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Crowdfunding From A to Z

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CROWDFUNDING FROM A TO Z

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As the expected deadline for the SEC to publish rules and regulations enacting the Crowdfunding Act (Title III of the Jumpstart Our Business Startups Act (JOBS Act)) grows nearer, it is a good time for a complete overview of crowdfunding. New Sections 4(6) and 4A of the Securities Act of 1933 codify the crowdfunding exemption and its various requirements as to Issuers and intermediaries. The SEC is in the process of drafting the underlying rules and regulations which will implement these new statutory provisions.

A. WHAT IS CROWDFUNDING?

The Crowdfunding Act amends Section 4 of the **Securities Act of 1933** (the Securities Act) to create a new exemption to the registration requirements of Section 5 of the Securities Act. The new exemption allows Issuers to solicit "crowds" to sell up to $1 million in securities as long as no individual investment exceeds certain threshold amounts.

The threshold amount sold to any single investor cannot exceed (a) the greater of $2,000 or 5% of the annual income or net worth of such investor, if the investor's annual income or net worth is less than $100,000; and (b) 10% of the annual income or net worth of such investor, not to exceed a maximum $100,000, if the investor's annual income or net worth is more than $100,000. When determining requirements based on net worth, an individual's primary residence must be excluded from the calculation. Clearly there is a conflict in the language determining threshold amounts. An investor could fall within both categories. The conflict has been pointed out in numerous letters to the SEC and will presumably be addressed in the rule making.

In addition, Section 302 of the Crowdfunding Act requires that all crowdfunding offerings be conducted through an intermediary that is a broker dealer or funding portal that is registered with the SEC and a member of a registered self-regulatory organization (SRO). Currently that SRO is Financial Industry Regulatory Authority (FINRA).

B. ISSUERS

General Issuer Requirements

An Issuer who offers or sells securities in a crowdfunding offering must:

(1) File with the SEC and provide investors and the funding intermediary (whether a funding portal or broker dealer) and make available to potential investors:

(a) The name, legal status, physical address, and website address of the Issuer;

(b) The names of the directors and officers, and each person holding more than 20% of the shares of the Issuer;

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(c) A description of the business of the Issuer and the anticipated business plan of the Issuer;

(d) a description of the financial condition of the Issuer, including (i) for offerings of $100,000 or less, income tax returns for the most recently completed year and financial statements certified by the principal executive officer as true and correct; (ii) for offerings of more than $100,000 but less than $500,000, financial statement reviewed by an independent public accountant in accordance with SEC standards and rules for such review; and (iii) for offerings more than $500,000, audited financial statements (note that the offering amount is determined by totaling all Section 4(6) offerings within the preceding 12-month period) ;

(e) A description of the stated purpose and intended use of the proceeds of the offering;

(f) The target offering amount and a deadline to reach the target and regular updates regarding the progress of meeting the target;

(g) The price to the public of the securities and the method of determining the price;

(h) A description of the ownership and capital structure of the Issuer including (i) terms of other securities offered and all other classes of securities of the Issuer including details on the differences and potential dilution that could result from a different class (for example, if preferred stock was converted); (ii) a description of how the exercise of rights held by principal shareholders could negatively impact the purchasers of the securities being offered; (iii) name and ownership levels of each existing shareholder owning 20% or more; (iv) how securities being offered are valued and examples of how they may be valued in the future; and (v) risks related to minority ownership and other capital-related risk, such as by the issuance of additional shares, sales of assets, transactions with related parties;

(i) All other risk factors of the offering;

(2) Not advertise the terms of the offering, except for notices which direct investors to the funding portal or broker;

(3) Not compensate, directly or indirectly, any person to promote the offering, unless certain disclosures are made regarding all such compensation; and

(4) File annual reports with the SEC and provide such reports to investors, with results of operations and financial statements.

More General Issuer Qualifications

All crowdfunding Issuers must be United States entities. Although the Act does not limit the entity type to a corporation, I imagine that the practice and industry itself will impose such a limitation.

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Crowdfunding Issuers cannot be subject to the reporting requirements of the Securities Exchange Act of 1934 or an investment company. These same restrictions currently apply for Issuers embarking on Rule 504 or Regulation A offerings.

Issuer Liability Under the Act

Section 302(c) of the Crowdfunding Act summarizes the potential liability to an Issuer for material misstatements and omissions. In particular, the Act gives a private cause of action to a crowdfunding investor for rescission if they still own the security (return of their money plus interest in exchange for giving back the stock) or for damages if they no longer own the security.

Section 302(c) of the Crowdfunding Act imposes liability for making an untrue statement of a material fact or omitting to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, provided the purchaser did not know of such untruth or omission. The liability standard is the same as is set out in Section 12(a)(2) of the Securities Act of 1933. The pertinent "moment of time" for considering liability is the time the investor makes a commitment for purchase. Section 12 requires that the investor prove causation—that is, that they relied on the misleading information and, as a result of relying on such information, they were damaged.

