

## SEC Adopts Final Crowdfunding Rules

***The Final Crowdfunding Rules give small businesses an additional avenue to raise capital, but impose significant compliance requirements on both issuers and intermediaries.***

On October 30, 2015, the US Securities and Exchange Commission (SEC) adopted final rules to permit companies to offer and sell securities through crowdfunding (the Crowdfunding Rules).<sup>1</sup> The Crowdfunding Rules enable investors to purchase securities in crowdfunding offerings, subject to certain limitations, and require issuers relying on the Crowdfunding Rules to disclose certain information about their business and offering, as mandated by Title III of the Jumpstart Our Business Startups Act (JOBS Act). Specifically, the Crowdfunding Rules permit an issuer to raise a maximum aggregate amount of US\$1 million through crowdfunding offerings in a 12-month period and allow investors to invest up to US\$100,000 across all crowdfunding offerings in the course of a 12-month period, depending on their annual income and net worth.

The Crowdfunding Rules notably allow issuers to conduct securities offerings that are exempt from the registration requirements of the Securities Act, yet that are open to all types of investors, including ordinary retail, non-accredited investors. As detailed below, however, it is not clear to what degree small companies will utilize the Crowdfunding Rules given the relatively low investment limits, the complexity of the rules, and the associated compliance costs. Issuers may instead opt to rely on other available exemptions which issuers may use to raise capital through crowdfunding, including SEC Regulation A+ and Regulation D, Rule 506(c).

All transactions which rely on the Crowdfunding Rules are also required to take place through an SEC-registered intermediary, either a broker-dealer or a “funding portal,” which is a new type of registered intermediary created by the Crowdfunding Rules that may engage in more limited activities than a registered broker-dealer. Intermediaries in crowdfunding offerings may receive compensation from issuers and/or investors in connection with facilitating crowdfunding offerings, including compensation in the form of the issuer’s securities. Intermediaries (and issuers) may also compensate third parties for referring people to the intermediary’s crowdfunding platform and/or the issuer’s offering on the platform, subject to certain restrictions. Intermediaries in crowdfunding offerings would also have extensive compliance obligations, including, but not limited to:

- Providing investors with certain educational materials
- Taking certain measures to reduce the risk of fraud
- Making information that a company is required to disclose available to the public on its platform
- Providing communication channels to permit discussions about offerings on the platform
- Providing disclosure to investors about the compensation the intermediary receives

- Having a reasonable basis for believing an investor complies with the investment limitations
- Providing certain notices and confirmations
- Complying with certain maintenance and transmission of fund requirements as well as completion, cancellation, and reconfirmation of offering requirements

In light of these compliance requirements, those crowdfunding intermediaries assessing the costs and benefits of registering as a funding portal, rather than a broker-dealer, may ultimately determine that broker-dealer registration is more attractive, as registered broker-dealers may engage in activities beyond the Crowdfunding Rules and, as highlighted below, are subject to fewer restrictions even in the context of offerings under the Crowdfunding Rules.

The Crowdfunding Rules become effective 180-days after publication in the Federal Register;<sup>2</sup> however, certain forms enabling funding portals to register with the SEC are effective January 29, 2016.

## Overview of the Crowdfunding Exemption

Section 4(a)(6) of the Securities Act of 1933 (Securities Act), as added by Title III of the JOBS Act, provides an issuer an exemption from the registration requirements of Securities Act Section 5 for crowdfunding transactions that satisfy the following requirements:

- The amount raised does not exceed US\$1 million in a 12-month period
- Individual investments in all crowdfunding issuers in a 12-month period are limited to either of the following:
  - The greater of US\$2,000 or 5% of annual income or net worth, if the investor’s annual income or net worth of the investor is less than US\$100,000
  - 10% of annual income or net worth (not to exceed an amount sold of US\$100,000), if the investor’s annual income or net worth is US\$100,000 or more; and
- Transactions must be conducted through an intermediary that is registered as either a broker-dealer or a new regulated entity called a “funding portal,” and each offering must be conducted exclusively through one intermediary.

