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Securities Law ADVISORY ■

OCTOBER 29, 2013

SEC Proposes New Rules for Crowdfunding Transactions

On October 23, 2013, the Securities and Exchange Commission (the "Commission") held an open meeting at which it proposed new rules on crowdfunding as mandated by the Jump Start Our Businesses Act (the "JOBS Act").[1]

Typically, crowdfunding involves an issuer seeking, through websites specializing in certain industries, a small individual contribution from a large number of people in return for a token of value (e.g., movie tickets for a movie produced with funds raised through crowdfunding). In the United States, crowdfunding participants have generally avoided making offers of financial returns or profits (an "equity model" of crowdfunding), since such transactions could subject both the issuer and the website (as a broker) to the registration requirements of the Securities Act. Title III of the JOBS Act ("Title III") created a new Section 4(a)(6) of the Securities Act of 1933, as amended (the "Securities Act"), exempting certain crowdfunding transactions from registration requirements under Section 5 of the Securities Act.

The Commission is proposing new rules and forms to implement Section 4(a)(6). Until final rules are adopted, no issuer or prospective issuer may rely on the crowdfunding exemption provided by Section 4(a)(6).

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[1] This advisory is based on the comments made at the October 23, 2013, open meeting, the Commission press release and the proposed rule (available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677). For an overview of the Jobs Act, see our advisory issued on April 5, 2012 (available http://www.alston.com/securities_law_jobs_act_capital_formation).

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Key Takeaways

The proposed rules would implement new Section 4(a)(6) of the Securities Act to exempt certain crowdfunding transactions from registration under Section 5 of the Securities Act.

Issuer Requirements:

- Eligible issuers could raise no more than $1 million in a 12-month period.
- Issuers would be required to make available to investors and file with the Commission limited periodic disclosures and financial statements.

Investor Qualifications:

- The maximum amount an individual could invest in Section 4(a)(6) offerings in a 12-month period depends on the individual's income or net worth.
- In no case could an individual invest more than $100,000 in Section 4(a)(6) offerings in a 12-month period.

Intermediary Requirements:

- The role of intermediaries would be to facilitate (i) transactions pursuant to Section 4(a)(6) and (ii) communication and the exchange of information between issuers and investors.
- Intermediaries would be required to register with the Commission and FINRA as brokers or "funding portals," a new intermediary classification limited to Section 4(a)(6) transactions.
- Intermediaries would be required to, through initial and ongoing screening and disclosure requirements, ensure that investors and issuers comply with the proposed rule.

The first part of this advisory describes the requirements proposed to be imposed on issuers and investors participating in Section 4(a)(6) offerings, while the second part discusses the proposed requirements and obligations of intermediaries.

Issuer and Investor Requirements

When Could Companies Rely on the Proposed Exemption?

A company may rely on the Section 4(a)(6) exemption to raise no more than $1 million in a 12-month period. Section 4(a)(6) provides that certain issuers are excluded from using the exemption, including non-U.S. companies, reporting companies under the Securities Exchange Act of 1934 (the "Exchange Act") and certain investment companies. The proposed rules would also exclude issuers who have sold securities under Section 4(a)(6), but failed to comply with the annual reporting requirements in the proposed rules. Any issuers without a specific business plan or whose business plan is to engage in a merger or acquisition with an unidentified company also could not rely on the exemption.

As required by the JOBS Act, the proposed rules also would impose "bad actor" disqualifications on issuers that are similar to those under Rule 262 of Regulation A and Rule 506 of Regulation D.[2] The provisions attempt to protect investors by reducing the potential for fraud related to crowdfunding offerings and lowering the burden on investors to investigate the issuer to uncover past wrongdoing.

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[2] For additional information regarding the "bad actor" disqualifications, see our advisory issued on July 22, 2013 (available at http://www.alston.com/advisories/JOBS-Act/).

How Much Capital Could Individuals Invest?

The proposed rules would limit the amount individuals can invest in crowdfunding transactions in a 12-month period based on an individual's income or net worth:

- If both net worth and annual income are less than $100,000, an individual may invest up to $2,000 or five percent of their annual income or net worth, whichever is greater.
- If either net worth or annual income is equal to or greater than $100,000, an individual may invest 10 percent of their annual income or net worth, whichever is greater, but may not purchase more than $100,000 of securities through offerings exempt under Section 4(a)(6).[3]

Under the proposed rules, annual income and net worth may be calculated jointly with the annual income and net worth of the investor's spouse.

What Disclosures Would Issuers Make?

