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SEC Issues Proposed Crowdfunding Rules

On October 23, 2013, the Securities and Exchange Commission (the “SEC”) issued proposed rules to effect Title III of the Jumpstart Our Business Startup (JOBS) Act, enacted on April 5, 2012. Title III and the proposed rules provide the framework for companies to raise capital through securities offerings using crowdfunding. Below is a summary of the proposed rules.

OVERVIEW

New proposed Section 4(a)(6) of the Securities Act of 1933 allows certain issuers to sell up to $1 million of securities within a twelve-month period using crowdfunding, if such securities are sold through an “intermediary.” Securities sold through other exemptions would not count toward the $1 million limit, but issuers relying on simultaneous or nearly simultaneous offerings using other exemptions must be careful that all the rules for each offering are followed (e.g., a Rule 506(b) offering cannot be subsequently made to investors who learned of the issuer or investment opportunity through the issuer’s previous Section 4(a)(6) offering because it would violate the non-solicitation rules of the Rule 506(b) offering). In addition, when calculating the amount of securities an issuer has sold, the issuer must include securities sold by entities controlled by, or under common control with, the issuer, as well as any securities sold by a predecessor of the issuer in a Section 4(a)(6) offering. Amounts received from friends and family, gifts, grants or loans, and donations received from traditional non-securities-based crowdfunding would not be included in the calculation.

Securities sold in a Section 4(a)(6) offering must be sold through a “platform” hosted by an intermediary—either a registered broker or a “funding portal,” a new type of regulated entity that would register with the SEC. A funding portal would host a platform on which the terms of the offering will be displayed, investors comment on and discuss the offering, issuers respond to investors’ inquiries regarding the company and/or the offering, and investment commitments are made by investors. Funding portals would only be permitted to host offerings of crowdfunded securities under the new proposed rules but broker-dealers could continue to assist issuers with all types of equity offerings, including crowdfunded offerings.

INVESTORS

Each individual investor is limited in the amount it can invest in Section 4(a)(6) offerings within a twelve-month period. If the investor’s annual income and net worth are both less than $100,000, the investor could invest the greater of $2,000 or 5 percent of annual income or net worth in a twelve-month period. If the investor’s annual income or net worth is equal to or greater than $100,000, then the investor could invest up to 10 percent of the investor’s annual income or net worth in a twelve-month period (not to exceed $100,000). Net worth and annual income would be calculated according to the existing accredited investor rules and may be calculated jointly with the investor’s spouse. Issuers could rely on intermediaries’ efforts to determine that investors will not exceed these limits (as long as the issuer does not have actual knowledge that the investor has exceeded the limits).

Most communications between investors and issuers would occur on the intermediary’s platform. However, issuers would be allowed to advertise a simple notice directing investors to the offering on the intermediary’s platform. This notice would include no more than a statement that the issuer is conducting an offering, the name of the intermediary, a link to the intermediary's platform, the terms of the offering (amount of securities offered, nature and price of the securities, and the closing date of the offering period), and identifying information about the issuer (name, address, phone number, web address, email address of a company representative, and a brief description of the business of the issuer).

Within the platform itself, the issuer could communicate with investors in the publicly viewable forum, so long as the issuer clearly discloses its identity in each communication. Similarly, any person compensated by the issuer to promote the offering could only promote the offering on the platform and must clearly disclose the compensation (both past compensation and prospective compensation) each time the person makes a promotional communication.

When an investor does make an investment commitment, the investor would be able to cancel the commitment until 48 hours prior to the deadline identified by the issuer in the offering statement. Note that if the target amount of the offering is reached prior to the deadline, the issuer would be able to close the offering so long as the offering has been open for at least 21 days, investors are given notice of the new closing date at least five business days prior to such closing, and investors are given the opportunity to cancel their investment until 48 hours prior to the new closing date. On the other hand, if the target amount of the offering was not met prior to the deadline set forth in the offering statement, or if the issuer otherwise cancels the offering, the intermediary must notify the investors that the offering is cancelled and direct the return of investor funds within five business days.

Once an investor purchases a security in a Section 4(a)(6) offering, the security could not be resold for one year, other than to the issuer, an accredited investor, a family member, a personal or family trust, or as part of a registered offering.

ISSUERS

Issuers that participate in Section 4(a)(6) offerings would be required to make certain disclosures to investors in an offering statement that would be filed with the SEC and made available to investors on the intermediary's platform. All issuers would need to provide a narrative discussion of the issuer's historical results of operations, liquidity and capital resources. The SEC expects that many of the companies that will take advantage of Section 4(a)(6) offerings will be early stage companies and, therefore, anticipates that the discussion will not be as lengthy or as detailed as the Management's Discussion and Analysis section required of reporting companies.

The type of financial statements required to be provided by issuers would depend on the aggregate amount of all Section 4(a)(6) offerings made by the issuer in the previous twelve months. If the offerings are $100,000 or less, the issuer must provide its most recently filed tax return (if any) and financial statements that are certified as true and complete in all material respects by the principal executive officer of the company. For offerings that are more than $100,000 but no more than $500,000, the issuer must provide financial statements that have been reviewed (but not audited) by an independent public accountant. For offerings that are greater than $500,000, the issuer must provide audited financial statements. Finally, the financial disclosures must be provided by all issuers, even if the issuer has no operating history, although the SEC expects that the disclosures for these companies will not be long or complicated.

