

The Legal Intelligencer

Preparing for New Crowdfunding Regulations on the Horizon

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On May 16, Regulation Crowdfunding is set to come into effect. Regulation Crowdfunding or Rule 100(a) was adopted in October 2015 and is applicable to crowdfunding offerings conducted in reliance on Section 4(a)(6) of the Securities Act of 1933, as amended. In preparation for the effectiveness of the crowdfunding rules, the U.S. Securities and Exchange Commission (SEC) has issued a bulletin that serves as a guide for companies and investors, whose activities will be covered by Regulation Crowdfunding (the bulletin). This article summarizes the practical terms of the -crowdfunding rules and the bulletin.

What is Crowdfunding?

Crowdfunding is a method of raising capital through the Internet that is -expected to be used by smaller and emerging companies for a range of different purposes. Title III of the Jumpstart Our Business Startups Act of 2012 (JOBS Act) created a federal exemption under the securities laws so that this type of funding method could be used to offer and sell securities. Regulation Crowdfunding is designed to assist smaller companies with capital formation while codifying certain protections for investors of crowdfunded projects. It also creates a new entity--—a funding portal—to allow Internet-based platforms or intermediaries to facilitate the offer and sale of -securities without having to register with the SEC as brokers.

Because the medium for crowdfunding, that is the Internet, is widely accessible, -crowdfunding may be used to fund companies with relatively high-risk profiles and attract -investors with less investing experience than traditional public -securities offerings. Commentators, such as Todd Crosland, CEO and founder of Seed Equity Ventures, a broker dealer already operating and doing equity raises under the SEC's Regulation D Rule 506(c) rules for general solicitations regarding crowdfunding, have indicated that the purpose and -effect of Regulation Crowdfunding "is to allow non-accredited investors the ability to invest in startups, which was once only reserved for the elite few." Accordingly, Regulation Crowdfunding establishes strict guidelines and limitations for both companies and investors wishing to engage in crowdfunding efforts.

How must Crowdfunding be Completed?

An -offering of securities under Regulation Crowdfunding is required to be conducted through an intermediary, -either a broker or a "funding portal." Regulation Crowdfunding sets up a regulatory framework for these intermediaries, which must register with the SEC (although not as a broker and thereby becoming subject to the broker-related rules and regulations) and be a member of the

Financial Industry Regulatory Authority Inc. (FINRA). Intermediaries may not: (1) offer investment advice or recommendations; (2) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (3) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess, or otherwise handle investor funds or securities; or (5) engage in such other activities as the SEC, by rule, deems appropriate.

In addition, intermediaries must protect investors by:

- Providing investors with educational materials on how to use the platform.
- Supplying investors with information about the securities being offered, including resale restrictions, investment limitations and relevant information about the issuer.
- Offering communication channels on the portal through which investors may engage in discussions about the offering.
- Explaining the source, form and amount of compensation the intermediary receives for hosting the transactions.
- Taking adequate measures to reduce fraud, including having a reasonable basis for believing an issuer is complying with Regulation Crowdfunding, that the issuer is maintaining accurate records of its securityholders and that investors are in compliance with the investment limitations.
- Furnishing adequate notices and confirmations at each step of the investment process.
- Complying with requirements regarding completion, cancellation or reconfirmation of offerings' requirements.

What are the Limitations Applicable to Crowdfunding?

Pursuant to Regulation Crowdfunding, an issuer may only raise up to \$1 million in any 12-month period by means of crowdfunding. In calculating the amounts sold for purposes of this threshold, amounts sold by a predecessor or by an entity under common control with the issuer will be aggregated with the amounts sold by the issuer. There is no integration with other offerings however. In other words, an issuer may conduct other exempt offerings around the same time as its crowdfunded offering. In addition, there are no restrictions limiting the type of securities that may be offered and sold in reliance on the crowdfunding exemption. Thus, offerings may take the form of common stock, preferred stock, another form of equity interest in the issuer or debt.

Not all issuers may take advantage of Regulation Crowdfunding—those include: issuers who are not organized under the laws of a state or territory of the United States or the District of Columbia; issuers already subject to reporting requirements under the Securities Exchange Act of 1934, as amended; investment companies as defined in the Investment Company Act of 1940 or companies that are excluded from the definition of "investment company" under Section 3(b) or 3(c) of the Investment Company Act; and any additional issuer that the commission prohibits, by rule or regulation, are prohibited from issuing securities pursuant to Regulation Crowdfunding.

Crowdfunding investors are limited in the amount of their investment. An investor may not invest more than an aggregate of \$1 million in any 12-month period. This limitation is subject to exceptions based on the investor's net worth and annual income. An investor will be limited to investing: (1) 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 (2) 10 percent of the lesser of the investor's annual income or net worth, not to exceed an amount sold of \$100,000, if both annual income and net worth are \$100,000 or more. Further, subject to certain exceptions, securities purchased in a crowdfunding transaction cannot be transferred for one year.

What are the Reporting Obligations?

In addition to the limitations imposed on both crowdfunding issuers and investors, issuers are subject to certain disclosure requirements under Regulation Crowdfunding. Issuers will be required to complete a number of disclosure forms, including an initial disclosure about the offering on Form C, amendments to Form C to report material changes (Form C-A), periodic updates on the offering on Form C-U and ongoing annual filings (Form C-AR) until a filing obligation is terminated (Form C-TR).

Basic issuer information will be required to be disclosed on Form C, such as the issuer's name, the form of entity, the jurisdiction of formation, formation date, address, website, number of employees, the issuer's website on which an investor can find the issuer's annual report and the date by which such report will be made available, whether the issuer or any predecessor previously failed to comply with the ongoing reporting requirements of Regulation Crowdfunding. Further, the issuer will be required to set forth a discussion of the business, the use of proceeds, the targeted offering size, the offering price and its directors and officers.

What Liability do Companies and Intermediaries Risk in a Crowdfunded Offering?

An issuer will be liable to its investors in a crowdfunded transaction if the issuer, in the offer or sale of the securities, makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading. To avoid liability, the issuer must show that it did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. Regulation Crowdfunding also contains a number of safe harbors for nonmaterial deviations from a term, condition or requirement of Regulation Crowdfunding.

A Final Word

To what extent crowdfunding will be used to raise capital over the Internet is yet to be seen. Issuers, portals, brokers and advisors must carefully adhere to the rules of Regulation Crowdfunding so as to not neglect or overlook any obligations that may have ramifications on the use of other forms of capital-raising methods that could be essential for an emerging company. The bulletin acts as a summary of the regulations; however, care should be taken in reviewing, understanding and appropriately applying the final rules. In determining whether to conduct an offering in reliance on Regulation Crowdfunding, companies should consult legal counsel and financial experts to confirm

that they conduct the offering in compliance with SEC regulation and that they have the finances to support the costs associated with conducting such an offering.

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