

# Chicago Daily Law Bulletin®

Volume 160, No. 188

## Waiting for crowd funding: When will SEC regulations arrive?

**L**ike Godot, crowd funding has not yet arrived. The JOBS Act, enacted in April 2012, mandated the Securities and Exchange Commission to issue regulations for crowd funding by the end of 2012. The SEC eventually proposed crowd-funding regulations in October 2013, but it has not yet adopted final regulations.

On Aug. 8, a bipartisan group of 26 U.S. representatives sent the SEC a letter complaining that, although more than 500 days have passed since the deadline, companies still cannot raise capital through crowd-funding, except in intrastate offerings conducted entirely within the borders of certain states — not Illinois — that permit it.

Crowd funding means using the Internet to raise money, often in small increments, from a potentially large number of sources. Websites such as Kickstarter and Indiegogo provide platforms for obtaining donations to fund artistic or charitable projects without any expectation of a return. Attempts by companies to solicit investments online, however, have run afoul of securities laws.

In 2011, the SEC stopped an attempt to raise \$300 million online to buy out Pabst Brewing Co. in an offering that was neither registered nor exempt. Before they were shut down, the promoters secured more than \$200 million in pledges, demonstrating the Internet's potential for raising capital.

Even when conducted via the Internet, securities offerings must be registered, which is difficult and expensive, or else be exempt from registration. The problem is that crowd funding doesn't fit under existing exemptions for private placements because it targets large numbers of investors lacking the income or net worth to be "accredited investors."

Although important details of crowd-funded offerings of securities will depend on the SEC's final rules, the JOBS Act has set many parameters for the new crowd-funding exemption.

- An issuer may sell up to \$1 million of securities in any 12-month period to an unlimited number of investors (so, the crowd-

funding exemption is geared for startups and other small businesses, not for takeovers of Pabst).

- The maximum amount of securities that an issuer may sell per year to any particular investor is the greater of \$2,000 or 5 percent of the investor's annual income or net worth (if less than \$100,000), or 10 percent of the investor's annual income or net worth (if \$100,000 or more).

- Public (i.e., SEC-reporting) companies, investment companies, non-U.S. companies and companies subject to "bad actor" disqualifications can't use the crowd-funding exemption.

- Offerings under the crowd-funding exemption must be conducted through an intermediary registered with the SEC as a broker or a specialized "funding portal."

- Advertising of crowd-funded offerings is not permitted, except for notices directing potential investors to the intermediary's platform.

- An issuer must disclose certain information, including its business plan, capital structure, planned use of proceeds and, depending on the target offering amount, income tax returns.

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- An issuer must also disclose either officer-certified financial statements, unaudited financial statements reviewed by an independent accountant or, if more than \$500,000 is raised, audited financial statements.

- An issuer must disclose the target offering amount, and investors may rescind their commitments until this amount is reached.

- Crowd-funded offerings issue "covered" securities, which are exempt from state "blue sky" registration requirements, but are not exempt from the anti-fraud provisions of securities laws.
- Securities issued under the

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crowd-funding exemption must be held for at least one year before they can be transferred, with limited exceptions.

Concern about crowd funding's potential for fraud — picture anonymous boiler rooms peddling fake securities to unsophisticated investors on the Internet's massive scale — led to the requirement that crowd-funded offerings be conducted by registered intermediaries acting as gatekeepers.

Intermediary brokers or funding portals that operate online platforms for crowd funding must disclose information to investors, educate investors about risks, protect investor privacy, make sure the offering caps are not exceeded, obtain background checks on an issuer's officers, directors and holders of more than 20 percent of its equity and perform other tasks that the SEC and FINRA (the intermediaries' self-regulatory organization) may require. Fees

fraud if these disclosures contain material misstatements or omissions. And the risk of shareholder lawsuits — alleging breach of fiduciary duty, for example — is multiplied by having hundreds or thousands of shareholders instead of a few.

Having so many shareholders can also cause corporate governance headaches for a startup. Obtaining sufficient shareholder votes for various approvals may become challenging. Annual shareholder meetings may become expensive. It may be difficult to attract later-stage investments from venture capital firms, which tend not to like complicated capital structures and large shareholder bases.

The initial holders of shares purchased in a crowd-funded offering are not counted toward the threshold number of shareholders of record-triggering SEC reporting requirements, such as filing 10-Ks, 10-Qs, 8-Ks, proxy statements, etc. The JOBS Act raised this threshold to 2,000 record holders or 500 record holders who are not accredited investors.

It's possible, though, that the SEC's final crowd-funding rules may count subsequent transferees of crowd-funding securities toward the shareholder threshold for reporting. This could lead to the disastrous result of requiring crowd-funding issuers to become SEC-reporting companies after the one-year holding period expires.

The utility of equity crowd funding will depend largely on the final rules that the SEC will eventually issue. Still, many features of the new crowd-funding exemption are already clear. Startups and others excited about crowd funding's potential for raising capital should use this interim period before it becomes available to assess its costs and benefits and to compare it with alternative means of capital formation such as private placements.