
Crowdfunding Overview

The following discussion summarizes important aspects of the crowdfunding proposals under consideration at the SEC and FINRA and in North Carolina. Our objective is to provide readers with a general understanding of the key substantive and procedural aspects of the proposed crowdfunding regulations. We remind you that, until **crowdfunding rules become effective, you may not rely on the exemptions described below to conduct securities offerings.**

Overview of Proposed Crowdfunding Rules

Crowdfunding¹ is a growing and developing method of raising money using the Internet. An entity or individual raising funds through crowdfunding typically seeks small individual contributions from a large number of people. A crowdfunding campaign generally has a specified target amount for funds to be raised and an identified use of those funds. The crowdfunding provisions of the JOBS Act were designed to help provide startups and small businesses with capital by making relatively low dollar offerings of securities less costly. They also permit the Internet-based platforms to facilitate the offer and sale of securities without having to register with the SEC as brokers (although registration as a funding portal would be required).

In late October, the SEC proposed a regulatory framework—including rules and forms—that would implement the crowdfunding provisions of the JOBS Act. The proposed crowdfunding rules and forms include a new regulation, Regulation Crowdfunding, which would govern offerings made in reliance on the Section 4(a)(6) exemption from Securities Act registration. FINRA also issued a regulatory notice soliciting comments on proposed rules and forms that would govern SEC-registered funding portals. Under the JOBS Act and the proposal, funding portals must be a member of a national securities association such as FINRA.

Requirements for Crowdfunding Offerings

Structure of Offering. To qualify for the exemption under Section 4(a)(6), crowdfunding transactions by an issuer must meet specified requirements, including:

- The amount raised must not exceed \$1 million in a 12-month period;
- Individual investments in a 12-month period are limited to:
 - The greater of \$2,000 or 5 percent of annual income or net worth, if annual income or net worth of the investor is less than \$100,000; and
 - 10 percent of annual income or net worth (not to exceed an amount sold of \$100,000), if annual income or net worth of the investor is \$100,000 or more; and
- Transactions must be conducted through an intermediary that either is registered as a broker or is registered with the SEC as a new type of entity called a “funding portal.”

¹ Although the meaning for the term varies with context, “crowdfunding” as used in this Alert refers solely to securities offerings made in reliance on Section 4(a)(6) of the Securities Act.

Securities purchased in a crowdfunding transaction (which the SEC has indicated could include debt securities) cannot be resold for a period of one year, unless they are sold to the issuer, to an accredited investor, or to a family member of the purchaser in connection with certain events like death or divorce or sold as part of a registered offering.

Disclosure Requirements. An issuer offering or selling securities in reliance on Section 4(a)(6) must file specified disclosures with the SEC, provide these disclosures and certain financial information to the relevant broker or funding portal, and make these disclosures available to actual and potential investors. Issuers may electronically refer investors to the information on the intermediary's platform through a posting on the issuer's website or by e-mail.

Form C. The SEC has created a new "Form C," which is designed to enable issuers to satisfy initial (and ongoing) disclosure requirements. As proposed, a Form C would be filed with the SEC on EDGAR: (1) before the commencement of a crowdfunding offering; (2) during the pendency of a crowdfunding offering to report progress toward the funding goal and, when applicable, certain changes to the offering or updates; (3) annually after completing a crowdfunding offering; and (4) at the conclusion of Form C reporting obligations.

Form C (which has multiple iterations for various purposes) utilizes the standard eXtensible Markup Language (XML) format for certain information, and issuers would customize the presentation of the rest of their disclosures and file those disclosures as exhibits to the Form C. Among other things, Form C would need to include information identifying:

- The issuer, including its name, jurisdiction and entity form, and address and website.
- The issuer's directors and officers, including their history with the company, business experience for the past three years, and other information.
- The issuer's 20% or more beneficial equityholders, calculated on the basis of voting power.
- The issuer's business and business plan.
- The issuer's ownership and capital structure.
- The target offering amount, deadline to reach it, and whether investments in excess of target offering amount will be accepted or how shares in oversubscribed offerings would be allocated.
- The offering price and method for determining price.
- The use of proceeds from the offering.
- The procedure on how investors may cancel an investment commitment.
- Additional information, including: (1) the intermediary for the offering and compensation being paid to the intermediary; (2) specific offering legends; (3) the number of current employees of the issuer; (4) material risk factors; (5) material terms of the issuer's indebtedness; (6) exempt offerings of the issuer in the last three years; and (7) certain related party transactions.

