SEC Adopts Rules to Allow Crowdfunding Beginning May 16, 2016

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December 2, 2015

Over two years after proposing rules, the Securities and Exchange Commission (SEC) recently adopted rules to implement Title III of the Jumpstart Our Business Startups Act (JOBS Act) and legalize the offer and sale of securities through crowdfunding (*i.e.*, an evolving form of Internet-based fundraising through small investments from a large number of individuals). The rules, titled Regulation Crowdfunding, will be effective May 16, 2016, although certain forms enabling funding portals to register with the SEC will take effect January 29, 2016. The SEC's adopting release for these rules can be found here.

Once the rules are effective on May 16, 2016, the crowdfunding rules will:

- allow eligible U.S. private companies to offer and sell through crowdfunding offerings up to $1 million of securities (including debt securities) to investors (including non-accredited investors) over a 12-month period without registration under the Securities Act of 1933 (Securities Act), subject to investor investment limits, financial statement and other issuer disclosure requirements, "bad actor" disqualification provisions and other specified conditions; and
- impose numerous requirements and prohibitions on registered funding portals and broker-dealers that eligible issuers must use as intermediaries in the offer and sale of securities under the rules.

The crowdfunding rules will provide eligible small and emerging private U.S. growth companies another potential fundraising avenue, especially those that are unable to obtain seed financing from angel or venture capital investors. However, the rules' $1 million offering cap, transfer restrictions and substantial compliance costs, including offering documentation, financial statement requirements, intermediary fees and ongoing public reporting requirements, highlight the need for eligible companies to carefully consider whether crowdfunding is the most effective option to satisfy their fundraising goals. Companies should consider whether other Securities Act registration exemptions with lower compliance costs and higher or no fundraising caps may be more cost-effective and better meet their needs, including Rule 506 (which allows online fundraising to accredited investors without the use of an intermediary and without the requirement for offering documentation) and Regulation A+. Moreover, eligible companies that seek to crowdfund under the rules should consider how to structure the offering to ensure that such fundraising does not make them less attractive to angel and venture capital investors for future fundraising rounds.

As part of its efforts to assist capital formation by smaller issuers outside of the requirements of the JOBS Act, the SEC also recently proposed amendments to:

- modernize Securities Act Rule 147 for intrastate offerings to further facilitate capital formation, including through intrastate crowdfunding provisions; and
- increase the aggregate amount that may be offered and sold pursuant to Securities Act Rule 504 from $1 million to $5 million and apply Securities Act Rule 506's "bad actor" disqualification provisions to Rule 504 offerings.

The SEC is seeking public comment through January 11, 2016 before determining whether to adopt these proposed amendments. The SEC's proposing release can be found here.

This client alert provides a brief overview of these recent SEC rulemakings.

Crowdfunding Rules

Eligible issuers. The following issuers are not eligible to use the crowdfunding rules:

- issuers organized outside the United States;

- SEC reporting companies (*i.e.*, issuers required to file reports with the SEC pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934);
- investment companies (as defined in Section 3 of the Investment Company Act of 1940 (1940 Act)) and companies that are excluded from the definition of investment company by 1940 Act Sections 3(b) or 3(c);
- issuers subject to the rules' disqualification provisions;
- issuers that have failed to comply with the rules' annual reporting requirements during the two years immediately preceding the filing of a crowdfunding offering statement; and
- issuers with no specific business plan or whose business plan is to engage in a merger or acquisition with an unidentified company or companies (*e.g.*, blank check companies).

"Bad actor" disqualification provisions. The rules set forth a list of events that will disqualify an otherwise eligible issuer from relying on the crowdfunding rules. The disqualification events are substantially similar to the disqualification events in Regulation A and Rule 506 and relate to issuers and other associated persons, including predecessors, directors, officers, 20 percent or greater shareholders and promoters. Disqualification events that occur before May 16, 2016 will not cause disqualification, but instead an issuer must disclose in its offering statement events that would have triggered disqualification had they occurred on or after May 16, 2016.

Issuer fundraising limits. An eligible issuer may sell up to $1 million[1] of securities through crowdfunding offerings in a 12-month period. The $1 million limit includes capital raised under the crowdfunding rules (but not under other Securities Act registration exemptions) by the issuer, any predecessor of the issuer and entities controlled by, or under common control with, the issuer. The rules do not limit the types of securities that may be offered, so issuers may offer and sell debt securities under the rules.[2]

Simultaneous or close in proximity offerings under the crowdfunding rules and another Securities Act registration exemption will not be integrated if each offering complies with the requirements of the applicable exemption being relied upon. If the concurrent exempt offering prohibits general solicitation (*e.g.*, a "quiet" Rule 506(b) offering), the issuer must ensure that purchasers in that offering were not solicited by means of the crowdfunding offering (*e.g.*, through the intermediary's public website). If an investor first discovers the issuer through a solicitation in a crowdfunding offering, that investor would likely not be eligible to participate in the concurrent exempt offering that prohibits general solicitation. If the concurrent exempt offering allows general solicitation (*e.g.*, a Rule 506(c) offering), that offering could not include an advertisement of the crowdfunding offering terms that is prohibited under the crowdfunding rules. Thus, the more restrictive solicitation requirements of the crowdfunding rules would govern, unless the issuer concludes that the purchasers in the crowdfunding offering were not solicited by means of the Rule 506(c) offering.

