
New Crowdfunding Rules for Issuers: Opportunities or Landmines?

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As directed by Congress under the JOBS Act of 2012, the Securities and Exchange Commission (SEC) recently adopted final rules to permit equity and debt “crowdfunding,” characterized by the SEC as “a relatively new and evolving method of using the Internet to raise capital to support a wide range of ideas and ventures.”¹ The final rules, referred to as “Regulation Crowdfunding,” were published in the Federal Register on November 16, 2015, and become effective May 16, 2016.

While a comprehensive summary of Regulation Crowdfunding is outside the scope of this alert, below is a summary of the new rules. If you are an issuer or intermediary interested in exploring the feasibility of crowdfunding for your business, please consult your legal advisor at WilmerHale for further information.

Overview of Regulation Crowdfunding

In contrast to an Internet service like Kickstarter, which permits investors to invest funds in exchange for the promise of goods or services, Regulation Crowdfunding will permit the purchase and sale of debt and/or equity securities. Unlike certain other securities offering exemptions, such as Rule 506 of Regulation D, there are no restrictions under Regulation Crowdfunding on participation by unaccredited investors. As discussed below, however, Regulation Crowdfunding includes a number of provisions intended to protect investors who engage in these transactions, including investment limits, required disclosures by issuers and a requirement to use regulated intermediaries.

Generally under Regulation Crowdfunding, an issuer may raise up to \$1,000,000 in a 12-month period through crowd-funded offerings. An issuer engaging in a crowd-funded offering must complete and file the newly created Form C, which requires the public disclosure of certain business and financial information of the issuer, including financial statements prepared in accordance with US GAAP.

Conducting a Crowd-funded Offering

Individual Investment Limitations

On the investor side, the amount an individual may invest across all crowd-funded offerings in which

the investor participates during any 12-month period will depend on the individual's annual income or net worth:

- An individual with an annual income or net worth less than \$100,000 may invest the greater of \$2,000 or 5% of the lesser of their annual income or net worth; and
- An individual with an annual income or net worth equal to or more than \$100,000 may invest 10% of the lesser of their annual income or net worth, subject to a maximum aggregate investment of \$100,000.²

Capital Limits on Crowdfunding Activities

While Regulation Crowdfunding limits issuers to raising \$1,000,000 in a 12-month period, only capital raised in reliance on the crowdfunding exemption will be counted toward the limit although the amount of securities sold by entities controlled by or under common control with the issuer must be aggregated with the amount to be sold by the issuer, as well as any amounts sold by a predecessor of the issuer.³ Issuers will be permitted to conduct a concurrent exempt offering under another available exemption during a crowdfunded offering as long as the issuer complies with the respective rules applicable to each offering. Note, however, that a concurrent exempt offering involving general solicitation would be subject to the advertising restrictions described below.

Mandatory Use of Crowdfunding Intermediaries

As required by the JOBS Act, all transactions relying on Regulation Crowdfunding must take place on an Internet platform, exclusively through an SEC-registered “intermediary,” which can be either a registered broker-dealer or a “funding portal.”⁴ An issuer relying on Regulation Crowdfunding may only conduct a crowdfunded offering through one intermediary's platform at a time. Regulation Crowdfunding will require intermediaries to, among other items:

- Provide potential investors with educational materials on the use of the intermediary's platform, the securities being offered and the issuer;
- Provide communication channels to permit discussions about the offering on its platform;
- Disclose the source, form and amount of any compensation the intermediary receives in connection with the offering;
- Take certain measures to reduce the risk of fraud, including having a reasonable basis for believing that an issuer is complying with Regulation Crowdfunding, that an issuer has established means to keep accurate records of its securityholders and that any potential investor complies with applicable investment limitations; and
- *Not* permit any of its directors, officers or partners to have any financial interest in the issuer or itself receive a financial interest in the issuer as compensation for services provided to the issuer in connection with the offering (subject to limited exceptions).⁵

These requirements suggest that intermediaries will have to operate fee-for-service crowdfunding businesses that will impose meaningful out-of-pocket expenses on issuers. Of course it is too early to predict the extent to which a funding portal industry will develop or the extent to which registered broker-dealers will be willing to provide intermediary services.

