

Client Alert

SEC Proposes Long-Awaited Crowdfunding Rules

November 5, 2013. The SEC has finally released its long anticipated set of proposed crowdfunding rules under the JOBS Act of 2012.

“Crowdfunding” as a generic phenomenon has existed for a number of years, typically in the form of websites such as Kickstarter that facilitate the raising of money for business and non-business ventures in exchange for rewards not tied to the future returns of the venture. When the SEC’s final crowdfunding rules take effect, crowdfunding will for the first time become a permissible means of offering and selling securities to potential investors throughout the country.

The proposed rules are aimed at implementing a new exemption from registration under the Securities Act of 1933 for certain small offerings of securities made publicly over the internet to any type of investor, in which each investor invests only a small amount. Congress mandated the creation of the exemption in Title III of the JOBS Act, and observers have waited over eighteen months for the SEC to issue the proposed rules necessary to bring the exemption into effect.

The proposed rules are subject to a 90-day public comment period, after which the SEC is expected to issue its final rules, which would then take effect at the time or times specified in the final rules. Until the final rules take effect, in 2014 and possibly not until sometime in mid-2014, the crowdfunding exemption remains unavailable.

The following summarizes key aspects of the proposed exemption, some of which were dictated by Congress and are set forth in Section 4(a)(6) of the Securities Act, and the rest of which are set forth in the rules proposed by the SEC. Given the existing and proposed additional terms of the exemption, it is difficult to predict whether crowdfunding in its final form will find favor with issuers, investors and other market participants.

Limitation on Size of Capital Raise

The crowdfunding exemption will be available only for offerings in which no more than \$1 million is raised in a rolling, 12-month look-back period. This effectively limits the use of the new exemption to

fairly small capital raises. Issuers will be permitted to conduct separate, additional offerings, including under other exemptions from registration, while also conducting crowdfunding offerings, so long as offerings in which the general solicitation of investors is prohibited are not indirectly promoted through the marketing of the crowdfunding offering. Nevertheless, as a result of the limit on the amount of capital that can be raised, it seems unlikely that many issuers with substantial capital needs will make crowdfunding one of their preferred financing options.

Limitation on Amount of Investment by a Single Investor

Issuers may only sell limited amounts of securities to a single investor during a rolling, 12-month look-back period. For investors whose annual income and net worth is less than \$100,000, the limit is the greatest of \$2,000 or 5% of the annual income or net worth of such investor. For all other investors, the limit is the greater of 10% of their annual income or net worth, but not more than \$100,000. For purposes of determining whether the \$100,000 ceiling has been reached, sales to a single investor under different exemptions must be aggregated with the proposed crowdfunding sale. For example, if an accredited investor purchased \$50,000 of securities from an issuer under a Regulation D, Rule 506 offering 6 months ago, and the investor now wishes to invest in a crowdfunding offering being conducted by the same issuer, such investor would be limited to investing up to \$50,000 in the crowdfunding offering. As a result of these limitations, it seems unlikely that institutional and other higher-income and higher-net worth investors will make crowdfunding offerings one of their preferred ways of investing.

Limitation on Resales of Securities by an Investor

Securities purchased in a crowdfunding transaction cannot be resold for a period of one year, unless they are sold back to the issuer, resold to an accredited investor (as defined in Regulation D under the Securities Act), resold in an SEC-registered offering or transferred to family members as a result of events such as death or divorce. As a result, it is not expected that aftermarket trading in securities issued through crowdfunding offerings will develop quickly, if at all, and most crowdfunding investors should expect to have to buy and hold their securities.

Limitation on Manner of Sale: Only Through a Registered Broker or “Funding Portal”

All offerings and sales made pursuant to the crowdfunding exemption must be made through either an SEC-registered broker or a new type of entity, a “funding portal,” that is registered with the SEC and meets certain requirements. Funding portals are intended to be internet-based intermediaries that perform fewer services than brokers, and so are regulated more lightly than brokers. Simultaneously with the SEC’s release of its proposed crowdfunding rules, FINRA released for public comment its proposed rules for the regulation of funding portals.

Filing and Information Requirements

As a condition to the use of the crowdfunding exemption, an issuer will be required to provide, prior to the time of the offering, various specified types of information to investors, the SEC and the broker or funding portal. The issuer will provide the information by completing and filing the SEC’s proposed new Form C. Information required by Form C includes basic information such as the issuer’s name and

address, and also a list of the issuer's directors, officers and 20% owners, a description of its business and business plan, a narrative discussion of its financial condition and results of operations, risk factors, a description of its capital structure and information relating to the offering (including a description of the intended use of proceeds, a target offering amount, fundraising deadlines, the offering price and the method of its determination and a description of the issuer's securities). Notably, certain financial information will also have to be provided, with more information required the greater the sum of (i) the target amount to be raised and (ii) all other amounts that may have been raised by the issuer under the crowdfunding exemption during the last 12 months. When that sum is \$100,000 or less, the issuer will have to provide U.S. GAAP financial statements, certified to be correct by the issuer's principal executive officer, for its last two fiscal years (or less if it has been in existence for a shorter period of time), and its most recent tax return. When that sum is between \$100,000 and \$500,000, the issuer will have to provide U.S. GAAP financial statements reviewed by an independent public accountant, along with the accountant's review report. When that sum is more than \$500,000, the issuer will have to provide U.S. GAAP financial statements audited by an independent public accountant, along with the accountant's audit report.

In addition to the information provided prior to the offering, issuers will have to provide other updating information at periodic intervals, and post annual reports with information similar to the Form C information within 120 days of the end of each fiscal year.

Conclusion

The rules the SEC has proposed to implement the crowdfunding exemption are extensive and in many ways complex. In light of the various restrictions and limitations imposed originally by Congress, and now proposed by the SEC, it remains to be seen how well the exemption will function in easing access to the public capital markets for small companies, while protecting investors. The proposed rules are likely to be the subject of robust public comment, and may change in various ways before the SEC issues final rules.

If you have any questions concerning the proposed new crowdfunding rules, please feel free to contact the Morrison Cohen attorneys named below (or your usual Morrison Cohen contacts):

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