Initial Disclosures: The proposed rules would require issuers relying on Section 4(a)(6) to make certain initial disclosures in an offering statement to ensure that retail investors are informed of the investment, its potential risks and their rights in the transaction. The issuer would be required to file the following disclosures with the Commission (under cover of a new "Form C"), and provide these disclosures to each investor and any intermediaries:

- the names, addresses and contact information of the issuer's officers and directors and owners of 20 percent or more of the issuer's outstanding voting securities, calculated as of the most recently practicable date;
- the business experience of directors and officers of the issuer during the past three years;
- description of the issuer's business and proposed business plan;
- the purpose and intended use of proceeds from the offering;
- the target offering amount and deadline, and whether and by how much the issuer will accept investments in excess of the target amount;
- information about the process to cancel or complete a transaction;
- the price of securities and the method in determining the price; and
- the issuer's ownership and capital structure, including other classes of securities and their terms, the risks relating to minority ownership and description of restrictions on transfer.

An issuer would be required to provide a discussion of its financial condition in the offering statement to inform investors of its historical results, its liquidity and its capital resources. For issuers that do not have prior operating history, the discussion should focus on financial milestones and challenges in terms of liquidity and capital.

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[3] The proposing release noted that the statute creates ambiguity, because in a situation where an investor's annual income is less than $100,000 and net worth is equal to or more than $100,000 (or vice versa), the language of the statute may be read so that both investment limitations apply. The Commission believes the correct interpretation is to impose a maximum investment limit of $100,000, but to provide for a "greater of" limitation within the limit. The Commission is requesting comment on this issue.

The required financial disclosures would depend on the aggregate target offering amounts of all offerings made in reliance on Section 4(a)(6) within the preceding 12-month period:

- issuers offering $100,000 or less would have to file, provide and make available to investors and each intermediary income tax returns filed for the most recent year and financial statements certified by the principal executive officer;
- issuers offering between $100,000 and $500,000 would have to file, provide and make available to investors and each intermediary financial statements reviewed by an independent public accountant;[4] and
- issuers offering more than $500,000 would have to file, provide and make available to investors and each intermediary audited financial statements.[5]

Continuing Disclosure and Filing Requirements: The proposed rules would require an issuer to file with the Commission on Form C-U regular updates on the progress of its offering, such as when one-half or the whole target amount has been reached, and provide such updates to investors and each intermediary. Any material changes to the initial disclosure would be filed on Form C-A as an amendment, and provided to investors and each intermediary. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether or not to purchase the securities.

An issuer selling securities under the proposed rules would have to file with the Commission an annual report on Form C-AR and make the report available to investors by posting it on its website. The annual report requires disclosure of information similar to that required in the offering statement, including the financial disclosure requirements applicable to the initial offering statement. An issuer's obligation to file annual reports pursuant to the crowdfunding rules would end when the issuer becomes an Exchange Act reporting company, the issuer or another party purchases all of the securities issued under Section 4(a)(6), or the issuer dissolves in accordance with state law.

Requirements for Intermediaries

Funding Portals

Registration: The proposed rules would require all crowdfunding transactions be conducted through an intermediary that qualifies as either a broker or funding portal. Section 304 of the JOBS Act defines "funding portal" as any person acting as an intermediary[6] in a transaction involving the offer or sale of securities for the account of others, solely pursuant to the Section 4(a)(6), that does not:

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4 The accountant must be independent under the Commission's independence rules, which are set forth in Rule 2-01 of Regulation S-X.

5 Under the proposed rules, the auditor conducting the audit of the financial statements would be required to be independent of the issuer and the audit would have to be conducted in accordance with the auditing standards issued by either the AICPA or the PCAOB.

6 The proposed rules also apply to persons associated with funding portals, which include any partner, officer, director, manager or other persons directly or indirectly controlling, or any employee of, a funding portal, except those persons whose functions are solely clerical or ministerial.

- offer investment advice or recommendations;
- solicit purchases, sales or offers to buy the securities offered or displayed on its platform or portal;
- compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform or portal;
- hold, manage, possess or otherwise handle investor funds or securities; or
- engage in such other activities as the Commission, by rule, determines appropriate.

Since funding portals, by definition, facilitate transactions in securities for the accounts of others, funding portals fall within the definition of "broker" under Section 3(a)(4) of the Exchange Act. The proposed rules would, however, exempt a registered funding portal from the requirement to register as a broker or dealer under Exchange Act Section 15(a) if the funding portal (i) remains subject to the authority of the Commission, (ii) is a member of a registered national securities association (e.g., FINRA), and (iii) is subject to other requirements that the Commission deems appropriate.[7]

To register with the Commission, a funding portal would have to file a completed Form Funding Portal[8] with the Commission.[9] The registrant would also need to amend, update and withdraw the Form Funding Portal as necessary to ensure the ongoing accuracy of the information therein.

