SEC ADOPTS REGULATIONS IMPLEMENTING "REGULATION CROWDFUNDING" UNDER SECTION 4(a)(6) OF THE SECURITIES ACT

On October 30, 2015, the Securities and Exchange Commission ("SEC") voted to adopt "Regulation Crowdfunding" (Regulation CF). Regulation CF is the set of rules and forms that will implement securities crowdfunding in the United States. The SEC was required to adopt these rules under the provisions of Title III of the JOBS Act of 2012. The final rules come after the SEC reviewed and considered over 485 comment letters from professional trade associations, investor organizations, law firms, investment companies and investment advisers, broker-dealers, potential funding portals, members of Congress, the SEC's Investor Advisory Committee, state securities regulators, government agencies, potential issuers, accountants, and other interested parties. The rules will go into effect on May 16, 2016, although entities that wish to act as broker-dealers and "crowdfunding portals" under Regulation CF will be able to start the application process from the end of January.

The changes from the SEC's proposed rules originally published in October 2013 are limited, and almost all those changes fall on the side of reducing burdens on the issuer. Of particular note is the fact that first-time issuers under the new rules will not be required to have their financial statements audited, and ongoing reports are not required even to be reviewed by an accountant. Additionally, the rules increase the ability of crowdfunding portals to use subjective criteria in deciding which companies' offerings to host on their sites, and also to invest in those offerings. From a technical perspective, the fact that the SEC has made it possible to file documents in PDF form will reduce the logistical burden on issuers. On the negative side, individual investment limits were reduced to be based on the lesser of a person's income or net worth. Additionally, the exclusion of crowdfunding shareholders from the "shareholder of record" count that triggers full registration with the SEC has become conditional.

Three weeks prior to the SEC adopting its final rules, FINRA, which is the self-regulatory organization for broker-dealers and which will also oversee the new "funding portals," submitted its final Funding Portal Rules to the SEC for final approval.

Section 4(a)(6) of the Securities Act, the "crowdfunding exemption"

Offers of securities to the public (which includes offers made over the internet) must be registered with the SEC under the Securities Act of 1933, unless an exemption from registration is available. The JOBS Act added a new exemption to the Securities Act, Section 4(a)(6), to permit securities crowdfunding without registration. The exemption is subject to the following statutory conditions:

- The aggregate amount sold to "all investors," including any amount sold in reliance on the new exemption, may not exceed $1 million in any 12-month period. The language of the statute (the JOBS Act) suggests that offerings made under other exemptions (Regulation D, for example) might count towards the $1 million limit, but the SEC's view is that since Congress intended crowdfunding to be an additional source of funds for small companies, the limit applies solely to sales under Section 4(a)(6), and that amounts sold under other

exemptions will not affect the limit. As discussed below, the SEC will permit crowdfunding offerings to be made concurrently with other exempt offerings, effectively permitting unlimited sizes of offerings to be made without registration.

- An investor is limited in the amount he or she may invest in crowdfunding securities in any 12-month period:
    - If either the annual income or the net worth of the investor is less than $100,000, the investor is limited to the greater of $2,000 or 5% of the lesser of his or her annual income or net worth.
    - If the annual income and net worth of the investor are both greater than $100,000, the investor is limited to 10% of the lesser of his or her annual income or net worth, to a maximum of $100,000.

  For calculating an investor's net worth, Regulation CF uses the same method as used in Regulation D, which excludes the value of the investor's primary residence. Investors may include their spouse's income for the purposes of the income test. The "lesser of" standard is a change from the proposed rules, which took a "greater of" approach to calculating the investment limit based on income or net worth. This change will significantly limit the funds available from non-accredited investors. However, the SEC's rules permit concurrent offerings under Section 4(a)(6) and Rule 506(b) or (c), which may effectively result in accredited investors not being subject to any limit on their investment.

- The transaction must be made through a broker, or through a "funding portal" (a new designation under the Securities Exchange Act of 1934) that meets the requirements set out below.
- The issuer must comply with the disclosure and other requirements set out below.

Note that compliance with each of these requirements is a condition to availability of the exemption from registration. If these conditions are not met and the relief for "insignificant deviations" discussed below is not available, then the issuer will have violated the Securities Act by making an unregistered offering of securities to the public.

Requirements for issuers

Incorporation and eligibility

The issuer must be incorporated or organized under the laws of a state or territory of the United States, or the District of Columbia. It may not be an "investment company" as defined under the Investment Company Act of 1940, and cannot be an SEC-reporting company. "Blank check" companies formed for unspecified purposes or to acquire other companies cannot make offerings under Regulation CF. Additionally, the exemption is not available to any issuer that is disqualified by reason of the bad actor disqualification, or if the issuer (or any entities controlled by or under common control with the issuer) has previously offered securities under Regulation CF and failed to file its ongoing reports with the SEC.

Many commentators urged the SEC to allow issuers to be able to issue securities through the use of single purpose funds. This would avoid the "messy cap table" problem identified by some angel and venture capital investors who do not want to have to deal with numerous small investors in a company. However, the SEC declined to create such an exemption, citing Congressional intent and the language of the statute, which specifically excludes investment companies from being able to rely on

Section 4(a)(6).

When determining issuer eligibility for the amount of funds to be raised and financial statements requirements, the SEC has clarified the language contained in the statutory text of Section 4(a)(6) that the definition of issuer includes all entities controlled by or under common control with the issuer and any predecessors of the issuer. For example, a single real estate developer that is raising funds for multiple issuers is subject to a 12-month cap of $1 million raised under Regulation CF aggregated across all issuing companies. Additionally, if an issuer controlled by that developer had made a previous offering under Regulation CF, then all future offerings in any company controlled by the developer in excess of $500,000 would be required to include audited financial statements.

The definition of common control may also have an impact on franchisees. If the franchise agreement controls the issuer and all other franchisees (i.e., has the power to direct or cause the direction of the management and policies of the entity), then all franchisees would be aggregated together when determining amounts offered and sold under Regulation CF and the financial statements to be required.

Disclosure

The SEC requires that issuers provide certain information to investors through the intermediaries' platforms and to the SEC directly via a filing of Form C on EDGAR, the SEC's data handling system. Form C will consist of XML-fillable fields in the front portion of the Form and then "Exhibits" which will include the rest of the information required to be filed. Some information is mandatory, but the issuer may include other information in the Form. The mandatory information for each issuer includes:

- The name, legal status (i.e., form, state, and date of organization), physical address, and website address.
- The names of the directors and officers (and any persons occupying a similar status or performing a similar function), the positions and offices held by those persons, how long they have served in those positions, and the business experience of those persons over the past three years.
- The name of each person who is a beneficial owner of 20% or more of the issuer's outstanding voting equity securities. These are the same shareholders covered by the "Bad Actor" disqualification provisions discussed below.
- A description of the business of the issuer and anticipated plan of business.
- The current number of employees of the issuer.
- A discussion of the material risk factors that make an investment in the issuer speculative or risky.
- The target offering amount and the deadline to reach the target amount, including a statement that if the sum of the investment commitments does not equal or exceed the target offering amount at the offering deadline, no securities will be sold in the offering, investment commitments will be cancelled and committed funds will be returned.
- Statement with respect to whether the issuer will accept investment in excess of the target amount and the maximum it will it accept. If the issuer accepts investments above the stated target, it must state the method it will use to allocate oversubscriptions.

