

# Client Update

## The SEC Hands Out a Halloween Treat to Crowdfunding Supporters

### NEW YORK

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On October 30, 2015, the Securities and Exchange Commission (“SEC”) adopted Regulation Crowdfunding (the “Final Rule”), which regulates the offer and sale of securities through a new type of offering involving a general solicitation without SEC registration.<sup>1</sup> Conceptually, crowdfunding as envisioned by Title III of the Jumpstart Our Business Startups Act (the “JOBS Act”)<sup>2</sup> is simple. It allows an issuer to raise capital, either equity or debt, in a small offering open to all investors, but limits the total amount purchased by any investor. Title III and Regulation Crowdfunding seek to model popular websites like Kickstarter and IndieGoGo, for securities offerings, but with various “guardrails” designed to prevent fraud and protect investors. The Final Rule sets forth the regulatory apparatus for these offerings that will govern both the issuers and the intermediaries (the so-called “funding portals,”<sup>3</sup> subject to oversight by both the SEC and the Financial Industry Regulatory Authority (“FINRA”)) as part of the JOBS Act.

We expect crowdfunding to appeal, at least initially, to two broad groups of issuers: smaller companies doing an early stage fundraising and issuers seeking to enhance their relationships with customers. This second group might use crowdfunding as more of a promotional tool to create interest in its products or services and to allow customers the ability to invest in something that really excites their imagination. These “first mover” customers can be quite effective in generating buzz for a product or idea. The tie-in with an ownership stake could be a powerful means to develop initial customer loyalty and enthusiasm.

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<sup>1</sup> Regulation Crowdfunding codified as amended at 17 C.F.R § 200, 227, 232, 240 and 249 (2015) available at <http://www.sec.gov/rules/final/2015/33-9974.pdf>.

<sup>2</sup> 15 U.S.C. § 77a et seq.

<sup>3</sup> See *infra*, “Restrictions on Intermediaries.”

Below we summarize the key provisions of Regulation Crowdfunding.

### **Effective Date**

Regulation Crowdfunding will become effective May 16, 2016. The forms that will enable funding portals to register with the SEC will become effective January 29, 2016.

### **Investors**

Offerings under Regulation Crowdfunding are not registered offerings, but there are no limitations on who may invest. While the SEC has already permitted crowdfunding-type offerings to accredited investors in the AngelList and Funders Club no-action letters,<sup>4</sup> offerings under JOBS Act Title III and Regulation Crowdfunding are not exclusively for accredited investors.

### **Issuers**

Many, though not all, US companies will be eligible to conduct a crowdfunding offering. Companies that are ineligible include non-US companies, issuers that are already SEC reporting companies, and both registered and exempt investment companies. Additionally, certain issuers would be ineligible, including (a) companies disqualified under Section 302(d) of the JOBS Act and Final Rule Section 503 (which includes, among other things, certain designated “bad actor” disqualifications), (b) previous crowdfunding issuers that have failed to comply with the applicable annual reporting requirements during the two years prior to a new offering, (c) companies that have no specific business plan and (d) companies whose sole business plan is to engage in a merger or acquisition with one or more other companies. Bad actor disqualification will occur based on a list of triggering events, including, but not limited to, certain criminal or civil securities law violations within the preceding five years.

### **Limitations on Amounts Raised Through Crowdfunding**

Regulation Crowdfunding sets the maximum that can be raised at \$1 million. The Final Rule made no changes to this limit despite significant comments on the issue. In discussing this decision, the SEC made clear that it had considered and rejected commenters attempts to exempt the costs associated with the

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<sup>4</sup> AngelList LLC, SEC No-Action Letter (Mar. 28, 2013) available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf>; FundersClub Inc., SEC No-Action Letter (Mar. 26, 2013) available at <http://www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf>.

fundraising (e.g., funding portal fees and attorneys' fees) from the limits. Only capital raised in reliance on Regulation Crowdfunding will count towards this \$1 million annual limit and there is no integration of these offerings with other offering types.

### **Limitations on Amounts Individuals May Invest and Secondary Transactions**

During the trailing 12 months preceding any crowdfunded transaction, an investor may invest no more than: (i) the greater of: \$2,000 or 5 percent of *the lesser of* the investor's annual income or net worth if *either* annual income or net worth is less than \$100,000; or (ii) 10 percent of *the lesser of* the investor's annual income or net worth, not to exceed an amount sold of \$100,000, if *both* annual income and net worth are \$100,000 or more. The investment limit reflects the aggregate amount an investor may invest across all crowdfunding offerings and all issuers in a 12-month period. These limitations apply to all investors, including retail investors (whether or not accredited) and institutional investors, and both U.S. and non-U.S. citizens or residents.

