



THE CROWDFUND ACT OF 2012 (TITLE III OF THE JOBS ACT): SUMMARY OF LAW AND MAJOR ISSUES RAISED IN “PRE-COMMENTS” TO THE SEC

New crowdfunding exemption 4(6)

The Act adds a new exemption from registration under the Securities Act of 1933, Section 4(6). The new exemption is subject to the following 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 suggests that offerings made under other exemptions (Regulation D, for example) might count towards the \$1 million limit, but discussions with Commission Staff suggest that the best view is currently that the limit applies solely to a crowdfunding round (possibly only to retail investors), and that amounts sold under other exemptions (or possibly to accredited investors under the 4(6) exemption) will not affect the limit. *Open issues: clarification as to (a) investors to which \$1 million limit applies; (b) clarification with respect to integration.*
- 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 his or her annual income or net worth. *Issues: what if split between income and net worth?*
 - If the annual income or net worth of the investor is \$100,000 or more, the investor is limited to 10% of his or her annual income or net worth, to a maximum of \$100,000. *Issues: investor limit appears to be with respect to investment in a single issuer and with respect to all crowdfunding securities purchased; statute contains inconsistencies.*
- The transaction must be made through a broker, or through a “funding portal” (a new designation under the Securities Exchange Act of 1934) which meets the requirements set out below. *Issues: does this force all local crowdfunding opportunities that would otherwise be community-based to take place online?*
- The issuer must comply with the disclosure and other requirements set out below.

Requirements for intermediaries

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

- Register with the Commission as a broker or as a funding portal.
- Register with a self-regulatory organization or SRO (the only eligible SRO at present being FINRA). *Issues: timing of FINRA rules and requirements. FINRA is used to dealing with large investments and entities that handle other people's money.*
- Provide Commission-mandated disclosures (including disclosures relating to risk) and investor education material.
- Ensure that investors review the education material, affirm that the investor understands the risk of loss, and answer questions demonstrating an understanding of the risks involved in investing in small businesses and the risks of illiquidity and other matters to be determined by the Commission. *Issues: how will investor education be monitored? Can this be done on an industry-wide as opposed to portal-specific basis?*
- Take measures to reduce the risk of fraud as mandated by the Commission, including obtaining a background and securities enforcement regulatory history check on officers, directors and 20% equity holders of the issuer. *Issues: (a) the statute does not provide how the results of such checks are to be used or disclosed; (b) nature of such checks is unclear.*
- Make the required issuer information (discussed below) available to investors and the Commission at least 21 days before any sales take place.
- Ensure that the issuer gets the offering proceeds only when it has reached the target offering amount, and let investors cancel their commitment to purchase securities in accordance with rules to be set by the Commission.
- Make such efforts as the Commission may determine to ensure that investors do not exceed the limits on investment set out above. *Issues: how will this be monitored, and how coordinated on an industry-wide basis?*
- Protect the privacy of information collected from investors.

Funding portals are exempt from having to register with the Commission as brokers, but the Commission will be adopting rules establishing conditions for that exemption.

Funding portals may not:

- Pay for finding potential investors. *Issues: exact prohibition needs clarification.*
- Give investment advice or recommendations. (They may sort or “curate” issuers, and may offer their services only to certain types of issuers, but any selectivity with respect to issuers may be problematic.) *Open issues: portals will need to be able to weed out obviously fraudulent or*

problematic issuers. They will want to be able to select issuers on the basis of their perceived quality or likely success.

- Solicit offers or sales to buy the securities offered on its portal. *Issue: this broad prohibition will require significant clarification, especially since the posting of a crowdfunding offering is in itself the solicitation of an offer.*
- Compensate anyone for such solicitation or based on the sale of securities on its portal.
- Hold or manage funds. *Issues: portals would not be able to hold securities either, or act as nominees in the way some commenters have requested, unless registered as Stock Transfer Agents.*
- Permit their officers, directors or partners from having a financial interest in an issuer using their services. *Issue: does this prohibit portals from making investments to show “skin in the game”?*
- Undertake other activities to be specified by the Commission.

