



Securities Law ALERT ■

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SEC Adopts New Rules for Crowdfunding Transactions

On October 30, 2015, the Securities and Exchange Commission (SEC) held an open meeting at which it adopted final rules regarding a company's ability to offer and sell securities using crowdfunding.¹ The final rules, Regulation Crowdfunding, implement Section 4(a)(6) of the Securities Act of 1933, as amended (the "Securities Act"), which was created by the Jump Start Our Business Startups (JOBS) Act of 2012 to exempt certain crowdfunding transactions from registration under Section 5 of the Securities Act and provide a new framework for the regulation of registered funding portals. The rules were approved by a vote of 3–1 with Commissioner Michael Piwowar dissenting. These rules represent the SEC's final major remaining rulemaking mandate under the JOBS Act. Several modifications from the proposed rules attempt to make engaging in crowdfunding transactions pursuant to the final rules less burdensome and costly for new issuers. While the rules do provide a new opportunity for startups to raise capital, the time and resources required to comply with the complex rules and disclosure requirements may still deter new, small companies from engaging in offerings pursuant to these rules.

The new rules and forms will be effective 180 days after they are published in the *Federal Register*, except that the forms allowing funding portals to register with the SEC will be effective January 29, 2016.

The first part of this advisory describes the requirements and limitations imposed on issuers and investors participating in crowdfunding offerings in reliance on Section 4(a)(6), while the second part discusses the requirements and obligations of the funding portals and broker-dealers that issuers are required to use as intermediaries.

¹ The final crowdfunding rules, Release Nos. 33-9974; 34-76324, are available here: <http://www.sec.gov/rules/final/2015/33-9974.pdf>. The proposed rules, Release Nos. 33-9470; 34-70741 are available here: <http://www.sec.gov/rules/proposed/2013/33-9470.pdf>. For an overview of the proposed rules, see our advisory issued on October 29, 2013: <http://www.alston.com/advisories/crowdfunding-advisory/>.

Key Takeaways

The final rules implement 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 can raise up to \$1 million in a 12-month period.
- Issuers are required to make available to investors and file with the SEC an offering statement on Form C and annual reports, each containing financial statements.
- In a change from the proposed rules, the financial statements for issuers conducting their first crowdfunding transaction will not need to be audited by an independent public accountant, even if the issuer seeks to raise \$500,000–\$1 million.
 - Depending on the amount an issuer seeks to raise, the financial statements for the first crowdfunding transaction must either be certified by the chief executive officer or reviewed by an independent public accountant, unless audited financial statements are otherwise available, in which case they must be provided.

Investor Requirements:

- The following limits apply to the amount that an investor may invest in crowdfunded offerings over a 12-month period, in the aggregate:
 - If either annual income or net worth is less than \$100,000, the greater of (1) \$2,000 or (2) 5% of the lesser of the investor's annual income or net worth; or
 - If both annual income and net worth are \$100,000 or more, 10% of the lesser of the investor's annual income or net worth, not to exceed \$100,000.

Intermediary Requirements:

- Each crowdfunding transaction must be conducted through one intermediary. Each intermediary must be registered with the SEC either as a broker or as a new type of entity called a funding portal. Funding portals are exempt from broker registration provided they register in accordance with the new rules on Form Funding Portal and become members of FINRA.
- An intermediary may receive securities in an issuer as compensation for serving as intermediary in an offering as long as the securities are of the same class and have the same terms, conditions and rights as the securities being sold through the intermediary's platform.
- An intermediary is required to take certain measures to prevent fraud in the offering, including (1) reasonably believing that the issuer is complying with Regulation Crowdfunding and (2) performing background checks on officers, directors and 20 percent beneficial owners of an issuer.
- An intermediary is required to provide educational materials to investors and take steps to confirm that the investor is qualified to participate in the offering and understands the risks of investing.

Issuer Requirements

Eligible issuers

Regulation Crowdfunding provides that certain issuers are excluded from using the exemption in Section 4(a)(6). The following companies cannot rely on Section 4(a)(6) to engage in crowdfunding transactions:

- Non-U.S. companies.
- Reporting companies under the Securities Exchange Act of 1934, as amended (the “Exchange Act”).
- Investment companies (as defined in the Investment Company Act of 1940) and companies that are excluded from the definition of investment company under Section 3(b) or 3(c) of the Investment Company Act.
- Issuers that have sold securities under Section 4(a)(6) but failed to comply with the annual reporting requirements during the two years immediately preceding the filing of the required new offering statement.
- Issuers without a specific business plan or whose business plan is to engage in a merger with or acquisition of an unidentified company.
- Issuers disqualified from relying on Section 4(a)(6), or “bad actors.”²

Disqualification for failure to comply with annual reporting requirements: The final rules clarified that, for an issuer that has failed to comply with the annual reporting requirements during either or both of the two years immediately preceding the filing of a new offering statement, the issuer will not be able to rely on the Section 4(a)(6) exemption until the missing report(s) has been filed. As soon as such issuer has filed with the SEC, and provided to investors, both of the annual reports required during the prior two years, the issuer will be able to rely on the Section 4(a)(6) exemption.