Fidelity Bond: Additionally, the proposed rules would require the funding portal to have a fidelity bond with a minimum coverage of $100,000 in place that covers any associated person unless otherwise excepted by the Financial Industry Regulatory Authority (FINRA) or securities rules.

Nonresident Funding Portals: The proposed rules would require funding portals incorporated or organized under the laws of a jurisdiction outside the United States ("nonresident funding portals") to ensure that the Commission retains comparable authority over the nonresident funding portal in the nonresident funding portal's foreign jurisdiction.[10]

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7 Note, for the purposes of Chapter X of Title 31 of the Code of Federal Regulations (subjecting brokers to, among other things, anti-money laundering provisions), a funding portal would remain a "broker or dealer."

8 The Commission has not given a timetable for the publication of the Form Funding Portal. In addition, FINRA has not yet proposed rules related to membership for funding portals, but will do so after the Commission adopts its funding portal rules.

9 The proposed Form Funding Portal contains eight sections relating to organization identification: the form of the organization, successions, control persons, disclosure information, non-securities related business, escrow, compensation arrangements and withdrawals.

10 Specifically, the nonresident funding portal would have to (i) have a sharing agreement between the Commission and the regulator in which the funding portal has its principal place of business; (ii) obtain a written consent and power of attorney appointing an agent for service of process and provide the Commission the name and address of such an agent; and (iii) certify to the Commission that the funding portal can submit to an onsite investigation and provide the Commission access to its books and records. The nonresident funding portal would have to recertify all of the above within 90 days of any relevant changes to the funding portal's regulatory framework.

Investor Protection

Issuer Access and Information: The proposed rules would prohibit any intermediary from granting an issuer initial or ongoing access to the intermediary's platform if, at any time, the intermediary has a reasonable belief[11] that:

- The issuer is not in compliance with relevant regulations, including being subject to "bad actor" disqualifications;
- The issuer lacks an established means to keep accurate records of holders of the offered securities; or
- The issuer or offering presents the potential for fraud or otherwise raises concerns regarding investor protection.

The intermediary would have to make publicly available on the intermediary's platform all of the issuer's required disclosures at least 21 days before any securities are sold and until the offer and sale of securities is completed or cancelled.

Investor Accounts and Disclosure Requirements: The proposed rules would prohibit an intermediary from accepting any funds from an investor until the investor opens an account with the intermediary and the intermediary receives consent from the investor allowing delivery of educational materials, notices and confirmations.[12] In general, once the investor established an account with the intermediary, the intermediary would have an ongoing duty to provide the investor with the following materials:

- **Educational Materials.** Upon the establishment of an account, the intermediary would have to disclose the process of, risks associated with and resale restrictions on the issuance of the securities in the offering, the information required in annual reports, the limitation on an investor's right to invest and cancel the investment, and the possibility that the issuer and intermediary may have an ongoing relationship.
- **Notice of Investment Commitment.** Upon receipt of an investment commitment from an investor, the intermediary would have to promptly notify the investor of the amount of the investment commitment, the price of the securities (if known), the name of the issuer and the cancellation deadline for the investment commitment.
- **Confirmation of Transaction.** Upon the completion of a transaction in a security, the intermediary would have to send to each investor notification confirming information related to the securities purchased by the investor.
- **Disclosure of Promoters.** Intermediaries would have to inform the investor that any person promoting the issuer's offering for compensation or who is a founder or an employee of an issuer that promotes the issuer on the intermediary's platform and disclose in all communications on the intermediary's platform that the promoter is receiving compensation and is engaging in promotional activities on behalf of the issuer.

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[11] Intermediaries would be allowed to reasonably rely on representations of the issuer absent knowledge or other information or indications that the representations are not true.

[12] Upon receiving such consent, unless otherwise permitted, the proposed rules would require all required information to be transmitted through an electronic message.

- **Disclosure of Compensation.** The intermediary would have to disclose the manner in which it is compensated in connection with the offering and sales of securities.

Investor Qualification: The proposed rules would also require that, prior to the acceptance of any investment commitment, an intermediary must have a reasonable basis to believe that the investor satisfies the investment requirements under Section 4(a)(6). The intermediary would have to obtain from the investor a representation that the investor reviewed the intermediary's educational materials and understands and is capable of bearing the risk of loss in the investment. The intermediary would also have to receive a questionnaire completed by the investor affirming the investor's understanding that there are restrictions on the investor's ability to cancel or obtain a return on the investment, that there are resale restrictions on the acquired securities and that the investment involves risks.

