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SEC Adopts Final Crowdfunding Rules

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Title III of the Jumpstart Our Business Startups Act of 2012 (the “JOBS Act”) was enacted with the intent of enabling small issuers greater access to capital, while maintaining certain safeguards for the protection of investors, especially less sophisticated investors. Consistent with this intent, the JOBS Act created an exemption from registration under the Securities Act of 1933 (the “1933 Act”) for certain “crowdfunding” activities conducted through intermediaries that meet specified conditions. Generally, “crowdfunding” refers to unregistered securities offerings that are made to a large number of investors, including non-accredited investors, each of whom invests a relatively small amount. This Legal Alert provides a summary of certain recent legal developments surrounding crowdfunding.

On October 30, 2015, the U.S. Securities and Exchange Commission (“SEC”) adopted the final rules that allow issuers to raise capital through crowdfunding, subject to specific requirements outlined in the rules (the “Crowdfunding Rules”). In addition, at the same meeting where the Crowdfunding Rules were adopted, the SEC proposed amendments to existing Rules 147 and 504, promulgated under the 1933 Act, which would relax some of the restraints placed on issuers offering securities under those exemptions. In anticipation of the SEC’s adoption of the Crowdfunding Rules, on October 9, 2015, the Financial Industry Regulatory Authority, Inc. (“FINRA”) filed proposed rule changes (the “Funding Portal Rules”) that would affect the regulation of SEC-registered Funding Portals (i.e., crowdfunding websites) and brokers that facilitate crowdfunding (collectively, “Intermediaries”). The new Crowdfunding Rules will become effective May 16, 2016,¹ and the proposed FINRA rules, if approved by the SEC, would become effective in early 2016.

Crowdfunding Rules

Issuer and Investor Limits

Title III of the JOBS Act created the exemption found under Section 4(a)(6) of the 1933 Act. The SEC originally proposed rules and forms pursuant to Title III in October 2013. Section 4(a)(6) and the newly adopted Crowdfunding Rules allow:

- issuers² relying on Section 4(a)(6) to raise up to \$1,000,000 through crowdfunding during a 12-month period; and
- individual investors to invest, in **all** crowdfunding offerings over a 12-month period, no more than the following, as applicable:

<p>If the individual investor's annual income or net worth is less than \$100,000³</p>	<p>Then the greater of:</p> <ul style="list-style-type: none"> • \$2,000 or • 5% of the investor's annual income or net worth, whichever is less.
<p>If both the individual investor's annual income and net worth are equal to or greater than \$100,000³</p>	<p>Then 10% of the investor's annual income or net worth, whichever is less, but no more than \$100,000.</p>

Form C Requirements

If an issuer relies upon the Section 4(a)(6) exemption, the issuer must prepare and file Form C, a new form created as part of the Crowdfunding Rules, with the SEC. Form C requires issuers to disclose specific information about the issuer and the crowdfunding offering, including information about the issuer's:

- directors and officers;
- 20% or greater beneficial owners;
- current business and anticipated plans;
- proposed use of the proceeds from the offering; and
- capital structure.

In addition, issuers must provide the target amount of the offering, the offering price and how the offering price will be determined, the offering deadline, and various other disclosure items. Form C also requires a narrative discussion that is similar to a management discussion and analysis (MD&A) required in public company 10-K filings, albeit with less required detail and complexity.

Issuers must also file financial statements for the two most recent fiscal years (or since inception if the issuer has been in existence less than two years) in connection with Form C, with the level of independent auditor involvement depending on the aggregate amount the issuer has raised in offerings relying on Section 4(a)(6) during the most recent 12-month period. These financial statement requirements are summarized briefly below:

<p>Offerings of \$100,000 or less</p>	<p>GAAP financial statements and the amount of total income, taxable income, and total tax as reflected on the issuer's tax return for its most recently completed fiscal year.</p> <p>If the issuer has reviewed or audited financial statements, it must provide these instead.</p>
<p>Offerings between \$100,000 and \$500,000</p>	<p>Reviewed GAAP financial statements that are accompanied by the review report.</p> <p>If the issuer has audited financial statements, it must provide these instead.</p>

