

## The CROWDFUND Act Gives Entrepreneurs and Start-up Companies an Important New Financing Alternative

On April 5, 2012, the long-awaited Jumpstart Our Business Startups Act of 2012 (the "JOBS Act") became law. The JOBS Act, which was the result of a long and public effort by both parties in Congress, amends the federal securities laws in a number of ways intended to make it easier for small and emerging companies to raise capital by selling securities. Of particular interest to entrepreneurs and start-up companies is Title III of the JOBS Act, the CROWDFUND Act (the "Crowdfund Act"), which will permit issuers to make certain "crowdfunding" securities offerings of up to \$1 million per year to ordinary investors without registration under the Securities Act of 1933 (the "Securities Act") and without many of the constraints that limit start-ups' ability to benefit from the existing private placement exemptions from the Securities Act.

The Securities Act generally prohibits companies from offering or selling securities unless the transaction has been registered with the SEC or qualifies for one of a limited number of exemptions from registration. The registration process is so expensive and time-consuming that a registered securities offering is almost never a realistic financing option for a typical start-up company. Moreover, making a registered offering generally subjects a company to the very cumbersome reporting and corporate governance requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), which makes registered offerings unattractive even to many companies that have the resources to complete them. While the existing private placement exemptions provide important avenues for start-up company financing, the investor sophistication and means requirements and prohibition on "general solicitations" in many of these exemptions make it difficult for these

businesses to use the internet and social media to find investors and, more generally, to approach small investors and investors outside their circle of "friends and family." Many private placements are also subject to the substantive registration and qualification requirements of the state securities or "blue sky" laws, which adds further expense and uncertainty to the process.

Crowdfunding is a relatively new fundraising approach that typically uses the internet and social media to raise money by getting small investments from a large number of individual investors. It has the potential to be an attractive fundraising vehicle for some start-ups and other small companies because it allows them to use the vast reach of the internet to find investors and it opens transactions to ordinary, "retail" investors who ordinarily cannot be meaningfully included in traditional private placements. Prior to the Crowdfund Act, however, crowdfunding has had only very limited usefulness for facilitating investments in private companies, mainly because it does not fit clearly into any of the existing private placement exemptions. Instead, its great potential has been demonstrated by its success in raising money for charitable purposes and for non-investment fundraising by very small companies and individuals. With the enactment of the Crowdfund Act, issuers willing to comply with the Crowdfund Act's significant disclosure and other requirements will be able to use this great potential to find investors previously unavailable to them.

The crowdfunding exemption will not be available until the SEC promulgates rules defining the details of the exemption. The Crowdfund Act requires the SEC to complete this rulemaking within 270 days.

## The New Crowdfunding Exemption

The Crowdfund Act adds Section 4(6) to the “Exempted Transactions” section of the Securities Act to exempt compliant crowdfunding transactions from the registration requirements of the Securities Act. The general requirements of the exemption are:

### **Issuer Volume Limitation**

The total amount of securities an issuer may sell to all investors during the 12-month period immediately preceding the 4(6) transaction, including those securities sold in the 4(6) transaction, may not exceed \$1 million.

### **Investor Volume Limitation**

The Crowdfund Act limits the total amount of securities an issuer may sell to any individual investor purchasing securities in a 4(6) transaction in any 12-month period, including both the 4(6) transaction and all other transactions during the period. The limitation is based on the investor’s annual income or net worth:

- The greater of \$2,000 or 5% of annual income or net worth, if the annual income or net worth of the investor is less than \$100,000; or
- 10% of annual income or net worth, up to a maximum of \$100,000, if the annual income or net worth of the investor is greater than \$100,000.

### **Limitations on Type of Issuer**

The Crowdfund Act provides that the exemption is not available to (i) companies that are not organized under and subject to the laws of a U.S. state or territory, (ii) Exchange Act reporting companies, and (iii) investment companies. In addition, the Crowdfund Act requires the SEC adopt a “bad actor” disqualification for the 4(6) exemption. This disqualification, which will be substantially similar to the one in Regulation A,

will prohibit from using the 4(6) exemption issuers that have committed, or have officers, directors or major investors that have committed, securities-related offenses or crimes.