In applying the exemption, the Crowdfunding Rules clarify that only the capital raised in reliance on the exemption provided by Section 4(a)(6) should be counted toward the US\$1 million limit; capital raised through other means, such as other exempt securities offerings, is not required to be counted in determining the aggregate amount sold in reliance on the Section 4(a)(6) exemption.<sup>3</sup>

The Crowdfunding Rules include no limitations with respect to particular types of investors. Accordingly, all retail, institutional, and accredited investors are eligible to participate in such crowdfunding transactions, and the investment limits under the exemption apply equally to all investor types.<sup>4</sup> Moreover, the Crowdfunding Rules do not limit the type of securities that may be offered in reliance on Section 4(a)(6). Accordingly, both equity and debt securities may be offered and sold in crowdfunding transactions.<sup>5</sup> Certain issuers, however, are not eligible to rely on the Section 4(a)(6) exemption. These include:

- Foreign issuers, issuers that are not organized under the laws of a state or territory of the United States
- Public companies, issuers that are subject to reporting requirements under the Securities Exchange Act of 1934 (Exchange Act)
- Mutual funds or private funds, investment companies as defined in the Investment Company Act of 1940 (Investment Company Act) or companies that are excluded from the definition of investment company under Section 3(b) or 3(c) of the Investment Company Act
- Issuers that are not eligible to rely on Section 4(a)(6) as a result of a disqualification
- Issuers that have failed to comply with the annual reporting requirements under the Crowdfunding Rules (discussed below) during the two years immediately preceding the filing of an offering statement
- Shell companies, companies that have no specific business plan or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies<sup>6</sup>

As noted above, a crowdfunding offering under Section 4(a)(6) must be made either through a registered broker-dealer or a registered funding portal. The Crowdfunding Rules require that an issuer relying on Section 4(a)(6) only use one intermediary and that all transactions must be conducted exclusively on the intermediary's platform in an "online-only" format.<sup>7</sup>

## Issuer Requirements

The Crowdfunding Rules implement the disclosure requirements applicable to issuers relying on the Section 4(a)(6) exemption by requiring issuers to file a "Form C" with the SEC prior to the commencement of the offering,<sup>8</sup> which must contain, at least:

- The name, legal status, physical address and website address of the issuer
- The names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20% of the shares of the issuer
- A description of the business of the issuer and the anticipated business plan of the issuer
- A description of the stated purpose and intended use of the proceeds of the offering which the issuer seeks with respect to the target offering amount
- The target offering amount, the deadline to reach the target offering amount and regular updates about the progress of the issuer in meeting the target offering amount
- The price to the public of the securities or the method for determining the price
- A description of the issuer's ownership and capital structure
- The name, SEC file number and Central Registration Depository number (as applicable) of the intermediary through which the offering is being conducted

- The amount of compensation paid to the intermediary for conducting the offering, including the amount of any referral or other fees associated with the offering
- The current number of the issuer's employees
- A discussion of the material factors that make an investment in the issuer speculative or risky
- A description of the material terms of any indebtedness of the issuer, including the amount, interest rate, maturity date and any other material terms
- Any exempt offerings conducted within the past three years
- Any related-party transactions since the beginning of the issuer's last fiscal year in excess of 5% of the aggregate amount of capital which the issuer raised 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<sup>9</sup>

In addition, issuers relying on the Crowdfunding Rules are required to comply with a number of financial disclosure requirements, which vary based on the amount offered and sold in reliance on Section 4(a)(6) within the preceding 12-month period. All financial statements prepared for purposes of the Crowdfunding Rules must be prepared in accordance with US generally accepted accounting procedures (GAAP).<sup>10</sup> Issuers must also provide a narrative discussion of their financial condition, which must include (if material), a discussion of liquidity, capital resources and historical results of operations.<sup>11</sup>

The Crowdfunding Rules also impose certain ongoing reporting requirements. Issuers selling securities pursuant to the Crowdfunding Rules are required to file an annual report with the SEC and post the report on its website, no later than 120 days after the end of the fiscal year covered by the report. The report must contain, at least, the issuer's financial statements — certified by the issuer's principal executive officer to be true and complete in all material respects — as well as the information required in the offering statement.<sup>12</sup> The Crowdfunding Rules also require issuers to provide progress updates about the issuer's progress toward meeting the target offering amount as well as amendments to the issuer's previous disclosures for any material change in the offer terms or disclosures previously provided to investors.

