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SEC adopts final rules for securities crowdfunding under Title III of the JOBS Act

December 2015

Crowdfunding is a promising method for startups and small businesses to raise capital. Dentons examines how new SEC rules will impact business owners, investors and other participants in this fast-growing segment of US capital markets.

Introduction

The US Securities and Exchange Commission (SEC) has adopted Regulation Crowdfunding, a series of rules that implements the provisions of Title III of the Jumpstart Our Business Startups Act, or JOBS Act, and allows startups and small businesses to raise up to a maximum aggregate amount of US$1,000,000 through securities-based crowdfunding offerings in a 12-month period, and allows investors to invest up to US$100,000 across all securities-based crowdfunding offerings in a 12-month period, depending on the investor's annual income and net worth.

The final rules also provide a framework to regulate a new category of so-called "funding portal"[1] intermediaries, in coordination with rules pertaining to funding portals proposed by the Financial Industry Regulatory Authority, Inc. (FINRA), the self-regulatory organization for broker-dealers and the new funding portals.[2] Crowdfunding issuers must use an intermediary that is either a registered broker-dealer or a funding portal in order to solicit investments from crowdfunding investors and issue crowdfunding securities to such investors.

The SEC approved these final rules, known as Regulation Crowdfunding, after more than a three-year comment period, on October 30, 2015. The new rules take effect on May 16, 2016.[3] Until that time, issuers and intermediaries may not use these rules to conduct any securities-based crowdfunding activities.

Background

Crowdfunding involves the use of the Internet by individuals or organizations to find other people or organizations to fund their projects, often artistic or charitable endeavors as well as personal and business projects, typically in exchange for a future service, product or other benefit. A crowdfunding campaign typically has a target amount of funds to be raised and an identified use for those funds. Because the Internet is the venue for crowdfunding activities, those seeking funds can appeal to anyone anywhere. Those who are interested in a crowdfunding campaign can in turn use the Internet to share information about the project with others, generating the "wisdom of the crowd" to collectively identify and reward, with a financial contribution, those projects deemed most attractive, or to reject those projects deemed unworthy or a mere "sham."

To date, crowdfunding generally has not been used by businesses seeking to raise capital in exchange for securities of the business because doing so would trigger the application of the Securities Act of 1933 (Securities Act), under which the offer and sale of securities is required to be registered with the SEC unless an exemption applies.

The JOBS Act provides such an exemption by adding Section 4(a)(6) to the Securities Act to permit eligible issuers to conduct limited sales of securities without registration under the Securities Act through Internet-based crowdfunding activities intermediated by either a registered broker-dealer or a funding portal.[4]

In addition, it exempts such issuers from state blue sky registration provisions (but not state anti-fraud provisions). Although the JOBS Act is in effect, its crowdfunding provisions could not be relied upon until the SEC, and FINRA with respect to funding portals, adopted final rules implementing securities-based crowdfunding.

The SEC's final rules, as required, closely track the provisions of the JOBS Act, including new Securities Act Section 4(a)(6). Under Section 4(a)(6):

- The amount raised by an issuer must not exceed US$1 million in a 12-month period.
- An investor is limited in the amount he/she may invest in crowdfunding securities in any 12-month period across all issuers.
- Transactions must be conducted through an intermediary that is registered either as a broker-dealer or a funding portal.

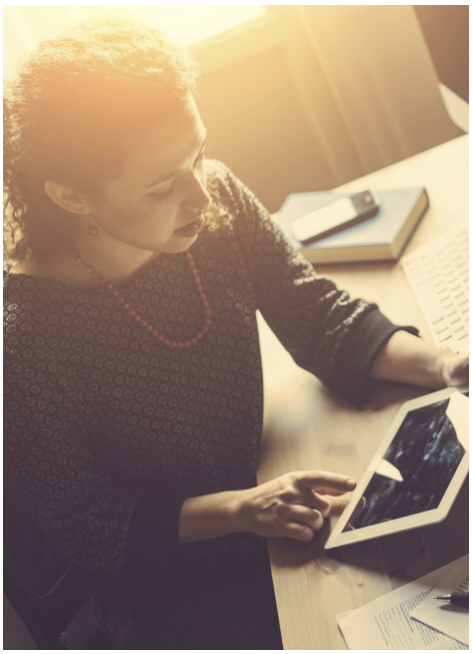
In addition, the crowdfunding provisions of the JOBS Act add:

- Section 4A to the Securities Act, which requires, among other things:
  - Issuers and intermediaries relying on the crowdfunding exemption to provide certain information to the SEC, investors and potential investors
  - Funding portals to register as such (or as a broker-dealer)
- Section 3(h) to the Securities Exchange Act of 1934 (Exchange Act), which requires the SEC to adopt rules exempting funding portals from having to register as brokers or dealers pursuant to Exchange Act Section 15(a)(1)
- Section 12(g)(6) to the Exchange Act, which requires the SEC to adopt rules exempting securities acquired pursuant to an offering made in reliance on the crowdfunding exemption from the registration requirements of Section 12(g)

Overview

Prior to issuing its initial proposal, the SEC solicited public input on each title of the JOBS Act, including Title III.[5] The adopting release also references and analyzes comments the SEC received during the post-proposal period.[6] In the adopting release for the new rules, the SEC acknowledges the need to balance the protection of ordinary investors from fraud against Congress' goal of reducing regulations on capital raising for startups and small companies. Many believe that securities-based crowdfunding may offer a potential solution to small businesses' funding problems. They point to the success of non-securities based crowdfunding activities through which individuals and organizations reportedly raised approximately US$2.7 billion in funding worldwide in 2012. However, even the strongest advocates of securities-based crowdfunding acknowledge the potentially substantial risks to investors. Investing in small businesses is inherently risky, as many new business ventures fail. Furthermore, small business investments tend to be highly illiquid since most such offerings are too small to support any active secondary trading market.