- A description of the purpose and intended use of the offering proceeds. The SEC elaborates that it expects issuers to provide a detailed description of the intended use of proceeds with enough information to allow investors to understand how the offering proceeds will be used. If an issuer is uncertain how the proceeds will be used, it should identify the probable uses and the factors impacting the selection of each use. Similarly, if the issuer accepts proceeds above the target amount, it should indicate the purpose and intended use of those excess funds.
- A description of the process to complete the transaction or to cancel an investment commitment.
- The price of the securities or the method for determining the price. If the issuer has not set a price at start of the campaign, it must provide a final price prior to any sale of securities.
- A description of the ownership and capital structure of the issuer. This requirement also includes:
    - Disclosure of the terms of the securities being offered as well as each other class of security of the issuer;
    - Any rights held by principal shareholders;
    - Name and ownership level of any 20% beneficial owner;
    - How the securities being offered are valued and how the securities may be valued in the future;
    - Risks to purchasers of the securities relating to minority ownership and the risks associated with corporate actions like the additional issuance of shares, issuer repurchases, and the sale of the issuer or issuer assets to related parties; and
    - Description of the restrictions on the transfer or the securities.
- The name, SEC file number and Central Registration Depository number of the intermediary conducting the offering.
- A description of the intermediary's financial interests in the issuer's transaction, including the amount of compensation paid to the intermediary for conducting the offering and the amount of any referral or other fees associated with the offering.
- A description of the material terms of any indebtedness of the issuer. Material terms include the amount, interest rate, maturity date, and any other terms a purchaser would deem material.
- A description of any exempt offering conducted within the past three years. The description should include the date of the offering, the offering exemption relied upon, the type of securities offered, the amount of securities sold, and the use of proceeds.
- A description of any completed or proposed transaction involving the issuer or any entity under common control with the issue for value exceeding five percent of the amount raised under Section 4(a)(6) within the past 12 months, including the current offering, when a control person, promoter, or family member had a direct or indirect material interest.
- A description of the financial condition of the issuer, including discussion of liquidity, capital resources, and historical results of operations covering each period for which financial statements are provided.
- The tax information and financial statements certified by the principal executive officer, reviewed financial statements, or audited financial statements of the issuer, depending on the level of the raise and raises within the previous 12 months, or whether this is the first offering of the issuer under Regulation CF.

- A description of any events that would have triggered disqualification under the Bad Actor disqualification had they occurred after the effective date of the final rule.
- Updates on progress towards meeting the target offering amount.
- A statement regarding where on the issuer's website investors will be able to find the issuer's annual report, and the date by which the annual report will be available.
- A statement regarding whether the issuer or any of its predecessors failed to comply with the ongoing reporting requirements of Regulation CF.
- Any other material information necessary in order to make previous statements not misleading.

Other than the information about the issuer that is required to be entered into the XML portion of the Form C (which is covers things like name, address, size of offering, etc.), the SEC does not specify the format or medium in which the mandatory disclosure must be presented, leaving flexibility for crowdfunding issuers to present some information in written offering documents, some in videos, and other information by graphic means.

In response to suggestions made in the comment process, the SEC includes an optional Question and Answer ("Q&A") format that an issuer can follow in order to provide the mandatory disclosure not covered by the XML portion of the Form. While this might assist some issuers who have not sought professional advice to make sure that they do not miss any important items, the Q&A itself is quite technical, and uses securities concepts such as "beneficial owner" and "material terms of outstanding classes of securities" which may be confusing to non-lawyers.

All information about an offering posted on an intermediary's site must be filed with the SEC via its electronic EDGAR data-handling system. The wording of the SEC's original proposals suggested that while the mandatory disclosure would have to be filed on Form C, it might be possible to post on the intermediary's website additional information that did not have to be filed. The SEC has made it clear that this is not the case. Online offerings, currently normally made in reliance on the exemption from registration provided by Regulation D, use a variety of offering materials, including offering memoranda, slide decks, videos and other materials. All these will need to be filed, but the SEC has made that process easier by permitting the filing of data in PDF format (not permitted in other types of SEC filing). Video and audio cannot be filed through EDGAR; a transcript must be filed instead. Not only must all these optional materials be filed, but the issuer (and in some circumstances the intermediary, as discussed in "Liability" below) is liable for any misstatements made in them.

Financial statements

Issuers of securities under Regulation CF are required to provide financial statements prepared in accordance with US Generally Accepted Accounting Practices (U.S. GAAP) covering the two most recently completed fiscal years (or shorter period since inception). The type of review that these financial statements have to undergo depends on the amount sought, the amount of securities that the issuer has already sold in reliance on Regulation CF in the preceding 12 months, and whether the issuer has previously sold securities in an offering under Regulation CF:

- If current offer plus previous raises amounts to $100,000 or less, the financial statements must be certified by the principal executive officer and accompanied by information from the company's tax returns (but not the tax returns themselves).

- If current offer plus previous raises amounts to $100-500,000, the financial statements will be required to be reviewed by a CPA.
- If current offer plus previous raises amounts to $500,000 or more, the financial statements must be audited by a CPA. However, if the issuer has not previously sold securities under Regulation CF, the financial statements will only be required to be reviewed by a CPA.

The financial statements are not permitted to be more than 18 months old. If more than 120 days has passed since the end of the most recently-ended fiscal year, the issuer will have to produce financial statements for that most recent year, but until that point could use financial statements from the preceding year. No interim financials are required.

The review standards to be used by the accountant are the Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. While there has been widespread applause at the more flexible position taken by the SEC in the final rules with respect to audit requirements, issuers should realize that the review process is a substantive one and that if they have been using simple financial statement software like QuickBooks, the reviewing CPA is likely to require them to revise, reformat and expand their financial statements in order to meet GAAP requirements. One issue that startups with revenue should pay particular attention to is their revenue recognition policies.

The SEC does not exempt very early-stage companies from these requirements. The SEC reiterated its position in the Proposing Release that "financial statements prepared in accordance with U.S. GAAP are generally self-scaling to the size and complexity of the issuer, which reduces the burden of preparing financial statements for many early stage issuers." Thus, even companies at the business plan stage seeking $500,000 would have to produce financial statements reviewed by a CPA.

