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About the Author:

Thomas E. Geyer is a member of the Firm's Directors & Officers Liability Group. He also practices in the areas of corporate and securities law, and is the former Commissioner of the Ohio Division of Securities.

He can be reached at 614.229.3206, or tgeyer@baileycav.com

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A Summary of the SEC and Ohio Crowdfunding Provisions

*Business today consists in persuading crowds.
– T.S. Eliot*

On May 16, 2016, the U.S. Securities and Exchange Commission's much-anticipated Regulation Crowdfunding took effect. This new set of SEC regulations implements the securities registration exemption for crowdfunding transactions contained in Section 4(a)(6) of the federal Securities Act of 1933. This article provides an overview of the federal provisions and the companion Ohio provision, R.C. 1707.092(C) (which was already in place on May 16, 2016). This article is summary in nature, and is not a substitute for a thorough review of the statutory provisions and regulations.

I. Background

Crowdfunding is a relatively new and evolving method of using the Internet to raise capital to support a wide range of ideas and ventures. An entity or individual raising funds through crowdfunding typically seeks small individual contributions from a large number of people. Individuals interested in the crowdfunding campaign – members of the "crowd" – may share information about the project, cause, idea or business with each other and use the information to decide whether to fund the campaign based on the collective "wisdom of the crowd."

– SEC Release No. 33-9974 (Oct. 30, 2015)

In 2012, Congress recognized the popularity of crowdfunding by including the "CROWDFUND Act" as Title III of the Jumpstart Our Business Startups (JOBS) Act. Title III amended the 1933 Act to add Section 4(a)(6), which generally provides an exemption from federal registration for transactions involving the offer or sale of securities by an issuer if: the aggregate amount sold to all investors by the issuer, during the 12-month period preceding the date of such transaction, is not more than \$1,000,000; the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption during the 12-month period preceding the date of such transaction, does not exceed certain thresholds based on the annual income or net worth of the investor; the transaction is conducted through an SEC-registered broker or funding portal; and the issuer complies with certain disclosure and reporting requirements.

Title III also amended the 1933 Act to add Section 4A, which imposes the disclosure and reporting requirements on the issuer of securities in a crowdfunding transaction; sets forth the requirements for crowdfunding intermediaries; and outlines the civil liability for misstatements and omissions of material facts in crowdfunding offerings.

Regulation Crowdfunding amplifies Sections 4(a)(6) and 4A. Thus, like other federal registration exemptions, e.g. Section 4(a)(2), certain terms of the exemption are set out in the statute, and certain additional terms are set out in SEC regulations.

II. Nature of the Issuer

By statute, the federal crowdfunding exemption is available only to issuers. However, certain issuers are not eligible to use the exemption, including: non-U.S. companies; companies that are reporting companies under the federal Securities Exchange Act of 1934; certain investment companies; companies that are disqualified under Regulation Crowdfunding's disqualification rules; companies that have failed to comply with the annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement; and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

Securities sold by the issuer may take the form of common stock, preferred stock, another form of equity interest in the issuer, or debt. However, securities purchased in a crowdfunding transaction generally cannot be resold for a period of one year. Holders of these securities do not count toward the threshold that requires an issuer to register its securities with the SEC under Section 12(g) of the 1934 Act if: the issuer is current in its annual crowdfunding-related reporting obligation; retains the services of a registered transfer agent; and has less than \$25 million in assets.

III. Nature of the Offering

A. Issuer Filing and Disclosure Obligations

The most valuable commodity I know of is information.
– Gordon Gekko

Section 4A(b)(1) of the 1933 Act specifies the information that an issuer making a crowdfunding offering must file with the SEC, provide to investors and the relevant broker or funding portal, and make available to potential investors. That information includes:

- The name, legal status, physical address and website address of the issuer;
- A description of the ownership and capital structure of the issuer, and the names of each director and officer of the issuer (and any person 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 and business plan of the issuer;
- Risk factors;
- Information about indebtedness, prior exempt offerings and related-party transactions;
- A description of the financial condition of the issuer, which must be certified by the issuer's principal executive officer, reviewed by an independent public accountant, or audited by an independent public account, depending on the size of the offering and whether made a prior 4(a)(6) offering;
- A description of the stated purpose and intended use of the proceeds of the offering;
- 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; and
- Information about the intermediary including compensation arrangements.

