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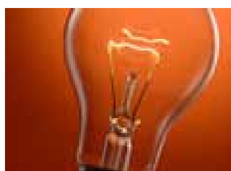

Is the Game Worth the Candle? The Burdens of the Proposed Crowdfunding Exemption

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In April 2012, Congress passed the Jumpstart Our Business Startups Act (the "JOBS Act") with the intent (as the Act's name suggests) to provide small businesses with increased access to sources of capital and bolster job and overall economic growth. Of the Act's several provisions, Section 201(a) of the JOBS Act directed the Securities and Exchange Commission (the "SEC") to lift the long-standing ban on general solicitation and advertising in offerings conducted pursuant to Rule 506 of Regulation D. In accordance with the foregoing mandate, earlier this year the SEC adopted new Rule 506(c) allowing companies to raise capital from accredited investors through general solicitation. Companies have already begun to utilize the new rule, which went into effect on September 23, 2013, to raise capital. For a more detailed analysis of new Rule 506(c) and related amendments, please see our legal insight[1] dated July 12, 2013.

With somewhat less fanfare, Congress, pursuant to Section 301 of the JOBS Act, added new Section 4(a)(6) to the Securities Act of 1933, as amended (the "Securities Act"), which provides a registration exemption for small companies and "startups" seeking to offer and sale securities through the Internet via "crowdfunding." This article explores crowdfunding and the SEC's proposed rules, and provides comparisons of the crowdfunding exemption with other registration exemptions available to companies seeking to raise capital through the sale of their securities. In its proposing release, the SEC noted that the crowdfunding rules were "designed to help provide startups and small businesses with capital by making relatively low offerings of securities less costly."[2] As will be discussed and analyzed in this article, however, the crowdfunding exemption, as proposed and statutorily mandated, poses various obstacles and regulatory hurdles that may undermine the relative utility of the exemption, especially when compared to other exemptions available to small companies.

Crowdfunding

"Crowdfunding" refers to a method of raising money, via the Internet, by seeking small contributions from large numbers of people. The broad expansion of access to the Internet has allowed for the fluid and fast exchange of information and ideas. Companies and individuals have sought to utilize this electronic medium to broadly disseminate their plans and projects with the goal of attracting a broad range of people who share similar interests but may not otherwise have been aware of the company or initiative and may not be wealthy and sophisticated investors that are typically targeted in private securities offerings.

Crowdfunding, however, does not necessarily entail the offer and sale of securities. For instance, non-equity crowdfunding has arisen as a popular way to fund various forms of artistic projects, including films, computer games and music. Internet-based platforms, such as Kickstarter,[3] provide information regarding various projects seeking donations and contributions and provide an opportunity for individuals to donate or contribute money to projects of their choice. In exchange, the contributors do not receive any ownership interest in the project; instead, they may receive rewards or gifts, such as a free copy of the finished work or tickets to view the film.

1 http://www.agg.com/files/Publication/8a06134f-f267-4e24-be23-801cf317bce0/Presentation/PublicationAttachment/73a56b82-de49-4824-91e4-80978aca7786/Alley-Ivie-SEC-Lifts-General-Solicitation-Ban-and-Imposes-Bad-Actor-Disqualifiers.pdf
2 http://www.sec.gov/rules/proposed/2013/33-9470.pdf
3 http://www.kickstarter.com/

Until recently, restrictions on general solicitation and investor sophistication requirements had made private placement exemptions generally unavailable for securities-based crowdfunding transactions, and registration is too costly in light of the size and funding goals of companies seeking to utilize crowdfunding. In this gap, supporters lobbied for a registration exemption and the implementation of a regulatory regime that would provide certainty for companies (and the related Internet-based platforms) seeking to engage in securities-based crowdfunding while providing such companies with greater sources of capital at marginal cost. Yet, investor advocates voiced legitimate concerns regarding the potential for fraud and the lack of transparency and accountability, and called for the imposition of various mechanisms to protect investors. As will be discussed further below, the crowdfunding exemption enacted by Congress, and as proposed by the SEC, offers small companies certain benefits, but with the intent to protect investors,[4] imposes disclosure requirements that companies may discover are too costly and burdensome.