In addition to those risks, state securities regulators and others have commented that small business investments may pose higher risks of fraud, self-dealing and overreaching by controlling shareholders. The JOBS Act and the new SEC rules attempt to address such risks by: (i) establishing issuer eligibility requirements that prohibit certain issuers from engaging in securities-based crowdfunding under the new exemption; (ii) requiring issuers to make specific disclosures to potential investors and the SEC in prescribed ways; (iii) strictly limiting the amount a single investor can invest within a 12-month period in securities-based crowdfunding offerings, as noted above and explained further below; and (iv) requiring a single funding portal or registered broker-dealer to act in the dual role of gatekeeper and facilitator between potential investors and the issuer. Under the SEC's rules, the intermediary is required to perform functions and implement procedures designed to protect investors. For example, the intermediary must provide an online communication platform for the issuer to make required disclosures and for the crowd to share information about potential investments.



Final rules

Issuer sale and investor purchase limits

The SEC's rules implement the requirements in Section 4(a)(6) that strictly limit the amounts of securities an eligible issuer can sell to investors in any 12-month period. The limitations are as follows:

- The aggregate amount an eligible issuer may sell to all investors during the prior 12-month period may not exceed US$1,000,000.[7]

This limitation is independent of any money raised pursuant to other exemptions, such as Regulation D, meaning that capital raised under other exemptions does not count toward the US$1,000,000 limit under Section 4(a)(6).

- The aggregate amount an investor may invest in all crowdfunding offerings (whether made by one or more issuers) during the prior 12-month period may not exceed:
    - The greater of US$2,000 or 5 percent of the lesser of the investor's annual income or net worth, if either the investor's annual income or net worth is less than US$100,000
    - Ten percent of the lesser of the investor's annual income or net worth, if both the investor's annual income and net worth are US$100,000 or more, provided that no investor may invest more than US$100,000 regardless of annual income or net worth[8]

The rules require a natural person's annual income or net worth to be calculated in accordance with the rules for determining accredited investor status.[9]

Securities-based crowdfunding transactions must be conducted exclusively over the Internet on a "platform" through either a broker-dealer or a funding portal intermediary. A platform is defined as "a program or application accessible via the Internet or other similar electronic communication medium through which a registered broker or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities." Each issuer is required to use only one intermediary so that the intermediary, among other things, can help ensure that neither the issuer nor any investor is exceeding the applicable aggregate issuer sale and investor purchase limits. Intermediaries are prohibited from soliciting investments or providing investment advice; however, the final rules change the proposed rules to permit an intermediary to engage in back office and other administrative functions off the intermediary's platform.

Resale restrictions

While securities-based crowdfunding transactions involve public offers and sales exempt from registration under the Securities Act, securities sold in a crowdfunding transaction are subject to transfer restrictions that prohibit an investor from reselling such securities for one year,[10] except when transferred:

- To the issuer of the securities
- To an accredited investor[11]
- As part of an offering registered with the SEC
- To a family member of the purchaser, a trust controlled by the purchaser, a trust for the benefit of a family member, or in connection with the death or divorce of the purchaser

Requirements for issuers

Issuer eligibility

To rely on the exemption provided under Section 4(a)(6), the issuer must be a company incorporated in or organized under the laws of a US state or territory. Certain entities are prohibited from engaging in securities-based crowdfunding offerings under Section 4(a)(6) as follows:

- All foreign issuers, including Canadian issuers
- Issuers already subject to SEC reporting requirements
- Investment companies registered or required to be registered under the Investment Company Act of 1940
- "Blank-check" companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company

- Companies that have failed to comply with the annual reporting and disclosure requirements under Regulation Crowdfunding during the two years preceding the filing of the offering statement[12]

Offering disclosure requirements

All mandated disclosures, discussed in detail below, must be made on the intermediary's website for access by investors and also via the SEC's EDGAR filing system using new Form C. According to the SEC, the benefit of Form C is that it provides key offering information in a standardized format, while also giving the issuers a degree of flexibility in the presentation of other required information.

Financial statement requirements

An issuer offering or selling securities in reliance on Section 4(a)(6) must prepare comprehensive disclosure about itself and the offering. The issuer must file this disclosure with the SEC publicly via EDGAR on Form C and make it available on the intermediary's platform for review or download by potential investors at least 21 days before any securities may be sold.

The type of financial statements an issuer is required to provide depend on the amount the issuer is seeking to raise in the crowdfunding transaction, as follows:

- **If targeting US$100,000 or less:** The amount of total income, taxable income and total tax or equivalent line items, as reported on the federal tax forms filed by the issuer for the most recently completed year (if any), certified by the principal executive officer of the issuer, and the financial statements of the issuer, also certified by the principal executive officer.[13] However, if financial statements of the issuer that have either been reviewed or audited by a public accountant independent of the issuer are available, then the issuer must provide these financial statements instead of the materials described in the preceding sentence.

- **If targeting more than US$100,000 and less than US$500,000:** Financial statements of the issuer reviewed by a public accountant independent of the issuer.[14] If financial statements of the issuer that have been audited by a public accountant independent of the issuer are available, the issuer must provide those instead of the reviewed statements.

- **If targeting more than US$500,000:** Financial statements of the issuer audited by a public accountant independent of the issuer; provided, however, that for issuers that are first-time issuers, financial statements of the issuer reviewed by a public accountant independent of the issuer would suffice. If audited financial statements are available, those must be provided instead.

All financial statements must be prepared in accordance with US GAAP and include a balance sheet, income statement, statement of cash flows, and changes in owners' equity for two years (or since inception if less than two years).

