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Title III Crowdfunding

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As required by Title III of the JOBS Act, on October 30, 2015, the SEC has published the final crowdfunding rules. Regulation Crowdfunding has 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. The new rules will be effective 180 days after publication, but the forms for registering a funding portal with the SEC will be effective and available January 29, 2016.

The SEC has dubbed the new rules "Regulation Crowdfunding." Regulation Crowdfunding provides the rules implementing Section 4(a)(6) of the Securities Act of 1933 (the Securities Act) and the regulatory framework for registered funding portals and broker-dealers that companies are required to use as intermediaries in crowdfunding offerings. In addition, Regulation Crowdfunding exempts securities sold under Section 4(a)(g) from the mandatory registration requirements found in Section 12(g) of the Securities Exchange Act of 1934 ("Exchange Act").

Background: What is Crowdfunding?

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 restrictions on general solicitation and advertising or purchaser qualification requirements. It is intended that crowdfunding offerings will be relatively low-cost and easy to implement; however, I am not sure that particular goal will be achieved.

Title III of the JOBS Act, called the Crowdfunding 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. The new exemption allows issuers 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.

The threshold amount sold to any single investor cannot exceed (a) the greater of $2,000 or 5% of the annual income or net worth of such investor if the investor's annual income or net worth is less than $100,000; and (b) 10% of the annual income or net worth of such investor, not to exceed a maximum of $100,000, if the investor's annual income or net worth is more than $100,000. When determining requirements based on net worth, an individual's primary residence must be excluded from the calculation. Clearly there is a conflict in the language determining threshold amounts; an investor could fall within both categories.

The conflict was pointed out in numerous letters to the SEC and has been addressed in the rule making and in particular (b) has been changed such that both an investor's annual income and net worth must be in excess of $100,000 to participate in the higher investment amount. In addition, Regulation Crowdfunding limits the total amount any investor can invest to $100,000. Significantly, the investment limitations apply across all crowdfunding issuers during any 12-month period.

Section 302 of the Crowdfunding Act 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 a registered self-regulatory organization (SRO). Currently that SRO is the Financial Industry Regulatory Authority (FINRA). Although funding portals will have to register with the SEC and become a member of FINRA, they will not have to register as a broker-dealer. FINRA has also published rules to regulate funding portals.

In addition, the Crowdfunding Act requires that issuers and intermediaries provide certain information to investors, potential investors and the SEC. Regulation Crowdfunding takes the disclosure requirement a step further and requires annual reports from the issuer. The ability to utilize crowdfunding will be 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 JOBS Act required the SEC to draft rules implementing the provisions of the Act. On October 30, 2015, the SEC issued a 685-page final rule release.

The SEC Rule Release – Introduction and Background

The SEC begins its rule release with a discussion of the crowdfunding concept and the difficulty of balancing rules that are not unduly burdensome, and thus discourage participation in crowdfunding on the one hand with rules that are too permissive and thus increase the risk for investors. The SEC also recognizes that the SEC staff will need to monitor the practical implementation of the new rules closely and implement amendments and interpretations as necessary as a workable crowdfunding system is created in the U.S.

Summary Breakdown of New Rules – The Crowdfunding Exemption

Issuer Eligibility/Exclusion of Certain Issuers from Eligibility

Regulation Crowdfunding requires that all crowdfunding issuers must be United States entities. In addition, certain issuers are excluded from relying on the exemption, including: (a) companies subject to the reporting requirements of the Securities Exchange Act of 1934; (b) an investment company as defined by the Investment Company Act of 1940, or excluded from such definition under 3(b) or 3(c) of the 1940 Act (i.e., hedge funds and private funds are also not eligible); (c) be subject to bad boy disqualifications as set forth in Rule 503(a) of Regulation Crowdfunding (which rule is substantially similar to the bad actor disqualifications in Rule 506); (d) companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years preceding an offering; and (e) blank check companies (i.e., 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).

The SEC specifically does not disqualify early-stage or start-up entities, noting that it is these entities that will benefit the most from Regulation Crowdfunding by obtaining "input from the crowd" on business plans and ideas at the inception.