Issuer Filing Requirements and Form C

The Form C must be filed and made public prior to the start of the offering. This means that no "exclusive first look," either by the issuer or any intermediary, will be permitted. All potential investors must have access to the offering at the same time.

Regulation CF creates a new XML-based fillable form, Form C, for use in allowing issuers to provide required information. There are several variants of Form C:

- **Form C**: used for the original offering statement to provide the required disclosures.
- **Form C/A**: used for amendments to a previously filed Form C.
- **Form C-U**: used by issuers at the end of the offering to disclose the total amount of securities sold.
- **Form C-AR**: used by issuers to provide the required annual reports.
- **Form C-AR/A**: used for amendments to a previously filed Form C-AR.
- **Form C-TR**: used by issuers who are terminating their reporting.

Form C will be used for the provision of some of the mandatory information in XML format, with other required disclosures being submitted as an attachment to Form C. Those attachments can be in PDF form, which is a new and very welcome development for the EDGAR filing process. (The attachments can also be in "EDGAR HTML" or ASCII.) As discussed above, so long as all the mandatory information is filed and presented to investors, the media used to present that disclosure are not specified by the SEC.

When information is presented in the form of video, the text of the video script must be filed; the EDGAR system does not handle video files.

Regulation CF requires issuers to file Form C with the SEC via EDGAR, as well as providing the Form C to the intermediary, investors, and potential investors; however, it allows issuers to satisfy this latter requirement by providing the intermediary with a copy of the disclosures provided to the SEC and directing investors to the intermediary via email or the issuer's website. To file a Form C the issuer must have EDGAR filing codes and a Central Index Key (CIK) code. If an issuer does not already have these codes it can obtain them from the SEC. The issuer may also work with an intermediary to prepare the disclosures and have the intermediary submit the Form C.

The SEC does not review, comment on or in any way approve the disclosure. It would be foolish, however, to assume that the SEC will not read information that is on EDGAR. An investor protection agency cannot be expected to look the other way if it sees information that it finds troubling, and issuers should operate on the assumption that the SEC staff and the state regulatory authorities will be scouring the Forms C that are filed for potentially misleading statements.

Ongoing disclosure requirements

Issuers that have sold securities in reliance on Section 4(a)(6) must file information with the SEC and post it on their websites on an annual basis. The annual filing must be made within 120 days of the issuer's fiscal year-end. The information included in the annual report is similar to that required in the initial filing, except that, in response to numerous objections to the burden of ongoing reporting as originally proposed, no accountants' audit or review of the financial statements will be necessary.

Regulation CF provides for five ways in which a company is able to cease filing ongoing reports with the SEC. Annual filing requirements continue until:

- The issuer becomes a fully-reporting registrant with the SEC;
- The issuer has filed at least one annual report, but has no more than 300 shareholders of record;
- The issuer has filed at least three annual reports, and has no more than $10 million in assets;
- The issuer or another party purchases or repurchases all the securities sold in reliance on Section 4(a)(6); or
- The issuer ceases to do business.

The ability for an issuer to cease filing if it has 300 or fewer holders of record, or assets not exceeding $10 million, is a modification from the proposed rule. These changes mitigate some of the compliance cost for small companies that have issued securities under Regulation CF, as does the elimination of the requirements for CPA review or audit.

Advertising and publicity

Pursuant to Section 4A(b)(2) of the Securities Act, an issuer may "not advertise the terms of the of the offering, except for notices which direct investors to the funding portal or broker."

Under the new rules, an issuer and any person acting on behalf of the issuer may publish a limited

notice (sometimes called a "tombstone") that advertises the terms of an offering so long as the notice includes the address of the intermediary's platform on which information about the issuer and offering may be found. While acknowledging that the statute restricts the ability of potential issuers to advertise, the SEC has explained that restrictions on advertising the terms of the offering are meant to direct the investors to the intermediary's platform. Once at the intermediary platform, the investors will have access to the information that will allow them to make an informed decision about the offering.

Under the rules, a notice advertising the terms of an offering may contain no more than the following (it can contain less):

- A statement that the issuer is conducting an offering, the name of the intermediary conducting the offering and a link to the intermediary's platform;
- The terms of the offering (the amount of the securities being offered, the nature of the securities, the price of the securities, and the closing date of the offering period); and
- Factual information about the legal identity and the business location of the issuer. This information is limited to the name of the issuer of the security, the address, phone number and the website of the issuer, an email address for a representative of the issuer, and a brief description of the issuer's business.

The rules do not place restrictions on how the issuer distributes these notices, the format of the notice, or its medium. Issuers can use social media, audio, video or street theater, so long as only the permitted content is included. An issuer could place these notices on various social media sites to attract potential investors and the notice would direct them to the intermediary page where they could access the information necessary to make an informed investment decision.

No other public communications about the offering are permitted. Posts on Facebook, tweets on Twitter, LinkedIn updates and the like that do not follow these limitations would all likely result in the issuer's violation of Section 5 of the Securities Act.

Under the rules, an issuer is allowed to communicate with investors and potential investors about the terms of the offering through communication channels provided by the intermediary through its platform, so long as the issuer identifies itself as the issuer in all communications. Anyone acting on behalf of the issuer must identify their affiliation with the issuer on all communications on the intermediary's platform. The SEC has clarified that the restrictions apply only to persons acting on behalf of the issuer. If a person whose only connection to the issuer was that she loved the company's product were to tweet that she intended to invest because the company was sure to succeed, this would be unlikely to be a problem for the issuer.

Issuers may engage third-parties to promote the offering in two contexts – through the communication channels provided by the intermediary, and through tombstone notices. Intermediaries are required to create communication channels on their platforms to facilitate discussion between prospective investors and the issuer (see below). Regulation CF anticipates instances where the issuer will have paid a promoter to respond to investors through those communication channels. In that situation, such compensation must be disclosed by the promoter with any communication on the platform. The second context involves payments to third-parties for publishing tombstone notices that direct to the intermediary's offering page. Regulation CF states that an issuer may not pay a third party to do what it cannot do itself. Paid

promoters should consider whether the disclosure requirements of Section 17(b) of the Securities Act apply to them.

An issuer would not be prohibited from disseminating other information about the company in the normal course of its business that does not relate to the terms of the offering, such as general business advertising.

Requirements for intermediaries

The following requirements apply to both broker-dealers and funding platforms; funding platforms will be subject to some limitations on their activities discussed in "Special limitations on funding portals" below.

Registration

A person acting as an intermediary in a transaction involving the sales of securities for someone else pursuant to Section 4(a)(6) must:

- Register with the SEC as a broker or as a funding portal. Regulation CF creates a streamlined registration process for funding portals. Non-U.S. funding portals are only be allowed to register with the SEC if the funding portal is based in a jurisdiction that has an information-sharing agreement with the SEC, and the funding portal is registered in that jurisdiction.
- Register with a self-regulatory organization, or SRO (the only eligible SRO at present being FINRA).

