

SEC Finally Issues Proposed Rules on Crowdfunding

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This week, after several rulemaking delays, the **U.S. Securities and Exchange Commission (SEC)** unanimously approved proposed rules on crowdfunding – which the SEC describes as an evolving method of raising money through the internet. Crowdfunding originally began outside the investment arena as a way for people to give money to inventors and artists in need of capital, often in exchange for something of value such as a t-shirt, the product sample or something similar. However, Title III of the Jumpstart of **Business Startups Act (JOBS Act)**, which was signed into law by President Obama on April 5, 2012, created an exemption under the securities laws so that startups and small businesses would have the option to raise capital and offer and sell securities over the internet. The JOBS Act, in part, is intended to ease restrictions on a company's ability to raise capital across a broad range of stages including startup seed financing, private placements and initial public offerings (IPOs).

Securities-based crowdfunding allows startups and small businesses to raise capital by pooling small investments from multiple people around the country. Specifically, this type of crowdfunding seeks to alleviate the funding gap and accompanying regulatory concerns faced by startups and small businesses looking to raise capital in relatively low dollar amounts. The SEC has had to balance easing access to capital with its mission to protect investors and require adequate disclosure about a company's operations. Therefore, although the JOBS Act seeks to make it easier for companies to raise capital, the proposed rules provide for certain restrictions and disclosures – which may actually result in significant costs for companies choosing to raise capital through crowdfunding.

To qualify for the proposed exemption, crowdfunding transactions must meet specified requirements. Not all companies will be eligible to crowdfund. Ineligible companies include: foreign companies, SEC reporting companies, certain investment companies, companies that have failed to comply with the proposed rules, and companies without a specific business plan, or companies that have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies.

The proposed rules also restrict the amount of capital a company can raise and permit individuals to invest subject to certain thresholds. Under the proposed rules:

- Companies will be allowed to raise a maximum aggregate amount of \$1 million in a 12-month

period through crowdfunding offerings. Capital raised by other means would not be counted towards the limitation. However, the amount of securities sold through crowdfunding by entities controlled by or under common control with the issuer would have to be aggregated with the amount sold by the issuer in the current offering.

- If investors' annual income and net worth are less than \$100,000, then, over a 12-month period, they are permitted to invest up to \$2,000 or 5 percent of their annual income or net worth – whichever is greater.
- If investors' annual income or net worth is equal to or more than \$100,000, then, over a 12-month period, they are permitted to invest up to 10 percent of their annual income or net worth – whichever is greater.

Such investors purchasing securities pursuant to a crowdfunding transaction will be restricted from reselling such securities for a period of one year. Also, for the benefit of companies, holders of securities acquired in a crowdfunding transaction would not count against the shareholder threshold that requires companies to register with the SEC under Section 12(g) of the Securities Exchange Act of 1934.

The proposed rules recommend that crowdfunding be conducted through SEC-registered intermediaries. These intermediaries are either broker-dealers or funding portals that will operate online platforms and be the exclusive facilitator of security-based crowdfunding. However, these intermediaries must first register with the SEC. These platforms will also be required to provide numerous protections and services to investors, including:

- Educational materials;
- Any available information about the issuer and the offering;
- Communication channels to permit discussions about offerings on the platform; and
- The facilitation of the offer and sale of securities.

Intermediaries will also be required to implement measures to reduce the risk of fraud – which is a significant concern of the SEC. No funding portal may offer investment advice, solicit the purchase, sale or an offer to buy securities offered or displayed on its website, and hold, possess, or handle investor funds or securities.

However, the SEC also creates a safe harbor for certain funding portal activities. Funding portals will be allowed to:

- Limit offerings made on the platform based on eligibility requirements;
- Highlight and display offerings on the platform;
- Provide search functions on the platform;
- Advise issuers on the structure or content of offerings;

- Compensate others for referring individuals to the funding portals and for other services; and
- Advertise the funding portal's existence.

Along with the restrictions imposed on intermediaries, the SEC will require companies conducting crowdfunding offerings to make certain disclosures, which will undoubtedly translate into costs for the issuer. The crowdfunding exemption requires issuers to file (i) a disclosure statement with the SEC 21 days prior to the first sale on new Form C, and (ii) certain scaled financial disclosures, including audited financials for offerings in excess of \$500,000. Companies must include in their offering documents, among other things:

- Information about officers and directors as well as owners of 20 percent or more of the company;
- A description of the business and how the proceeds will be used;
- The price of the securities being offered, the target offering amount, the deadline to reach the target offering amount, and whether investments in excess of the target amount will be accepted;
- Certain related-party transactions;
- A description of the financial condition of the company; and
- Financial statements of the company.

Depending on the amount offered and sold during a 12 month period, the financial statements may need to be accompanied by a copy of the company's tax returns or reviewed or audited by an independent public accountant or auditor.

Additionally, the company must amend its offering materials if material changes in the offering occur. It should also be noted that all offering documents must be provided to the intermediary facilitating the offering and to potential investors. Moreover, companies who rely on the crowdfunding exception will be required, under the proposed rules, to file an annual report with the SEC and provide such report to its investors.

The SEC will seek public comment on the proposed rules for a 90-day period after publication in the Federal Register. When that period ends, the SEC will review the comments and determine whether to adopt the proposed rules in current form or make changes. Final rules could be adopted during the second quarter of 2014.

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