

ADVISORY | Securities

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SEC PROPOSES RULES FOR CROWDFUNDING

On October 23, 2013, the Securities and Exchange Commission (“SEC”) unanimously voted to propose “Regulation Crowdfunding,” a new set of rules needed to implement a portion of the Jumpstart Our Business Startups Act (the “JOBS Act”).¹ If adopted, Regulation Crowdfunding would permit companies to offer and sell securities through “crowdfunding,” which refers to raising limited amounts of capital from a potentially large pool of investors over the Internet. Crowdfunding is an evolving method of raising capital for non-traditional businesses and ideas, ranging from artistic pursuits to storefront businesses to technological inventions. As a new means to offer and sell securities, crowdfunding is one of the most hyped and controversial aspects of the JOBS Act.

REGULATION CROWDFUNDING - OVERVIEW

As proposed, Regulation Crowdfunding would allow a company to offer and sell up to \$1 million of securities over a 12-month period without registration under the Securities Act of 1933 (the “Securities Act”). All offerings under Regulation Crowdfunding are required to take place through a registered broker or a funding portal, which is a new form of financial intermediary. State registration and offering requirements that would otherwise apply to crowdfunding are preempted by the JOBS Act; however, such offerings remain subject to state enforcement actions for fraud, deceit or similar unlawful conduct.

Ineligible Companies

Not all companies would be permitted to use Regulation Crowdfunding. The following companies would be ineligible to rely upon the new crowdfunding exemption for securities offerings: (1) companies that already have a reporting obligation under the Securities Exchange Act of 1934 (the “Exchange Act”); (2) companies organized outside of the United States; (3) certain investment companies; (4) companies that are subject to the disqualification provisions of the proposed rules;² (5) companies that have failed to comply with the annual reporting requirements in the proposed rules; and (6) blank check companies.³

Eligible Investors

The SEC has not proposed to limit the investors who may participate in an offering under Regulation Crowdfunding, however, the aggregate amount sold to any investor by an issuer, including in any

¹ See Release No. 33-9470 (Oct. 22, 2013), which is available on the SEC’s website [here](#) (hereinafter, the “Crowdfunding Release”). Regulation Crowdfunding is proposed to be adopted under Title III of the JOBS Act, which added new Section 4(a)(6) to the Securities Act of 1933.

² The disqualification provisions are modeled on the new “bad actor” provisions in Rule 506 of Regulation D.

³ A blank check company is a development stage company that has no specific business plan or purpose or that has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person. See Rule 419(a)(2) under the Securities Act.

offering under Regulation Crowdfunding during the 12-month period preceding the date of the transaction, may not exceed:

- \$2,000 or 5% of the investor's annual income or net worth, whichever is greater, if both the annual income and net worth of the investor are less than \$100,000; or
- 10% of the annual income or net worth, whichever is greater, not to exceed \$100,000, for an investor who has either annual income or net worth of \$100,000 or more.⁴

The maximum investment amounts are to apply across all offerings under Regulation Crowdfunding in which an investor has participated in the preceding 12 months, and not just the discrete offering in question.

Required Use of an Intermediary

The JOBS Act requires that a crowdfunding transaction be “conducted through a broker or funding portal that complies with the requirements of” the JOBS Act.⁵ The proposed rules would also prohibit a company from using more than one intermediary to conduct an offering or concurrent offerings made in reliance on Section 4(a)(6) of the Securities Act.⁶ This is to avoid creating multiple “crowds” and to facilitate the sharing of information among members of the crowd.⁷

Communication Restrictions

As provided in the JOBS Act, under the proposed rules a company engaging in crowdfunding generally may not advertise the terms of the offering outside of the broker or funding portal facilitating the offering. A company may, however distribute notices that direct investors to such broker or funding portal.⁸ A notice may include no more than the following: (1) a statement that the company is conducting an offering, the name of the intermediary through which the offering is being conducted and a link directing the potential investor to the intermediary's platform; (2) the terms of the offering; and (3) factual information about the legal identity and business location of the company, a representative's e-mail address and a brief description of the company's business. Companies may place notices in any advertising medium, including newspapers or social media sites.⁹ Companies also may continue to engage in communications that do not refer to the terms of the offering during the pendency of the offering.¹⁰

Required Offering Disclosures

In addition to the requirements above, a company engaging in crowdfunding under the proposed regulation would have to file certain disclosures with the SEC, including financial information, and

⁴ For the purposes of this calculation, “net worth” is to be calculated in accordance with Regulation D.