Offerings over \$500,000	<p>A first-time issuer under Section 4(a)(6) conducting an offering over \$500,000 is required to provide reviewed financials that are accompanied by the review report (unless the issuer has audited financials).</p> <p>Issuers that have previously sold securities under Section 4(a)(6) are required to provide audited GAAP financial statements, accompanied by the audit report.</p>
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Issuers are required to file certain ongoing updates and annual reports that are detailed below:

<p>Amendments to Offering Statement: Form C/A</p>	<p>Form C/A must be filed and provided to potential investors, subscribers (i.e., those that have committed to invest in the offering), and the relevant Intermediary if there are material changes, additions, or updates to information that was provided in Form C for an offering that has not been completed or terminated yet. The issuer must affirmatively request on Form C/A that subscribers reconfirm their commitments in the applicable offering within five business days of filing Form C/A. If a subscriber does not reconfirm a commitment, then the subscriber's commitment will be considered cancelled.</p>
<p>Progress Update: Form C-U</p>	<p>Form C-U must be filed and provided to potential investors, subscribers, and the relevant Intermediary no later than 5 business days after: (1) the offering reaches 50% and 100% of the target offering amount; and/or (2) the offering deadline if the issuer will accept more proceeds than the original target offering amount. However, if the issuer makes frequent updates regarding the progress of the offering on the Intermediary's website, then Form C-U will only be required to disclose the total amount of commitments within five days of the passing of the offering deadline.</p>
<p>Annual Reports: Form C-AR</p>	<p>Form C-AR must be filed and posted on the issuer's website, along with applicable financial statements, no later than 120 days after the fiscal year period covered in Form C-AR has concluded.⁴</p>
<p>Amendments to Annual Reports: Form C-AR/A</p>	<p>Where there is a material a change in the information reported on a Form C-AR, Issuers are required to amend the previously Form C-AR by filing a Form C-AR/A as soon as practicable after the need for the amendment has been discovered.</p>

Termination of Reporting: Form C-TR	<p>An issuer may become eligible to terminate its ongoing annual reporting requirements if one of the following occurs:</p> <ul style="list-style-type: none"> • The issuer becomes a reporting company that must comply with the Securities Exchange Act of 1934, as amended; • The issuer has filed at least one annual report through Form C-AR, has no more than 300 holders of record, and its total assets do not exceed \$10,000,000; • The issuer has filed at least three annual reports through Form C-AR; • All of the issuer's securities sold under Section 4(a)(6) were repurchased by another party or the issuer; or • The issuer has liquidated its assets or dissolved. <p>To terminate Form C-AR reporting requirements, an issuer must file Form C-TR within five business days from the date on which the issuer became eligible to terminate its reporting obligation.</p>
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Use of Intermediaries

The Crowdfunding Rules require issuers relying on Section 4(a)(6) to use an Intermediary to facilitate a crowdfunding offering. An Intermediary can be: (1) a broker-dealer registered with the SEC; or (2) a Funding Portal registered with the SEC under the new Funding Portal registration process created by the Crowdfunding Rules. In addition to requiring that Intermediaries must be registered with the SEC as a broker or Funding Portal, the Crowdfunding Rules establish certain other requirements for Intermediaries, including each of the following:

- Directors, officers, and partners of an Intermediary are generally prohibited from having a financial interest in an issuer for which the Intermediary is facilitating the crowdfunding offering. However, the Intermediary may receive a financial interest in the issuer using the Intermediary's services if: (1) the financial interest is compensation in exchange for the services provided for that particular offering; and (2) the financial interest is limited to the securities of the same class, terms, and rights granted to securities issued through the offering that the Intermediary facilitated.
- Intermediaries must provide certain information to investors, including: (1) information about the issuer and the offering no later than 21 days before the first day securities are sold to any investor; and (2) educational materials as prescribed by the Crowdfunding Rules.
- Intermediaries must establish certain anti-fraud policies and are responsible for ensuring investors do not exceed the investment limitations discussed above in the section, "Issuer and Investor Limits." In monitoring such investment limitations, Intermediaries may rely on the information investors represent to the Intermediaries regarding their income, net worth and total crowdfunding investments for the previous 12 months.
- Intermediaries must allow subscribers to revoke their commitments, regardless of the reason, until 48 hours before the offering deadline. If an issuer moves an offering's closing deadline to an earlier date or time than originally scheduled because the issuer has acquired commitments for its target amount through the offering, the issuer and Intermediaries must follow certain notice procedures to give subscribers the opportunity to cancel their commitments before the new deadline. There are also procedures and requirements that Intermediaries must follow if an offering is terminated or materially changed.

