

Investment Crowdfunding: FAQ



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Investment Crowdfunding: FAQ

Frequently asked questions:

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Investment Crowdfunding: FAQ

Q: What is “investment crowdfunding” (ICF) and how is it different from other types of crowdfunding?

A: Investment crowdfunding refers to a new way businesses can raise capital by offering and selling their own securities to the general public through an internet-based intermediary. ICF is part of the 2012 Jumpstart Our Business Startups (JOBS) Act, which created a new exemption in Section 4(a)(6) of the Securities Act of 1933 from the general requirement under Section 5 of the Securities Act that offers and sales of securities must be registered with the SEC. Raising capital for a business from investors with a financial interest in the business' success brings ICF under the jurisdiction of federal and state securities laws.

The term “crowdfunding” is sometimes used to refer to several different fundraising techniques, including some techniques that are not deemed offers and sales of securities under federal law as well as some that are securities offerings but rely on other exemptions under the Securities Act.

Websites such as Kickstarter, Indiegogo and RocketHub, for example, allow companies and individuals to raise money for a variety of projects using donation-based crowdfunding, in exchange for which donors often receive rewards for their money such as a product of the company, a t-shirt, or tickets to an event. Since the recipients of these funds do not issue securities in exchange for the money the activity is not subject to federal or state securities laws.

Other websites, such as EarlyShares, MicroVentures and SeedInvest, allow companies to connect with “accredited investors” in unregistered securities offerings, usually under the exemption for private offerings in Section 4(a)(2) of the Securities Act. This medium was expanded with the adoption of Rule 506(c) of Regulation D in September 2013, permitting general solicitation and advertising in some unregistered offerings. Typically, broker-dealers licensed by FINRA – and regulated by the SEC and FINRA – operate these platforms, and only accredited investors are allowed to invest in these companies.

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Q: Is ICF permitted in the United States today?

A: No. Although ICF is part of the Jumpstart Our Business Startups (JOBS) Act, which was signed into law on April 5, 2012, the JOBS Act requires the SEC to adopt rules implementing the new exemption under Section 4(a)(6) of the Securities Act (to be known as “Regulation Crowdfunding”) before ICF will become legal. The JOBS Act required the SEC to adopt rules implementing Section 4(a)(6) by December 31, 2012, however the SEC did not propose rules for Regulation Crowdfunding until October 23, 2013. A 90-day public comment period is currently in progress with respect to the proposed rules, after which the SEC may either extend the public comment period or adopt final rules. Regulation Crowdfunding will not become effective until 60 days after final rules are adopted and published in the Federal Register. Until then, the SEC has reminded issuers that any offers or sales of securities purporting to rely on the ICF exemption would be unlawful under the federal securities laws.

Q: Are there limits on the amount of money a company can raise in an ICF offering?

A: Yes. Regulation Crowdfunding will limit the total amount of securities sold by a company to all investors under Section 4(a)(6) to \$1 million during the preceding 12 months. The SEC’s proposed rules clarify that only securities sold under Section 4(a)(6) (and not any other exemption from registration) would count toward a company’s \$1 million capital raise maximum.

In calculating the limit, a company would be required to add together proceeds raised in Section 4(a)(6) offerings by the company itself, its predecessors and entities it controls or is under common control with. The amount of proceeds raised in these offerings cannot exceed \$1 million in any rolling 12-month period.

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Q: Are there limits on the amount of money an individual investor can invest in an ICF offering?

A: Yes, there is a limit on the amount of securities a company may sell in any one year to any single investor in ICF offerings. There is some ambiguity regarding these limits in the language of the JOBS Act, but the SEC's proposed rules adopt an approach that seeks to resolve this ambiguity.

Under Section 4(a)(6) and as proposed by the SEC, the total amount of securities sold to any single investor by a company during the preceding 12 months cannot exceed:

- If *both* the annual income and net worth of the investor are below \$100,000, the greater of:
 - \$2,000;
 - 5% of the annual income of the investor; and
 - 5% of the net worth of the investor.
- 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 SEC's proposed rules would permit issuers to rely on the efforts of ICF intermediaries to determine whether an investor has reached these limits, provided the issuer does not have actual knowledge to the contrary.

A natural person's income and net worth are calculated for these purposes using the SEC's rules for measuring the income and net worth of an accredited investor. The dollar thresholds under Regulation Crowdfunding are subject to adjustment by the SEC at least once every five years.