Limitation on Capital Raised/Integration

The exemption from registration provided by Section 4(a)(6) is available to a U.S. issuer provided that "the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under new Section 4(a)(6) during the 12-month period preceding the date of such transaction, is not more than $1,000,000." This wording opened debate as to which other exempt offerings, if any, would be integrated with the $1,000,000 limit for the new Section 4(a)(6) exemption. The SEC concluded that "the overall intent of providing the exemption under Section 4(a)(6) was to provide an additional mechanism for capital raising for startup and small businesses and not to affect the amount an issuer could raise outside of that exemption."

In the rule, capital raised through other means does not aggregate or integrate with capital raised under the Section 4(a)(6) Regulation Crowdfunding exemption. Moreover, capital raised through non-equity-based crowdfunding (such as donation or reward offerings) would also not aggregate or integrate in determining the $1,000,000 limit. An issuer could complete an offering made in reliance on Section 4(a)(6) that occurs simultaneously with, or is preceded or followed by, another exempt offering.

However, Section 4(a)(6) offerings conducted by entities controlled by or under common control with the issuer do aggregate and integrate with the issuer's offering. Securities Act Rule 405 defines "control" as "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." Offerings by predecessor issuers also integrate and aggregate with the issuer's offerings.

In addition, caution would need to be taken if the simultaneous offerings were being conducted under an exemption that did not allow advertising.

Investment Limitation

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 $2000 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.

Annual income and net worth are both to be calculated the same as they are calculated in determined accredited investor status under Securities Act Rule 501. Under Rule 501 a person's residence is not included in the net worth calculation. Annual income and net worth may be calculated jointly with a spouse so long as the aggregate investment amount of both spouses does not exceed the individual limit. The investment limitations apply to all investors, including retail, institutional, accredited, and both U.S. and non-U.S. citizens and residents.

Issuers will be able to rely on the funding intermediaries (i.e., funding portal or broker-dealer) to determine whether investors comply with their investment limits, except where the issuer has actual knowledge otherwise.

Resale Restrictions

Securities purchased in a crowdfunding offering are generally restricted for a period of one year. Such securities may not be transferred by the investor until after a one-year holding period, except that they may be resold back to the issuer, to an accredited investor as defined in Rule 501, as part of a registered offering with the SEC, or to a family member in connection with death or a divorce.

Transactions Conducted Through an Intermediary

Section 4(a)(6)(C) 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 a registered self-regulatory organization (SRO). The SEC believes that requiring an issuer to use only one intermediary, rather than multiple intermediaries, to conduct a Regulation Crowdfunding offering helps foster the creation of a crowd and serves the statutory purpose. In addition, from a practical perspective it would be difficult to determine compliance with the $1,000,000 limitation on capital raised and investor investment limitations if multiple intermediaries are allowed. Accordingly, the final rules prohibit an issuer from using more than one intermediary to conduct a 4(a)(6) offering.

In addition, the final rules require that funding platforms conduct Section 4(a)(6) offerings exclusively through their electronic platforms (i.e., no offline transactions). The rules define “platform” to mean an “internet website or other similar electronic 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 in reliance on Section 4(a)(6).” To avoid doubt, the SEC specifies that back office and administrative procedures such as document maintenance and preparation of confirmations and notice may be completed offline. To facilitate this requirement, intermediaries will be required to have investors consent to the electronic delivery of all documents and information connected with the offering.

Whether the crowdfunding intermediary is a broker-dealer or new funding portal, they will be subject to the intermediary requirements set out in Section 4A(a) of the Securities Act.

A crowdfunding intermediary must generally provide investors with educational materials, take measures to reduce the risk of fraud, make information about the offering and the issuer available to investors, provide communication channels to permit discussions about the offering on the platform; and facilitate the offer and sale of crowdfund securities.

In particular, a platform must:

(i) Provide disclosures to potential investors, including disclosures related to risks and other investor education materials;

(ii) Ensure that each investor reviews investor education information and positively affirms that they understand that they risk losing their entire investment and can afford such loss;

(iii) Ensure that each investor answers questions demonstrating an understanding of the level of risk generally applicable to investments in start-ups, emerging businesses, and small issuers;

(iv) Ensure that each investor answers questions demonstrating an understanding of the risk of illiquidity;

(v) Take measures to reduce the risk of fraud by establishing rules and procedures, including obtaining background and securities enforcement history checks on each officer, director and person holding more than 20% of the outstanding equity of an issuer and denying access to the platform if any persons are subject to the bad actor prohibitions or the intermediary otherwise believes the issuer is a fraud risk;

(vi) Not later than 21 days prior to the first day securities are sold, file with the SEC and make available to potential investors all disclosure information required and provided by the issuer. (This requirement raises many questions, such as: Who is responsible for the accuracy of the information filed? Will there be a review process with the SEC? Can sales begin if there are open comments with the SEC?)