Where an issuer sets a target amount but is willing to accept more than that target, the issuer must disclose the maximum amount it will accept and provide disclosure about the intended use of the additional proceeds, the method of allocation of the above-target shares and other disclosures. Additionally, the financial statement requirement is based on the maximum amount the issuer is willing to accept rather than the target amount.[15]

In addition to financial statements, the issuer must present a narrative discussion of its financial condition, which discussion is conceptually similar to the management's discussion and analysis required by Item 303 of Regulation S-K for registered offerings (MD&A). While the SEC did not prescribe the content or format of such information, it stated that the discussion here need not be as lengthy or detailed as the MD&A but should address the issuer's historical results of operations, liquidity and capital resources.[16]

Where an issuer is conducting a "follow-on" offering, the financial statements requirements are based on the aggregate amount offered by such issuer during the 12-month period prior to and including the target amount of the current offering. Thus, for example, if an issuer has made a prior offering with a target amount of

US$400,000, and such issuer seeks to conduct another crowdfunding offer with a target of US$200,000, it must provide audited financial statements as the aggregate amount of the two offerings would exceed US$500,000.[17]

Additional disclosure requirements

In addition to the financial statement requirements, other required disclosures include:

- The issuer's name, legal status, physical address and website address
- The names and three-year business experiences of directors and officers of the issuer, and the names of holders of 20 percent or more of the issuer's voting power[18]
- A description of the business and the business plan of the issuer
- A sufficiently detailed description of the intended use of the proceeds of the offering and the length of the period for which the proceeds are expected to satisfy the operational needs of the issuer
- The target offering amount, the deadline to reach that amount, how oversubscribed offerings will be allocated, and regular updates regarding the progress of the issuer in meeting the amount
- The offering price of the securities or the method for determining the price
- A description of the ownership and capital structure of the issuer, including:
  - The terms of the securities being offered and each other class of security of the issuer, including the number of securities being offered and/or outstanding, whether or not such securities have voting rights, any limitations on such voting rights, how the terms of the securities being offered may be modified and a summary of the differences between such securities and each other class of security of the issuer, and how the rights of the securities being offered may be materially limited, diluted or qualified by the rights of any other class of security of the issuer
  - A description of how the exercise of any rights held by the principal shareholders of the issuer could affect the purchasers of the securities being offered
  - How the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future
  - The risks to purchasers of the securities relating to minority ownership in the issuer and the

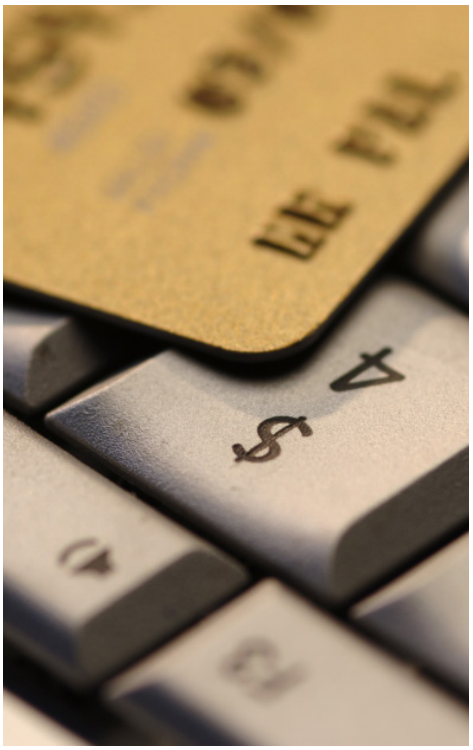
risks associated with corporate actions, including additional issuances of securities, issuer repurchases of securities, a sale of the issuer or of assets of the issuer or transactions with related parties

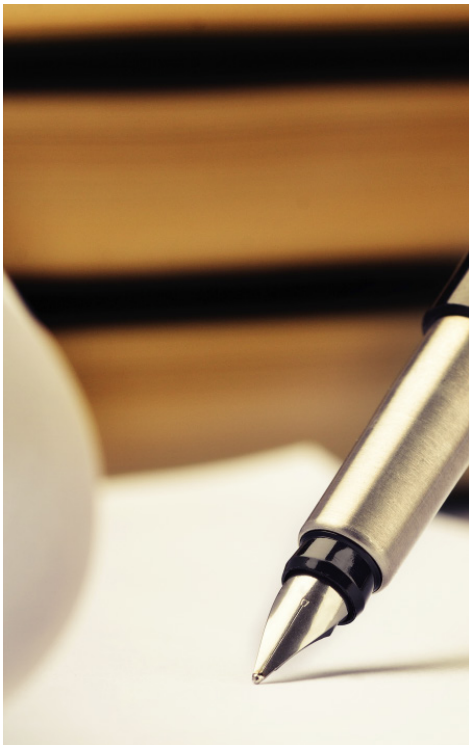
- A description of transfer restrictions with respect to the securities

In addition to the above statutory disclosure requirements, the final rules also require that an issuer's disclosure materials include the following:

- A discussion of the material factors that make an investment in the issuer speculative or risky
- A description of certain related-party transactions
- A description of the material terms of any indebtedness of the issuer, including the amount, interest rate, maturity date and any other material terms
- Disclosure of exempt offerings conducted by the issuer within the past three years, including the date of offering, the offering exemption relied upon, the type of securities offered and amount of securities sold and the use of the proceeds
- Disclosure of the current number of employees of the issuer
- Disclosure of the amount of compensation paid to the intermediary for conducting the offering, including the amount of any referral or other fees associated with the offering
- Inclusion of certain legends in the offering statement
- Disclosure of the name, SEC file number and Central Registration Depository number (as applicable) of the intermediary through which the offering is being conducted
- Disclosure of the location on the issuer's website where investors will be able to find the issuer's annual report and the date by which that report will be available
- Disclosure of an intermediary's direct or indirect interest in the issuer or any arrangement for the intermediary to acquire such an interest[19]
- Disclosure of whether the issuer or any of its predecessor companies previously failed to comply with Regulation Crowdfunding's reporting requirements
- Disclosure of any material information necessary in order to make statements made, in light of the circumstances under which they were made, not misleading

Issuers do not have to duplicate their disclosures and thus may cross-reference within the offering statement or annual report, including to the information's location in the financial statements.





