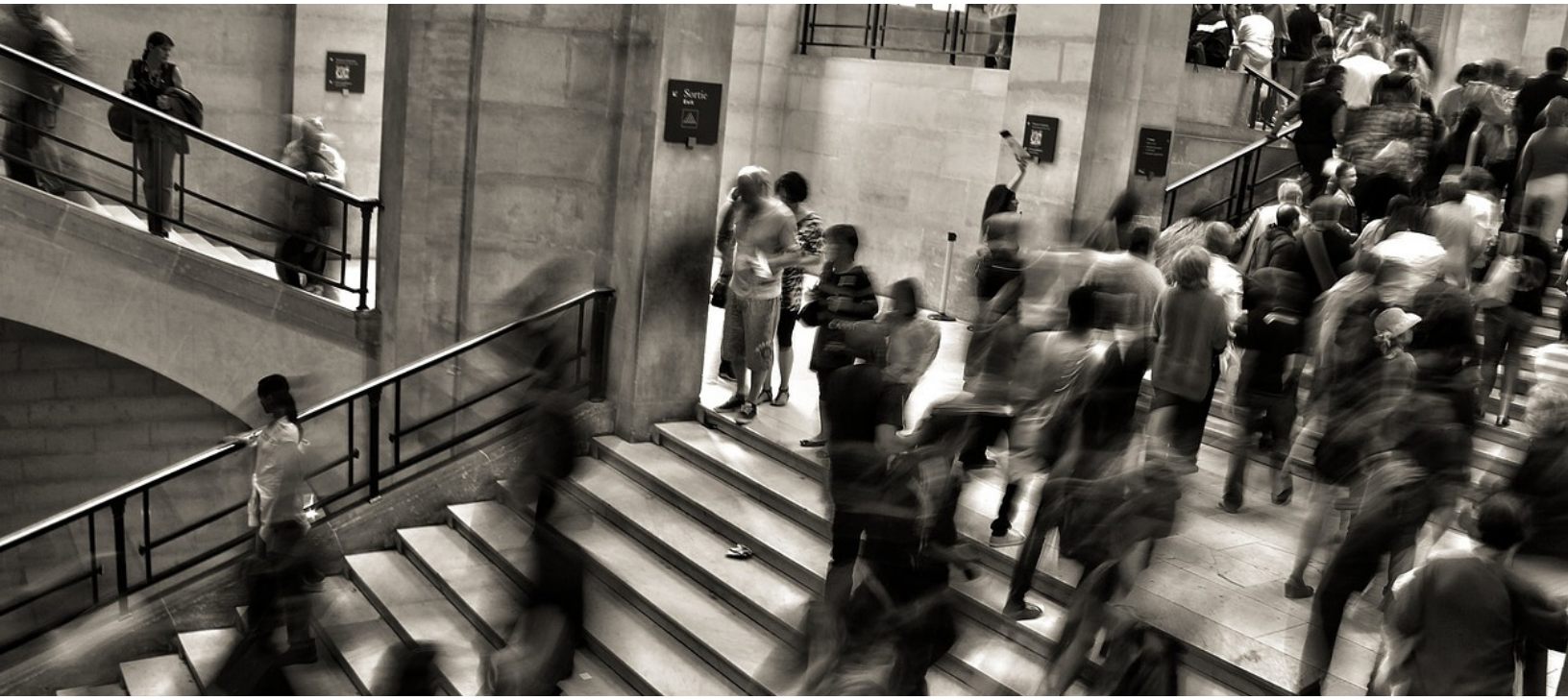
FINKEL LawGroup

THE EXECUTIVE'S GUIDE TO THE SEC'S FINAL CROWDFUNDING REGULATIONS

Why the Rules May Stymie Fund Raising Via the Internet



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The U.S. Securities and Exchange Commission (***"SEC"***) adopted its long-anticipated regulations to govern raising capital via crowdfunding transactions on October 30, 2015. The rules – known as "Regulation Crowdfunding" or "Regulation CF" – are mandated by Title III of the Jumpstart Our Business Startups Act ("***JOBS Act***"). These new rules govern the offer and sale of securities under Section 4(a)(6) of the Securities Act of 1933 ("***Securities Act***") through crowdfunding transactions. They also include provisions relating to the regulation of funding portals and broker-dealers (i.e., intermediaries) who facilitate the offer and sale of securities in those transactions. They are the last major rulemaking the SEC has undertaken to implement the 2012 JOBS Act.

