

# It's Official: SEC Publishes Final Rules for Investment Crowdfunding

Article By:

Michael G. Wooldridge

Harvey Koning

Kimberly A. Baber

Seth W. Ashby

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Crowdfunding started as a way for music fans to get together and fund a tour for their favorite band, and quickly spread as a way to support an innovative business, develop an interesting project, or support a particularly worthy cause. Generally, crowdfunding is the soliciting of relatively small contributions from many people (the crowd), usually through an online portal specifically set up to sell the business or product and to facilitate payment. While the opportunity to invest in a start-up via crowdfunding may be exciting to certain investors and entrepreneurs, since the enactment of the ***Jumpstart Our Business Startup Act of 2012 (the "JOBS Act")***, which created the foundation for investment crowdfunding at the federal level, the ***Securities and Exchange Commission ("SEC")*** has been working to develop a set of regulations that will balance the benefits of crowdfunding with appropriate investor protection.

On October 30, 2015, the SEC adopted final rules regarding the solicitation of company equity through crowdfunding. These new rules will permit companies for the first time, at the federal level, to offer and sell securities through these online portals, allowing businesses to raise money from a very broad and very diverse group of people. In a crowdfunding offering, companies raising capital will not be subject to the restriction on "general solicitation" or the "accredited investor" requirements. This means that companies interested in raising capital via crowdfunding across state lines may publish that fact to the general public, and will be able to accept investments from almost anyone, subject to certain conditions.

Below is a brief summary of the SEC's final rules ("Regulation Crowdfunding"):

- **Investment Limits.** Over any 12-month period, eligible companies may raise a maximum of \$1 million through crowdfunding offerings, while individuals may invest between \$2,000 and 10% of the lesser of annual income or net worth if both annual income and net worth are over \$100,000, with a formula to determine the exact amount. During any 12-month period, an

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investor will not be allowed to invest more than \$100,000 between all crowdfunding transactions. These limits are designed to reduce the risk to investors, but they also reduce the value of a crowdfunding offering for companies. However, a company engaged in a crowdfunding offering is still permitted to concurrently engage in another exempt offering as long as each offering complies with the requirements of each specific exemption. For example, a company may engage in both a crowdfunding offering under Regulation Crowdfunding and an "accredited investor only" offering under Regulation D (Rule 506), as long as both offerings satisfy their respective requirements. Certain companies are disqualified from participating in crowdfunding offerings.

- **Holding Period.** Generally, securities purchased through a crowdfunding transaction must be held by the investor for at least one year, but the holders of crowdfunded securities will not count toward the threshold for registration as a public security under Exchange Act Section 12(g) if the company is current in its annual reporting and has assets of less than \$25 million as of the end of the most recent fiscal year. This is similar to other types of exempt offerings, where the idea is to purchase the securities for investment and not resale.
- **Crowdfunding Platforms.** The new rules require crowdfunding offerings to be handled through an SEC-registered intermediary, and such offerings must be conducted online (i.e., accessible by the "crowd"). The intermediary can be a registered broker-dealer or a "funding portal." A funding portal will be required to register with the SEC as well as become a member of FINRA, the Financial Industry Regulatory Authority. The internet requirement was added to guarantee the "crowd" has access, but also to ensure a forum to handle disclosure and facilitate an exchange of information on the offering. Funding portals will have a responsibility to be as transparent as possible. They must provide investors with education materials about the portal itself, and the requirements of companies that make offerings on the portal. They must take measures to reduce the risks of fraud, including, if necessary, prohibiting companies that they believe will carry a high risk of fraud from making offerings. They must disclose their compensation and relationship to the offering. In sum, significant obligations are placed on intermediaries that facilitate any crowdfunding offering.
- **Goals and Early Closing.** Each company will be required to disclose a target or maximum amount sought to be raised via Regulation Crowdfunding. Importantly, investors may withdrawal their money up to 48 hours before the funding deadline. If the target is reached before the deadline, the intermediary must notify investors, and the company must provide 5 days' advance notice, before closing the offering early. If the goal is not met within the allotted time, no securities will be sold and all investors will receive their funds back.
- **Disclosure Requirements.** Each company offering securities through Regulation Crowdfunding will be required to submit detailed information with the SEC, as well as provide the information to the funding portal and investors. For example, the offering price or method of determining the offering price, the use of funds, the target offering amount, the deadline for reaching the target, whether investment in excess of the target will be accepted, the company's financial information and condition, a description of the business and the proceeds, information on officers, directors, and significant investors, and related party transactions, must all be disclosed. Disclosure requirements depend on the size and sophistication of the company (e.g., audited financials are required in some cases). Although general solicitation will be allowed, the information communicated to potential investors must be provided through the funding portal. That is, except for basic information about the existence of the offering (similar to "tombstone" ads permitted under Securities Act Rule 134),

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companies must simply direct potential investors to the funding portal.

- **Continuing Disclosure.** Companies must make progress update filings throughout the process of a Regulation Crowdfunding offer that inform existing investors about any material changes or funding milestones. Each company that completes a crowdfunding offering must file an annual report along with financial statements certified by its principal executive officer shortly after the end of the fiscal year. Unlike traditional offerings exempt from registration with the SEC, Regulation Crowdfunding subjects companies to continuing (and significant) disclosure of financial and other information to investors and regulators alike.

Regulation Crowdfunding will become effective 180 days after the final rules are published in the Federal Register. However, funding portals that would like to get ahead of the curve will be able to access the forms required to register with the SEC on January 29, 2016. Contact your Varnum Attorney for more information on these matters or securities offerings generally.

*This article was co-authored by Mark Van Wieren.*

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