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SEC Invites the "Crowd" Into Equity Financing

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A Summary of the SEC's Final Crowdfunding Rules

On October 30, 2015, the Securities and Exchange Commission (the "SEC") adopted final rules ("Regulation Crowdfunding") and forms implementing the crowdfunding provisions of Title III of the Jumpstart Our Business Startups Act (the "JOBS Act") passed on April 5, 2012. Regulation Crowdfunding will allow private companies to offer and sell securities to non-accredited investors under specific conditions.

Crowdfunding is the practice of funding a project or business venture from a large number of people, the crowd, through an online platform. Before the SEC adopted Regulation Crowdfunding, private companies could generally only offer securities to accredited investors (e.g. those with income over $200,000/year or with a net worth over $1 million). Under Regulation Crowdfunding, a private company may raise, from unaccredited investors, up to $1 million in a 12-month period without registering the offering with the SEC. Additionally, issuers are required to provide disclosures to investors and prospective investors. Finally, issuers are required to use SEC-registered broker-dealers or Internet-based crowdfunding platforms, called "funding portals," to facilitate the offer and sale of securities in crowdfunding transactions.

Regulation Crowdfunding will become effective May 16, 2016. Form Funding Portal is effective December 22, 2015. Amendments to Form ID are effective January 29, 2016.

This alert summarizes the essential provisions of the final rules. Please refer to SEC Release Nos. 33-9974 and 34-76324; File No. S7-09-13; and Federal Register Vo. 80, No. 220 for more detailed information.

Rules related to issuers

To qualify for the crowdfunding exemption from registration provided by Section 4(a)(6) of the Securities Act of 1933, as amended (the "Securities Act"), an issuer must meet the offering requirements described below and must make their crowdfunding offerings through a broker or funding portal that meets the requirements described below under "Rules Related to Crowdfunding Platforms."

Crowdfunding investment restrictions

The amount an issuer raises *through crowdfunding offerings* must not exceed $1 million in a 12-month period.

Disclosures required of issuers

An issuer offering securities through crowdfunding must disclose in its offering documents, among other things:

- Price to the public or the method for determining the price, the target offering amount, the expected closing date, whether the issuer will accept investments in excess of the target amount, and procedures for an investor to cancel an investment commitment;
- A discussion of the issuer's financial condition (similar to Management's Discussion and Analysis but not as lengthy or detailed);
- Specified information about the issuer and its officers, directors and 20% or more stockholders;
- Certain financial disclosures are required in accordance with US GAAP;
- A description of the issuer's business, including ownership and capital structure, and use of proceeds from the offering;

- Description of the rights, restrictions, and limitations on any securities outstanding or being offered by the issuer, including debt securities;
- Material factors that make an investment in the issuer speculative or risky;
- Material terms of any indebtedness as well as any exempt offerings the issuer conducted within the past three years; and
- Certain related party transactions.

Financial disclosures

The financial disclosures an issuer is required to make depend on the size of the offering and whether this is the issuer's first reliance on Regulation Crowdfunding.

Size of Offering	Disclosures	Certification	Audit Required
Up to $100,000	Total income Total taxable income Total tax reflected on federal returns Financial statements	Certified by principal executive officer ("PEO")	No, but if financial statements have been audited, they must be provided and certification by PEO not required
$100,001–$500,000	Financial statements reviewed by an independent public accountant		No, but if financial statements have been audited, they must be provided
$500,001–$1,000,000 (relying on Regulation Crowdfunding for the first time)	Financial statements reviewed by an independent public accountant		No, but if financial statements have been audited, they must be provided
$500,001–$1,000,000 (previously relied on Regulation Crowdfunding)	Audited financial statements		Yes

Regulation Crowdfunding has specific forms to be filed with the SEC for the initial offering, any material changes to the offering, reports on the issuer's progress toward reaching the target offering amount, and a final report at the end of the offering.

Ineligible issuers

The following companies are not eligible to use Regulation Crowdfunding:

- Non-US companies;
- Issuers already reporting under the Exchange Act of 1934;
- Investment companies and certain companies excluded from the definition of investment company;

- Issuers that have been disqualified under the crowdfunding disqualification rules, including issuers with a "Bad Actor" disqualification substantially similar to the disqualification under Rule 506 of the Securities Act;
- Issuers that fail to comply with the annual reporting requirements during the two years immediately prior to the filing of an offering statement; and
- Issuers without a specific business plan or with a business plan described as merging with or acquiring an unidentified company or companies.

Rules related to investors

Regulation Crowdfunding limits how much an individual may invest, *in the aggregate across all crowdfunded offerings* in a 12-month period.

- If the investor's annual income or net worth is less than $100,000, then the greater of
  - $2,000 or
  - 5% of *the lesser of* annual income or net worth.
- If *both* the investor's annual income *and* net worth is equal to or more than $100,000, then 10% of *the lesser of* annual income or net worth, such amount not to exceed $100,000.
- Annual income and net worth are calculated in accordance with Rule 501(a) of the Securities Act Rules for determining whether an individual is an accredited investor.
- During the rolling 12-month period, the aggregate amount of securities sold to an investor through all crowdfunding offerings may not exceed $100,000.