Regulation Crowdfunding Rule 501 prohibits the transfer of securities issued in the crowdfunding for a period of one year, other than to the issuer, an accredited investor or a family member of the purchaser. This transfer restriction also is binding on any purchaser within the first year, such that any purchaser in the primary issuance or secondary market during the first year can only sell to those permitted purchasers.

### **Restrictions on Intermediaries**

Section 4A permits two types of intermediaries for a crowdfunding offering: a registered broker-dealer and a new type of regulated entity called a "funding portal." The issuer may use only one intermediary in connection with its offering. Funding portals must register with both the SEC and a self-regulatory organization ("SRO"). FINRA has adopted final rules for the registration of funding portals.<sup>5</sup> While the overall regulatory burden on funding portals will be somewhat less than what broker-dealers face, as a regulated entity the funding portal will nevertheless need to consider and establish compliance functions commensurate with the level and complexity of their organizations and can expect FINRA (and the SEC) to exercise regulatory oversight over their activities.

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<sup>5</sup> Notice of Filing a Proposed Rule Change to Adopt the Funding Portal Rules and Related Forms and FINRA Rule 4528 (Oct. 22, 2015)  
<https://www.sec.gov/rules/sro/finra/2015/34-76239.pdf>.

Cybersecurity has been a recent area of focus from both the SEC and FINRA for broker-dealers (and investment advisers).<sup>6</sup> It will be interesting to see how funding portals and their regulators approach this issue.

### **Disclosure Requirements**

An issuer wishing to avail itself of Regulation Crowdfunding must file specified disclosures with the SEC and provide these disclosures to investors and the relevant intermediary for dissemination to investors by posting on its platform. These disclosures would include, for example, certain disclosures related to the issuer and the issuer's business, the offering itself, and certain investor-protection statements.

In addition to disclosures during the offering, issuers of successful crowdfunding offerings will be required to file an annual report with the SEC and provide it to investors. These annual reports require disclosures of information similar to what is contained in the offering disclosures, but much less than is required of a public company. The SEC expects the issuer to determine how best to convey the information.

### **Intermediary Obligations**

Whether the intermediary is a broker-dealer or a funding portal, its obligations in connection with each offering follow the same basic pattern: (1) they are required to maintain a web platform to host the offering and provide certain consumer protection disclosures; (2) they must open accounts for investors in the offering; and (3) they must arrange for the secure transmission of funds and securities.

### **Advertising the Offering**

An issuer generally may not advertise the terms of the offering, except through the intermediary's platform. However, issuers may utilize a notice containing the terms of the offering, basic factual information about the issuer and the internet address of the intermediary's platform. There are no limitations on how the issuer can make this notice available. If the issuer's chosen intermediary is a funding portal, the funding portal also may not advertise the offering, but can advertise its services as an intermediary in crowdfunding transactions generally and identify one or more issuers or offerings available on its platform.

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<sup>6</sup> Feigelson, Schneider, Shaul, "SEC Regulation of Cybersecurity and Tech Risk Converges" LAW360 (Oct. 23, 2015) available at <http://www.law360.com/articles/718238/sec-regulation-of-cybersecurity-and-tech-risk-converges>.

The issuer and its employees may participate in any discussion forum or other similar communication channel on the platform so long as it identifies itself as an issuer. Intermediaries are required to have such a communications mechanism on their platforms and make it available in all offerings. Additionally, the issuer can utilize (and compensate) promoters to participate through the communications channel, so long as the promoter identifies itself as such each time it makes a “promotional communication” and discloses that it has earned or will earn compensation for its efforts. Note, however, that the SEC understands “promoters” to broadly apply to all persons “acting on behalf of the issuer,” regardless of whether the compensation they will receive is specifically tied to promotional activities.

### **Restrictions on Compensation in Connection with an Offering**

The Rule places various limitations on the payment and receipt of compensation in connection with a crowdfunding offering. The restrictions can depend on the identity of the payor, the recipient or both. Issuers may compensate the intermediary for its participation in the offering, which can include an ownership interest, so long as the ownership interest is of the same type as that being offered on the intermediary’s platform. Funding portals may compensate others for the referral (but not solicitation) of issuers and investors so long as the compensation is not transaction-based, unless the person it will pay is a registered broker-dealer; however, they may not compensate anyone for soliciting investors or prospects and may not pay transaction-based compensation to anyone (lest they be required to register as a broker-dealer).

### **CONCLUSION**

Regulation Crowdfunding adds a new, more innovative twist to the capital markets. The SEC has sought to balance the promise of such innovation with its traditional investor protection role. How these offerings evolve and whom they target will keep industry watchers busy in the years to come. We cannot wait to look at the first offering.

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Please do not hesitate to contact us.