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Q: What types of companies can raise capital using an ICF offering?

A: In general, privately-held operating companies based in the United States which are in good standing with the SEC will be eligible to raise capital in an ICF offering. Section 4A(f) of the Securities Act makes certain categories of issuers ineligible to rely on Section 4(a)(6), including:

- Non-U.S. issuers;
- SEC reporting companies; and
- “Investment companies” (as defined in the Investment Company Act of 1940) and companies excluded from that definition by Sections 3(b) and (c) of the Investment Company Act, including most hedge funds.

The SEC’s proposed rules would also make the following issuers ineligible to rely on Section 4(a)(6):

- Issuers that failed to file with the SEC and provide to investors, to the extent required, annual reports required by Regulation Crowdfunding during the two years immediately before any new ICF offering. Once all delinquent reports have been filed, the issuer will be permitted to launch a new ICF offering.
- Issuers with no business plan or a business plan to engage in a merger with an unidentified company.
- Issuers subject to “bad boy” disqualification under Section 302(d) of the JOBS Act.

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Q: What types of companies can raise capital using an ICF offering? (cont'd)

A: Section 302(d) of the JOBS Act requires the SEC to establish a disqualification provision for ICF offerings substantially similar to those of Rule 262 of Regulation A. The SEC's proposed rules would adopt disqualification provisions similar to Rule 506(d), which disqualifies certain issuers from relying on the Regulation D safe harbor from Securities Act registration.

Under the proposed ICF disqualification provision, an issuer would be unable to rely on the ICF exemption if any person covered by the rule was involved in a disqualifying event. Covered persons include:

- The issuer, its predecessors and certain affiliates;
- Any of the issuer's directors, officers, general partners or managing members;
- Any 20% beneficial owner of the issuer (calculated by voting power);
- Any promoter connected with the issuer at the time of sale;
- Any compensated solicitor for the offering; and
- Any director, officer, general partner or managing member of a compensated solicitor for the offering.

The disqualifying events covered by the proposal are modeled on those of Rule 262, and include, among other things, certain securities-law related injunctions and restraining orders entered in the last five years and certain regulatory orders entered in the last ten years. Like the Rule 506 disqualification provision, the proposal would include an exception for disqualifying events about which the issuer did not know and, in the exercise of reasonable care, could not have known.

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Q: What types of disclosure must a company make to raise money through an ICF offering?

A: Under the SEC's proposed rules, companies seeking to raise capital through an ICF offering would be required to file certain information with the SEC and to provide the information to investors, potential investors and the relevant ICF intermediary, including information regarding:

- The issuer itself (e.g., name, address, entity form and website address);
- The issuer's directors and officers (e.g., their history with the issuer, business experience for the past three years, etc.);
- The issuer's 20% or greater beneficial owners;
- The issuer's business and business plan;
- The issuer's intended use of the proceeds raised in the offering;
- The target offering amount and deadline and information regarding investment commitments, including statements that:
 - commitments may be cancelled until 48 hours before the deadline;
 - the ICF intermediary will notify investors when the target offering amount is met;
 - if the issuer reaches the target offering amount before the deadline it may close the offering early if it provides notice of the new offering deadline at least five business days before the new deadline;
 - if a material change to the offering occurs, investors must reconfirm their commitment or their commitment will be cancelled and their funds returned; and
 - if the target offering amount is not met, commitments will be cancelled and funds returned.

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Q: What types of disclosure must a company make to raise money through an ICF offering? (cont'd)

A: Under the SEC's proposed rules, companies also would be required to disclose information regarding:

- The offering price and how it will be determined; and
- The issuer's ownership and capital structure, including:
 - the terms and voting rights of the securities offered and each other class of security of the issuer and a summary of the differences between each class;
 - how the rights of the securities offered may be materially limited, diluted or qualified by the rights of any other class of security;
 - how the exercise of the rights held by the principal stockholders of the issuer could affect new investors;
 - the names and ownership level of 20% beneficial owners;
 - risks relating to minority ownership and risks associated with corporate actions including additional issuances, issuer repurchases, a sale of the issuer or its assets or transactions with related parties; and
 - a description of the restrictions on the transfer of the securities.
- Certain other information not directly required by statute, including the intermediary's identity, compensation being paid to the intermediary, number of current employees of the issuer, risk factors, material terms of the issuer's indebtedness, exempt offerings of the issuer in the last three years, and certain related party transactions.

