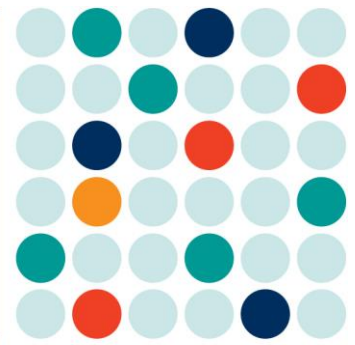


LEGAL UPDATE

November 2015

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FINAL EQUITY CROWDFUNDING RULES ADOPTED BY THE SEC TO PROMOTE CAPITAL RAISING BY EMERGING COMPANIES

On October 30, 2015, the U.S. Securities and Exchange Commission (the “SEC”) adopted long-awaited rules – known as “Regulation Crowdfunding” – that implement an exemption under the federal securities laws for equity crowdfunding transactions.¹ As a result of the rules, qualifying U.S. companies will be able to raise up to \$1 million annually by selling their securities to a large number of accredited and unaccredited investors in small increments through on-line platforms maintained by broker-dealers or registered funding portals.

The adoption of Regulation Crowdfunding (or “Reg CF”, for short) fulfills the mandate set forth in Title III of the Jumpstart Our Business Startups Act, which added a new Section 4(a)(6) to the Securities Act of 1933 (the “Securities Act”) to exempt equity crowdfunding transactions from the registration requirements of the Securities Act. The SEC proposed Regulation Crowdfunding in October 2013.² The final rules are substantially similar to the proposed rules in most material respects, but with important changes and clarifications to certain key provisions, particularly those relating to individual investment limitations and financial statement requirements.

Reg CF attempts to provide smaller companies with innovative ways to raise capital, while at the same time making sure that sufficient safeguards exist to

protect a new group of largely unsophisticated investors. The balancing of these interests has been at the heart of the equity crowdfunding debate since the concept was first proposed, and it will likely remain a major topic of discussion as issuers begin to utilize the exemption and the SEC monitors how it works in practice.

Given the significant requirements, restrictions and obligations to which issuers and intermediaries (i.e., the brokers and/or funding portals through which crowdfunding offerings will be conducted) will be subjected – particularly given the limited amount of capital that can be raised – it is unclear how popular the crowdfunding exemption will become. However, if the amount of attention that crowdfunding has received over the past few years is any indication, there are a number of business owners and entrepreneurs who will be willing to explore this new opportunity.

Offering Limitations and Issuer Eligibility

The final rules permit an issuer to sell up to \$1 million of securities using the crowdfunding exemption during any 12-month period. Capital raised using another registration exemption will not be counted in determining the aggregate amount sold in reliance on Section 4(a)(6), and such exempt offerings will not be integrated with crowdfunding offerings so long as the issuer complies with the requirements of each exemption.

The following issuers will not be eligible to utilize Reg CF:

- non-US issuers;
- publicly reporting issuers;
- entities that either are registered under the Investment Company Act of 1940, or that are exempt from registration under Section

¹ The adopting release for Regulation Crowdfunding can be found here: <http://www.sec.gov/rules/final/2015/33-9974.pdf>.

² The proposing release for Regulation Crowdfunding can be found here: <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>.

3(b) or Section 3(c) of such act;

- issuers that have completed crowdfunding offerings but have failed to comply with the post-offering reporting requirements applicable to them; and
- issuers that either have no specific business plan or that have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

In addition, an issuer will be disqualified from utilizing the crowdfunding exemption if such issuer and/or certain of its associated persons engaged in specified securities violations or other similar bad acts. These disqualification provisions are substantially similar to the “bad actor” provisions that apply to offerings conducted pursuant to Rule 506 of Regulation D.

Status of Securities

Purchasers of securities issued pursuant to the crowdfunding exemption will not be counted toward the limitation on the number of record holders that an issuer may have before it is required to register a class of securities under Section 12(g) of the Securities Exchange Act of 1934 (the “Exchange Act”), provided that the issuer is current in its annual reporting obligations under Reg CF, it has total assets of not more than \$25 million, and it has engaged a registered transfer agent. Issuers will be required to establish a means to track their shareholders.

