



## Alerts

### SEC Proposes Crowdfunding Rules Under JOBS Act

**December 11, 2013**

*Hinshaw Alert*

Congress enacted the JOBS Act in April of 2012. The JOBS Act added Sections 4(a)(6) and 4A to the Securities Act of 1933 (the "1933 Act"). These provisions directed the SEC to adopt rules to exempt crowdfunding offerings from registration under the securities laws. The SEC released its proposed crowdfunding rules a few weeks ago. Comments are due on the crowdfunding rules on February 3, 2014. We anticipate that these rules will be finalized in the second quarter of 2014.

A brief discussion of the proposed crowdfunding rules is set forth below. A more detailed discussion may be found [here](#).

### Crowdfunding Rules for Companies Seeking to Raise Capital

#### Offering and Investment Limits

The aggregate amount of securities that may be sold by a company within a 12-month period in crowdfunding transactions may not exceed \$1 million. During any 12-month period, the aggregate amount of securities sold to any investor by all companies in crowdfunding transactions must not exceed the greater of:

- (i) \$2,000 or 5% of either the annual income or net worth of such investor (and his spouse), if both the annual income and the net worth of the investor is less than \$100,000; and
- (ii) 10% of either the annual income or net worth of such investor (and his spouse), not to exceed a maximum aggregate amount of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000.

The transaction must be conducted exclusively through a single intermediary -- a registered broker-dealer or a funding portal.

The net worth and annual income tests will to be calculated using the accredited investor tests contained in Rule 501 of Regulation D. Before accepting any investment commitment, an intermediary must have a reasonable basis to believe that the investor satisfies the investment requirements under the crowdfunding rules; the intermediary may rely on the investor's representations that the investor so qualifies.

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#### Service Areas

Business & Commercial  
Transactions

Securities



The investor purchase limits are calculated on all crowdfunding purchases made by an investor during any 12-month period. Thus, an investor's purchases **in all crowdfunding transactions during such period must be aggregated** (and not just from the offering in which the investor is participating). A company may rely on the efforts of an intermediary to ensure that an investor does not exceed these aggregate purchase amounts.

### Restrictions on Resales

Crowdfunding securities may not be transferred by the purchaser for one year after the date of purchase, except when transferred:

- to the company that issued the securities;
- to accredited investors (as defined in Rule 501 of Regulation D);
- as part of an offering registered with the SEC; or
- to a family member of the purchaser or the equivalent, or in connection with certain events (e.g., death or divorce).

### Advertising

Companies will not be permitted to advertise crowdfunding offerings; they will be allowed to provide very limited notices that direct investors to the intermediary's platform. A company may communicate with investors and potential investors about the terms of the offering through communication channels provided by the intermediary on the intermediary's platform. The company must identify itself as the entity making the communications.

### Compensation

A company may compensate or commit to compensate, directly or indirectly, a person to promote its crowdfunding offering through communication channels provided by a broker or funding portal. The company, however, must ensure that such person clearly discloses the receipt, past or prospective, of such compensation and ensure that such disclosure is made each time a promotional communication is made.

### Offering Circular; Annual Reporting Requirements

A company that offers crowdfunding securities must electronically file an offering circular on Form C with the SEC. The intermediary must provide a link to the offering circular to investors. A company would be required to amend its Form C disclosures by filing a Form C-A that will contain updates or material changes. The amendment would have to be provided to investors and each intermediary. Investor reconfirmations must be obtained following the disclosure of a material change.

A company will have to file with the SEC on Form C-U regular updates on the progress of its offering, such as when one-half or the whole target amount has been reached, and provide such updates to investors and each intermediary.

A company that completes a crowdfunding offering would have to file with the SEC an annual report on Form C-AR and make the report available to investors by posting it on its website. The Form C-AR must be filed within 120 days of the end of the fiscal year. The annual report requires disclosure of information similar to that required in the offering statement filed on Form C, including the financial disclosure requirements applicable to the initial offering statement.