Obligations with respect to fraud prevention and compliance

The statute requires intermediaries to take risks to reduce the risk of fraud, and Regulation CF requires intermediaries to take positive action in several areas:

- **Intermediaries must have a "reasonable basis for believing" that the issuer has met the disclosure and process requirements described below**. An intermediary may rely on issuer representations to form that reasonable basis for belief. However, the SEC emphasized that an intermediary has a responsibility to assess whether reliance on representations is reasonable, given its course of interactions with potential issuers. This means that the representation must be detailed enough to evidence a reasonable awareness by the issuer of its obligations and its ability to comply with those obligations. As a result, this requirement cannot be met with a simple representation ("checking the box") that the issuer has complied with Regulation CF, but requires an inquiry into the issuer and the steps it has taken to comply with Regulation CF.
- **Intermediaries must have a "reasonable basis for belief" that the issuer has established a way to keep accurate records of the holders of securities.** Similarly with the reasonable basis for belief as to issuer compliance, the SEC provides that an intermediary may accept representations from an issuer that it has established a means to keep track of securityholders. However, any such representation from the issuer must detail recordkeeping functions such as:
    - Monitoring the issuance of securities through the intermediary's platform;
    - Maintaining a master security holder list;

- Maintaining a transfer journal or other such log;
- Effecting the exchange or conversion of any securities;
- Maintaining a control book demonstrating historical registration of those securities; and
- Countersigning and legending physical certificates.

If the issuer has engaged a registered transfer agent, the intermediary will be deemed to have met the requirement of establishing a reasonable basis for belief.

- **The intermediary must deny access to its platform if it has a reasonable basis to believe that any specified person is subject to a "Bad Actor" disqualification.** This requirement is tied to the statutory mandate under Section 4A(a)(5) of the Securities Act that an intermediary conduct a background and securities enforcement regulatory history check on the issuer and its covered persons. In order to meet this requirement, the intermediary must conduct these checks on the issuer, predecessors of the issuer, officers and directors (or any person occupying a similar status or performing a similar function), and any 20 percent beneficial owner of the issuer.
- **The intermediary must deny access to its platform if it has a reasonable basis to believe that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection.** Here, the intermediary must be able to adequately and effectively assess the risk of fraud from the issuer or its offering, and may not ignore facts about the issuer that indicate fraud or investor protection concerns. If it cannot adequately assess the issuer or resolve concerns, the intermediary must deny access to its platform. This may occur, for example, where an issuer's directors are foreign nationals whose country of origin does not allow for third parties to review criminal or regulatory enforcement background information. If it becomes aware of the potential for fraud after granting access to its platform, it must cancel the offering. The SEC does not further define what constitutes "concerns about investor protection," and creates some ambiguity as to what is required of intermediaries.

Opening of investor accounts

An intermediary may not accept any investment commitment from investors in a transaction under Regulation CF, until that investor has opened an account with the intermediary and consented to electronic delivery of materials. The SEC does not specify the exact information that the intermediary must obtain from an investor, and leaves it to intermediaries to determine what they will require for business purposes and compliance purposes. The requirements that investors consent to electronic delivery of information is important for the functioning of securities crowdfunding. As almost all activity related to the offering and ongoing reporting will be delivered electronically via email, by being directed to a URL, and through the intermediary's portal, investors are required to consent to such delivery of information in lieu of paper mailings.

Notices regarding promoters of the issuer

At the time that an investor opens an account with an intermediary, the intermediary must inform the investor that anyone who promotes an offering in exchange for compensation, or who is a founder or an employee of an issuer promoting the issuer through the communication channels on the platform must disclose the fact that he or she is engaging in promotional activities on behalf of the issuer. The SEC believes this requirement will assist investors by alerting them at the outset about the promotional activities of issuers or representatives of issuers.

Compensation disclosure

An additional notice requirement for intermediaries when establishing an account for an investor includes disclosure of the manner in which they will be compensated in connection with offerings and sales made in reliance on Section 4(a)(6). For a platform that will accept a range of compensation types from issuers (e.g., flat fee, commission, equity interest, etc.), each type of compensation that it will accept must be disclosed. The SEC determined that this requirement is better suited to the time of an investor's account opening rather than prior to the point when an investor makes an investment commitment because it will help investors make better-informed decisions when reviewing offerings on the platform.

Provision of educational materials

As part of the statutory requirements for offerings under Section 4(a)(6), intermediaries are required to provide disclosures and investor educational materials. Regulation CF requires these educational materials to be provided to investors at the time they open accounts with intermediaries. Regulation CF further requires that the materials be written in plain language and otherwise designed to communicate effectively specified information. These materials are required to cover:

- The process for investing on the intermediary's platform.
- The risks associated with crowdfunding securities.
- The types of securities that may be offered on the intermediary's platform and the risks associated with each, including dilution (note that the intermediary may be deemed not to have met this criterion if an issuer sells a securities product not previously explained in its education materials).
- Restrictions on resale.
- The type of information that an issuer is required to deliver annually, and that such information may cease to be provided in the future.
- Investor limit amounts.
- The limitation's on an investor's right to cancel an investment commitment and circumstances in which an issuer may cancel and investment commitment.
- The need for an investor to consider whether crowdfunding securities are appropriate for him or her.
- That at the end of the offering, there might not be any ongoing relationship between the issuer and the intermediary.
- The circumstances under which an issuer may cease to publish annual reports and the corresponding absence of current financial information about the issuer.

The SEC declined to develop its own investor educational materials for the purpose of this requirement, instead leaving it to each platform to determine the best means to educate their investors. These educational materials must be made continuously available. Should the intermediary make material revisions to its educational materials, it must provide the updated materials to all investors prior to accepting any additional investment commitments or effecting any further transactions.

Acknowledgement of risk

Prior to accepting any investor commitments for any particular offering, Regulation CF requires that intermediaries receive a representation from the investor that the investor has reviewed the educational materials and understands that the entire amount of the investment is at risk and may be lost. Additionally, intermediaries must require investors to complete a questionnaire that demonstrates the investor's understanding that:

- There are restrictions on the investor's ability to cancel an investment commitment and obtain a return of the commitment.
- It may be difficult to resell securities acquired in an offering of securities under Section 4(a)(6).
- Investing in securities sold under Section 4(a)(6) involves risk and that the investor should not invest any funds unless the investor is able to bear the entire loss of the investment.

The SEC declined to develop such a questionnaire and instead left it to the discretion of intermediaries. The SEC stated that this flexibility will allow intermediaries to tailor questionnaires to the business and likely investor base of the intermediary. Intermediaries may require additional information in these questionnaires, such as information concerning the investor's level of investment experience, where the investor acquired any information about the offering, and the percentage of the investors liquid net worth represented by the proposed investment.

