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## Law Alert

**To:** Firm Clients and Contacts  
**From:** Niesar & Vestal LLP  
**Date:** May 13, 2016  
**Re:** **New Crowdfunding Rules Take Effect May 16, 2016**

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Last October the Securities and Exchange Commission (“SEC”) adopted final rules to allow companies to offer and sell securities through crowdfunding to the general public without registering the transaction with the SEC. These new crowdfunding rules take effect May 16, 2016. These rules appear to be the SEC’s bowing to the mandate of Congress in the Jobs Act that the SEC adopt rules permitting crowdfunding. However, the numerous onerous conditions on the use of the procedure, and the limitations on who may invest and how much, have caused many commentators to question whether and when a business should consider using this approach to funding.

Crowdfunding is a financing method in which money is raised through soliciting relatively small individual investments or contributions from a large number of people. It has been used to raise funds through the internet for a variety of projects. Until now, the only legal form of crowdfunding in the US has involved companies raising funds as charitable contributions or in exchange for a promise to provide goods in the future. The new rules permit companies to raise funds through crowdfunding in exchange for issuing equity or debt securities.

The new crowdfunding rules impose investment limits, limits on the amount an issuer can raise, and disclosure requirements, and create a regulatory framework for the broker-dealers and funding portals that facilitate crowdfunding transactions. Specifically, the following requirements must be met to comply with the new crowdfunding rules:

1. Issuers may raise up to \$1,000,000 in a 12-month period.

2. Investors must be individuals, not entities.

3. Investors with either annual income or net worth that is less than \$100,000 can invest, during any 12-month period, up to the greater of (i) \$2,000 or (ii) 5% of the lesser of annual income or net worth. Annual income and net worth may be calculated jointly with the investor's spouse, however, if a joint calculation is used then the collective investment of investor and investor's spouse cannot exceed the limit that would apply to an individual investor at that joint annual income or net worth level. Net worth does not include the value of the investor's primary residence.

4. Investors with annual income equal to or more than \$100,000 and net worth equal to or more than \$100,000 can invest, during any 12-month period, up to the lesser of (i) \$100,000 or (ii) 10% of the lesser of annual income or net worth. Annual income and net worth may be calculated jointly with the investor's spouse, however, if a joint calculation is used then the collective investment of investor and investor's spouse cannot exceed the limit that would apply to an individual investor at that joint annual income or net worth level. Net worth does not include the value of the investor's primary residence.

5. Crowdfunding offerings must be made via a "crowdfunding intermediary", i.e. a broker-dealer or a funding portal that is registered with the SEC and is a member of the Financial Industry Regulatory Authority. A "funding portal" is a new type of intermediary that performs limited functions in connection with a crowdfunding offering, and may not offer investment advice, make recommendations, or solicit purchases, sales or offers to buy securities offered or displayed on its website. Investors may only invest in a crowdfunding offering through the online platform, such as a website or a mobile app, of a crowdfunding intermediary. Investors need to open an account with the crowdfunding intermediary to make an investment. Crowdfunding intermediaries provide investors with information about the process for investing and the types of securities being offered, and make available to the SEC and potential investors the disclosure required to be provided by issuers at least 21 days prior to any sale. Crowdfunding intermediaries are not permitted to provide access to their platforms to issuers that they have a reasonable basis for believing have the potential for fraud. Crowdfunding intermediaries may rely on investors' representations concerning compliance with investment limits.

6. Issuers must disclose to investors and the crowdfunding intermediary and file with the SEC an offering document containing general company information, information about their business plan, operations, financial condition, officers and directors, the price of the securities offered and method for determining the price, the target offering amount, the deadline to reach the target, whether the issuer will accept investments in excess of the target, related party transactions, risks specific to the company and industry, anticipated use of proceeds, and financial statements covering the two most recently completed fiscal years or the period since the

inception of the business, if shorter. Issuers must also file annual reports containing information similar to the information required in the offering document with the SEC and provide the annual reports to investors. This annual reporting obligation continues until (i) the issuer becomes an SEC reporting company, (ii) the issuer has filed at least one annual report and has fewer than 300 holders of record, (iii) the issuer has filed at least 3 annual reports and has total assets that do not exceed \$10 million, (iv) all of the issuer's shares issued pursuant to the crowdfunding offering are repurchased by the issuer, or (v) the issuer liquidates or dissolves its business.

7. The financial information required to be disclosed by an issuer depends on the amount of money being raised or raised by the issuer in the prior 12 months and whether it is the first time the issuer has done a crowdfunding offering:

- a. \$100,000 or less – unaudited financial statements and specific line items from income tax returns, both certified by the principal executive officer of the issuer
- b. \$100,000.01 to \$500,000 – unaudited financial statements reviewed by an independent public accountant and the accountant's review report
- c. \$500,000.01 to \$1,000,000 for first time crowdfunding issuer– unaudited financial statements reviewed by an independent public account and the accountant's review report
- d. \$500,000.01 to \$1,000,000 for issuer who has previously engaged in a crowdfunding offering – audited financial statements audited by an independent public accountant and the accountant's audit report

8. Securities issued under the crowdfunding rules may not be resold for the first year unless the shares are transferred to the issuer, to an accredited investor, to a family member or family trust, or in connection with death/divorce or a registered offering.

9. An issuer can publish a notice advertising the crowdfunding offering and certain factual information about the issuer, provided that the notice includes the address of the intermediary's platform on which additional information about the issuer and the offering may be found. Other advertising about the offering is not permitted.

10. If an issuer does not raise the full amount of its funding goal, it cannot keep any of the money raised, and it loses its out-of-pocket up-front costs. Therefore setting a realistic goal is critical to the success of a crowdfunding offering.

Advantages of the new crowdfunding rules are that anyone can invest (not just rich accredited investors), companies can raise up to \$1,000,000, companies can engage in some advertising of the offering, investors can share in the company's profits, and there is no upfront audit required for first time issuers.

Disadvantages of the new crowdfunding rules are that entities (like corporations and limited liability companies) and funds (like venture capital funds and angel funds) cannot invest

in crowdfunding offerings, there are burdensome compliance and disclosure requirements, there are initial legal, filing and crowdfunding intermediary fees, and ongoing annual reporting requirements that require time and money, and a crowdfunding offering may result in a long list of shareholders which might discourage venture capital firms from future investments in the issuer. Thus an early-stage company primarily financed through crowdfunding may not have the benefit of professional early-stage investors such as angel investors and venture capital firms.

Companies should consider carefully the costs of complying with the very detailed and extensive requirements of raising any significant funds using this procedure. Additionally, they should consider the annual costs of having possibly hundreds of investors who may have purchased as little as \$2,000 of the issuer's securities. Consider that each \$100,000 raised, if subscribed at \$2,000 per investor, represents 50 people. Each investor will be required to be invited to an annual meeting, receiving notice thereof and a description of what is to be transacted at the meeting. Many state laws require that each shareholder also receive an annual report consisting of at the least a complete financial statement. Many smaller investors may pester the company with requests for information and updates, whether they have the right to them or not. Worse yet, Aunt Tilly might think it a dandy Christmas gift to give each of her ten nieces and nephews a few of her shares in the company. And there are always the concerns about what the SEC intends to do with the information submitted to it. In any case, no business should launch into this sort of crowdfunding without first seeking advice from counsel experienced with early stage funding.

This article is intended to provide a general summary and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. To learn more about any matter discussed in this law alert, please contact any Niesar & Vestal attorney.

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