

## SEC Proposes Crowdfunding Rules Under JOBS Act

October 24, 2013

Yesterday the Securities and Exchange Commission proposed rules under the JOBS Act that would permit startups and other businesses to raise investment capital through “crowdfunding” – the process of seeking relatively small investments from a broad group of investors via the Internet. Crowdfunding has historically not been used to raise investment capital (as opposed to being used, for example, to solicit donations) because offers and sales of securities to the public generally require compliance with the registration requirements of the Securities Act of 1933.

The proposed rules provide a limited exemption from the Securities Act registration requirements in order to –

- permit companies to raise investment capital through crowdfunding, up to certain offering-size and per-investor dollar thresholds;
- require disclosure from companies raising capital; and
- create a regulatory framework for intermediaries that facilitate crowdfunding transactions.

Many senior officials of the SEC, worried about potential fraud, spoke out against crowdfunding when the JOBS Act was first considered. The proposed rules contain a number of restrictions and safeguards to help mitigate these concerns.

The SEC is seeking comment from the public on the proposals for 90 days (the deadline for comments is expected to be shortly after January 21, 2014).

### Crowdfunding Exemption

As proposed, a company may raise investment capital through crowdfunding if certain conditions, including the following, are met –

- the company raises no more than \$1 million through crowdfunding in the trailing 12-month period;
- each of its investors has invested no more than the following in all crowdfundings relying on the exemption in the trailing 12-month period:
  - for an investor whose annual income and net worth are both less than \$100,000, the greater of \$2,000, 5% of annual income and 5% of net worth; and
  - for others, 10% of annual income or 10% of net worth, whichever is greater, up to \$100,000 in the trailing 12-month period;
- the transaction is conducted exclusively through a single qualifying intermediary’s platform; and
- the company provides certain disclosures.

The crowdfunding exemption will not be available to companies already reporting with the SEC, companies organized outside the United States, investment companies (and certain funds excluded from the Investment Company Act definition of investment company), companies that are disqualified under the proposed rules, companies that are not in compliance with the proposed annual reporting requirements and companies without a business plan or those whose business plan is to enter into business combination transactions with unidentified targets.

Securities sold in crowdfunding transactions would be subject to resale restrictions for one year, during which time transfers could only be made to family members, accredited investors or the company, or in registered transactions.

## Disclosure Requirements

Companies raising investment capital through crowdfunding would be required to prepare an offering statement that must be filed with the SEC, provided to its intermediary and made available to investors. Among other things, the offering statement would disclose –

- information about officers, directors and 20% owners;
- a description of the company's business and business plans, number of employees and the use of proceeds from the offering;
- information about the risks of the offering;
- the price to the public of the securities being offered, how the valuation of the securities was determined, the target offering amount, the deadline to reach the target amount and whether the company will accept capital in excess of the target amount;
- information about related-party transactions;
- information about the financial condition of the company; and
- financial statements that, depending on the target amount offered in crowdfunding transactions during the trailing 12-month period, would have to be accompanied by a copy of the company's tax returns or reviewed or audited by an independent public accountant.

The rules would require the offering statement to be updated for material events over the course of the offering prior to completion, and provide investors with the option to back out of their investment in such an event.

Companies relying on the crowdfunding exemption would also be required to file an annual report with the SEC and post it on their website, which would include updates of many of the items included in the initial offering statement.

In contrast to the SEC's newly relaxed rules on advertising in private offerings, no advertising will be permitted for these offerings other than very limited notices and communications through the intermediaries described below.

## Crowdfunding Intermediaries

Crowdfunding transactions must take place exclusively online through platforms operated by an SEC-registered intermediary, either a broker-dealer or a new type of SEC registrant called a "funding portal." A company's crowdfunding intermediary is barred from any ownership of the company's securities.

The proposed rules would, among other things, require intermediaries to –

- have a reasonable basis for believing that the crowdfunding company is complying with the applicable rules;
- ensure that the company's disclosure is made publicly available for 21 days before securities are sold;
- provide investors with educational materials;
- take measures to reduce the risk of fraud and deny access to any company where it believes the company or the offering presents the potential for fraud or otherwise raises concerns regarding investor protection;

- make available information about the company and the offering;
- provide communication channels to permit discussions about offerings on the platform; and
- avoid offering investment advice or making recommendations.

---

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

<b>Alan F. Denenberg</b>	<b>650 752 2004</b>	<a href="mailto:alan.denenberg@davispolk.com">alan.denenberg@davispolk.com</a>
<b>Joseph A. Hall</b>	<b>212 450 4565</b>	<a href="mailto:joseph.hall@davispolk.com">joseph.hall@davispolk.com</a>
<b>Michael Kaplan</b>	<b>212 450 4111</b>	<a href="mailto:michael.kaplan@davispolk.com">michael.kaplan@davispolk.com</a>
<b>Richard D. Truesdell, Jr.</b>	<b>212 450 4674</b>	<a href="mailto:richard.truesdell@davispolk.com">richard.truesdell@davispolk.com</a>
<b>Sarah Ashfaq</b>	<b>212 450 4246</b>	<a href="mailto:sarah.ashfaq@davispolk.com">sarah.ashfaq@davispolk.com</a>

**Any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend any transaction or matter addressed herein.**

---

© 2013 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's [privacy policy](#) located at [davispolk.com](http://davispolk.com) for important information on this policy. Please consider adding Davis Polk to your Safe Senders list or adding [dpwmail@davispolk.com](mailto:dpwmail@davispolk.com) to your address book.

Unsubscribe: If you would rather not receive these publications, please respond to this email and indicate that you would like to be removed from our distribution list.