Whatever format the process may take, the intermediary will be required to receive the representation and questionnaire responses from the investor each time an investor makes an investment commitment even if the investor has previously made investments through the intermediary.

Requirements for intermediaries with respect to transactions

The SEC sets out the methods by which an intermediary must comply with the statutory requirements for managing offerings taking place under Section 4(a)(6) in in Rules 303 and 304.

Intermediary must make issuer information available

During the course of an offering, the intermediary must make the issuer's required disclosure information publicly available on the intermediary's website. This information must be available for at least 21 days prior to any sale of securities and displayed in a manner that allows for any visitor, including regulators, to access, download, and save. This rule poses compliance challenges for intermediaries. First, it is unclear how an issuer's amendment to its disclosure information impacts the 21-day availability requirements prior to sale. Second, it is possible an intermediary will be liable for allowing sales to occur if the issuer has not supplied the complete set of information it is required to disclose. As such intermediaries must ensure that issuer's disclosures are complete. The intermediary is not required to ascertain whether investors have reviewed the disclosure material.

Investor qualifications

Intermediaries are responsible for ensuring an investor stays within the annual investment limit. To comply with this requirement, intermediaries must have a reasonable basis for believing that the investor satisfies his or her annual investment limit. An intermediary may rely on investor representations concerning the investor's annual income, net worth, and the amount of the investor's other investments made under Section 4(a)(6).

Additionally, for each transaction, intermediaries are required to obtain a representation from an investor that the investor has reviewed the educational materials and require the investor to complete a questionnaire covering the restrictions on the ability of the investor to cancel the investment commitment, the limitations on resale of securities, and the riskiness of transactions under Section 4(a)(6).

Communication channels for issuers and investors

Regulation CF is designed on the premise that crowdfunding requires the crowd to be able to communicate with each other and with the issuer to evaluate the investment opportunity. As such, the final rules require that the intermediary establish communication channels on the intermediary's platform to provide a centralized and transparent means for members of public to asset the investment offering. Specifically, the intermediary must:

- Permit public access to view the discussions made in the communication channels;
- Restrict posting of comments to those persons who have opened an account with the intermediary on its platform;
- Require that any person posting a comment in the communication channels clearly and prominently disclose with each posting whether he or she is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer, or is otherwise compensated, whether in the past or prospectively, to promote the issuer's offering; and
- If a funding portal, not participate in the communications other than to establish guidelines for communications and remove abusive or potentially fraudulent communication.

The SEC leaves open to intermediaries whether to allow their registered users to post under their real names or under aliases. Either choice will affect the quality of communications presented. For example, real names might limit participation, but aliases could encourage inaccurate or abusive posts.

Other considerations for intermediaries when establishing communication channels include objective enforcement of communications. For instance, promotion of a positive comment or removal of a negative comment that is not abusive may be considered the provision of investment advice.

Providing notices to prospective purchasers

Upon receipt of an investment commitment, the intermediary must provide the investor with a notification disclosing:

- The dollar amount of the investment commitment;
- The price of the securities, if known;
- The name of the issuer; and
- The date and time by which the investor may cancel the investment.

Transmission or maintenance of funds from investors

The rules pertaining to transmission of funds under Regulation CF vary based on the status of the intermediary as a registered broker-dealer or funding portal. Broker-dealers must comply with existing regulations set out in Rule 15c2-4. Under the regulation, funds must be promptly deposited into a separate bank account until the close of the offering when it is promptly transmitted to the issuer.

Funding portals, which are prohibited from handling funds or securities, must:

- Direct funds to a qualified third-party that has agreed to hold the funds in escrow, with qualified third-parties including a registered broker-dealer, bank or credit union; and
- Direct the qualified third party to transmit funds to the issuer or return funds to the investor depending on the result of the offering under Section 4(a)(6).

Confirmation of transactions

Intermediaries are responsible for sending notice to investors confirming the completion of the transaction. Those notices must disclose pertinent details of the transaction, including:

- The date of the transaction;
- The type of security that the investor is purchasing;
- The identity, price, and number of securities purchased by the investor, as well as the number of securities sold by the issuer in the transaction and the price(s) at which the securities were sold;
- If a debt security, the interest rate and the yield to maturity calculated from the price paid and date of maturity;
- If a callable security, the first date that the securities can be called by the issuer; and
- The source, form and amount of any remuneration received or to be received by the intermediary in connection with the transaction, including any remuneration to be received by the intermediary from persons other than the issuer.

Intermediary responsibility for cancellations and reconfirmations

At various times during an offering, the intermediary may be responsible for reconfirming an investment commitment with investors or cancelling the investment commitment. In the event than an issuer makes a material change to the terms of an offering or to the information provided by the issuer, intermediaries are required to contact investors that have made a commitment and request the investor re-commit to the investment in light of the new information. This confirmation must be received within five days or else the investment commitment must be cancelled by the intermediary. If the intermediary was required to cancel the investment commitment, it must then send a notice of the cancellation to the investor and direct a refuse of the investor's funds. In the case of a material change occurring within five days of the target end of the offering established by the issuer, the offering must be extended to allow five full business days for the investor to re-commit to the investment.

If an issuer does not raise the target funds by the deadline it established, the intermediary has five days to provide investors with notice of the cancellation of the investment commitment, direct the refund of investor funds, and prevent investors from committing any additional funds to the offering.

Protect the privacy of information collected from investors

The statutory language of Section 4A(a)(9) of the Securities Act requires that intermediaries protect the privacy of information collected from investors. Rather than creating new privacy rules, the SEC adopted rules to clarify that broker-dealers and funding portals are required to comply with Regulation S-P, Regulation S-ID, and Regulation S-AM. Taken together, these regulations obligate intermediaries to have policies and procedures in place to protect nonpublic information about investors, prevent identify theft, and limit the information shared with affiliates.

Limitation on payments to finders

An intermediary in an offering under Section 4(a)(6) is prohibited from compensating finders or any person for providing personally identifiable information on any investor or potential investors.

Financial interest in issuers

By statute, the directors, officers, or partners of an intermediary are prohibited from having a financial interest in an issuer using its services. The SEC clarified the way in which this prohibition applies to the intermediary itself. An intermediary may receive a financial interest in the intermediary as a form of compensation for the services performed by the intermediary; the financial interest must be of the same class and at the same terms as the securities being sold under Section 4(a)(6).

Special limitations on funding portals

Under the Securities Exchange Act and Regulation CF, funding portals are limited purpose broker-dealers that may assist issuers in the offering and sale of securities subject to certain limitations on their activities. The statutory prohibitions on funding portals include:

- Paying for finding potential investors;
- Giving investment advice or recommendations;
- Soliciting offers or sales to buy the securities offered on its portal
- Compensating anyone for such solicitation or based on the sale of securities on its portal;
- Holding or managing funds; and
- Permitting their officers, directors or partners to have a financial interest in an issuer using their services.

