

## Securities Law Issues Involving Crowdfunding Transactions

By Michelle L. Jacko

*It has been almost 6 years since the [Jumpstart Our Business Startups \(JOBS\) Act](#) was signed into law. Steadily, the SEC and other federal and [state agencies](#) have been implementing various components of the JOBS Act, including new channels of raising capital formation for private funds and other issuers. In this issue of Currents, we'll explore two such channels: [Crowdfunding](#) and [Private Fund Public Solicitations](#).*

### Introduction

The challenge for many small businesses is having access to cash when starting their business operations. In 2012, an easier path to capital raising finally emerged. Under Title III of the Jumpstart Our Business Startups (JOBS) Act, Section 4(a)(6) was added to the Securities Act of 1933 ("Securities Act"), which provides an exemption from registration for the offer and sale of securities for certain crowdfunding transactions.

Crowdfunding allows issuers to raise capital through use of the Internet. Generally, a corporate entity or individual will seek small capital contributions for a particular business idea or venture. The "crowd" (i.e., the investors providing such capital) then share information about the issuer's business idea or venture, which can prove helpful in deciding whether to fund the campaign based on the feedback from the "crowd."

In 2015, Regulation Crowdfunding<sup>1</sup> was adopted by the U.S. Securities and Exchange Commission ("SEC") to implement Title III, thus allowing for qualifying companies to commence raising capital. This month's Risk Management Tip will focus on securities law regulations involving crowdfunding transactions and will provide practical considerations for engaging in crowdfunding activities.

### Requirements of Regulation Crowdfunding

There are numerous requirements for Regulation Crowdfunding that issuers must be aware of. To illustrate some of the challenges which a business owner may face, consider the following hypothetical case study.

Sarah is starting her own wealth management firm that will focus on socially responsible investing. She has received positive feedback from friends and family, but now realizes that the costs of her infrastructure associated with the launch of her business is much more than originally forecasted. If only she had an additional \$350,000, she could hire the right support, engage experienced vendors, and purchase the software and technologies necessary for her to successfully launch her business.

Sarah engages counsel to learn about various options available to her and learns that crowdfunding offers a great opportunity for her to raise capital. Importantly, however, she quickly learns that there are specific limitations that she must consider.

### About the Author

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1. See <https://www.sec.gov/rules/final/2015/33-9974.pdf>.

1. *Issuers May Only Raise \$1.07 Million in the Aggregate Over a 12-Month Period*

Pursuant to Regulation Crowdfunding, an issuer may only raise \$1,070,000 in the aggregate over a 12-month period. This includes both any amounts already sold by the issuer (e.g., to affiliates as well as predecessors of the issuer) plus the dollar amount the issuer intends to raise through Regulation Crowdfunding. Learning this, Sarah is pleased that her capital raise requirements meet this threshold and determines that her entire raise can be conducted through Regulation Crowdfunding.

2. *Investors Are Limited in the Amounts They Can Invest in a 12-Month Period*

Sarah has indications of interest from certain family and friends who are interested in this capital raise opportunity. If she pursues Regulation Crowdfunding, those investors must be able to satisfy the following:

- a. If the investor's annual income or net worth<sup>2</sup> is less than \$107,000, then the investor can only invest the greater of \$2,200 or 5% of the lesser of the investor's net worth or annual income.
- b. If the investor's annual income and net worth are equal to or more than \$107,000, then the investor can invest up to 10% of the lesser of the investor's net worth or annual income.
- c. For all investors, during a 12-month period, the total amount of an investor's Regulation Crowdfunding investments must not exceed \$107,000 regardless of annual income or net worth.

Sarah believes that these thresholds can be met by most of her potential investors.

3. *The Regulation Crowdfunding Offer Must Be Exclusively Conducted Through an Online Platform*

Sarah learns that as an issuer, she will need to find a broker-dealer or a funding portal registered with the SEC and FINRA to help facilitate her Regulation Crowdfunding offering. This crowdfunding intermediary should be carefully vetted prior to engagement. Information related to brokers may be found on FINRA's BrokerCheck system at <https://brokercheck.finra.org/>, while information related to funding portals registered with the SEC which are funding portal members of FINRA is available at <https://www.finra.org/about/funding-portals-we-regulate>.