(vii) Ensure that no offering proceeds are given or available to the issuer until the target offering amount has been raised, and allow investors to cancel their investment during that time;

(viii) Make efforts to ensure that no investor exceeds its allowable investment amount in any 12-month period, including from all issuers and all funding portals;

(ix) Take steps to protect the privacy of information collected from investors;

(x) Not compensate promoters, finders, or lead generators for providing the broker or funding portal with personal indentifying information of any potential investor (the SEC needs to clarify in its rule making whether a funding portal or broker faces any aiding and abetting or other liability for accepting such information that they have not paid for, or whether such practice will be acceptable. In addition, the SEC needs to clarify that brokers and funding portals can indeed compensate promoters, finders and lead generators for directing traffic to their site and other outside promotional activities as long as personal identifying information is not included);

(xi) Prohibit its directors, officers or partners from having any financial interest in any issuer using its service. Moreover, the final rules prohibit these persons from receiving a financial interest in the issuer as compensation for services provided to, or for the benefit of, the issuer in connection with the offer and sale of its securities. However, the intermediary itself does not have the same prohibitions. The intermediary may have a financial interest in an issuer that is offering or selling securities in a crowdfunding offering through the intermediary's platform provided that: (i) the intermediary receives the financial interest from the issuer as compensation for the services provided to, or for the benefit of, the issuer in connection with the crowdfunding offering on the intermediary's platform; and (ii) the financial interest consists of securities of the same class and having the same terms as those offered in the crowdfunding offering;

(xii) Have a reasonable basis for believing that the issuer's offering is in compliance with all the rules and regulations of Regulation Crowdfunding, including satisfying itself that the disclosures and representations of the issuer made to both the intermediary and the potential investors are reliable and accurate; and

(xiii) Have a reasonable basis for believing that the issuer has established means to keep accurate records of the holders of the securities it will offer and sell through its platform which can be satisfied by ensuring that the issuer has engaged the services of an SEC-licensed transfer agent;

Unless such funding portal is also a broker-dealer and subject to certain safe harbor exceptions to facilitate the offering, a funding portal may not:

(i) offer investment advice or recommendations;

(ii) solicit purchases, sales, or offers to buy the 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; or

(iv) hold, manage, possess, or otherwise handle investor funds or securities.

Broker-dealer intermediaries may perform each of the above listed services. Accordingly, broker-dealer intermediaries have a definite monetary advantage over funding portals in the crowdfunding arena. First, a broker-dealer is already licensed, a member of FINRA and versed in abiding by strict regulations and reporting requirements.

Advertising and Solicitation

An issuer and funding intermediary may engage in advertising and solicitation subject to certain limitations. Advertisements may not include the terms of the offering (securities offered, price, offering period, etc.) unless the advertisement directs investors to the intermediary's platform and includes a statement disclosing: (i) a statement that the issuer is conducting an offering pursuant to the crowdfunding exemption, the name of the intermediary and a link to the intermediary's platform; (ii) the terms of the offering; and (iii) factual information regarding the legal identity and business location of the issuer, including the issuer's name, address, phone number, website, name and e-mail address of representative and a brief description of the issuer's business.

The form of advertisement is not limited and can include print- and web-based ads as well as social media. When an issuer is communicating with potential investors through the intermediary's platform, it must identify itself as the issuer to avoid any misconception that the communication is from the intermediary itself or another unbiased third party using the platform. Moreover, similar to Section 17 of the Securities Act, persons making communications on behalf of the issuer related to the offering or with the intent of selling securities must identify themselves and disclose the compensation received.

Finally, the issuer can continue to publicize information in the ordinary course of business unrelated to the offering, such as related to its products and services.