The SEC provided additional clarification of the statutory limitations by creating a conditional safe harbor for funding portals. Under the conditional safe harbor, funding portals may:

- Determine whether and under what terms to allow an issuer to offer securities on the funding portal's platform;
- Apply objective criteria to highlight offerings on the platform;
- Provide search functions for investors to search and sort offerings based on objective criteria;
- Provide communication channels that allow the issuer to communicate with investors and potential investors;
- Advise issuers on the structure and content of the offering;
- Compensate third parties for referring persons to the portal and other services, so long as the referral does not include personally identifiably information of any potential investor and the compensation is not transaction based unless the party is a registered broker-dealer;
- Pay or offer to pay compensation to a registered broker-dealer for services;
- Receive compensation from a registered broker-dealer;
- Advertise the existence of the funding portal and identify one or more issuers using objective

criteria to determine which issuers to identify;

- Deny access to the funding portal's platform if the funding portal has a reasonable basis for believing that the issuer presents the potential for fraud;
- Direct investors where to transmit funds for the purchase of securities; and
- Direct third-parties to release funds to issuers or return funds to investors.

Curation of offerings by funding portals

In its proposed rules, the SEC expressly prohibited funding portals from "curating" offerings, as such subjective curation would be investment advice — an activity prohibited to funding portals by statute. In the final rules, the SEC relaxed this requirement by providing funding portals the ability to determine whether and under what terms to allow issuers onto their platforms so long as curation does not result in the provision of investment advice. This requirement is connected with the advertising restrictions discussed below. For instance, curation by the funding portal may not support a claim that the issuers on the platform "are safer or better investments". Instead, the curation should be a back-office type activity that helps portals bring forward the types of issuers they want without that activity becoming a selling point for the platform of the issuers.

Highlighting issuers and offerings

In keeping with the prohibition on providing investment advice, funding portals are only permitted to highlight specific issuers or offerings through the application of objective criteria that is reasonably designed to highlight a broad selection of issuers. The objective criteria must be applied consistently to all issuers and offerings and may not highlight issuers and offerings based on the advisability of investing, whether implicitly or explicitly. Some of the objective criteria noted by the SEC are: the type of securities being offered; the geographic location of the issuer; and the number or amount of investment commitments made. Funding portals may not use the objective criteria in such a way that it highlights or promotes a specific offering, as that would not be designed to highlight a broad selection of issuers.

Funding portals are further prohibited from receiving special or additional compensation for identifying or highlighting (or offering to highlight) an issuer or offering on the platform.

Providing search functions

Funding portals may provide search functions that allow investors to sort through offerings based on objective criteria. The search function may allow for the search to be based on multiple criteria that would result in investors only viewing a limited number of offerings. The SEC identifies examples of acceptable search criteria that include the percentage of the target offering amount that has been met, geographic proximity to the investor, and days remaining before the offering deadline. Any criteria chosen by the funding portal must not cross into advisability of investing.

Providing communication channels

In providing communication channels as required by all intermediaries in offerings under Section 4(a)(6), funding portals have limitations on their participation in those communication channels. Funding portals, and their associated persons, may not participate in the communications through the communication channels. They may only establish guidelines about communication through the provided channels and may remove abusive and fraudulent communications. Funding portals are required to make these communication channels open to the public and only allow potential investors with accounts to post on these channels. Funding portals must require any commenter posting in the

channels to disclose if he or she is receiving compensation for promoting an issuer. The SEC clarifies that any communication channel can include ratings of the offering by investors and potential investors (e.g., up-votes, down-votes, likes, dislikes). Any rating system used must provide for both positive and negative ratings. If the funding portal only allows for positive ratings, that may be considered investment advice.

Advising Issuers

Funding portals are permitted to advise an issuer about the structure or content of the offering, which includes preparing the offering documentation. The SEC noted that a funding portal could provide pre-drafted templates or forms to the issuers, and provide advice on the types of securities the issuer can offer, the terms of those securities and crowdfunding regulations.

Paying for referrals

Funding portals may compensate a third party for referring potential investors to the portal so long as the third party does not provide the funding portal with any personally identifiable information about any of the potential investors. This might include hyperlinks from third parties' sites. Compensation for such referrals may not be based on the purchase or sale of a security on the portal's platform unless the third party is a registered broker-dealer.

Compensation arrangements with registered broker-dealers

Funding portals may enter into certain agreements with registered broker-dealers where they can pay each other for services. The proposed rules permit a funding portal to pay or offer to pay a registered broker-dealer for services in connection with an offering made in reliance on Section 4(a)(6). In addition, the SEC allows funding portals to provide services and be paid by a registered broker-dealer in connection with the funding portal's offer or sale of securities in reliance on Section 4(a)(6). However, the final rules do not allow a funding portal to receive compensation for referrals of investors in offerings made other than in reliance on Section 4(a)(6). This is relevant to the financial considerations for funding portals offering securities of an issuer pursuing concurrent offerings under Section 4(a)(6) and Rule 506(c). The funding portal may not receive commissions for referring accredited investors to a broker-dealer managing the offering under Rule 506(c).

Advertising the funding portal and offerings

Funding portals are subject to limitations on publicity that do not apply to broker-dealers (which have pre-existing and strict rules about advertising and the use of social media). Under the final rules, a funding portal is:

- Permitted to advertise its own existence;
- Permitted to identify issuers or offerings in its advertisements based on objective criteria that would identify a large selection of issuers, so long as the criteria used do not implicitly endorse one issuer or offering over others and are consistently applied to all issuers and offerings; and
- Prohibited from receiving special or additional compensation for identifying or highlighting an issuer or offering in its advertisements.

The rule does not restrict the media formats that funding portals may use to advertise, and is solely focused on the content.

Denying potential issuers access to the platform

To stay within the safe harbor established by the SEC, funding portals may engage in the required activity for all intermediaries to deny access to potential issuers where the funding portal has a reasonable basis for believing that the issuer or the offering presents the potential for fraud, or otherwise raises concerns about investor protection. To meet this requirement, the funding portal must deny access if it reasonably believes that it is unable to adequately or effectively assess the risk of fraud of the issuer or its potential offering. This obligation also applies to issuers or offerings that have been accepted to the platform and the funding portal later becomes aware of the potential for fraud. In that case, the funding portal must promptly remove the offering from the platform.

Accepting investor commitment and directing the transmission of funds

While funding portals are explicitly prohibited from handling customer funds and securities by statute, they may accept investment commitments on behalf of issuers and direct those funds to be deposited with a qualified third party. The funding portal is permitted to instruct the qualified third party to deliver funds to the issuer upon completion of the offering, or return funds to investors in the event the offering is cancelled. Qualified third parties include registered broker-dealers, and banks or credit unions that have agreed to hold the funds in escrow.