⁵ The term “funding portal” would be defined as any broker acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(a)(6) of the Securities Act, that does not: (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its platform or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the SEC by rule, determines appropriate. See proposed Rule 300(c)(2) of Regulation Crowdfunding.

⁶ See proposed Instruction 1 to paragraph (a)(3) of proposed Rule 100 of Regulation Crowdfunding.

⁷ Crowdfunding Release, at 30.

⁸ See proposed Rule 204 of Regulation Crowdfunding.

⁹ Crowdfunding Release, at 109.

¹⁰ Crowdfunding Release, at 111.

provide such disclosures about itself and the offering to current and potential investors and the relevant intermediary.¹¹

These disclosures, which are mandated by the JOBS Act, would include information about or a description of the following:

- the company, its officers, directors and 20% shareholders;
- the company's business and anticipated business plan;
- the company's financial condition, with disclosures ranging, depending on the size of the offering, from income tax returns and financial statements certified by the CEO to audited financial statements;¹²
- the use of proceeds from the offering;
- the target offering amount, price of the securities and method by which the price was determined; and
- the company's ownership and capital structure.

In addition, the SEC has proposed disclosures requiring crowdfunding companies to:

- identify the intermediary used and disclose how it is compensated;
- include certain legends in the offering document;
- discuss material risk factors relating to the investment; and
- disclose the current number of employees, material terms of any indebtedness, exempt offerings within the past three years, and certain related-party transactions.

The proposed rules would require companies to file such disclosures with the SEC on new Form C at the time of the crowdfunding transaction. The proposal does not mandate a specific disclosure format, but such disclosures must be made in English and are subject to the anti-fraud and civil liability provisions of the Securities Act.¹³

Resale Restrictions

Securities purchased under Regulation Crowdfunding may not be resold for a period of one year unless such securities are sold: (1) to the company that issued the securities; (2) to an accredited investor; (3) as part of a registered offering; or (4) to a family member in connection with events such as the death or divorce of the purchaser. Following the expiration of a year, securities sold in exempt crowdfunding offerings are freely transferable.

¹¹ See Section 4A(b)(1) and proposed Rule 201 of Regulation Crowdfunding.

¹² See Section 4A(b)(1)(D) and proposed Rule 201(t) of Regulation Crowdfunding. This provision establishes a framework of tiered financial disclosure requirements. For an offering of less than \$100,000, a company must provide income tax returns and financial statements that are certified by the CEO. For an offering of between \$100,000 and \$500,000, a company must provide financial statements that have been reviewed by an independent public accountant. For offerings of \$500,000 or more, a company must provide audited financial statements.

¹³ See Crowdfunding Release, at 42, n.90; Rule 306 of Regulation S-T.

Insignificant Deviations from Regulation Crowdfunding

The SEC is proposing a safe harbor for companies for certain insignificant deviations from a term, condition or requirement of Regulation Crowdfunding.¹⁴ To qualify for the safe harbor, a company must show that:

- the failure to comply with a term, condition or requirement was insignificant with respect to the offering as a whole;
- the company made a good faith and reasonable attempt to comply with all applicable terms, conditions and requirements of Regulation Crowdfunding; or
- the company did not know of the failure to comply, where the failure to comply with a term, condition or requirement was the result of the failure of the intermediary to comply with the requirements of Section 4A(a) of the Securities Act and the related rules,¹⁵ or such failure by the intermediary occurred solely in offerings other than the company's offering.

Safe harbor conditions similar to (1) and (2) are provided in Rule 508 of Regulation D, and are meant to reduce the concern of startups and small businesses relying on the regulation, many of which may not be familiar with the federal securities laws. The third prong is intended to prevent a disqualification due to a failure by the intermediary that likely would be out of the company's control.

Integration with Other Exempt Offerings

Crowdfunded offerings would not be integrated with other exempt offerings made by a company, provided that each offering complies with the requirements of the applicable exemption that is being relied upon for the particular offering.¹⁶ This would mean that a company could conduct a crowdfunding offering simultaneously with a general solicitation under Rule 506(c) of Regulation D.