This information is to be provided on the Form C: Offering Statement, which was promulgated as a part of Regulation Crowdfunding, and is to be filed with the SEC through the EDGAR system.

B. Issuer Advertising

Section 4A(b)(2) of the 1933 Act prohibits issuers from advertising the terms of a crowdfunding offering, "except for notices which direct investors to the funding portal or broker." According to Regulation Crowdfunding, such a notice may direct investors to the intermediary's platform and include the following information:

- A statement that the issuer is conducting an offering pursuant to Section 4(a)(6), the name of the intermediary through which the offering is being conducted, and a link directing the potential investor to the intermediary’s platform;
- The terms of the offering; and
- Factual information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and website of the issuer, the e-mail address of a representative of the issuer and a brief description of the business of the issuer.

Notwithstanding the prohibition on advertising, an issuer, and persons acting on behalf of the issuer, may communicate with investors and potential investors about the terms of the offering through communication channels provided by the intermediary on the intermediary’s platform, provided that an issuer identifies itself as the issuer in all communications (and persons acting on behalf of the issuer must identify their affiliation with the issuer in all communications). Thus, some level of communication with “the crowd” is permitted.

C. Issuer Reporting

Section 4A(b)(4) of the 1933 Act provides that, not less than annually, a crowdfunding issuer must file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer. As amplified by Regulation Crowdfunding, the annual report must: contain information similar to that required in the offering statement; include disclosure about the issuer’s financial condition; be filed no later than 120 days after the end of the most recently completed fiscal year covered by the report; and be posted to the issuer’s website.

IV. Nature of the Investors

The mob rushes in where individuals fear to tread.
— B.F. Skinner

There are no financial sophistication or financial wherewithal requirements applicable to a crowdfunding investor. However, Section 4(a)(6)(B) of the 1933 Act limits the amount that an issuer may raise from an individual investor. Specifically:

Investor’s Financial Status	Maximum Crowdfunding Investment
Annual Income or Net Worth < \$100,000	Greater of: (a) \$2,000; or (b) 5% of the lesser of the Annual Income or Net Worth
Annual Income and Net Worth ≥ \$100,000	Lesser of: (a) 10% of Annual Income; (b) 10% of Net Worth; or (c) \$100,000

V. Intermediaries

Section 4(a)(6)(C) of the 1933 Act requires a crowdfunding transaction to be conducted through a broker or funding portal that complies with the requirements of Section 4A(a) of the 1933 Act. The term “broker” is generally defined in Section 3(a)(4) of the 1934 Act as any person that effects transactions in securities for the account of others. Section 3(a)(80) of the 1934 Act defines the term “funding portal” as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(a)(6), that does not: (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the SEC, by rule, determines appropriate.

Funding portals must register with the SEC on the new Form Funding Portal, and become a member of a national securities association, *i.e.*, FINRA. However, Regulation Crowdfunding exempts funding portals that meet certain

requirements from registration as a broker-dealer. All funding portals must have policies and procedures reasonably designed to prevent violations of federal securities laws.

Regulation Crowdfunding also requires intermediaries (brokers and funding portals) to, among other things:

- Provide investors with educational materials that explain, among other things, the process for investing on the platform, the types of securities being offered, and the information a company must provide to investors, resale restrictions, and investment limits;
- Take certain measures to reduce the risk of fraud, including having a reasonable basis for believing that a company complies with Regulation Crowdfunding and that the company has established means to keep accurate records of securities holders;
- Make an issuer's required disclosures available to the public on its platform for a minimum of 21 days before any security may be sold in the offering, and throughout the offering period;
- Provide communication channels to permit discussions about offerings on the platform;
- Provide disclosure to investors about the compensation the intermediary receives;
- Refrain from accepting an investment commitment from an investor until after that investor has opened an account with the intermediary; and
- Have a reasonable basis for believing an investor complies with the annual individual investment limitations.