Regulation Crowdfunding attempts to achieve a balance between creating a viable crowdfunding model for startups and small businesses while providing adequate protections for investors. The final rules establish a framework under which a large number of investors – the "crowd" – can invest in securities of privately held companies, particularly startups and small businesses, via the Internet. The rules became effective May 16, 2016. The forms that allow funding portals to register with the SEC became effective January 29, 2016. The full text of the SEC's final release can be found here[1].

1 This white paper is the first of several white papers Finkel Law Group will provide to clients and interested readers that contain information about the new regulations promulgated by the SEC to implement the various titles of the JOBS Act, and the expected impact of those new regulations on companies seeking to raise money through the sale of debt or equity securities.

Executive Summary

These new rules:

- Allow companies to raise investment capital through crowdfunding offerings of up to $1,000,000 in a 12-month period.
- Allow investors – whether accredited or non-accredited – to purchase securities in crowdfunding offerings calculated as a fixed dollar amount or percentage of the investor's net worth in each 12 month period.
- Require companies to disclose a substantial amount of information about their business and the securities being offered in crowdfunding offerings.
- Create a regulatory framework for registered funding portals and broker-dealers that companies are required to use as intermediaries in crowdfunding transactions.

While crowdfunding presents a compelling new financing option for many small issuers that currently have difficulty raising capital, compliance with the rules may prove disproportionately costly relative to the maximum amount of money that can be raised.

Companies that issue securities using this method will confront substantial compliance costs and potential liabilities associated with significant disclosure and reporting obligations the rules impose and the required use of a registered intermediary.

Other deterrents to crowdfunding include the $1,000,000 aggregate offering limit – which may not be enough money to make an issuer's business viable – and relatively low individual investment limits, which, by restricting the upside of each investment, may discourage investors and make it harder for companies to reach their funding targets.

Additional deterrents include advertising restrictions on crowdfunding transactions, which will limit the range of investors attracted to the company, and restrictions on transferring securities purchased in crowdfunding transactions, which will complicate investors' exit strategies.

These costs and limitations, as well as those discussed below, will likely limit the usefulness of crowdfunding as a capital raising alternative for startups and small businesses.

Crowdfunding Overview

The new rules implement section 4(a)(6) of the JOBS Act, which exempts from the public registration requirements of the Securities Act a company's ability to sell up to $1,000,000 in securities in a 12-month period so long as the offering is conducted through a broker-dealer or registered funding portal.

Crowdfunding transactions must be conducted exclusively on-line through one of these intermediaries to promote the formation of a "crowd" and allow participants to share information about the offering. Promoting the sale of securities through a single intermediary makes it easier to monitor the company's compliance with the offering limits and allows the intermediary to qualify investors who purchase the securities offered.

A company may rely on the intermediary's efforts to ensure that investors comply with the investment limits so long as the company does not have knowledge to the contrary about those investors.

Crowdfunding Requirements for Issuers

Types of Companies. While virtually any type of enterprise can raise capital through crowdfunding, certain issuers are not eligible to offer to sell securities via crowdfunding. They include the following:

- Non-U.S. companies;
- Companies considered "bad actors" as defined in a manner similar to the Rule 506(d) "bad actor" provisions in Regulation D;
- Investment companies and private funds;
- Reporting companies under the Securities Exchange Act of 1934 (***"Exchange Act"***);
- Companies that are delinquent in filing the on-going reports under the rules; and
- Companies with no specific business plan or whose business plan is to engage in a merger or acquisition with an unidentified company.

Types of Securities. There are no restrictions on the type of securities that may be offered and sold in reliance on the section 4(a)(6) exemption. Offerings may take the form of common stock, preferred stock, another form of equity interest in the company, or debt.

Investor Limits. The section 4(a)(6) exemption imposes certain limits on the total amount of securities that can be sold to any single investor during a 12-month period:

Investor's Financial Position	Aggregate Limits on All Crowdfunding Investments by Investor
Annual income or net worth < $100,000	Greater of: • $2,000 or • 5 percent of the lesser of the investor's annual income or net worth
Annual income and net worth ≥ $100,000	Lesser of: • 10 percent of the investor's annual income or • 10 percent of the investor's net worth • up to $100,000

For investors who are natural persons, annual income and net worth are calculated using the same method to determine accredited investor status under Rule 501(a) of Regulation D.