### **Required Intermediary**

Crowdfunding transactions must be conducted through a broker or “funding portal” that has registered with the SEC and any applicable self-regulatory organization. The intermediaries will play an important gatekeeping role in crowdfunding transactions, and they will have significant responsibility for preventing issuer fraud and for protecting investors. These responsibilities include educating and screening potential investors, taking appropriate action to reduce the risk of fraudulent transactions (including checking the background of the issuer and its insiders), providing disclosure to the SEC, ensuring that the issuer does not receive any investors’ money until the target offering amount has been raised, and taking steps to ensure that investors do not purchase more than their annual limit of securities of the issuer. Intermediaries will also have restrictions on their ability to use finders and similar persons and on certain financial relationships with the issuer.

### **Restrictions on Advertising**

While issuers are generally prohibited from advertising the terms of the 4(6) transaction, they are permitted to use advertisements that direct potential investors to the broker or funding portal. Because this advertising will permit the issuer to direct the public to generally accessible intermediary websites describing the transaction, issuers in crowdfunding transactions will have much greater latitude to offer and sell securities to strangers than they do in traditional private placements, which prohibit “general solicitations” of investors.

## **Target Offering Size**

Issuers making a 4(6) offering must disclose the amount of money they intend to raise. Investors will be able to rescind their commitments if the issuer does not reach this target.

## **Securities Act Liability**

Issuers will be subject to the liability provisions of Sections 12(b) and 13 of the Securities Act, which give purchasers a right of rescission, if the issuer's disclosure in connection with a 4(6) transaction includes material misstatements or omissions.

## **Exchange Act Relief**

A significant concern for companies seeking to raise equity financing has been Section 12(g) of the Exchange Act and Rule 12g-1 thereunder, which historically made companies subject to the substantial and expensive reporting and corporate governance requirements of the Exchange Act if they had more than 500 "record" holders of any class of equity securities and assets of at least \$10 million. Title V of the JOBS Act provides relief to all issuers by raising the Section 12(g) threshold to 2,000 persons or 500 persons who are not accredited investors. More importantly, though, the Crowdfund Act provides that shares issued pursuant to the 4(6) exemption will not count toward the Section 12(g) shareholder threshold. While the \$10 million asset threshold will likely allow many start-ups to avoid Exchange Act registration, this exclusion will be important to many issuers offering equity securities in crowdfunding transactions, because the small investments and small investors characteristic of crowdfunding could cause an issuer to have more than 500 shareholders who are not accredited investors - even in a comparatively small transaction.

## **Blue Sky Relief**

Securities sold in 4(6) transactions will be "covered securities" under Section 18 of the Securities Act, which means they will be exempt from the substantive registration and qualification

requirements of state securities or "blue sky" laws. The Crowdfund Act expressly provides, however, that state law anti-fraud provisions and notice requirements will apply to 4(6) securities.

## **Restrictions on Transfer**

Like other privately placed securities, securities sold in 4(6) transactions will not be immediately freely transferrable. Subject to limited exceptions, 4(6) securities must generally be held for one year before they can be transferred without restriction.

## **Issuer Disclosure Requirements**

While issuers in 4(6) transactions are not required to prepare a full registration statement, the Crowdfund Act does require them to provide substantial disclosure to potential investors. The information that must be disclosed includes:

- the issuer's directors, officers, and each person holding more than 20% of its shares;
- the issuer's business plan;
- financial information, depending on the size of the offering:
  - offerings under \$100,000 - income tax returns and financial statements certified by the issuer's principal executive officer;
  - offerings over \$100,000 but under \$500,000 - financial statements reviewed by an independent public accountant; and
  - offerings over \$500,000 - audited financial statements;
- use of proceeds and target offering amount; and
- information about the offered securities and the issuer's other securities, including substantial disclosure about the rights of crowdfunding investors relative to the issuer's other investors.

In addition, the Crowdfund Act requires the SEC to adopt rules requiring the issuer to provide ongoing financial disclosure on at least an annual basis.

## Conclusion

The passage of the Crowdfund Act should be a welcome relief to start-up and small business owners looking for access to additional sources of funding. Despite its limitations and obligations, the Section 4(6) exemption will give many companies access to investors that they would not be able to reach through traditional private placements. Many important details of the crowdfunding exemption will be contained in the SEC's rules, and we will provide additional guidance when these rules are promulgated. In the meantime, please do not hesitate to contact the attorneys listed in this memorandum or your usual contacts at Taft if you have questions about crowdfunding and how it may be useful to your business.

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