The Commission will specify by rule the circumstances that will disqualify a broker or portal from offering securities under Section 4(6).

Requirements for issuers

The issuer must be incorporated or organized under the laws of a US state. It may not be an “investment company” under the Investment Company Act of 1940, and cannot be an SEC-reporting company.

Issuers of crowdfunded securities must:

- Provide (the statute says “file” but as discussed below, liability follows private as opposed to public standards) the Commission and investors and the intermediary with the following information:
 - Name, legal status, web address and physical address.
 - Names of officers, directors and 20% shareholders.
 - Description of business and anticipated business plan.
 - Description of financial condition AND:
 - If raising \$100,000 or less, tax returns and financial statements certified by principal executive officer.
 - If raising \$100-500,000, reviewed financial statements.
 - If raising \$500,000 or more, audited financial statements.

Issues: SEC Staff has indicated that audit will not be at PCAOB level, but it will still be expensive. If issuer does two \$400,000 raises, audited or not?
- Description of intended use of proceeds of offering.
- Target offering amount, deadline to reach that amount, and regular updates regarding progress toward target.

- Price of securities or method to determine that price (with the ability for investor to rescind commitment to purchase after the price has been determined).
 - Description of ownership and capital structure of the issuer, including:
 - Terms of securities offered and each other class of securities of the issuer (and the differences between them), including how those terms might be limited, diluted or qualified by the rights of other classes of security.
 - A description of how exercise of rights of controlling shareholders could affect the rights of crowdfunding shareholders.
 - Identification of holdings of 20% security holders.
 - How securities offered are valued and how they may be valued in the future, including during corporate actions.
 - Risks of minority ownership, risks associated with future corporate actions, including additional issuances of shares, sale of issuer's assets and related party transactions.

Issues: these are sophisticated concepts and issuers may require assistance in drafting appropriate disclosure.
 - Other information prescribed by the Commission.
- Not advertise the terms of the offering, except for notices which direct investors to the broker or funding portal. *Issues: the Commission may give some guidance as to the nature of these notices. Guidance as to how social media may be used will be very important, and the circumstances under which social media communications might be attributed to the issuer will require clarification.*
 - Not compensate anyone for promoting its offerings without disclosing that compensation. *Issues: would this cover, for example, paid advertising by the portal?*
 - "File" annual reports of results of operations and financial statements in accordance with Commission rules.
 - Comply with other Commission investor protection requirements.

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Liability

Issuer (and control persons including directors and principal officers) have 12(a)(2)-type liability. If the issuer makes an untrue statement of a material fact or omits to state a material fact necessary to make its statements, in light of the circumstances in which they were made, not misleading, and cannot sustain the burden of proof that it did not know, and in the exercise of reasonable care, could not have known, of such untruth or omission, it must reimburse the purchase price of securities plus interest. *Issues: no "substantial compliance" provision. Inadvertent violations are likely.*

State law

The Commission will make the issuer information available to state regulatory authorities. The states are pre-empted from requiring registration of Section 4(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 rules that are different or additional to what is required under the Act.

Resale restrictions

Securities sold under Section 4(6) can only be resold:

- Back to the issuer.
- To an "accredited investor".
- In a registered offering of securities (such as an IPO).
- To a family member or on death or divorce.

The Commission may adopt other restrictions and will likely clarify that these are "restricted" securities under the definition of Rule 144(a). *Issues: some commenters have requested the ability to create "liquidity platforms" for crowdfunded securities, which will not be possible unless such platforms are registered as stock exchanges or alternative trading systems.*

Crowdfunding securities and registration under the Exchange Act

Securities acquired in a Section 4(6) offering are not included in counting the number of shareholders that triggers the need to register a class of securities under the Exchange Act. *Issues: presumably once sold to an accredited investor, the shares would then count towards the registration trigger?*

CrowdCheck, Inc.
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