Investment Limitations for Individuals

Reg CF limits the amount that individual investors can invest in crowdfunding offerings during any 12 month period. If an investor’s annual income or net worth is less than \$100,000, then such investor will be permitted to purchase securities in a crowdfunding transaction in an amount of up to the greater of \$2,000 or 5% of the lesser of such investor’s annual income or net worth. If both the annual income and the net worth of an investor is equal to or more than \$100,000, then a limit of 10% of such investor’s annual income or net worth, whichever is lesser, will apply. Notwithstanding the foregoing, the maximum amount that an investor will be allowed to invest in all crowdfunding offerings during any 12 month period will be capped at \$100,000. An intermediary must have a

reasonable basis to believe that each investor that makes an investment commitment on its platform satisfies these limitations.

Transfer Restrictions

Securities purchased in a crowdfunding transaction generally may not be transferred for one year after the date of purchase. However, such securities may be transferred during such a period: (i) to the issuer; (ii) to an accredited investor; (iii) as part of a registered offering; (iv) to a family member of the purchaser or the equivalent, or in connection with certain events, including death or divorce of the purchaser, or other similar circumstances; or (v) in certain estate planning contexts.

Offering-Related Disclosure Requirements

Issuers utilizing the crowdfunding exemption must file specified disclosures with the SEC, provide these disclosures to investors and the intermediary for the offering, and make these disclosures available to potential investors. These disclosures – which would be made by filing a new Form C with the SEC – will include:

- general identifying and biographical information about the issuer, its officers and directors, and the holders of 20% or more of its outstanding voting equity securities;
- a description of the issuer’s business and business plan;
- a description of the purpose of the offering and the intended use of the offering proceeds;
- the target offering amount and the deadline to reach the target offering amount³;
- the offering price (or the method for determining the offering price);
- a description of the issuer’s ownership and capital structure;
- risk factors regarding the issuer and the offering;

³ Issuers must disclose whether they will accept investments in excess of the target offering amount and, if they will, such issuers must disclose, at the commencement of the offering, the maximum amount that they will accept.

- a description of the material terms of any indebtedness;
- a description of recent exempt offerings of securities;
- a description of certain related-party transactions;
- a narrative discussion of the issuer's financial condition (essentially a mini MD&A);
- a description of certain basic information regarding the intermediary, including the compensation being paid to it⁴, and its financial interests in the issuer and the offering; and
- any material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

Issuers can elect to make certain of these disclosures in a Q&A format, which the SEC indicated may be less burdensome for companies that are not familiar with preparing SEC disclosures.

In addition to the items listed above, the required disclosures will include financial statements of the issuer, prepared in accordance with generally accepted accounting principles, the type and extent of which will depend upon the size of the offering⁵.

Specifically, an issuer conducting an offering of:

- \$100,000 or less must provide the amount of total income, taxable income and total tax or equivalent line items, as reported on the federal tax forms filed by such issuer for the most recently completed fiscal year (if any), and the financial statements of such issuer, in each case, certified by the

⁴ The compensation being paid to the intermediary can be disclosed either as a dollar amount or percentage of the offering amount or as a good faith estimate if the exact amount is not available at the time of the filing.

⁵ the required financial statements must cover the shorter of the two most recently completed fiscal years or the period since the issuer's inception.

principal executive officer;⁶

- More than \$100,000, but not more than \$500,000, must provide financial statements reviewed by an independent public accountant;⁷ and
- More than \$500,000 must provide financial statements that are audited by an independent public accountant; provided, that first-time issuers may provide financial statements that are reviewed by an independent public accountant, unless audited statements are available.

As indicated above, not only must these disclosures be filed with the SEC, they also must be made publicly available on the intermediary's platform for a minimum of 21 days before any securities are sold in the offering, and remain publicly available on such platform until the completion or cancellation of the offering.