VI. Civil Liability

Section 4A(c) of the 1933 Act provides for civil liability if an issuer relying on Section 4(a)(6) of the 1933 Act 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 in the light of the circumstances under which they were made not misleading, provided that the purchaser did not know of such untruth or omission. An issuer may avoid such liability if it sustains the burden of proof that it did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. Further, an issuer may avoid or limit liability through the "negative causation" defense in Section 12(b) of the 1933 Act. An action against the issuer may be brought by any purchaser in the crowdfunding offering, either at law or in equity, to recover the consideration paid for such security with interest, less the amount of any income received, upon the tender of such security, or for damages if such person no longer owns the security. The cause of action is subject to the one year/three year statute of limitations in Section 13 of the 1933 Act.

VII. Ohio

The JOBS Act amended Section 18(b)(4) of the 1933 Act to include securities offered pursuant to the Section 4(a)(6) exemption in the definition of "covered securities." As a result, Ohio's notice filing provision – R.C. 1707.092(C) – is the Ohio companion provision for a federal crowdfunding offering made pursuant to Section 4(a)(6).

A. Issuer Filing Obligations

The JOBS Act also amended Section 18(c)(2) of the 1933 Act to add a new paragraph (F), which addresses the filing and fee that a state may require in connection with an offering of crowdfunding securities that qualify as covered securities. Specifically, a filing with, and a payment to, the Division is required in connection with federal crowdfunding offering made pursuant to Section 4(a)(6) only if: (1) the issuer has its principal place of business in Ohio; or (2) purchasers of 50% or greater of the aggregate amount of the issue are residents of Ohio.

If a filing with the Division is required, R.C. 1707.092(C) provides that such filing shall consist of: (1) any document filed with the SEC, *i.e.* a copy of the Form C, and a copy of the periodic report required by Section 4A(b)(4) of the 1933 Act (the filing of this periodic report also will satisfy the "annual or periodic reports" requirement in R.C. 1707.092(C)(2)); (2) a consent to service of process; and (3) a filing fee consisting of \$100 plus one-tenth of one percent of the aggregate price

at which the securities are to be sold to the public in Ohio (which calculated fee shall not be less than \$100 nor more than \$1,000).

Consistent with Section 18(a) of the 1933 Act, such filing with the Division shall be in the nature of a notice filing, and no Ohio law, rule, regulation, order, or other administrative action shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer.

B. Intermediaries

The JOBS Act amended Section 15(i) of the 1934 Act to include SEC-registered funding portals within the category of securities professionals subject to limited state regulation. However, pursuant to Section 15(i)(2)(B) of the 1934 Act, an SEC-registered funding portal with its principal place of business in Ohio is subject to Division examination and enforcement of any Ohio law, rule, regulation, or administrative action, provided that such law, rule, regulation, or administrative action is not in addition to or different from the requirements for registered funding portals established by the SEC.

C. Enforcement

Pursuant to Section 18(c)(1) of the 1933 Act, the Division retains jurisdiction under Ohio law to investigate and bring enforcement actions regarding securities or securities transactions in connection with a federal crowdfunding offering made pursuant to Section 4(a)(6) of the 1933 Act, with respect to fraud or deceit, or unlawful conduct by a broker, dealer, funding portal, or issuer.

Pursuant to Section 18(c)(3) of the 1933 Act, the Division may suspend the offer or sale of securities in a crowdfunding offering as a result of the failure to submit any filing or fee required under law and permitted by Section 18 of the 1933 Act.

“Nobody goes there anymore. It’s too crowded.”
— Yogi Berra

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Author’s Note: A similar version of this article appeared in Ohio Securities Bulletin Issue 2016:2.