



Alerts

SEC Adopts JOBS Act Crowdfunding Rules

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Corporate / Financial Institutions Alert

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Congress enacted the JOBS Act in April of 2012 adding Sections 4(a)(6) and 4A to the Securities Act of 1933 (the "1933 Act"). Among other things, this legislation directed the SEC to adopt rules to exempt crowdfunding transactions from registration under the federal securities laws. The SEC released its proposed crowdfunding rules in October of 2013.

On October 30, 2015, the SEC adopted the final crowdfunding rules.

The crowdfunding rules contain limits on the amount of funds that companies can raise in a crowdfunding transaction and the amount an investor can invest in crowdfunding offerings. The rules also govern the manner in which such an offering must be conducted and set forth the reporting and disclosure obligations a company must comply with during and following a crowdfunding offering. In addition, these rules provide that 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".

The crowdfunding rules will become effective in May of 2016 (180 days after their publication in the Federal Register), except those applicable to the forms allowing funding portals to register with the SEC; these forms will be effective on January 29, 2016.

For a more detailed discussion on the [JOBS Act Crowdfunding Rules](#).

Crowdfunding Rules for Companies Seeking to Raise Capital

Offering and Investment Limits

The crowdfunding rules contain the following thresholds and 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.

Attorneys

Timothy M. Sullivan

Service Areas

Business & Commercial
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Securities



- 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;

(ii) 10% of either the annual income or net worth of such investor (and his spouse), if either the annual income **or** net worth of the investor is equal to or more than \$100,000; and

(iii) a maximum aggregate amount of \$100,000 for all crowdfunding purchases in the 12-month period.

With respect to the limits on investors, the SEC illustrates such rules as provided below:

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). The net worth and annual income tests will to be calculated using the accredited investor tests contained in Rule 501 of Regulation D.

“Bad Actor” Disqualification

A company may not conduct a crowdfunding offering if it has run afoul of any of the “bad actor” disqualifications under Rule 503 of the crowdfunding rules.

Restrictions on Resales

Crowdfunding securities may not be transferred by the purchaser for one year after the date of purchase, except when transferred: (i) to the company that issued the securities; (ii) to accredited investors (as defined in Rule 501 of Regulation D); (iii) as part of an offering registered with the SEC; or (iv) to a family member of the purchaser or the equivalent, or in connection with certain events (e.g., death or divorce).

Advertising

Companies may provide very limited notices that direct investors to the intermediary's platform (the "Offering Notice"). This notice may include no more than the following: (i) a statement that the company is conducting a crowdfunding offering, the name of the intermediary and a link directing the potential investor to the intermediary's platform; (ii) the terms of the offering, including the type of securities, offering price and closing date; and (iii) information about the legal identify and business location of the company, which must be limited to the name of the company, the address, the phone number and website of the company, the e-mail address of a representative of the company and a brief factual description of the business of the company.

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. Persons acting on behalf of the company (including founders and employees) must identify their affiliation with the company in all 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 an intermediary on its platform. 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; Ongoing Reporting Requirements



A company that offers crowdfunding securities must electronically file an offering circular on Form C with the SEC. The company must provide to investors and the intermediary, offering materials which contain, among other things, information about the business, directors, officers and principal shareholders, and financial statements. A company will have to secure SEC access codes in order to file this form. The intermediary must provide a link to the offering circular to investors.

A company will be required to amend its Form C by filing a Form C/A that will contain updates or material changes with respect to offerings that have not been completed or terminated. The amendment would have to be provided to investors and each intermediary.

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 final Form C-U must be filed within five business days after the offering deadline. If the company will except proceeds in excess of the offering amount, it must file a final Form C-U to disclose the total sold within five business days after the completion of the offering.

A company that completes a crowdfunding offering will 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.

An company must file with the SEC a Form C-TR to terminate its reporting obligations within five business days of the date on which it becomes eligible to do so. A company can terminate its ongoing reporting requirements upon the earliest to occur of the following: (i) the company is required to file reports under the Exchange Act; (ii) the company has filed at least one annual report and has fewer than 300 holders of record; (iii) the company has filed at least three annual reports and has total assets that do not exceed \$10 million; (iv) the company or another party purchases or repurchases all of the securities issued pursuant to the crowdfunding exemption, including any payment in full of debt securities or any complete redemption of redeemable securities; or (v) the company liquidates or dissolves in accordance with state law.

