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SEC Issues Whitepaper On Title III Crowdfunding

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

On February 28, 2017, the SEC released a white paper on Regulation Crowdfunding, which law went into effect on May 16, 2016. Regulation Crowdfunding had been long in the making, with the JOBS Act having been passed on April 5, 2012, and the first set of proposed crowdfunding rules having been published on October 23, 2013. Regulation Crowdfunding provides the rules implementing Section 4(a)(6) of the Securities Act of 1933 (the Securities Act).

From the time the SEC published the final Regulation Crowdfunding rules and regulations on October 30, 2015, the regulatory framework has met with wide criticism. The most commonly repeated issues with the current structure include: (i) the $1 million annual minimum is too low to adequately meet small-business funding needs; (ii) companies cannot "test the waters" in advance of or at the initial stages of an offering; and (iii) companies cannot currently use a Special Purpose Vehicle (SPV) in a crowdfunding offering.

To address the feedback and offer a resolution, on March 23, 2016, North Carolina Representative Patrick McHenry introduced HR 4855, aptly titled the "Fix Crowdfunding Act." The Fix Crowdfunding Act would increase the annual funding limit from $1 million to $5 million. The Act would also allow for the use of special purpose vehicles (SPV's) in the fundraising process. It is thought that an SPV structure helps protect the smaller investors by allowing them to pool funds together with larger investors in an entity that offers separate protections than the offering company itself. Finally, the Fix Crowdfunding Act adds "test the waters" provisions allowing companies to communicate with potential investors and gauge interest before spending significant time and expense on the offering process. The Fix Crowdfunding Act passed the House on July 5, 2016, but there has been no further action.

Background

Crowdfunding generally is where an entity or individual raises funds by seeking small contributions from a large number of people. The crowdfunder sets a goal amount to be raised from the crowd, with the funds to be used for a specific business purpose. In addition, a crowdfunding campaign allows the crowd to communicate with each other, thus adding the benefit of the "wisdom of the crowd." Small businesses can particularly benefit from crowdfunding as they are not limited by purchaser qualification requirements and, subject to the rules, can engage in general solicitation and advertising. It is intended that crowdfunding offerings will be relatively low-cost and easy to implement; however, the general consensus is that that particular goal falls short.

Title III of the JOBS Act amended Section 4 of the Securities Act, adding Section 4(a)(6) to create a new exemption to the registration requirements of Section 5 of the Securities Act. Effective May 16, 2016, Regulation Crowdfunding, implementing Section 4(a)(6), became effective.

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Regulation Crowdfunding allows companies to solicit “crowds” to sell up to $1 million in securities in any 12-month period as long as no individual investment exceeds certain threshold amounts. Regulation Crowdfunding limits investment amounts per investor for all crowdfunding offerings by all issuers in any 12-month period as follows: (a) if either annual income or net worth is less than $100,000, the investment limitation is the greater of $2,000 or 5% of the lesser of annual income or net worth; or (b) if both annual income and net worth are equal to or greater than $100,000, the investment limitation is 10% of the lesser of annual income or net worth. In addition, the final rule provides an overall investment limitation of $100,000 for any investor in any 12-month period. Significantly, the investment limitations apply across all crowdfunding issuers during any 12-month period.

Regulation Crowdfunding requires that all crowdfunding offerings be conducted through an intermediary that is a broker-dealer or funding portal that is registered with the SEC and a member of FINRA. All offerings must be conducted through the intermediary’s Internet-based platform. Securities sold in a crowdfunding offering are generally restricted for one year.

In offerings over $100,000, financial statements must be reviewed by an independent accountant and in offerings over $500,000 audited financial statements must be provided, provided however that audits are not required for a first-time offering.

In addition, Regulation Crowdfunding requires that companies and intermediaries provide certain information to investors, potential investors and the SEC prior to making an investment. The offering disclosure document is on Form C. Companies must also provide the SEC and investors with a closing report on Form C-U and an annual report on Form C-AR following the offering.

The registered intermediary has certain requirements designed to reduce fraud. Among others, the intermediary is responsible for filing the Form C with the SEC, must provide communication channels to allow discussion of the offerings on its platform, must disclose compensation received by the intermediary, and must provide educational materials to investors.

The ability to utilize crowdfunding is subject to bad boy restrictions and other disqualifying events. All crowdfunding issuers must be United States entities. Crowdfunding issuers cannot be subject to the reporting requirements of the Securities Exchange Act of 1934 or an investment company as defined by the Investment Company Act of 1940.

The SEC White Paper

The SEC white paper reviewed crowdfunding offerings from the date of inception of Regulation Crowdfunding on May 16, 2016, through December 31, 2016. During that time there were 163 offerings by 156 companies seeking to raise a total of $18 million. The average offering sought $110,000 but allowed over-subscriptions, generally up to the total $1 million statutory limit. The average offering closed in 4 to 5 months.

Since first-time issuers are not required to file audited financial statements, many set maximum offering limits at the total allowed $1 million mark. As repeat issuers enter the market, the average size of maximum offering amount may decrease to avoid audit expenses.

Of the offerings, approximately $10 million was raised, by 33 issuers, with the average amount raised being $290,000. However, some of these offerings remained open on December 31, 2016, so this number would likely be higher today.

For offerings initiated in 2016, 24 were withdrawn by companies or associated with an intermediary whose FINRA membership was terminated and funding portal registration withdrawn, seeking a total of $2.3 million based on the target amount.

Most offerings solicited in all states. The most popular type of securities was equity, including both common and preferred, followed by simple agreements for future equity (SAFE's) and debt.

The most popular state of incorporation was Delaware, and the most popular location of the business was California, followed by Texas and New York. Most issuers have been pre-revenue start-ups or development-stage companies, with the median company having under $50,000 in assets, under $5,000 in cash, $10,000 in debt, no revenues and 3 employees. The average issuer had 5 employees, assets of $327,000 and cash of $64,000. However, many companies were growing. The median growth from the prior fiscal year was 15%, and median sales growth was 80%.

Some of the companies also did prior, concurrent or subsequent Regulation D (15%) or Regulation A (3%) offerings. None of the issuers had previously been listed on an exchange or subject to the Exchange Act reporting requirements.

As of December 31, 2016, 21 funding portals have registered with the SEC and FINRA. One funding portal had its FINRA membership terminated and withdrew its SEC registration. In addition, 8 broker-dealers have conducted crowdfunding offerings. The average funding portal fee is 5%, though broker-dealers averaged at 7.7%.

The SEC acknowledges that the initial results are probably not indicative of what the crowdfunding market will look like as it matures. In particular, companies, investors and the intermediaries will gain experience and learn from mistakes as time goes on. Moreover, it is likely that the number of intermediaries will grow and some may be industry-specific or concentrate on specific demographics.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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