Disclosure Requirements

Pursuant to the JOBS Act and Regulation Crowdfunding, an issuer who offers or sells securities in a crowdfunding offering must file with the SEC and provide investors and the funding intermediary (whether a funding portal or broker-dealer) and make available to potential investors:

(a) The name, legal status, physical address, and website address of the issuer;

(b) The names of the directors and officers, and each person holding more than 20% of the shares of the issuer;

(c) A description of the business of the issuer and the anticipated business plan of the issuer;

(d) A description of the financial condition of the issuer, including (i) for offerings of $100,000 or less, income tax returns for the most recently completed year and financial statements certified by the principal executive officer as true and correct; (ii) for offerings of more than $100,000 but less than $500,000, financial statements reviewed by an independent public accountant in accordance with SEC standards and rules for such review; and (iii) for offerings more than $500,000, audited financial statements (note that the offering amount is determined by totaling all Section 4(6) offerings within the preceding 12-month period);

(e) A description of the stated purpose and intended use of the proceeds of the offering;

(f) The target offering amount and a deadline to reach the target and regular updates regarding the progress of meeting the target;

(g) The price to the public of the securities and the method of determining the price;

(h) A description of the ownership and capital structure of the issuer, including (i) terms of other securities offered and all other classes of securities of the issuer, including details on the differences and potential dilution that could result from a different class (for example, if preferred stock was converted); (ii) a description of how the exercise of rights held by principal shareholders could negatively impact the purchasers of the securities being offered; (iii) name and ownership levels of each existing shareholder owning 20% or more; (iv) how securities being offered are valued and examples of how they may be valued in the future; and (v) risks related to minority ownership and other capital-related risk, such as by the issuance of additional shares, sales of assets, or transactions with related parties.

In addition to the specific disclosure requirements, the issuer must disclose any material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

Detailed Offering Statement Disclosure Requirements

Regulation Crowdfunding requires an issuer to disclose detailed information in relation to a crowdfunding offering. The rule specifically declines to require a specific presentation or format for much of the disclosure; however, the SEC does create a new Form C set up in a streamlined Q&A format. Parts of the Form C are required and others are optional such that the issuer can provide attachments with disclosure information in a different format. The Form C is a fillable form that can be submitted to the SEC with the ability to add attachments as needed.

The Form C must be filed with the SEC prior to commencement of the offering and a copy must be provided to funding intermediaries and investors. The disclosure documents can be delivered to investors by directing them to the intermediary's platform, through a posting on the issuer's website or by e-mail.

In addition, an issuer is required to amend and update offering documents if there is a material change. Amendments must be filed with the SEC and provided to funding intermediaries and investors. If the amendment contains a material change, investors must reconfirm their investment within 5 business days or such investment will be deemed canceled.

Issuers must provide updates on their progress in reaching the target offering amount using a Form C-U. Updates must be provided within 5 business days after reaching 50% and then 100% of the target offering amount ---– provided, however, an issuer can meet the interim Form C-U update requirement by making regular updates publicly available on the intermediary website. All issuers must file a final Form C-U disclosing the total amount of securities sold in the offering within 5 business after reaching the offering deadline.

General Information about the Issuer, Officers and Directors, and Shareholders

Its name and legal status, including form of organization, jurisdiction and date of organization;

Its physical address and website address;

The location on the issuer's website, and time of availability, of its ongoing annual reports under Regulation Crowdfunding, as well as any failure to comply with ongoing reporting requirements;

The names of the directors and officers, including any person holding a similar position or providing a similar function, all positions and offices held by such person, the period of time they have served such position and a description of their business experience during the past three years, including their principal occupation and employment and the name of the business entity in which such occupation or employment took place;

The name of persons, as of the most recent practicable date, who are the beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; and

Disclosures related to disqualifying events and other bad actor disclosures.

Description of the Business

The rules require issuers to disclose information about their business and business plan; however, the final rules specifically decline to set out the parameters of such disclosure. Issuers must determine the proper disclosure for their business based on their stage of development, industry and the offering size. Moreover, the SEC declined to provide a non-exclusive list of the types of disclosure as they rightfully believe such list would be viewed as a de facto disclosure requirement.

Use of Proceeds

As required by the JOBS Act, the final rules require a description of the use of the proceeds from the offering. The SEC notes that it expects the disclosure to "provide a sufficiently detailed description of the intended use of proceeds to permit potential investors to evaluate the investment." Examples of possible specific line items include specific acquisitions, repayment of affiliated or non-affiliated debt, intermediary compensation and commissions, employee compensation, repurchase of outstanding securities and general working capital. Moreover, it is suggested that the working capital line item disclose the amount of time such working capital is expected to last. If an issuer indicates that it will allow an oversubscription of the target offering amount, it will be required to provide a separate use of proceeds for the excess proceeds.