Advertising Restrictions and Limitations on Other Public Announcements

Advertising outside of the intermediary's Internet platform for crowdfunding is limited under Regulation Crowdfunding. Any advertisement or public announcements made in connection with a crowdfunded offering, whether made directly by the issuer or indirectly by anyone acting on behalf of the issuer, must be limited to:

- A statement that the issuer is conducting an offering, the name of the intermediary through which the offering is being conducted and a link to its platform;
- The terms of the offering (limited to amount of securities offered, nature of securities, price and closing date); and
- The name, address, phone number and website of the issuer, as well as the email address of a representative of the issuer and a brief description of the business of the issuer.⁶

Regulation Crowdfunding does permit an issuer to communicate with investors about itself and the offering through the intermediary's platform, so long as the issuer identifies itself in all such communications. Other than the identification requirement, Regulation Crowdfunding does not restrict issuers from participating in such communications.⁷ However, we would counsel issuers to carefully evaluate them under the same standards of accuracy and truthfulness used for other publicly available communications, to protect against potential securities fraud claims.

If an issuer hires a promoter to promote an offering in intermediary communication channels, the issuer must take steps to ensure that the promoter clearly discloses the receipt of compensation each time the person makes a promotional communication, and that if the promoter's communications occur outside of the intermediary's platform they will be subject to the same content restriction that issuers face.⁸

Minimum Offering Timeline and Commitment Cancellations

Offerings must be held open for a minimum of 21 days during which investment commitments may be accepted. Potential investors are permitted to cancel their investment commitments until 48 hours prior to the deadline specified by the issuer for any reason. Within the final 48 hours prior to the deadline, investors may only cancel their commitments if there is a material change in the offering or the issuer's business as described below.

Limitations on Resale of Crowdfunded Securities

Securities sold in a crowdfunded offering generally may not be resold for a one-year period, unless the securities are transferred:

- To the issuer;
- To an accredited investor;
- As part of an offering registered with the SEC; or
- To a member of the family of the purchaser, to a trust controlled by the purchaser or created for the benefit of a family member, or in connection with the death or divorce of the

purchaser.⁹

State Blue Sky Requirements

Crowdfunded offerings will not be subject to state registration requirements under so-called “blue sky” laws.

Issuer Requirements

Certain Issuers Ineligible for Crowdfunding

Certain companies will not be eligible to take advantage of Regulation Crowdfunding. Ineligible companies include non-US companies, companies that are already reporting under the Securities Exchange Act of 1934, certain investment companies, companies that are subject to disqualification under the final rules (similar to “bad actor” disqualifications recently implemented by the SEC under Rule 506), companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding (discussed further below) during the two years immediately preceding the filing of the offering, and shell companies that have no specific business plan or that have indicated that their business plan is to engage in a merger or acquisition with an unidentified entity.¹⁰

Initial Issuer Disclosure Requirements

Issuers who want to rely on Regulation Crowdfunding will be required to file Form C electronically through the SEC's EDGAR system prior to commencement of the offering,¹¹ which must include, among other items:

- Its name, legal status, physical address and website address;
- The names of its directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20% of its voting equity;
- A description of its business, anticipated business plan and current number of employees;
- The target offering amount, the deadline to reach the target offering amount and whether it will accept investments in excess of the target amount;
- The purpose and intended use of the proceeds of the offering;
- The price to the public of the securities or the method for determining the price;
- The name and certain file numbers of the intermediary through which the offering is being conducted;
- The amount of compensation to be paid to the intermediary and any direct or indirect interest the intermediary has in the issuer;
- A discussion of the issuer's financial condition, including a discussion on the material factors that make an investment in the issuer speculative or risky;
- A description of the material terms of any indebtedness of the issuer;
- A description of any registration-exempt offerings conducted by the issuer within the preceding three years; and
- A description of certain related-party transactions.¹²