Individual investment limits. Any investor, including non-accredited investors, may participate in a crowdfunding offering. However, an individual investor (whether a retail, institutional or accredited investor) can only purchase up to the following amount of securities from all issuers pursuant to the crowdfunding rules during a 12-month period:

- the greater of $2,000 or 5 percent of the lesser of the investor's annual income or net worth if *either* annual income or net worth is less than $100,000; or
- 10 percent of the lesser of the investor's annual income or net worth, not to exceed $100,000, if *both* annual income and net worth are equal to or exceed $100,000.[3]

The annual income and net worth of a natural person must be calculated pursuant to Securities Act Rule 501's provisions regarding the calculation of income and net worth of an accredited investor. A natural person may calculate his or her annual income and net worth jointly with his or her spouse.

Importantly, an issuer may rely on an intermediary's required efforts to determine whether an investor's purchases exceed the investment limits if the issuer lacks knowledge that the investor had exceeded, or would exceed, the limits as a result of purchasing securities in the issuer's offering.

Offering statement disclosure requirements. Prior to commencing a crowdfunding offering, eligible issuers must file with the SEC and provide to investors and the intermediary an offering statement on new Form C. The offering statement must contain information similar to that found in a prospectus or private placement memorandum, including information about the offering price and target offering amount, intended use of the offering proceeds, officers and directors, greater than 20 percent shareholders, the issuer's business, business plan, capital structure and financial condition (similar to MD&A in public company filings), risk factors, certain related party transactions, the intermediary and its compensation and any material information not specifically required by the rules.

The offering statement must also include financial statements covering the two most recently completed fiscal years or, if shorter, the period since inception prepared in accordance with U.S. GAAP.[4] The level of review required depends on the aggregate amount sold under the crowdfunding rules during the prior 12 months and the target offering amount of the current offering.

- *$100,000 or less* – Financial statements accompanied by certain information from the issuer's federal income tax returns for the most recently completed fiscal year (but not the actual tax return), each certified by the issuer's principal executive officer with a signed SEC-designated certification. If financial statements that have been reviewed or audited by an independent public accountant are available, those must be provided instead.
- *Over $100,000 – $500,000* – Financial statements reviewed by an independent public accountant with a signed review report. If financial statements that have been audited by an independent public accountant are available, those must be provided instead.
- *Over $500,000 – $1,000,000* – Financial statements audited by an independent public accountant with a signed audit report containing an unqualified opinion. However, issuers conducting their first crowdfunding offering with a target offering amount in this range may provide financial statements reviewed by an independent public accountant with a signed review report, unless financial statements that have been audited by an independent public accountant are available, in which case those must be provided instead.

Issuers must also file with the SEC and provide to investors and the intermediary (1) amendments to the offering statement during the offering period to disclose material changes or updates, (2) progress updates when the issuer reaches 50 and 100 percent of the target offering amount and (3) a final progress update of the amount sold where the issuer will accept proceeds in excess of the target offering amount.

Offering mechanics. All crowdfunding offers and sales, including concurrent offerings made under the rules, must be conducted (1) through *a single* intermediary that is an SEC-registered broker-dealer or an SEC-registered funding portal and that is also a FINRA member and (2) *exclusively* through the intermediary's "platform" – a program or application accessible via the Internet or other similar electronic communication medium through which a registered broker or a registered funding portal acts as an intermediary in an offering under the crowdfunding rules. Although an offering must be conducted exclusively on the intermediary's platform, an intermediary may perform back office and other administrative functions off its platform. The rules set forth the requirements for a funding portal to register with the SEC, which would occur by completing and filing with the SEC a Form Funding Portal.

Investors may cancel their investment commitments for any reason until 48 hours prior to the offering deadline disclosed in the offering statement. If an issuer meets its target offering amount before the disclosed deadline, it may close the offering early subject to certain conditions, including providing notice to investors who will retain their unconditional right to cancel their investment commitments until 48 hours prior to the new deadline.

If there is a material change to the offering terms or the information provided by the issuer, an investor must affirmatively reconfirm its investment commitment or else it will be automatically cancelled. If the investment commitments do not equal or exceed the disclosed target offering amount at the offering deadline, the issuer cannot sell securities in the offering, investment commitments will be cancelled and committed funds returned to investors.

