Locke Lord LLP

April 2012

Crowd Funding – Who in their Right Mind Would…

Author Thomas D. Sherman // T: 404-870-4672 // tsherman@lockelord.com

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the "JOBS Act").

Included among its provisions is Title III - "Crowd Funding," which creates a new Sections 4(6) and 4A under the Securities Act of 1933 (the "Securities Act").

Crowd Funding is available only to issuers (presumably corporations, partnerships, limited liability companies, etc.) organized in the United States, is not available to registered Investment Companies under the Investment Company Act of 1940, issuers already subject to SEC reporting under the Securities Exchange Act of 1934 (the "Exchange Act") and, most importantly, issuers whose officers, directors or principal shareholders have been guilty of any of the so-called "bad-boy" offenses provided in the disqualification provisions of Section 262 of Regulation A under the Securities Act, 17 CFR Section 230.262, or state equivalents within the past five or possibly 10 years. Section 4A(f).

Up to $1 million per year (which apparently may be debt or equity) may be raised by eligible companies under new Section 4(6)(A) of the Securities Act without registering the offerings under Section 5 of the Securities Act. The antifraud provisions of state security laws and both the Securities Act and the Exchange Act will still apply, and there's a new special anti-fraud civil remedy/rescission provision applicable to Crowd Funding offerings as well. Section 4A(c)(2).

The Securities and Exchange Commission (the "Commission") has 270 days from April 5 to draft and issue proposed regulations. Realistically, that means that Crowd Funding offerings will not be available until 2013 and well after the presidential election.

If an investor has net worth or annual income of $100,000 or greater (which may or may not include that of the investor's spouse - TBD), that investor can invest up to $100,000; if the investor's annual income/net worth is less than $100,000, then the investor may invest the greater of $2,000 or 5 percent of annual income/net worth. Section 4(6)(B).

Not addressed are potentially qualified investors that may not be individuals, if any, so the Commission will have to sort that out in the rules.

Importantly, these investment limitations apply to the *aggregate* amount that a single investor may commit to *all* Crowd Funding offerings during each 12 month period, not just each single Crowd Funding Issuer. And how is any Crowd Funding Issuer to determine that? Details to follow, but the statute states that it is also the responsibility of the Broker/Crowd Funding Portal (see below) which the issuer *must* use in the transaction - *i.e., no employees/officers of the issuer may conduct the Crowd Funding offering*, unlike most, if not all, other exempt offerings) - to "ensure" that no single Crowd Funding investor exceeds his/her annual crowd-funding investment limit. Section 4A(8). Does this mean that a customary questionnaire might not be enough and that the Crowd Funding Issuer and/or the Broker/Crowd Funding Portal must request the potential Crowd Funding investor's tax returns? TBD.

The Crowd Funding Issuer must file disclosure documents with the Commission that it must also provide to all investors and potential investors and the Broker/Crowd Funding Portal. When those documents must be filed with the Commission by the Crowd Funding Issuer, if there is a review process for the documents and if there is a filing fee, are apparently all items TBD. The statute does require materials to be made available to the Commission *by the Broker/Crowd Funding Portal* not later than 21 days prior to the first day on which the securities are sold to any investor (*or such other period as the Commission may establish*.) Section 4A(a)(6). These provisions seem to create two separate filings, one by the Crowd Funding Issuer and another by the Broker/Crowd Funding Portal. Whether the filing with the Commission is confidential, as it may be with emerging growth companies, is TBD.

The disclosure items include a description of the Crowd Funding Issuer's financial condition [most recent quarterly income statement and balance sheet – year to date? TBD] and, *in addition*: 1) for Crowd Funding offerings of $100,000 or less - the Crowd Funding Issuer's most recent a) tax returns and b) financial statements certified as true and complete in all material respects by the Crowd Funding Issuer's CEO; 2) for offerings of between $100,000 and $500,000 - "reviewed" financials by an independent public accountant; and 3) for offerings greater than $500,000, audited financial statements. Section 4A(b)(1)(D). Full GAAP financials, complete with footnotes? TBD.

In addition, immediately prior to closing the sale, the Crowd Funding investors must be afforded a rescission right by the Crowd Funding Issuer to cancel their commitment to purchase the securities. Section 4A(b)(1)(G).

The Crowd Funding Issuer must establish a 'target' offering amount and a deadline for reaching that target amount, and must provide *regular* (what 'regular' means is TBD) updates to potential investors during the Crowd Funding offering process as to where the Crowd Funding Issuer stands in terms of reaching that amount. Section 4A(b)(i)(F).

Required disclosures also include risk factors, dilution exposure, related party transactions, how the purchase price was determined, description of the business, use of proceeds, cap table, and identification of all officers and directors and shareholders who own more than 20 percent of the shares of the Crowd Funding Issuer. Section 4A(b)(1).

No Crowd Funding Issuer advertising is permissible (unlike the new Rule 506 latitude) other than directing potential investors to the Broker/Crowd Funding Portal. Section 4A(b)(2).

The Broker/Crowd Funding Portal must be registered with the Commission, must be FINRA licensed and must make its own disclosures to investors/potential investors.

