

# New Regulation Crowdfunding: A Financing Lifeline for Startups and Small Businesses

Nov 12 2015

Posted By: Kenneth A. Hoogstra

Practice Area: Business and Corporate Law & Securities Law & Start-up and Next Level Business Planning

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One of the most difficult challenges for entrepreneurs is acquiring sufficient capital to execute on a concept and develop a successful business. Current financing options for startups and small businesses include raising capital through commercial loans, venture capital and angel financing, or family and friends. Unfortunately, these traditional sources of financing may be unavailable for a multitude of reasons, including insufficient collateral, inadequate guarantor support, the undesirability of a particular industry, lack of scalability, or an unproven business model.

Further complicating entrepreneurs' efforts to start up a successful business are the myriad of federal and state laws governing the offers and sales of securities. Under U.S. securities laws, any offer or sale of a security (such as stock in a corporation or LLC units sold to passive investors) must be registered with the U.S. Securities and Exchange Commission (SEC) unless an exemption from registration is available. Many exemptions carry extensive disclosure requirements, or limit sales to high income/high net worth investors.

To address the existing financing gap for many startups and small businesses, the Jumpstart Our Business Startups (JOBS) Act created a novel opportunity to raise capital – securities-based crowdfunding. The JOBS Act added section 4(a)(6) to the Securities Act of 1933, which provides an exemption from the registration requirement for securities-based crowdfunding offerings. However, the JOBS Act also provided that the new crowdfunding rules would not become effective until the SEC issued regulations describing the scope of the section 4(a)(6) exemption.

On October 30, 2015, the SEC issued its final Regulation Crowdfunding rules, which implement section 4(a)(6) of the Securities Act. Regulation Crowdfunding generally permits issuers to offer and sell securities to a number of investors through a hosted online platform with relatively fewer regulatory hoops to jump through compared to other types of exempt securities offerings. Notably, Section 18(b)(4)(C) of the Securities Act of 1933 added by the JOBS Act, preempts state law registration and qualification requirements for securities offerings conducted in reliance on the section 4(a)(6) exemption, further reducing the regulatory compliance burden for issuers.

### **What Is Crowdfunding?**

While "crowdfunding" is used ubiquitously to refer to raising funds for a project, philanthropic cause, or business venture in relatively small amounts from a large pool of people, not all types of crowdfunding are subject to securities laws or SEC oversight. For instance, the concept of crowdfunding encompasses at least four distinct types:

- (1) donation-based crowdfunding, in which funders make contributions to a charitable project (*e.g.*, Indiegogo);
- (2) reward-based crowdfunding, in which funders receive rewards for their contributions (*e.g.*, Kickstarter);
- (3) lending-based crowdfunding, in which parties lend money to a company subject to the company's promise to repay the loan, with interest, within a specified payment period (*e.g.*, Prosper); and
- (4) equity-based crowdfunding, in which parties invest in the equity of a company with the expectation of a return on investment (*e.g.*, OfferBoard).

To be clear, new Regulation Crowdfunding only regulates transactions in which a company issues a security (such as an equity or a debt security) in exchange for an investor's capital (*i.e.*, securities-based crowdfunding).

Among other things, Regulation Crowdfunding provides:

- The aggregate amount of all securities sold by an issuer to all investors (accredited or unaccredited) pursuant to section 4(a)(6) during a 12-month period cannot exceed \$1,000,000.
- The aggregate amount of all securities sold to any single investor among all section 4(a)(6) offerings during any 12-month period cannot exceed the greater of \$2,000 or 5% of the lesser of the investor's annual income or net worth, if either annual income or net worth is less than \$100,000. If both annual income and net worth are equal to or exceed \$100,000, then securities totaling up to 10% of the lesser of the investor's annual income or net worth (but not to exceed \$100,000) may be sold to such investor. Issuers may rely on the efforts of intermediaries (*i.e.*, broker-dealers or funding portals) to ensure the foregoing individual investment limits are not exceeded.
- A section 4(a)(6) offering must be conducted through a single intermediary exclusively through such intermediary's online platform.
- Investors in a section 4(a)(6) offering may cancel an investment commitment for any reason until 48 hours prior to the offering deadline.
- A section 4(a)(6) offering is not available for certain types of issuers, including issuers subject to certain "bad actor" disqualifier events, issuers that have failed to comply with the Regulation Crowdfunding ongoing reporting requirements, or reporting companies under the Securities Exchange Act of 1934.
- The issuer must make specific disclosures to the intermediary and investors on new SEC Form C, including, among other things, the issuer's financial statements (the formality of which depends on the size of the offering, and which may need to be audited), information regarding the issuer's business, and information regarding the offering such as the target offering amount, the deadline to reach the target offering amount, and the terms of the securities being offered. The issuer's Form C must be filed electronically with the SEC, and will be viewable by the public immediately upon filing.
- The issuer is also subject to, with certain exceptions, an ongoing obligation to file an annual report with the SEC no later than 120 days after the end of each fiscal year.
- Securities purchased in a section 4(a)(6) offering generally may not be resold for one year. This restriction is subject to limited exceptions such as transfers to an accredited investor or to a family member or trust controlled by the initial investor.
- Issuers have limited rights to advertise the terms of a section 4(a)(6) offering.
- Intermediaries involved in a section 4(a)(6) offering must comply with specific educational and gatekeeper rules. For example:
  - An intermediary has the right to deny an issuer access to its platform if, among other things, the intermediary believes the offering presents the potential for fraud.
  - Whenever an investor establishes an account with an intermediary, the intermediary must deliver educational materials to the investor that explain the risks, restrictions, and limitations of investing.
  - The intermediary must make the issuer's required disclosures available on the intermediary's platform for a minimum of 21 days before any securities are sold.

Regulation Crowdfunding and Form C will be effective 180 days after the date of publication in the Federal Register (which effective date is expected to occur in May 2016). Forms related to the registration of funding portals with the SEC will be effective January 29, 2016.

In light of the burgeoning crowdfunding market and the limited availability of financing options for startups and small businesses, there is enormous potential for Regulation Crowdfunding's internet-based offering framework. There are, however, numerous considerations that need to be addressed to successfully conduct a securities-based crowdfunding offering. Threshold considerations include how to adequately and strategically satisfy an issuer's obligations in connection with a section 4(a)(6) offering, assessing the impact a section 4(a)(6) offering may have on the availability of traditional sources of capital such as bank or venture capital financing, and successfully structuring a section 4(a)(6) offering as part of a comprehensive plan to foster additional capital formation in the future.

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