Communication Channels

The proposed rules would require an intermediary to provide on its platform communication channels enabling investors and potential investors (e.g., members of the "crowd") to communicate with one another and with representatives of the issuer, provided that:

- if the intermediary is a funding portal, it may not participate in such communications other than to establish guidelines for communication and remove abusive or potentially fraudulent communications;
- the intermediary permits public access to view the communication channels;
- the intermediary restricts posting on the communication channels to only those that have accounts with the intermediary; and
- the intermediary requires all persons posting comments in the communication channels to disclose whether he or she is a founder, employee of the issuer engaging in promotional activities on behalf of the issuer or is otherwise compensated to promote the issuer's offering.

Transactions

The proposed rules would require a funding portal to transmit the investor's investment commitment to a bank that would either (i) hold the funds in escrow and transmit or return such funds as the funding portal requires or (ii) maintain a bank account(s) for the exclusive benefit of the investors and the issuer. If the issuer reaches its target amount prior to the cancellation date, the funding portal would have to direct the bank to transmit the funds to the issuer. If the investor cancels its investment commitment[13] or the issuer fails to complete the offering,[14] the intermediary would have to direct the bank to return the funds to the investors.

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[13] In general, the proposed rules would allow an investor to cancel and receive investment commitments at any time until 48 hours prior to the deadline identified in the issuer's materials.

[14] If an issuer does not complete an offering, the intermediary must, within five days, notify the investors of the cancellation and the reason for the cancellation, refund the investors and prevent investors from making investment commitments with respect to the offering on the intermediary's platform.

If there is a material change in the offering or in the information provided by the issuer, the intermediary would be required to communicate the material change to the investors and notify the investors that their investment commitment will be cancelled unless the investor reconfirms his or her investment within five days.[15] If the investor fails to deliver confirmation, the intermediary would have to send the investor notice of the cancellation and the reason for the cancellation.

Prohibitions

Financial Interests: The proposed rules would prohibit an intermediary and any of its directors, officers or partners, or any person occupying similar status or performing similar functions, from possessing or receiving any direct or indirect ownership of, or economic interest in, any class of securities that an issuer offers through the intermediary's platform.

Payments to Third Parties: The proposed rules would prohibit any person from providing an intermediary with personally identifiable information[16] of any investor or potential investor. An intermediary would be permitted to compensate a third party for directing issuers or potential investors to the intermediary's platform, provided that, if the compensation is not made to a registered broker or dealer, the compensation could not be based on the purchase or sale of a security offered under Section 4(a)(6).

Miscellaneous Provisions

Restrictions on Resales

Under the proposed rules, securities issued in reliance on Section 4(a)(6) may not be transferred by the purchaser for one year after the date of purchase, except when transferred:

- to the issuer of the securities;
- to accredited investors;
- as part of an offering registered with the Commission; or
- to a family member of the purchaser or the equivalent,[17] or in connection with certain events.[18]

The Commission did not provide any guidance with respect to subsequent trading of securities acquired in a Section 4(a)(6) offering.

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[15] If material changes to the offering or to the information provided by the issuer occur within five business days of the maximum number of days that an offering is to remain open, the offering must be extended to allow for a period of five business days for the investor to reconfirm his or her investment.

[16] Personally identifiable information includes any information that can be used to distinguish an individual's identity (e.g., name, social security number, etc.).

[17] The proposed rule would include children, stepchildren, grandchildren, parents, stepparents, grandparents, spouses or spousal equivalents, siblings, mothers-in-law, fathers-in-law, sons-in-law, daughters-in-law, brothers-in-law and sisters-in-law of the purchaser, as well as adoptive relationships in the definition of "family member of the purchaser or equivalent."

[18] These events include death or divorce of the purchaser or other similar circumstances in the discretion of the Commission.

Exemption from Section 12(g)

The proposed rules would permanently exempt securities issued pursuant to Section 4(a)(6) from the record holder count under Section 12(g).[19] An issuer seeking to exclude a person from the record holder count would be required to demonstrate that the securities held by the person were initially issued in the Section 4(a)(6) offering.

Public Comment Period

The Commission is seeking comments on the proposed rules. Comments may be submitted to the Commission for 90 days following the rule's publication in the Federal Register. Comments may be submitted by mail, email or online form.[20]

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[19] As amended by the JOBS Act, Section 12(g) of the Exchange Act requires, *inter alia,* issuers with total assets in excess of $10 million and a class of securities held of record by either 2,000 persons or 500 persons who are not accredited investors to register such class of securities with the Commission.

[20] Instructions on how to submit a comment are available at http://www.sec.gov/rules/submitcomments.htm.

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