Restrictions on Transfer. Securities purchased in a crowdfunding transaction cannot be transferred for one year, unless they are transferred to the issuer, an accredited investor, as part of a registered offering, to certain members of the purchaser's family, the purchaser's trust, or in connection with the purchaser's death or divorce. Resale restrictions apply to any purchaser during the one year period. Absent the development of an active secondary trading market, resales may be limited far beyond the one year period.

Exemptions from Exchange Act. A company does not need to count the holders of securities purchased through a crowdfunding transaction when determining whether it meets the Exchange Act threshold for registration, as long as the company is current in its annual reporting obligations, has less than $25 million in assets, and retains the services of a registered transfer agent for shareholder recordkeeping.

Disclosure Obligations. A company seeking to raise money in a crowdfunding transaction must file specific disclosures with the SEC via Edgar. It also must provide those disclosures to the company's intermediary so it can make them available to investors. While generally less expansive and detailed than a registered public offering, a crowdfunding offering must still disclose the following:

- The company's name, legal status, physical address and website address;
- The names of each director and officer of the company, any person occupying a similar status or performing a similar function, and each person holding more than 20 percent of the company's shares;
- A description of the company's business and its anticipated business plan;
- A description of the company's financial condition, which must be certified by its principal executive officer, reviewed or audited by an independent CPA, depending on the size of the offering and whether the company has previously offered securities in reliance on section 4(a)(6);
- A description of the stated purpose and intended use of the proceeds of the offering made by the company with respect to the target offering amount;
- The type and terms of the securities offered including transfer restrictions;
- The target offering amount, the deadline to reach that amount, and regular updates on the company's progress in meeting the target offering amount;
- The price to the public of the securities or the method for determining the price;
- A description of the company's ownership and capital structure;
- The name, SEC file number and CRD number of the funding portal or broker-dealer through which the offering will be conducted;
- The amount of compensation paid to the intermediary to conduct the offering, including all referral and other fees associated with the offering;
- Any other direct or indirect interest the intermediary holds in the company or any arrangement for the intermediary to acquire such an interest;
- Risk factors;

- Information about indebtedness, prior exempt offerings and related-party transactions;
- Whether oversubscriptions will be accepted and, if so, how they will be allocated;
- Maximum offering amount, if different from the target offering amount;
- Current number of employees of the company;
- Selected and detailed financial data for the prior two fiscal years prepared in accordance with GAAP;
- The jurisdictions in which the company intends to offer the securities; and
- Any material information necessary to make the disclosures, in light of the circumstances under which they were made, not misleading.

The SEC's filing requirements include an optional question and answer format that companies may elect to use to provide the disclosures. Companies who use this format must prepare their disclosures by answering the questions provided and filing that disclosure as an exhibit to is submission to the SEC and intermediary.

Financial Statements. The financial statements a company discloses to investors for a crowdfunding transaction must be prepared in accordance with GAAP. For offerings of $100,000 or less, statements must be certified by the company's principal executive officer as true and complete in all material respects. For offerings of $100,000 to $500,000, statements must be reviewed by an independent CPA and include a signed review report. For offerings of more than $500,000 but less than $1,000,000, statements must be audited by an independent CPA and include a signed audit report.

Amendments to Offering Statements. A company must disclose material changes in the offering to investors. Once disclosed, investors must reconfirm their investment commitments within 5 business days. If an investor does not reconfirm her investment, it is cancelled and the funds must be returned. A "material" change is a facts-and-circumstances determination. Information is material if there is a substantial likelihood a reasonable investor would consider it important in deciding whether or not to purchase the securities. The final rules contain several examples of what the SEC considers material changes, including the issuer's financial condition, intended use of the proceeds, method of calculating the purchase price, and determination of the final purchase price.

Progress Reports. A company is required to file progress reports with the SEC to disclose whether it is meeting its target offering amount when it achieves the following milestones: (1) Commitments for 50 percent of the deal, (2) commitments for 100 percent of the deal, (3) subscriptions accepted in excess of the initial offering amount, and (4) when the offering closes.

Reporting Obligations. Crowdfunding companies are subject to ongoing annual reporting requirements under Section 4A(b)(4) of the Securities Act and Rule 202 of the new regulations. Each crowdfunding company must file an annual report with the SEC no later than 120 days after the end of the most recent fiscal year covered by the report. The report also must be posted to the company's website. The annual report must contain information similar to that required in the offering statement, including disclosure about the company's financial condition.

