

## Crowdfunding Regulations - Issuer Rules

This May, the U.S. Securities and Exchange Commission’s highly anticipated equity crowdfunding rules (the “Crowdfunding Rules”) took final effect. A product of the Jumpstart Our Business Startups Act of 2012, crowdfunding has, for some time, been acclaimed an evolutionary capital raise mechanism. Through crowdfunding, start-ups and emerging companies can cast a wide net in acquiring much-needed, and often hard-to-find, early-stage funding. In its original



form, crowdfunding was an unregulated, reward-based system under which small businesses would use online host platforms, such as kickstarter.com, to seek out and raise capital from investors to fund their operations and push trendy ideas and initiatives to market. In return for their monetary contributions, investors would receive nominal gifts from the issuer in lieu of any actual equity stake in the company. Under the Crowdfunding Rules, investors are now able to make similar monetary investments in return for some form of equity, ownership or economic interest.

This article is the first in a series that will explore the Crowdfunding Rules as applied to the various participants in a crowdfunded offering. The voluminous Crowdfunding Rules seek to regulate three groups: (1) the issuers that conduct crowdfunded private placements under Rule 4(6)(a) of the Securities Act of 1933, (2) intermediaries that facilitate these private placements through advertising the issuer’s content and identifying and arranging

potential investors, and (3) individual and institutional investors that field offers and purchase securities under these offerings. This first article will focus on those portions of the rules governing issuers and will survey rules issuers must take into consideration prior to conducting crowdfunded offerings.

Under the Crowdfunding Rules an issuer is limited to raising \$1 million of investor capital across all of such issuer's crowdfunded offerings conducted within any 12-month period.<sup>1</sup> In determining these limitations, the Securities and Exchange Commission (SEC) expressed concerns with instituting a higher (or unlimited) offering cap given the novelty of equity crowdfunding. The SEC intends to employ a wait-and-see approach, as with most SEC rule promulgations, in determining whether a higher funding cap is prudent. The million-dollar limitation only applies to an issuer's crowdfunded offerings, and does not affect or otherwise seek to limit offering amounts of other capital raises that such issuer may be conducting concurrently under a separate registration exemption. Moreover, in the event an issuer is conducting a crowdfunded offering concurrently with a separate exempt private placement, the two offerings will not be integrated so long as the issuer abides by all applicable rules for each exemption.

As is the case with all private placements, an issuer's disclosure of pertinent offering and company information to potential investors is of particular importance. However, due to the lower levels of experience, net-worth/income and sophistication allowed by the SEC for crowdfunding subscribers relative to those under other SEC exemptions found under Regulation D, such disclosures have a heightened importance in a crowdfunding context. Required disclosures under the Crowdfunding Rules include: (i) the name, legal status, physical address and website address of the issuer; (ii) the names of the issuer's directors and officers (or persons of like status), as well as name and status of each person holding more than 20 percent of the issuer's shares; (iii) a description of the issuer's business and anticipated business plan; (iv) a description of the issuer's financial condition; (v) the target amount the issuer hopes to raise under the offering, the deadline upon which they hope to reach the target offering amount and regular updates on the issuer's progress in reaching this amount; (vi) a description of the issuer's stated purpose and intended use of the target offering amount; (vii) the price of the securities for sale or the method for determining the price; and (viii) a description of the issuer's ownership and capital structure. An issuer must make these necessary disclosures by filing a Form C with the SEC either through electronic or a paper filing.

In addition to the initial disclosures mentioned above, the Crowdfunding Rules require that an issuer file annual reports with the SEC regarding results of operation and financial condition, and that those reports be posted on the

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<sup>1</sup> In determining the amount an issuer may sell under the crowdfunding exemption for any 12-month period, the issuer should take into account the aggregate amounts sold or to be sold by entities controlled by, or under common control with, the issuer, as well as amounts sold by any predecessor of the issuer within the applicable timeframe.

issuer’s website for investor review. Generally, these financial statements need not be reviewed or audited by an independent certified public accountant prior to their publication, but rather only need to be certified as true and complete by a principal executive officer of the issuer. If, however, an independent certified public accountant has reviewed or audited the issuer’s financial reports for reasons not pertaining to the applicable offering, then that issuer will be required to provide such reports in lieu of an officer representation. The SEC has carved out five exemptions obviating annual report filing requirements for issuers that: (i) are required to file reports under Sections 13(a) or 15(d) of the Securities Exchange Act of 1934; (ii) have filed at least one annual report and have fewer than 300 holders of record; (iii) have filed at least three annual reports and have total assets not exceeding \$10 million; (iv) have purchased/repurchased all securities issued their crowdfunded offering (which includes payment of full debt securities and/or a complete redemption of all redeemable securities issued thereunder); or (v) have liquidated or dissolved in accordance with applicable state law. Many of the above exemptions, and in particular exemption (iii), provide reasonable cutoff dates upon which issuers may opt-out from providing annual reports, and alleviate



the concern that an issuer’s annual filing requirements may run indefinitely.

Under the Crowdfunding Rules, an issuer is not permitted to advertise the terms of their crowdfunded offerings and may only provide notices to investors that direct them to the intermediary responsible for facilitating the offering. Further, these permitted notices may only contain the following information: (i) a statement that the issuer is conducting an offering; the name of the applicable intermediary and

link directing investors to the intermediary’s platform; (ii) the terms of the offering; and (iii) factual information about the legal identity and business location of the issuer.<sup>2</sup> An issuer is also prohibited from engaging the services of a third party to advertise the offering through channels other than the intermediary’s website. Under this advertising prohibition, communication between an issuer and potential investor is limited and guided; however, an issuer will have the opportunity to communicate with investors freely about the terms of the offering so long as such communication takes place on an intermediary’s website and the issuer identifies itself as such in all communications.

<sup>2</sup> For purposes of the Crowdfunding Rules, “terms of the offering” includes (1) the amount of securities being offered; (2) the nature of the securities; (3) the price of the securities and (4) the closing date upon which the securities are being offered.

As a final requirement, the Crowdfunding Rules prohibit an issuer from compensating, or otherwise committing to compensate, directly or indirectly, any person to promote the issuer's offering unless the issuer has taken reasonable steps to ensure that such person discloses the receipt of both former and future compensation in each promotional communication. In addition, an issuer's personnel, including its founders and employees, who engage in advertising activities via the intermediary's website must, in all instances, disclose that he or she is conducting such activities on the issuer's behalf. This requirement extends to all issuer personnel regardless of whether or not such person is receiving compensation specifically for promotional services and activities.

Some have critiqued the issuer regulations under the Crowdfunding Rules as expensive, onerous and unpalatable to start-ups with very limited capital and staff resources. Only time will tell whether the rules as currently in effect will strike an acceptable balance for the SEC in managing the financial concerns of issuers and protecting a more inclusive class of investors – one which has historically been characterized by the SEC as more inexperienced and unsophisticated.

This publication is prepared for the general information of our clients and other interested persons. Due to the general nature of its content, it should not be regarded as legal advice. You should consult with your DarrowEverett LLP attorney to discuss crowdfunding and the SEC's rules as pertaining to issuers.

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