

The SEC's proposed new rules on equity crowdfunding

On 23 October 2013, the United States Securities and Exchange Commission ('SEC') unanimously voted to propose rules permitting equity crowdfunding as required by Title III of the Jumpstart Our Business Startups ('JOBS') Act. Under the proposal a company would be permitted to use a crowdfunding portal to offer securities and raise up to \$1 million in any 12-month period from an unlimited number of investors regardless of their net worth or sophistication. The proposed rules are subject to a public comment period and the SEC would be required to take further action in order to enact the proposed rules into law. Scott H. Kimpel, Partner at Hunton & Williams LLP, Washington DC, explains the proposed rules and the doubts expressed by some that the SEC's rules will fail to create a vibrant crowdfunding market.

Crowdfunding is a subset of the crowdsourcing movement. At a typical crowdsourcing website, the party seeking financing posts a project proposal online and states a funding goal. Potential contributors then visit the website and donate funds to support the project. Sometimes, but not always, the patrons get free samples of the entrepreneurs' products in exchange for their donations. If and when projects meet their funding goals, the crowdfunding website takes a small percentage of the funds generated and transfers the balance to the projects' creators. At this time, most crowdfunding sites operating in the United States or seeking funds from US residents generally

prohibit the offer or sale of securities. Thus, they do not run afoul of the US securities laws, which place substantial restrictions on the offer and sale of securities to the general public.

Some features of the SEC's proposal include the following:

- The total amount sold by the company to all investors, including amounts sold in reliance on this crowdfunding exemption, during the preceding 12 months may not exceed \$1 million;

- There is no minimum net worth or financial sophistication requirement imposed on investors wishing to participate in a crowdfunded offering;

- The total amount sold to any single investor by the company, including amounts sold in reliance on the crowdfunding exemption, during the preceding 12 months may not exceed:

a/ if either the annual income or net worth of the investor is below \$100,000, the greater of \$2,000 or 5% of the annual income or net worth of that investor; and

b/ if either the annual income or net worth of the investor is \$100,000 or more, 10% of the annual income or net worth of the investor (up to a maximum aggregate amount sold of \$100,000).

The transaction would be required to be conducted through a registered securities broker or a new kind of intermediary known as a 'funding portal.'²

The proposed rules would generally require intermediaries to:

- have a reasonable basis for believing that the crowdfunding company is complying with the applicable rules;

- ensure that the company's disclosure documents are made publicly available for 21 days before securities are sold;

- provide investors with educational materials;

- take various steps to reduce the risk of fraud;

- make available information about the company and the offering;

- provide communication channels to permit discussions about offerings on the platform; and

- avoid offering investment advice or making recommendations.

Companies would be required to provide financial disclosures to potential purchasers that would vary based on the size of the offering. For offerings that have in the aggregate, together with all other crowdfunding offerings by the company in the past 12 months, target offering amounts of:

- \$100,000 or less: the company would be required to provide income tax returns for its most recently completed year and financial statements certified by the principal executive officer;

- more than \$100,000 but less than \$500,000: the company would be required to provide financial statements reviewed by a public accountant that is independent of the company; and

- more than \$500,000: the company would be required to provide audited financial statements.

Companies offering securities via crowdfunding would be required to prepare an offering statement that would be filed with the SEC, provided to its intermediary and made available to investors. Among other things, the offering statement would be required to disclose:

- information about the company's officers, directors and 20% owners;

- a description of the company's business and business plans, number of employees and the use of proceeds from the offering;

- information about the risks of

the offering;

- the price to the public of the securities being offered, how their valuation was determined, the target offering amount, the deadline to reach the target and whether the company will accept capital in excess of the target;

- information about related-party transactions;

- information about the financial condition of the company; and

- financial statements that, depending on the target amount offered in crowdfunding transactions during the trailing 12-month period, would have to be accompanied by a copy of the company's tax returns or reviewed or audited by an independent public accountant.

Companies would be limited in their ability to advertise the offering outside of the crowdfunding portal.

Companies that complete a crowdfunded offering would have an ongoing requirement to provide an annual report describing their operations and financial condition to the SEC. The crowdfunding exemption would not be available to public companies already filing reports with the SEC, companies incorporated outside the United States, registered mutual funds and certain private investment funds, and various other types of special-purpose companies that would be disqualified under the proposed rules. Because there has been some confusion in the marketplace, it is worth remembering that a company may not conduct a crowdfunded securities offering to the general public until such time as the SEC adopts final rules. As a cautionary note, in 2011, the SEC shut down 'buyabeercompany.com' because in effect it was conducting an unregistered crowdfunded offering to the public³.

The promise of equity

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crowdfunding is to create a simple, inexpensive way for garage start-ups and other smaller businesses to raise capital without the need to rely heavily on lawyers, investment bankers and other intermediaries. The SEC's proposed rules, which closely track the JOBS Act's mandates, would create a system that is anything but simple and inexpensive. Preparing financial statements, drafting lengthy disclosure documents, retaining brokers or funding portals, and undertaking an annual reporting obligation to the SEC - all for gross proceeds less than \$1 million annually - seem a heavy lift for any small business, particularly one seeking seed capital. Other permissible techniques for privately raising capital exist, and these other techniques are neither as complicated as the SEC's crowdfunding model, nor are they limited to \$1 million in total proceeds. Indeed, the SEC recently created a new private placement exemption under its Rule 506(c) that permits a company to publicly advertise a private securities offering so long as the universe of subscribers is limited to investors meeting minimum net-worth requirements. Furthermore, the SEC staff have recently permitted a number of limited-purpose crowdfunding portals to commence operations on the condition that they only allow 'accredited' investors meeting minimum net-worth requirements to participate. Any private company considering a crowdfunded offering must be aware of the potential burdens a large group of minority shareholders could impose. A corporation with large numbers of shareholders must develop a system for tracking its investor base and ensuring that required communications are distributed to investors in a timely fashion.

Minority investors will have the benefits of various statutory protections and fiduciary regimes designed to constrain the activities of management and controlling shareholders. Thus, the founders may be limited in their ability to make decisions about the operation of the business if those decisions could disadvantage minority investors. Looking ahead to future fundraising, more-sophisticated investors, such as venture capital and private equity funds, may be discouraged from investing in a business that has a complicated capital table with a large retail investor base.

Given the onerousness of the proposed rules and the other factors described in this article, many observers have expressed doubts as to how vibrant a market will develop in the SEC-regulated crowdfunding space. Nevertheless, numerous businesses have commenced operations in anticipation of the crowdfunding rules' adoption and hope to capitalise on this new fundraising technique by offering their services to companies and investors. Time will tell if the promise of equity crowdfunding is to be fulfilled.

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1. The complete proposal is available at www.sec.gov/rules/proposed/2013/33-9470.pdf

2. Finra, another regulatory body that oversees US broker-dealers, has also proposed rules governing the registration and operations of funding portals.

3. Available at <http://www.sec.gov/news/press/2011/2011-122.htm>