Target Offering Amount and Deadline

As required by the JOBS Act, the rules require issuers to disclose the target offering amount and a deadline to reach the target and regular updates regarding the progress of meeting the target. In addition, the rules require disclosure as to whether the issuer will allow an oversubscription from the target amount and an absolute maximum amount it will accept: "For example, if the issuer sets a target amount of $200,000 but is willing to accept up to $750,000, the issuer would be required to disclose both the $200,000 target offering amount and the $750,000 maximum offering amount that it will accept." Disclosure as to how oversubscribed shares will be allocated will be required.

The rules require issuers to describe the process to cancel a subscription or investment commitment or to complete and close the investment once the target amount has been achieved, including the following statement:

> Investors may cancel an investment commitment until 48 hours prior to the deadline identified in the issuer's offering materials;
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> The intermediary will notify investors when the target offering amount has been met;
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> If an issuer reaches the target offering amount prior to the deadline identified in its offering materials, it may close the offering early if it provides notice about the new offering deadline at least five business days prior to that new deadline (absent another material change that would require an extension of the offering and reconfirmation of the investment commitment); and
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> If an investor does not cancel an investment commitment before the 48-hour period prior to the offering deadline, the funds will be released to the issuer upon closing of the offering and the investor will receive securities in exchange for his or her investment.

The rules also require issuers to disclose that if an investor does not reconfirm their investment decision following a material change, the investment will be canceled and the committed funds will be returned. A reconfirmation cannot be had through negative response. Finally, if the target amount is not achieved by the offering deadline, the offering will be canceled and all funds will be returned.

Offering Price

As required by the JOBS Act, the final rules require an issuer to disclose the offering price or the formula for determining the offering price, provided that if only a formula is disclosed, prior to the sale, each investor must be provided in writing with a final price. Moreover, the issuer must disclose the deadline to reach the target offering amount and whether the issuer will accept investments in excess of the target offering amount.

Ownership and Capital Structure

Regulation Crowdfunding requires disclosure of:

The terms of the securities being offered and each other's class of security of the issuer, including the number of securities being offered and/or outstanding ones, whether or not such securities have voting rights, any limitations on voting rights, how the terms of the securities can be modified and a summary of the differences between the different classes of securities of the issuer, and how the rights of the securities can be limited, diluted, or qualified.

A description of how the exercise of the rights held by the principal shareholders of the issuer could affect the investor's securities;

The name and ownership level of persons who are 20% or more beneficial owners;

How the securities being offered are valued and examples of methods that the issuer may use to value securities in the future;

The risks to the purchasers of the securities related to minority ownership in the issuer and the risks associated with corporate actions, including additional issuances, issuer repurchases, a sale of the issuer or of assets or transactions with related parties; and

A description of the restrictions on the transfer of the securities.

Additional Disclosure Requirements

In addition, Regulation Crowdfunding also requires:

Disclosure of the name, commission file number and CRD number of the intermediary conducting the offering;

Disclosure of the amount of compensation paid to the intermediary, including the amount of any referral or other fees associated with the offering and any other financial interest of the intermediary;

Disclosure of certain legends to be included in the offering statement, including regarding ongoing reporting requirements of the issuer;

Disclosure of the current number of employees of the issuer;

A discussion of the material risk factors;

A description of the material terms of any indebtedness of the issuer, including the amount, interest rate and maturity date;

Disclosure of exempt offerings conducted within the past three years;

Disclosure of certain related party transactions, including by and between the issuer and any officer, director, promoter, or 20% or more beneficial owner or immediate family members of the foregoing; and

Management, discussion and analysis on the issuer's financial condition, including to the extent material, a discussion of liquidity, capital resources and historical results of operations.

