

## Services

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# SEC Proposes JOBS Act Crowdfunding Rules

On Oct. 23, 2013, the Securities and Exchange Commission (SEC) adopted proposed rules to permit the offering of equity securities via crowdfunding. In Title III of the Jumpstart Our Business Startups Act, known as the JOBS Act, a Senate amendment referred to as the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, or the CROWDFUND Act, created a new exemption from registration under Section 4(a)(6) of the Securities Act. Small offerings of securities to the public over the Internet were to be allowed without registration if the aggregate amount of securities sold by the issuer in the preceding 12-month period did not exceed \$1 million.

The SEC's proposed rules, "Regulation Crowdfunding," provide the framework for the exemption. The following is a summary of the 585-page proposal.

### **Crowdfunding Exemption**

If adopted, the proposed rules would implement the new Section 4(a)(6) exemption from the registration requirements of Section 5 of the Securities Act for certain crowdfunding transactions. As proposed, crowdfunding transactions would be required to meet the following requirements in order to qualify for the exemption:

**Limitation on capital raised.** The aggregate amount sold to all investors by the issuer in reliance on the exemption provided under Section 4(a)(6) during any rolling 12-month period must not exceed \$1 million. Capital raised through other means should not be counted in determining the aggregate amount sold in reliance on Section 4(a)(6). The dollar amount would be adjusted by the SEC not less than once every five years to reflect changes in the

Consumer Price Index.

**Investment limitation.** The amount sold to any one investor by an issuer under the exemption during any rolling 12-month period cannot exceed (1) if the investor's net worth is less than \$100,000, the greater of \$2,000 or 5 percent of the annual income or net worth of the investor; and (2) if the investor's net worth is equal to or greater than \$100,000, 10 percent of the annual income or net worth of the investor, not to exceed a maximum \$100,000 aggregate amount sold. Income and net worth of a natural person would be calculated in accordance with the SEC's rules for calculating the income and net worth of an accredited investor. The dollar amount would be adjusted by the SEC not less than once every five years to reflect changes in the Consumer Price Index. Issuers can rely on other exemptions to offer and sell additional securities to accredited investors and institutional investors (and, in some cases, investors that do not meet the definition of accredited investor).

**Transactions conducted through an intermediary.** A transaction in reliance on Section 4(a)(6) must be conducted through a single, online-only broker or funding portal that complies with the requirements of new Section 4A, which governs intermediaries.

**Exclusion of certain issuers from eligibility.** Certain issuers are excluded from eligibility to rely on the Section 4(a)(6) exemption, including (1) foreign issuers; (2) reporting companies; (3) investment companies and companies excluded from the definition of investment company under the Investment Company Act; (4) issuers that are disqualified as "bad actors" (as discussed below); (5) issuers that fail to file ongoing annual reports; and (6) issuers with no specific business plan.

## **Issuer Requirements**

Issuers themselves would be required under the proposed rules to comply with various requirements in order to rely on the new Section 4(a)(6) exemption. The proposed rules require issuers to file an offering statement on Form C: Offering Statement with the SEC and provide it to investors and the broker or funding portal, disclosing (1) general information about the issuer, its officers, directors and holders of more than 20 percent of the outstanding shares; (2) a description of the business and the business plan of the issuer; (3) the financial condition of the issuer; (4) the purpose of the offering

and the intended use of proceeds; (5) the target offering amount and deadline, as well as regular updates of the issuer's progress; and (6) the price of the securities and the method of determining it.

There is no proposed format for the disclosures required by Form C. The SEC envisions that the issuer and intermediaries would determine the best way to present the required information. The issuer would, however, be required to amend its offering statement by checking the box for Form C-A and including any material changes in the offering terms or the disclosure previously provided. Issuers would have to file annual reports via EDGAR by checking the box for Form C-AR and would be required to post the annual reports to their websites, although filing an annual report on Form C-AR would not make the issuer a reporting company under the Exchange Act of 1934. The annual report would provide investors with updated financial information about the issuer. Under the proposed rules, if the issuer (1) becomes a reporting company under the Exchange Act by having a class of securities registered under Section 12 or subject to Section 15(d) of the Exchange Act, (2) purchases (or a third party purchases) all of its outstanding shares, or (3) liquidates and dissolves its business, the issuer may check the box and file Form C-TR to terminate its Form C reporting requirements.