- Intermediaries must maintain communication channels among: (1) investors (including potential investors and subscribers); and (2) investors (including potential investors and subscribers) and the issuer about the crowdfunding offerings taking place through that particular Intermediary.
- Intermediaries must be members of FINRA. In anticipation of the SEC's adoption of the Crowdfunding Rules, FINRA has proposed its own set of rules that specifically govern Funding Portals, which are discussed below.

Advertising and Communications

The Crowdfunding Rules also establish advertising limitations for issuers. An issuer may not directly or indirectly advertise the offering, except through a notice that meets certain standards. A permissible notice about the issuer's crowdfunding offering must direct potential investors to the Intermediary's platform and include no more than:

- a statement that the offering is taking place pursuant to Section 4(a)(6), the name of the Intermediary, and a link to the Intermediary's platform;
- the terms of the offering; and
- factual information about the issuer's legal identity, business location, and contact information, as well as a brief description of the issuer's business.

An issuer and persons acting on behalf of the issuer may communicate with investors and potential investors through communication channels provided by the Intermediaries, including on their websites, about the amount of securities offered, the nature of the securities, the price of the securities, and the closing date of the offering period provided that the issuer identifies itself as the issuer in all such communications. An issuer is **not** permitted to communicate with potential investors about the offering, during its pendency, outside of such channels.

Integration

The Crowdfunding Rules provide that Section 4(a)(6) offerings will not be integrated with offerings conducted under other 1933 Act exemptions, even if concurrently made, so long as each offering complies with its respective exemption.

FINRA's Proposed Role in Crowdfunding Regulation

Proposed Funding Portal Rules

FINRA's Funding Portal Rules, if adopted, would apply only to Funding Portals that both register with the SEC as such and become members of FINRA. In its commentary in its release of the Funding Portal Rules, FINRA stated that it intends for the Funding Portal Rules to be more "streamlined" than its existing rules for brokers.

The Funding Portal Rules cover a wide range of topics, including the process of becoming a member, the actions required of a Funding Portal member, and arbitration and mediation procedures if a controversy were to occur. Specifically, the Funding Portal Rules would prohibit the use of manipulative and misleading tactics and require a Funding Portal to maintain high standards of commercial honor and just and equitable principles of trade when conducting its business. Furthermore, Funding Portals would be required to comply with FINRA's By-Laws and Code of Procedure, as well as implement certain supervisory systems. Funding Portals would also be required to follow the appropriate reporting requirements, including, but not limited to, information regarding gross revenue, contact information, and records of persons associated with the Funding Portal. Like other members of FINRA, Funding Portals that become members could also become subject to FINRA investigations and sanctions under the proposed rules.

Acknowledging that registered broker members of FINRA may act as intermediaries for crowdfunding offerings, FINRA also proposed Rule 4518, which would require that the registered broker notify FINRA of its involvement in a crowdfunding transaction either: (1) before engaging for the first time in a transaction

exempted by Section 4(a)(6); or (2) within 30 days of directly or indirectly controlling, or being controlled by or under common control with, a Funding Portal.

FINRA's Regulatory Distinctions between Funding Portals and Brokers

On the whole, the FINRA and SEC requirements that regulate Funding Portals would be less burdensome than the FINRA requirements for broker-dealers. For example, FINRA has 180 days to determine whether a broker who has applied for membership should be admitted, whereas FINRA only has 60 days to determine whether a Funding Portal should be admitted. The Funding Portal Rules also provide for more consolidated standards for evaluating a Funding Portal applicant than those FINRA uses to evaluate broker applicants. Even after a Funding Portal becomes a member of FINRA, the ongoing compliance rules are more flexible than those that regulate broker members. For example, Funding Portal members, unlike broker members, would not have to meet minimum net capital requirements.

