of the investor's annual income or net worth. All other individuals are limited to investing up to 10 percent of the lesser of the investor's annual income or net worth, but not to exceed $100,000 for each investor.

Significant reporting requirements apply to any company intending to use Title III crowdfunding. Under the SEC's final rules, a Title III crowdfunding issuer is required to file a new Form C on EDGAR (the SEC's electronic filing system) before the offering is commenced. Among many other things, Form C will include information on:

- The issuer's officers and directors
- The issuer's 20 percent or greater shareholders or equity holders
- The issuer's business and business plan
- The target offering amount and deadline to reach it
- The offering price and how it will be determined
- The risks of investing in the business

This is far from an exhaustive list, but nonetheless highlights the significant disclosure requirements imposed on issuers.

A Title III offering also must provide specific financial information to potential investors. The extent and level of detail or verification needed will depend on the amount of capital being raised.

- In offerings of $100,000 or less, issuers must provide U.S. Generally Accepted Accounting Principles (GAAP) financial statements for the two most recently completed fiscal years (or shorter period for companies not then two years old), and total income, taxable income and total tax reflected on the issuer's federal tax return for the most recently completed fiscal year.
- For offerings between $100,000 and $500,000, an issuer must provide U.S. GAAP financial statements for these same periods, but these must be reviewed by an independent public accountant.
- For offerings greater than $500,000, reviewed financial statements suffice for the first offering, but audited financials are required for any subsequent offerings.

These reporting requirements continue annually until one of the following occurs: the issuer becomes a public company, has less than 300 equity holders, has filed three annual reports and has total assets of less than $10 million, the securities sold in the offering are sold to a third party or repurchased by the issuer or the issuer goes out of business.

Why is Title III crowdfunding an attractive option? First and foremost, it provides an opportunity to advertise the offering to the public. Prior to the JOBS Act, advertising a private securities offering to the public was not permitted. This was the so-called "general advertising and general solicitation" restrictions imposed by Regulation D of the Securities Act of 1933. Now, issuers in a Title III crowdfunding can advertise publicly that they are selling securities, although their advertisement must be limited to directing their investor audience to the internet portal that is conducting their offering. The issuer is then free to communicate with its investors or potential investors through the portal, opening a whole new landscape in investor solicitations and communications.

Other aspects of the new rules issued by the SEC are noteworthy. First, Title III offerings will not be integrated with any other exempt offering being conducted by the issuer, as long as the issuer strictly complies with each of the respective exemptions. Also, securities purchased in a Title III crowdfunding offer are restricted securities and cannot be resold for a one-year period, subject to a few limited exceptions. Finally, an issuer in a Title III crowdfunding does not need to count the investors in that funding when determining if it has crossed the shareholder threshold that would cause it to be a public reporting company.

Will crowdfunding prove to be a game changer in the world of capital raising? It's clear that Congress wanted this to be the new frontier in raising capital for companies. But the popularity of this new option hinges on how companies respond to the significant requirements imposed on them by the regulations. That, coupled with the fact that an issuer will have potentially hundreds or even thousands of investors who will be complete strangers to the company, it seems unlikely that crowdfunding will reach new frontier status.

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