

CORPORATE

SEC RELEASES CROWDFUNDING RULES FOR SECURITIES OFFERINGS

Investors will be able to purchase securities through internet crowdfunding platforms under new final rules released by the Securities and Exchange Commission (SEC) in October. The final rules, known as "Regulation Crowdfunding," originated in Title III of the Jumpstart Our Business Startups Act of 2012 (JOBS Act). The rules will take effect in May 2016.

Alongside Regulation Crowdfunding, the SEC also proposed amendments to Rules 147 and 504 under the Securities Act of 1933 (the Proposed Amendments). A brief review of Regulation Crowdfunding and the Proposed Amendments is provided below for companies or investors eager to discover new capital raising or investment opportunities and for broker-dealers interested in expanding into the crowdfund arena.

Key Points: What to Know About Regulation Crowdfunding

The Regulation Crowdfunding rules are extensive, but they can be more readily understood and categorized as: 1) operative provisions; 2) disclosure mandates; and 3) crowdfunding platforms.

Operative Provisions

Regulation Crowdfunding will: i) enable companies to raise up to \$1 million, in the aggregate, over a 12-month period; ii) for individual investors whose annual income or net worth is less than \$100,000, enable such investors to spend the greater of \$2,000 or five percent of the lesser of their annual income or net worth on crowdfunding investments over a 12-month period; iii) for individual investors whose annual income or net worth equals or exceeds \$100,000, enable such investors to spend ten percent of the lesser of their income or net worth on crowdfunding investments over a 12-month period. The goal is to allow more people to dabble in investments, and to level the playing field for investments by ensuring that even the wealthiest of individual investors cannot spend more than ten percent of their income or net worth on crowdfunding offerings in a given 12-month period. Also crucial to note are the following points:

- Securities purchased in a crowdfunding transaction will be considered restricted securities and will be subject to resale restrictions for one year in most circumstances;
- All of the new crowdfunding offerings will need to be completed with the assistance of a registered broker-dealer or done through a registered "funding portal," to be discussed in greater depth below; and

- Some companies are unable to use the exemption, including foreign companies, publicly-traded companies, and companies that are subject to disqualification under Regulation Crowdfunding.

Disclosure Mandates

Companies seeking to raise money through crowdfunding will have to meet specific disclosure requirements under Regulation Crowdfunding including:

1. The price of the securities to be offered;
2. how the price was determined;
3. the target offering amount;
4. the deadline to reach the target offering amount;
5. the funding deadline;
6. whether the company intends to accept investments that will cause the target offering amount to be exceeded;
7. a discussion of the company's financial health;
8. a discussion of the business and how proceeds from the offering will be used;
9. information about directors, officers, and owners of 20 percent or more of the companies;
10. certain related-party transactions; and
11. financial statements of the company that may or may not need to be audited, depending on a fairly complex set of circumstances.

Crowdfunding Platforms

Regulation Crowdfunding contemplates the creation of crowdfunding portals to facilitate Internet-based transactions that, in theory, reduce costs and boost efficiency. The "funding portals" will need to be registered with the SEC via a new form – Form Funding Portal – and such portals will need to be registered as members of a national securities association (i.e., FINRA). In short, the funding portals will be the intermediary platforms through which all crowdfunding will be conducted, and these portals will need to comply with the following requirements:

1. provide investors with informative materials explaining how to use the platform, what is being offered, and all relevant

disclosures about the company, resale restrictions, investment limitations, and the like;

2. take measures to reduce fraud risks, including by verifying with the companies offering securities that such companies are in compliance with Regulation Crowdfunding and that the companies are maintaining up-to-date records of their securityholders;
3. post and maintain mandatory disclosures for 21 days before any offerings are live (i.e., a waiting period of 3 weeks) and throughout the actual offering period;
4. make available forums or other communication venues for investors to discuss offerings on the platform;
5. explain how the intermediary is being compensated for hosting the transactions;
6. require investors to set up accounts officially before being allowed to buy securities;
7. have a reasonable basis to believe that investors are in compliance with the investment limitations (i.e., they will need to ensure investors are not exceeding their spending limits in a given 12-month period);
8. provide adequate notices and confirmations at each step of the investment process;
9. comply with maintenance and transmission of funds requirements; and
10. comply with any requirements dealing with completion, cancellation, and re-confirmation of offerings requirements.

Crowdfunding intermediaries will be prohibited from providing access to companies they believe pose fraud or other problems that could negatively impact investor protections; holding financial interests in companies offering securities on their platforms, unless such financial interests are being used as consideration to pay the intermediaries for their services (subject to certain conditions); and paying third parties to provide information that will personally identify any investors or potential investors who may be using or planning to use the platform. Specific to funding portals as intermediaries, Regulation Crowdfunding also prohibits such portals from: offering investment advice or making purchase recommendations; soliciting purchases, sales, or offers; soliciting purchases, sales, or offers via promoters or other persons for pay; and holding or handling investors' funds or securities. Despite the numerous prohibitions, Regulation Crowdfunding is intended

to make transactions smoother and provide a safe harbor (i.e., set of guidelines) for funding portals, such that, if the portals follow the guidelines precisely, they can be assured that they are in compliance with Regulation Crowdfunding.

Key Points: What to Know About the Proposed Amendments

In an effort to balance the need to help smaller companies raise capital with the need to protect investors from fraudulent and misleading securities sales, the SEC has proposed amending Rules 147 and 504 as follows:

- Rule 147 – This rule currently allows a safe harbor for exemption from costly registration for offers and sales made entirely within one state. The amendments are intended to make it easier for companies to make intrastate offerings of their securities by: 1) eliminating restrictions on offers (i.e., general solicitation and advertising will be allowed), though sales would still need to be made only to residents of the issuer's state or territory; and 2) expanding the meaning of "intrastate offering" and the issuer eligibility requirements. The amended Rule 147 would apply to offerings registered in-state or conducted under an exemption from state law registration that caps the amount of securities allowed to be sold by an issuer at \$5 million over a given 12-month period, along with spending limits for investors.
- Rule 504 – This rule currently provides a safe harbor exemption from registration for certain small offerings. The amendments would boost capital-raising by increasing the aggregate amount of securities allowed to be offered and sold under Rule 504 from \$1 million to \$5 million, during any 12-month period. The amendments would boost protection for investors by prohibiting a set of defined "bad actors" from participating in such offerings.

Conclusion: Timelines for Regulation Crowdfunding and the Proposed Amendments

The new Regulation Crowdfunding rules and forms will be effective 180 days after they get published in the Federal Register (i.e., in May 2016). The forms that will enable funding portals to get registered with the SEC will become effective on January 29, 2016, thereby allowing the funding portals to be active or ready for transactions months before any transactions under the new rules are allowed by law.

Regarding the Proposed Amendments to Rules 147 and 504, the SEC is welcoming public comments, and will continue to do so for a 60-day period, which will end approximately by the end of the year. Crowdfunding has been the subject of much discussion and debate as evidenced by the nearly three years it took the SEC to promulgate Regulation Crowdfunding. It is still too early to predict whether crowdfunding will emerge in 2016 as a successful alternate path for capital-raising for small companies. Indeed, only time will tell whether

the SEC will manage to balance its primary goal of investor protection with the ambitious aim of offering a more grassroots-level option of raising money.

To review the text of Regulation Crowdfunding and the Proposed Amendments, see the following links from the SEC: <http://www.sec.gov/rules/final/2015/33-9974.pdf> and <http://www.sec.gov/rules/proposed/2015/33-9973.pdf>.

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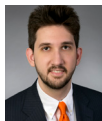
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