

Crowdfunding Under the JOBS Act

June 15, 2012

On April 5, 2012, the Jumpstart Our Business Startups Act of 2012 (the “JOBS Act”) was enacted into law. The intent of the JOBS Act is to enhance access to private and public capital, by:

- enhancing the ability of companies to raise funds through transactions that are exempt from registration under the Securities Act of 1933 (the “Securities Act”);
- raising the thresholds that require privately held companies to register their securities under the Securities Exchange Act of 1934 (the “Exchange Act”) and become subject to the periodic disclosure requirements and other obligations thereunder applicable to public companies; and
- making it easier for emerging growth companies to pursue an initial public offering (“IPO”) under the Securities Act and become a reporting company under the Exchange Act by easing the regulatory burdens associated with IPOs and phasing-in the obligations of being a public company.

One section of the JOBS Act that has drawn particular attention and focus from the media and the general public are the provisions that require the Securities and Exchange Commission (the “SEC”) to promulgate rules that will permit privately-held companies (including startups and entrepreneurs) to engage in “crowdfunding” offerings of up to \$1 million per year to various investors that will be exempt from registration under the Securities Act. **Crowdfunding Offerings** Essentially, crowdfunding is a capital raising activity whereby a company solicits the investment of small amounts of money from a large number of investors, primarily through the use of the Internet. Prior to the JOBS Act, however, crowdfunding had only limited usefulness for facilitating investments in smaller companies because such offerings do not fit clearly into any of the pre-JOBS Act private placement exemptions under the Securities Act or under applicable state securities or blue sky laws. The Securities Act generally prohibits companies from offering or selling securities unless the offering has been registered with the SEC or qualifies for one of a limited number of exemptions from registration. The registration process is very expensive and time-consuming, to the point that a registered securities offering is almost never a realistic financing option for a typical start-up

company trying to raise small amounts of money from numerous investors. In addition, even for companies with the resources to complete the registration process, by making a registered offering these companies become subject to the reporting requirements of the Exchange Act, which makes the process even more unattractive by adding another layer of complexity. Although scaled-back disclosures are available for smaller reporting companies and the JOBS Act has reduced the disclosure burdens for IPOs by emerging growth companies, these relaxed registration provisions are not aimed at, and do not necessarily, fit a company desiring to raise small amounts of capital through crowdfunding. While the pre-JOBS Act private placement exemptions from Securities Act registration may provide useful means for raising capital, the investor sophistication and wealth requirements and prohibition on general solicitations in many of these exemptions make it practically impossible for these businesses to use the Internet and social media to find investors as well as to approach small investors and investors outside their circle of contacts. Many private placements are also subject to the state securities or “blue sky” laws that serve to add further expense to the process. While the JOBS Act makes it easier to conduct private placements to accredited investors through general solicitations, a company wishing to raise funds through crowdfunding would likely need access to non-accredited investors in order to accomplish its capital needs. In order to facilitate the ability of privately-held companies to access capital through crowdfunding, the JOBS Act added a new Section 4(6) to the Securities Act that specifically exempts crowdfunding transactions from registration under the Securities Act so long as such transactions comply with certain requirements (the “Crowdfunding Exemption”). Set forth below is a description of the requirements to be satisfied as a condition to reliance on the Crowdfunding Exemption.

Company Qualification Standards Under the JOBS Act, the only companies eligible to rely on, and to avail themselves of, the Crowdfunding Exemption are those companies that: (a) are domestic entities, (b) are not subject to the reporting requirement of the Exchange Act, and (c) are not investment companies. Such company also must not be considered a “bad actor” under a definition to be determined by the SEC, which is to be based in part on the disqualification provisions of current Regulation A.

Aggregate Offering Limits The total amount of securities an issuer may sell to all investors, including any amount sold in reliance on the Crowdfunding Exemption, during the 12-month period preceding the date of the transaction shall not exceed \$1 million.

Annual Investor Caps The JOBS Act also limits the total amount of securities an issuer may sell to any individual investor who purchases securities in a crowdfunding transaction in a given 12-month period. The amount of such limitation is based on the individual investor’s annual income or net worth, as follows: (i) if the investor’s annual income or net worth is less than \$100,000, the cap is the greater of \$2,000 or 5% of annual income or net worth or (ii) if the investor’s annual income or net worth is greater than \$100,000, the cap is 10% of annual income or net worth, up to a maximum of \$100,000.