Crowdfunding exemption

Ineligible Companies. The crowdfunding exemption is designed to benefit startups and small or early stage companies. As compared to the exemptions available pursuant to Regulation D, the crowdfunding exemption is available to a narrower range of companies. Congress precluded the following types of companies from availing themselves of the crowdfunding exemption:

1. Non-US companies;
2. Companies subject to the reporting requirements under the Securities and Exchange Act of 1934, as amended (the “Exchange Act”); and
3. Investment companies, as defined under the Investment Company Act of 1940 (the “Investment Company Act”), and certain entities, including hedge funds and other “private funds,” as defined under the Investment Company Act.

In addition, similar to offerings conducted pursuant to Regulation A or Rules 505 and 506 of Regulation D, securities offerings involving certain bad actors will be disqualified from relying on the crowdfunding exemption. The contours of the bad actor disqualification provisions of the crowdfunding exemption are beyond the scope of this article, but companies must be mindful of the scope and breadth of the disqualification rules’ application. Furthermore, companies that fail to articulate a specific business plan, or that state their plan is to merge with an unidentifiable company, may not rely on the crowdfunding exemption. The level of specificity will vary based on the business’s stage of development and its industry. In addition, as an incentive to comply with the rule’s filing requirements, companies that fail to abide by the exemption’s annual reporting requirements (as discussed below) during the two years preceding the offering statement (as discussed below) will not be eligible for the exemption.

Aggregate Offering Amount Limitation. Similar to Rule 504 offerings, companies may not raise more than one million dollars ($1 million) during a twelve (12) month period pursuant to the crowdfunding exemption. In contrast, companies may raise an unlimited amount of capital pursuant to either Rule 506(b) or Rule 506(c).

Integration. As proposed, capital that companies may raise pursuant to other exemptions, including Rule 506(c), would not count towards the $1 million limit and neither would donations or contributions received from separate non-securities-based crowdfunding efforts. Nonetheless, companies conducting another exempt offering concurrently with a crowdfunding offering will have to take careful steps to ensure that the company abides by the separate requirements of each exemption. For example, a company conducting a Rule 506(b) offering (which may not be conducted via general solicitation) and a crowdfunding offering would need to make sure that its Rule 506(b) investors were not solicited by means of the crowdfunding offering, such as via the intermediary’s website or through notices posted on social media such as Facebook.

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4 Congress’s intent can be discerned in the alternative title for the crowdfunding provisions of the JOBS Act: “Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012.”

Intermediaries. Crowdfunding offerings must be conducted "on-line" or through the Internet, but companies may not effect crowdfunding transactions through the company's own website. Instead, companies must conduct the crowdfunding transactions via a single intermediary, either a registered broker-dealer or a new entity known as a "funding portal," which must effect the transactions through the broker's or funding portal's "platform" or website.[5] An investor seeking to invest in an offering conducted in reliance on the crowdfunding exemption would need to open an account with the intermediary and consent to electronic delivery of materials. In contrast, companies conducting Rule 506 offerings are not required to utilize a "middleman" or intermediary, and may offer and sale their securities directly to investors.

Individual Investor Limitations. Small companies and startups needing an influx of capital often have uncertain business prospects that may deter investments from accredited investors. Unlike Rule 506 offerings, in crowdfunding offerings, the company can accept investments from an unlimited number of investors without regard to their sophistication, subject to the following limitations on the investment amounts.

