

Crowdfunding: A New Way to Raise Capital Or A Cut-Back in Investor Protection?

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“Crowdsourcing” and “crowdfunding” have become popular terms for harnessing the power of the “crowd” (that is, the general public) to solve problems. On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (JOBS Act) and, in so doing, brought the popular fundraising technique known as crowdfunding into an unexpected arena: capital raising. Title III of the Act covers crowdfunding of securities. Its provisions allow companies to raise limited amounts of capital from a large pool of investors by adding an exemption from the registration requirements of the Securities Act of 1933. While some provisions of the Act have already taken effect, the SEC has 270 days to promulgate rules to implement the crowdfunding provisions.

Basic Framework

Under the Act, a transaction involving the offer and sale of securities is exempt from registration if it meets the following basic requirements:

Qualified Issuers. The issuer may not be a public company, investment company or foreign private issuer.

Limit on Total Amount Raised. The aggregate amount sold to all investors under the crowdfunding exemption in any 12-month period may not exceed \$1,000,000.

Limit on Amounts Sold to Individual Investors. The aggregate amount sold to any one investor under the crowdfunding exemption in any 12-month period may not exceed:

- For investors with annual income or net worth of under \$100,000 (calculated according to SEC calculation rules for accredited investors), \$2,000 or 5% of the investor’s annual income or net worth (whichever is greater);
- For investors with annual income or net worth of \$100,000 or more, 10% of the investor’s annual income or net worth with a cap of \$100,000.

Intermediary Requirement. The transaction must be conducted through a broker or funding portal (funding portals are discussed in greater detail below).

Disclosure and Registration Requirements. The intermediary and issuer both must comply with disclosure and reporting requirements specified in the Act and promulgated through the SEC rulemaking process (discussed below).

Specific Disclosure and Registration Requirements

The following are the disclosure and registration requirements that intermediaries and issuers must meet in order to qualify for the crowdfunding exemption from registration.

Requirements for Intermediaries. In addition to certain other requirements in the Act and set through SEC rulemaking, an intermediary, whether a broker or funding portal, engaging in a transaction under the Act must not compensate promoters, finders or lead generators. In addition, it must:

- Register with the SEC as a broker or funding portal and with any applicable self-regulatory organization;
- Ensure that investors review educational information and understand the risks associated with loss of investments generally and

startups specifically;

- Take steps to reduce the transaction's risk of fraud, including obtaining background checks for each officer, director, and holder of more than 20% of the issuer's shares;
- Provide the SEC and potential investors with basic information about the issuer (as disclosed by the issuer and discussed below);
- Provide offering proceeds to the issuer only when the target offering amount is reached or exceeded; and
- Ensure that no investor has exceeded the individual investment limit.

Requirements on Issuers. In addition to certain other requirements in the Act and set through SEC rulemaking, an issuer engaging in a transaction under the Act must not compensate any person to promote its offerings or advertise the terms of the offering except to send investors to the funding portal or broker handling the offering. In addition, it must provide to the SEC and investors annual operational and financial reports and provide to the SEC, the intermediary and the investors:

- Basic information about itself, including name, address, legal status, website, and names of officers, directors and holders of more than 20% of the issuer's shares;
- A description of its business and anticipated business plan;
- Financial information, with varying levels of detail as follows:
 - ▶ For offerings that have target amounts under \$100,000, the issuer's most recent tax return and financial statements certified by its principal executive officers;
 - ▶ For offerings with target amounts between \$100,000 and \$500,000, the issuer's financial statements reviewed by an independent public accountant; and
 - ▶ For offerings with target amounts of over \$500,000, the issuer's audited financial statements;
- The target amount and the deadline to reach the target amount;
- The price to the public of the securities or the method for determining the price; and
- A description of the ownership and capital structure of the issuer, including, among other things, a description of how the exercise of other shareholders' rights could negatively impact the purchaser.

Funding Portals

The Act creates a new exemption from broker-dealer registration for funding portals, subject to SEC rulemaking. Given the restrictions on issuers' and intermediaries' ability to provide compensation for promotion of offerings, it remains to be seen what the economic model will be for funding portals. A funding portal is defined as a person acting as an intermediary in a crowdfunding transaction that does not:

- Offer investment advice or recommendations;
- Solicit purchases, sales, or offers for the securities displayed on its website;
- Compensate employees, agents or others for such solicitation or for the sale of the securities displayed on its website; or
- Hold, manage or otherwise handle investor funds or securities.

Other Legal Issues

Liability. The Act imposes liability on an issuer for making an untrue statement of material fact or failing to state a material fact in a transaction under the Act. Any person who purchases a security under the Act may bring an action against such an issuer.

Importantly, the Act's definition of "issuer" includes any person who offers or sells a security in a crowdfunding transaction and, to the extent that they offer or sell a security in such a transaction, also includes the issuing company's directors, partners, and principal executive, financial and accounting officer(s).

Defining "issuer" in this way appears to be a significant expansion of personal liability to directors and officers, and it remains to be seen whether the uncertain scope of personal liability will inhibit crowdfunding transactions under the Act.

Restriction on Sales. Securities purchased under the Act may not be transferred 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.

Interaction with State Law. Securities offered under the Act are "covered securities" under the National Securities Markets Improvement Act of 1996, which preempts state regulation of crowdfunding transactions. However, states may still take enforcement action against an issuer or intermediary for fraud, deceit or other unlawful conduct.

Relationship with Rule 10b-9. Section 4A(a)(7) of the Act states that an intermediary may provide offering proceeds to the issuer only when the aggregate capital raised is equal to or greater than the target offering amount and that it must allow all investors to cancel their commitments to invest. Thus, the "all-or-none" nature of crowdfunding offerings implicates Rule 10b-9 of the Securities Exchange Act. Rule 10b-9 requires that, in an all-or-none offering, any money paid for the securities be "promptly refunded" to investors if all of the securities are not sold. The JOBS Act is silent on the issue of when investors are entitled to a "prompt refund." The SEC will likely promulgate rules on this point, but Rule 10b-9 may fill in some of the gaps for the time being.

What it Means

Businesses, investors and intermediaries are already preparing to engage in crowdfunding transactions. A company called Rock the Post calls itself a "business social network" and aims to bring together through its website entrepreneurs and funders. The company received venture capital financing in November 2011. Similarly, Arctic Island, a self-proclaimed crowdfunding platform, announced on April 9 that it closed on a \$200,000 angel investment to fund its website, which also aims to bring investors, entrepreneurs, and other interested parties into a specialized social network.

Although any number of websites would love to be the Facebook of the venture capital world, it remains to be seen to what extent business can truly take advantage of the Act's provisions. First, although some of her concerns were addressed in the final version of the Act, Chairman of the SEC Mary Schapiro has expressed misgivings about crowdfunding. Accordingly, the SEC may promulgate rules that limit the Act's provisions in significant ways.

Furthermore, small startups and those funding them should be concerned about the possibility of having large numbers of unsophisticated investors at such an early stage in the business's life cycle. The logistics for a small company to communicate with so many shareholders could prove daunting. Additionally, crowdfunding could negatively impact a business's ability to pursue future rounds of financing or acquisitions if funders or other companies steer clear of businesses with crowdfunding histories.

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