Limits on amounts issuers may raise

An issuer may raise up to \$1 million, in the aggregate, during a 12-month period in reliance on the new Section 4(a)(6) exemption. Only capital raised in reliance on the Section 4(a)(6) exemption is counted toward the limit; capital raised through other means will not be aggregated with capital raised through crowdfunding for determining whether this limit has been reached.

Therefore, an issuer could run a concurrent exempt offering under another rule, such as Securities Act Rule 506, which would not be aggregated with the crowdfunding offering, as long as each offering complies with the requirements of the applicable exemption that is being relied upon for the particular offering. However, an issuer that uses general solicitation for an offering pursuant to Securities Act Rule 506(c) should take precautions to ensure that investors are not brought into the crowdfunded offering by such general solicitation since Section 4(a)(6) contains limitations on an issuer’s ability to advertise, as discussed below.

² The Section 4(a)(6) disqualification standard is substantially similar to those under Rule 262 of Regulation A and Rule 506 of Regulation D. 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/>).

An issuer must aggregate the amount of securities sold in reliance on Section 4(a)(6) during the preceding 12-month period by (1) entities controlled by or under common control with the issuer and (2) any predecessor of the issuer.

Disclosure requirements

Initial disclosures: The new rules require issuers relying on Section 4(a)(6) to make certain initial disclosures in an offering statement prior to the commencement of an offering to ensure that retail investors are informed of the investment, its potential risks and their rights in the transaction. The issuer is required to file with the SEC on EDGAR a Form C that provides the disclosures described below, and provide these disclosures to each investor and the funding portal or broker-dealer intermediary. The first section of Form C, which must be provided in XML format, must include the following information:

- **Basic information about the issuer, including:** (1) entity name, (2) legal status, (3) jurisdiction of formation, (4) formation date, (5) physical address, (6) website address, (7) number of employees, (8) website on which an investor can find the issuer's annual report and the date by which such report will be made available, and (9) whether the issuer or any predecessor previously failed to comply with the ongoing reporting requirements of Regulation Crowdfunding.
- **Basic information about the funding portal or broker-dealer intermediary, including:** (1) the intermediary's CIK number, SEC file number and FINRA Central Registration Depository (CRD) number, (2) fees being paid to the intermediary, expressed either as a dollar amount or as a percentage of the offering amount, and (3) a description of the intermediary's financial interests in the transaction and in the issuer.
- **Basic information about the offering, including:** (1) the type of security offered, (2) the target number of securities to be offered, (3) the price or method for determining the price of the securities, (4) the target and maximum offering amount, if different, (5) whether oversubscriptions will be accepted and, if so, the basis for allocating oversubscriptions and (6) the deadline to reach the target offering amount.
- **Selected financial data for the prior two fiscal years, including** (1) total assets, (2) cash and cash equivalents, (3) accounts receivable, (4) short-term debt, (5) long-term debt, (6) revenues/sales, (7) cost of goods sold, (8) taxes paid and (9) net income.

The remaining information required to be provided may be provided to investors in the optional Question and Answer format included in Form C or in any other format included on the intermediary's platform. Such information is required to be filed as an exhibit to Form C. This information includes:

- **Director and officer information,** including each person's name, positions and offices held with the issuer and duration in those positions and business experience over the past three years.
- **Names of beneficial owners of 20 percent or more** of the issuer's voting equity securities, calculated on the basis of voting power, as of the most recent practicable date (but no earlier than 120 days prior to the date the Form C is filed), and the ownership level of such persons.
- **Description of the business and business plan,** but no particular form is prescribed, and the rules are meant to provide flexibility for issuers regarding information they disclose about their businesses.

