

## The Legal Intelligencer

# SEC Proposes Much-Anticipated Crowdfunding Rules, But Will Small Businesses Actually Crowdfund?

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On Oct. 23, the U.S. Securities and Exchange Commission (SEC) finally proposed rules to implement the crowdfunding provisions of the Jumpstart Our Business Startups Act of 2012 (JOBS Act). The crowdfunding provisions enable U.S. issuers to sell securities over the Internet without needing to register under the Securities Act of 1933, as amended. Crowdfunding is a new and evolving method of raising capital and has largely been successful in providing funding in the nonprofit sector, where it is sometimes referred to as crowdsourcing. Congress established a foundation for crowdfunding through the enactment of the JOBS Act in April 2012 and directed the SEC to adopt rules to implement the registration exemption provided by the statute by Dec. 31, 2012. As a result, these proposed rules from the SEC have been widely anticipated.

At the time the JOBS Act was enacted, the crowdfunding provisions were met with both enthusiasm and criticism. For very early-stage companies, the first round of capital can have a significant impact on the company's future. Companies at this stage are often too small to attract the interest of angel investors, and founders are forced to turn to friends and family for start-up funds. Crowdfunding is intended to enable these small, start-up companies to access capital at low cost. Critics, however, fear that there are insufficient safeguards to protect investors from fraud and the opportunistic scenarios that could be found over the Internet.

### **Overview of the Proposed Crowdfunding Rules**

The JOBS Act and the proposed rules would allow U.S. issuers that are not currently subject to SEC reporting requirements to raise up to \$1 million in a 12-month period through crowdfunding transactions, those over the Internet with additional restrictions described below. While there are no restrictions on the type of investor that may participate in such an offering, there would be limits on the amount an investor may invest in any 12-month period. Investors with an annual net income or net worth of less than \$100,000 can invest up to 5 percent of such net worth, or \$2,000, whichever is more, every 12 months. Investors with an annual income or net worth exceeding \$100,000 can invest up to 10 percent of such net worth (with no limit) every 12 months. The SEC considered whether to impose different limitations on different types of investors (i.e. retail versus accredited investors) but, recognizing other available exemptions, declined to impose such an investment limitation structure.

Crowdfunding offerings must be conducted over the Internet and can only be done through an exchange or funding portal that is registered with the SEC. The funding portal is subject to a number of requirements, including (1) ensuring it has a reasonable basis for believing that the crowdfunding company is complying with applicable rules; (2) ensuring that the company's disclosure is made publicly available for 21 days before securities are sold; (3) providing investors with educational materials; (4) taking measures to reduce the risk of fraud with respect to the crowdfunding transaction, and denying access to any company to the portal if it believes the company or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection; (5) making available information about the company and the offering; and (6) providing communication channels on the platform to permit discussions about the offerings listed in the funding portal. Most significantly, the intermediary is prohibited from providing investment advice or making recommendations regarding any offerings or companies.

Companies that engage in crowdfunding offerings are subject to certain disclosure and ongoing reporting requirements. In connection with an offering, a company must provide, among other things, (1) information about officers, directors and 20 percent owners; (2) a description of the company's business and business plans, number of employees, and the use of proceeds from the offering; (3) information about the risks of the offering and the price to the public of the securities being offered; (4) how the valuation of the securities was determined; (5) the target offering amount, the deadline to reach the target amount, and whether the company will accept capital in excess of the target amount; (6) information about related-party transactions and the financial condition of the company; and (7) certain financial statements. Depending on the target amount offered in a crowdfunding transaction during the trailing 12-month period, financial statements would have to be accompanied by a copy of the company's tax returns or reviewed or audited by an independent public accountant. Once a company has completed a crowdfunding offering, it would be required to provide annual reporting to the SEC with information similar to that provided in its offering statement, including financial statements. This ongoing reporting obligation would continue until (1) the company becomes a public reporting company, (2) all of the shares issued in crowdfunding transactions have been acquired by the issuer or a third party, or (3) the company goes out of business.

### **Viability of the Crowdfunding Exemption**

Given the various requirements set forth in the JOBS Act and in the proposed rules, many wonder how practical the crowdfunding exemption really is. Even the SEC has acknowledged this concern, stating that the proposed rules "could significantly affect the viability of crowdfunding as a capital-raising method for startups and small businesses."

While the crowdfunding exemption is intended to allow small businesses to access capital in a low-cost manner, companies may find that the exemption is more trouble than it is worth. The reporting and financial statement requirements may prove to be too much of a burden on a small company. The cost of preparing the required disclosure

and financial statements, not to mention compensation for the funding portal, could be significant for the small, start-up companies that are the intended beneficiaries of the crowdfunding exemption. A company that offers \$500,000 or more of securities is required to provide audited financial statements. Such company must then continue to provide audited financial statements for so long as it is subject to disclosure obligations under the crowdfunding rules. For some companies, the audited financial statements requirement may prove to be too large an expense and require too much management time and effort to be beneficial for the amount of funds raised.

Fraudulent behavior also remains a concern. The SEC built some measures into the proposed rules that are designed to prevent investor fraud. For example, funding portals will be required to create communication tools that would enable potential investors to share thoughts on companies trying to raise funds. Companies are also required to provide updating disclosure while conducting an offering. However, there are other areas of the proposed rules that some say weaken investor protection, such as the prohibition on intermediaries to provide any form of investment advice or recommendations to potential investors.

### **What's next?**

The SEC established a 90-day comment period and must review such comments and approve final rules before they are adopted. In the proposed rules, the SEC requested comment on 284 matters. Given the extensive nature of the proposal and the significance these rules will have on small companies, it is highly likely that it will take the SEC some time to adopt final rules. Only time will tell if companies will actually take advantage of the crowdfunding exemption in the way Congress envisioned. In the meantime, echoing its previous guidance, the SEC reminded issuers that, until final rules are adopted, issuers and intermediaries cannot rely on the crowdfunding exemption created by the JOBS Act.

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