The Crowdfunding Act defines the Issuer, for purposes of liability, as the Issuer's directors or partners, the principal executive officer or officers, principal financial officer and controller or accounting officer, and any other person that is part of the Issuer that offers or sells the securities in the crowdfunding offering. In layman's terms, all of the key officers, directors and employees of an Issuer in a crowdfunding offering can face personal liability for untrue statements or omissions.

The Issuer (and the individuals) can raise several defenses, such as proof that the investor had actual knowledge of the information or should have been aware of the information if they had taken reasonable care and inquiry. The Act also specifically allows the Issuer to raise the defense that they did not know, and in the exercise of reasonable care, could not have known of such untruth or omission.

Bad Boy Disqualification

The Crowdfunding Act requires that the SEC create disqualification rules for both Issuers and funding portals and intermediaries and lists certain provisions to be included in the disqualification provisions. "Bad actor" disqualification requirements, sometimes called "bad boy" provisions, prohibit Issuers and others (such as underwriters, placement agents and the directors, officers and significant shareholders of the Issuer) from participating in exempt securities offerings if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.

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The Crowdfunding Act disqualifies any offering or sale of securities by a person that:

(i) is subject to a final order of a state securities commission or agency or other state authority that (a) bars the person from associated with an entity regulation by such agency; (b) bars the person from engaging in the business of securities, insurance or banking; or (c) bars the person from engaging in savings associations or credit unions;

(ii) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the offering; or

(iii) has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

In addition, the SEC is empowered to add additional disqualification factors in its rule making.

C. INTERMEDIARIES

Intermediary Use and Funding Portal Registration Requirements

Section 302 of the Crowdfunding Act requires that all crowdfunding offerings be conducted through an intermediary that is a broker dealer or funding portal registered with the SEC.

The Act creates an exemption to broker dealer registration for “funding portals” that, in addition to broker dealers, can act as crowdfunding intermediaries. Funding portals will be required to be registered with the SEC and to follow all such registration and ongoing rule and reporting requirements. As with other aspects of the new law, these rules and ongoing reporting requirements have yet to be drafted. In accordance with the Crowdfunding Act, funding portals must be “subject to the examination, enforcement and other rulemaking authority” of the SEC and must be a member of an SRO registered with the SEC. Currently, the only applicable registered SRO is **FINRA**.

Intermediary Requirements

Whether the crowdfunding intermediary is a broker dealer or new funding portal, they will be subject to the intermediary requirements set out in Section 4A(a) of the Securities Act. Each of the requirements is subject to the more detailed rules that will be drafted by the SEC.

A crowdfunding intermediary must:

(1) Provide disclosures to potential investors, including disclosures related to risks and other investor education materials;

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(2) Ensure that each investor reviews investor education information and positively affirms that they understand that they risk losing their entire investment and can afford such loss;

(3) Ensure that each investor answers questions demonstrating an understanding of the level of risk generally applicable to investments in start-ups, emerging businesses, and small Issuers;

(4) Ensure that each investor answers questions demonstrating an understanding of the risk of illiquidity;

(5) Take measures to reduce the risk of fraud by establishing rules and procedures including obtaining background and securities enforcement history checks on each officer, director and person holding more than 20% of the outstanding equity of an Issuer;

(6) Not later than 21 days prior to the first day securities are sold, file with the SEC and make available to potential investors all disclosure information required and provided by the Issuer. (This requirement raises many questions, such as: Who is responsible for the accuracy of the information filed? Will there be a review process with the SEC? Can sales begin if there are open comments with the SEC?)

(7) Ensure that no offering proceeds are given or available to the Issuer until the target offering amount has been raised, and allow investors to cancel their investment during that time;

(8) Make efforts to ensure that no investor exceeds its allowable investment amount in any 12-month period, including from all Issuers and all funding portals (i.e., $2,000 or 5% of annual net income or net worth if net income or net worth is less than $100,000, or 10% of annual income or net worth up to $100,000 if annual income or net worth is over $100,000);

(9) Take steps to protect the privacy of information collected from investors;

(10) Not compensate promoters, finders, or lead generators for providing the broker or funding portal with personal indentifying information of any potential investor (The SEC needs to clarify in its rule making whether a funding portal or broker faces any aiding and abetting or other liability for accepting such information that they have not paid or, or whether such practice will be acceptable. In addition, the SEC needs to clarify that brokers and funding portals can indeed compensate promoters, finders and lead generators for directing traffic to their site and other outside promotional activities as long as personal identifying information is not included); and

(11) Prohibit its directors, officers or partners from having any financial interest in any Issuer using its service.

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Funding Portal Limitations; the Broker Dealer Advantage; Intermediary Fees.

Section 304 of the Crowdfunding Act defines a funding portal as "any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(6) of the Securities Act of 1933" (i.e., the new crowdfunding section)—provided, however, that a funding portal intermediary may not:

(i) offers 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 (hopefully the SEC rules will provide guidance on who can provide these functions and the mechanics of those functions).

Broker dealer intermediaries may perform each of the above listed services. Accordingly, broker dealer intermediaries have a definite monetary advantage over funding portals in the crowdfunding arena. First, a broker dealer is already licensed, a member of FINRA and versed in abiding by strict regulations and reporting requirements.

