
Federal Crowdfunding: The SEC Final Rule

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Crowdfunding is an evolving method of raising capital through the Internet via individual and institutional investors. Equity based crowdfunding for small businesses generally has not been used because a public offer or sale of securities must be registered with the United States Securities and Exchange Commission (the "SEC"), and the cost is prohibitive. On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups (JOBS) Act, Title III of which established a framework intended to enable startups and small businesses to raise capital through securities offerings using crowdfunding through the Internet. The crowdfunding provisions of the JOBS Act conditionally exempt securities sold pursuant to a new Section 4(a)(6) of the Securities Act of 1933 (the "Securities Act") from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act").

The Title III crowdfunding exemption legalized interstate equity based crowdfunding and loosened the SEC regulations which prohibited soliciting investment opportunities from the general public. The JOBS Act tasked the SEC with adopting rules to implement and govern the crowdfunding exemption by the end of 2012. In November, 2015, after much deliberation and hundreds of comments from the public, the SEC published these final rules in a 685 page release.

Crowdfunding final rules govern the offer and sale of securities. The most notable change is that it permits individuals to invest in securities-based crowdfunding transactions, subject to certain investment limits. In addition, the new rules limit the amount of money an issuer can raise using the crowdfunding exemption, impose strict disclosure requirements and provide a framework for the regulation of registered funding portals and broker-dealers to facilitate the transactions.

The new crowdfunding rules and forms will be effective in May 2016, 180 days after they are published in the Federal Register.

1. CROWDFUNDING: Fundraising for Real Estate Developers and Companies

Raising capital from accredited and institutional investors using the Internet is an increasingly popular means of raising capital for new real estate ventures. By providing real estate developers with a direct link to prospective accredited investors, more than \$2 billion is expected to be raised through publicly soliciting private offerings of real estate investments by the close of 2015. Because crowdfunding offerings are limited to \$1 million, the newly finalized rules are designed for small companies, not for larger developers.

(a) OFFERINGS

Crowdfunding is designed to assist smaller companies with capital formation and to provide all investors with adequate protections. The new rules require individuals and companies to disclose certain information about their business and securities offerings, and enable issuers to advertise offerings without registering with the SEC and doing a full initial public offering.

To qualify for the exemption, crowdfunding transactions by an issuer company, including all entities controlled by or under common control with the issuer, must meet several requirements.

First, a company may not raise more than \$1 million through crowdfunding offerings in a 12-month period. Only securities sold under Section 4(a)(6) of the Securities Act are counted in determining the capital raised through crowdfunding. Capital raised through other exempt transactions is not included in determining cap imposed under crowdfunding rules. The second requirement is that an issuer company must conduct all crowdfunding transactions through a single, SEC-registered, funding portal or registered dealer-broker. Finally, companies that make offerings under the crowdfunding exemption are subject to strict disclosure and auditing regulations.

(i) Disclosure and Audit Requirements

Companies relying on the crowdfunding exemption must file an annual report with the SEC and provide investors with sufficient information to make a well informed decision. The key disclosure requirements under the new crowdfunding rules include: the price or method of determining the price of the security, a description of the business and the business plan, the intended use of the proceeds, the target offering amount and the deadlines to reach it, the company financial statements, the risks, and the person or persons behind the company. The required disclosure must be filed with the SEC and provided to prospective investors and the dealer-broker being used for the offering.

Under crowdfunding rules, the issuer company's financial statements must be audited by an independent auditor, provided that a company may opt out of the audit requirement if it meets the following requirements:

1. Company is a first time issuer under crowdfunding rules;
2. Company is offering between \$500,000 and \$1 million in securities;
3. Company provides financial statements reviewed by an independent public accountant; and
4. Company does not have available audited financial statements.

(ii) Ineligible Companies and Bad Actor-Style Disqualification

Under Section 4A(f), certain companies are not eligible to use the exemption, including non-U.S. companies, reporting companies under the Exchange Act, certain investment companies, companies that during the two years immediately preceding the filing of the offering statement failed to comply with the crowdfunding rules annual reporting requirements, companies without a business plan or companies that plan to engage in a merger or acquisition with an unidentified company or companies.

Furthermore, this disqualification applies to the issuing company if any "covered person" was involved in a "disqualifying event" such as securities-law related injunctions and restraining orders entered in the last five years and certain regulatory orders entered in the last ten years. Covered persons include:

1. The issuer, its predecessors and certain affiliates.
2. Any of the issuer's directors, officers, general partners or managing members.
3. Any 20% beneficial owner of the issuer (calculated by voting power).
4. Any promoter connected with the issuer at the time of sale.
5. Any compensated solicitor for the offering.
6. Any director, officer, general partner or managing member of a compensated solicitor for the offering.

(b) INVESTORS

The newly finalized crowdfunding regulations open up the doors to smaller investors. The old system allowed companies and entrepreneurs to publicly offer and sell securities only by a fully registered offering, or to conduct a limited offering to investors with relatively high annual incomes or net worth. Now, crowdfunding regulations allow suitable individuals to invest in securities-based crowdfunding transactions subject to certain investment limits. Anyone can now invest at least \$2,000, but beyond that amount, investors are still restricted based on income or net worth.

The new crowdfunding regulations permit individual investors, over a 12-month period, to invest in the aggregate across all crowdfunding offerings up to a predetermined limit based on the investor's net income or net worth. If the investor has a net worth or income of \$100,000 or less a year, he or she will be able to invest during any 12-month period, the greater of \$2,000 or 5 percent of the lesser of his or her income or net worth. If the investor has a net worth or income of more than \$100,000 per year, the investment threshold for any 12-month period is 10 percent of the investor's income or net worth, whichever is less. Under crowdfunding regulations, issuers may rely on their registered intermediary to determine whether an investor has reached the individual limits. This reliance is limited by the issuer's actual knowledge of the investor's limits, contrary to what is reported by the intermediary.

Regardless of the investor's status, the aggregate amount of securities sold during any 12-month period to an investor through all crowdfunding offerings may not exceed \$100,000. In addition, securities purchased in a crowdfunding transaction generally cannot be resold for one year.

2. CROWDFUNDING: Problems

The new crowdfunding regulations present obvious problems. First, by imposing a \$1 million cap, the new regulations limit the amount of capital a company can obtain through crowdfunding and the company will likely need to obtain additional capital from other sources. Second, limiting the amount that may be sold to an investor limits larger investors from making substantial investments in a company. Finally, the likely cost of registration and potential liabilities of a funding portal may deter most companies from assuming that role.

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