Financial Information. As required by the JOBS Act, the SEC's proposal would require an issuer to provide certain financial information to investors participating in a crowdfunding offering. Generally, issuers must provide US GAAP financial statements for the two most recently completed fiscal years (or shorter period during which the issuer has been operating); however, the detail of review depends on the amount of money to be raised in the offering. As proposed, for:

- Offerings of \$100,000 or less, the issuer must provide US GAAP financial statements (for the period described above) and its filed income tax return for the most recently completed fiscal year, if any, in both cases certified by the issuer's principal financial officer.
- Offerings of between \$100,000–\$500,000, the issuer must provide US GAAP financial statements (for the period described above) reviewed (in accordance with AICPA standards) by an independent public accountant, and accompanied by the accountant's review report.
- Offerings over \$500,000, the issuer must provide US GAAP financial statements (for the period described above) audited (in accordance with AICPA or PCAOB standards) by an independent auditor (not necessarily a PCAOB-registered firm), and accompanied by the audit report.

The Form C would also need to include a narrative discussion of the issuer's financial condition covering, among other things, its historic results of operations, if applicable, and liquidity and capital resources, or challenges thereof. According to the proposing release, this discussion would be similar to the Management Discussion and Analysis (or MD&A) disclosure included in public company annual proxy disclosures, but generally not as lengthy or detailed.

Restrictions on Advertising and Communications. Under the proposal, issuers would only be permitted to advertise their offerings through a special notice (similar to "tombstone ads" under Rule 134 of the Securities Act for public offerings), which could include the terms of the offering, the address of the intermediary's platform on which additional information about the issuer and the offering may be found, and other specified information. The proposal would not restrict an issuer's ability to communicate other information that does not refer to the terms of the offering, so a company could continue to engage in customary advertising for products and services as long as the offering is not referenced.

Crowdfunding involves real-time commentary and feedback by potential investors on the value of an investment or the business of a company. Investors are expected to dialogue directly with the issuer and among themselves regarding the terms and value of the offering while it is on-going. To enable issuers to respond to this type of commentary, the proposed rules also would allow an issuer to communicate with investors and potential investors about the terms of the offering through communication channels provided by the intermediary on the intermediary's platform, so long as the issuer identifies itself as such in all communications. If an issuer compensates a person to promote the offering through the crowdfunding intermediary's communication channels, the issuer must take reasonable steps to ensure the compensated promoter identifies itself as such.

Ineligible Companies and Disqualifications. Certain types of issuers may not rely on the Section 4(a)(6) crowdfunding exemption. Title III specifically prohibits foreign issuers, Exchange Act reporting companies and certain investment companies (which the SEC has determined would exclude hedge funds) from crowdfunding. The SEC's proposal would also add to the list of ineligible issuers the following: (1) issuers with no business plan or a business plan to engage in a merger with an unidentified company or companies and (2) issuers that failed to make required Form C filings (discussed below) in the two years before a crowdfunding offering. As required by the JOBS Act, the SEC's proposal adopts disqualification provisions (similar to recently adopted disqualification provisions for Rule 506 offerings), providing that an issuer will be unable to rely on the crowdfunding exemption if any person covered by the rule was

convicted of certain felonies or securities law violations within the past five to ten years. Like the new Rule 506 disqualification provisions², the proposal would include an exception for disqualifying events of which the issuer did not know and, in the exercise of reasonable care, could not have known.

Ongoing Reporting, Updates, and Amendments. After completion of a crowdfunding offering, the issuer would be required within 120 days of the end of each fiscal year to file on EDGAR and post to its website an annual report on Form C-AR. This annual report would include financial statement and narrative disclosures meeting the highest standard applicable to any of the issuer's past crowdfunding offerings.

The annual reporting requirement would continue until either: (1) the issuer becomes a reporting company under the Exchange Act; (2) the issuer or another party repurchases all of the securities sold under the crowdfunding exemption; or (3) the issuer liquidates or dissolves its business under state law. In the event one of the three events occurs, the issuer would be required to file a notice of termination of its annual reporting obligation (on Form C-TR) within five business days from the date of the terminating event.

The proposed rules also require that an issuer provide certain updates in the course of an offering (involving filing a Form C-U with the SEC on EDGAR and providing such information to investors and the relevant intermediary). As proposed, the rules would require an issuer to regularly update the issuer's progress in meeting the target offering amount no later than five business days after the issuer reaches particular intervals. If the issuer will accept proceeds in excess of the target offering amount, the issuer also would be required to provide a final progress update, no later than five business days after the offering deadline, disclosing the total amount of securities sold in the offering.