The SEC's final rules modified its original proposal requiring the company to include audited or reviewed financial statements in its annual report. The final rule allows the financial statements included in a company's annual report to be certified by the principal executive officer as true and complete in all material respects. If, however, the company happens to have financial statements that have been reviewed or audited by an independent CPA, it must provide them.

Advertising. The final rules prohibit companies from advertising the terms of an offering, "except for notices which direct investors to the funding portal or broker." The new rule describes the acceptable content of such notices, which can include no more than the following:

- A statement that the company is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the investor to the intermediary's platform;
- The terms of the offering (e.g., amount offered, type of security, price of security, and closing date of offering period); and
- Factual information about the legal identity and business location of the company, limited to the name of the company offering the security, the address, phone number and website of the company, the e-mail address of a representative of the company, and a brief description of its business.

The rules make clear that permitted notices will be similar to "tombstone ads" under Securities Act Rule 134, except that the notices are intended to direct an investor to the intermediary's platform through which the offering is being conducted, such as through a link directing the investor to the platform. The final rule does not restrict a company's ability to communicate other types of information that may occur in the ordinary course of its business that does not refer to the offering. The rules also do not provide a safe harbor for the release of such information into the marketplace.

Crowdfunding Requirements for Intermediaries

Crowdfunding transactions must be conducted exclusively on-line through an intermediary, which must be either a broker-dealer or funding portal. Companies relying on the new rules must conduct their offerings exclusively through one intermediary platform at a time.

Statutory Prohibitions & Safe Harbor. The rules place specific restrictions on funding portals consistent with their more limited activities and regulatory status than that of a fully registered broker-dealer. For example, the rule prohibits funding portals from, among other activities:

- Offering investment advice or making recommendations, even if incidental to the execution of a transaction;
- Soliciting purchases, sales or offers to buy securities offered or displayed on their platforms;
- Compensating promoters and other persons for solicitations or based on the sale of securities; and
- Holding, possessing, or handling investor funds or securities.

A non-exclusive safe harbor exists that allows funding portals to engage in certain restricted activities without running afoul of the rules. Portals can limit offerings and issuers allowed on the platform, highlighting and displaying offerings on the platform, advising company's on the structure and content of the offering, and cancelling offerings to avoid fraud or protect investors.

Registration with SEC. Funding portals must register with the SEC, and become a member of a national securities association, like FINRA. Although the types of activities in which funding portals may be engaged bring them within the definition of a "broker" under Section 3(a)(4) of the Exchange Act, the rule exempts funding portals that meet certain requirements from registration as a broker-dealer. All funding portals are required to have in place policies and procedures reasonably designed to prevent violations of federal securities laws and reduce the risk of fraud.

Requirements on Intermediaries. The rules also require intermediaries, including funding portals, to, among other things:

- Provide investors with educational materials that explain, among other things, the process for investing on the platform, the types of securities being offered, and the information a company must provide to investors, resale restrictions, and investment limits;
- Take certain measures to reduce the risk of fraud, including having a reasonable basis for believing that a company complies with Regulation CF and the company has established means to keep accurate records of securities holders;
- Make a company's required disclosures available to the public on its platform for a minimum of 21 days before any security is sold in the offering, and throughout the offering period;
- Provide communication channels to permit discussions about offerings on the platform;
- Provide disclosure to investors about the compensation the intermediary receives;
- Refrain from accepting an investment commitment from an investor until after that investor has opened an account with the intermediary;
- Have a reasonable basis for believing an investor complies with the annual individual investment limitations;
- Provide investors notices once they have made investment commitments and confirmations at or before completion of a transaction;
- Comply with maintenance and transmission of funds requirements; and
- Comply with completion, cancellation and reconfirmation of offering requirements.

Restrictions on Intermediaries. The rules prohibit intermediaries from engaging in certain activities, such as:

- Providing access to companies that they have a reasonable basis to believe have the potential to commit fraud or cause other harms to investors;
- Having a financial interest in a company that is offering or selling securities on its platform unless the intermediary receives the financial interest as compensation for the services rendered in connection with the offering made in reliance on Section 4(a)(6); and
- Compensating any person for providing the intermediary with personally identifiable information of any investor or potential investor.
- Obligation to Reduce the Risk of Fraud. Because intermediaries serve as gatekeepers, they must take certain steps to reduce fraud, including the following:
- Having a reasonable basis to believe a company complies with the rule and keeps accurate records of persons who purchase securities; and
- Denying access to the platform to any company the intermediary reasonably believes may engage in fraud in the sale of securities via the platform, or whose officers, directors or 20 percent shareholders have violated the bad actor rules.