A company's obligation to file such annual reports would end when (i) it begins reporting under the Exchange Act of 1934 (the "1934 Act"), (ii) the company or another party purchases all of the securities issued under the crowdfunding rules, or (iii) the company dissolves in accordance with state law.

## Intermediaries—General

### General



Under the proposed rules, a crowdfunding transaction must take place exclusively online through platforms operated by a **single** SEC registered intermediary, either a registered broker-dealer or a new type of SEC registrant called a “funding portal.” An intermediary must be a member of FINRA or any other applicable national securities association registered under Section 15A of the 1934 Act.

### **Financial Interests**

An intermediary (and any of its directors, officers or partners, or any person occupying similar status or performing similar functions) may not possess or receive any direct or indirect ownership of, or economic interest in, any class of securities that a company offers through the intermediary’s platform.

### **Compensation**

A company may compensate the intermediary for its participation in the crowdfunding offering, so long as that compensation does not include a financial interest in the company. An intermediary must advise all investors who open accounts with it of the manner in which it will be compensated in connection with a crowdfunding offering.

An intermediary may compensate a third party for directing (but not soliciting) companies or potential investors to the intermediary’s platform. If the compensation is not paid to a registered broker or dealer, the compensation could not be based on the purchase or sale of a security offered under the crowdfunding rules.

An intermediary would be prohibited from compensating any person for providing an intermediary with personally identifiable information (e.g., name, social security number) of any investor or potential investor.

Broker-dealer intermediaries may pay transaction-based compensation to appropriately registered persons (but not funding portals) for the referral of issuers and/or investors.

### **Company Access and Information**

An intermediary must not grant a company access to the intermediary’s platform if, at any time, the intermediary has a reasonable belief that the company:

- is not eligible to rely on the crowdfunding exemption;
- lacks an established means to keep accurate records of holders of the offered securities; or
- is not in compliance with relevant regulations, including being subject to “bad actor” disqualifications under Rule 503 of Regulation D.

In addition, an intermediary may not grant access to its platform if it believes the company or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection.

An intermediary must conduct a background and securities enforcement regulatory history check on each company whose securities are to be offered by the intermediary, as well as on each of the company’s officers, directors (or any person occupying a similar status or performing a similar function) and 20% owners.

The intermediary would have to make publicly available on the intermediary’s platform all of the company’s required disclosures at least 21 days before any securities are sold and until the crowdfunding offer has been completed or cancelled.

### **Investor Accounts and Disclosure Requirements**

An intermediary would not be able to accept an investment commitment from an investor until the investor opens an account with the intermediary and the investor consents to the electronic delivery of materials.

### **Investor Qualification**



Before accepting any investment commitment, an intermediary must have a reasonable basis to believe that the investor satisfies the investment requirements under the crowdfunding rules; the intermediary may rely on the investor's representations that the investor so qualifies.

The investor would also have to complete a questionnaire affirming the investor's understanding:

- that there are restrictions on the investor's ability to cancel or obtain a return of the investment;
- that it may be difficult to resell the acquired securities;
- that the investment involves risks; and
- that the investor should not invest unless the investor can afford to lose the entire investment.

### **Communication Channels**

The communication channels on an intermediary's platform must allow investors and potential investors to communicate with one another and with representatives of the company, provided that the intermediary must:

- permit public access to view the communication channels;
- restrict posting on the communication channels to only those that have accounts with the intermediary; and
- require all persons posting comments in the communication channels to disclose whether he or she is a founder, employee of the company engaging in promotional activities on behalf of the company or is otherwise compensated to promote the company's offering.

If the intermediary is a funding portal, it may not participate in such communications other than to establish guidelines for communication and remove abusive or potentially fraudulent communications.

### **Disposition of Investor Funds**

An intermediary that is a registered broker would have to comply with Rule 15c2-4(b) of the 1934 Act when handling investor funds.

A funding portal must instruct investors to send their funds to a bank that would either

- hold the funds in escrow and transmit or return such funds as the funding portal directs or
- maintain a bank account(s) for the exclusive benefit of the investors and the company selling the securities.

