

Management Alert



Overview of Proposed SEC Crowdfunding Regulations

On October 23, 2013 the Securities and Exchange Commission (the “SEC”) proposed Regulation Crowdfunding (“Regulation CF”) to implement the Crowdfunding provisions of Title III of the Jumpstart Our Business Startups Act of 2012 (the “JOBS Act”). The new rules mirror the provisions of Title III, expand the scope and requirements of the exemption in several key respects and establish the guidelines for issuers, intermediaries and investors in the Crowdfunding space. To be clear, Regulation CF addresses the on-line based issuance of securities to the general public without registration and represents a sea-change in the past eighty years of securities regulation.

Eligibility

Only private U.S. companies that are not subject to filing periodic reports with the SEC are eligible to rely on the Regulation CF exemption. Foreign issuers may not rely on the exemption. Investment companies under the Investment Company Act of 1940, as amended (the “Investment Company Act”), as well as companies exempt from the Investment Company Act pursuant to Sections 3(b) or 3(c) thereof (e.g., hedge funds) are likewise excluded from relying on the Regulation CF exemption. In addition, an issuer would be disqualified from relying on the Regulation CF exemption if:

- it failed to file an annual report required by Regulation CF during the preceding two years;
- it has no specific business plan;
- its business plan is to engage in a merger or acquisition with an unidentified company or companies; or
- any “bad actors” are involved in the offering process.

The proposed bad actor disqualifications under Regulation CF are substantially the same as the bad actor disqualifications under Rule 506(d) of Regulation D that became effective on September 23, 2013. A notable distinction is that while only executive officers of an issuer are subject to the bad actor disqualification provisions of Rule 506(d), the proposed Regulation CF bad actor disqualifications would apply more broadly to any officer of an issuer.

Offering Limits

Regulation CF provides that a company may offer and sell up to \$1,000,000 in securities in any rolling 12-month period. Although investors need not be accredited or qualified investors as those terms are defined by federal securities laws, they are subject to certain limits based on their annual income or net worth. If both the annual income and the net worth of an investor are less than \$100,000, then the aggregate amount of securities sold by a company to such investor in reliance on the Regulation CF exemption may not exceed the greater of \$2,000 or 5% of the annual income or net worth of such investor. If either the annual income or the net worth of an investor is equal to or greater than \$100,000, then the aggregate amount of securities sold by a company to such investor in reliance on the Regulation CF exemption may not exceed 10% of the annual income or net worth of such investor, up to a maximum of \$100,000.

The proposed rules further provide that existing rules and interpretations under Regulation D for determining accredited investor status shall apply to Regulation CF for purposes of calculating an investor's net worth or income. Notably this permits investors to aggregate their income and net worth with their spouses and excludes the value of an investor's primary residence from the net worth calculation.

Crowdfunding Requirements and Conditions

A Crowdfunding offering in reliance on proposed Regulation CF may only be effected through a single, on-line intermediary (a "Crowdfunding Portal"), which may be either a registered broker dealer or a funding portal. The issuer may not publicly solicit its offering or effect sales of the offered securities outside of the Crowdfunding Portal, but would be permitted to publish a notice of the offering that publicly discloses no more than the following information:

- A statement that the company is conducting the offering;
- The legal name, business address, phone number and website of the issuer, a brief description of its business and the e-mail address of a representative of the company;
- The name of the Crowdfunding Portal and a link to its website; and
- Terms of the offering limited to:
 - The name and nature of the securities;
 - The amount of securities;
 - The price of the securities; and
 - The closing date of the offering period.

Regulation CF requires an issuer to provide an offering statement that contains certain information about it and its business as set forth in Title III of the JOBS Act. The offering statement must be filed with the SEC on new Form C and would be furnished to investors through the Crowdfunding Portal. This information mandated by Form C includes the information that may be contained in the offering notice detailed above, as well as a business description and anticipated business plan, the financial condition of the company, the target offering amount, deadline to reach the target offering amount and updates on completion of target amount, use of proceeds, description of ownership and capital structure, and the names of directors, officers and beneficial owners of 20% or more of the issuer's equity securities and the amount of securities owned by each. To the extent the issuer pays any compensation to a promoter to market or endorse the offering within the funding portal or otherwise, the issuer must disclose such compensation.

In addition, Regulation CF would require the offering statement to include additional disclosure not mandated by Title III of the JOBS Act as follows:

- The name, SEC File No. and CRD of the Crowdfunding Portal;
- The compensation being paid to the Crowdfunding Portal, including any referral or other fees;
- A description of the material terms of any indebtedness of the company, including amount, interest rate and maturity date;
- All exempt offerings conducted within the past three years;
- Transactions with related parties;
- A discussion of the material factors that make an investment in the company speculative or risky;
- The number of employees of the company; and
- Certain securities legends customary in current private placement transactions.

The offering statement must include graduated financial information depending on the size of the offering. For instance, in an offering of up to \$100,000, the company must provide to the Crowdfunding Portal and investors its last filed income tax returns and financial statements prepared in accordance with U.S. GAAP and certified by the principal executive officer. For offerings more than \$100,000 but not more than \$500,000, the company must provide the Crowdfunding Portal and investors with financial statements reviewed by an independent auditor. For offerings in excess of \$500,000, audited financial statements are required and must be provided to the Crowdfunding Portal and investors and also filed with the SEC.