In addition to the above, the issuer will have to provide annual financial statements under US GAAP

(including each of a balance sheet, income statement, statement of cash flows, statement of stockholders equity and notes to the financial statements) covering the shorter of the two most recently completed fiscal years of the issuer, or the period since inception of the business. Such annual financial statements must be certified, reviewed or audited, depending on the amount of crowdfunding securities offered and sold by the issuer during a 12-month period as follows:

- For offerings of \$100,000 or less, financial statements certified as true and complete in all material respects by the principal executive officer;
- For offerings of more than \$100,000 but less than \$500,000, financial statements reviewed, but not audited, by an independent public accountant; and
- For offerings of more than \$500,000 (but less than the \$1,000,000 aggregate cap):
- If the offering is the issuer's first offering under Regulation Crowdfunding, financial statements reviewed, but not audited, by an independent public accountant; or
- If the offering is not the issuer's first offering under Regulation Crowdfunding, financial statements audited by an independent public accountant, provided, however, that in any of the foregoing, if the issuer has reviewed or audited financial statements available, the issuer must provide those notwithstanding any lesser applicable option above.¹³

Material Changes and Progress Updates

Issuers will be required to file reports through the SEC's EDGAR system disclosing material changes, additions or updates to information that it provides to investors for any offering that has not yet been completed or terminated. What constitutes a material change, addition or update will be a facts-and-circumstances analysis. There is no specified filing deadline for reporting material changes, additions or updates. Instead, following any such reports, investors must reconfirm their investment commitment within five business days or have their orders automatically canceled.¹⁴

Moreover, Regulation Crowdfunding will require issuers to provide progress updates about the issuer's progress toward meeting target offering amounts no later than five business days after the dates that an issuer reaches 50 and 100 percent of the target offering amount. If an issuer will accept proceeds in excess of the target offering amount, the issuer also would be required to provide a final progress update no later than five business days after the offering deadline, disclosing the total amount of securities sold in the offering. The progress report updates may be satisfied if the relevant intermediary for the offering makes the progress updates publicly available on its platform. However, if the intermediary does not provide such an update, the issuer will be required to file the progress updates itself through the SEC's EDGAR system. In addition, an issuer relying on the intermediary's reports of progress must still file a final report through the SEC's EDGAR system at the end of the offering to disclose the total amount of securities sold in the offering.¹⁵

Ongoing Annual Report Requirements

Issuers who want to utilize Regulation Crowdfunding also will be required to file (and post on their websites) annual reports covering most of the original information on Form C disclosed above, updated in all respects as applicable, by no later than 120 days after the end of each fiscal year.¹⁶

The primary difference between an annual report and the initial information provided is that the financial statements included for the most recent fiscal year with an annual report need only be certified by the principal executive officer of the issuer to be true and correct in all material respects (unless reviewed or audited financial statements are otherwise already available).

Issuers who have utilized Regulation Crowdfunding will be required to continue to file (and post on their websites) annual reports each year until they become public, repurchase all securities issued pursuant to the crowdfunding exemption, or liquidate or dissolve. Moreover, certain smaller issuers are provided other instances in which they will no longer have to provide annual reports:

- The issuer has filed at least one other annual report, and has fewer than 300 holders of record; or
- The issuer has filed at least three annual reports and has total assets that do not exceed \$10,000,000.¹⁷

Practical Takeaways from Regulation Crowdfunding

When Congress adopted the JOBS Act in April 2012, many budding entrepreneurs rejoiced at the prospect of easier and quicker access to capital to turn their ideas into money-making ventures. These entrepreneurs envisioned joining their tech-savvy competitors and colleagues in the new world of crowdfunding, where startups vie for average investors' dollars through website offerings unencumbered by the strict rules and regulations that govern other types of financings. In an economic environment in which traditional paths to capital for entrepreneurs, such as small business loans, can be difficult to access, crowdfunding offered what looks like an attractive funding alternative.