Advertising offering terms prohibited. In contrast to Rule 506(c) offerings, which permit general solicitation if certain conditions are satisfied, an eligible issuer or persons acting on its behalf cannot advertise, directly or indirectly, the terms of a crowdfunding offering. However, an issuer can publish notices (for example, in newspapers or on social media sites or the issuer's website) that direct investors to the intermediary's platform and contain only limited factual information about the offering and the issuer. Despite this advertising prohibition, an issuer (or persons acting on its behalf) may communicate with investors about the offering terms through communication channels provided on the intermediary's platform if the issuer identifies itself (or persons acting on its behalf identify their affiliation with the issuer) in all such communications.

Promoter compensation. An eligible issuer may not compensate or commit to compensate, directly or indirectly, any person to promote its crowdfunding offerings through communication channels provided on the intermediary's platform, unless the issuer or a person acting on its behalf takes reasonable steps to ensure that the promoter clearly discloses the past or future receipt of such compensation with each communication. This disclosure requirement applies not only to persons hired specifically to promote the offering, but also the issuer's founders, employees and directors and persons who undertake promotional activities on the issuer's behalf.

Transfer restrictions. Securities purchased in a crowdfunding offering may not be transferred for one year thereafter by either the initial purchaser or a subsequent transferee, unless transferred:

- to the issuer;
- to an accredited investor (as defined in Securities Act Rule 501(a));
- as part of an SEC-registered offering; or
- to a family member, a trust controlled by the purchaser or created for the benefit of a family member or in connection with the death or divorce of the purchaser or similar circumstances.

Holders of crowdfunding securities excluded from SEC registration threshold calculations. Holders of securities issued under the crowdfunding rules will not count toward the shareholder threshold that requires an issuer to register with the SEC under Section 12(g) of the Securities Exchange Act of 1934 if the issuer (1) is current in its annual reporting obligations under the rules, (2) engages a registered transfer agent for the crowdfunding securities and (3) has less than $25 million in total assets at the end of its most recently completed fiscal year. An issuer seeking to exclude a person from the shareholder threshold count will have the responsibility to demonstrate that the securities held by the person were initially issued in a crowdfunding offering.

Statutory liability. The anti-fraud and civil liability provisions of the Securities Act apply to offerings made under the crowdfunding rules, meaning that issuers will be subject to liability for material misstatements and omissions in their offering materials.

Ongoing SEC reporting requirements. Issuers that complete a crowdfunding offering (regardless of amounts raised) must post on their website and file with the SEC an annual report on Form C-AR within 120 days after the end of the fiscal year covered by the report. The report must include financial statements certified by an issuer's principal executive officer and the non-offering related information required in the offering statement. This ongoing reporting requirement will continue until an issuer:

- becomes a public company;
- files at least one annual report *and* has fewer than 300 holders of record, which would include not only holders of the securities issued in a crowdfunding offering under the rules but also any other holders of that class of securities;
- files annual reports for at least the three most recent years *and* has total assets of $10 million or less;
- repurchases all of its securities issued under the rules; or
- liquidates or dissolves its business.

State securities laws preempted. Securities issued under the crowdfunding rules are considered "covered securities" under the Securities Act and are exempt from state securities laws' registration and qualification requirements. However, the state securities commissions retain the authority to bring enforcement actions for fraud in connection with crowdfunding offerings.

Intermediary requirements. A crowdfunding intermediary, in its role as "gatekeeper," must, among other things:

- take certain measures to reduce the risk of fraud, including having a reasonable basis to believe (which may be based upon issuer representations, unless there is reason to question the representations) that the issuer complies with the crowdfunding rules and has established means to maintain accurate records of the holders of the securities to be offered and sold through the intermediary's platform;
- deny an issuer access to its platform if the intermediary has a reasonable basis for believing that the issuer or its officers, directors or 20 percent or greater shareholders is subject to the rules' disqualification provisions (the intermediary must conduct background and securities enforcement regulatory history checks on these parties) or that the issuer or the offering present the potential for fraud or otherwise raises investor protection concerns;
- provide investors specified educational materials about the crowdfunding offering;
- disclose to investors the intermediary's compensation;
- post on its platform the information that the issuer is required to make public (*e.g.*, the offering statement) at least 21 days before any securities are sold in an offering;
- have a reasonable basis to believe that an investor satisfies the rules' individual investment limitations (which may be based upon investor representations, unless there is reason to question the representations);
- accept an investment commitment from an investor only after that investor has opened an account with the intermediary and the intermediary has obtained investor consent to electronic delivery of materials;
- obtain specific representations and questionnaires from investors;
- provide communication channels on its platform to facilitate discussion of the offering between investors and with issuer representatives;
- provide to investors specified investment commitment and transaction confirmation notices; and
- comply with requirements for the maintenance and transmission of funds and the completion, cancellation and reconfirmations of investment commitments.

