November 2015

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Joining the Crowd: SEC Adopts Final Crowdfunding Regulations — Part II — Issuers

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Background

On October 30, the U.S. Securities and Exchange Commission ("SEC") adopted final rules, in the form of Regulation Crowdfunding, to implement the securities-based crowdfunding exemption contained in Section 4(a)(6) of the Securities Act of 1933, as amended ("1933 Act"), as mandated by Title III of the Jumpstart Our Business Startups Act ("JOBS Act").[1] Regulation Crowdfunding will become effective on May 16, 2016. The full text of the adopting release can be found here.

Part I of this three-part client alert, available here, provided a general overview and summary of Regulation Crowdfunding. This Part II focuses specifically on requirements imposed on issuers seeking to offer securities under the new rules. Part III will focus on the requirements imposed on intermediaries.

The Crowdfunding Exemption

Section 4(a)(6) and Regulation Crowdfunding

Section 4(a)(6) and Regulation Crowdfunding establish a new exemption from registration under the 1933 Act for companies seeking to raise small amounts of capital from a broad group of investors through the Internet ("crowdfunding"). Under Regulation Crowdfunding, companies may offer any type of security (e.g., stock, debt, return on investment, or some other form of interest in the company) pursuant to Section 4(a)(6) without registering the offer and sale of such securities with the SEC. Transactions made in reliance on Section 4(a)(6) must be conducted through the Internet website or other similar electronic medium of a single registered broker or funding portal ("intermediary"). Through the use of the Section 4(a)(6) exemption, issuers, particularly smaller businesses and startup companies, will be able to raise capital to support their businesses and fund their projects without having to endure the lengthy process and significant expense of SEC and state registration. However, in light of the widespread reach of securities-based crowdfunding, Regulation Crowdfunding requires that issuers comply with certain requirements and disclosure obligations for the protection of investors, as discussed below.

Eligible Issuers

Certain types of issuers will not be eligible to conduct transactions in reliance on Section 4(a)(6). These ineligible issuers include (i) foreign issuers that are not organized under the laws of a state or territory of the United States or the District of Columbia; (ii) companies subject to the reporting requirements of the Securities Exchange Act of 1934, as amended

[1] *Pub. L. No. 112-106, 126 Stat. 306 (2012).*

("1934 Act"); (iii) investment funds (including private funds and other funds excluded from the definition of investment company under Section 3(b) or 3(c) of the Investment Company Act of 1940); (iv) certain disqualified issuers (see "Disqualification Provisions" below); (v) issuers that have not filed with the SEC and provided to investors, to the extent required, annual reports required by Regulation Crowdfunding during the past two years; and (vi) issuers that have no specific business plan, or that have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Limit on Capital Raising

An issuer may raise an aggregate of $1 million during a 12-month period in reliance on Section 4(a)(6). Amounts raised through other exempt transactions will not be counted in determining the aggregate amount raised in reliance on Section 4(a)(6), and offerings made in reliance on Section 4(a)(6) will not be integrated with other exempt offerings made by the issuer (such as Regulation D offerings), provided the conditions of each exemption are satisfied. However, amounts raised in reliance on Section 4(a)(6) by a predecessor to the issuer or by entities controlled by or under common control with the issuer must be aggregated for purposes of the $1 million limit.

Eligible Investors and Investment Limits

There are no constraints on the type of investor that may purchase securities in a transaction made in reliance on Section 4(a)(6). However, Regulation Crowdfunding limits the amount of capital an investor may contribute to crowdfunding offerings made in reliance on Section 4(a)(6) during a 12-month period, as follows:

Financial Position of Investor	**Aggregate Limits on <u>All</u> Crowdfunding Investments by Investor**
Annual income or net worth < $100,000	Greater of: • $2,000 or • 5% of the lesser of the investor's annual income or net worth
Annual income and net worth ≥ $100,000	Lesser of: • 10% of the investor's annual income • 10% of the investor's net worth • $100,000

The limits are equally applicable to all investors, including accredited investors and large institutions. The annual income and net worth calculations must be calculated in accordance with Rule 501 of Regulation D. If spouses calculate their net worth or annual income jointly, the aggregate investment of the spouses cannot exceed the limit that would apply to an individual investor at that income and net worth level.