- **Use of proceeds**, including a reasonably detailed description of the purpose of the offering, such that investors are provided with enough information to understand how the offering proceeds will be used.
- **Target offering amount and deadline** to reach the target offering amount, as well as whether investments in excess of the target offering amount will be accepted and how shares in oversubscribed offerings will be allocated.
- **Description of how to cancel an investment commitment**, including the fact that investors can cancel an investment until 48 hours prior to the deadline identified in the issuer's offering materials.
- **Information regarding how and when an issuer may close an offering early**, including that the intermediary will notify investors when the target offering amount has been met and that the offering may be closed early if at least five business days' notice is provided.
- **The offering price** or the method for determining the price, provided that investors shall have the right to cancel their investment upon determination of the final price, which must be provided to each investor in writing prior to the sale.
- **Ownership and capital structure information**, including the number of securities offered and those outstanding, whether securities have voting rights and any limitations on voting rights, a description of any restrictions on transfer, a description of how the securities offered are being valued, and a description of risks relating to minority ownership, potential dilution and other corporate actions.
- **Risk factors** that may make the investment speculative or risky.
- **Indebtedness of the issuer**, including the amount, interest rate, maturity date and any other material terms.
- **Exempt offerings** conducted in the past three years, including the date of the offering, the exemption relied upon, the type and amount of securities sold and use of proceeds.
- **Related party transactions** in excess of 5 percent of the aggregate amount of capital raised during the preceding 12-month period in crowdfunding transactions (including the current offering) since the beginning of the issuer's last fiscal year.
- **Financial disclosure**, in narrative format, including a discussion of liquidity, capital resources and historical results of operation, to the extent material, for each period for which financial statements are provided, and a discussion of any material changes or trends in the financial condition and results of operations.
- **Any additional material information** necessary in order to make the statements made, in light of the circumstances, not misleading.

Form C also includes certain legend requirements and requires disclosure of the fact that the issuer will file a report with the SEC annually and how such ongoing reporting obligations may be terminated in the future.

Financial statement requirements: All issuers relying on the Section 4(a)(6) exemption must file with the SEC and provide to investors and the relevant intermediary a complete set of their financial statements covering the shorter of the two most recently completed fiscal years or the period since the issuer's inception, prepared in accordance with U.S. generally accepted accounting principles (GAAP). Required financial statements include balance sheets, statements of comprehensive income, statements of cash flows, statements of changes in stockholders' equity and notes to the financial statements. The requirements

for these financial statements in the final rules (including whether they need to be reviewed or audited by an independent accountant) vary based on the amount of securities offered and sold in reliance on Section 4(a)(6) within the preceding 12-month period.

- **Issuers offering \$100,000 or less:** Provide the amount of total income, taxable income and total tax as reflected in the issuer's federal income tax returns and financial statements, each certified by the principal executive officer. However, if financial statements of the issuer are available that have either been reviewed or audited by an independent public accountant, the issuer must provide those financial statements instead and need not include the information reported on the federal income tax returns or the certification of the principal executive officer.
- **Issuers offering more than \$100,000 but not more than \$500,000:** Provide financial statements reviewed by an independent public accountant. However, if financial statements of the issuer are available that have been audited by an independent public accountant, the issuer must provide those financial statements instead and need not include the reviewed financial statements.
- **Issuers offering more than \$500,000:** For issuers offering securities in reliance on Regulation Crowdfunding for the first time, provide financial statements reviewed by an independent public accountant. However, if financial statements of the issuer are available that have been audited by an independent public accountant, the issuer must provide those financial statements instead and need not include the reviewed financial statements. For issuers that have previously sold securities in reliance on Regulation Crowdfunding, provide financial statements audited by an independent public accountant.

To qualify as "independent," a public accountant must either (1) comply with the SEC's independence rules (set forth in Rule 2-01 of Regulation S-X) or (2) comply with the independence standards of the American Institute of Certified Public Accountants (AICPA).

Continuing disclosure requirements: An issuer will have continuing reporting obligations during and following completion of the offering, including:

- **Amendments using Form C/A:** Amendments are required for updates or material changes (generally those that would affect an investor's investment decision). Investor reconfirmations must be obtained following the occurrence of a material change.
- **Progress updates on Form C-U:** Updates are required within five days after (1) the issuer receives commitments for 50 percent of the target amount of the offering; (2) the issuer receives commitments for 100 percent of the target amount; (3) the issuer intends to accept subscriptions in excess of the initial offering amount; or (4) the issuer has closed the offering. Issuers may rely on the intermediary's reports of progress toward meeting the target amount, if the intermediary provides such public updates on its platform, but must still file a Form C-U at the end of the offering to disclose the total amount of securities sold.
- **Annual reports on Form C-AR:** A crowdfunding issuer must file an annual report with the SEC and post it on its website within 120 days of the end of the issuer's fiscal year. The annual report must be certified by the issuer's principal executive officer and must include the same information required in the offering statement. However, financial statements included in the annual reports only require the certification of a principal executive officer, regardless of the size of the offering, and do not need

to be audited or reviewed by an independent public accountant unless the issuer has such financial statements available for other purposes.

