

The SEC Promulgates Long Awaited Rules on Investor Regulation Crowdfunding

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Most of us are generally familiar with the concept of crowdfunding – the practice of a group of unrelated people financing a product with modest amounts of money online. Many recent crowdfunding efforts have involved charitable crowdfunding or pre-payments for future goods or services. With respect to the latter, for example, numerous persons might pre-pay the purchase price (at a discount) for a cooler that blends frozen drinks, plays music and air conditions the open air space around it. Once enough funds have been raised to manufacture it, and it is, in fact, manufactured, each pre-paying person is entitled to receive the finished product. This type of funding is known as ‘**Rewards Crowdfunding**’ and tends to be regulated by consumer protection laws.

There are however, additional types of crowdfunding which do not involve raising charitable dollars or pre-payments for the purchase of a product. One alternative type of crowdfunding involves a company’s use of the internet to solicit potential investors, issuing a small ownership stake in the company, or a promissory that would pay interest in exchange for a relatively small investment amount. The companies that do this are looking for financing alternatives to venture capital or angel investors to get off the ground. Some use this type of financing as a springboard to obtain larger future financing from venture capital. These types of crowdfunding involve the sale of “*securities*”. Generally, they are regulated under the Securities Act of 1933 (“**’33 Act**”).

The SEC had partly opened the door on permitting a version of this type of crowdfunding by permitting public advertising of “*private*” offerings under what is known as ‘**Regulation D**’ offerings; however, sales of securities under this public advertising exemption were limited to “*accredited investors*”, as that term is defined under the SEC’s Regulation D. This change occurred with the SEC’s issuance of Regulation D rules on July 10, 2013.

On May 16, 2016, the SEC rules permitting an additional type of crowdfunding, known as ‘**Regulation Crowdfunding**’, became effective. This new form of crowdfunding permits those individuals that do not meet the accredited investor requirements for a Regulation D offering to invest in securities crowdfunding, provided that the company they are investing in complies with Section 4(a)(6) of the ‘33 Act.

Limitations of Regulation Crowdfunding

Regulation Crowdfunding companies are limited in the amount of capital that they can raise under Section 4(a)(6) in any rolling 12-month period to a maximum of \$1 million (this amount may be adjusted by the SEC not less frequently than once every 5 years, to reflect changes to the Consumer Price Index). Regulation Crowdfunding companies can raise additional funds in the same 12-month period through traditional Regulation D offerings, including offerings to angel or venture capital investors.

Of the \$1 million that a company can raise under Regulation Crowdfunding, the limits that an investor can invest are:

for investors who either have an annual income or net worth of:

less than \$100,000

at least \$100,000

the greater of:

(a) \$2,000 or

(b) 5% of the lesser of the investor's annual

10% of the lesser of the investor's annual

Investors in Regulation Crowdfunding, are limited to making a total of \$100,000 in aggregate investments in a 12-month period, regardless of the number of Section 4(a)(6) investments being financed.

Offerings and Filing Requirements of Regulation Crowdfunding

Companies that choose to use Regulation Crowdfunding, must comply with strict SEC guidelines. Offering Notices can only include: (1) a statement that the issuer is conducting an offering, (2) name, legal status, physical address, website, directors and officers of the issuer, (3) the name of beneficial owners of 20 percent or more of the securities of the issuer, (4) the name of the online platform where the offering is being made, (5) the amount, nature and price of the securities being offered, (6) the closing date, and (7) a brief description of the company. Additionally, the company is required to file Form C with the SEC and disclose information about the company, its business plan and management's experience for the past 3 years prior to filing. Furthermore, financial statements must be provided as well as a section containing management's discussion and analysis of the company's financial condition, results of operations, liquidity and capital resources. Reports must be filed on a regular basis with the SEC during specific filing periods until certain benchmarks are reached and the issuer becomes a reporting company under the Securities Exchange Act of 1934. These reports are costly and time consuming to produce.

Offering Platforms of Regulation Crowdfunding

The offering must be made through an internet platform offered by a registered broker-dealer or a funding portal which is also registered with the SEC. The company must limit the crowdfunding transaction to a single intermediary which must in turn police investor limits and take steps to reduce fraud. Portals may be paid in equity (on same terms and price as issued to investors).

Overview

While this new crowdfunding channel opens doors to new potential investors, it is very burdensome and costly to companies looking to raise funds. Only in time will we see if Regulation Crowdfunding is a successful alternative to the many other forms of existing crowdfunding.