Pursuant to Securities Act Section 4A(b)(2), advertising in connection with any crowdfunding offering is prohibited, except that the Crowdfunding Rules allow an issuer to publish a notice advertising the terms of an offering, which are similar to so-called "tombstone ads" under Securities Act Rule 134.<sup>13</sup> The Crowdfunding Rules also allow an issuer to communicate with investors about the terms of the offering through communication channels which the intermediary provides on the intermediary's platform, so long as the issuer identifies itself as the issuer in all communications. Further, to the extent that an issuer engages anyone to promote the issuer's offering through communication channels provided by the intermediary, the issuer must take reasonable steps to ensure that the person clearly discloses the receipt of compensation each time the person makes a promotional communication.<sup>14</sup>

Although the Crowdfunding Rules represent an exciting development for early-stage companies seeking to raise capital through crowdfunding, a number of observers have questioned whether the issuer requirements outlined above will simply prove too onerous for the Crowdfunding Rules to be workable. Indeed, in a dissenting statement, one SEC Commissioner cautioned that the rules will "spin a complex web of provisions and requirements for compliance" and that such burdens will spook many small businesses from pursuing crowdfunding as a viable path to raising capital.<sup>15</sup>

## Intermediary Requirements

As noted above, Section 4(a)(6) of the Securities Act and the Crowdfunding Rules require crowdfunding transactions to be conducted through an intermediary that is registered with the SEC as either a broker-dealer or a “funding portal” and that is also a member of a national securities association (currently, the Financial Industry Regulatory Authority (FINRA)). A “funding portal” is defined as any person that acts as an intermediary for the offer and sale of securities for the account of others, but solely with respect to offerings pursuant to Section 4(a)(6) of the Securities Act and the Crowdfunding Rules.<sup>16</sup> Thus, unlike a registered broker-dealer, a funding portal’s activity would be limited to offerings under the Crowdfunding Rules. To the extent that a funding portal were to act as an intermediary in an offering of securities not under the Crowdfunding Rules, the funding portal would be required to register as a broker-dealer.

Although funding portals would perform similar functions as a broker-dealer, given their more limited function, the Crowdfunding Rules prohibit a funding portal from engaging in the following types of activities:

- Offering investment advice or recommendations
- Soliciting purchases, sales or offers to buy the securities offered or displayed on its website or portal
- Compensating employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal
- Holding, managing, possessing or otherwise handling investor funds or securities
- Engaging in such other activities as the SEC determines appropriate<sup>17</sup>

While the Crowdfunding Rules provide a safe harbor under which funding portals may engage in certain activities consistent with these restrictions, notably an intermediary that is a registered broker-dealer is not subject to these same restrictions and could engage in each of these activities, to extent otherwise permitted under the Crowdfunding Rules, without monitoring its compliance under the more prescriptive safe harbor provisions for funding portals.

## Financial Interest Restrictions

The Crowdfunding Rules prohibit an intermediary’s directors, officers or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in an issuer using the intermediary’s services or receiving a financial interest in the issuer as compensation for services provided to the issuer in connection with the offer and sale of the issuer’s securities.<sup>18</sup> In a significant departure from the SEC’s initial proposal, however, the Crowdfunding Rules would permit an intermediary itself to have a financial interest in an issuer that is offering or selling securities under the Crowdfunding Rules, so long as (i) the intermediary receives the financial interest from the issuer as compensation for the services provided to the issuer in connection with the offer or sale of such securities being offered or sold in reliance on the Crowdfunding Rules through the intermediary’s platform; and (ii) the financial interest consists of securities of the same class and having the same terms, conditions and rights as the securities being offered or sold in reliance on the Crowdfunding Rules through the intermediary’s platform.<sup>19</sup>

## Measures to Reduce Risk of Fraud

The Crowdfunding Rules require that an intermediary take certain steps to reduce the risk of fraud occurring on its platform. Among the Crowdfunding Rules’ requirements, an intermediary must have a

reasonable basis — which may be based upon representations from the issuer — to conclude that: (i) an issuer seeking to offer and sell securities in reliance on Section 4(a)(6) through the intermediary's platform complies with the applicable requirements in Securities Act and the Crowdfunding Rules; and (ii) an issuer has established means to keep accurate records of the holders of the securities the issuer would offer and sell through the intermediary's platform.<sup>20</sup>

