



Crowdfunding Proposal: Quick First Look

Today, the Securities and Exchange Commission (the “Commission” or the “SEC”) voted to approve the release of proposals that would provide a framework for crowdfunding as required by the Jumpstart Our Business Startups (JOBS) Act. In this alert, we provide some brief background on the statutory provisions of the JOBS Act relating to crowdfunding, and highlights of the SEC’s proposal based on today’s open meeting. A detailed analysis of the proposal will follow once the proposing release is made public.

Background

Title III of the JOBS Act addresses crowdfunding, an outgrowth of social media that provides an emerging source of funding for a variety of ventures. Crowdfunding works based on the ability to pool money from individuals who have a common interest and are willing to provide small contributions for a venture. Given the difficulty in relying on existing exemptions from registration for crowdfunding efforts involving the offer and sale of securities, Title III of JOBS Act amended section 4(a) of the Securities Act to add a new paragraph (6), which provides for a new crowdfunding exemption from SEC registration (subject to rulemaking by the SEC), as well as pre-emption from state Blue Sky laws.

Title III of the JOBS Act addresses crowdfunding by providing an exemption from registration provided that:

- the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, is not more than \$1 million;
- the aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, does not exceed:
 - the greater of \$2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000, or
 - 10% of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000;
- the transaction is conducted through a registered broker or funding portal that complies with the requirements of the exemption; and

- the issuer complies with a number of specific informational and other requirements specified under the exemption.

Title III had specified that the SEC must issue rules to implement this provision not later than 270 days following enactment. While the SEC has now proposed rules until final rules are adopted the crowdfunding exemption contemplated by Securities Act section 4(a)(6) is not available.

An exempt crowdfunding offering must be made through an intermediary that has registered with the SEC as a broker or as a funding portal. Funding portals will not be subject to registration as a broker-dealer, but would be subject to an alternative regulatory regime with oversight by the SEC and the Financial Industry Regulatory Authority (FINRA). A funding portal is defined as an intermediary for exempt crowdfunding offerings that does not: offer investment advice or recommendations; solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; compensate employees, agents, or other persons for such solicitation, or based on the sale of securities displayed or referenced on its website or portal; hold, manage, possess, or otherwise handle investor funds or securities; or engage in other activities as the SEC may determine by rulemaking. A crowdfunding intermediary must provide specified disclosures to investors and take other steps related to the offering oriented toward investor protection.

Issuers also must meet specific conditions in order to rely on the exemption, including making filings with the SEC and providing to investors and intermediaries information about the issuer (including financial statements, which would be reviewed or audited depending on the size of the target offering amount), its officers, directors, and greater than 20% shareholders, and risks relating to the issuer and the offering, as well specific offering information such as the use of proceeds for the offering, the target amount for the offering, the deadline to reach the target offering amount, and regular updates regarding progress toward reaching the target. A crowdfunding issuer will also be subject to reporting requirements after the offering, as the SEC may determine pursuant to its rules. Securities sold in crowdfunding offerings are not restricted securities, but they are subject to transfer restrictions for one year following the sale.

The SEC's rules also must prohibit issuers from advertising the terms of the exempt offering, other than to provide notices directing investors to the funding portal or broker, and will require disclosure of amounts paid to compensate solicitors promoting the offering through the channels of the broker or funding portal.

A purchaser in a crowdfunding offering could bring an action against an issuer for rescission in accordance with section 12(b) and section 13 of the Securities Act, as if liability were created under section 12(a)(2) of the Securities Act, in the event that there are material misstatements or omissions in connection with the offering.

The crowdfunding exemption is only available for domestic issuers that are not reporting companies under the Exchange Act and that are not investment companies, or as the SEC otherwise determines is appropriate. Bad actor disqualification provisions similar to those required under Regulation A are also required for exempt crowdfunding offerings.

The Title III exemption pre-empts state securities laws by making exempt crowdfunding securities "covered securities"; however, some state enforcement authority and notice filing requirements would be retained. State regulation of funding portals will also be pre-empted, subject to limited enforcement and examination authority.

