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PERSPECTIVE

A few considerations before plunging into crowdfunding

By Glenn Luinenburg and Shahzia Rahman

The Securities and Exchange Commission has issued its long-anticipated proposals to implement crowdfunding under Title III of the Jumpstart Our Business Startups Act (JOBS Act). While the proposal brings budding entrepreneurs one step closer to easier and quicker access to capital, equity crowdfunding will only become available once final rules are adopted.

Navigating these new regulations will be challenging for investors and issuers alike. Below are the answers to seven basic questions issuers and potential investors will need to consider before taking the plunge once final rules are adopted.

Key Questions for Issuers

What kind of companies cannot crowdfund? While many companies will be able to take advantage of the crowdfunding exemption, there are limitations under the proposed rules regarding which issuers are eligible to crowdfund. Issuers that fall into the following categories will not be able to raise money via the crowdfunding rules:

» Issuers organized outside the U.S.

» Publicly traded companies, or companies that are otherwise subject to the reporting requirements of the Securities Exchange Act of 1934, as amended.

» Investment companies, as defined in the Investment Company Act of 1940 or companies that are excluded from the definition of investment company under Section 3(b) or 3(c) of the Investment Company Act.

» Issuers that have been disqualified from participating, either under Section 302(d) of the JOBS Act as a "bad actor" or because they failed to comply with the ongoing annual reporting requirements imposed on crowdfunding issuers described in further detail below.

» Issuers that do not have a specific business plan or who have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

How much money can issuers raise? Issuers will be able to raise up to $1 million over a 12-month period under the proposed rules.

What are the basic steps to do an offering? Issuers will be required to use an intermediary, such as a funding portal or a registered broker dealer. Their offerings must be made on the internet. The SEC noted that offerings made by other means would not be widely accessible to the public, which, in its view, would defeat the benefit of the collective wisdom of the members of the crowd.

Issuers also will be required to prepare an offering statement on Form C. The offering statement will need to be filed with the SEC and provided to the issuer's intermediary and current and potential investors. The offering statement must also be amended for any material change in the offer terms or disclosure previously provided to investors. Disclosure required in the offering statement includes, among other things:

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» Information about the issuer's officers, directors and beneficial owners of 20 percent or more of the issuer's stock.

» A description of the issuer's business, its anticipated business plan, the reason for the offering and the purpose and intended use of the offering proceeds.

» A description of the ownership and capital structure of the issuer.

» Financial statements (which may need to be reviewed by an independent accountant or formally audited, depending on the size of the offering).

» The material risks involved in the investment.

The proposal would also require an issuer to prepare and file with the SEC regular updates on its progress in meeting the target offering amount. These updates must also be provided to the issuer's intermediary and current and potential investors.

In addition, an issuer will not be able to broadly advertise its offering or generally solicit investors. Advertising is severely limited under the proposed rules and issuers are generally limited to advertising through the intermediary's platform.

The proposed rules permit issuers to publish a limited notice advertising certain terms of the offering, such as the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period. The notice must also include the address of the intermediary's platform on which additional information about the issuer and the offering can be found.

What obligations does an issuer have after the offering? Under the proposed rules, issuers that sell securities under the crowdfunding rules will be required to file an annual report on Form C with the SEC. This requires similar information to that provided in the offering statement, including disclosure about the issuer's financial condition that meets the financial statement requirements that were applicable to the offering statement.

The reporting obligations are effectively in place for the life of a private company and only end when an issuer (i) goes public or is otherwise subject to Exchange Act reporting obligations, (ii) repurchases all of the shares issued in reliance on the crowdfunding exemption or (iii) liquidates or dissolves.

Failure to make the required filings will disqualify an issuer from engaging in future crowdfunding efforts.

Key Questions for Potential Investors

Do I have to be an accredited investor? No, the proposed crowdfunding rules will allow anyone to invest, regardless of whether or not you are accredited. Your income does, however, limit the amount you can invest.

How much money can I invest? At the time of your investment, you will need to look back over the prior 12 months and calculate how much you have invested in crowdfunding offerings across all issuers. During this 12 month period:

» Investors with annual income and net worth of less than $100,000 can only invest the greater of (i) $2,000 or (ii) 5 percent of their annual income or net worth.

» Investors with an annual income or net worth of $100,000 or greater may invest 10 percent of their annual income or net worth, up to $100,000.

When can I resell the shares I purchase in a crowdfunding offering? Crowdfunded securities will not be transferable for one year unless the transfer is to the issuer, an accredited investor, as part of a registered offering, or to a member of the purchaser's family. Once the one-year holding period is up, the securities would be freely transferrable.

THE CUTTING EDGE

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While the proposed rules will liberalize the ways in which a company can raise money and open the door to a wide variety of investors, the burdens of ongoing disclosure requirements and the limitations on advertising may make crowdfunding a less attractive option to issuers.

With many optimistic that the SEC will implement final rules later this year, the balance between providing broader and more meaningful access to the capital markets to issuers and adequate protections for a large group of new and potentially unsophisticated investors may be a hard one to strike.

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