A Summary of Crowdfunding under the JOBS Act

by Frank Vargas partner at Rimon, P.C. and Michael Vargas associate at Rimon, P.C.

Introduction

On April 5, 2012, President Barack Obama signed the Jumpstart Our Business Startups (JOBS) Act (available at https://www.sec.gov/spotlight/jobs-act.shtml) into law. The Act has a number of important provisions, but among them Titles II, III, and IV stand out as fundamentally expanding the options available for companies to raise investment capital. These are the "crowdfunding" provisions that authorize companies to solicit and consummate equity investments from the general public. Prior to this point, such a transaction would have only been permitted through an initial public offering (IPO), or far less commonly through a Regulation A offering. This practice note provides a general overview of the JOBS Act and the three crowdfunding Titles, and how these provisions change our national securities laws.

Why Did Congress Pass the JOBS Act?

The business and investment communities have been agitating for changes to securities laws for a generation (or more). The Securities Act of 1933 and the Securities Exchange Act of 1934 were passed to address a number of glaring unethical practices in the securities markets following the lavish excesses of the Gilded Age and the devastation of the 1929 Wall Street Crash and subsequent Great Depression. Of particular concern to legislators was the practice of unregulated "brokers" traveling around the country and soliciting investments from the burgeoning middle class that remained unsophisticated about financial transactions and investments. This issue was exacerbated by the fact that issuing companies were not required to make particularly detailed disclosures about their financial performance or outlook in the first place. As a result, middle class investors were often swindled, and even if they did make sound investments, only insiders were privy to the essential information that would allow them to protect their interests.

The 1933 and 1934 Acts sought to change this by requiring that companies looking to raise money from the public must register with the Securities and Exchange Commission (SEC) and be subject to extensive scrutiny and disclosure requirements. This process is long, complex, fraught with potential liability, and, as a consequence, extremely expensive. However, the Securities Act left open a safe harbor for private offerings under Section 4(a)(2), and giving the SEC authority to promulgate regulations along these same lines. Still, the SEC regulations incorporated the 1933 and 1934 Acts' suspicion of selling to average citizens. This suspicion took the form of two defining features of these exemptions: (1) that the securities be offered exclusively to "accredited investors," usually investors with at least $200,000 in annual income or $1,000,000 in assets; and (2) that issuing companies be prohibited from making "general solicitations and advertising" in the private sale of their securities (this feature became SEC Rule 502).

In 1982, the SEC relaxed these requirements slightly when it passed Regulation D, allowing a limited number of non-accredited investors to take part or allowing some general solicitation, but only if other conditions were met. For example, a company could make general solicitations in a Rule 504 offering, but only if it was made only to accredited investors. In a Rule 505 offering, unaccredited investors were permitted, but not general solicitation and the offering cap was set significantly lower. And in a Rule 506 offering, unaccredited investors were permitted, but including them would trigger additional disclosure requirements.

The time was finally ripe for change following the Great Recession of 2008. By 2012, the country had yet to fully extricate itself from the economic slump brought on by the 2008 crash. The unemployment rate was still at 8%, and progress in bringing it down had proven frustratingly slow and difficult. Legislators were eagerly looking for ways to bring unemployment back under control, or, with the 2012 election right around the corner, to be seen as doing everything they could to bring it under control. Progressives eager to create jobs were finally on the same page with anti-regulation conservatives, and a moment of rare bipartisanship was born, resulting in the JOBS Act of 2012.

Rules 502, 506(b), and 506(c)

Prior to the passage of the JOBS Act, Rule 506 was the most commonly used exemption offering by the SEC. The Rule allowed issuers to raise an unlimited amount of capital so long as the buyers were all accredited investors plus no more than 35 unaccredited investors. However, Rule 502, which prohibited general solicitation and advertising, still applied. Despite this, the Rule 506 exemption was appealing for the fact that it was uncapped and for the fact that investors could self-qualify by signing a series of representations, which greatly reduced the amount of due diligence in which the company had to engage. Furthermore, many private investments that rely on this Rule are between an issuer and a small group of wealthy investors with whom the company will have already negotiated, so there is no real need for general solicitation. Not surprisingly, more than 90% of all private offerings claimed the Rule 506 exemption.