An intermediary is also required to deny access to its platform if the intermediary has a reasonable basis to conclude that an issuer, or any of the issuer's officers, directors (or any person occupying a similar status or performing a similar function), or any 20% beneficial owner is subject to a disqualification under the Crowdfunding Rules.<sup>21</sup> In satisfying this requirement, the Crowdfunding Rules require that the intermediary conduct background checks and securities enforcement regulatory checks on the issuer and the other relevant persons.<sup>22</sup>

An intermediary must also deny access to its platform if it has a reasonable basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection. For purposes of this requirement, an intermediary must deny access if it reasonably believes that it is unable to adequately or effectively assess the risk of fraud related to the issuer or its potential offering.<sup>23</sup> In addition, if an intermediary becomes aware of information after it has granted access that causes it to reasonably believe that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection, the intermediary must promptly remove the offering from its platform, cancel the offering, and return (or direct the return of) any funds investors have committed in the offering.<sup>24</sup>

### **Account Opening Procedures**

An intermediary may not accept any investment commitment from an investor until the investor has opened an account with the intermediary and the intermediary has obtained consent to electronic delivery of materials from the investor.<sup>25</sup> In addition, in connection with opening an account, an intermediary is required to provide certain disclosures and educational materials to investors, which must describe, at least the following:

- The process for the offer, purchase and issuance of securities through the intermediary
- The risks associated with investing in the securities
- The types of securities that may be offered on the intermediary's platform and the risks associated with each type of security, including the risk of dilution resulting in limited voting power
- The restrictions on the resale of the securities
- The types of information that an issuer is required to provide in annual reports, the frequency of the delivery of that information, and the possibility that the issuer's obligation to file annual reports may terminate in the future
- The limits on the amounts investors may invest
- The circumstances in which the issuer may cancel an investment commitment
- The limitations on an investor's right to cancel an investment commitment

- The need for the investor to consider whether investing in a security offered and sold in reliance on Section 4(a)(6) is appropriate for him or her
- That following completion of an offering, there may or may not be any ongoing relationship between the issuer and intermediary<sup>26</sup>

Intermediaries must also inform investors that any person who promotes the issuer's offering for compensation must clearly disclose in all communications on the intermediary's platform the compensation that the intermediary is receiving and that the intermediary is, in fact, engaging in promotional activities.<sup>27</sup> Finally, when establishing an account for an investor, the intermediary must clearly disclose the manner in which the intermediary is compensated in connection with the offering of securities on the platform.<sup>28</sup>

### **Transaction Information Requirements**

Intermediaries are required to make available to the SEC and to investors any information which the issuer must provide.<sup>29</sup> The Crowdfunding Rules further require that this information: (i) be publicly available on the intermediary's platform; (ii) be available for a minimum of 21 days before any securities are sold in the offering; and (iii) remain publicly available on the intermediary's platform until the offer and sale of securities is completed or cancelled.<sup>30</sup> Moreover, an intermediary would be prohibited from requiring any person to establish an account with the intermediary in order to access this information.<sup>31</sup>

### **Investor Qualification**

Prior to accepting any investment commitment, an intermediary is required to have a reasonable basis for believing that the investor satisfies the investment limits established by the Crowdfunding Rules.<sup>32</sup> For purposes of this rule, the intermediary would be permitted to rely on an investor's representations concerning annual income, net worth and the amount of the investor's other investments in securities sold in reliance on the Crowdfunding Rules, unless the intermediary has reason to question the reliability of the representation. The intermediary is also required to obtain certain acknowledgments of risk from each investor.<sup>33</sup>

### **Communication Channels**

The Crowdfunding Rules require an intermediary to provide, on its platform, channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary's platform.<sup>34</sup> An intermediary that is a funding portal is prohibited from participating in communications in these channels, because (as noted above) the intermediary is prohibited from offering any investment advice or recommendations.<sup>35</sup>

The Crowdfunding Rules also require that the intermediary: (i) make the communications channels publicly available; (ii) permit only those persons who have opened accounts to post comments; and (iii) require any person posting a comment in the communication channels to disclose whether he or she is a founder or an employee of an issuer engaging in promotional activities on behalf of the issuer, or is otherwise compensated to promote the issuer's offering.<sup>36</sup>