Financial Disclosure

Regulation Crowdfunding requires a tiered financial disclosure, including a description of the financial condition of the issuer, as follows:

> (i) for offerings of $100,000 or less, the issuer must provide (x) the amount of total income, taxable income and total tax (or equivalent line items) as reported on the U.S. federal income tax returns filed by the issuer for the most recently completed fiscal year, if any, and (y) the financial statements of the issuer, in both cases certified by the principal executive officer of the issuer to be true and complete in all material respects;
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> (ii) for offerings of more than $100,000 but less than $500,000, he issuer must provide financial statements reviewed by a public accountant that is independent of the issuer; and
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> (iii) for offerings of more than $500,000, audited financial statements from an independent PCAOB auditor. However, the SEC has provided a limited one-time exclusion from the audit requirements for issuers conducting their first Regulation Crowdfunding offering provided that the issuer does not have audited financial statements available at the time. Such issuers may provide reviewed financials instead.

In determining the threshold offering amount for disclosure, the rules require that an issuer aggregate any amounts offered and sold (rather than all offered amounts, including those not sold) under Regulation Crowdfunding in the preceding 12-month period. In addition, possible oversubscriptions must be added and included.

The rules require all issuers to file with the SEC, provide to investors and the intermediary and make available to potential investors a complete set of their financial statements (a balance sheet, income statements, statement of cash flows and states of changes in ownership equity), prepared in accordance with U.S. GAAP covering the shorter of the two most recent fiscal years or the period since inception.

Financial statements must cover the two most recently completed fiscal years or the period since incorporation, if shorter. For the first 120 days following the end of a fiscal year, an issuer can rely on the prior year's financial statements so long as the issuer was not otherwise required to provide updated financial statements as a result of ongoing reporting obligations, or if the current year financial statements were, in fact, complete and available.

Regardless of the age of financial statements, an issuer must include a discussion of any changes in financial condition subsequent to the statements.

As required in the JOBS Act, the rules require an issuer that is conducting an offering of $100,000 or less to provide its filed income tax returns for the most recently completed fiscal year, if any, and its financial statements certified by its principal executive officer. The rules require issuers to redact personal identifiable information such as Social Security numbers. If tax returns are not completed and filed as of the date of the offering, the prior year's returns can be provided with a discussion of any changes. The SEC has created a form of certification for executive officers to sign attesting to the truth and accuracy of financial statements.

For offerings of more than $100,000 but less than $500,000, the issuer must file with the SEC and provide potential investors and intermediaries with financial statement reviewed by an independent public accountant. To qualify as independent, an accountant will need to comply with the SEC's existing independence rules as set out in Rule 2-01 of Regulation S-X. Moreover, the financial statements must be reviewed in accordance with the Statements on Standards for Accounting and Review Services ("SSARS") issued by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants ("AICPA"). These are the most widely used review standards, and the SEC did not see any reason to modify them for purposes of Regulation Crowdfunding. The issuer will be required to provide the SEC, investors and intermediaries with a copy of the accountant's review report.

For offerings of more than $500,000, the issuer must file with the SEC and provide potential investors and intermediaries with audited financial statements together with the audit report. The auditor must be independent, and the audit must be conducted in accordance with the AICPA or PCAOB standards. The rule does not require that the auditor be PCAOB registered. The receipt of a qualified audit opinion would not discount the audited financial statements; however, an adverse opinion or disclaimer of opinion by the auditor would render the audited financial statements unusable for purposes of the rule. However, the SEC has provided a limited one-time exclusion from the audit requirements for issuers conducting their first Regulation Crowdfunding offering provided that the issuer does not have audited financial statements available at the time. Such issuers may provide reviewed financials instead.

The Offering Process

As indicated above, the offering must be completed using an intermediary and a Form C must be filed with the SEC prior to commencement of the offering. The Form C and all disclosure documents must be provided to funding intermediaries and investors.

An investor can cancel an investment commitment for any reason until 48 hours before the offering deadline and during that 48 hours only if there is a material change to the terms of the offering and upon receipt of such material change disclosure from the issuer.

In addition, an issuer is required to amend and update offering documents if there is a material change. Amendments must be filed with the SEC and provided to funding intermediaries. Funding intermediaries must in turn provide the amendments to investors and (i) describe the material change; and (ii) inform the investor that the investment will automatically be canceled if not confirmed within 5 days. That is, if the amendment contains a material change, investment must reconfirm their investment within 5 business days or such investment will be deemed canceled. If the material change occurs within five business days of the offering deadline, the offering must be extended to allow five business days for the investor to reconfirm.