The SEC's final rules also adopt a change from the proposed rules that will make it easier for businesses to comply with the disclosure requirement. Companies will be able to provide the required information using an optional question-and-answer format. Companies that choose this option must answer the provided questions and file that disclosure as an exhibit to Form C.

The SEC is not required to comment on, qualify (as with Regulation A offering statements) or declare effective (as with Securities Act registration statements) an issuer's disclosures made on Form C or otherwise on the intermediary's website. All issuer disclosures, however, whether included in Form C or on the intermediary's website, are subject to the anti-fraud provisions under Section 4A(c) of the Securities Act. Moreover, issuers should expect the SEC staff to review issuer crowdfunding disclosures as it monitors the use of the final crowdfunding rules and performs its enforcement functions.

Investment process and related disclosures

As noted above, issuers must disclose the target offering amount, the deadline to reach that amount, how oversubscribed offerings will be allocated and regular updates regarding the progress of the issuer in meeting the amount. As the offering is being conducted, issuers must allow investors with expressed interest in the offering to exit the offering as follows:

- Issuers must provide investors with the unconditional right to cancel their investment commitments until 48 hours prior to the offering deadline identified in the issuer's offering materials—after that deadline passes, an investor would only be able to cancel an investment commitment following notice of a material change to the offering, including determination of the final price of the securities offered.
- If an investor does not affirmatively reconfirm an investment commitment within five business days of receipt of notice of a material change to the terms of the offering, the investment must be cancelled and the intermediary is required, within five business days, to direct the return of committed funds.

If an issuer reaches its target offering amount prior to the expiration of a specified offering deadline, the issuer may close the offering early provided that:

- The offering was open for at least 21 days
- The intermediary provides notice about the new offering deadline at least five business days prior to the new offering deadline
- Investors are given an opportunity to reconsider their investment decision and cancel their commitment until 48 hours priors to the new deadline
- At the time of the new offering deadline, the issuer continues to meet or exceed the target offering amount

The rules provide that, if an offering is not completed because the target offering amount is not reached or the issuer otherwise terminates the offering, the intermediary must provide notice of the termination, including the reasons, direct the refund of investor funds and prevent investors from making further investments in the terminated offer.

Ongoing SEC disclosure requirements

The final rules require any issuer that has sold securities in a crowdfunding offering to file with the SEC via EDGAR, and post on its website, an annual report on Form C-AR disclosing its financial condition and results of operations and other information similar to that required about the issuer on Form C. The issuer must file the report within 120 days of the issuer's fiscal year end.

The annual report must also include financial statements of the issuer. While the proposed rules indicated that audited or reviewed financial statements would be required based upon the highest standard previously provided by the issuer for a crowdfunding offering, the final rules only require financial statements that are certified by the issuer's principal executive officer (unless reviewed or audited financial statements are already available, in which case, the ongoing annual report must contain

such reviewed or audited financial statements).

The proposed rules stated that issuers that trigger the ongoing reporting requirements would be required to file annual reports until:

- The issuer becomes a reporting company under Section 13(a) or Section 15(d) of the Exchange Act
- The issuer or another party repurchases all of the securities issued in the crowdfunding offering
- The issuer liquidates or dissolves its business in accordance with state law

The final rules retain the above termination events and add the following two events that terminate the ongoing reporting requirement:

- The issuer has filed at least one annual report and has fewer than 300 holders of record
- The issuer has filed at least three annual reports and has total assets that do not exceed US$10 million

Advertising restrictions

Section 4(a)(6) prohibits issuers from advertising their offerings outside of the intermediary's communication channels except for certain limited notices that direct investors to the intermediary's platform. Under the SEC's final rules, the only offline, or non-intermediary, website advertising that issuers may conduct is to publish a tombstone-like notice advertising the "terms of the offering," provided that the notice also includes the name of the intermediary facilitating the offering and a reference to the intermediary's platform where additional information about the issuer and the offering may be found. The "terms of the offering" are limited to:

- The amount of securities offered
- The nature of the securities
- The price of the securities
- The closing date of the offering period

Limited factual information about the issuer, including its name, business address, website address and other basic identifying information is also permitted in the notice. The SEC has not imposed limitations on how the issuer distributes the notices and notes that issuers could publish these tombstone-like notices on social media sites or the issuer's own website or in newspapers and other offline venues. Permitting advertising outside of the intermediary's communication channels or platform could be crucial to the success of securities-based crowdfunding, as the strongest interest in many small businesses and startups may be found locally where the issuer's business and management team are located or where its products and services are sold. The SEC notes that these rules will allow issuers to use social media to attract investors while protecting investors by requiring issuers who advertise to link their investors to the intermediary's platform, where the investors can read the required disclosure.

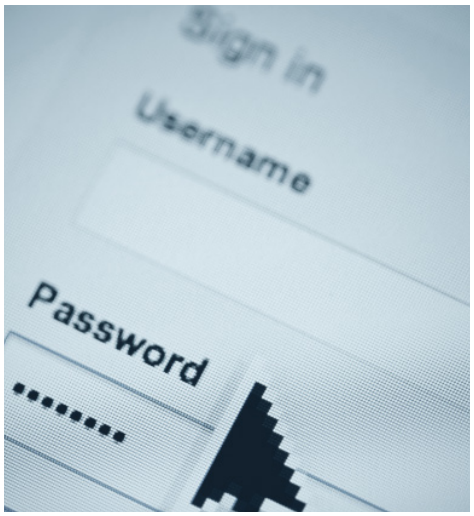
Recordkeeping

The final rules require an issuer to establish a means to keep accurate and complete records of the securities it sells to investors. Although the SEC did not propose a particular form or method of recordkeeping of securities that an issuer must have in place, the final rules do provide issuers and intermediaries with a safe harbor if the issuer engages the services of a registered transfer agent.