Compliance issues

Funding portals are required to implement written policies and procedures for complying with the various statutory and regulatory requirements for financial intermediaries. In the proposed rules, the SEC noted that funding portals would be required to register as brokers but for the specific exemption from registration that applies to registered funding portals. In the final rules, the SEC determined that funding portals must put in place customer privacy protections of 17 CFR § 248 as they apply to broker-dealers, and the provisions relating to examination and inspection of books and records and facilities by the SEC and FINRA. Of note, the SEC determined that the compliance policies of funding portals do not need to include anti-money laundering provisions. The SEC notes that other parties involved in transactions facilitated by funding portals, such as broker-dealers and banks holding funds, continue to have their own anti-money laundering procedures.

How investors will pay for securities

The statutory authority for crowdfunding and the requirements for intermediaries does not limit or require a particular payment mechanism by investors. The SEC declined to impose any restrictions on the form of payment that intermediaries may accept. For instance, investors will be able to transmit funds to intermediaries (or their escrow agents) by bank transfer, debit card or PayPal accounts linked to debit cards or funds deposited with Paypal. The SEC leaves intermediaries to use their own discretion in determining whether to accept certain payment methods, like credit cards.

In the case of credit cards, there are regulatory issues involved in the purchase of securities using credit (“on margin”) and this is likely to be an area where credit card companies may have to deal with a large number of disputes and potential “charge-backs.” For these reasons, credit card companies may decline to provide their services to this industry altogether, and individual intermediaries may choose not to accept credit cards, for either regulatory or economic reasons.

FINRA requirements

On October 9, 2015 FINRA filed with the SEC for approval its rules for funding portals. Under FINRA's rules, funding portals would not be subject to some of the more onerous obligations of full broker-dealers, such as capital requirements, and FINRA has not proposed that funding portal personnel be required to pass examinations on securities markets and law, although they will be required to demonstrate that they understand and are capable of compliance with securities regulations.

Funding portals will be subject to FINRA's rules relating to their conduct during offerings taking place under Section 4(a)(6). Specifically, funding portals will be required to adhere to "high standards of commercial honor and just and equitable principles of trade". Additionally, funding portals may not effect any transactions by their own manipulative or deceptive conduct, or by aiding and abetting such conduct of another person, including any issuer. Further, funding portals will be responsible for the content of any "funding portal communication", which includes all written or electronic communications distributed by or made available by a funding portal, which may include issuer-created content.

Why intermediaries need to check that the issuer has met the conditions of the exemption

The filing of the information set out above to the SEC is one of the conditions of the exemption from registration for an offering by an issuer. As mentioned above, if an issuer does not comply with all of the SEC's filing requirements, and the omission is not so small that it can fit within the "insignificant deviation" rule, the conditions for the Section 4(a)(6) exemption are not met, and the offer violates the registration requirements of Section 5 of the Securities Act. The remedy for this violation is rescission (i.e., giving the investors their money back; it is like the investors having an ongoing right to "put" the securities back to the issuer). If an intermediary were to host on its platform an offering to which a rescission right applied, and no mention were made of that fact, this would almost certainly be an "omission of a material fact" that the intermediary would be responsible for. Intermediaries should therefore check to make sure the issuers have complied with Regulation CF's requirements, or have a third party do so.

Simultaneous accredited and crowdfunding offerings

The SEC makes clear its position that that an offering made in reliance on Section 4(a)(6) should not be integrated with another exempt offering. "Integration" means treating two different offerings made at the same time as if they were one offering, subject to all the conditions of both offerings. Because the SEC will not automatically integrate Section 4(a)(6) offerings with other offerings, an issuer may make a Section 4(a)(6) offering that occurs simultaneously with, or is closely preceded or followed by an offering made under Regulation D. While the offers will not be integrated, an issuer must take care that if the Regulation D exemption prohibits general solicitation (e.g. Rule 506(b)), purchasers in that offering may not be solicited by the Section 4(a)(6) offering. Similarly, if the other exemption allows for general solicitation (e.g., Rule 506(c)), then those general solicitations may not include advertisements prohibited under Section 4(a)(6).

It seems likely that "side-by-side" offerings, made to "accredited" investors under Rule 506(b) or 506(c) alongside offerings to unaccredited friends and family in reliance on Section 4(a)(6), will become popular. Rule 506 does not mandate specific disclosure, but the mandatory information requirements would be relatively easy to comply with for most issuers making a Rule 506 offering, and the modest additional costs would be more than offset by the goodwill engendered by including customers and early supporters. In particular, the disclosure requirements under Regulation CF are

easier to comply with than the requirements that apply if non-accredited investors are included in an offering under Rule 506(b). Side-by-side offerings of this type may be most easily undertaken by fully-registered broker dealers, who would be able to charge commissions for both the accredited and non-accredited investors. Funding portals may need to act as "bulletin boards" (platforms that do not solicit investors and do not charge commission) or form a relationship with a fully-registered broker with respect to the Rule 506 portion of the offering. This should not be done without the advice of experienced securities law counsel.

The ability to make concurrent offerings means that, when structured properly from a regulatory point of view, a crowdfunding offering can include an accredited investor component increasing the overall size significantly beyond $1 million and not imposing any investment limitations on accredited investors.

Relief for insignificant deviations

The statutory and regulatory requirements for crowdfunding issuers and intermediaries are complex and extensive, and inexperienced issuers may innocently fail to comply with them. The SEC has adopted a three-prong test that would provide issuers a safe harbor for insignificant deviations from a term, condition, or requirement of Regulation CF.

In order to qualify for the safe harbor under proposed Rule 502, the issuer relying on the exemption in Section 4(a)(6) must show:

- The failure to comply with a term, condition, or requirement was insignificant with respect to the offering as a whole;
- The issuer made a reasonable and good faith effort to comply with all terms, conditions, and requirements of Regulation CF; and
- The issuer did not know of the failure to comply, where the failure to comply with a term, condition or requirement was the result of the failure of the intermediary to comply with the requirements of Section 4A(a) and the related rules, or such failure by the intermediary occurred solely in offerings other than the issuer's offering.

So long as the issuer acted in good faith while attempting to comply with the rule, the issuer should not lose the Section 4(a)(6) exemption just because there was a failure to comply with the rule that was insignificant in light of the offering as a whole.

The third prong of the safe harbor provision should prevent an issuer from losing the exemption in Section 4(a)(6) because an intermediary violated Section 4A(a). If the issuer knows of the intermediary's failure to comply with a term, condition, or requirement of Regulation CF, and does nothing to correct it, the issuer will lose the exemption.

Liability

The statutory language expressly set out the liability imposed on issuers for making false or misleading statements and omissions. Section 4A(c) of the Securities Act, added by the JOBS Act, provides that an issuer, including its officers and directors, will be liable to the purchaser of its securities in a transaction under Section 4(a)(6) if the issuer makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in light of the circumstances under which there were made, not misleading. The company and its officers and

directors bear the burden of proof when defending themselves against this liability — they must show that they did not know, and in the exercise of reasonable care, could not have known, of the misleading statement or omission.