### **Maintenance and Transmission of Funds**

Intermediaries that are registered broker-dealers must comply with established requirements in Exchange Act Rule 15c2-4 for the maintenance and transmission of funds.<sup>37</sup> Because a funding portal cannot receive any funds, it would be required to direct investors to transmit money or other consideration directly to a "qualified third party" that has agreed in writing to hold the funds for the benefit of the

investors and the issuer and to promptly transmit or return the funds to the persons entitled to such funds.<sup>38</sup>

### **Notice of Investment Commitments and Confirmation of Transactions**

Upon receipt of an investment commitment, an intermediary is required to promptly send to the investor a notification disclosing: (i) the dollar amount of the investment commitment; (ii) the price of the securities, if known; (iii) the name of the issuer; and (iv) the date and time by which the investor may cancel the investment commitment.<sup>39</sup> This notification must be provided by e-mail or other electronic media. Then, at or before the completion of a transaction under the Crowdfunding Rules, an intermediary is required to provide each investor a notification that discloses:

- The date of the transaction
- The type of security that the investor purchased
- The identity, price, and number of securities the investor purchased, as well as the number of securities the issuer sold in the transaction and the price(s) at which the securities were sold
- If a debt security, the interest rate and the yield to maturity calculated from the price paid and the maturity date
- If a callable security, the first date that the security can be called by the issuer
- The source, form and amount of any remuneration which the intermediary has received or will receive in connection with the transaction.<sup>40</sup>

### **Completion of Offerings, Cancellations and Reconfirmations**

In general, investors in an offering under the Crowdfunding Rules have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the issuer's offering materials.<sup>41</sup> Thereafter, an investor would not be able to cancel any investment commitments made within the final 48 hours of the offering (except in the circumstances described below). An issuer that reaches its target offering prior to the deadline identified in its offering materials would be permitted to close the offering once the target amount is reached, subject to certain conditions, including that the intermediary provide notice about the new offering deadline at least five business days prior to the new offering deadline.<sup>42</sup>

To the extent that there is a material change to the terms of an offering or to the information the issuer previously provided, the intermediary must notify any investor who has made an investment commitment of the material change and further provide notice that the investor's investment commitment will be cancelled, unless the investor reconfirms his or her investment commitment within five business days of receipt of the notice. If the investor fails to reconfirm his or her investment within those five business days, the intermediary must send a further notice within five business days that the commitment was cancelled and direct the refund of the investor's funds.

Finally, if an issuer does not complete an offering, for example, because the target offering amount was not reached or the issuer decided to terminate the offering, the intermediary is required, within five business days, to: (i) give or send to each investor who had made an investment commitment a notification disclosing the cancellation of the offering, the reason for the cancellation, and the refund amount that the investor should expect to receive; (ii) direct the refund of investor funds; and (iii) prevent

investors from making investment commitments with respect to that offering on the intermediary's platform.<sup>43</sup>

### **Payments to Third Parties**

Under the Crowdfunding Rules, an intermediary may not compensate any person for providing the intermediary with the personally identifiable information of any investor or potential investor in securities offered and sold in reliance on Section 4(a)(6) of the Securities Act.<sup>44</sup> However, intermediaries are permitted to compensate third parties for general business advertising including, for example, web search engine direction or other standard internet marketing techniques so long as that compensation is not based, directly or indirectly, on the purchase or sale of a security offered in reliance on the Crowdfunding Rules.

### **Funding Portal Requirements**

Securities Act Section 4A(a)(1) requires that an intermediary facilitating a transaction made in reliance on Securities Act Section 4(a)(6) register with the Commission as a broker or a funding portal. As noted above, a "funding portal" is any person acting as an intermediary in transactions involving the offer and sale of securities solely pursuant to Securities Act Section 4(a)(6) and the Crowdfunding Rules. Because a funding portal would be engaged in the business of effecting securities transactions for the accounts of others through crowdfunding, the portal would, in fact, fall within the definition of "broker" under the Exchange Act. Nonetheless, the Crowdfunding Rules do not require that funding portals register as broker-dealers provided that they register with the SEC as funding portals, which, as a practical matter, is similar to the process for broker-dealer registration.