Requirements for intermediaries

The SEC's rules require a crowdfunding transaction to be conducted online through a broker or funding portal. A funding portal is a new category of broker required to register with the SEC and FINRA and is defined as a person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others solely pursuant to Section 4(a)(6). The intermediary requirement is intended to ensure that:

- All relevant information regarding the offering will be available to the crowd in a single, regulated, online location—the intermediary's website—enabling the "wisdom of the crowd" to form and grow.
- The investor protection provisions of the rules, including issuer disclosure requirements, prescribed offering procedures,



issuer offer limits and investor investment limits are implemented and monitored by such intermediaries.

Communication channels

Regulation Crowdfunding requires an intermediary to provide on its platform channels through which investors can communicate with one another and with representatives of the issuers about offerings made on the intermediary's portal. While the JOBS Act does not require such a feature, the SEC agreed with Title III commenters who suggested that such a feature would be an integral component of crowdfunding by providing a centralized and transparent way for investors to share their views and communicate with representatives of the issuer about the offering. Some of the requirements of the communication channels are as follows:

- While the general public must be able to view communications on the channel, only persons that have accounts with the intermediary may post comments on the channel.
- While intermediaries may track the origins of, and remove, any abusive or potentially fraudulent comments made on the channels, they may not themselves participate in these discussions.
- Any person posting a comment would have to declare if he/she is a founder or employee of the issuer, or is engaging in promotional or otherwise compensatory activities on behalf of the issuer.
- The issuer must identify itself as the issuer in all these communications.

Registration and SRO membership

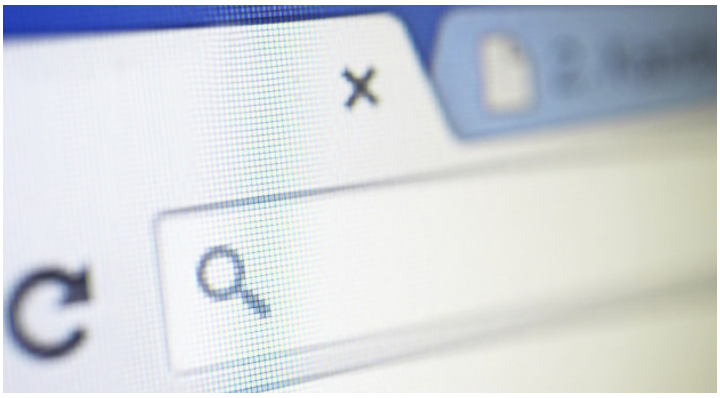
The final rules require intermediaries to:

- Register with the SEC as a funding portal pursuant to Regulation Crowdfunding Rules Section 227.400 or as a broker under Exchange Act Section 15(b)
- Register with a national securities association registered under Exchange Act Section 15A[20]

Non-US based funding portals may register as funding portals provided that an information-sharing agreement exists between the SEC and the "competent regulator" in the non-resident funding portal's home country. In addition, the non-resident funding portal must appoint an agent to submit to service of process in the United States and must allow prompt on-site inspection of its books and records by the SEC.

Financial interests

The SEC's original proposal prohibited an intermediary and its directors, officers or partners from having any financial interest in an issuer using its services. Under the adopted rules, directors, officers, and partners are still forbidden from having a financial



interest in an issuer; however, an intermediary itself may, under certain conditions, have a financial interest in an issuer. This financial interest must be in exchange for compensation for the intermediary's services and must consist of securities of the same class and having the same terms and conditions as the securities being offered or sold through the intermediary's platform.

The SEC was concerned with potential conflicts of interest, including the possibility that an interested intermediary might have an incentive to ensure the success of its own investment in the issuer to the disadvantage of ordinary investors. While allowing intermediaries to have a financial interest in the issuer, the rules also require any intermediary with such an interest to disclose that interest. These rules allow for constructively aligning the funding portal's interest with that of potential investors and mitigating any potential conflicts of interest.

Measures to reduce risk of fraud

To reduce the risk of fraud, the SEC requires intermediaries to:

- Obtain a background check, including any regulatory enforcement actions, on each officer, director and holder of 20 percent voting power of the issuer
- Have a "reasonable basis" for believing that an issuer is in compliance with the applicable Regulation Crowdfunding requirements and has an established means to keep accurate records of its securityholders consistent with the crowdfunding rules[21]
- Deny access to its services if it has a reasonable basis for believing that the issuer or the offering presents a potential for fraud or raises concerns about investor protection[22]

Regulation Crowdfunding requires an intermediary to deny an issuer access to its services when it has a reasonable basis for believing that the issuer or any of its officers, directors, or holders of 20 percent voting power are subject to disqualification under the rules. The rules, however, permit an intermediary to reasonably rely on the representations of the issuer regarding its compliance with the applicable crowdfunding rules, provided the intermediary has no reason to question the reliability of those representations. If an intermediary allows an issuer access to its platform and later learns of information that causes it to reasonably believe that the issuer or offering presents the potential for fraud, the intermediary must remove the offering from its platform and return any funds to the investors.

Numerous Title III commenters requested guidance on the acceptable scope of the background and securities enforcement regulatory history checks, or the appropriate actions an intermediary should take with respect to information uncovered during such checks. The SEC, however, did not provide specific procedures for intermediaries to follow, in part to control costs faced by the intermediaries. Instead, the SEC decided to allow each intermediary to use its own experience and judgment, with the view that each intermediary's concern for the reputational integrity

of its own platform will result in systems and processes that effectively reduce the risk of fraud.

