

Patterson Belknap Webb & Tyler LLP

Corporate Alert

November 2013

SEC Proposes Crowdfunding Rules Under the JOBS Act

The U.S. Securities and Exchange Commission (SEC) recently unanimously voted to issue proposed rules under Title III of the JOBS Act related to crowdfunding. Crowdfunding is a general term for internet-based fundraising characterized by decentralized groups of donors/investors individually committing relatively minor amounts of capital to small businesses, social projects, artistic performances, etc. Popular sites such as Kickstarter and IndieGoGo already provide a crowdfunding platform for the solicitation of donations, while sites like Fundrise, CircleUp and AngelList offer securities using existing securities registration exemptions such as Regulation A and Regulation D. However, under current federal securities laws and regulations, participation in crowdfunding offerings under Regulation D cannot be extended to non-accredited investors, and the use of Regulation A involves an onerous disclosure and review process at both the state and federal levels. The JOBS Act and the recently released proposed rules provide an outline for a regulatory regime that narrowly permits certain issuers, investors and intermediaries to participate in investment-based crowdfunding while attempting to limit the occurrence of fraud.

Broadly stated, the JOBS Act exempts certain activities related to crowdfunding from the registration requirements of the U.S. Securities Act of 1933 (Securities Act), and provides investment limitations on investors, as well as disclosure requirements for issuers and intermediaries engaged in crowdfunding transactions. The JOBS Act also exempts certain crowdfunding intermediaries (funding portals) from broker/dealer registration under the U.S. Securities Exchange Act of 1934 (Securities Exchange Act).

The JOBS Act brings crowdfunded securities under the definition of “covered securities” in Section 18 of the Securities Act, thus exempting them from certain state “blue sky” registration and qualification requirements. The JOBS Act further provides that no filing or fee may be required with respect to crowdfunded securities under state blue sky laws, except for those of the state in which the issuer’s principal place of business is located, or where a majority of purchasers of such securities reside. Further, the funding portals’ crowdfunding activities (as discussed below) are exempted from state blue sky laws, except for those of the state in which a funding portal’s principal place of business is located. The exemption from blue sky laws generally only applies to registration and offering requirements, and does not limit states’ enforcement powers. The proposed rules discuss this exemption briefly and do not substantially add to the statutory provisions.

Overview of Proposed Rules

For Issuers/Investors:

Investor’s maximum permitted investment per issuer (incl. affiliates), per 12 month period		
Max. investment	Investor income less than \$100k	Investor income at or over \$100k
Investor net worth less than \$100k	Greater of: <ul style="list-style-type: none"> • \$2,000 • 5% net worth, or • 5% income 	Greater of: <ul style="list-style-type: none"> • 10% net worth, or • 10% income • Limited to \$100k
Investor net worth at or over \$100k	Greater of: <ul style="list-style-type: none"> • 10% net worth, or • 10% income • Limited to \$100k 	Greater of: <ul style="list-style-type: none"> • 10% net worth, or • 10% income • Limited to \$100k

Additional restrictions	
Max. capital raise	\$1 million per 12 month period (aggr. all affiliates; only includes capital raised under crowdfunding exemption, not other exemptions (e.g., Regulation D))
Issuers disqualified from crowdfunding exemption	<ul style="list-style-type: none"> • Foreign companies • Reporting companies • Certain investment companies • Companies with no specific business plan or that merely indicate plans to merge with or acquire unidentified company • Previous users of crowdfunding exemption that do not comply with disclosure • Affiliate, director, officer, etc. convicted of certain crimes, false filings, etc. (bad actor)

Issuer financial disclosure requirements (must file with the SEC, provide to investors and intermediary and make available to potential investors)	
Offering amount (within 12 month period)	Required financial information
Less than or at \$100k	<ul style="list-style-type: none"> • Issuer tax return for most recently completed year, and • Financial statements certified by principal executive officer
\$100k to \$500k	<ul style="list-style-type: none"> • Financial statements reviewed by independent public accountant
More than or at \$500k	<ul style="list-style-type: none"> • Audited financial statements