Required Use of Intermediaries Crowdfunding transactions must be conducted through a broker or a “funding portal” that has registered with the SEC and any applicable self-regulatory organization. A “funding portal” is defined under the JOBS Act to be a person acting as an intermediary involving the offer and sale of securities through the Crowdfunding Exemption; provided that such person does not: (a) offer investment advice or recommendations; (b) solicit purchases, sales, or offers to buy securities

offered or displayed on its website or portal; (c) compensate employees or other persons for such solicitation based on the sale of securities displayed or referenced on its website or portal; (d) hold, manage, possess or otherwise handle investor funds or securities or (e) engage in other activities prohibited by SEC rules. The officers, directors, and partners of an intermediary may not have a financial interest in the company using its services for a crowdfunding offering. **Regulation of**

Intermediaries Intermediaries will be responsible for:

- educating and screening potential investors;
- taking appropriate action to reduce the risk of fraudulent transactions (including checking the background of the issuer and its insiders);
- providing any required disclosure to the SEC;
- ensuring that the issuer does not receive any investors' money until the target offering amount has been raised; and
- taking steps to ensure that investors do not purchase more than their annual limit of securities of the issuer.
- In addition, intermediaries will also have restrictions on their abilities to use finders and similar persons and on certain of their financial relationships with issuers.

Disclosure Obligations of Companies Companies that intend to engage in a crowdfunding offering under the JOBS Act also must furnish the following information to the SEC and to potential investors (which the intermediary must furnish to such investors at least 21 days prior to the first sale of shares pursuant to the crowdfunding offering):

- the names of the issuer's directors, officers, and each person holding more than 20% of its shares;
- the issuer's business plan;
- certain financial information of the issuer, depending on the size of the offering;

For offerings of less than \$100,000, issuers must provide income tax returns and financial statements certified by the issuer's principal executive officer.

For offerings of more than \$100,000 but less than \$500,000, issuers must provide financial statements reviewed by an independent public accountant.

For offerings of more than \$500,000, issuers must provide audited financial statements;

- how the proceeds will be used;

- the amount of the target offering, the deadline to reach the target amount, and regular updates regarding the progress of the company in reaching the targeted amount; and

If the issuer does not reach this target, investors will be permitted to rescind their commitments.

- information about the offered securities and the issuer's other securities, including how the shares were valued, and about the risks to crowdfunding investors relative to the issuer's other investors.

In addition, the JOBS Act requires that the SEC adopt rules that require the issuer to provide ongoing financial disclosure on at least an annual basis. **Other Obligations and Limitations Imposed on**

Companies In addition to the disclosure obligations to be satisfied in connection with a crowdfunding offering, companies relying on the Crowdfunding Exemption:

- may not advertise the terms of its offering, except through an intermediary;
- may not compensate any person to promote its offering through communications provided by an intermediary (unless the person discloses the receipt of such compensation each time it makes a promotional communication in accordance with rules to be established by the SEC);
- must provide at least annually to the SEC and its investors reports of results of operations and financial statements of the company; and
- must satisfy any other requirements imposed by the SEC.

Although issuers are generally prohibited from advertising the terms of a crowdfunding transaction, they will be permitted to use advertisements that direct potential investors to the broker or funding portal intermediary. Since such advertisements will permit the issuer to direct the public to generally accessible intermediary websites that describe the transaction, issuers in crowdfunding transactions will have much greater leeway to offer and sell securities to strangers than they previously have had in traditional private placements, as these prohibit general solicitations of investors. **Potential Liability of Issuers under the Crowdfunding Exemption** Companies selling securities in a crowdfunding offering will be subject to civil liability under Section 12(a)(2) of the Securities Act (the provisions that provides for prospectus liability for public offerings). As a result, a purchaser could bring an action against an issuer for misstatements or omissions made orally or in written materials in the course of the offer and sale of such securities. **Exchange Act Considerations** Prior to the enactment of the JOBS Act, Section 12(g) of the Exchange Act and the rules promulgated thereunder generally required companies with \$10 million in assets and a class of equity securities held of record by 500 or more persons at the end of their fiscal year to register their equity securities under the Exchange Act and to become subject to the reporting requirements of the Exchange Act (unless such securities were already so registered under the Exchange Act. This created significant concerns for privately-held companies that were seeking to raise equity financing, but were not yet ready to undertake the substantial and expensive reporting and