Termination of reporting: An issuer must continue to comply with the ongoing reporting requirements until it is eligible to terminate its reporting based on one of the following criteria:

- The issuer is required to file reports under Section 13(a) or 15(d) of the Exchange Act.
- The issuer has filed at least one annual report pursuant to Regulation Crowdfunding and has fewer than 300 holders of record and has total assets that do not exceed \$10 million.
- The issuer has filed at least three annual reports pursuant to Regulation Crowdfunding.
- The issuer or another party repurchases all of the securities issued in reliance on Section 4(a)(6) of the Securities Act, including any payment in full of debt securities or any complete redemption of redeemable securities.
- The issuer liquidates or dissolves its business in accordance with state law.

When an issuer is no longer subject to the ongoing reporting obligations, it must file a Form C-TR within five days of the date on which it becomes eligible to terminate its reporting.

Limits on advertising

The final rules limit the ability of the issuer, as well as the ability of others acting on the issuer's behalf, to advertise. An issuer relying on Section 4(a)(6) may release an offering notice that contains limited factual information about the issuer and the offering, similar to what is permitted in tombstone ads under Securities Act Rule 134. An advertising notice can only include the following information:

- A statement that the issuer is conducting an offering.
- The name of the intermediary.
- A link directing investors to the intermediary's platform.
- The terms of the offering.
- Limited factual information about the issuer, including the name, address, phone number, website and email address of a representative, and a brief description of the business of the issuer.

Exemption from Section 12(g) of the Exchange Act

Section 12(g) of the Exchange Act requires issuers with assets in excess of \$10 million and a class of securities held by either 2,000 record holders or 500 holders who are not accredited investors to register that class of securities. Holders of securities issued pursuant to an offering made in reliance on Section 4(a)(6) would not be counted toward the record holder count under Section 12(g) if the issuer (1) is current in its annual reporting obligations, (2) has less than \$25 million in total assets at the end of its last fiscal year, and (3) has engaged the services of a registered transfer agent. An issuer seeking to exclude a person from the record holder count is responsible for demonstrating that the securities held by the person were initially issued in a Section 4(a)(6) offering.

Investor Requirements

Limits on investment amount

The final rules clarify the limits on investments in crowdfunding offerings by individual investors. The investor limit is an aggregate limit, which applies to all investments made by an investor over a 12-month period in crowdfunded offerings across all issuers and does not relate to one specific offering.

An individual investor is limited to investing:

- If either annual income or net worth is less than \$100,000, the greater of (1) \$2,000 or (2) 5% of the lesser of the investor's annual income or net worth; or
- If both annual income and net worth are \$100,000 or more, 10% of the lesser of the investor's annual income or net worth, not to exceed \$100,000.

The investor's annual income and net worth will be calculated in accordance with Securities Act Rule 501, which specifies the manner in which such amounts are calculated for purposes of determining accredited investor status. Since these calculation principles allow net worth or annual income to be calculated jointly for spouses, the SEC added an instruction to clarify that, when such a joint calculation is used, the aggregate investment of the individual and his or her spouse may not exceed the limit that would apply to an individual investor.

The issuer can rely on the funding portal or broker-dealer intermediary's calculation of the investment limit as long as the issuer does not have knowledge that the investor has exceeded, or would exceed, the investment limits as a result of purchasing securities in the issuer's offering.

Limitations on transfer

Investors generally will be required to hold the securities they purchase in crowdfunded offerings pursuant to Section 4(a)(6) for one year from the date of purchase. There are limited exceptions for transfers to the issuer, an accredited investor, a family member of the purchaser or estate type transfers, and third parties in registered offering.

Intermediary Requirements

A company relying on the exemption provided by Section 4(a)(6) is required to conduct its offering through an intermediary that complies with Section 4(a)(6) of the Securities Act. An offering pursuant to Section 4(a)(6) can be made through only one intermediary. The final rules require intermediaries to perform certain diligence, communication and disclosure functions with the goal of educating investors and protecting them from fraud. A person acting as an intermediary in a crowdfunding transaction will either have to register with the SEC as a broker under Section 15(b) of the Exchange Act or register as a new type of entity called a "funding portal."