Issuers must provide updates on their progress in reaching the target offering amount using a Form C-U. Updates must be provided within 5 business days after reaching 50% and then 100% of the target offering amount – provided, however, an issuer can meet the interim Form C-U update requirement by making regular updates publicly available on the intermediary website. All issuers must file a final Form C-U disclosing the total amount of securities sold in the offering within 5 business after reaching the offering deadline.

An offering must be kept open for a minimum of 21 days. An offering can be closed early if the targeted offering amount is met as long as the offering has been kept open for the 21-day minimum and each investor and potential investor is given a minimum of 5 days' notice of the new deadline and such notice must include a statement that the investor or potential investor has the right to cancel commitments until 48 hours prior to the new deadline and whether the investor will continue to accept new investments during that 48-hour window. Moreover, the issuer must continue to meet the targeted offering amount at the new earlier deadline.

If the target offering amount is not reached by the stated offering deadline, or the issuer otherwise terminates the offering prior to completion, the intermediary must notify all investors of the termination and return investor funds within 5 business days of such termination.

Post-offering Reporting Requirements

Issuers must file an annual report with the SEC on Form C-AR and provide a copy to investors within 120 days after the issuer's fiscal year end. The annual report must include substantially the same information as the offering statement except that information related to the terms of the offering itself may be omitted (the offering results are not omitted). In addition, in lieu of the financial information required in the offering statement, the issuer may provide financial statements covering the two most recently completed fiscal years certified by the principal executive officer of the issuer to be true and correct in all material respects rather than audited or reviewed financial statements (unless any such reviewed or audited financial statements are available, in which case those must be provided instead) and a description of the financial condition of the issuer with respect to the period covered by the financial statements.

The annual report must also be posted on the issuer's website. Any amendments to the annual report may be filed in Form C-AR/A.

The issuer must continue to file annual reports until the earliest of the following:

The issuer becomes subject to the reporting requirements of the Securities Exchange Act;

The issuer has filed at least one annual report since the completion of its most recent Regulation Crowdfunding offering, and has fewer than 300 shareholders of record;

The issuer has filed at least three annual reports since the completion of its most recent Regulation Crowdfunding offering, and has less than $10 million in assets;

The issuer, or another party, has repurchased all of the securities issued in the Regulation Crowdfunding offering; or

The issuer has liquidated or dissolved its business in accordance with state law.

The issuer must file an exit Form C-TR (termination of reporting) upon becoming eligible to cease filing annual reports.

Although the failure to file required reports will not destroy the crowdfunding exemption for completed offerings, it does effect the eligibility to complete any additional crowdfunding offerings while delinquent. Moreover, the failure to file reports subjects the issuer to the potential of an SEC enforcement action.

Conditional Exclusion from Section 12(g) of the Exchange Act

Exchange Act Section 12(g) requires that an issuer with total assets exceeding $10,000,000 and a class of equity securities held of record by either 2,000 persons or 500 persons who are not accredited register with the SEC, generally on Form 10, and thereafter be subject to the reporting requirements of the Exchange Act.

Regulation Crowdfunding exempts securities in crowdfunding offerings from the Section 12(g) registration requirements if the issuer meets all of the following conditions:

- The issuer utilizes an SEC-registered transfer agent;
- The issuer remains subject to the crowdfunding reporting obligations; and
- The issuer has less than $25 million in assets.

Moreover, even if a crowdfunding issuer is not eligible for the Section 12(g) registration exemption as set forth above, that issuer will have a two-year transition period prior to being required to having to register under the Exchange Act, as long as during that two-year period, the issuer continues to file all of its ongoing reports in a timely manner with the SEC.

Issuer and Intermediary Liability

Regulation Crowdfunding gives a private cause of action to a crowdfunding investor for rescission if they still own the security (return of their money plus interest in exchange for giving back the stock) or for damages if they no longer own the security.

Regulation Crowdfunding imposes liability for making an untrue statement of a material fact or omitting to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, provided the purchaser did not know of such untruth or omission. The liability standard is the same as is set out in Section 12(a)(2) of the Securities Act of 1933. The pertinent "moment of time" for considering liability is the time the investor makes a commitment for purchase. Section 12 requires that the investor prove causation—that is, that they relied on the misleading information and, as a result of relying on such information, they were damaged.

