

ALERT

## Crowdfunding: SEC Rules Will Determine New Industry's Fate

By Andrew M. Walsh

Heralding it as a “potential game changer” for startups and other emerging growth companies, President Obama signed into law the Jumpstart Our Business Startups (JOBS) Act on April 5, 2012, and proclaimed, “Because of this bill, startups and small business will now have access to a big new pool of American investors, namely the American people.”

The JOBS Act creates a new “crowdfunding” exemption from registration for securities offered to the public — including non-accredited investors — via the Internet by emerging companies. (Generally, an accredited investor is someone who has a net worth exceeding \$1 million, excluding the value of their primary residence, or income exceeding \$200,000 in each of the two most recent years.) Already, entrepreneurs and new funding intermediaries are gearing up to participate in this new industry that promises to make capital raising and startup investing more accessible.

Summarized, the crowdfunding provisions of the JOBS Act 1) create an exemption from registration for securities offerings of less than \$1 million involving non-accredited investors and limits the amount that an investor may purchase according to net worth and income; 2) exempt intermediaries (crowdfunding websites) from broker-dealer registration, and place certain requirements upon such entities; and 3) place certain disclosure and other requirements upon the issuers. The JOBS Act also preempts state blue-sky regulations, which are an unpopular source of expense among issuers and investors.

Until now, existing crowdfunding intermediaries, such as Kickstarter, Indiegogo and RocketHub, have been successful, but they have been restricted to fundraising for creative-type projects involving no sales of securities. Dozens of new intermediaries are gearing up to launch in a “first to market” race, but only after the Securities and Exchange Commission has promulgated rules as part of what the president characterized as “vigorous oversight.”

The new law's crowdfunding provisions and other provisions, such as permitting the “general solicitation.” of accredited investors and relaxing the requirements for IPO companies to file audited financials, have stirred controversy because some perceive it as the type of “deregulation.” that caused the dot-com debacle of the late 1990s. In the case of crowdfunding,

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however, the SEC has until the end of 2012 to issue rules and much commentary is expected.

### Section 4(6) Offerings: Crowdfunding Exemption

The new exemption created by the JOBS Act is set forth in a new Section 4(6) of the Securities Act of 1933 and applies to offerings of not more than \$1 million conducted through a broker or "funding portal." The maximum amount of securities that each investor in such a "4(6)" offering may purchase depends on such investor's "annual income or net worth, as applicable." If an investor's net worth or annual income is less than \$100,000, then such investor is limited to purchasing "the greater of \$2,000 or 5 percent of the annual income or net worth of such investor..." If an investor's annual income or net worth is more than \$100,000, then the limit is "10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000..."

Crowdfunding investors will not be able to resell their securities for a period of one year, except to accredited investors, family members or back to the issuer. The ability to resell to accredited investors suggests a new source of deal flow for secondary markets for private company stock.

### Requirements on Intermediaries

The JOBS Act permits broker-dealers or "funding portals" to act as intermediaries in crowd-sourced offerings. "Funding portal" is defined as "any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to [the crowdfunding exemption]." In addition to any rules adopted by the SEC, the funding portals may not 1) offer investment advice; 2) solicit purchases, sales or offers to buy the participating issuers' securities; 3) compensate its employees or agents with commissions on sales of such securities; or 4) handle investor funds.

The JOBS Act exempts crowdfunding websites from registration as broker-dealers under Section 15(a)(1) of the Securities Exchange Act of 1934, but, in order to conduct offerings, they must register with the SEC as funding portals and with an applicable self-regulatory organization. Already, a self-regulatory organization and at least two industry associations have formed. The Crowdfund Intermediary Regulatory Association seeks to work with the SEC to advise on reasonable and appropriate regulations and oversight to reduce fraud and protect investors. The National Crowdfunding Association and Crowdsourcing.org were formed to educate the public, media and regulatory bodies, and serve as promoters of the industry.