An intermediary may reasonably rely on an issuing company's representations about its compliance with disclosure and recordkeeping requirements unless it has reason to question the reliability of those representations. An intermediary must investigate the regulatory history of each company and its directors, officers and 20 percent shareholders to determine if they are subject to a disqualifying event that prevents them from using the platform to raise funds via crowdfunding.

Qualifying Investors. Before accepting an investment from an investor an intermediary must have a reasonable basis to believe the investor meets the investment limits, and must obtain a written acknowledgment from the investor of certain risks associated with the investment. An intermediary may rely on the investor's representations unless it has reason to question the reliability of the representations. In turn, the company may rely on the intermediary's diligence so long as the company does not have knowledge to the contrary.

Other Requirements

No Integration. A crowdfunding offering will not be integrated with another exempt offering made by the issuer so long as each offering complies with the requirements of the applicable exemption being relied upon to offer and sell the securities. A company making concurrent offerings under Regulation CF, Regulation A, Regulation D (either a 506(b) or 506(c) offering) or some other exemptions should have robust procedures and on-going compliance monitoring processes in place to ensure the multiple offerings are kept separate, and the requirements of each exemption are continually met.

Promoter Compensation. A company may not compensate anyone to promote its offering through the communication channels on the intermediary's platform unless the receipt of such compensation is clearly disclosed with such promotional communications. The rules identify a number of reasonable steps a company can take to ensure proper disclosures.

Insignificant Deviations. The rules include a safe harbor for insignificant deviations from a term, condition or requirement of the rules. To qualify for the safe harbor, a company must show that:

- The failure to comply with a term, condition or requirement was insignificant with respect to the offering as a whole;
- The company made a good faith and reasonable attempt to comply with all applicable terms, conditions and requirements of the rules; and

The company did not know of the failure to comply, where the failure to comply was the result of the failure of the intermediary to comply with certain requirements, or such failure by the intermediary occurred solely in offerings other than the company's offering.

Despite the safe harbors, a company's failure to comply with Regulation CF remains actionable by the SEC.

Bad Actor Disqualification. The rule imposes bad actor disqualification provisions on issuers and intermediaries. With respect to companies, the disqualification provisions are substantially similar to those imposed under Rule 262 of Regulation A and Rule 506 of Regulation D. The final rule allows for a waiver from, and reasonable care exception to, these provisions. With respect to intermediaries, the rule imposes the disqualification provisions under section 3(a)(39) of the Exchange Act for broker-dealers.

State Preemption. Section 305 of the JOBS Act amended Section 18(b)(4) of the Securities Act to preempt the ability of states to regulate certain aspects of crowdfunding conducted under Section 4(a)(6). Under the preemption, companies need not register crowdfunding offerings or sales made under Section 4(a)(6) with the states. Section 305 of the JOBS Act also amended Section 15(i) of the Exchange Act so that intermediaries, including funding portals, will not have to comply with state registration or other requirements applicable to broker-dealers with respect to their crowdfunding activities.

Take Aways

As we have mentioned on our firm's blog, the initial and on-going requirements imposed on companies seeking to raise capital in crowdfunding transactions are substantial. It is too early to tell whether small businesses and startups will avail themselves of crowdfunding platforms to raise relatively small amounts of capital in light of these requirements. After all what company would spend upwards of $100,000 on attorneys and accountants to raise no more than $1 million in a single offering in a 12-month period.

Both federal and California law already contain several regulatory provisions – including Regs A, A+ and D – that impose far less onerous legal and accounting requirements, and allow companies to raise substantial sums of money from accredited and non-accredited investors alike. That said, only time will tell whether Regulation CF will facilitate equity crowdfunding via the Internet to the benefit of companies and investors alike or kill this potentially revolutionary method of raising capital by small companies and startups across the U.S.

Finkel Law Group, with offices in San Francisco and Oakland, has a thriving securities and corporate finance practice that over the last 20 years has helped hundred of privately held companies raise capital in the private equity and debt markets. We know our way around federal and state securities laws, and are adept at explaining in plain English what those requirements mean to you. The SEC's new crowdfunding rules are just one of many federal and states securities regulations in which we have expertise and provide advise and counsel to our clients. When you need intelligent, insightful, conscientious and cost-effective legal counsel to assist you with a securities or corporate finance transaction, please contact us at (415) 252-9600, (510) 344-6601 or info@finkellawgroup.com to speak with one of our attorneys about your transaction.

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