Issuer non-financial disclosure requirements (must file with the SEC, provide to investors and intermediary and make available to potential investors)	
<ul style="list-style-type: none"> • Name, legal status, address and website • Directors, officers and 20%+ owners • Business description & material risk factors, and use of offering proceeds • Number of employees • Target offering amount and deadline • Statement on excess investment 	<ul style="list-style-type: none"> • Description of other offerings, related party transactions and financial condition • Bad actor events prior to effect. date of final rule • Process to complete transaction/cancel investment • Ownership and capital structure, classes of securities and related rights and restrictions • Intermediary identification and compensation

For Funding Portals:

In addition to allowing registered broker/dealers to act as crowdfunding intermediaries under the JOBS Act, the proposed rules create a newly designated crowdfunding intermediary called a "funding portal," facilitating primary issuances of securities on behalf of issuers without the burden of registering as a broker/dealer under the Securities Exchange Act. While funding portals do not need to register as broker/dealers to be crowdfunding intermediaries, certain funding portals' activities are prohibited.

Prohibited Activities for Funding Portals

- Compensating others for finding investors
- Providing investment advice
- Soliciting purchases or offers to purchase securities or compensating others to do so
- Holding or managing investor funds
- Officers or directors of funding portal having financial interest in an issuer

Because these broad prohibitions include certain activities funding portals are meant to engage in, the proposed rules include certain safe harbors.

Funding Portal Safe Harbor Activities Notwithstanding Prohibitions

- Imposing broad objective eligibility requirements for issuers (e.g., industry type, security type, minority ownership)
- Highlighting issuers and providing search and sort functionality (must be broad and objective)
- Advertising funding portal's existence
- Facilitating and moderating (but not participating in) communications among investors and issuers
- Advising issuers on structure and content of offering
- Compensating others for referrals to funding portal and its services (compensation not based on purchase or sale)

Progress vs. Protection

While Congress has signaled its interest in promoting crowdfunding for small businesses seeking to raise capital by passing the JOBS Act, the efficacy of the legislation and the balance between the regulatory objectives of promoting crowdfunding and protecting retail investors will be determined largely by the rollout of regulations now in proposed form.

Crowdfunding Proponents' Arguments	Crowdfunding Skeptics' Arguments
<ul style="list-style-type: none"> • Technological progress and egalitarian capitalism • Securities laws drafted during Great Depression must be updated to reflect technological feasibility and advancements • Existing securities laws prevent the vast majority of Americans from participating in early equity financing, giving opportunity and access to wealthy investors while preventing entrepreneurs without Wall Street connections from using grassroots methods to raise capital 	<ul style="list-style-type: none"> • Need more investor protection • Crowdfunding's technological feasibility does not obviate need for accepted and proven regulatory treatment • The ease and speed with which crowdfunding gives issuers direct access to retail investors make protections more necessary than ever

Request for Comments

The SEC's requests for comments on the proposed crowdfunding rules are broad and comprehensive. Where the SEC has rulemaking discretion, such as prohibiting activities of funding portals, it requests comments as to whether additional activities should be prohibited or if any of the proposed prohibitions should be modified or removed. Where the SEC has more limited discretion, for example with issuer disclosure requirements (many of which are specified by the JOBS Act), the SEC asks whether the requirements are appropriate and whether additional requirements should be prescribed. Aside from broad questions of scope and appropriateness, the SEC's requests for comments focus on the technical aspects and risks generally associated with the infrastructure of the nascent crowdfunding industry. The SEC has asked the public to submit comments on the proposed rules on or before February 3, 2014. Given the scope of the proposed rules and the span of their impact, we expect extensive comments from interested parties.

Should you have any questions on the subject of the proposed new rules, or wish us to comment on your behalf about the proposed new rules, please contact Peter J. Schaeffer at (212) 336-2313 (pjschaeffer@pbwt.com), Jean-Claude Lanza at (212) 336-2022 (jlanza@pbwt.com), Daniel Ashe at (212) 336-7626 (dashe@pbwt.com) or Jonah Rizzo-Bleichman at (212) 336-2863 (jrizzo@pbwt.com).

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