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Disclosure Requirements for Offering Statements

Form C

Building on the disclosure requirements mandated by Section 4A(b)(1) of the 1933 Act, Rule 201 of Regulation Crowdfunding requires an issuer seeking to raise capital in reliance on Section 4(a)(6) to file certain disclosures with the SEC in an offering statement on new Form C, and to provide the same disclosures to investors through the issuer's chosen intermediary. The initial offering statement must include the information that is displayed on the relevant intermediary's platform.

Form C will be used for all of an issuer's filings with the SEC related to offerings made in reliance on Section 4(a)(6). The filings must be made electronically on the SEC's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system, and the issuer must check the relevant box on the cover of the Form C to indicate the purpose of the Form C filing.

Certain information filed on Form C must be presented in eXtensible Markup Language ("XML") format. Form C contains an optional "Question and Answer" ("Q&A") format that an issuer may use to provide the disclosures that are not required to be presented in XML format. The questions in the Q&A are designed to facilitate the preparation of the required Form C disclosures. An issuer using the Q&A format will prepare its disclosures by answering the questions and filing disclosures as an exhibit to the Form C. An issuer can also customize the presentation of its non-XML disclosures and file such disclosures as exhibits to the Form C in portable document format ("PDF"). Exhibits submitted in PDF will still be considered official filings, but they allow an issuer to take advantage of more diverse presentations of information, including charts, graphs, and transcripts or descriptions of video presentations or other media not reflected in the PDF.

Issuers do not need to provide physical or electronic copies of the required disclosures directly to investors. Instead, an issuer may satisfy its disclosure obligations by referring investors and potential investors to the information about the issuer posted on the intermediary's platform through a posting on the issuer's website or by email.

Information about the Issuer

An issuer relying on Section 4(a)(6) will be required to disclose its contact information and certain information about its legal status, directors, officers, and certain significant shareholders. These disclosures include: (i) the name and legal status of the issuer, including its form of organization, jurisdiction in which it is organized, and date of organization; (ii) the physical address and website address of the issuer; (iii) the names of, and certain biographical information about, the issuer's directors and officers; and (iv) the names of persons who are the beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power ("20% Beneficial Owners").

An issuer will also be required to disclose:

- A description of (i) its business and business plan; (ii) the issuer's ownership and capital structure, including the terms of the securities being offered and a description of the restrictions on the transfer of securities;[2] and (iii) the issuer's financial condition;

[2] Securities issued in a transaction made in reliance on Section 4(a)(6) cannot be transferred by any purchaser of such securities for one year after the date of the original purchase, subject to certain exceptions.

- The current number of employees of the issuer;
- A discussion of material (i) risk factors; (ii) terms of any indebtedness of the issuer; and (iii) changes or trends known to management in the financial condition and results of operations of the issuer;
- Any exempt offerings conducted within the past three years (including any concurrent exempt offerings);
- Any related-party transactions[3] since the beginning of the issuer's last fiscal year that exceed five percent of the aggregate amount of capital raised by the issuer in reliance on Section 4(a)(6) during the preceding 12-month period, inclusive of the amount the issuer seeks to raise in the current offering;
- The location on the issuer's website where investors will be able to find the issuer's annual report and the date by which such report will be available on the issuer's website;
- Whether the issuer or any of its predecessors previously has failed to comply with the ongoing reporting requirements of Regulation Crowdfunding; and
- Any material information necessary to make the statements made, in light of the circumstances under which they were made, not misleading.

Information about the Offering

An issuer also must disclose certain information about the offering itself. For example, an issuer must describe the purpose of the offering and the intended use of proceeds; the target offering amount and the deadline to reach the target offering amount; the offering price of the securities or the method for determining the price; the name, SEC file number and Central Registration Depository number of the intermediary through which the offering is being conducted; the amount of compensation paid to the intermediary; and any interests in the issuer held by the intermediary, or any arrangement for the intermediary to acquire such an interest.

An issuer must also include statements in its offering materials disclosing that investment commitments will be cancelled and committed funds will be returned to investors if the target offering amount is not met, whether the issuer will accept investment commitments in excess of the target offering amount and in what amounts, the processes by which investors can cancel an investment commitment, and how the issuer will complete the transaction once the target offering amount is met. This process is described below.

Financial Statements

An issuer conducting an offering in reliance on Section 4(a)(6) will also be required to include financial statements, prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP"), in its offering statement. The financial statements must cover the two most recently completed fiscal years, or the period since the issuer's inception, if shorter.