In the era of Kickstarter, GoFundMe, and other donation-based crowdfunding websites, however, issuers suddenly had an opportunity to raise capital through online platforms. Instead of an issuer going to and negotiating with one or more investors, the issuer could post their offering on a website and let interested investors come to them. This drastically changed the power dynamics between issuers and investors, and it worked great for companies looking to raise capital through donations. However, if the company was looking to sell equity, there was a potential Rule 502 problem, as such advertising would fall under "general solicitation."

To resolve this issue, Title II of the JOBS Act split Rule 506 into Rule 506(b) and Rule 506(c). Rule 506(b) is identical to the original rule, allowing unlimited capital investments from up to 35 unaccredited and unlimited accredited investors, but prohibits general solicitation. New Rule 506(c), however, allows general solicitation for an unlimited amount of investments, but only so long as all of the investors are accredited. New Rule 506(c) also no longer allows investors to self-certify, and the issuer has a duty to engage in a reasonable investigation of the purchaser's qualifications. Still, this duty can be, and in many cases has been, picked up by the online platform.

Regulation Crowdfunding

Rule 506(c) is, in essence, the "unlimited option," allowing issuers to raise a limitless amount through general solicitation so long as they do so from accredited investors. Title III of the JOBS Act creates an alternative more "limited option," but throws open the door to all potential investors, including unaccredited investors. Under the new Section 4(a)(6) of the Securities Act of 1933, issuers have the option of a "Regulation Crowdfunding" offering. After a long delay, the SEC issued its final rules in late 2015, and those rules became effective in the spring of 2016.

Fundraising and Investing Limits

Although a Regulation Crowdfunding offering is open to everyone, the SEC put in place two stringent limitations, presumably to provide the additional protections the SEC believes are needed for unaccredited investors and consistent with the Securities Act's suspicion of selling to unaccredited investors. The first limitation applies to the offering as a whole. Like many other exemptions, the Regulation Crowdfunding exemption is capped. Under Section 4(a)(6), the cap is set at $1,000,000.

The second limitation applies to the unaccredited investors. In addition to the fundraising cap, Section 4(a)(6) also applies a cap to the amount each individual purchaser can invest. For individuals with an annual income or net-worth under $100,000, they are limited to the greater of $2,000 or 5% of their annual income or net-worth. For wealthier individuals who have an annual salary or net-worth greater than $100,000, they are still limited to 10% of the lesser of their income or net-worth. Finally, an investor can purchase no more than $100,000 worth of securities through all Regulation Crowdfunding offerings in any 12-month period.

There are a few important points to highlight here:

- Note that this high net-worth definition is quite a bit lower than the normal "accredited" investor standard, which is an individual annual salary of $200,000 or a $1 million net-worth. This means there is going to be a larger pool of potential investors in this second bracket.
- However, note also that there is a cap on the aggregate amount a person can invest in all Regulation Crowdfunding offerings. In other words, this is not a substitute for traditional investing, but rather an opportunity for a small amount of high-risk venture investing. Given the extremely high risk of early-stage investing, this limitation is not especially surprising.
- Assuming an issuer is able to raise the full $1 million, the investor is looking at up to 500 new investors. Under normal circumstances this could put the company in jeopardy of hitting the shareholder cap in the Securities Exchange Act, which would require them to register with the SEC. Thankfully, the JOBS Act exempts Section 4(a)(6) investors from the registration requirement under Section 12 of the Securities Exchange Act, so issuers should not be concerned that new Regulation Crowdfunding shareholders could force them to register with the SEC.