4. *Certain Disclosures Must Be Provided by Issuers*

Sarah continues her research and discovers there is a lot she will be required to do to prepare for her Regulation Crowdfunding offering. First, she will need to complete Form C (her offering statement) and file that through the SEC's EDGAR system. The offering statement will need to provide required information related to Sarah's officers, directors and owners of 20% or more of her company. She also will need to provide a description of her business, a description of how she intends to use the proceeds from the offering, how the price of her offering will be determined, the target offering amount and deadline to reach that target along with a statement of her company's financial condition. After learning this, Sarah reaches out to her accountant and counsel for additional guidance.

5. *Financial Statements Requirements Differ Based on the Size of the Offering*

Based upon her meeting with her professional advisors, Sarah learns that the amount of her Regulation Crowdfunding capital raise will trigger her financial statement requirements.

For issuers raising \$107,000 or less, the issuer will need to have the issuer's federal tax returns certified by the principal executive officer, or have the financial statements audited or reviewed by an independent accountant. For issuers offering \$107,000 to \$535,000 (such as Sarah), the issuer is required to have the financial statements reviewed or audited by an independent accountant and make available the accountant's review report. For anything over a \$535,000 raise, first time crowdfunding issuers are held to the same standards; i.e., the issuer is required to have the financial statements reviewed or audited by an independent accountant. However, for veteran crowdfunding issuers, they must have their financial statements audited by an independent public accounting firm.

Even though Sarah knows that an audit of her financial statement would be more expensive, she believes that would provide a higher level of scrutiny and provide potential investors with a greater sense of comfort about her company.

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2. For calculating net worth and annual income, spouses are allowed to calculate this jointly.

## 6. Limits on Advertising

Sarah is surprised to learn that the way in which she can promote this opportunity is limited. As an issuer, she cannot advertise the terms of the Regulation Crowdfunding opportunity, except to provide a notice that directs investors to the crowdfunding intermediary's platform. Specifically, she would be permitted to share:

- The offering is made pursuant to Section 4(a)(6) of the Securities Act;
- The name of the intermediary through which the offering is being made; and
- A link to the intermediary's platform.

While the issuer can provide information related to the offering, the issuer can only share generic information, such as the name, address and telephone number associated with the offering, the legal entity sponsoring the offering and the business location of the issuer.

Consequently, one of the areas that Sarah should consider is the crowdfunding platform itself. Because sharing of views by members of the crowd is considered to be an integral part of crowdfunding, the crowdfunding platform's communication channels and "online forum" to allow the crowd of investors to weigh in on the pros and cons of Sarah's opportunity, should be reviewed carefully. She will also want the ability to address questions posed by the crowd as quickly as possible.

## 7. Other Considerations

Sarah confers with counsel on what other areas she needs to be aware of. Regulation Crowdfunding does impose restrictions on resale; i.e., the securities purchased cannot be resold for a period of one year. However, certain exceptions exist if shares are transferred:

- To the company that issued the securities;
- To an accredited investor;
- To a family member of the purchaser; or
- As part of an offering registered with the SEC.

In addition, Sarah learns that if she ever wishes to expand her company to include other officers, directors, managing members or affiliates, or consider the use of a promoter or finder for the offering, she would have to consider whether they could be deemed a "bad actor" pursuant to Rule 503, and thus disqualified from making an offering. "Bad Actor" disqualifying events include certain criminal court convictions, court injunctions, restraining orders, final orders of certain state and federal regulator and SEC disciplinary orders (among other events). While exceptions and waivers exist, Sarah is working with counsel to develop a "Bad Actor" worksheet, which will be used by her to conduct due diligence on any person or entity involved with her offering.

## Conclusion

Crowdfunding offers opportunities – both for the general public and the issuer – to participate in early capital raising opportunities. Because of the intricacies involved in this offering, it is important to engage qualified professionals to guide you through this process. This Risk Management Tip was designed to provide a summary of Regulation Crowdfunding considerations that most commonly impacts small business and does not contain all requirements under the rule. We strongly encourage you to review Regulation Crowdfunding<sup>3</sup> in its entirety and refer to the SEC's Small Entity Compliance Guide for Issuers, which may be found at <https://www.sec.gov/info/smallbus/secg/rcomplianceguide-051316.htm>.

*This article is for information purposes and does not contain or convey legal advice. The information herein should not be relied upon in regard to any particular facts or circumstances without first consulting with a lawyer.*

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3. See <https://www.sec.gov/rules/final/2015/33-9974.pdf>.