Funding portals

Though funding portals are “brokers” within the meaning of Section 3(a)(4) of the Exchange Act, the new rules exempt them from broker registration, provided that a funding portal is registered in accordance with the rules and becomes a member of a national securities association, which is currently FINRA. FINRA has issued proposed new funding portal rules, which are currently being reviewed by the SEC. The proposed rules were published in the *Federal Register* on October 28, 2015, and the SEC has 45 days to approve or disapprove the rules or institute proceedings to determine whether the proposed rule change should be disapproved. A funding portal would register with the SEC by filing a form called a Form Funding Portal that contains information similar to, but less extensive than, the information required for broker-dealers on Form BD.

Funding portals will engage in activities more limited than those undertaken by registered brokers and are prohibited by the rules from taking the following actions:

- Offering investment advice or making recommendations.
- Soliciting purchases, sales or offers to buy securities offered or displayed on its platform or portal.
- Compensating employees or agents for solicitations based on the sale of securities on its platform or portal.
- Holding, managing, possessing or handling investor funds or securities.

Rule 402 of Regulation Crowdfunding provides a safe harbor for some limited activities related to these prohibitions.

Financial interests in issuer

An intermediary’s directors, officers and partners cannot have any financial interest in an issuer using its service and cannot receive such an interest as compensation for services provided to an issuer. However, the intermediary itself may have a financial interest in an issuer using the intermediary’s platform; provided that (1) the financial interest is compensation for the services provided in connection with the issuer’s offering and (2) the financial interest consists of securities of the same class and with the same terms, conditions and rights as the securities being sold through the intermediary’s platform.

Fraud prevention measures

An intermediary must take certain measures to reduce the risk of fraud in an offering, including having a reasonable basis for believing that an issuer complies with requirements in Regulation Crowdfunding and for believing that an issuer has established means to keep accurate records of its security holders. An intermediary may reasonably rely on the representations of the issuer unless the intermediary has reason to question the reliability of those representations. An intermediary can satisfy the records requirement if the issuer has engaged the services of a transfer agent registered under Section 17A of the Exchange Act.

An intermediary will be required to deny access to its platform if it has a reasonable basis for believing that an issuer or any of its officers, directors or 20 percent beneficial owners is subject to disqualification

from relying on Section 4(a)(6) for being a “bad actor,” as discussed above. The intermediary must conduct a background and securities enforcement history check on the issuer and on each of its officers, directors and 20 percent beneficial owners.

Educational materials and other information

An intermediary must provide investors with certain educational materials that are in plain English when investors open accounts. These materials must include disclosures related to a number of issues, including the risk of investing in securities, investors’ cancellation rights, resale restrictions and issuer reporting requirements.

The final rules provide an intermediary with flexibility in terms of determining the specific content of the materials and their overall format and manner of presentation. The intermediary must also keep the educational materials accurate and provide investors with revised materials before accepting any additional investing commitments.

An intermediary must make available to the SEC and to the public the information the issuer is required to disclose on the platform throughout the offering period and for at least 21 days before any security may be sold in the offering. The intermediary cannot require any person to open an account with the intermediary in order to view or receive this information.

Confirmation of investor qualification

The final rules obligate the intermediary to confirm that an investor is qualified to participate in the offering and understands the risks of investing. Before accepting an investment commitment from any investor, an intermediary must have a reasonable basis to believe that the investor falls within the investment limitations set forth in the rule. An intermediary may reasonably rely on an investor’s representations.

In addition, the final rules require intermediaries to confirm that an investor: (1) has reviewed the intermediary’s educational materials, (2) understands that the entire amount of his or her investment may be lost and he or she is in a financial condition to bear the loss of the investment, and (3) has completed a questionnaire developed by the intermediary demonstrating an understanding of the risks of any potential investment and other required statutory elements.

Investor communication

On its platform, the intermediary must provide channels through which investors can communicate with one another and with representatives of the issuer. The communications must be publicly available for viewing, but only individuals who have opened an account will be able to post. The intermediary broker or funding portal is not allowed to participate in these communications.

Conclusion

Regulation Crowdfunding was adopted in order to create a simpler way for small businesses and startup companies to raise capital, and the final rules include several modifications from the proposed rules in an attempt to make engaging in crowdfunding transactions less burdensome and costly for new issuers. However, these rules still contain many disclosure requirements that may be difficult for new issuers to provide and technical requirements that could be challenging. It is unclear at this time whether the time and resources required to comply with the complex rules and disclosure requirements will deter new, small companies from engaging in offerings pursuant to these rules. However, the SEC staff will study and prepare a report no later than three years following the effective date of Regulation Crowdfunding on the impact of the regulation on capital formation and investor protection.

If you have any questions or would like additional information regarding these new crowdfunding rules, please contact your Alston & Bird securities attorney.

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