Issuers would also be required to provide other disclosures in the offering statement, including (among other disclosures), information about directors, officers, and 20 percent beneficial stockholders, a description of the intended use of proceeds from the offering, the price of the securities (or the method for determining the final price), a description of the ownership and capital structure of the issuer, the amount of compensation paid to the intermediary hosting the offering, the number of employees of the issuer, a disclosure of exempt offerings made in the last three years, a description of the business plan of the issuer, a discussion of material risk factors, a description of the material terms of any indebtedness of the issuer, and disclosure of certain related party transactions. The issuer must also identify the target amount of the offering, whether the issuer would accept amounts in excess of the target offering amount, the maximum amount the issuer would accept, and how oversubscribed shares would be allocated.

During an offering, the issuer must also file progress updates with the SEC when 50 percent of the target amount of the offering has been reached and again when 100 percent of the target has been reached. The progress updates must be filed within five business days of meeting the target amount, but if both the 50 percent target and the 100 percent target are met within five business days of each other, the two reports can be consolidated into one progress update. If the issuer sells securities beyond the target amount, the issuer would also be required to file a final progress update indicating that the offering has been finalized and reporting the final amount of securities sold in the offering.

After a Section 4(a)(6) offering, the issuer would be required to file and post on its website an annual report no later than 120 days after the end of the issuer's fiscal year. The information required on the annual report will be similar to the information required on the initial offering statement. The obligation to complete the annual report continues until the issuer becomes a reporting company, the issuer or another party purchases all the securities issued in a Section 4(a)(6) offering, or the issuer liquidates or dissolves its business. The issuer must file a final annual report with the SEC within five business days of the occurrence of one of these terminating events.

Issuers that are required to file the annual report and fail to do so for two consecutive years are prohibited to make subsequent Section 4(a)(6) offerings. In addition, the following issuers would be excluded from making Section 4(a)(6) offerings: non-U.S. issuers, reporting companies, investment companies (as defined in the Investment Company Act of 1940), 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. Furthermore, issuers could be disqualified from making Section 4(a)(6) offerings by bad actor rules that are substantially similar to the bad actor rules in SEC Rules 262 and 506.

INTERMEDIARIES

As noted above, there are two types of intermediaries: brokers and funding portals. Some of the proposed rules apply to intermediaries generally, but because funding portals are a new type of registered entity (and because registered brokers are already heavily regulated), many of the proposed rules relating to intermediaries apply specifically to funding portals.

Intermediaries are tasked with weeding out fraudulent issuers or offers, and they are required to conduct a background and securities enforcement regulatory history check on each issuer. Other than this requirement, the intermediary can rely on the representations of the issuer. Nonetheless, the intermediary would be required to deny issuers access to the platform if the intermediary believes the issuer or its offering would present a potential for fraud. Furthermore, the intermediaries' belief of potential for fraud need not be based on a reasonable basis, and intermediaries are therefore granted considerable discretion to exclude issuers from their platforms.

This discretion must be balanced by funding portals with the restriction that funding portals will not be allowed to offer investment advice or recommendations. The proposed rules state that funding portals can exclude certain issuers and offerings on their platforms only by objective criteria such as types of securities offered or issuers from specific industries or geographic regions. Thus, other than the belief of potential for fraud, funding portals could not use subjective criteria to exclude issuers and offerings because it would be deemed investment advice. Despite this restriction on providing investment advice, funding portals also would be granted a safe harbor to allow them to advise issuers about the structure or content of the issuer's offering, including preparing offering documents.

The proposed rules also prohibit a funding portal from soliciting purchases of securities offered on its platform and from compensating brokers or other agents for such solicitation. The proposed rules allow intermediaries to compensate a third party solely for directing issuers or potential investors to the funding platform (such as through an advertisement on a search engine), but an intermediary cannot compensate a third party for providing personally identifiable information of any investor or potential investor. Moreover, the compensation could not be based on the purchase or sale of a security.

While brokers can directly receive funds submitted by investors, funding portals would be prohibited from holding, managing, possessing or otherwise handling investor funds or securities. Thus, funding portals would have to set up an escrow arrangement with a bank and would direct investors to submit their investment funds to the bank, and the funds would be released to the issuer upon completion of the offering, or returned to the investor upon cancellation of the offering.

Other notable provisions of the proposed rules relating to intermediaries include the following:

- Intermediaries and intermediaries' directors, officers or partners must have no financial interest in the issuers that make offerings on their platforms. This rule would also prohibit issuers from receiving securities of issuers as compensation for hosting the offering on the intermediary's platform.
- When investors open accounts with an intermediary, the intermediary would be required to provide educational materials about Section 4(a)(6) offerings and other disclosures, including the manner in which the intermediary will be compensated for Section 4(a)(6) offerings.
- While officers and directors of issuers would not be prohibited from purchasing the issuer's securities in Section 4(a)(6) offerings, intermediaries are to scrutinize any purchases by these individuals for indications, such as repeated investment commitments and cancellations, that the purchases are designed to create an impression that the offering has reached or will reach the target amount.
- Funding portals could not effect secondary market purchases.
- Funding portals must have a fidelity bond with a minimum coverage of $100,000.
- Funding portals would have specific recordkeeping requirements and would be subject to inspections and examinations by SEC officials.
- Funding portals would be subject to Anti-Money Laundering monitoring and reporting requirements as well as existing privacy regulations (Regulation S-P, Regulation S-AM, and Regulation S-ID).

NEXT STEPS

The SEC has implemented a 90-day comment period, ending on February 3, 2014, after which the SEC will eventually issue the final crowdfunding rules.

If you have any questions about this topic, please contact a member of our **Venture Capital/Emerging Company** Practice Group.