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CROWDED MARKETS - THE SEC ADOPTS NEW RULES PERMITTING TITLE III CROWDFUNDING

The Securities and Exchange Commission's final rules aimed at allowing companies to use crowdfunding to offer and sell securities under Title III of the JOBS Act, differ from previous regulations in several respects. Among them are:

- Crowdfunding sites like Kickstarter and Indiegogo accept donations without an expectation of a profit or return (except for, perhaps, a prototype, t-shirt or other trinket/giveaway) whereas a Title III crowdfunding site involves the offer and sale of a security (often ownership in the company) in exchange for actual capital and with an expectation of a return.
- "Equity crowdfunding" sites, which were created under the JOBS Act's earlier "crowdfunding" rules, allow companies to offer securities via Internet platforms to the public either via Rule 506(c) public solicitations or through the states' various state-specific crowdfunding exemptions. But, sales of securities through these platforms are typically limited to accredited investors whereas Title III crowdfunded securities can be sold to non-accredited investors.
- While the rules, which were adopted last week, dramatically expand the pool of potential investors, there are a number of robust limitations and obligations that apply when using Title III crowdfunding to raise capital.

The issuers must:

- Not raise more than $1 million in a 12-month period
- Offer the securities only through a registered broker-dealer or SEC-registered crowdfunding "portal"; crowdfunded sales through a company's own site are still not permitted
- Use one crowdfunding portal at a time; multiple offerings across multiple portals are not permitted
- Make significant disclosures about the company, its founders, its business plan, its use of proceeds, its financials, any related party transactions and other key information

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- File an annual report with the SEC and provide it to investors
- Provide audited financials (although some first-time offerors may provide "reviewed" rather than audited financials) prepared in accordance with U.S. GAAP
- Cancel the offering and return all funds if the investment goal is not reached or if the company otherwise cancels or terminates the offering; the company would not have the ability to waive the minimum investment amount
- Refrain from integrating Title III crowdfunded offerings with other offerings that are exempt under another provision (e.g., an equity crowdfunded offering)

Certain companies cannot offer securities under the final rules. They include non-U.S., Exchange Act reporting, and certain investment companies. They also include companies that have no specific business plan or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company. In addition, “bad actor” disqualifications similar to those in Regulation A and Regulation D apply, which disqualify a company if it or any of its principals, officers, directors, 20 percent owners or promoters have been subject to certain SEC, state, FINRA or court actions or events.

Investors in the offering must:

- Hold the securities for one year after purchase and perhaps indefinitely because no real secondary market exists
- Observe limitations on how much they can invest:
- If annual income or net worth is less than $100,000, they can invest the greater of $2,000 or 5 percent of the lesser of their income or net worth
- If both the annual income and net worth are more than $100,000, they can invest up to 10 percent of the lesser of their annual income or net worth
- During a 12-month period, they may not invest more than $100,000

These limits apply in the aggregate and not on an investment by investment or issuer by issuer basis.

The general solicitation provisions of the JOBS Act and the final crowdfunding rules serve as major policy changes, allowing for widespread distribution of securities to non-accredited investors and potentially allowing issuers to lawfully seek and raise capital from a much broader segment of the population. Retail and consumer product companies appear to be among the heaviest users of intrastate crowdfunding exemptions, and that trend may carryover to the federal exemption.

However, numerous challenges exist, which may deter usage of this new opportunity:

- Compliance costs (including accounting, legal, portal and marketing fees and expenses) may prove challenging to issuers as these costs will likely amount to tens of thousands of dollars even with the exemption.
- Companies that use Title III to raise money will have dozens or even hundreds of investors - creating significant investor relations, corporate governance and administrative challenges.
- Due to the enhanced disclosure requirements, certain personal financial information of the founders may be required to be disclosed.
- Those seeking to serve as a portal have significant regulatory and compliance requirements, the cost of which will likely be passed on to the issuers.

Although the crowdfunding rules have been heavily anticipated, we are keenly anticipating information and data as to whether the newly adopted rules prove useful for issuers and intermediaries, especially those seeking to raise smaller amounts of capital. While an underpinning of the JOBS Act was to provide more flexibility for raising capital, the final rules' costly procedural and informational requirements may deter smaller issuers, which were ironically the ones who most hoped to benefit from the regulations. We will continue to monitor developments and counsel clients in this area.