Although an intermediary may receive equity compensation from an issuer consisting of the same securities offered or sold through the intermediary's platform, the intermediary's directors, officers or partners (or any person occupying a similar status or function) are prohibited from having, or from receiving as compensation for the services to be provided to an issuer, a financial interest in an issuer offering or selling securities under the rules through the intermediary's platform. As a result, issuers lacking sufficient capital to pay intermediary fees could instead pay them in stock. Intermediaries are prohibited from compensating any person for providing personally identifiable information of any investor or potential investor.

The rules exempt an intermediary that is registered as a funding portal from the requirement to register as a broker-dealer under the Exchange Act. A funding portal's activities, unlike a broker-dealer, are limited to acting as an intermediary in crowdfunding offerings under the rules. Therefore, a funding portal is prohibited from engaging in certain types of activities, including offering investment advice or recommendations and soliciting purchases, sales or offers to buy the securities on its platform. However, the rules provide a safe harbor that allow a funding portal to engage in specified permitted activities consistent with these restrictions, including allowing a funding portal to determine whether and under what conditions to allow an issuer to use its platform subject to certain conditions.

The SEC specifically declined to exempt funding portals (or any intermediaries) from the statutory liability provision of Securities Act Section 4A(c). As a result, the SEC believes that "it appears likely" that intermediaries would be considered "issuers" for statutory liability purposes, although the determination of issuer liability for an intermediary under Section 4A(c)

will be a facts and circumstances determination.

Proposed Amendments to Securities Act Rules 147 and 504

Rule 147. Securities Act Rule 147 is a safe harbor for intrastate offerings exempt from Securities Act registration pursuant to Securities Act Section 3(a)(11). The SEC is proposing amendments to Rule 147 to modernize the rule to allow intrastate offerings relying upon newly adopted and proposed crowdfunding provisions under state securities law, while retaining the ability of issuers to raise money solely from investors within the state where their "principal place of business" is located pursuant to state securities laws without concurrently registering the offers and sales with the SEC. The proposed amendments would, among other things:

- limit the availability of the exemption to offerings that are registered in-state or conducted under an exemption from state law registration that limits the amount of securities (1) an issuer may sell to $5 million in a 12-month period and (2) an investor may purchase;
- eliminate the restriction on offers, which would allow issuers to engage in general solicitation and general solicitation (including through the Internet) accessible by out-of-state residents, while requiring that sales be made only to persons that the issuer reasonably believes are residents of the state or territory in which the issuer has its "principal place of business;" and
- refine what it means to be an intrastate offering and ease some of the existing issuer eligibility requirements by, among other things, eliminating the requirement that an issuer must be incorporated or organized in the same state that it is conducting the offering, requiring only that the issuer have its "principal place of business" within the state and relaxing the quantitative tests that determine the in-state nature of the issuer's business.

As proposed, amended Rule 147 would function as a separate Securities Act registration exemption rather than as a safe harbor under Section 3(a)(11). If the proposed amendments are adopted, Section 3(a)(11) would continue to be available as a statutory exemption.

Rule 504. The proposed amendments would:

- increase the aggregate amount of securities that may be offered and sold under Securities Act Rule 504 during any 12-month period from $1 million to $5 million; and
- disqualify an issuer from relying on Rule 504 if any of the "bad actor" disqualification provisions in Rule 506(d) occur on or after effectiveness of the proposed amendments and require disclosure for disqualification events that occur before effectiveness.

The SEC noted that if the proposed amendments were adopted, Securities Act Rule 505 could have less utility to issuers. As a result, the SEC requests comment on whether Rule 505 should be repealed or retained in its current form or in a modified form.

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Andrews Kurth advises numerous public companies, including publicly traded partnerships, in a variety of industries and will continue to follow developments related to the topic of this client alert and other SEC rulemaking and guidance.

If you would like more information about the subject of this client alert and other corporate and securities law developments, please contact the authors or your Andrews Kurth representative in the Corporate Securities Practice Section.

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1. The SEC must adjust this dollar limit at least once every five years to reflect any changes in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics.

2. In the adopting release, the SEC noted that the issuance of a debt security raises questions about the applicability of the Trust Indenture Act of 1939 (TIA). TIA Section 304(b) provides an exemption for any transaction that is exempted by Securities Act Section 4 from the provisions of Section 5 of the the Securities Act. Thus, an eligible issuer offering debt securities under the crowdfunding rules would be able to rely on this exemption.

3. These dollar amounts are subject to adjustment by the SEC as discussed in note 1. An issuer wishing to sell more than the individual investment limits to accredited and institutional investors can seek to rely on other Securities Act registration exemptions.

4. The financial statements must include balance sheets, statements of comprehensive income, statements of cash flows, statements of changes in stockholders' equity and notes to the financial statements.