Issuers will be required to amend the Form C disclosures on a new Form C/A whenever any material changes occur regarding such disclosures. Further, issuers must provide progress updates upon the achievement of certain offering milestones, including the receipt of commitments for 50% or 100% of the deal, or the closing of the offering.

Ongoing Reporting Requirements

An issuer that completes a crowdfunding offering must file an annual report on Form C/AR no later than 120 days after the end of the issuer's subsequent fiscal years that contains substantially the same information as is included in the offering statement.⁸ This filing requirement would continue

⁶ If financial statements of the issuer are available that have either been reviewed or audited by an independent public accountant, then these financial statements must be provided instead of the information described above.

⁷ If financial statements of the issuer are available that have been audited by an independent public accountant, then these audited financial statements must be provided instead of the reviewed financial statements.

⁸ Instead of requiring financial statements in the annual report that meet the highest standard provided in connection with the offering, as was proposed, the final rules require financial statements certified by the principal executive officer of the issuer to be true and complete in all material respects. However, issuers that have available financial statements that have been

until the earliest to occur of the following: (i) the issuer becomes a reporting company under the Exchange Act; (ii) the issuer has filed at least one annual report and has fewer than 300 holders of record; (iii) the issuer has filed at least three annual reports and has total assets that do not exceed \$10 million; (iv) the issuer or another party purchasing or redeems all of the securities issued pursuant to the crowdfunding exemption; or (iii) the issuer liquidates or dissolves.

Intermediaries Generally

All crowdfunding transactions must be conducted through either a registered broker-dealer or a “funding portal” that complies with the requirements of the Securities Act. The rules establish a streamlined registration process that permits a funding portal to register with the SEC by publicly filing a new Form Funding Portal that contains information that is consistent with the information required for broker-dealers on Form BD, while not as extensive in every respect.

Although funding portals are brokers under the federal securities laws, a registered funding portal will be exempt from the broker registration requirements of the Exchange Act so long as it limits its activities to those permitted for funding portals under Regulation CF.

To provide guidance regarding the activities in which funding portals may engage without becoming obligated to register as brokers, the rules provide a non-exclusive safe harbor that covers certain permitted activities. These activities include:

- determining whether and under what circumstances to allow an issuer to offer and sell securities through its platform, provided that the funding portal avoid any appearance that it is giving investment advice or recommendations;
- highlighting and displaying offerings based on objective criteria in a manner so as not to recommend or implicitly endorse one issuer or offering over another;
- providing communication channels regarding the offering for potential

reviewed or audited by an independent certified public accountant must provide them and will not be required to have the principal executive officer certification.

investors and issuers;⁹

- providing search functions on the platform that permit users to search, sort or categorize available offerings according to objective criteria;
- advising issuers on the structure or content of offerings;
- compensating others for referring persons to the portal and for other services; and
- advertising the existence of the platform or the existence of certain offerings on the basis of objective criteria.

Although funding portals that comply with the new regulations will be exempt from the broker registration requirements, they will remain subject to the full range of the SEC’s examination and enforcement authority, and they must be members of a registered national securities association.

Issuers can only use a single intermediary for a particular offering or concurrent offerings made in accordance with Reg CF. All offerings must be conducted online only through the intermediary’s platform.

Advertising Requirements

Reg CF generally prohibits issuers from engaging in advertising in connection with any crowdfunding offering. However, issuers may publish a notice that only contains limited information about the issuer and the terms of an offering, provided that the notice includes the name of the intermediary and the address of its platform on which additional information about the issuer and the offering may be found. This notice is intended to be similar to tombstone ads permitted under Rule 134 of the Securities Act. Issuers may also communicate with investors about the offering through communication channels provided by the intermediary on its platform, so long as the issuer identifies itself as the issuer in all communications. Further, issuers will be able to continue engaging in regular business communications that do not refer to the terms of the offering.¹⁰

⁹ Note that the intermediary itself cannot participate in these communications.