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[3] A related-party transaction is a transaction to which the issuer is a party and in which certain other persons, such as directors or officers of the issuer, 20% Beneficial Owners, promoters, or family members of any of the foregoing, have a direct or indirect material interest.

An issuer generally must disclose audited[4] or reviewed[5] financial statements if available, but the minimum level of financial statement disclosure will depend on the aggregate amount of securities offered and sold in reliance on Section 4(a)(6) during the preceding 12-month period as follows:

Aggregate Amount of Securities Offered and Sold in Reliance on Section 4(a)(6) in the Preceding 12-Month Period	Financial Statement Requirements
≤ $100,000	If no reviewed or audited financial statements are available: • Taxable income and total tax reflected on the issuer's federal income tax returns, **certified** by the principal executive officer[6] • Financial statements **certified** by the principal executive officer[7]
> $100,000, but ≤ $500,000	If no audited financial statements are available: • **Reviewed** financial statements
> $500,000	If the issuer has previously sold securities in reliance on Section 4(a)(6): • **Audited** financial statements If the issuer has not previously sold securities in reliance on Section 4(a)(6) and no audited financial statements are available: • **Reviewed** financial statements

The Offering Process

Target and Maximum Offering Amounts

At the time of offering, an issuer must establish a target offering amount below which it will not conclude the offering. If the target offering amount is not met at the time of the offering deadline, no securities will be sold in the offering, investment commitments will be cancelled,

[4] Audits are not required to be conducted by firms registered with the Public Company Accounting Oversight Board ("PCAOB"). Audited financial statements must, however, be audited in accordance with either the U.S. generally accepted auditing standards, or "U.S. GAAS," promulgated by the American Institute of Certified Public Accountants ("AICPA") or the standards of the PCAOB. However, because issuers relying on Section 4(a)(6) are neither "issuers" as defined by the Sarbanes-Oxley Act of 2002 nor broker-dealers registered under the 1934 Act, AICPA rules would require the audit to be compliant with U.S. GAAS even if the auditor has conducted the audit in accordance with PCAOB standards.

[5] Reviewed financial statements must be reviewed in accordance with the Statements on Standards for Accounting and Review Services ("SSARS") promulgated by the AICPA.

[6] The principal executive officer must certify that the disclosure of the amount of total income, taxable income and total tax accurately reflects the information in the issuer's federal income tax returns.

[7] The principal executive officer must certify that the financial statements are true and complete in all material respects.

and committed funds will be returned to the investors. An issuer may also elect to accept investment commitments in excess of the target offering amount. If the issuer elects to accept additional commitments, it must also determine at the time of offering the maximum amount of investment commitments it will accept and how securities in such an oversubscribed offering will be allocated. For example, if an issuer sets a target offering amount of $80,000, but is willing to accept up to $350,000, the issuer must disclose both amounts.[8]

Progress Updates

Regulation Crowdfunding will require issuers to provide investors with regular progress updates on the amount of investment commitments received during the offering period, and to disclose the total amount of securities sold in the offering. An issuer can satisfy the progress update requirements by relying on the relevant intermediary to make frequent, publicly available updates on its platform about the issuer's progress. If the intermediary does not provide such updates, the issuer must file the update information with the SEC on "Form C-U: Progress Update" no later than five business days after each of the dates on which an issuer receives investment commitments for 50% and 100% of the target offering amount. In all cases, the issuer also must file a final progress update, no later than five business days after the offering deadline, disclosing the total amount of securities sold in the offering.

Material Amendments

An issuer will be required to amend its disclosures for any material change[9] in the offer terms or in any disclosure previously provided to investors. The issuer must do so by filing the amended disclosures with the SEC on "Form C/A: Amendment" and providing the amended disclosures to investors and the relevant intermediary. A material change will require affirmative reconfirmation by investors of their investment commitments within five business days.[10] An issuer can also file amendments to disclose nonmaterial changes. These amendments will not require investors to reconfirm their investment commitments.