Intermediaries--General

Under the crowdfunding 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” (see “**Intermediaries—Funding Portal**”). An intermediary must be a member of FINRA or any other applicable national securities association registered under Section 15A of the Exchange 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.

An intermediary may not have a financial interest in a company that is offering or selling securities through the intermediary's platform unless: (i) the intermediary receives the financial interest from the company as compensation for the services provided to, or for the benefit of, the company in connection with the offer or sale of the securities being offered or sold in reliance on the crowdfunding exemption on the intermediary's platform; and (ii) the financial interest consists of securities of the same class and having the same terms, conditions and rights as the securities being offered or sold on the platform.

Compensation

A company may compensate the intermediary for its participation in the crowdfunding offering. 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 must not be based on the purchase or sale of a security offered under the crowdfunding rules.

Disqualification

An intermediary that is subject to a "statutory disqualification" under the Exchange Act is prohibited from participating in crowdfunding transactions, absent relief from the SEC.

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: (i) the company is not eligible to rely on the crowdfunding exemption; (ii) the company lacks an established means to keep accurate records of holders of the offered securities; (iii) the company is subject to "bad actor" disqualifications under the crowdfunding rules; or (iv) 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 will 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 will 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. The intermediary would have an ongoing duty to provide the investor with the following: (i) educational materials; (ii) information about the company and the offering; (iii) notice of an investment commitment and confirmation of the transaction; and (iv) information about promoters and compensation.

Investor Qualification

Before accepting any investment commitment, an intermediary must have a reasonable basis to believe that the investor satisfies the investment limitations discussed above. The intermediary may rely on the investor's representations that the investor so qualifies unless the intermediary has reason to believe otherwise. The intermediary will have to obtain from the investor a representation that the investor has reviewed the intermediary's educational materials, understands that the entire investment may be lost and is capable of bearing the risk of loss in the investment.

The investor will also have to complete a questionnaire affirming the investor's understanding that: (i) there are restrictions on the investor's ability to cancel or obtain a return of the investment; (ii) it may be difficult to resell the acquired securities; (iii) the investment involves risks; and (iv) 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: (i) permit public access to view the communication channels; (ii) restrict posting on the communication channels to only those that have accounts with the intermediary; and (iii) 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 of the Exchange Act when handling investor funds.

If an intermediary is a funding portal, it must instruct investors to send their funds to a qualified third-party (a broker or dealer, bank or credit union) that will hold the funds in escrow. If the company reaches its target amount by the offering deadline and closes the offering, the funding portal will direct the third-party to transmit the funds to the company. If the investor cancels its investment commitment or the company fails to complete the offering, the funding portal will instruct the third-party to return the funds to the investors.

Completion of Offerings, Cancellations, Reconfirmations and Material Changes

Investors will 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 will 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. To effectuate this, the offering will have to have remained open for a minimum of 21 days. In addition, the intermediary must provide notice to investors about the new offering deadline at least five business days prior to the new offering deadline. 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 must 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 will 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.

If there is a material change, the company must file an amendment on Form C/A with the SEC and the intermediary.

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 crowdfunding 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.

A funding portal is defined as any person acting as an intermediary in a crowdfunding transaction that does not: (i) offer investment advice or recommendations; (ii) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (iii) 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 (iv) hold, manage, possess or otherwise handle investor funds or securities.

SEC Registration

A funding portal must 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 crowdfunding rules require funding portals to become members of FINRA. FINRA has proposed rules that would apply to funding portal members.
- 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 (set forth below).
- 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 allow startups and small investors to take advantage of these capital raising opportunities. As can be seen from what follows, however, the JOBS Act provisions and crowdfunding rules establish what may be a cumbersome and potentially costly regulatory regime. Costs companies may incur in meeting requirements related to financial statements and costs related to preparing the required offering circular may deter companies from undertaking crowdfunding offerings. In addition, companies will have to pay a fee to an intermediary for its services.

Furthermore, companies that use the exemption will have to post their financial information on their websites in an annual report; the report will be available for all the world to see, including competitors. Because of the individual investor investment limitations, a company may add a significant number of shareholders. It may be costly and time consuming to manage all of these new shareholders. Companies will have to consider a variety of issues when it brings in a new group of investors that it may not have had to consider when it was closely held, such as will fiduciary duties that are owed to shareholders, the observance of more corporate formalities, the election of directors and the distribution of company information.

With a proposed limit of \$1 million on the amount that a company may raise in crowdfunding transactions in any 12-month period and the costs that may be incurred to complete a crowdfunding offering, the issue to 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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