

October 24, 2013



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The SEC's Proposed Crowdfunding Rules: May Not Be a Crowd Pleaser

On October 23, 2013, the Securities and Exchange Commission (the "SEC") released proposed rules under the Jumpstart Our Business Startups ("JOBS") Act to permit companies to offer and sell securities through crowdfunding. Companies have been able to use crowdfunding to raise money through small contributions from a large number of individuals without issuing securities (but often by providing a product or a gift) through popular websites such as Kickstarter and Indiegogo. However, because of federal and state securities laws, crowdfunding has not been available to companies seeking to raise capital through the issuance of securities. If the SEC's proposed crowdfunding rules are ultimately adopted, this could change.

Under the Securities Act of 1933 (the "Securities Act"), an offer or sale of securities must be registered with the SEC unless an exemption from such registration is available. Subject to the SEC adopting final rules, Title III of the JOBS Act amends the Securities Act to provide a new exemption from the SEC's registration requirements for crowdfunding. Under the SEC's proposed rules, a new registration exemption (Section 4(a)(6)) would be available from the SEC registration requirements under certain conditions, including:

- the aggregate amount sold to all investors by the issuer in reliance on the crowdfunding exemption during the 12-month period preceding the date of such transaction is not more than \$1,000,000;
- the aggregate amount sold to any investor by the issuer in reliance on the crowdfunding exemption during the 12-month period preceding the date of such transaction does not exceed the greater of:
 - > the greater of \$2,000 or five percent (5%) of the annual income or net worth of such investor, as applicable, if both the annual income and the net worth of such investor is less than \$100,000; and
 - > ten percent (10%) of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of such investor is equal to or more than \$100,000;
- the transaction is conducted through a registered broker-dealer or an SEC compliant "funding portal" (defined as intermediary in a crowdfunding transaction that does not:

(a) offer investment advice or recommendations; (b) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (c) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (d) hold, manage, possess, or otherwise handle investor funds or securities; or (e) engage in such other activities that the SEC determines are inappropriate);

- the issuer must be a domestic company that is not subject to the reporting requirements under the Securities Exchange Act of 1934 and may not be an investment company, a private investment or hedge fund, a shell company or a blank check company;
- the issuer provides the SEC (through the EDGAR public filing system), investors and the relevant broker-dealer or funding portal with certain information on a new Form C, including:
 - > the names of the directors and officers and each person holding more than 20 percent of the shares of the issuer;
 - > a description of the business of the issuer and the anticipated business plan of the issuer;
 - > a description of the material risks of the investment;
 - > a description of the financial condition of the issuer including for offerings that, together with all other crowdfunding offerings of the issuer within the preceding 12-month period, have in the aggregate, target offering amounts of:
 - \$100,000 or less: (a) the income tax returns filed by the issuer for the most recently completed year (if any); and (b) financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects;
 - more than \$100,000 but not more than \$500,000: financial statements reviewed by an independent public accountant using professional standards and procedures for such review or standards and procedures established by the SEC by rule for such purpose; and
 - more than \$500,000 (or such other amount as the SEC may establish by rule): audited financial statements;
 - > a description of the stated purpose and intended use of the proceeds of the offering;
 - > the target offering amount, the deadline to reach the target offering amount and regular updates regarding the progress of the issuer in meeting the target offering amount;

- > the price to the public of the securities or the method for determining the price provided that, prior to the actual sale, the issuer must disclose the final price in writing to the investors, and the issuer must provide the investors with a reasonable opportunity to rescind the commitment to purchase the securities; and
 - > a description of the ownership and capital structure of the issuer, including (a) the terms of the securities being offered and each other class of security of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including how the rights of the securities being offered may be materially limited, diluted, or qualified by the rights of any other class of security of the issuer; (b) a description of how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered; (c) the name and ownership level of each existing shareholder who owns more than 20 percent of any class of the securities of the issuer; (d) how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions; and (e) the risks to purchasers of the securities relating to minority ownership in the issuer, and the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties.
- the issuer cannot advertise the terms of the offering, except for notices which direct investors to the funding portal or broker-dealer;
 - the issuer must clearly disclose all compensation paid directly or indirectly to all persons that have promoted the offering through the channels of the broker-dealer or funding portal;
 - the issuer must file regular reports of the results of its operations and financial statements with the SEC after the offering; and
 - the securities purchased may not be transferred for a one-year period after the purchase (other than transfers to the issuer, accredited investors or family members or transfers effected in connection with a registered offering or the death or divorce of the investor).

While the funding portals would not be required to be registered as broker-dealers as such, they would be required to register with the SEC using a modified Form BD (called a Form Funding Portal) and would be required to become a member of the Financial Industry Regulatory Authority. The funding portals would be required to (a) provide certain disclosures to prospective investors, (b) ensure that the investors understand the risks involved with offering, (c) verify an investor's eligibility to participate in the offering and (d) comply with certain other measures intended to protect investors participating in crowdfunding offerings.

Even though the SEC's proposed rules would provide companies with additional relief from the SEC's registration requirements, these proposed rules would not reduce their liability exposure for material misrepresentations or omissions that are made in connection with



the offering. If an issuer in a crowdfunding offering makes any material misrepresentation or omission in the offering, an investor in the offering would have the right to rescind the transaction in addition to any other remedies available to the investor under applicable law for monetary damages.

Conclusion

While the SEC’s proposed rules are intended to make it easier for start-up companies to raise capital, the financial and compliance burdens imposed on crowdfunding offerings may make it impractical and prohibitively expensive for start-up companies to benefit from them. In addition to the costs that start-up companies will incur to prepare disclosure materials, engage and compensate a broker-dealer or funding portal and prepare financial statements, these companies will be required to regularly file financial and informational reports that will be available to the general public (including competitors, customers and strategic partners) to review. A company will need to weigh the benefits of raising a limited amount of capital through crowdfunding against the financial and compliance obligations associated with the proposed crowdfunding rules, especially if the company is otherwise able to raise capital from “accredited investors” under the recently relaxed general solicitation and general advertising rules under Regulation D (see our Publication [“SEC Adopts Final Rules on Amendments to Rule 506 Private Placement Exemption”](#) dated August 1, 2013).

In the proposing release, the SEC posed 295 questions for further consideration in connection with the crowdfunding process. The SEC has provided a 90-day comment period for the proposed rules, after which period the SEC will review the comments and determine whether to adopt the rules. Until the final rules are adopted by the SEC, companies cannot avail themselves of the crowdfunding exemption from the SEC’s registration requirements.

Questions?

If you have any questions regarding this alert, please contact Dormer Stephen at (860) 251-5938 or dstephen@goodwin.com or Donna Brooks at (860) 251-5917 or dbrooks@goodwin.com.

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