Highlights from the SEC's Open Meeting

During the open meeting, representatives from the Staff of the SEC provided an overview of key aspects of the crowdfunding rule proposal, and several of the Commissioners made brief statements that were generally supportive of the proposal and moving forward to implement the JOBS Act mandate to facilitate capital formation through crowdfunding. Below, we summarize their comments:

Intermediaries: All offerings must be conducted through an intermediary that is either a registered broker-dealer or a registered funding portal. The Commission is proposing a series of rules governing the activities of intermediaries participating in crowdfunding offerings. The Staff noted that FINRA is expected to propose its own regulations on funding portals.

Eligible Issuers: Certain companies will not be eligible to avail themselves of the crowdfunding exemption, including foreign issuers, SEC-reporting companies, companies that are registered under the Investment Company, issuers with no specific business plan, SPACs or blind pools, or issuers that are delinquent in their SEC filings.

Disclosure Requirements: An entity that wants to engage in crowdfunding must comply with certain disclosure requirements. The issuer will be required to provide disclosures concerning its business and operations; the terms of the offering; use of proceeds from the offering; the price to public; disclosures regarding related party transactions; and disclosures regarding management and directors.

Financial Statements: An issuer also will be required to prepare financial statements compliant with US GAAP for a period that is the shorter of the two most recently completed fiscal years or since the issuer's inception. The Staff described a phased requirement as to review or audit of these financial statements, which requirements vary depending on the amount that the issuer proposes to raise in the offering. For example, for smaller offerings, the financial statements must be certified by the issuer's chief financial officer; whereas for larger offerings, the financial statements must be audited.

Ongoing Reporting Requirements: An issuer that completes a crowdfunding offering will be required to file annual reports with the SEC that will be required to include information similar to the information prepared in connection with the offering. The annual report requirement will be applicable until such time as: the issuer becomes subject to Exchange Act reporting; all securities sold in the offering have been retired; or the company winds down its operations.

Funding Portals: Funding portals will be required to undertake certain activities, such as providing investors with educational materials about the risks of crowdfunding; making available information about the issuer on its website; and complying with AML and privacy requirements. The proposed rules incorporate requirements designed to prevent or mitigate conflicts of interest. The proposed rules require regulatory checks on officers, directors, major shareholders of funding portals.

Funding Portal Framework: The activities of funding portals will be limited to crowdfunding. Funding portals must become members of FINRA and register with the SEC. Funding portals cannot offer investment advice; cannot handle customer funds or securities; or undertake other broker-dealer activities.

Resale Restrictions: Securities sold in a crowdfunding offering will be restricted for one year since securities were offered.

Bad Actors: The SEC is proposing bad actor rules to prevent bad actors from acting as intermediaries or being associated persons of intermediaries.

Holder of Record: Holders will be exempt from the Exchange Act Section 12(g) holder of record count.

The Commissioners requested comments on three issues. First, Commissioner Stein noted that there is some ambiguity in the JOBS Act regarding the amount that a single investor should be permitted to invest in that the statute references both an income and a net worth test. She noted that the proposed rules take the approach of permitting an investor to invest the greater of the amounts resulting from using the income and net worth tests. Another approach would be to limit the permissible investment amount to the lesser of the resulting caps. Also, it

was noted that in calculating net worth for these purposes, the proposing release excludes from the net worth calculation the value of the individual's primary residence.

She also noted that the SEC would be interested in the views of commenters regarding whether foreign (non-U.S.) funding portals should be allowed to register with the SEC. The proposing release permits foreign funding portals to register provided that they are able to meet certain requirements regarding access to books and records necessary for regulatory oversight.

Finally, she noted that the proposing release requires issuers to keep accurate records of their securityholders, but acknowledged that there were costs associated with recordkeeping, such as transfer agent fees. Commissioner Piowar noted that the SEC would be interested in learning about cost-effective solutions to help issuers manage their recordkeeping responsibilities.

The SEC has provided a 90 day comment period.

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