### **Registration Process**

The Crowdfunding Rules establish a process under which a funding portal registers with the SEC by filing a form containing information which is similar to the information required of registered broker-dealers on Form BD.<sup>45</sup> The "Form Funding Portal" would include information concerning the funding portal's principal place of business, its legal status and its disciplinary history; business activities, including the types of compensation the funding portal would receive; control affiliates of the funding portal and disclosure of their disciplinary history; and escrow and compensation arrangements.<sup>46</sup> A funding portal's registration will become effective on the later of: (i) 30 calendar days after the date that the SEC receives the registration; or (ii) the date that a national securities association (*i.e.*, FINRA) approves the funding portal for membership.<sup>47</sup>

FINRA has proposed rules (FINRA Crowdfunding Proposal) that would require applicants seeking to register as funding portals to submit a form "FP-NMA."<sup>48</sup> Under the FINRA Crowdfunding Proposal, FINRA would then determine whether to approve an application based upon whether the applicant satisfies all of the following standards:

- The funding portal applicant and its associated persons are capable of complying with applicable federal securities laws, the rules and regulations thereunder, and the FINRA rules.
- The funding portal applicant has established all contractual or other arrangements and business relationships with banks, broker-dealers, clearing corporations, service bureaus, escrow agents, transfer agents, technology service providers, or others necessary to initiate operations as a funding portal.

- The funding portal applicant has a supervisory system that is reasonably designed to achieve compliance with applicable federal securities laws, the rules and regulations thereunder, and the FINRA rules.
- The funding portal applicant has fully disclosed and established through documentation all direct and indirect sources of funding.
- The funding portal applicant has a recordkeeping system that enables the applicant to comply with federal, state and self-regulatory organization recordkeeping requirements.

The SEC has not yet approved the FINRA Crowdfunding Proposal. Accordingly, those intermediaries seeking to offer services as a funding portal will have to wait for approval of these rules before they are permitted to offer services. By contrast, a registered broker-dealer could begin acting as an intermediary in offerings under the Crowdfunding Rules as soon as the rules become effective.

### **Safe Harbor for Certain Activities**

As noted above, given a funding portal's limited function and exemption from the broker-dealer registration requirements, a funding portal is not permitted to engage in the following types of activities: (i) offering investment advice or making recommendations; (ii) soliciting purchases, sales or offers to buy the securities offered or displayed on its platform or portal; (iii) compensating employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform or portal; or (iv) holding, managing, possessing or otherwise handling investor funds or securities.<sup>49</sup>

To provide clarity as to the scope of activities a funding portal may engage in, the Crowdfunding Rules set forth a non-exclusive safe harbor that identifies permissible activities. These activities include, without limitation:

- Highlighting and displaying offerings on the platform
- Advising an issuer about the structure or content of the issuer's offering, including assisting the issuer in preparing offering documentation
- Compensating a third party for referring a person to the funding portal, subject to certain conditions
- Receiving compensation from a registered broker-dealer for services the funding portal provided in connection with the funding portal's offer or sale of securities
- Advertising the existence of the funding portal and identifying one or more issuers or offerings available on the portal<sup>50</sup>

### **Compliance Requirements**

A funding portal is required to implement written policies and procedures reasonably designed to achieve compliance with the federal securities laws and the rules and regulations thereunder relating to its business as a funding portal.<sup>51</sup> Funding portals are also required to comply with the same privacy rules applicable to broker-dealers.<sup>52</sup> Unlike the SEC's initial proposal, however, a funding portal would not be subject to anti-money laundering (AML) requirements or be required to obtain a fidelity bond.