The following table from the SEC's release provides examples of an individual investor's aggregate investment limits in a rolling 12-month period.

Examples of Aggregate Investment Limits in a 12-Month Period

Investor Annual Income	Investor Net Worth	Calculation	Investment Limit
$30,000	$105,000	Greater of $2,000 or 5% of $30,000 ($1,500)	$2,000
$150,000	$80,000	Greater of $2,000 or 5% of $80,000 ($4,000)	$4,000
$150,000	$100,000	10% of $100,000 ($10,000)	$10,000
$200,000	$900,000	10% of $200,000 ($20,000)	$20,000

$1,200,000	$2,000,000	10% of $1,200,000 ($120,000), subject to $100,000 cap	$100,000

Source: Securities & Exchange Commission

Other restrictions and exclusions

- Securities purchased in a crowdfunding transaction generally cannot be resold for a period of one year with limited exceptions.
- Holders of crowdfunded securities do not count toward the minimum stockholder threshold to require an issuer to register its securities under Section 12(g) of the Exchange Act, so long as the issuer meets certain requirements.
- An issuer may rely on its crowdfunding platform partner to determine whether an investor has reached the individual investor limits, so long as the issuer does not have conflicting information on the investor.
- An issuer may compensate a person to promote the offering but such promoter must identify itself as a promoter in all communications to investors and prospective investors. Crowdfunding platforms also must inform investors of any compensated promoters.

Rules related to crowdfunding platforms

Crowdfunding offerings must be conducted exclusively over the Internet through either a registered broker or a registered funding portal, the latter being a new type of registrant under the JOBS Act. These intermediaries must, among other things:

- Be registered with the SEC as a broker or a funding portal;
- Provide investors with educational materials about the risks of investing in general and about the specific crowdfunding offering, and other information that will be help the prospective investor decide whether to participate in a crowdfunding offering or to invest in the specific issuer;
- Confirm that each investor (1) has reviewed the educational materials, (2) can answer questions about the risks associated with investments in startups and emerging companies, and (3) affirms her or his understanding of the risk of loss and that the she or he can bear such a loss;
- Take measures to reduce the risk of fraud;
- Have a reasonable basis to believe that no investor has made Regulation Crowdfunding purchases in the aggregate, from all issuers, that exceed the limits for that investor;
- Make information about the issuer and the offering available to investors and prospective investors;
- Give each investor notification disclosing (1) the dollar amount of the investor's investment commitment; (2) the price of the securities, if known; (3) the name of the issuer; and (4) the date and time by which the investor may cancel the investment commitment;
- Provide communication channels about the offering on the crowdfunding platform to permit discussions among investors and with the issuer; and
- Facilitate the offering and sale of crowdfunded securities.

Under Regulation Crowdfunding, funding portals are prohibited from doing the following:

- Offering investment advice or making recommendations;
- Soliciting purchases, sales, or offers to buy securities offered or displayed on its platform;
- Allowing their officers, directors, and partners to have any financial interest in an issuer using their crowdfunding platform services;
- Compensating promoters and others for solicitations with a fixed fee or based on the sale of securities; and
- Holding, possessing, or handling investor funds or securities.

Additional requirements and information

Crowdfunding offerings will not be integrated with other exempt offerings so long as each offering complies with the relevant exemption for that offering. For example, if the company makes an exempt offering that prohibits general solicitation (e.g. under Regulation 506(b)) in parallel with a crowdfunding offering, the company should ensure that the purchaser's interest was independent of, or prior to, the crowdfunding offering.

Crowdfunding offerings must be conducted through an intermediary and exclusively over the Internet.

Conclusion

The number of investors in the United States who are accredited has been estimated anywhere from 3% to 8%. The adoption of Regulation Crowdfunding means investing in private companies, albeit on a limited basis, is now available to a large population of investors for whom such investments were previously unavailable. Many of these investors may not understand the risky nature of investing in private companies. Companies should be prepared to address this risk. Additionally, a company may have so many crowdfunding investors that it could face unexpected burdens in trying to communicate with them once they become shareholders.

Private companies that might at some point seek venture financing should consider how their crowdfunded offerings could affect the interest of venture capitalists. For example, how will the company need to structure VC financings to accommodate the number of stockholders who purchased securities in a crowdfunded offering?

Most small businesses do not have ready access to capital from angel investors and venture capitalists. Regulation Crowdfunding gives these businesses the ability to raise capital. At the same time, the anticipated effort and costs of offering securities under Regulation Crowdfunding, including legal, accounting,regulatory compliance, intermediate portal, advertising, promotion, and transfer agent fees, may make a crowdfunding offering too costly for the amount of money being raised. It is possible that, as the number of crowdfunding offerings increases, providers may adapt their services so that companies may find costs for supporting crowdfunding offering decreasing over time.

It remains to be seen whether Regulation Crowdfunding facilitates private investment from a new class of investors or whether the SEC's rules are too burdensome. We will monitor the adoption of crowdfunding as a viable method of raising private equity.

For more information about Regulation Crowdfunding, contact the attorneys listed above or a member of your Cooley client team.

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