Required Disclosures

Unlike the Regulation D exemptions, an issuer relying on Section 4(a)(6) must make certain disclosures on a new "Form C", and will be required to file an annual report with the SEC. The required disclosures on Form C include:

- The price of the securities (or method for determining the price)
- The target offering amount
- The deadline for reaching the targeted amount
- Whether the company will accept investments beyond the targeted amount
- A discussion of the company's financial condition
- Financial statements and tax returns either audited or reviewed by an independent public accountant, depending on the amount of the offering
- A description of the business
- How the proceeds will be used
- Information about the directors, officers, and controlling shareholders
- Certain third-party transactions

Fortunately for issuers, these disclosures are nowhere near as extensive as a full public offering or even a smaller offering under Regulation A. Still, issuers should expect disclosures comparable to a private placement memorandum (PPM), a disclosure document common in many Regulation D offerings. Note, however, that Form C requires financial statements that are audited or reviewed by an independent CPA for companies that propose to raise more than $500,000 in any Regulation Crowdfunding offering after the initial offering. This is a significant departure from a typical early-stage PPM. Many early-stage companies, especially those likely looking to raise funds through crowdfunding, do not normally have audited financials because of the cost of their preparation, so this is something to point out to clients.

Brokers and Crowdfunding Platforms

A unique feature of the Regulation Crowdfunding offering is that it must be consummated through a registered broker-dealer or a registered "funding portal." In response to this requirement, the SEC ordered all Self-Regulatory Organizations (SROs) to issue rules regulating these intermediaries. The only SRO for broker-dealers and funding portals is the Financial Industry Regulatory Authority (FINRA). FINRA released its final rules in January of 2016, and they were quickly approved by the SEC in February. Those rules include, among other things:

- Rule 110. Requires funding portals to become members of FINRA and outlines the application process for becoming such a member.
- Rule 200. Regulates funding portal communications with investors and prohibits, among other things:
  - False, exaggerated, unwarranted, promissory, or misleading statements or claims
  - Material omissions of fact or qualifications
  - Exaggerated or unwarranted claims, opinions, forecasts, or predictions regarding performance
- Rule 300(c). Requires funding portals to report violations.
- Rule 800(b). Requires funding portals to make certain public disclosures similar to FINRA's "BrokerCheck" system.

For a full discussion of the FINRA Rules, see Crowdfunding Intermediaries under the JOBS Act.

It is not entirely clear why Congress decided to require an intermediary in these transactions. On the one hand, the funding portal requirement seems natural and convenient, given the popularity of websites like Kickstarter and GoFundMe. It may also serve as yet another layer of protection for unsophisticated investors, particularly since the FINRA Rules impose special rules of honesty and fair dealing on those intermediaries. On the other hand, these intermediaries will no doubt increase the cost of such deals through operating fees, such as Kickstarter and GoFundMe taking fees from campaigns they oversee. These intermediaries may also create a false sense of legitimacy, giving the impression to investors that a company on a funding portal must be viable, which would cause the investor to engage in less of their own due diligence.

As of the time of writing, there are only 19 funding portals approved by FINRA. As that number increases and as the amount companies are able to raise through them grows, we may discover the wisdom or folly of the intermediary requirement.

Regulation A+

Perhaps no exemption has been more of a disappointment to the business community than Regulation A. Initially drafted as a "mini-IPO," the Reg A offering was exempt from Rule 502. It had two major flaws, however. First, the offering amount was capped at $5 million, which was extremely low for a public offering. In fact, many of the Regulation D private offering exemptions had caps equal to or higher than that. Second, the SEC required extensive disclosure, only slightly less onerous than a traditional IPO and significantly more expansive than a Regulation D offering. In the end, the expense of consummating a Regulation A offering was excessively high compared to the amount an issuer could raise, and with the existence of the far more appealing Regulation D exemptions, Regulation A was not especially popular. Indeed, before the JOBS Act, Regulation A offerings were almost non-existent.

Congress sought to remedy this issue through Title IV of the JOBS Act, which instructed the SEC to create a new exemption for public capital raises up to $50 million. The SEC responded by breaking the new Regulation A+ into two tiers: Tier 1 offerings of up to $20 million in any 12-month period, and Tier 2 of up to $50 million in a 12-month period. This section will go over the major themes of the two Regulation A Tiers. For a full discussion see Regulation A Plus.