Cancellation and Closing

Generally, investors can cancel an investment commitment until 48 hours prior to the deadline identified in the issuer's offering materials. If an issuer reaches the target offering amount prior to the deadline identified in its offering materials, the issuer can close the offering early if it provides at least five business days' notice prior to the new deadline (absent a material change that would require an extension of the offering and reconfirmation of the investment commitment). If an investor does not cancel an investment commitment before the 48-hour period prior to the offering deadline, the capital raised in the offering will

[8] The financial statement requirements applicable to an offering are determined by the maximum amount of investment commitments the issuer will accept; therefore, in the example above, the issuer must include reviewed financial statements as required for offerings between $100,000 and $500,000.

[9] The SEC considers a change to be material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether or not to purchase the securities. For example, a material change in the financial condition or the intended use of proceeds would require an amendment. In the adopting release, the SEC declined to provide further guidance as to what constitutes a material change, noting instead that issuers should determine whether changes are material based on the facts and circumstances.

[10] When filing a material amendment, an issuer will be required to check the box on the cover of Form C indicating that investors must reconfirm their investment commitments.

be released to the issuer upon closing of the offering and the investor will receive securities in exchange for his or her investment. If an investor does not reconfirm his or her investment commitment after a material change has been made to the offering, the investor's investment commitment will be cancelled and committed funds will be returned to the investor.

Advertising

Regulation Crowdfunding places limits on advertisements regarding the terms of a crowdfunding offering made by or on behalf of an issuer. Notices advertising the terms of an offering may only include: (i) a statement that the issuer is conducting an offering, the name of the intermediary through which the offering is being conducted, and a link directing the investor to the intermediary's platform; (ii) the terms of the offering (which means the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period); and (iii) factual information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and website of the issuer, the e-mail address of a representative of the issuer, and a brief description of the business of the issuer. All advertisements *must* include the web address of the intermediary's platform on which additional information about the issuer and the offering can be found. Notwithstanding these limitations, an issuer may communicate with investors about the terms of the offering through communication channels provided by the intermediary on the intermediary's platform, so long as the issuer (and persons acting on behalf of the issuer) identifies itself as the issuer in all communications.

Promoter Compensation

An issuer relying on Section 4(a)(6) may only compensate or commit to compensate, directly or indirectly, any person to promote its offering through communication channels provided by the relevant intermediary if the issuer takes reasonable steps to ensure that the person clearly discloses the receipt of compensation (both past and prospective) each time the person makes a promotional communication, regardless of whether such compensation is paid for the promotional activities. In addition, an issuer cannot compensate or commit to compensate, directly or indirectly, any person to promote its offering outside of the communication channels provided by the relevant intermediary unless the promotion is limited to notices that comply with the advertising rules.

Ongoing Reporting Requirements

Annual Reports

Issuers who successfully complete a crowdfunding offering will be required to comply with ongoing reporting requirements pursuant to Rule 202 of Regulation Crowdfunding. No later than 120 days after the end of an issuer's fiscal year, the issuer will be required to file an annual report with the SEC on "Form C-AR: Annual Report." This report must also be posted to the issuer's website. An issuer's annual report must include all of the information required in the offering statement that is not specific to the offering, including financial statements. However, regardless of the amount of capital raised in crowdfunding transactions by the issuer, the financial statements filed with annual reports need only be certified by the issuer's principal executive officer, unless the issuer has available financial statements that have

been reviewed or audited by an independent certified public accountant, in which case, the issuer must provide the reviewed or audited financial statements, as applicable.

Termination

An issuer will be eligible to terminate its ongoing reporting obligations by filing "Form C-TR: Termination of Reporting" with the SEC within five business days from the date on which any of the following events occurs:

- The issuer is required to file reports under Sections 13(a) or 15(d) of the 1934 Act;
- The issuer has filed at least one annual report and has fewer than 300 holders of record;
- The issuer has filed at least three annual reports and has total assets that do not exceed $10 million;
- The issuer or another party purchases or repurchases all of the securities issued pursuant to Section 4(a)(6), including any payment in full of debt securities or any complete redemption of redeemable securities; or
- The issuer liquidates or dissolves in accordance with state law.