Annual Reporting Requirement

A company that has completed an offering under Regulation Crowdfunding would be required to file with the SEC and post on its website an annual report.¹⁷ This annual report would include most of the information included in the offering document, with the exception of information about completed offerings under Regulation Crowdfunding. This report is due within 120 days after the end of the company's fiscal year and the obligation to file annual reports would continue until the earliest of the following: (1) the company becomes subject to a reporting obligation under the Exchange Act; (2) all of the securities issued pursuant to Regulation Crowdfunding have been

¹⁴ See proposed Rule 502 of Regulation Crowdfunding.

¹⁵ The JOBS Act added Section 4A to the Securities Act. Among other things, the proposed rules implementing Section 4A(a) would require a crowdfunding intermediary to make any information required to be provided by the issuer under Rules 201 and 203(a) of proposed Regulation Crowdfunding available to the SEC and to potential investors, and to make this information publicly available via its crowdfunding platform for a minimum of 21 days before any securities are sold in the offering and until the offer and sale of securities is completed or cancelled, in a manner that reasonably permits a person accessing the platform to save, download or otherwise store the information. An intermediary would also be prohibited from requiring any person to establish an account with the intermediary in order to access this information. See proposed Rule 303(a) of Regulation Crowdfunding.

¹⁶ See Section 4A(g) of the Securities Act (providing that "[n]othing in the exemption shall be construed as preventing an issuer from raising capital through means other than [S]ection 4[(a)](6)"); Crowdfunding Release, at 18.

¹⁷ The annual report would not be required to be posted on the website for the intermediary that facilitated the offering. Crowdfunding Release, at 94.

repurchased by the company or another party, including any payment in full of debt securities or any complete redemption of redeemable securities; or (3) the company is liquidated or dissolved.¹⁸

REGULATION CROWDFUNDING - INTERMEDIARIES

As noted above, any offering made under Regulation Crowdfunding must be made through either an SEC-registered broker or an SEC-registered funding portal, and each type of crowdfunding intermediary must also register with any applicable self-regulatory organization.

Funding Portals

A crowdfunding intermediary that is not a registered broker-dealer must register with the SEC as a funding portal using proposed Form Funding Portal. The information provided as part of that process, other than personally identifiable information or other information with a significant potential for misuse, would be accessible to the public, as is the case with the broker-dealer registration form, Form BD.¹⁹

The SEC is proposing to provide a non-exclusive, conditional safe harbor from the broker-dealer registration provisions of the Exchange Act for funding portals that register as such and comply with certain restrictions.²⁰ Under the proposal, a funding portal may not:

- offer investment advice or make recommendations;
- solicit purchases, sales or offers to buy securities offered or displayed on its website;
- compensate employees, agents or other persons for soliciting purchases, sales or offers on the platform; or
- hold, possess, or handle investor funds or securities.

Notwithstanding these restrictions, under the safe harbor the funding portal may:

- limit offerings available on the platform based on eligibility requirements;
- highlight and display offerings on the platform;
- provide communication channels among investors, prospective investors and issuers;
- provide search functionality on the platform;
- advise issuers on the structure and content of offerings;
- compensate promoters and other referring persons and related services; and
- advertise the funding portal's existence.²¹

In light of the limited nature of this safe harbor, there are some services that funding portals cannot provide. For example, a funding portal, by definition, is limited to acting as an intermediary in

¹⁸ See proposed Rule 202(a) of Regulation Crowdfunding. The annual report on Form C-AR would not be required to be distributed to shareholders physically or via email. Crowdfunding Release, at 94.

¹⁹ See Crowdfunding Release, at 126 and 201.

²⁰ See proposed Rule 402 of Regulation Crowdfunding.

²¹ See Crowdfunding Release, at 228.

primary issuances of securities pursuant to Regulation Crowdfunding. Thus, a funding portal could not effect secondary market transactions in securities.²²

Gatekeeping Responsibilities of Funding Portals and Brokers

Regulation Crowdfunding proposes to impose a gatekeeping responsibility on brokers and funding portals.²³ Among other requirements, such intermediaries must:

- provide disclosures to potential investors relating to risks of crowdfunding and other investor education materials;
- implement procedures to reduce fraud, including:
 - forming a reasonable basis for believing that a crowdfunding company is complying with the applicable requirements;²⁴
 - before permitting an offering through its platform, at minimum, conducting a background and securities enforcement regulatory history check on the company and its officers, directors and greater than 20% beneficial owners; and
 - denying access to its platform to any company that may pose the risk for fraud or otherwise raises concerns regarding investor protection;²⁵
- provide information about the company and the offering to investors;
- provide (and police) communication channels for discussions about offerings on the platform;²⁶ and
- facilitate the offer and sale of crowdfunded securities.

