

Equity Crowdfunding Under Federal Law: Issuers

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On October 23, 2013, the Securities and Exchange Commission released proposed rules for implementing the crowdfunding exemption from the Securities Act registration requirements that is set forth in the Jumpstart Our Business Startups Act (JOBS Act). The equity crowdfunding exemption, which seeks to build on the popularity of rewards-based and donation crowdfunding through sites like Kickstarter and Indiegogo, would allow private companies to sell securities in small denominations to a broad range of investors over the Internet.

The proposed rules, which were due to be released at the end of last year, hew close to the statute and fill in the details of a fairly burdensome regulatory framework for both issuers and intermediaries, but do not go as far as some crowdfunding proponents had feared or as some investor protection advocates had hoped. The sheer size of the proposing release for the new rules (585 pages in the original PDF) should be enough to warn investors and issuers that equity crowdfunding is not “Kickstarter for stocks.” Heavy comments from both sides are expected during the 90-day comment period for the rules, and final rules are not expected to be in place until next summer at the earliest.

Until then, equity crowdfunding is not legal.

This alert focuses on the requirements for issuers in connection with use of the crowdfunding exemption. An alert focused on the requirements for intermediaries can be found by [clicking here](#).

Limitations on Size of Offering and Size of Investment

Under the proposed rules, an issuer may offer and sell securities in reliance on the crowdfunding exemption if:

- The amount raised by the issuer in reliance on the crowdfunding exemption during the 12-month period preceding the date of the proposed sale (including the amount to be raised in the proposed sale) does not exceed \$1 million;
- Investments by any single investor in the issuer during the 12-month period preceding the date of the proposed sale do not exceed:
 - ▶ the greater of \$2,000 or 5% of the annual income or net worth of the investor, if the annual income and net worth of the investor are less than \$100,000; and
 - ▶ the greater of 10% of the annual income or net worth of the investor (not to exceed an amount sold of \$100,000), if the annual income or net worth of the investor is \$100,000 or more; and
- Transactions must be conducted through an intermediary that either is registered as a broker or is registered as a new type of entity called a “funding portal.”

In addition, under the proposed rules, issuers relying on the crowdfunding exemption will be subject to certain disclosure, ongoing reporting and other requirements. Details regarding these requirements are described below.

General Disclosure Requirements

Under the proposed rules, an issuer offering securities in reliance on the crowdfunding exemption must file an “Offering Statement” on Form C with the SEC via EDGAR. The Offering Statement must also be provided to the issuer’s investors and intermediary and made available to potential investors. The Offering Statement must include extensive amounts of information regarding the issuer and the

offering, including:

- the names of the issuer's directors and officers and holders of 20% or more of the issuer's equity securities,
- information regarding the employment history of directors and officers,
- a business plan for the issuer,
- a discussion of the material factors that make an investment in the issuer risky,
- the target offering amount and the deadline for completion of the offering including a statement that if the target is not met, then no securities will be sold in the offering,
- a description of the intended use of the offering proceeds,
- a description of the process to complete the transaction or cancel an investment commitment,
- the price of the securities,
- a description of the capital structure of the issuer,
- the amount of compensation paid to the intermediary for conducting the offering,
- details of any indebtedness of the issuer,
- a description of exempt offerings conducted within the past three years,
- a description of related party transactions during the preceding 12-month period, and
- a description of the financial condition of the issuer.

Financial Statements

The Offering Statement on Form C would also require the issuer to file its financial statements, as follows.

For an offering that, when combined with other offerings made by the issuer during the preceding 12-month period in reliance on the crowdfunding exemption, targets an offering amount greater than \$500,000, the issuer must provide financial statements that have been audited by an independent public accountant.

For offerings greater than \$100,000 up to \$500,000, the issuer's financial statements must be reviewed (a technical term for an attest function that is less thorough than an audit) by an independent public accountant.

For offerings of \$100,000 or less, the issuer must provide previous income tax returns and its financial statements must be certified by its principal executive officer.

