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## Crowdfunding: The Real Thing Is Almost Here

In 2012, wanting to assist small businesses and boost job creation, Congress enacted the JOBS Act. Part of the JOBS Act requires the SEC to adopt rules to exempt crowdfunding offerings from registration under the securities laws. Last Wednesday, October 23rd, the SEC issued its long-awaited rule proposal on crowdfunding, bringing it one step closer to fruition.

Crowdfunding means different things to different people. Crowdfunding, crowdsourcing, and general solicitation in private offerings all seem to be mixed up together when people talk about crowdfunding. The SEC's recent rule proposal may seem confusing because many appear to already be involved in crowdfunding. To clear up any confusion and to help explain the SEC's rule proposal, the following briefly explains the current state of crowdfunding.

### What Is Crowdfunding?

First, the SEC is involved only with securities-based crowdfunding. If anyone sells securities, they must register the transaction with the SEC or have an exemption from registration. Securities-based crowdfunding will be one of these exemptions when the SEC adopts rules.

Other forms of capital-raising are often called crowdfunding, but there are important differences under the securities laws.

Some intermediaries currently "crowdfund" funds for a variety of projects, but the funding recipients do not issue securities in exchange for the money received. These intermediaries conduct donation-based capital raises that avoid securities regulation because there is no purchase or sale of securities. Examples include Kickstarter, Indiegogo, GoFundMe, and RocketHub. Although donors do not get securities, they typically get rewards for their money, such as a product of the company, a t-shirt, tickets to an event, etc.

Some intermediaries currently provide a web-based platform for issuers to connect with "accredited investors" in unregistered securities offerings, usually under the exemption for private offerings in Section 4(a)(2) of the Securities Act of 1933 (the "Securities Act"). This medium was expanded when Rule 506(c) of Regulation D went into effect in September 2013, permitting general solicitation and advertising in some unregistered offerings. Typically, broker-dealers licensed by FINRA – and regulated by the SEC and FINRA – operate these capital-raising websites, and only accredited investors may invest in these companies.

### The SEC's Crowdfunding Rule Proposal

The crowdfunding exemption proposed by the SEC, in accordance with the mandate in the JOBS Act, differs from the methods above. Generally, investors will receive securities in exchange for their capital contributions, and non-accredited investors may participate in the crowdfunding offerings.

The following provides a summary of the key aspects of the crowdfunding rules proposed by the SEC:

- Issuers may raise a maximum of \$1 million annually under the crowdfunding exemption. Amounts raised in other offerings under other exemptions would not count toward the maximum limit.
- The aggregate amount sold to any investor under the crowdfunding exemption in a 12-month period cannot exceed:
  - The greater of \$2,000 or 5 percent of the annual income or net worth of the

investor, if either the annual income or net worth of the investor is less than \$100,000; and

- Ten percent of the annual income or net worth of the investor, not to exceed the maximum aggregate amount of \$100,000, if either the annual income or net worth of the investor is \$100,000 or more. The annual income and net worth amounts are calculated according to the rules used to determine annual income and net worth for accredited investors. This means that the investor's primary residence will be excluded from the calculation and the investor's annual income and net worth may be calculated jointly with that of the investor's spouse.
- A securities transaction under the crowdfunding exemption must be conducted through a broker or funding portal that complies with the requirements of Section 4A(a) of the Securities Act.
- Crowdfunding offerings may be conducted only over the internet.
- Issuers may not be eligible for additional crowdfunding offerings if they have not met their annual reporting requirements during the two years immediately preceding the new offering.
- The proposed rules exclude certain issuers, including issuers without a specific business plan, registered public companies, foreign issuers, investment companies, and hedge funds.
- Issuers are required to disclose in filings with the SEC the following items, among others:
  - Shareholders holding more than 20 percent of the issuer's total outstanding voting securities;
  - The current business and the anticipated business plan;
  - Financial condition;
  - Use of proceeds;
  - Target offering amount, deadline to reach the target offering amount, and regular updates regarding the progress toward the target offering amount;
  - Price of the securities and the method used to determine the price;
  - Ownership and capital structure;
  - Risk factors;
  - Related-party transactions, since the beginning of the issuer's last full fiscal year, in excess of 5 percent of the amount of capital raised under the crowdfunding exemption during the preceding 12 months; and
  - Compensation paid to the intermediary.
- The proposed rules require financial disclosure to be filed with the SEC, provided to the intermediary, and made available to potential investors. Financial statements must be prepared in accordance with U.S. GAAP, covering the shorter of the two most recently completed fiscal years or the period since inception of the business. The level of financial disclosure depends upon the size of the offering:
  - Issuers offering \$100,000 or less:  
Income tax returns filed by the issuer for the most recently completed year and financial statements certified by the principal executive officer.
  - Issuers offering more than \$100,000 but not more than \$500,000:  
Financial statements reviewed by an independent public accountant.
  - Issuers offering more than \$500,000:  
Audited financial statements
- Securities purchased in a crowdfunding offering are subject to restrictions on resale for one year.
- Issuers may not advertise the terms of an offering under the crowdfunding exemption, but issuers may publish a notice advertising the terms of the offering if the notice includes the address of the intermediary's platform on which additional

information about the issuer and the offering may be found. These notices would be similar to tombstone ads permitted under Securities Act Rule 134.

- Issuers, officers, directors, general partners, managing members, 20 percent beneficial owners, promoters, and compensated solicitors are all subject to “bad actor” disqualification provisions. Disqualifying events include felony and misdemeanor convictions for securities fraud in the last 10 years, securities-related injunctions or court orders within the last 5 years, and certain SEC orders. The disqualification provision will require extra diligence from issuers to ensure that covered persons have not had a disqualifying event that would make the issuer ineligible for the crowdfunding exemption.
- A funding portal is any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to the crowdfunding exemption, that does not:
  - Offer investment advice or recommendations;
  - Solicit purchases, sales or offers to buy the securities offered or displayed on its platform or portal;
  - Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform or portal;
  - Hold, manage, possess, or otherwise handle investor funds or securities; or
  - Engage in such other activities as the SEC determines appropriate.
- FINRA has also issued proposed rules for funding portals and broker-dealers who will participate in crowdfunding offerings.
- After an issuer sells securities under the crowdfunding exemption, annual reports must be filed no later than 120 days after the end of the most current fiscal year covered by the report. Issuers must continue to file annual reports until:
  - The issuer becomes a reporting company under the Securities Exchange Act of 1934;
  - The issuer or another party purchases or repurchases all of the securities issued in crowdfunding offerings; or
  - The issuer liquidates or dissolves its business in accordance with state law.

## Conclusion

The proposed crowdfunding rules impose substantial requirements on issuers. Prior to deciding to pursue a crowdfunding strategy, we suggest that business owners consider the requirements that the SEC has proposed to impose on crowdfunding offerings and discuss with their advisers the impact and costs of these requirements. The proposed crowdfunding rules provide an exciting new opportunity for fundraising and may provide a good source of capital for the right issuers. Since the crowdfunding rules are only proposed rules, they are still subject to public comment and revision by the SEC prior to adoption. If parties would like to weigh in on the SEC’s proposed rules, they can submit comments on the proposed crowdfunding rules to the SEC within 90 days from the date the rule proposal is published in the Federal Register, which is expected to occur shortly.

If you have any questions, please contact the Venable attorney with whom you work, one of the authors, or a member of Venable’s **Corporate Finance and Securities Team**.

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