The proposed rules also would prohibit an issuer from compensating, or committing to compensate, directly or indirectly, any person to promote the issuer's offering through communication channels provided by the Crowdfunding Portal unless the issuer takes reasonable steps to ensure that the person clearly discloses the receipt (both past and prospective) of compensation each time the person makes a promotional communication.

Annual Reporting

After a company completes an offering in reliance on Regulation CF, the company would be required to file an annual report on new Form C-AR that updates all of the information in the Form C on an annual basis so that investors will have annual, current information on the financial condition and results of operations of the company. The Form C-AR must be filed with the SEC within 120 days of the end of its fiscal year. The annual report also must be furnished to investors by posting to the company's website.

Regulation of Crowdfunding Portals

A Crowdfunding Portal must be registered with the SEC either as a broker or funding portal and must be a member of a national securities association (e.g., FINRA). A non-broker may register as a funding portal with the SEC and, subject to compliance with the restrictions on Crowdfunding Portals, will remain exempt from having to register as a broker dealer with the SEC.

A non-broker would be able to register with the SEC by filing a form substantially similar too, though less extensive than, Form BD that is currently used for the registration of broker dealers ("Form BD Light"). Form BD Light would require a funding portal to provide the following information:

- Its legal name and principal place of business;
- Its disciplinary history, if any;
- Business activity, including the types of compensation it would receive;
- Control affiliates of the funding portal and their disciplinary history, if any;
- Its website address or other means of access; and
- Confirmation of its FINRA membership or membership with another national securities association.

Foreign persons or entities wishing to register as a funding portal would be subject to increased disclosure requirements as well as additional restrictions and regulation.

A Crowdfunding Portal may not 1) provide investment advice, 2) solicit purchases or sales of securities offered on its website, 3) compensate employees, agents or other persons for solicitation of the purchases or sales of securities on its website, or 4) hold, manage, possess or otherwise handle investment funds or issuer securities and must engage a third party to conduct such tasks. The proposed rules do not provided a definition for the term "investment advice," but the proposed rules do include a non-exclusive safe harbor for certain activities by a Crowdfunding Portal (discussed below).

The proposed rules also prohibit a Crowdfunding Portal from conducting secondary market activity in the securities issued through its website. In addition, neither the Crowdfunding Portal nor any of its directors, officers or partners may have any interest in the issuers on the Crowdfunding Portal, and such persons are prohibited from receiving a financial interest in the issuer as compensation for services to be provided to or on behalf of the issuer in connection with the offer and sale of tis securities.

The SEC intends a Crowdfunding Portal to play a watchdog role by ensuring the transactions conducted on its website are free from fraud. A Crowdfunding Portal may reasonably rely on the representations of both issuers and investors with respect to their compliance absent knowledge or indications that such representations are not true. The Crowdfunding Portal must deny access to its platform to persons subject to the “bad actor” disqualifications and must conduct a background and securities enforcement regulatory check on each issuer before it can access the platform. The funding portal also must provide all potential investors with educational materials describing investments in general and the risks associated therewith. Each investor must agree to receive all information electronically. The Crowdfunding Portal must establish a communication channel on its website to allow discourse between potential investors and issuers and foster the sense of community from which crowdfunding was initially derived.

Safe Harbor Activities for Crowdfunding Portals

Proposed Regulation CF includes a non-exclusive safe harbor for certain activities that would not be deemed to be investment advice or other activities expressly prohibited by Regulation CF Section 3(a)(80) of the Securities Exchange Act of 1934, as amended. The activities permitted by the proposed safe harbor include:

- Limiting offerings made on or through the Crowdfunding Portal based on eligibility requirements established by the Crowdfunding Portal;
- Highlighting and displaying offerings on the Crowdfunding Portal;
- Providing communication channels for potential investors and issuers;
- Providing search functions on the Crowdfunding Portal;
- Advising issuers on the structure or content of offerings;
- Compensation others for referring persons to the Crowdfunding Portal and for other services;
- Advertising the existence of the Crowdfunding Portal; and
- Accept investment commitments and direct the transmission of funds.

Summary

The SEC is soliciting significant comments on many provisions of proposed Regulation CF, including whether additional registration and reporting should be required of both issuers and Crowdfunding Portals. The comment period will remain open for a period of 90 days after the proposed rules are published in the Federal Register later this week.

The practicality of these regulations remains to be seen, as several costs and barriers to accessing crowd capital remain, however, many are hopeful that Regulation CF will provide a viable fundraising strategy for start-up companies. Now that the preliminary framework of the disclosure and registration rules under Forms C, C-AR and BD Light have been proposed, issuers and market participants interested in becoming Crowdfunding Portals can begin to adopt policies and procedures and develop appropriate infrastructures and internal controls to meet the requirements of the proposed rules.

This client alert is intended only to provide a brief summary of the proposed Crowdfunding rules. We invite you to participate in a special webinar on the new Crowdfunding rules on November 13, 2013, which you can register for [here](#).

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Seyfarth Shaw LLP Management Alert | October 30, 2013

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