If the investor's annual income and net worth are both less than $100,000,[6] then the investor would not be permitted to invest more than $2,000 or five percent (5%) of his or her annual income or net worth (whichever is greater). If either the annual income or net worth is more than $100,000, then the investor can invest ten percent (10%) of his or her annual income or net worth (whichever is greater), but cannot exceed $100,000. A company is spared the onerous burden of verifying that each investor has satisfied the investor limitations, and unless it has contrary knowledge, the company may rely on the intermediary's efforts to determine that the investor has not exceeded the limitations.[7]

Limited Advertising. Unlike companies utilizing Rule 506(c), companies relying on the crowdfunding exemption cannot rely on general solicitation and advertising to sell their securities,[8] but unlike Rule 506(b) offerings, companies may conduct limited advertising (outside of the intermediary's platform) in the form of notices that direct investors to the intermediary's platform. Companies can distribute such notices, similar to "tombstone ads," via print or electronic media. For example, companies could post the notices on social media sites such as Facebook, LinkedIn or Twitter (although Twitter's 140 character limit could restrict the length of the notice). The notices may contain no more than the following information:

1. A statement that the company is conducting an offering pursuant to the crowdfunding exemption, the name of the intermediary, and a link to the intermediary's platform;
2. the amount, nature and price of the securities offered, along with the closing date of the offering period; and
3. the name of the company, and its address, phone number and website, the e-mail address of a representative of the company and a brief description of its business.

The proposed rules also would allow a company to communicate with investors and potential investors about the terms of the offering through communication channels provided on the intermediary's platform, so long as the issuer identifies itself as the issuer in all communications. Through such media, the company would be able to answer questions and/or refute statements made on such channels regarding the terms of its offering. Such channels could take the form of a chat room, message board, or comment threads. A founder or an employee of the company who engages in promotional activities on behalf of the company through the communication channels provided by the intermediary would be required to disclose, with each posting, that he or she is engaging in those activities on behalf of the company.

5 The SEC and FINRA have proposed rules establishing a regulatory regime for the intermediaries. Such rules, however, are beyond the scope of this article.

6 The investor's annual income and net worth can be calculated jointly with the income and net worth of the investor's spouse. *See* http://www.sec.gov/rules/proposed/2013/33-9470.pdf

7 The proposed rules require that prior to permitting an investor to make an investment commitment on its platform, an intermediary must have a reasonable basis to believe that the investor satisfies the investment limitations. The intermediary, however, is permitted to rely on the investor's representations. In contrast, companies engaging in Rule 506(c) offerings, which permit general solicitation, must take reasonable steps, or utilize certain verification methods, to determine the "accredited investor" status of its investors.

8 Companies are not prohibited from continuing to advertise their business or engaging in other communications during the term of the offering if such advertisements do not discuss the terms of the offering.

Resale Restrictions. Securities acquired in Rule 505 and 506 offerings are "restricted securities," and may be resold pursuant to Rule 144 under the Securities Act if certain conditions are met (including a one-year holding period for securities of non-reporting companies). In comparison, investors generally must hold their crowdfunding securities for one year; however, the investor may transfer his or her crowdfunding securities during the initial one-year period (1) to the issuer of the securities; (2) to an accredited investor; (3) in connection with a registered offering; (4) to a family member or equivalent, or in connection with certain events, including death or divorce; or (5) to a trust controlled by the initial purchaser or to a trust created for the benefit of a member of the family of the purchaser or the equivalent.

State Law Preemption. Unlike Rule 505 securities, but similar to Rule 506 securities, crowdfunding securities will be "covered securities" that are exempted from state registration requirements. The costs of compliance with the myriad state blue sky registration requirements would have overwhelmed any companies contemplating the proposed crowdfunding exemption. Yet, similar to companies conducting Rule 506 offerings, states may still require companies relying on the crowdfunding exemption to provide the respective state regulatory offices with certain notice filings and fees.

Disclosure Requirements

In an effort to protect investors and promote transparency, Congress and the SEC prescribed extensive disclosures that companies relying on the crowdfunding exemption must provide to the SEC, the intermediary, investors and potential investors.[9] These disclosure requirements (as set forth below) present a time-consuming and costly obstacle for small companies seeking to raise a relatively small amount of capital. In contrast, except for the Form D, neither Rule 506(b) nor Rule 506(c) mandates particular disclosures that must be provided to accredited[10] investors. Yet, antifraud rules continue to apply, and companies relying on Rule 506 often provide their investors with private placement memoranda ("PPMs") or other offering documents.[11]