Given that the investors may not be accredited or even sophisticated, the JOBS Act places upon the funding portals certain responsibilities such as providing risk disclosures and "other investor-education information, as the Commission shall... determine appropriate." It also requires the portals to "ensure" that each investor has reviewed such information and has acknowledged the risk of entire



loss of investment. The JOBS Act also requires the funding portal to “take such measures to reduce the risk of fraud . . . as established by the Commission” and to conduct background checks on the issuer’s officers, directors and 20% shareholders.

The new law also contemplates “target” offering amounts and requires that the funding portal ensures that the investors’ commitments are only delivered to the issuer when such target is reached, and, if not, that each investor has the right of rescission.

### Requirements for Issuers

The JOBS Act requires that the issuers seeking exemption from registration under Section 4(6) must file with the commission and make available to potential investors, among other things, 1) a description of the issuer’s business and the “anticipated business plan” of the issuer; 2) a description of the financial condition of the issuer, tax returns and financial statements; 3) the target offering amount, its deadline and regular updates regarding the progress of the issuer in meeting such amount; 4) the price of the security, or the method for determining the price; and 5) a description of the ownership and capital structure of the issuer, including the terms of all of the issuer’s securities, how they may affect the crowdfunding investors and certain risk factors.

For offerings of not more than \$100,000, the issuer’s most recent tax return (if any) is required and the financial statements do not need to be reviewed or audited, but they must be certified by the principal executive officer of the issuer. For offerings that exceed \$100,000, but not more than \$500,000, the financial statements must be reviewed by an independent public accountant, and for offerings over \$500,000, the financial statements must be audited.

Issuers must also file with the commission, at least annually, reports of the results of operations and financial statements. The JOBS Act requires the SEC to specify the form of such reports — whether they would need to be “audited,” “reviewed” or “certified” — and to provide any termination date for such obligation. If audited statements are required on an ongoing basis, issuers and investors should take into consideration the cost of compliance.

The JOBS Act provides that crowdfunding investors may bring an action against a Section 4(6)–exempted issuer to recover the consideration paid for the security, or for damages if such person no longer owns the security, if the issuer makes an untrue statement of material fact, or material omission in their offering documents.

### Developing Questions Surrounding Crowdfunding

One of the important questions surrounding crowdfunding as a feasible method of raising capital is whether subsequent private equity investors or strategic corporate investors would want to invest in a startup that has a large number of small, unsophisticated investors. If there is an increase in perceived risk relating to a larger shareholder base, it could affect the issuer’s cost of capital. In addition, the ongoing administrative cost of complying with the SEC rules may be unattractive to entrepreneurs and their subsequent investors.

Another question is whether the funding portal is able to attract sophisticated investors to the issuer. Without sophisticated participants, the investment is likely to be considered “dumb money” invested by individuals who cannot help the company with their expertise or professional network. It will be a key objective for funding portals to distinguish themselves as being trusted, compliant marketplaces of opportunity, and to execute social networking and marketing strategies which attract more sophisticated investors.

Another concern debated by commentators is whether the exemption will attract subpar issuers or even scam artists. It is unclear at this early stage what types of companies will gravitate to the crowdfunding option and how well the SEC will strike a balance between market access and oversight. If a company truly has a compelling and marketable idea, should it need to go the crowdfunding route, which some perceive as a last resort?

Other open questions address the feasibility of shareholder agreements and the types of securities that are permitted. Will the SEC create any safe harbors as to investor rights and types of securities? Should the crowd be aggregated into one investor?

It is too early to tar crowdfunding as a last-resort method of financing or as a scam magnet. If the cost of capital proves to be lower, if geographic



constraints are obviated, if the issuer has more bargaining power than against, say, an angel fund, or if there is more appetite in the crowd for certain types of opportunities, it may turn out that, in certain cases, crowdfunding is a recommended alternative to traditional funding sources.

The success of regulated crowdfunding in the United States rests upon the efficacious SEC rules and credible, high-integrity industry participants. It would be consistent with the

SEC's mission of protecting investors, and therefore not surprising, if the SEC's initial rules were more, rather than less, restrictive as to the types of equity and features legally offered. We expect the Crowdfund Intermediary Regulatory Association, National Crowdfunding Association and other crowdfunding thought leaders, such as Steve Case, to take active, thoughtful roles in shaping the answers to these developing questions. ▲

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