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SEC Approves Final Rules for CrowdfundingBy [Bruce Newsome](#), [Bo Sartain](#), and [Lucy Liu](#)

The Securities and Exchange Commission (the "SEC") adopted the final rules to Regulation Crowdfunding on October 30, 2015, which implemented Title III of the JOBS Act to allow companies to raise capital through crowdfunding. The final rules are codified as Regulation Crowdfunding in furtherance of Section 4(a)(6) of the Securities Act of 1933. Regulation Crowdfunding creates a regulatory framework for small businesses and startups to raise capital by selling unregistered securities through an Internet-based platform to individual investors. Regulation Crowdfunding will be effective May 16, 2016, although funding portals may begin to register with the SEC starting January 29, 2016. Release No. 33-9974 can be found [here](#).

Background

Crowdfunding allows companies to use the Internet to raise capital, typically by soliciting small individual contributions from a large number of investors. Before Regulation Crowdfunding, websites such as AngelList already allow companies to sell unregistered securities to accredited investors. Other websites such as Kickstarter also allow companies to raise capital by offering goods or services that are not securities to non-accredited investors. Regulation Crowdfunding does not affect these two other types of crowdfunding, as it governs primarily the offer and sale of unregistered securities to investors regardless of accreditation.

Issuer Requirements

Under a crowdfunding offering, a qualifying company can solicit up to \$1 million in a 12-month period from non-accredited investors by offering securities through an intermediary that hosts the offering on an Internet website or a similar electronic medium. Such an offering can only be made through an intermediary, which can be either a registered broker-dealer or a registered funding portal.

A company that does not fall into the following categories is eligible to use Regulation Crowdfunding:

- A company that is not organized under or subject to the laws of a state or territory of the United States or the District of Columbia;
- A company that is a reporting company pursuant to the Securities Exchange Act of 1934;
- A company that is an investment company pursuant to the Investment Company Act of 1940;
- A company that is otherwise disqualified under Regulation Crowdfunding as a bad actor;
- A company that sold securities under Section 4(a)(6) during the 2 years preceding the current Section 4(a)(6) offering but did not file all the annual reports required; or
- A company that either has no business plans or has business plans to engage in a merger or acquisition with an unidentified company or companies.

While an issuer cannot advertise the terms of a Section 4(a)(6) offering, it can include: (i) a basic statement that such an offering is occurring; (ii) the name of the intermediary; (iii) a link to the intermediary's platform; (iv) the terms of an offering; and (v) certain factual information about the legal identity and business of the issuer. However, an issuer must be allowed to communicate with investors and potential investors through the intermediary's platform.

Investor Requirements

Unlike other private placement exemptions, investors who are offered and sold securities pursuant to a Section 4(a)(6) offering do not need to be accredited or sophisticated. However, an individual's annual income or net worth is used to determine how much he or she can invest under Regulation Crowdfunding. In a 12-month period, an investor can, in the aggregate across all Section 4(a)(6) offerings, invest up to: (i) \$2,000 or 5 percent of the annual income or net worth of the investor, whichever is greater, if either the investor's annual income or net worth is less than \$100,000 or (ii) 10 percent of annual income or net worth of the investor, whichever is greater but not to exceed \$100,000, if both the annual income and net worth of the investor are equal to or exceeds \$100,000. The calculations for annual income and net worth are the same as the calculations for such of accredited investors pursuant to Regulation D.

Intermediary Requirements

Regulation Crowdfunding requires Section 4(a)(6) offerings to be conducted exclusively through intermediaries. Such intermediaries must either be a broker-dealer registered with the SEC or a funding portal registered with the SEC. A funding portal engages in similar activities as a broker-dealer, but only in the context of Section 4(a)(6) offerings. To conduct any other types of offerings, a funding portal must register as a broker-dealer with the SEC.

Funding portals cannot engage in certain activities as intermediaries, while broker-dealers are not subject to the same restrictions in a Section 4(a)(6) offering. These restrictions include:

- Offer investment advice or recommendations;
- Solicit actual purchases, sales, or offers to buy the securities which are being offered or displayed on its platform or portal;
- Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform or portal;
- Hold, manage, possess or otherwise handle investor funds or securities; and
- Engage in such other activities as the SEC determines to be appropriate.

Regulation Crowdfunding also includes provisions applicable only to funding portals, which govern filing requirements, conditional safe-harbors for permissible activities, internal compliance requirements, and record-keeping requirements. Additionally, funding portals must register with the Financial Industry Regulatory Authority.

With limited exceptions, Regulation Crowdfunding does not allow an intermediary and its directors, officers, partners or persons performing other similar functions to have a financial interest in an issuer that is conducting a Section 4(a)(6) offering through such intermediary's platform.

An intermediary must make the issuer's Form C: Offering Statement (described below), any Form C: Progress Update filings (which are to be filed within five business days after each of the dates when the issuer reaches 50 percent and 100 percent of the target offering amount, respectively), and the terms of the offering publicly available on the intermediary's platform, in a format allowing potential investors to save such information, for a minimum of 21 days before any securities are sold in connection with the offering. This information must remain publicly available until the offering is completed or canceled. An intermediary may not restrict access to such information by requiring potential investors to first open an account with the intermediary before accessing such

information. However, investors cannot make a commitment regarding the offer or sale without first opening an account with the intermediary. Investors may cancel an investment commitment for any reason until 48 hours prior to the deadline included in the offering materials, and may only cancel within the 48 hour deadline for certain reasons as prescribed in Regulation Crowdfunding.