¹⁰ The SEC did not believe that a safe harbor for regularly released factual business information that does

Further Issues Regarding Intermediaries

Financial Interests

The directors, officers and partners of intermediaries will be prohibited from having any financial interest in any issuer that such intermediary services, and will also be prohibited from receiving any financial interest in such issuer as compensation for services provided to, or for the benefit of, such issuer, in connection with the offer and sale of such issuer's securities.¹¹ However, an intermediary can have a financial interest in an issuer that is using the intermediary's platform provided that (i) the intermediary receives the financial interest from the issuer as offering compensation and (ii) the financial interest consists of securities of the same class and having the same terms, conditions and rights as those sold in the offering.

Investor Protection Issues

Intermediaries must have a reasonable basis for believing that the issuer is in compliance with relevant regulations and has established means to keep accurate records of holders of the securities it offers.¹² Each intermediary must deny access to its platform if it has a reasonable basis for believing that an issuer, or any of its officers, directors or 20% beneficial owners, is disqualified from utilizing the crowdfunding exemption or if the intermediary has a reasonable basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection. Intermediaries must conduct a background and securities enforcement regulatory

not refer to the terms of the offering was necessary, and thus did not include such a safe harbor in the final rules. However, the SEC notes in the proposing release that issuers may generally look to the provisions of Rule 169 under the Securities Act for guidance in making determinations regarding the release of this type of information.

¹¹ A "financial interest" in an issuer means a direct or indirect ownership of, or economic interest in, any class of the issuer's securities.

¹² Issuers will be deemed to have satisfied the requirement that they have established means to keep accurate records of their securityholders if they engage the services of a registered transfer agent.

history check on each issuer whose securities are to be offered by the intermediary, as well as on each of its officers, directors and 20% holders.

Educational Materials

Intermediaries must deliver to investors, at account opening, educational materials that are designed to communicate specified information regarding the particulars of the offering and the offering process (including the compensation to be received by the intermediary) and the risks and restrictions applicable thereto, to make such materials available on their platforms, and to make revised materials available before accepting any additional investment commitments or effecting any further transactions in securities offered and sold in reliance on Reg CF.

Before acceptance of each investment commitment, intermediaries must obtain from each investor a representation that he or she has reviewed the educational materials, understands that the entire amount of his or her investment may be lost, is in a financial condition to bear the loss of the investment, and solicits from each investor answers to certain questions demonstrating the such investor understands the risks and restrictions involved in the offering process.

Cancellations, Commitments and Related Notices

Cancellation of Commitment

Investors will have the unconditional right to cancel their investment commitment for any reason until 48 hours prior to the deadline identified in the offering materials. Thereafter, investors will not be able to cancel any investment commitments made within the final 48 hours of the offering. In the event that there are material changes to the terms of the offering or to the information that the issuer provides to prospective investors, all investment commitments previously received (including those received within the final 48 hours of the offering) must be reconfirmed within five days following notice of such changes, or else such commitments will be cancelled.

Commitment Notice

An intermediary, upon receipt of an investment commitment, must promptly send to the investor a notice disclosing: (1) the dollar amount of the investment commitment; (2) the price of the securities, if known; (3) the name of the issuer; and

(4) the date and time by which the investor may cancel the investment commitment.

Confirmation Notice

At or before the completion of the offering, the intermediary must send to each investor a notice disclosing: (1) the date of the transaction; (2) the type of securities that the investor is purchasing; (3) the identity, price and number of securities purchased by the investor, as well as the number of securities sold by the issuer in the transaction and the price at which the securities were sold; (4) certain specified terms of debt or callable securities, if applicable; and (5) the source, form and amount of any remuneration to be received by the intermediary in connection with the transaction.

Effectiveness

The new rules and forms are expected to become effective in May 2016, except that the forms enabling funding portals to register with the SEC (i.e., Form Funding Portal) will become effective January 29, 2016.

The foregoing is merely a discussion of the New Equity Crowdfunding Rules. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Michael Campoli at (212) 326-0468, or mcampoli@pryorcashman.com.

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