In addition, although several commenters requested that the SEC clarify that the anti-fraud provision of Section 4A(c) of the Securities Act that is applicable to "issuers" would not extend to intermediaries, on the basis that subjecting intermediaries to such liability would have a chilling effect on intermediaries and those who are considering whether to act as intermediaries in crowdfunding. However, the SEC declined to do so. The SEC noted that the determination of "issuer" liability for an intermediary under Section 4A(c) will turn on the facts and circumstances of the particular situation. Therefore, as a practical matter, an intermediary will have to weigh the benefits of acting as a crowdfunding intermediary against the potential liability under Section 4A(c), and should establish due diligence policies and procedures before acting as an intermediary in a crowdfunding offering.

Providing investors with educational materials

The new rules require intermediaries to deliver to investors educational materials that are in plain language and designed to communicate effectively specified information, such as the types of securities available for purchase on the platform and the risks associated with them. For example, some of these materials would need to explain:

- The risks associated with investing in crowdfunding securities
- The restrictions on the resale of crowdfunding securities
- The types of information that an issuer is required to provide in annual reports and the possibility that the issuer's obligation to file annual reports with the SEC may terminate in the future
- The limitations on the amounts investors may invest in crowdfunding transactions
- The circumstances in which the issuer may cancel an investor's crowdfunding investment commitment

In addition, before an investor makes an investment commitment, an intermediary is required to obtain a representation that the investor has reviewed the educational materials and understands the investment risks.

Compliance with investment limitations

In accordance with the JOBS Act, Regulation Crowdfunding requires intermediaries to ensure that the issuer and investors do not exceed the rolling 12-month issuer sale and investor purchase limits. Intermediaries have the flexibility to take more stringent measures to ensure compliance with investment limits.

With respect to the individual investor purchase limits, many Title III commentators stated that it would be difficult for an intermediary to monitor individual investor investment limits because an investor may not always use the same intermediary or the same user account when making multiple issuer crowdfunding investments. In response to these comments, the SEC's rules permit an intermediary to rely on an investor's representations concerning adherence to the investment limitation requirements. Such reliance must be "reasonable," so the intermediary must obtain information about, and take into account, other investments made by the investor in offerings on the intermediary's platform. Intermediaries are permitted to reasonably rely on a centralized data repository of investor information, but the creation of such a database is not necessary. Similarly, to make it easier for intermediaries to ensure that issuers are in compliance with the 12-month/US$1 million aggregate offering limit, issuers are required to post all their crowdfunding offerings with only one intermediary on one portal.

Maintenance and transmission of funds

By statute, intermediaries that are funding portals are not permitted to hold, manage, possess or otherwise handle any investor funds.[23] The rules require funding portals to direct investors to transmit money directly to a "qualified third party"[24] that has agreed in writing to hold the funds in escrow for the benefit of the investor and the issuer. The final rules do not require either particular payment mechanisms or net capital standards for funding portals. When the target

offering amount has been met and the cancellation period for each investor has expired, the funding portal must direct the qualified third party to transmit the funds to the issuer. If the issuer does not meet the target offering amount or otherwise terminates the offering, or an investor cancels his/her commitment, the funding portal must direct the qualified third party to return the funds to the investor.

Prohibitions on funding portals

Funding portals are restricted from engaging in a number of activities that registered broker-dealers are permitted to engage in. The final rules prohibit funding portals from:

- Offering investment advice or recommendations
- Soliciting purchases, sales or offers to buy securities displayed on its platform
- Compensating employees, agents or other persons for such solicitation, or based on the sale of securities displayed on its platform
- Holding, managing, possessing or otherwise handling investor funds or securities

In light of these prohibitions, and based on Title III commenter requests for "bright line rules" on how intermediaries could avoid non-compliance with certain of these prohibitions, the SEC adopted a conditional, non-exclusive safe harbor identifying certain limited activities that would not run afoul of these prohibitions, including:

- Limiting offerings made on or through the funding portal's platform[25]
- Highlighting particular crowdfunding offerings on the platform[26]
- Providing communication channels for potential investors and issuers, subject to the requirements described earlier
- Providing search functions on the platform
- Advising issuers on the structure or content of offerings, including preparing offering documentation
- Compensating others for referring persons to the funding portal and for other services, so

long as the third party does not provide personally identifiable information about any investor and that the compensation is not based on a securities transaction

- Advertising the funding portal's existence

Funding portals also must implement written policies and procedures to ensure that they remain aware of, and compliant with, the regulatory requirements. There are no specific requirements for these policies.

Recordkeeping

In addition to the responsibility to ensure that issuers have accurate records regarding their securityholders (which would be satisfied if the issuer engages the services of a registered transfer agent), intermediaries that are funding portals also have their own recordkeeping responsibility under Regulation Crowdfunding. Funding portals must make and preserve records relating to, among other things, investors who purchase or attempt to purchase securities through the funding portal, issuers who attempt to offer and sell securities through the funding portal and all communications that occur on their platforms. These records must be maintained for five years and be easily accessible for the first two years. The funding portals may use a third party to maintain these records.

Anti-Money Laundering (AML) Statute and privacy requirements

While the SEC's initial proposal required funding portals to comply with certain AML provisions as if they were brokers, the SEC ultimately decided not to adopt that requirement. The SEC believes that other regulators would be more effective at developing AML obligations for funding portals. Broker-dealers, however, continue to have AML obligations.

Funding portals are subject to the same privacy rules applicable to brokers. Specifically, funding portals are required to comply with Regulation S-P (Privacy of Consumer Financial Information and Safeguarding Personal Information), Regulation S-AM (Limitations on Affiliate Marketing), and Regulation S-ID (Identity Theft Red Flags).

Exchange Act Section 12(g) registration

Pursuant to the JOBS Act, holders of securities sold in a crowdfunding transaction do not count towards the securityholder thresholds under Section 12(g) of the Exchange Act. Section 12(g) requires companies with total assets exceeding US$10 million to register with the SEC when their equity securities are held of record by 2,000 persons or 500 persons who are not accredited investors. Crowdfunding transactions contemplate that an issuer may sell securities directly to a large number of individual investors, each of whom might be counted as a holder of record. Investors in public companies often hold their securities through a broker, bank or other nominee, in which case the nominee (or other entity) rather than the investor is counted as a record holder.