Other Important Maters

Disqualification Provisions

Regulation Crowdfunding includes bad actor disqualification provisions similar to those contained in Rule 262 under Regulation A and Rule 506 under Regulation D.[11] If an issuer, or certain other covered persons, are disqualified pursuant to the bad actor provisions, the issuer will not be eligible to offer and sell securities in reliance on Section 4(a)(6). Covered persons include the issuer and any predecessor or affiliate of the issuer; 20% Beneficial Owners; any promoter connected with the issuer in any capacity at the time of sale; compensated solicitors; and general partners, directors, officers, or managing members of any such solicitor. Disqualifying events include, among others, certain (i) felony and misdemeanor convictions, injunctions, and court orders relating to securities or false SEC filings; (ii) final orders and bars of certain state and other federal regulators; (iii) SEC cease-and-desist orders; (iv) involvement as a registrant, issuer, or underwriter with respect to an offering subject to a stop order or suspension proceedings; and (v) United States Postal Service false representation orders within the last five years.

Disqualifying events that pre-date the effectiveness of Regulation Crowdfunding will not cause disqualification. Instead, such events must be disclosed in the issuer's offering materials. In addition, events relating to certain affiliated issuers will not disqualify an offering if the affiliated entity did not control, and was not under common control with, the issuer at the time of such events.

The disqualification provisions include a "reasonable care" exception. Specifically, an issuer will not lose the benefit of the Section 4(a)(6) exemption if it can show that it did not know, and in the exercise of reasonable care could not have known, of the existence of a disqualification. For example, if an issuer obtained written representations from a person

[11] Refer to our client alert on bad actor disqualification under Regulation D, which can be found here.

that such person was not subject to a disqualifying event, and performed its own searches of public records for evidence of a disqualifying event, then it is unlikely that the issuer would be disqualified from reliance on Section 4(a)(6). In addition, the SEC will consider requests for a waiver from the disqualification provisions.

1934 Act Reporting

Simultaneously with Regulation Crowdfunding, the SEC adopted new Rule 12g-6 under the 1934 Act. Rule 12g-6 exempts all securities issued pursuant to an offering made in reliance on Section 4(a)(6) from the record holder count under Section 12(g) of the 1934 Act,[12] provided that the issuer (i) is current in its ongoing reporting requirements under Regulation Crowdfunding, (ii) has total assets as of the end of its last fiscal year of no more than $25 million, and (iii) has engaged the services of a registered transfer agent. An issuer that exceeds both the shareholder thresholds of Section 12(g) and the $25 million total asset threshold will have a two-year transition period before it must register securities pursuant to Section 12(g), provided it continues to comply with its ongoing reporting requirements under Regulation Crowdfunding during such period. Notably, the $25 million limit on total assets may deter companies with aggressive growth plans from making use of Section 4(a)(6) and/or prompt such companies to issue redeemable securities to avoid the obligation to register with the SEC prior to an initial public offering of their securities.

Statutory Liability and Insignificant Deviations

An issuer will be liable to a purchaser of its securities in a transaction made in reliance on Section 4(a)(6) if the issuer, in the offer or sale of the securities, 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 they were made, not misleading. To avoid liability, the issuer must show that it did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

Regulation Crowdfunding includes a safe harbor for insignificant deviations from a term, condition, or requirement of Regulation Crowdfunding. To qualify for the safe harbor, the issuer relying on Section 4(a)(6) must show that (i) the failure to comply with a term, condition, or requirement was insignificant with respect to the offering as a whole; (ii) the issuer made a good faith and reasonable attempt to comply with all applicable terms, conditions, and requirements of Regulation Crowdfunding; and (iii) 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 intermediary-related requirements, or such failure by the intermediary occurred solely in offerings other than the issuer's offering. Notwithstanding the safe harbor, any failure to comply with Regulation Crowdfunding is still actionable by the SEC.

Next Steps and How We Can Help

The much-anticipated Regulation Crowdfunding will officially be available to the "crowd" on May 16, 2016. The 686-page SEC adopting release outlines in detail the rules and regulations applicable to issuers that intend to rely on the Section 4(a)(6) crowdfunding

[12] Section 12(g) of the 1934 Act requires that an issuer with total assets exceeding $10 million and a class of equity security held of record by 2,000 persons, or 500 persons who are not accredited investors, register such class of security with the SEC, which would require the issuer to comply with the 1934 Act reporting requirements.

exemption. These rules and regulations contain numerous disclosure and procedural requirements intended to facilitate small business capital formation while simultaneously protecting investors. Although the new rules will not be fully effective for several months, interested parties should familiarize themselves with the rules and start planning and drafting now. If you have any questions about the new rules, their potential benefits to you, or any other matters related to raising capital in the public and private securities markets, please contact any of the authors listed below, or one of the K&L Gates attorneys with whom you work.

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