If the company reaches its target amount by the offering deadline and closes the offering, the funding portal would direct the bank to transmit the funds to the company. If the investor cancels its investment commitment or the company fails to complete the offering, the intermediary would instruct the bank to return the funds to the investors.

### **Completion of Offerings, Cancellations and Reconfirmations**

Investors would have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline set forth in the company's crowdfunding materials. Thereafter, an investor would not be able to cancel any investment commitments made within the final 48 hours (except in the event of a material change to the offering).

If a company reaches the target offering amount prior to the announced deadline, it may close the offering early if at the time of the new offering deadline, the company continues to meet or exceed the target offering amount. An investor must be given the opportunity to reconsider the investment and to cancel the investment until 48 hours prior to the new offering deadline.

If there is a material change in the offering or the information provided by the company, the intermediary would communicate the material change to any investor who made an investment commitment. The intermediary must also indicate that the investor's investment will be cancelled unless the investor reconfirms his or her commitment within five business days of receipt of the notice. If the investor fails to reconfirm the investment, the intermediary would then provide or send the investor a notification disclosing that the commitment has been cancelled, the reason for the cancellation and



the refund that the investor should expect to receive. The intermediary would also direct the party holding the offering proceeds to refund the investor's funds.

Finally, if a company does not complete an offering because the target is not reached or the company decides to terminate the offering, the intermediary must, within five business days, give or send to each investor who made an investment commitment a notification disclosing the cancellation of the offering, the reason for the cancellation, and the refund amount that the investor should expect to receive. The intermediary must direct the party holding the offering proceeds to refund the investors' funds. The intermediary must also prevent investors from making investment commitments with respect to that offering on its platform.

## Intermediaries—Funding Portals

### General

Under the proposed rules, a crowdfunding transaction must take place exclusively online through platforms operated by a **single** SEC registered intermediary, either a registered broker-dealer or a new type of SEC registrant called a “funding portal.”

A funding portal is defined as any person acting as an intermediary in a crowdfunding transaction that does not:

- offer investment advice or recommendations;
- solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal;
- compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; or
- hold, manage, possess or otherwise handle investor funds or securities.

### SEC Registration

A funding portal would register with the SEC by filing a Form Funding Portal, which includes information concerning the funding portal's principal place of business; its legal organization; its disciplinary history, if any; its business activities, including the types of compensation the funding portal has received; FINRA membership and membership with any other registered national securities association; and the funding portal's website address(es) or other means of access.

### FINRA Membership

The JOBS Act and the proposed crowdfunding rules require funding portals to become members of FINRA. FINRA has proposed rules that would apply to funding portal members. The comment period for these rules ends on February 3, 2014. To become a FINRA member, a funding portal would have to file with FINRA an application on Form FP-NMA.

FINRA will approve the application if it determines that the applicant meets the five standards for membership contained in the proposed FINRA rules.

FINRA will also establish a system which would make certain information about funding portal members publicly available.

### Conclusion

The theory underlying crowdfunding is that it is a capital raising technique that will allow startups to inexpensively raise capital from a large group of investors. The investment opportunity would be available to all investors, not just those with a high net worth or net income, allowing the small investor to acquire shares on a company that one day might become a Fortune 100 company (e.g., Facebook) and reap the benefits of such an investment.

The JOBS Act provisions and the SEC crowdfunding rules are supposed to bring this opportunity to startups and small investors. As can be seen from what follows, however, the JOBS Act provisions and the proposed crowdfunding rules establish what may be a cumbersome and potentially costly regulatory regime. This may deter startups from initiating crowdfunding offerings and intermediaries (the ones who would, under the rules, sell the shares for startups) from participating in such transactions. With a proposed limit of \$1 million on the amount that a company may raise in a



crowdfunding exemption transaction in any 12-month period and the costs that may be incurred to complete a crowdfunding offering, the issue that must be resolved is whether the benefits of raising capital through crowdfunding or acting as a crowdfunding intermediary would be great enough to justify the compliance costs and potential liability risks.

For further information on this issue, please contact [Tim Sullivan](#), [Mike Morehead](#) or your [regular Hinshaw attorney](#).

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