Issuers may advertise the terms of the offering similar to "tombstone" ads permitted under Securities Act Rule 134 but may only include (1) a statement that the issuer is conducting an offering, the name of the intermediary through which the offering is being conducted, and a link directing the potential investor to the intermediary's website; (2) the terms of the offering; and (3) factual information about the identity and business location of the issuer.

### **Intermediary Requirements**

Under the proposed rules, funding portals are persons (and their associated partners, officers, directors or managers) acting as intermediaries in transactions involving the offer or sale of securities for the account of others, solely pursuant to Section 4(a)(6), that do not (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy; (3) compensate employees, agents or other people for such solicitation or based on the sale of securities; or (4) hold, manage, possess or otherwise handle investor funds or securities.

Although funding portals are exempt from the requirement of Exchange Act Section 15(a) to register as a broker or dealer, new Section 4A(a)(1) requires intermediaries to register with the SEC as a broker or a funding portal and must register with the Financial Industry Regulatory Authority (FINRA) or any other self-regulatory organization that may become registered with the SEC in the future.

Intermediaries must take such measures to reduce the risk of fraud with respect to transactions made in reliance on Section 4(a)(6), including having a reasonable basis for believing that an issuer is in compliance with the relevant regulations and has an established means to keep accurate records of

holders of the securities it offers and denying access to the site if it believes the issuer or its offering would present a potential for fraud. Intermediaries must conduct background and securities enforcement regulatory history checks on the issuer and its associated partners, officers, directors and managers.

The SEC has proposed a nonexclusive list of safe harbor activities in which a funding portal may engage that do not run afoul of the limitations placed on funding portals, including:

Limiting offerings made on or through the funding portal's platform based on eligibility requirements.

Highlighting and displaying offerings on the platform.

Providing communication channels for potential investors and issuers.

Providing search functions on the platform.

Advising issuers on the structure or content of offerings.

Accepting investor commitments.

Compensating others for referring persons to the funding portal and for other services.

Advertising the funding portal's existence.

## **Miscellaneous Provisions**

**Restrictions on resales.** Securities issued in reliance on Section 4(a)(6) must be held for one year, except for transfers (1) to the issuer; (2) to an accredited investor; (3) as a part of an offering registered with the SEC; or (4) to a family member of the purchaser or in connection with the death or divorce or other similar circumstance of the purchaser.

**Availability of information to states.** Section 4A(d) requires the SEC to make, or cause the intermediary to make, offering statements and annual reports available to states. The SEC has taken the position that because it requires information to be filed on EDGAR, the information is publicly available and is therefore available to states. The SEC does not propose to impose any additional obligations on intermediaries to make information available to states.

**Exemption from Section 12(g).** Securities issued in reliance on Section 4(a)(6) are permanently excluded from the threshold number of shareholders of record for mandatory registration under Section 12(g) of the Securities Act. This exclusion is of the securities themselves, whether they are held by the original purchaser or any transferee. However, the issuer seeking to exclude a person from the record holder count has the burden of demonstrating that the securities held by the person were initially issued in a crowdfunded offering pursuant to Section 4(a)(6), which means the issuer will need to keep detailed records of transfers.

**Disqualification.** The SEC has proposed to disqualify certain felons and other bad actors from being able to rely on Section 4(a)(6). This “bad actor” rule is substantively identical to the “bad actor” rule recently adopted to apply to Regulation D offerings using general solicitation and general advertising.

### **What This Means to You**

As these rules are only proposed, issuers are not able to begin using crowdfunding to offer equity securities to the public via the Internet. We are, however, closer to the reality of online crowdfunding now that the rulemaking process has begun. The SEC has made a detailed request for comment on the proposed rules, and the comment period will be open for 90 days from the date that the proposal is published in the Federal Register. Time will tell whether the rules will be adopted as proposed or whether we will see any significant changes to the crowdfunding exemption.

Significantly, the JOBS Act added securities sold in crowdfunded offerings to the list of federally covered securities for which pre-emption applies, so securities sold in crowdfunded offerings will be exempt from state blue sky registration, documentation and offering requirements. However, both the state of the issuer’s principal place of business and the state in which the purchasers of 50 percent or more of the aggregate amount of the securities reside are permitted to require notice filings and fees for crowdfunded offerings. The JOBS Act also pre-empts state blue sky regulation of registered funding portals, except for examination or enforcement rules that are not in addition to or different from the requirements for funding portal registration established by the SEC.

### **Contact Information**

If you have questions concerning these or any other securities or corporate governance issues, please contact your Husch Blackwell attorney or one of our Securities & Corporate Governance attorneys.