Form C. Companies relying on the crowdfunding exemption will be required to file an initial offering statement on new Form C with the SEC through EDGAR. Form C requires disclosure of some of the same information as current Form D,[12] such as the company's name, address, legal status, the target offering amount and the names of directors and officers. The company would, however, be required to also disclose the business experience of its directors and officers, and the names of owners of twenty percent (20%) or more of the company's outstanding voting equity securities. Furthermore, the company would need to disclose the deadline to reach the target; whether it will accept investments in excess of the target amount, and if so, the maximum amount it will accept; the price of the securities or the method for determining such price; and the company's ownership and capital structure, including discussions of the risks related to minority ownership and the securities' transfer restrictions. In addition, the company would need to provide a description of its business, its anticipated business plan, and the purpose and intended use of the offering proceeds, including sufficient information to permit potential investors to evaluate the investment.

The SEC also proposed several additional disclosure requirements that were not statutorily mandated. Such discretionary additions may face particularized scrutiny from opponents of the extensive disclosure regime, and would require companies to disclose the following:

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9 The company would provide to the relevant intermediary a copy of the disclosures filed with the SEC on EDGAR. To satisfy the requirement to provide the disclosures to investors and make them available to potential investors, the company would provide the information to investors electronically by referring (via a posting on the company's website or by email) investors to the information on the intermediary's platform.

10 Companies relying on Rule 506(b) are required to provide certain disclosures to any non-accredited investors. See Rule 502(b).

11 PPMs often contain some of the information required by the proposed crowdfunding rules, including, without limitation, a description of (i) the company's business and business plan; (ii) the purpose and intended use of the proceeds; and (iii) risk factors.

12 The SEC has proposed rules that would revise Form D to expand the information provided by issuers. For a discussion of the proposed rules, please see our legal insight: http://www.agg.com/files/Publication/8a06134f-f267-4e24-be23-801cf317bce0/Presentation/PublicationAttachment/73a56b82-de49-4824-91e4-80978aca7786/Alley-Ivie-SEC-Lifts-General-Solicitation-Ban-and-Imposes-Bad-Actor-Disqualifiers.pdf

1. the name, SEC file number and CRD number of the intermediary, and the amount of compensation paid to the intermediary;
2. certain legends to be included in the offering statement;
3. the number of employees of the company;
4. risk factors, and the material terms of any indebtedness of the company;
5. any exempt offerings conducted within the past three years; and
6. certain related-party transactions.

The SEC also exercised its discretion to propose requiring the company to describe (i) the investor's cancellation rights and (ii) the process to complete the transaction once the target amount is met, including a statement that:

1. investors may cancel an investment commitment until forty-eight (48) hours prior to the offering deadline;
2. the intermediary will notify investors when the target offering amount has been met;
3. if the company reaches the target offering amount prior to the offering deadline, then it may close the offering early if it provides notice about the new offering deadline at least five (5) business days prior to that new deadline;
4. 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 company upon closing of the offering and the investor will receive securities in exchange for his or her investment; and
5. if the sum of the investment commitments does not equal or exceed the target offering amount at the time of the offering deadline, no securities will be sold in the offering, investment commitments will be cancelled and committed funds will be returned.

Financial Condition. A company is also required to provide a narrative discussion of its financial condition. This "mini-MD&A"[13] will require the company to discuss its historical results of operations, liquidity and capital resources in a clear and understandable manner. The length and detail required will depend on the stage of development of the company undertaking the crowdfunding offering. Startups and new companies that do not have an operating history would need to discuss financial milestones and operational, liquidity and other challenges. If the company does have an operating history, then the company would need to focus on whether historical earnings and cash flows are indicative of what investors should expect in the future. The proposed rules also require that companies describe the business's other available sources of capital, and discuss how the offering proceeds will affect their liquidity and whether the offering proceeds are necessary to their business's viability.

Financial statement disclosure. In addition to a narrative discussion of the company's financial condition, companies relying on the crowdfunding exemption would be required to file with the SEC, provide to investors and the relevant intermediary and make available to potential investors a complete set of the company's financial statements (a balance sheet, income statement, statement of cash flows and statement of changes in owners' equity), prepared in accordance with U.S. generally accepted accounting principles ("GAAP"),[14] covering the shorter of (i) the two most recently completed fiscal years or (ii) the period since inception of the business. The level of financial statement disclosure depends on the aggregate amount of crowdfunding securities offered and sold by the company during the preceding 12-month period, along with the amount the company is seeking to raise in its present crowdfunding offering.