The statutory language applies this liability to "any person who offers or sells the security in such offering." The SEC (applying interpretation set out in a Supreme Court case) originally noted that on the basis of this definition, intermediaries, including funding portals, would be subject to this liability. While many commenters objected to this interpretation, the SEC declined to retract the statement or to create an exemption from liability for funding portals (or any intermediaries). The SEC states that the status of an intermediary as “issuer” will depend on a facts and circumstances analysis. The SEC points out that there are appropriate steps that intermediaries might take in order to rely on the “reasonable care” defense provided by Congress. These steps may include establishing policies and procedures reasonably designed to achieve compliance with Regulation CF, conducting a review of the issuer's offering documents before posting them to the platform, to evaluate whether they contain materially false or misleading information. CrowdCheck can help with these processes.

Issuers and intermediaries should be aware that the JOBS Act and Regulation CF do not limit liability associated with other anti-fraud rules and statutes of the securities laws that already exist. For instance, issuers will continue to face liability for manipulative or deceptive practices or misleading statements under Rule 10b-5. Additionally, intermediaries, issuers, and anyone who "willfully participates" in an offering could be liable for false or misleading statements made to induce a securities transaction under Section 9(a)(4) of the Exchange Act.

It is to be hoped that the issue never comes up because no intermediaries find themselves defending allegations of misleading statements, but it is interesting that there has been no discussion of the impact of the Supreme Court 2010 *Janus* decision on potential intermediary liability. This decision examined what it means to “make” a misleading statement under Rule 10b-5, which has many common elements with Section 4A(c).

In addition to SEC liability for securities law violation, FINRA imposes liability on funding portals and broker-dealers that violate the FINRA rules of conduct. Under FINRA Rules 2010, 2020, and funding portal Rule 200, brokers and funding portals are required to observe high standards of commercial honor and not to engage in manipulative, deceptive, or other fraudulent devices.
Additionally, funding portal Rule 200 prohibits a funding portal from including on its website information from an issuer that the portal knows or has reason to know contains any untrue or misleading statement.

State law

Under the JOBS Act, the states are pre-empted from requiring registration of Section 4(a)(6) offerings, but there is no restriction of their ability to take enforcement action with respect to fraud or deceit by issuers, brokers or funding portals. States may impose fees if they are the principal place of business of the issuer or if more than half the purchasers of a crowdfunding offering are in that state. A funding portal’s home state may regulate the portal, but cannot impose different or additional rules.

The SEC declined to mandate that the issuer provide any information directly to state securities regulators on the assumption that state securities regulators would be able to access the issuer’s mandatory disclosures on EDGAR.

Resale restrictions

Securities issued pursuant to Section 4(a)(6) are not freely transferrable by the purchaser for one year after the date of purchase. The statutory text outlines four situations in which a transfer may be made prior to the end of the one-year period; the SEC did not significantly alter these provisions in its Rule 501. Prior to the end of one year, transfers may be made:

- To the issuer of the securities;
- To an accredited investor;
- As part of an offering registered with the SEC; or
- To a member of the family of the purchaser or the equivalent, to a trust controlled by the purchaser, to a trust created for the benefit of a member of the family of the purchaser, or in connection with the death or divorce of the purchaser.

The SEC clarified that the restrictions on transfer apply to all holders during the one-year period, whether they purchased their securities from the issuer or in a secondary transaction. The SEC did not provide guidance or structure with respect to subsequent trading of crowdfunding securities. However, it should be noted that the JOBS Act pre-emption of state regulation applies only to the initial offer and sale of securities by the issuer. After the end of the statutory restriction on transfer, investors would likely be able to transfer their securities to someone else without registration at the federal level, in reliance on Section 4(a)(1) of the Securities Act. However, subsequent trades must also be made in accordance with state law (which is only preempted when the issuer is a full SEC-reporting company), and the law varies widely from state to state with respect to how securities of non- public companies can be resold. Crowdfunding securities will thus be extremely illiquid.

Any entity providing an exchange or market or liquidity facility for the resale of crowdfunding securities would need to be registered with the SEC as a stock exchange or alternative trading system.

Crowdfunding securities and registration under the Exchange Act

The Exchange Act typically requires companies to become reporting companies under the Exchange Act when their shares are held of record by 2,000 persons or 500 persons who are not accredited investors. Recognizing that offers under Section 4(a)(6) are likely to bring in many shareholders, the JOBS Act exempts Section 4(a)(6) securities from the shareholder threshold. The SEC interpreted the statute in Rule 12g-6 to provide that all securities issued pursuant to a Section 4(a)(6) offering would be exempted from the holders-of-record count under the Exchange Act. In other words, the exemption follows the security, not the purchaser. So if a purchaser resells Section 4(a)(6) securities to another person after one year, there is no change to the number of holders of record. Issuers will have to make sure their securities sold under Section 4(a)(6) bear clear identification as such. In a change from the proposed rules, the exemption from record holder count is conditional upon:

- The issuer being current in its ongoing reporting obligations;
- The issuer not having assets more than $25 million; and
- The issuer engaging a transfer agent registered with the SEC to keep its books.

This conditionality may prove problematic to issuers whose operations (and thus assets) grow rapidly, although the SEC grants them a two-year period in which to transition to full reporting

status. Crowdfunding issuers will have to make very sure that they file their annual Form C-ARs on time.

How CrowdCheck can help

Section 4(a)(6) and proposed Regulation CF place considerable obligations and potential liability on both issuers seeking investment and the intermediaries who assist them; CrowdCheck can help.

- CrowdCheck helps intermediaries perform their required investigations into issuers and their principals by conducting background checks and securities regulatory checks.
- CrowdCheck can provide assurance to the intermediary that the issuer has met the requirements of Regulation CF.
- CrowdCheck assists issuers in preparing and filing their required disclosures so they are complete, compliant, and accurate, and provides those disclosures to the SEC, intermediaries, and potential investors in an easy to use and understand format. The due diligence included as part of the process of developing the disclosures for issuers helps intermediaries demonstrate "reasonable care" in their investigation of issuers, mitigating the risk of fraud and liability.
- CrowdCheck reviews issuer produced disclosure materials to ensure they are complete, then allowing intermediaries to rely on representations by those issuers.
- CrowdCheck assists issuers with ongoing disclosure compliance.
- CrowdCheck works with intermediaries to develop educational materials for investors.

This is only a summary of the new rules, and is intended for general information only. As always, you should consult legal counsel if you have any questions about how the rules may apply to you or your business. Contact CrowdCheck for more information about the rules and the ways we can help.

www.crowdcheck.com
info@crowdcheck.com
@crowdcheck
703 548 7263