The SEC's final rules condition the exemption from Section 12(g). To have its crowdfunding securities exempted from the record holder count, an issuer must:

- Have assets no greater than US$25 million
- Be current in its ongoing annual reports
- Have engaged the services of a registered transfer agent

If an issuer exceeds the US$25 million asset threshold, it will have two years before it is required to register its securities under Section 12(g) as long as it is current in its annual reports. A company that meets the conditional exemption of Section 4(a)(6) securities from the Section 12(g) threshold effectively avoids the imposition of a smaller investor limitation on securities-based crowdfunding transactions compared generally to transactions by public companies.

What we might expect

Regulation Crowdfunding is in many ways strictly limited by the provisions in the JOBS Act itself. While market participants have continued to express significant interest in securities-based crowdfunding transactions, the costs to issuers and the complexity of the rules may outweigh the benefits.

For example, the extensive compliance requirements to register as a funding portal with FINRA, coupled with the limited ability to engage in activities that registered broker-dealers are permitted to engage in could deter potential funding portals from registering as such and encourage them to register as broker-dealers. In addition, the potential for intermediaries to be subject to anti-fraud liability would likely increase transaction costs in crowdfunding offerings, which effectively lowers the amount of funds an issuer can raise through crowdfunding offerings.

Issuers still must comply with advertising and other offering communication restrictions, including the requirement that almost all offering communications be limited to the intermediary's platform for the offering. Offline advertising is permitted only where the issuer limits the information in the advertisement to that of the type typically seen in today's tombstone ads. The advertising and communication limitations therefore could impose real hurdles to a small business that wants to advertise the offering locally using physical advertisements. Issuers that violate these requirements can face significant issues, including potential violations of Section 5 of the Securities Act.

While crowdfunding securityholders are, under certain circumstances, not counted towards the registration thresholds under Section 12(g) of the Exchange Act, they may be so diverse and numerous that an issuer may find significant challenges in communicating with them, including addressing questions or requests for business updates. The final rules do permit issuers to communicate with investors through the funding portal, which may ease that burden. Nonetheless, the conditional nature of this exemption means that noncompliance with the annual report requirements could be extremely costly and force companies to count additional investors as record holders. In addition, having a large number of small investors may complicate the issuer's capitalization table and balance sheet in ways that may ultimately impede the issuer's ability to raise further capital.

Nevertheless, the smallest, earliest-stage companies may focus on the potential of securities-based crowdfunding transactions where friends and family or banks cannot provide needed financing. Issuers that are aware of and consider ways to address the potential challenges of having a large and diverse base of securityholders, that carefully consider the services provided by intermediaries and select the "right one" for its offering and business, and that prepare carefully and efficiently for the initial and ongoing disclosure requirements may find significant benefits under the new offering exemption once it becomes effective.

The SEC has stated that its staff will submit a report within three years of the adoption of Regulation Crowdfunding in order to analyze the impact of the regulation on capital formation and investor protection.

You can find the adopting release (including the full text of the new rules) at http://www.sec.gov/rules/final/2015/33-9974.pdf.

Endnotes

[1]A funding portal is defined as a crowdfunding intermediary that does not: (i) offer investment advice or recommendations; (ii) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (iii) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (iv) hold, manage, possess, or otherwise handle investor funds or securities; or (v) engage in such other activities as the SEC, by rule, determines appropriate.

[2]FINRA recently filed with the SEC a proposal for regulating funding portals, which is available at http://www.finra.org/sites/default/files/rule_filing_file/SR-FINRA-2015-040.pdf.

[3]The forms permitting the funding portals to register with the SEC will be effective on January 29, 2016.

[4]In this paper, we generally refer to such activities as "securities-based crowdfunding." The SEC's rules are also often described elsewhere as relating to "equity crowdfunding" in light of the view that such crowdfunding activities, once permitted, are likely to involve offers and sales of equity. We note, however, that the SEC's rules are not limited to equity offerings.

[5]The public comments received by the SEC on Title III, referred to in this paper as "Title III comments," are available on its website at http://www.sec.gov/comments/jobs-title-iii/jobs-title-iii.shtml.

[6]The comments about the proposed rules can be found at http://www.sec.gov/comments/s7-09-13/s70913.shtml.

[7]The SEC is required to adjust this amount for inflation at least once every five years.

[8]These final rules clarify the ambiguity in the SEC's proposed rules about whether the 5 percent and 10 percent limits applied to the lesser or greater of the investor's annual income or net worth (if they differed) and which limit applied if only one of the investor's annual income or net worth was greater than US$100,000. Thus, under the final rules, an investor with net worth of US$80,000 and annual income of US$150,000 would have an investment limit of US$4,000, i.e., 5 percent of US$80,000.

[9] *See* Securities Act Rule 501(a)(5) (net worth) and Securities Act Rule 501(a)(6) (income). The calculation of net worth excludes the value of the investor's primary residence.

[10]The adopting release notes that the final rule differs from the proposed rule in that the one-year resale restriction applies to any purchaser during the one-year period beginning when the issuer first issues the securities, not just the initial purchaser.

[11]The person reselling the securities must have a "reasonable belief" that the purchaser is an accredited investor.

[12]When the issuer remedies such compliance failure by filing the required documents with the SEC, the issuer may again rely on the Section 4(a)(6) exemption. The final rules also require an issuer to disclose in its offering statement and annual report if it (or any of its predecessor companies) previously failed to comply with Regulation Crowdfunding's reporting requirements.

[13]Unlike the proposed rules, the final rules do not require the issuer to produce a copy of the tax returns.