Offerings of $100,000 or less. The company would be required to provide (i) financial statements certified by the company's CEO or equivalent officer and (ii) filed income tax returns for the most recently completed fiscal year, if any. The company is permitted to redact personally identifiable information in its tax returns.

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13 A management's discussion and analysis of financial condition and results of operations, or MD&A, is required by Item 303 of Regulation S-K for registered offerings.
14 In its proposing release, presumably to address projected concerns regarding the expense associated with the preparation of the financial statements, the SEC remarked: "Financial statements prepared in accordance with U.S. GAAP are generally self-scaling to the size and complexity of the company, which should reduce the burden of preparing financial statements for many issuers." http://www.sec.gov/rules/proposed/2013/33-9470.pdf

Offerings between $100,000 and $500,000. Companies would be required to provide (i) financial statements reviewed by an independent public accountant 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"), and (ii) a copy of the public accountant's review report. The accountant must be independent pursuant to the SEC's independence rules set forth in Regulation S-X.

Offerings more than $500,000. Companies would be required to provide (i) financial statements audited by an independent auditor in accordance with the auditing standards issued by either the AICPA or the Public Company Accounting Oversight Board, and (ii) a copy of the audit report.

Progress Updates. The company's disclosure requirements do not stop at the initial offering statement. In addition to amendments that must be filed in the event of material changes in the offering's terms or the company's prior disclosures, the proposed rules would require a company to file with the SEC, provide investors and the relevant intermediary, and make available to potential investors a Form C: Progress Update (Form C-U). Pursuant to such form, the company would be required to disclose its progress in meeting the target offering amount no later than five business days after the issuer reaches fifty (50) and one hundred (100) percent of the target offering amount. If the company will accept proceeds in excess of the target offering amount, then the company also would be required to provide a final progress update (Form C-U), no later than five business days after the offering deadline, disclosing the total amount of securities sold in the offering.

Annual Reporting Requirements. Moreover, companies that successfully close a crowdfunding offering must file an annual report (Form C-AR: Annual Report) on EDGAR and on the company's website. The report would be due no later than 120 days after the end of the most recent fiscal year covered by the report. The annual report would contain similar disclosures as the initial offering statement, such as information regarding the company's directors and officers, business, current number of employees, financial condition (including financial statements), capital structure, risk factors, material indebtedness and certain related-party transactions. Companies would, however, not be required to provide certain offering-specific information (such as the target offering amount and terms and price of the offered securities). The company could be saddled with the ongoing cost of providing the annual report for many years; the company's reporting obligation would not cease until it (a) become an Exchange Act reporting company; (b) the company or another party purchased or repurchased all of the crowdfunding securities; or (c) the company was liquidated or dissolved. The company would be required to file another form within five days of the terminating event.

Conclusion

The compliance costs associated with the initial and ongoing disclosure requirements, combined with the relatively minimal amount of capital that can be raised, may cause companies, especially in the long-term, to avoid reliance on the crowdfunding exemption in its current form, as proposed. For similar (and other) reasons, issuers have shied away from reliance on the exemptions provided by Regulation A and Rule 504. Small companies and startups may instead turn to Rule 506, particularly Rule 506(c), to enjoy the benefits of raising an unlimited amount of capital via general solicitation. Yet, certain companies may be unable to attract a sufficient number of accredited or sophisticated investors to utilize either Rule 506(b) or Rule (c), and may need access to capital from investors not generally involved in private placements. To foster and develop interest, such companies may also need to engage in some form of advertising, which would not be an option in Rule 506(b) offerings. Nevertheless, before choosing to rely on the crowdfunding exemption, if adopted as proposed, the company should be mindful that the ongoing costs of compliance, including legal, accounting and audit expenses, and the potential for missteps, may outweigh the benefits offered by the exemption.

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