corporate governance requirements of the Exchange Act. Certainly, such requirements could have a negative impact on relatively small offerings to numerous investors (such as under current Regulation A, serial exempt private placement offerings, and potentially, crowdfunding offerings). However, as part of the JOBS Act, the holders of record thresholds for requiring Exchange Act registration were increased to 2,000 persons, provided that no more than 499 persons are non-accredited investors. In addition and perhaps even more important, the JOBS Act provides specific additional relief under the Exchange Act registration requirements for shares issued pursuant to the Crowdfunding Exemption. Such shares are not included in the calculation of the holders of record. The crowdfunding exemption from the calculation of holders of record applies to the securities sold in such transactions, not the purchasers or holders of such securities. As a result, companies engaging in crowdfunding offerings may need to establish a mechanism to track such securities prior to any subsequent Exchange Act registration (i.e., special legends). For a more detailed discussion of the amendments made to the Exchange Act registration requirements by the JOBS Act, please see our firm's bulletin "[*JOBS Act Eases Requirements for Triggering SEC's Exchange Act Registration.*](#)"

Restrictions on Resales Shares that are sold pursuant to the Crowdfunding Exemption may not be resold by the investor until one year after the purchase of the shares, unless such shares are: (a) subsequently registered under the Securities Act; (b) transferred back to the issuing company; (c) transferred to an accredited investor or family member of the investor or (d) transferred in connection with the investor's death or divorce. Further, the SEC may impose additional restrictions by rule.

State Preemption Offerings under the Crowdfunding Exemption will not be subject to registration under the laws of any state or regulation relating to securities offerings or documentation requirements. States do retain the authority to take enforcement actions against companies, funding portals, and other persons or entities for fraudulent conduct in connection with a crowdfunding offering.

Potential Implications The Crowdfunding Exemption could prove helpful to small and emerging businesses looking for access to additional sources of funding. The potential impact of these changes include, among other things:

- Crowdfunding has the potential to be a very attractive fundraising vehicle for start-ups and other small companies because it provides them a new relatively inexpensive means, after considering the post-offering requirements, to find investors outside of the traditional angel investors or multiple friends and family rounds. Crowdfunding transactions provide companies with the ability to attract investment from ordinary, "retail" investors who ordinarily cannot be meaningfully included in traditional private placements.
- Companies selling securities pursuant to a crowdfunding offering may find themselves with a large base of unsophisticated investors, which may require them to expend more time and resources in their shareholder communications and investor relations than might otherwise be the case (e.g., may require additional solicitation efforts when seeking shareholder action, and more regular reporting of financial and business results).

- Companies will be required to comply with both offering and post-offering disclosure requirements that might not be required by companies raising private equity capital by other means (including the ongoing annual financial disclosure that will be required). However, it is not clear that this will add much cost to the disclosure process used in connection with other exempt offerings.
- However, companies engaging in a crowdfunding offering pursuant to the Crowdfunding Exemption will be required to hire intermediaries to conduct the transaction. This will increase the costs of the offering and currently it is difficult to predict what those costs might be.
- It may be more difficult for companies that have engaged in a crowdfunding offering to attract later round financing or to engage in a merger or acquisition transaction due to likely requirement that shareholder approval be obtained. Further, most venture capital and private equity firms, as well as most institutional investors, are reluctant to invest in an entity with a large base of unsophisticated investors. In any event, any such transaction will require substantial shareholder communication and will likely be more expensive to undertake.

In spite of its limitations and obligations, the Crowdfunding Exemption will still give many companies access to investors that they would not have been able to reach through traditional private placements prior to the passing of the JOBS Act. Companies willing to comply with the JOBS Act's significant disclosure and other requirements will be able to use crowdfunding to find investors previously unavailable to them. **Effective Date** The SEC is required to adopt rules implementing the Crowdfunding Exemption within 270 days of the enactment of the JOBS Act (December 31, 2012). As a result, it is important to note that the issuers will not be allowed to use the Crowdfunding Exemption until the SEC adopts implementing rules providing greater detail required by the JOBS Act.

Authored By



Richard A. Denmon



Carlos A. Mas



Madelyn Spatt Shulman

Related Practices

[Business Transactions](#)

[Securities Litigation and Enforcement](#)

[Securities Transactions and Compliance](#)

©2024 Carlton Fields, P.A. Carlton Fields practices law in California through Carlton Fields, LLP. Carlton Fields publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information and educational purposes only, and should not be relied on as if it were advice about a particular fact situation. The distribution of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship with Carlton Fields. This publication may not be quoted or referred to in any other publication or proceeding without the prior written consent of the firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our Contact Us form via the link below. The views set forth herein are the personal views of the author and do not necessarily reflect those of the firm. This site may contain hypertext links to information created and maintained by other entities. Carlton Fields does not control or guarantee the accuracy or completeness of this outside information, nor is the inclusion of a link to be intended as an endorsement of those outside sites.