Proposed Amendments to Rules 147 and 504

Concurrent with adopting the Crowdfunding Rules, the SEC proposed amendments to Rule 147 and Rule 504. Each of these amendments are discussed below. The SEC will accept comments on these proposed rules until January 11, 2016.

Proposed Amendments to Rule 147

Rule 147 is a safe harbor to an intrastate exemption found under Section 3(a)(11) of the 1933 Act. Currently, the intrastate exemption only allows for an offering to be exempted from the registration requirements of the 1933 Act if the issuer is incorporated in the same state in which all offerees (not just those who actually purchase securities through the offering) reside.

The SEC has proposed three changes to modernize Rule 147 “to further facilitate capital formation, including through crowdfunding provisions.” These proposed changes include the following:

- replacing the requirement that all offerees be residents of the issuer’s state or territory of incorporation with the requirement that all **purchasers** be residents of the issuer’s state or territory of incorporation;
- distinguishing Rule 147 as an entirely new intrastate exemption separate from the intrastate exemption found in Section 3(a)(11);
- easing some of the requirements that affect an issuer’s eligibility to qualify for Rule 147; and
- limiting the federal exemption to offerings that either: (1) are registered under state law in the state in which all of the purchasers are residents; or (2) meet the requirements for a state exemption that: (a) limits how much an investor may invest; and (b) prohibits an issuer from selling more than \$5,000,000 worth of securities in a 12-month period.⁵

Proposed Amendments to Rule 504

Currently, Rule 504 allows certain issuers to be exempt from registration with the SEC if the issuers offer and sell no more than \$1,000,000 of their securities in a 12-month period. The SEC has proposed to modify Rule 504’s requirements by: (1) increasing the \$1,000,000 limitation to \$5,000,000; and (2) disqualifying “certain bad actors” from being able to use the Rule 504 exemption.

Future Considerations

The adoption of the Crowdfunding Rules, the proposal of the Funding Portal Rules, and the proposal of the amendments to Rules 147 and 504 demonstrate the ongoing establishment of the regulatory framework relevant to crowdfunding. With the adoption of the Crowdfunding Rules, small businesses may now be able to acquire capital from non-accredited investors more efficiently. However, issuers that intend to use crowdfunding to raise capital should carefully consider the significant complexities of, and ongoing requirements under, the regulatory framework relevant to crowdfunding.

The SEC Release announcing the adoption of the Crowdfunding Rules and the proposed amendments to Rule 147 and Rule 504 can be found [here](#). FINRA's announcement regarding the proposed Funding Portal Rules and Rule 4518 can be found [here](#).

For more information about these issues, please contact the author(s) of this Legal Alert or your existing firm contact.

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¹ However, Form Funding Portal, the form that Funding Portals must file with the SEC to become registered with the SEC and the amendments to Form ID will become effective January 29, 2016.

² The following companies are ineligible for the exemption under Section 4(a)(6): non-U.S. companies; companies that report to the SEC under the Securities Exchange Act of 1934, as amended; certain investment companies; companies that are subject to disqualification under the Crowdfunding Rules; companies that have not complied with the annual reporting requirements under the Crowdfunding Rules for the two years immediately preceding the filing of the crowdfunding offering statement; and companies that lack a specific business plan or intend to participate in a merger or acquisition with an unidentified company or companies.

³ "Annual income" and "net worth" are calculated based on the same SEC rules that are used to calculate whether an investor is an "accredited investor" under the 1933 Act.

⁴ Financial statements to be included in Form C-AR are not required to be reviewed or audited, unless the issuer prepares reviewed or audited financials for another purpose.

⁵ "SEC Adopts Rules to Permit Crowdfunding," October 30, 2015 at <http://www.sec.gov/news/pressrelease/2015-249.html>.