It is undisputed that a funding portal will be able to charge a fee to an Issuer for using its service. However, how that fee will be determined and how much that fee can be is currently unknown. Only licensed registered broker dealers can charge a commission for raising money. Only licensed registered broker dealers will be able to offer the foregoing services and charge fees for these services. Moreover, I note that a funding portal has to ensure that Issuers do not receive money until a target offering is made, but at the same time can't hold the investors' money during that time. It seems the SEC will have to require the use of a broker dealer, clearing firm or trusted specialized escrow agent by funding portals to address this quandary.

D. THE CROWDFUNDING ACT AND STATE SECURITIES LAWS

In addition to federal securities laws, each state has its own securities laws and governing body which oversees and enforces such laws. The individual state securities statutes are not uniform; every state is different. However, many aspects of federal securities law pre-empt state securities laws. Still, pre-emption is never complete pre-emption. Although the federal securities laws may pre-empt the state securities laws in the areas of form and procedure of an offering, state regulators are always empowered to investigate and prosecute violations of their state anti-fraud securities provisions. Moreover, state regulators can require certain disclosure filings (such as a copy of the Form D) and the payment of fees.

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In an offering under the Crowdfunding Act, which is Internet-based, investors will come from any or all of the 50 states. It would be incredibly difficult and expensive for a company to learn about and abide by the laws of each of these states. Section 305 of the Crowdfunding Act amends Section 18 of the Securities Act of 1933 to include securities sold in a crowdfunding offering as "covered securities" for purposes of federal pre-emption of state law. Consistent with general pre-emption law, Congress specifies that Section 305 relates "solely to State registration, document and offering requirements... and shall have no impact or limitation on other State authority to take enforcement action with regard to an Issuer, funding portal, or any other person or entity using the exemption from registration provided by Section 4(6) of the Act."

Specific Provision as to Issuer's Filing and Fee Requirements

In addition, the Crowdfunding Act specifically prohibits states from requiring a filing or charging a fee in connection with notice requirements, except for the home state of the Issuer and any state in which more than 50% of all the investors reside.

Specific Provision as to Funding Portal's Registration Requirements

The Crowdfunding Act amends Section 15 of the Securities Exchange Act of 1934 (Registration and Regulation of Broker Dealers) to prohibit any state from enforcing any law, rule or regulation against a registered funding portal for operating as such. In layman's terms, a state cannot require a funding portal to register as a broker dealer in that state, nor can they prosecute a funding portal for acting as an unregistered broker dealer. States can still investigate and prosecute funding portals for fraud.

E. MISCELLANEOUS PROVISIONS

Crowdfunding Securities Are Restricted

The Crowdfunding Act has a self-contained restrictive provision on the resale of crowdfunding securities. In particular, the securities issued in a crowdfunding offering are restricted securities. Such securities may not be transferred by the investor until after a one-year holding period, except that they may be resold back to the Issuer, to an accredited investor, as part of a registered offering with the SEC, or to a family member in connection with death or a divorce.

Many of the mechanics of the restriction are unclear, including, for example, whether an accredited investor purchaser would be still be subject to the one-year holding period. In addition, as the Crowdfunding Act does not refer to Rule 144, it is unclear whether the crowdfunding securities become wholly free trading after a one-year holding period, or default to Rule 144, including the Rule 144 restrictions related to shell companies.

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Integration

The integration doctrine sets forth principals for determining whether two or more securities offerings are really one offering that does not qualify as an exempt offering, or an exempt offering is really part of a registered public offering. The crowdfunding exemption in Section 4(6) of the Securities Act provides that "the aggregate amount sold to all investors by the Issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12 month period preceding the date of such transaction" may not exceed $1,000,000. It is unclear what other exempt offerings will integrate with a crowdfunding offering which is limited to $1 million in any 12-month period or whether a crowdfunding offering will integrate with a public offering. The current integration rules (Rule 155 and 502(a)) are inapplicable to a crowdfunding offering on their face.

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Securities attorney Laura Anthony provides ongoing corporate counsel to small and mid-size public companies as well as private companies intending to go public on the over-the-counter market, including the OTCBB and OTCQB. For nearly two decades, Ms. Anthony has dedicated her securities law practice to being "the big firm alternative." Clients receive fast and efficient cutting-edge legal service without the inherent delays and unnecessary expense of "partner-heavy" securities law firms.

Ms. Anthony's focus includes, but is not limited to, crowdfunding, registration statements, PIPE transactions, private placements, reverse mergers, and compliance with the reporting requirements of the Securities Exchange Act of 1934, including Forms 10-Q, 10-K and 8-K, as well as the proxy requirements of Section 14. Moreover, Ms. Anthony represents both target and acquiring companies in reverse mergers and forward mergers, including the preparation of deal documents such as Merger Agreements, Stock Purchase Agreements, Asset Purchase Agreements and Reorganization Agreements. Ms. Anthony prepares the necessary documentation and assists in completing the requirements of federal and state securities laws and SROs such as FINRA and DTC for corporate changes such as name changes, reverse and forward splits and change of domicile.

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