An intermediary is also expected to have a reasonable basis for believing that a company has established means to keep accurate records of the holders of the securities it would offer and sell through the intermediary's platform.

Handling of Offering Proceeds

Regulation Crowdfunding proposes to restrict how offering proceeds are handled. First, an issuer cannot receive the proceeds from a crowdfunded offering until at least 21 days have passed since the date that the required offering information has been posted on the website of the intermediary facilitating the offering.

Second, a broker or funding portal may only transmit offering proceeds to an issuer if the target offering amount is met or exceeded. A registered broker can accomplish this by holding such amounts in a separate account as agent or depositing such amounts in an escrow account at a bank until the targeted offering amount is raised. Since it is not a registered broker, a funding portal

²² See Crowdfunding Release, at 127.

²³ See proposed Rules 301 - 303 of Regulation Crowdfunding.

²⁴ The intermediary may rely on the representations of the company concerning compliance with the requirements in Section 4A(b) of the Exchange Act and the related requirements in Regulation Crowdfunding unless the intermediary has reason to question the reliability of those representations. See proposed Rule 301(b) of Regulation Crowdfunding.

²⁵ See proposed Rule 301(c) of Regulation Crowdfunding.

²⁶ Under the proposed rules, an intermediary that is a funding portal would be prohibited from participating in any communications in these channels, apart from establishing guidelines for communication and removing abusive or potentially fraudulent communications. See Crowdfunding Release, at 177 and proposed Rule 303(c) of Regulation Crowdfunding.

cannot receive any funds and would be required to direct investors to transmit money or other consideration directly to a qualified third party that has agreed in writing to hold the funds for the benefit of the investors and the issuer and to transmit or return the funds promptly to the persons entitled to such funds.²⁷

FINRA Funding Portal Rules

On October 23, 2013, FINRA proposed rules regarding funding portals and is soliciting public comment through February 3, 2014 on such rules and the related forms for SEC-registered funding portals that become FINRA members pursuant to the crowdfunding provisions of the JOBS Act.²⁸

CONCLUSION

There is understandable excitement surrounding the SEC's crowdfunding proposal. Crowdfunding could represent a seismic shift in the way that small businesses raise capital in the United States. Regulation Crowdfunding could present a significant opportunity to facilitate that shift and, in the process, to democratize the capital markets by taking better advantage of the Internet and evolving technology.

Any excitement around the proposed exemption, however, should be tempered by the long list of conditions to its use. In that regard, one obvious example relates to the disclosure and reporting obligations that will apply to companies that take advantage of the proposed rules. These required disclosures, especially those around financial information, raise concerns that the rules will be overly burdensome and would make crowdfunding offerings prohibitively expensive for the average startup or small business. Similarly, the limitations on the size of such offerings and individual investments are likely to constrain use of the proposed rules for all but the smallest of businesses. By way of contrast, for example, new Rule 506(c) of Regulation D offers a less cumbersome and less expensive route to capital raising with general solicitation, provided that actual purchasers in the offering are limited to accredited investors.

Further, although the crowdfunding proposal may make it easier for startups and small business to raise capital, as already warned by comment letters to the SEC, it may also raise confusion in the markets and open the door to fraudulent behavior. This could undermine confidence in transactions using the new exemption.

Nonetheless, the JOBS Act and current political winds are strongly in the sails of this rulemaking. There is also substantial appetite more generally in the small business and start-up sectors for a regulation of this type. And, finally, there are many brokers and other intermediaries positioning themselves to offer their services to companies and investors in this new space. For these reasons, negative comments will only shape, but not stop, the adoption of Regulation Crowdfunding.

²⁷ See Crowdfunding Release, at 182.

²⁸ See Regulatory Notice No. 13-34 (October 2013), which is available on FINRA's website [here](#).

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