## Liability Risks

Securities Act Section 4A(c) provides, in part, that an issuer will be liable to a purchaser of its securities in a transaction exempted by 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 true. Section 4A(c)(3), in turn, defines, an issuer as including “any person who offers or sells the security in such offering.” A number of market participants commenting on the scope of these provisions requested that the SEC clarify that Section 4A(c) liability does not extend to intermediaries, on the basis that including intermediaries as “issuers” for purposes of these provisions could have a chilling effect on those considering whether to act as intermediaries for transactions under the Crowdfunding Rules.<sup>53</sup> According to commenters, the chilling effect would be particularly true for funding portals given that the activities in which a funding portal may engage in are, by definition, far more limited than the activities in which a registered broker-dealer may engage. However, the SEC declined to make any clarification in the final rules, finding instead that the determination of “issuer” liability for an intermediary under Section 4A(c) will turn on the facts and circumstances of the particular matter in question.<sup>54</sup> As a practical matter, therefore, an intermediary considering whether to offer its services under the Crowdfunding Rules will have to weigh the benefits against potential liability risks under Section 4A(c) and also establish policies and procedures to conduct a review of the issuer’s offering documents before posting them to its platform.

## Miscellaneous Provisions

In addition to the issuer- and intermediary-specific provisions outlined above, the Crowdfunding Rules also:

- Restrict resales of securities purchased under the Crowdfunding Rules for a period of one year, unless such securities are transferred in any of the following ways:
  - To the issuer of the securities
  - To an accredited investor
  - As part of an offering registered with the Commission
  - To a member of the family of the purchaser or the equivalent, to a trust controlled by the purchaser, to a trust created for the benefit of a member of the family of the purchaser or the equivalent, or in connection with the death or divorce of the purchaser or other similar circumstance
- Provide that securities issued pursuant to an offering made under Section 4(a)(6) are exempted from the record holder count under Section 12(g), provided that the issuer is current in its ongoing annual reports required pursuant to the Crowdfunding Rules, has total assets as of the end of its last fiscal year not in excess of US\$25 million, and has engaged the services of a transfer agent registered with the SEC
- Set forth disqualification provisions for issuers and certain associated persons that are substantially similar to the “bad actor” disqualification provisions contained in other parts of the federal securities laws

## Practical Implications of the Crowdfunding Rules

The Crowdfunding Rules represent another avenue, in addition to SEC Regulation A+ and Regulation D, Rule 506(c), under which issuers may raise capital through crowdfunding platforms. Given the existence of the other available exemptions and the costs and limitations (US\$1 million in a 12-month period) involved, whether a significant number of issuers will avail themselves of this exemption remains uncertain. Nonetheless, these three different avenues represent significant new opportunities for issuers, potential intermediaries and investors alike, which portends a bright future for crowdfunding, generally. Potential crowdfunding intermediaries, however, may question the advantages of registering as funding portals given the extensive compliance requirements that would apply, the limited ability to engage in a number of activities that their registered broker-dealer counterparts would be permitted to engage in, and the potential liability risks described above. Accordingly, we expect many to forego funding portal registration for broker-dealer registration.