There's also a curious provision about no compensation to any person to promote the Crowd Funding offering through communication channels provided by the Broker/Crowd Funding Portal unless *that person* [NB, not the Crowd Funding Issuer] complies with TBD disclosure obligations. Section 4A(b)(3).

And here's the clincher. Each Crowd Funding Issuer must file with the Commission, 'not less than annually,' and provide to investors, financial statements as the Commission, by rule, shall determine to be appropriate. Section 4A(b)(4). Will these annual financials, filed with the Commission and distributed to shareholders, become 'liability' documents, as with, for example, a public company's Form 10K annual report?

But wait, there's more. In addition, the Crowd Funding Issuer must 'comply with such other requirements as the Commission may, by rule, prescribe for the protection of investors and in the public interest.' Section 4A(b)(5).

Not to be Neglected – the Broker/Crowd Funding Portal

A funding portal is a newly created creature defined as an intermediary in a Crowd Funding transaction that does not offer investment advice or recommendations, solicit purchases of securities offered or displayed on its website, compensate its employees for such solicitation or based on sales through the portal, hold any investor funds, or engage in other activities as may be determined by the Commission. Section 304(b); new Section 3(a)(80) of the Exchange Act.

The Broker/Crowd Funding Portal must be registered with the Commission, must be FINRA licensed and must make its own disclosures to investors/potential investors. Each Broker/Crowd Funding Portal must 'ensure' that each investor reviews all of the investor related information (including yet-to-be-defined investor education information), positively affirms that the investor understands that he/she might lose the entire investment and can bear the risk of that loss and the investor understands risks of illiquidity, investing in start-ups and 'an understanding of such other matters as the Commission determines appropriate, by rule.' Section 4A(a). These requirements appear to be very special suitability/know your customer standards.

The Broker/Crowd Funding Portal must 'ensure' that no offering proceeds are distributed to the Crowd Funding Issuer until the target offering amount is achieved. Section 4A(a)(7). Since the Crowd Funding Portal, by definition, may not hold any investor funds, this will become a tricky part of the rule making.

Presumably there is a new requirement for an independent escrow agent (that might be a Broker) that must receive the funds from investors and, after the target amount is deposited and rescission period expired, only then may the new capital be released to the Crowd Funding Issuer – all TBD.

The Broker/Crowd Funding Portal must conduct background checks on officers, directors and 20 percent or more shareholders of the Crowd Funding Issuer and "adopt other measures to reduce the risk of fraud as shall be established by the Commission." Section 4A(a)(5).

The Broker/Crowd Funding Portal has *its own* risk factor disclosures for investors which include publishing and distributing 'investor education materials.' Section 4A(a)(3).

The good news is that Crowd Funding exempt offerings are 'covered securities' under Section 18 of the Securities Act and, as such, are free from the registration requirements (but not antifraud provisions) of any state blue sky laws. Section 305.

Crowd Funding Portals (unlike Brokers) may be regulated only in their home states, and that regulation may not be different from or more onerous than that provided under federal law.

There is a mandatory, one-year holding period for Crowd Funding securities except for sales back to the issuer, to accredited investors, as part of a registered offering or transfers to family members in the event of death or divorce. Section 4A(e). Presumably, typical shareholder agreements with the Crowd Funding Issuer are still permitted.

Conclusion

These unnecessarily complex Crowd Funding provisions stand in stark contrast to the relaxed public solicitation/advertising rules now permitted for Rule 506 private offerings to accredited investors, the new relaxed filing/governance standards for 'emerging growth companies' with miniscule $1 billion in annual revenues and the increase in the 'of record' shareholders before registration with the Commission is required. A start-up with, let's say less than $500,000 in annual revenues that seeks to raise $1 million from 10 investors under Crowd Funding cannot advertise, must raise funds through a Broker or Crowd Funding Portal, must have audited financials and register/file with the Commission, initially (at least 21 days before selling any of the securities), must afford investors rescission rights before launch, is required to escrow investor funds until targeted funding is achieved, and must file annual audited financials with the Commission and provide those financial statements to its shareholders. On the other hand, a company with revenues of $900 million and 1,900 'of record' investors not more than 500 of which are non-accredited can raise $50 million in a Rule 506 offering from accredited investors with general advertising and solicitation, technically no disclosure documents, may utilize its own executives to assist in the offering, is not required to file anything with the Commission (other than its Form D post sale), is not required to have audited financials, and is not required (absent state law requirements in some instances) to even provide annual financials to its shareholders. What were they Possibly Thinking?!

There is a mandatory, one-year holding period for Crowd Funding securities except for sales back to the issuer, to accredited investors, as part of a registered offering or transfers to family members in the event of death or divorce.

About the Author

Thomas D. Sherman is Of Counsel in the Atlanta office of Locke Lord. Mr. Sherman has more than 41 years of hands-on, results-oriented accomplishments in a wide variety of legal matters including mergers, acquisitions and joint ventures; SEC practice and compliance (Sarbanes-Oxley Act); commercial and employment law; equity and debt, public and private financings; general corporate law; litigation, including litigation management; and senior executive matters, including employment contracts, non-competition restrictions and severance agreements.

Scan this code with your device's QR reader to learn more about Locke Lord's Corporate practice.