Regulation Crowdfunding defines the issuer, for purposes of liability, as the issuer's directors or partners, the principal executive officer or officers, principal financial officer and controller or accounting officer, and any other person that is part of the issuer that offers or sells the securities in the crowdfunding offering, including the intermediary. In layman's terms, in addition to the intermediary, all of the key officers, directors and employees of an issuer in a crowdfunding offering can face personal liability for untrue statements or omissions.

The issuer (and the individuals) can raise several defenses, such as proof that the investor had actual knowledge of the information or should have been aware of the information if they had taken reasonable care and inquiry. The rules also specifically allow the issuer to raise the defense that they did not know, and in the exercise of reasonable care, could not have known of such untruth or omission.

Bad Boy Disqualification

The Crowdfunding Act required that the SEC create disqualification rules for both issuers and funding portals and intermediaries and lists certain provisions to be included in the disqualification provisions. "Bad actor" disqualification requirements, sometimes called "bad boy" provisions, prohibit issuers and others (such as underwriters, placement agents and the directors, officers and significant shareholders of the issuer) from participating in exempt securities offerings if they have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.

The Crowdfunding Act disqualifies any offering or sale of securities by a person that:

- is subject to a final order of a state securities commission or agency or other state authority that (a) bars the person from associating with an entity regulation by such agency; (b) bars the person from engaging in the business of securities, insurance or banking; or (c) bars the person from engaging in savings associations or credit unions;

- constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct within the 10-year period ending on the date of the filing of the offering; or

- has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

- The disqualification events that must be disclosed in the offering statement are substantially similar to the existing "bad actor" disqualification events with respect to Rule 506 of Regulation D under the Securities Act, and include certain criminal convictions, court injunctions and restraining orders, regulatory agency orders, SEC disciplinary, cease-and-desist and stop orders, suspension or expulsion from membership in self-regulatory organizations and U.S. Postal Service false representation orders.

Regulation Crowdfunding/State Law Pre-emption

In addition to federal securities laws, each state has its own securities laws and governing body which oversees and enforces such laws. The individual state securities statutes are not uniform; every state is different. However, many aspects of federal securities law pre-empt state securities laws. Still, pre-emption is never complete pre-emption. Although the federal securities laws may pre-empt the state securities laws in the areas of form and procedure of an offering, state regulators are always empowered to investigate and prosecute violations of their state anti-fraud securities provisions. Moreover, state regulators can require certain disclosure filings (such as a copy of the Form D) and the payment of fees.

In an offering under the Crowdfunding Act, which is Internet-based, investors will come from any or all of the 50 states. It would be incredibly difficult and expensive for a company to learn about and abide by the laws of each of these states. Section 305 of the Crowdfunding Act amends Section 18 of the Securities Act of 1933 to include securities sold in a crowdfunding offering as "covered securities" for purposes of federal pre-emption of state law. Consistent with general pre-emption law, Congress specifies that Section 305 relates "solely to State registration, document and offering requirements… and shall have no impact or limitation on other State authority to take enforcement action with regard to an Issuer, funding portal, or any other person or entity using the exemption from registration provided by Section 4(6) of the Act."

Under Regulation Crowdfunding, states are pre-empted from regulating certain aspects of crowdfunding conducted in accordance with the new rules, including state registration, documentation and offering requirements with respect to crowdfunded securities. In addition, no notice filings and fees may be required with respect to offers and sales of crowdfunded securities except as may be required by the securities commission of the state of the principal place of business of the issuer or any state in which purchasers of 50 percent or greater of the aggregate amount of the issue are residents.

Specific Provision as to Issuer's Filing and Fee Requirements

In addition, the Crowdfunding Act specifically prohibits states from requiring a filing or charging a fee in connection with notice requirements, except for the home state of the issuer and any state in which more than 50 percent of all the investors reside.

Specific Provision as to Funding Portal's Registration Requirements

The Crowdfunding Act amends Section 15 of the Securities Exchange Act of 1934 (Registration and Regulation of Broker Dealers) to prohibit any state from enforcing any law, rule or regulation against a registered funding portal for operating as such. In layman's terms, a state cannot require a funding portal to register as a broker-dealer in that state, nor can they prosecute a funding portal for acting as an unregistered broker-dealer. States can still investigate and prosecute funding portals for fraud.

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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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