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## Endnotes

- <sup>1</sup> Crowdfunding, Final Rule, Release Nos. 33-9974; 34-76324; File No. S7-09-13 (Oct. 30, 2015), available at: <http://www.sec.gov/rules/final/2015/33-9974.pdf> [hereafter, the Crowdfunding Release].
- <sup>2</sup> As of the date of this *Client Alert*, the Crowdfunding Rules have not been published in the Federal Register.
- <sup>3</sup> See Crowdfunding Release at pp. 18-19. However, the amount of securities sold in reliance on Section 4(a)(6) by entities controlled by or under common control with the issuer must be aggregated with the amount to be sold by the issuer in the offering to determine the aggregate amount sold in reliance on Section 4(a)(6) during the preceding 12-month period. The Crowdfunding Rules also mandate that the aggregate amount of securities sold in reliance on Section 4(a)(6) include securities sold by any predecessor of the issuer in reliance on Section 4(a)(6) during the preceding 12-month period.
- <sup>4</sup> See *id.* at p. 28.
- <sup>5</sup> See *id.* at p. 152.
- <sup>6</sup> See *id.* at p. 36-41.
- <sup>7</sup> See Crowdfunding Release at p. 29-33.
- <sup>8</sup> See *id.* at p. 42; 17 C.F.R. § 227.201.
- <sup>9</sup> See Crowdfunding Release at p. 44.
- <sup>10</sup> See Crowdfunding Release at p. 100.
- <sup>11</sup> See *id.* at p. 76-77; 17 C.F.R. § 227.201(s).
- <sup>12</sup> See Crowdfunding Release at p. 121-125; 17 C.F.R. § 227.202. However, issuers that have available financial statements that have been reviewed or audited by an independent certified public accountant because the accountants prepare the statements for other purposes must provide the statements and will not be required to have the principal executive officer certification.
- <sup>13</sup> See Crowdfunding Release at p. 141; 17 C.F.R. § 227.204.
- <sup>14</sup> See Crowdfunding Release at p. 145-146; 17 C.F.R. § 227.205.
- <sup>15</sup> See Dissenting Statement at Open Meeting on Crowdfunding and Small Business Capital Formation, Commissioner Michael S. Piwowar (Oct. 30, 2015), available at: <http://www.sec.gov/news/statement/piwowar-regulation-crowdfunding-147-504.html>.
- <sup>16</sup> See Crowdfunding Release at p. 153; 17 C.F.R. § 227.300.
- <sup>17</sup> See *id.*
- <sup>18</sup> See Crowdfunding Release at p. 164; 17 C.F.R. § 227.300(b).
- <sup>19</sup> See *id.*
- <sup>20</sup> See Crowdfunding Release at p. 171; 17 C.F.R. § 227.301(a)-(b).
- <sup>21</sup> See Crowdfunding Release at p. 181; 17 C.F.R. § 227.301(c).
- <sup>22</sup> See *id.*
- <sup>23</sup> See Crowdfunding Release at p. 183.
- <sup>24</sup> See Crowdfunding Release at p. 183; 17 C.F.R. § 227.301(c).
- <sup>25</sup> See Crowdfunding Release at p. 189; 17 C.F.R. § 227.302.
- <sup>26</sup> See Crowdfunding Release at p. 191; 17 C.F.R. § 227.302(b).
- <sup>27</sup> See Crowdfunding Release at p. 200; 17 C.F.R. § 227.302(c).
- <sup>28</sup> See Crowdfunding Release at p. 202; 17 C.F.R. § 227.302(d).
- <sup>29</sup> See Crowdfunding Release at p. 203; 17 C.F.R. § 227.303(a).
- <sup>30</sup> See *id.*
- <sup>31</sup> See *id.*
- <sup>32</sup> See Crowdfunding Release at p. 208; 17 C.F.R. § 227.303(b).
- <sup>33</sup> See *id.*
- <sup>34</sup> See Crowdfunding Release at p. 219; 17 C.F.R. § 227.303(c).
- <sup>35</sup> See *id.*
- <sup>36</sup> See *id.*
- <sup>37</sup> See Crowdfunding Release at p. 227; 17 C.F.R. § 227.303(e).
- <sup>38</sup> See *id.* A qualified third party means a: registered broker or dealer that carries customer or broker or dealer accounts and holds funds or securities for those persons; or bank or credit union (if such credit union is insured by National Credit Union

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Administration) that has agreed in writing either to hold the funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when so directed by the funding portal.

<sup>39</sup> See Crowdfunding Release at p. 225; 17 C.F.R. § 227.303(d).

<sup>40</sup> See Crowdfunding Release at p. 236; 17 C.F.R. § 227.303(f).

<sup>41</sup> See Crowdfunding Release at p. 240; 17 C.F.R. § 227.304.

<sup>42</sup> See *id.*

<sup>43</sup> See Crowdfunding Release at p. 242; 17 C.F.R. § 227.304(d).

<sup>44</sup> See Crowdfunding Release at p. 248; 17 C.F.R. § 227.305.

<sup>45</sup> See Crowdfunding Release at p. 250.

<sup>46</sup> See *id.*

<sup>47</sup> See Crowdfunding Release at p. 251; 17 C.F.R. § 227.400.

<sup>48</sup> See Proposed Rule Change to Adopt the Funding Portal Rules and Related Forms and FINRA Rule 4518, SR-FINRA-2015-040, available at: <http://www.finra.org/industry/rule-filings/sr-finra-2015-040>.

<sup>49</sup> See Crowdfunding Release at p. 277.

<sup>50</sup> See *id.*; 17 C.F.R. § 227.402.

<sup>51</sup> See Crowdfunding Release at p. 311; 17 C.F.R. § 227.403.

<sup>52</sup> See Crowdfunding Release at p. 317.

<sup>53</sup> See Crowdfunding Release at p. 339.

<sup>54</sup> See *id.*