Continuing Reporting Requirements

Under the proposed rules, an issuer that has offered and sold securities in reliance on the crowdfunding exemption must file an "Annual Report" on Form C with the SEC via EDGAR. The Annual Report must include information regarding the results of the issuer's operations and financial statements. The Annual Report must also be posted on the issuer's website. An issuer must continue to comply with this annual reporting requirement until the earliest to occur of the following:

- The issuer becomes subject to Securities Exchange Act of 1934 (Exchange Act) reporting requirements (10-Qs, 10-Ks, etc.),
- The issuer or another party repurchases all of the securities issued in reliance on the crowdfunding exemption, or
- The issuer liquidates or dissolves.

Under the proposed rules, issuers must also file on Form C with the SEC via EDGAR (1) amendments to disclose any material changes or updates to the Offering Statement (if the offering has not yet been completed) and (2) progress updates to disclose the issuer's progress in meeting the target offering amount. These amendments and progress updates must also be provided to the issuer's investors and intermediary and made available to potential investors.

Excluded Issuers – Bad Actors

The proposed rules include “bad actor” disqualification provisions that are substantially similar to the recently adopted disqualification provisions of Rule 506 of Regulation D (which, in turn, are substantially similar to the disqualification provisions of Rule 262 of Regulation A).

Under the proposed rules, issuers would not be permitted to conduct offerings in reliance on the crowdfunding exemption if the issuer or certain other covered parties (including any predecessor of the issuer, any affiliated issuer, any director, officer, general partner or managing member of the issuer, any beneficial owner of 20% or more of the issuer’s outstanding voting equity securities, any promoter connected with the issuer in any capacity at the time of such sale, any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities, or any general partner, director, officer or managing member of any such solicitor) has a relevant criminal conviction, regulatory court order or has participated in another disqualifying event as described in the proposed rules.

Excluded Issuers For Other Reasons

In addition, under the proposed rules, an issuer would not be permitted to conduct an offering in reliance on the crowdfunding exemption if that issuer:

- Is not organized under the laws of the U.S.,
- Is subject to Exchange Act reporting requirements,
- Is an investment company, as defined in the Investment Company Act, or is excluded from the definition of investment company under Section 3(b) or 3(c) of the Investment Company Act,
- Has not complied with the annual reporting requirements described above during the two years preceding the filing of a Form C in connection with a proposed offering, or
- Has no specific business plan or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies.

No General Solicitation

The crowdfunding exemption does not permit general solicitation.

The proposed rules include advertising limitations with respect to offerings conducted in reliance on the exemption. Under the proposed rules, an issuer could publish a notice advertising certain limited terms of an offering (the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period) provided that the notice includes the address of the intermediary’s platform on which additional information about the issuer and the offering may be found. An issuer would not otherwise be permitted to advertise, directly or indirectly, the terms of an offering made in reliance on the crowdfunding exemption. The SEC did not propose limitations on how the issuer would distribute such notices, and the release accompanying the proposed rules contemplates the publication of such notices on social media platforms.

Offerings Must Be Conducted Via The Internet

The proposing release also noted that the SEC intends for all offerings that are made in reliance on the crowdfunding exemption to be conducted through use of the internet. The SEC noted that offerings made by means other than the internet would not be widely accessible by the public, which would defeat the benefit, in the SEC’s view, of the collective wisdom of the members of the crowd.

Insignificant Deviations From The Rules

The proposed rules include a safe harbor for certain insignificant deviations from a term, condition or requirement of the proposed rules. An issuer could rely on this safe harbor (and the exemption would not be lost) if the issuer could show that:

- The failure to comply was insignificant with respect to the offering as a whole,
- The issuer made a good faith and reasonable attempt to comply with all terms, conditions and requirements of the rules, and
- If the failure was a result of certain actions by the intermediary, the issuer did not know of such failure or such failure related to offerings other than the issuer’s offering.

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