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Q: What types of disclosure must a company make to raise money through an ICF offering? (cont'd)

A: Under the SEC's proposed rules, companies also would be required to disclose the following financial information, with the level of disclosure based on the aggregate amount a company offers and sells under Section 4(a)(6) in a rolling 12-month period:

- Offerings ≤ \$100,000. U.S. GAAP financial statements (including a balance sheet, income statement, statement of cash flows and statement of changes in owners' equity) for the two most recently completed fiscal years or shorter period during which the company has been operating, and filed income tax returns for the most recently completed fiscal year, if any, in both cases certified true and complete by the company's principal executive officer.
- Offerings > \$100,000 but ≤ \$500,000. U.S. GAAP financial statements reviewed by a public accountant independent of the company and accompanied by the review report.
- Offerings > \$500,000. U.S. GAAP financial statements audited by an independent auditor and accompanied by the audit report.

Companies also would be required to provide a narrative discussion of their financial condition (similar to the MD&A disclosure required by Regulation S-K) covering, among other things, historic results of operations, liquidity and capital resources.

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Q: What restrictions apply to the conduct of an ICF offering?

A: Under the SEC's proposed rules, an ICF offering may be conducted only through a registered broker or funding portal. Each offering must be conducted using only one intermediary and all offerings must be conducted over the internet, exclusively through that single intermediary's platform.

Advertisements for an ICF offering may contain only certain limited information, similar to a "tombstone ad" under Rule 134 under the Securities Act. For example, an ad can state that the issuer is conducting an offering, provide the basic terms of the offering (e.g., the nature, amount and price of the securities offered and the closing date of the offering period), provide factual information about the legal identity and business location of the issuer, the name of the intermediary and a link to its platform.

Companies are prohibited from compensating any person to promote an ICF offering outside of the communication channels provided by the intermediary, unless the promotion is limited to notices that comply with the advertising rules referenced above.

Companies are prohibited from compensating any person to promote an ICF offering through communication channels provided by the intermediary unless they takes reasonable steps to ensure that the person clearly discloses the receipt of compensation each time he or she makes a promotional communication.

Securities issued in an ICF offering cannot be transferred for one year, except to the issuer, an accredited investor, a family member of the purchaser in connection with the death or divorce of the purchaser or other similar circumstance, or as part of an SEC-registered offering.

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Q: What types of oversight are ICF intermediaries subject to?

A: Section 4(a)(6)(C) of the Securities Act requires all ICF offerings to be conducted through a registered broker or funding portal that complies with Section 4A(a) of the Securities Act. Section 4A(a) places certain requirements on these intermediaries, including the following:

- Registration with the SEC and FINRA. An intermediary must register as a broker under Section 15(b) of the Exchange Act or as a funding portal under Securities Act Section 4A(a)(1) and proposed Rule 400 of Regulation Crowdfunding. All intermediaries must also become FINRA members.
- Financial Interests. Intermediaries and their directors, officers and partners are prohibited from having any direct or indirect financial interest in an issuer using their services.
- Measures to Reduce Risk of Fraud. Intermediaries are required to take certain measures to reduce the risk of fraud in ICF offerings.
- Educational Materials. Intermediaries are required to provide investors with certain educational materials.
- Investor Limitations. Intermediaries are required to ensure no investor exceeds the investment limits, but would be allowed to rely on an investor's representations about its income and net worth and total ICF investments made in the last 12 months.
- Right to Cancel. Investors must be given an unconditional right to cancel their commitment for any reason until 48 hours before the deadline identified in the issuer's offering materials.
- Communication Channels. Intermediaries must provide communication channels to permit discussions among investors and between investors and the issuer about offerings on the platform.

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Q: How does a funding portal differ from a registered broker?

A: In addition to creating the Section 4(a)(6) exemption, the JOBS Act also created a new type of financial intermediary under the securities laws—the funding portal. Funding portals are internet-based platforms or intermediaries that may facilitate ICF offerings without having to register as broker under the Exchange Act.

In order to qualify for the funding portal exemption, a funding portal may not:

- Offer investment advice or recommendations;
- Solicit purchases, sales or offers to buy securities displayed on the platform;
- Compensate employees, agents or other persons for solicitation or based on sales; or
- Hold, manage, possess or otherwise handle investor funds or securities.

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