Issuer and Investor Limitations

A Regulation A Tier 1 offering is capped at $20 million, and a Tier 2 offering is capped at $50 million; however, either Tier can offer an amount below the maximum. In other words, a Tier 2 offering could set the minimum raise at $15 million and still qualify as a Tier 2. The caps refer to the maximum of each offering.

Unlike a private offering, current shareholder can sell their shares in a Regulation A offering as they would in an IPO. The amount that can be sold is limited, however. In a Tier 1 offering, only $6 million can be raised from selling shareholder stock, and in a Tier 2 offering, only $15 million can be raised in this fashion. Still this could be a good exit opportunity for current shareholders.

Unless the securities are listed on an exchange, an unaccredited investor is limited to investing no more than 10% of the greater of their annual income or net-worth. However, Regulation A securities are freely tradable and can be listed on a stock exchange. In such circumstances the limitation on investment is lifted.

Like the Section 4(a)(6) shareholder, Regulation A shareholders are exempt from the shareholder cap of Section 12 of the Securities Exchange Act. This may come as little comfort, however, since Regulation A has its own reporting requirements.

Interaction with State Blue Sky Laws

The SEC rules preempt Regulation A Tier 2 offerings from state Blue Sky laws, including merit review. However, Tier 1 offerings are still subject to state laws. Some states such as California still require a notice filing for Tier 2 offerings to be made before any sales are made in the state. In California, this notice must include a copy of the offering circular and a $600 fee.

Disclosure and Solicitation

A Regulation A offering is made through an Offering Statement or Offering Circular. The Offering Statement is not much different in substance or form than an S-1 Prospectus, though it may be significantly shorter. The fourteen required items are:

1. Cover page of offering circular
2. Table of contents
3. Summary and risk factors
4. Dilution
5. Plan of distribution and selling stockholders
6. Use of proceeds to issuer
7. Description of business

8. Description of property
9. Management's discussion and analysis of financial condition and results of operations / plan of operations for issuers
10. Directors, executive officers, and significant employees
11. Compensation of directors and executive officers
12. Security ownership of management and certain security holders
13. Interest of management and others in certain transactions
14. Securities being offered

The issuer should also be prepared to submit all solicitation materials, including "testing the waters" (TTW) materials. Testing the waters refers to sharing solicitation materials with potential investors before the offering is made. This includes sharing the materials online and through social media if appropriate. However, no binding purchases can be consummated during this time. TTW materials must include a legend that (1) no money or other consideration is being solicited, and if sent, will not be accepted; (2) no sales will be made or commitments to purchase accepted until the offering statement is qualified; and (3) a prospective purchaser's indication of interest is non-binding. Be cautious, as these materials are also subject to the anti-fraud provisions of the securities laws.

Concluding Thoughts

Titles II, III, and IV of the JOBS Act represent a significant shift in the regulation of securities in the United States. Congress sought to loosen the restrictions on general solicitation in light of new technology and greater availability of financial information and sophistication brought about by the information revolution. Still, it is clear from the limits on these new crowdfunding options that Congress and the SEC have not forgotten or discarded the essential motivation of the 1933 and 1934 Acts: the protection of unsophisticated investors from unscrupulous brokers. While these new crowdfunding mechanisms offer tremendous opportunity for issuers and investors alike, the influx of less financially sophisticated investors also presents a danger. The legal practitioner who serves any issuers, funding portals, or investors in these offerings would be wise to exercise prudence, caution, and an abundance of care, as these investors are at the core of the SEC's mission and the very foundation of the 1933 and 1934 Acts.

Related Content

For additional information on Crowdfunding, see the following practice notes:

- A Comparison of the JOBS Act Crowdfunding Regulations (and When to Use Them)
- Comparing Crowdfunding Instruments: Common Stock, Preferred Stock, Convertible Notes and SAFEs
- Regulation A Plus
- Crowdfunding Intermediaries under the JOBS Act