Despite its theoretical promise, the balance between facilitating broader and meaningful access to the capital markets to smaller companies and providing adequate protections for a large group of new and potentially unsophisticated investors has proved to be a hard one to strike. Indeed, in the JOBS Act itself, Congress imposed a number of significant statutory restrictions on crowdfunding and mandated the SEC to undertake substantial rulemaking to implement them. Thus, while the SEC certainly had some discretion through the rulemaking process, a number of the investor protection measures, including limits on investment amount, and mandatory use of intermediary platforms were directly required by Congress. While the rules the SEC proposed in October 2013 would liberalize the ways in which issuers can raise money, commentators believed that the burdens of the mandated disclosures, financial statements and other ongoing reporting requirements would seem likely to discourage smaller companies from raising capital through crowdfunding. The final rules are essentially the same as those originally proposed in October 2013. The most notable change from the proposed rules to the final rules is that financial statements only need to be reviewed by an independent public accounting firm (instead of audited) for offerings of more than \$500,000 but less than the \$1,000,000 aggregate cap.

An issuer considering a crowdfunded offering will need to weigh the costs and benefits of compliance with the regulations, including whether it has available the required financial statements and, more importantly, whether it is willing to publicly disseminate those financial

statements and other information about its financial condition and business mandated by Form C. The issuer should work closely with its lawyers and accountants to understand the expected costs and expenses associated with the initial filings and ongoing compliance with Regulation Crowdfunding. In addition, the issuer should consider the impact of having a large stockholder base early in its lifecycle, including the administrative costs and corporate governance challenges associated with crowdfunding stockholders.

It remains to be seen whether Regulation Crowdfunding strikes a feasible balance between facilitating capital formation and protecting investors. Some crowdfunding proponents remain optimistic that the final rules will facilitate a responsible emerging industry that will provide entrepreneurs with the capital they need to turn their ideas into reality.

¹ See Crowdfunding, Final Rule, Release Nos. 33-9974; 34-76324; File No. S7-09-13 at 6.

² Annual income and net worth should be calculated in the same manner in which they are calculated for purposes of determining accredited investor status under Rule 501 of Regulation D. *Id.* at 27, 548.

³ See *id.* at 18-19.

⁴ A funding portal will be required to register with the SEC and FINRA, but will not be able to conduct certain activities that registered broker-dealer may, such as offering investment advice or making recommendations, soliciting purchase, sales or offers to buy securities, and holding, possessing or handling investor funds or securities. See *id.* at 151-53. The registration process and FINRA requirements for funding portals are outside the scope of this alert. Potential funding portals will be able to begin registration beginning January 29, 2016.

⁵ See *id.* at 151-81.

⁶ See *id.* at 136-142.

⁷ "We believe that one of the central tenets of the concept of crowdfunding is that the members of the crowd decide whether or not to fund an idea or business after sharing information with each other. As part of those communications, we believe it is important for the issuer to be able to respond to questions about the terms of the offering or even challenge or refute statements made through the communication channels provided by the intermediary." *Id.* at 141.

⁸ See *id.* at 195-99.

⁹ See *id.* at 324-27.

¹⁰ See *id.* at 34-40.

¹¹ Regulation Crowdfunding does not formally define the "commencement" of an offering. However, the SEC has interpreted the term "offer" broadly in the past, explaining that "the publication of

information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer..." *Id.* at 142, quoting from Securities Offering Reform, Release No. 33-8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)] at 44731.

¹² *See id.* at 40-114.

¹³ *See id.*

¹⁴ *See id.* at 112-15; 564-65.

¹⁵ *See id.* at 109-12; 564-65.

¹⁶ *See id.* at 428.

¹⁷ *See id.* at 430.

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