Under Regulation Crowdfunding, an intermediary must have a reasonable basis for believing that the issuer seeking to offer and sell securities under Section 4(a)(6) complies with all applicable requirements and has established means to keep accurate records of securities holders in connection with this offering. As part of its investigation, an intermediary must conduct additional inquiries, such as background checks and securities enforcement regulatory history checks. An intermediary can rely on the representations of the issuer that it has complied with applicable requirements and has established a record-keeping system, unless the intermediary has reason to question the reliability of such representations.

An intermediary must also have a reasonable basis for believing that the investor satisfies the investment limitations, such as annual income, net worth, or amount of aggregate Section 4(a)(6) investments. An intermediary may rely on the investor's representations concerning such compliance unless the intermediary has reason to question the reliability of such representations. Additionally, an intermediary must collect certain representations and questionnaires from the investor, which mostly concern whether the investor understands the terms and risks of a Section 4(a)(6) offering.

Filings with the SEC

Initial Filings

Prior to the commencement of the offering of securities, the issuer files its initial offering statement on Form C: Offering Statement with the SEC and must make this filing available to potential investors. Regulation Crowdfunding requires that the issuer disclose on this Form C, among other things:

- The name, legal status, physical address and website address of the issuer;
- The names and certain other information of the directors, officers and other persons holding similar status or performing similar functions of the issuer;
- The current number of employees of the issuer;
- The names of each person who is the beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities;
- A description of the business and any anticipated business plans of the issuer;
- A description of the purpose and intended use of the proceeds from the offering;
- The target offering amount, the deadline to reach the target, and whether the issuer will continue to accept contributions after meeting the target offering amount;
- Regular updates about the progress in meeting the target amount;
- A description of financial conditions and certain financial statements of the issuer (described below);
- The price of the securities or the method for determining the price;
- A description of the issuer's ownership and capital structure;
- The name of the intermediary and compensation paid for conducting the offering;
- Material factors that might make this particular investment speculative or risky;
- A description of material terms of any indebtedness of the issuer, including the amount, interest rate, maturity date and any other material terms;
- A description of exempt offerings conducted within the past three years by the issuer;

- Certain related-party transactions; and
- Any material information that is necessary in order to make any previously made statements, in light of the circumstances, not misleading.

One of the potentially burdensome provisions of Regulation Crowdfunding is the requirement that issuers file financial statements with the SEC. If the offering size is \$100,000 or less, the issuer must include in its Form C select line items of its most recent federal income tax returns and financial statements, which must be certified by the principal executive officer of the issuer as true and complete in all material respects. If the offering size is more than \$100,000 but less than or equal to \$500,000, the issuer must include financial statements that have been reviewed by a public accountant independent of the issuer. If the offering size is more than \$500,000, then the issuer must include audited financial statements by a public accountant independent of the issuer; however, in its initial Section 4(a)(6) offering of such size, the issuer can use financial statements that have been reviewed by a public accountant that is independent of the issuer. Such financial statements should be prepared in accordance with U.S. generally accepted accounting principles. The filing period for financial statements should include the two most recently completed fiscal years, or the period since the issuer's inception if shorter than two years.

Ongoing Reporting

Regardless of size, an issuer must also file its annual report with the SEC and make such report available on its website within 120 days after the end of the fiscal year. The annual report should include the results of operations and the financial statement of the issuer. Such ongoing disclosure requirements are required until: (i) the issuer becomes a reporting company; (ii) the issuer repurchases or another party purchases from the initial investors all of the shares issued under Section 4(a)(6); (iii) the issuer has filed at least one annual report and has fewer than 300 holders of record; (iv) the issuer has filed annual reports for at least the three most recent years and has total assets of \$10 million or less; or (v) the issuer liquidates or dissolves its business.

Resale Restrictions

Securities purchased pursuant to a Section 4(a)(6) offering have resale restrictions of one year, unless such securities are transferred: (i) to the issuer; (ii) to an accredited investor; (iii) as part of an offering that is registered with the SEC; or (iv) to a family member or equivalent of the purchaser, a trust controlled by the purchaser, a trust created for the benefit of a member of the family of purchaser or equivalent, or in connection with the death or divorce of the purchaser or other similar circumstances.

Potential Impact

Regulation Crowdfunding allows small businesses and startups access to a new venue in raising capital. While the SEC currently allows such companies to raise capital from non-accredited investors by soliciting cash for goods or services, Regulation Crowdfunding now permits non-accredited investors to share in the profits of the company. This may be more attractive to certain investors looking to invest who could not meet the standard of an accredited investor.

Additionally, if an issuer makes both a crowdfunding offering and another exempt offering (such as a Regulation D offering), the two will not be integrated as long as each offering complies with its own particular exemption requirements. This allows issuers multiple concurrent methods to raise capital without having to become a reporting company under the Securities Exchange Act of 1934.

However, the success and impact of Regulation Crowdfunding remains to be seen. Crowdfunding requires burdensome initial filings and ongoing disclosures with the SEC. Depending on the size of the offering, such small businesses and startups may need to employ additional financial and legal experts. The risk of legal liabilities in connection with a crowdfunding offering may be higher for issuers and intermediaries, as some non-accredited investors might lack the necessary financial and business skills to truly understand the risks associated with such an offering. An issuer can only raise up to \$1 million in a 12-month period under a crowdfunding offering, so the benefits of such capital-raising may be significantly offset by the potentially burdensome legal and financial costs incurred in connection with the offering. Finally, investors may not have any current meaningful exit options after the one-year holding period concludes, which increases the chances of suffering meaningful investment losses. Therefore, investors may be reluctant to invest in such offerings.

If you are considering raising capital under Regulation Crowdfunding or have any questions about this topic, please contact one of the following lawyers.

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