[14]The final rules amend the definition of "independent" in this context to allow for compliance with the independence standards of the American Institute of Certified Public Accountants (AICPA) as an alternative to compliance with the SEC's independence rules in SEC Rule 2-01 of Regulation S-X.

[15]*See* Regulation Crowdfunding, Rule 201(t)(3) and Instruction 1 to paragraph (t).

[16]If an issuer has a prior operating history, the discussion should also focus on whether historical earnings and cash flows are representative of what investors should expect in the future. If the issuer does not have a prior operating history, the discussion should focus on financial milestones, liquidity and other operational challenges.

[17]*See* Regulation Crowdfunding, Rule 201(t)(3) and Instruction 1 to paragraph (t).

[18]The names of the 20 percent holders must be disclosed at the "most recent practicable date" but no earlier than 120 days before the date the offering statement or annual report is filed.

[19]As explained below, while the proposed rules did not permit intermediaries to hold any interest in an issuer, the final rules do so permit.

[20]While the proposed rules specified that registration with FINRA was required, the final rules allow for registration with either FINRA or a new national securities association that may be registered in the future.

[21]The final rules state that an intermediary will have satisfied its requirement regarding recordkeeping if the issuer has utilized a transfer agent's services. This is meant to be a "safe harbor" for compliance, as the SEC does not require that issuers utilize transfer agents or other third-party agents.

[22]The "reasonable basis" test in the final rules provides an objective standard to replace the subjective standard in the proposed rules. Under the final rules, an intermediary must also deny access if it reasonably believes that it is unable to adequately assess the risk of fraud of the issuer or offering.

[23]*See* Exchange Act Section 3(a)(80)(D).

[24]A "qualified third party" includes certain registered broker-dealers, banks, or credit unions insured by the National Credit Union Administration.

[25]The final rules note that a funding portal may exercise its discretion to limit offerings, so long as it complies with all other provisions of Regulation Crowdfunding (including the prohibition on providing investment advice).

[26]This highlighting must be based on objective and consistently applied criteria designed to highlight a broad selection of issuers and that do not implicitly result in providing investment advice. The criteria used must be disclosed on the intermediary's platform. The intermediary may not receive compensation for highlighting a particular issuer.

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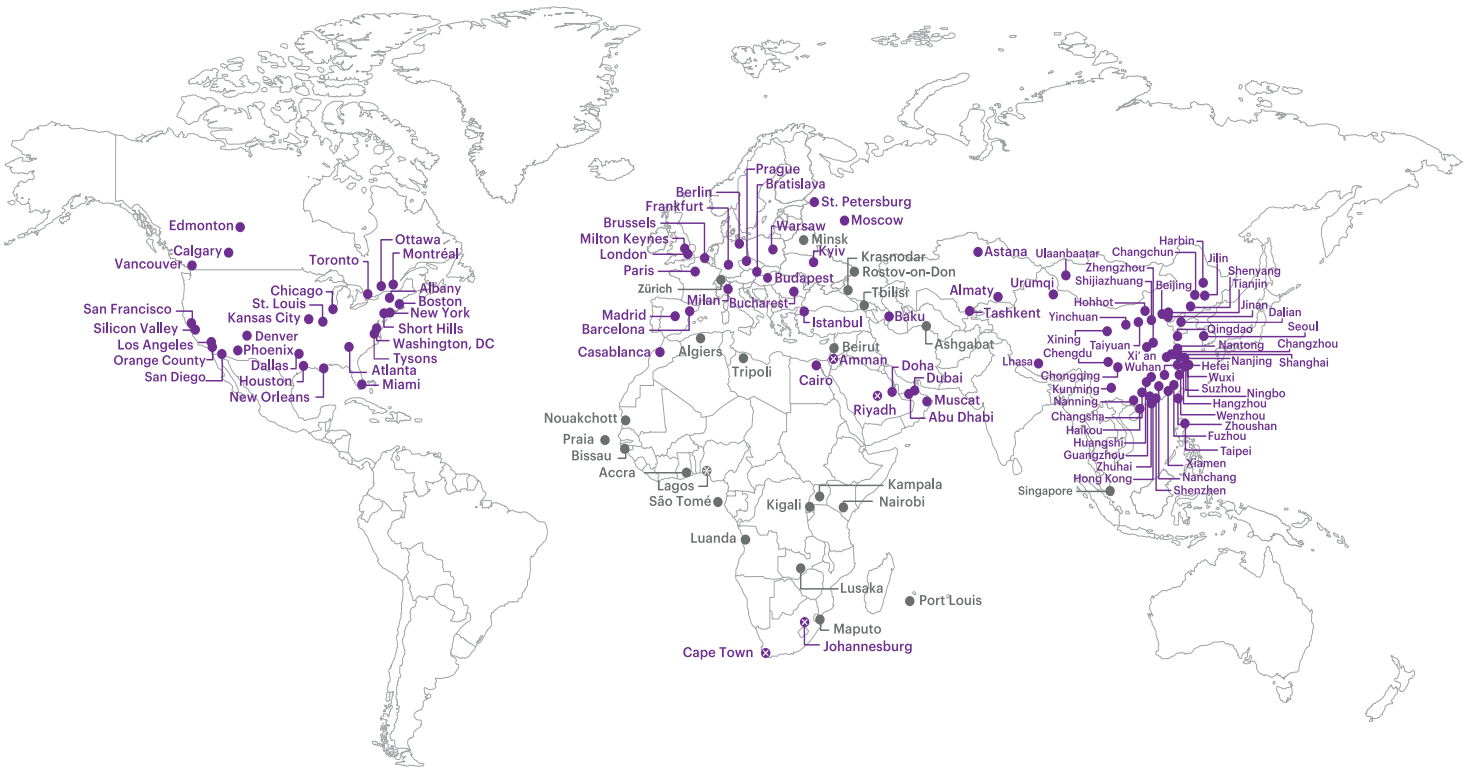

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