Finally, the SEC proposes to require that an issuer amend its disclosure for any material change in the offer terms or disclosure previously provided to investors. The amended disclosure would be filed with the SEC via EDGAR on Form C-A, provided to investors and the relevant intermediary and made available to potential investors. If any change, addition or update constitutes a material change to information previously disclosed, investors would have five business days to reconfirm their investment commitments or the investment commitments would be cancelled. Issuers would be permitted to amend the Form C to provide information with respect to nonmaterial changes.

Crowdfunding Intermediaries

In the SEC's view, registered intermediaries are necessary to bring the issuer and potential investors together and to provide safeguards to potential investors. Crowdfunding offerings are required to be conducted through a broker or funding portal that complies with the Securities Act. The proposed rules provide two new requirements: (1) issuers are only allowed to use one intermediary for their crowdfunding offering and (2) intermediaries must be online.

Funding Portals. The JOBS Act created the "funding portal" as a new entity under the securities laws. Funding portals are Internet-based platforms or intermediaries that may

² See our August 9 Alert: [New Rules May Revolutionize Private Placements: Five Steps You Can Take NOW to be Prepared](#) for more details.

facilitate crowdfunding offerings without having to register as brokers. The SEC proposes to establish a streamlined registration process under which a funding portal would register with the SEC by filing information consistent with, but less extensive than, the information required for broker-dealers. In order to qualify for the funding portal exemption, a funding portal may not:

- Offer investment advice or recommendations.
- Solicit purchases, sales or offers to buy securities displayed on the platform.
- Compensate employees, agents or other persons for solicitation or based on sales.
- Hold, manage, possess or otherwise handle investor funds or securities.

Requirements for Crowdfunding Intermediaries. Crowdfunding intermediaries must abide by the following requirements, among others:

- Be registered with the SEC as a broker or funding portal.
- Prohibit their directors, officers and partners, and the intermediary itself, from having any financial interest in an issuer using their services.
- Take specified measures to reduce the risk of fraud in crowdfunding offerings.
- Make available information about the issuer and the offering, such as the issuer's Form C (and related amendments and updates) at certain times.
- Ensure that no investor exceeds the investment limits.
- Allow investors the unconditional right to cancel their investment commitments until 48 hours before the deadline identified in the issuer's offering materials.
- Provide communication channels that meet certain requirements to permit discussions among investors and between investors and the issuer about offerings on the platform.

Proposed FINRA Crowdfunding Rules. Intermediaries are required to register with FINRA, the only national securities association. FINRA is simultaneously soliciting public comment on a set of proposed rules—referred to as the Funding Portal Rules—and related forms for SEC-registered funding portals that become FINRA members. The proposed Funding Portal Rules include:

- Subjecting all funding portal members to FINRA by-laws.
- Outlining a streamlined application process for funding portals applying for membership.
- Providing standard of conduct for funding portal members.
- Requiring a system of supervision of associated persons for funding portal members, implementation of a written anti-money laundering program, and agreement to report to FINRA regulatory proceedings, disciplinary and other events.
- Subjecting funding portal members to the FINRA investigations and sanctions rules.

North Carolina Crowdfunding Bill

The NC JOBS Act currently remains in the Commerce Committee of the NC Senate but will be eligible for consideration by the Senate in the 2014 short session that begins in May, 2014. Key features of the NC JOBS Act include:

- Issuers must be business entities incorporated in NC;
- Investors must be NC residents;

- Transaction must meet the requirements of the federal exemption for intrastate offerings in Section 3(a)(11) of the Securities Act;
- Offering amount under exemption not to exceed the following amounts in a 12-month period:
 - \$1 million without audited US GAAP financial statements for the issuer's most recently completed fiscal year, or
 - \$2 million with audited US GAAP financial statements for the issuer's most recently completed fiscal year;
- Investors would be able to invest no more than \$2,000 per issuer (unless they are accredited, in which case there is no limit on the amount they can invest);
- Issuers would be required to communicate in writing the business plan, intended use of proceeds, and the terms of the offering;
- Quarterly reports would be provided to all investors discussing executive compensation and management analysis of operating results and financial condition;
- Issuers would be permitted to promote the offering publicly after filing notice with the state securities regulatory agency; and
- Investors would be required to certify in writing by the time of sale that they understand the risks of unregistered securities, that they may lose their entire investment, and that there may be no ready market for the sale of the securities.

We cannot predict whether the NC JOBS Act will ultimately pass the Senate (with or without modification). As is the case with the SEC's crowdfunding proposals, companies may not conduct offerings in reliance upon these provisions unless (and until) it becomes law in North Carolina.

Please contact us if you have any questions or would like to learn more about the information covered in this Alert.

