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The State of Crowdfunding Regulation in the United States

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In the United States, crowdfunding has evolved over the last five years to refer to several different funding approaches:

- Donation-based funding that is not a securities offering.
- Securities offered via an internet platform, structured in a manner to comply with the customary private placement exemption criteria under Regulation D of the United States (US) Securities Act of 1933 (the 'Securities Act'), for offerings to 'accredited investors' (being certain specified institutional investors, and natural persons who meet net income or net worth tests²) – this type of sale is sometimes referred to as 'accredited investor crowdfunding' but it is not crowdfunding in the true sense of the concept.
- Securities offered to anyone, including retail investors, pursuant to the criteria provided in the safe harbour rule 'Regulation Crowdfunding'.³

This is a broad topic and this article will focus only on retail crowdfunding pursuant to Regulation Crowdfunding.

Key elements of Regulation Crowdfunding

The key elements of Regulation Crowdfunding are as follows:

1. *Amount of offering.* Up to US\$1m in a 12-month period through crowdfunding.
2. *By?* Issuers that are US entities (domiciled in the US), that are not reporting companies under the Securities Act, not funds and not subject to disqualification (not 'bad actors', a prior Regulation Crowdfunding issuer that has failed to provide ongoing disclosure or a development company with no business plan).

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² The definition of 'accredited investor' is outlined in rule 501(a) of Regulation D under the Securities Act. The definition includes certain entities that are in the business of making investments (such as a bank, insurance company, registered investment company, business development company or small business investment company, pension plans, charitable organisations) and a natural person who meets one of the following tests: (1) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds US\$1m at the time of the purchase excluding the value of the person's primary residence; or (2) a natural person with income exceeding US\$200,000 in each of the two most recent years of joint income with a spouse with income exceeding US\$300,000 for those years and a reasonable expectation of the same income level in the current year.

³ 17 CFR Parts 200, 227, 232, 239, 240, 249, 269 and 274.



3. *Who can invest?* Accredited investors and non-accredited investors.
4. *Is there a dollar cap on the amount investors may invest?* Yes. An investor is subject to an investment limit on amounts invested in any 12-month period through crowdfunding equal to:
 - the greater of: US\$2,000 or five per cent of the lesser of the investor's annual income or net worth if either annual income or net worth is less than US\$100,000; or
 - ten per cent of the lesser of the investor's annual income or net worth, not to exceed an amount sold of US\$100,000, if both annual income and net worth are US\$100,000 or more.
5. *Is the type of security limited?* No. Debt and equity securities are allowed.
6. *Is an intermediary required?* Yes. A registered broker-dealer or a registered funding portal must be used, and the issuer can use only one intermediary for an offering.

The issuer and the offering

Issuer eligibility criteria

Issuers must be US entities that are not reporting companies under the Securities Act, not funds and not subject to disqualification (not 'bad actors', a prior Regulation Crowdfunding issuer that has failed to provide ongoing disclosure and not a development company without a business plan). A foreign private issuer must use a US operating entity.

Offering disclosure requirements

Regulation Crowdfunding includes specific disclosure obligations. The initial disclosure about the issuer and the offering is filed with the Securities and Exchange Commission (SEC), including a discussion of the following matters:

- use of proceeds;
- targeted offering size;
- offering price;
- description of the business;
- identity of directors and officers;
- beneficial ownership and capital structure, identifying owners of 20 per cent or more of the equity;
- indebtedness;
- related party transactions of a certain size;
- description of all exempt offerings in the prior three years;
- risk factors;
- transfer restrictions;
- management's discussion and analysis; and
- information about the intermediary/portal.



Financial statement requirements

The issuer's financial statements must be prepared in accordance with US Generally Accepted Accounting Principles (GAAP). Depending on the amount of money being raised as described below, financial statements may need to be audited in accordance with either American Institute of CPAs (AICPA) standards or Public Company Accounting Oversight Board (PCAOB) standards:

- *US\$100,000 or less.* If financial statements of the issuer are available that have either been reviewed or audited by a public accountant independent of the issuer, then these financial statements must be provided. If not, the issuer must disclose the amount of total income, taxable income and total tax or equivalent line items, as reported on the federal tax forms filed by the issuer for the most recently completed year (if any), certified by the principal executive officer of the issuer, and the financial statements of the issuer, also certified by the principal executive officer.
- *More than US\$100,000 but less than US\$500,000.* If financial statements have been audited by a public accountant independent of the issuer, the issuer must provide the audited statements. If not, it must provide financial statements reviewed by a public accountant independent of the issuer.
- *More than US\$500,000.* If audited financial statements are available, they must be provided. If not, the issuer must provide financial statements of the issuer audited by a public accountant independent of the issuer; provided, however, that for issuers that are first-time issuers, offerings that have a target offering amount of more than US\$500,000 but not more than US\$1m, the financial statements of the issuer must be reviewed by a public accountant independent of the issuer.

Rights of investors to cancel

Investors have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline set in the issuer's offering materials. This deadline can be shortened if an issuer reaches the target offering amount prior to the deadline identified in its offering materials, it closes the offering and sets a new deadline as long as the offering had been open for a minimum of 21 days. Investors have the opportunity to reconsider the investment and cancel their commitment up to 48 hours prior to a new deadline.

The intermediary must send investors information about a material change to the terms of the offering or the issuer's information, with notice that the commitment will be automatically cancelled if not reconfirmed within five business days of receipt of the notice, followed up by a refund if reconfirmation is not received.

Advertising, post-offering reporting

An issuer's ability to advertise or promote the offering is limited to certain offering notices (basic offering details) and certain communications with potential investors made exclusively through the platform, which has many responsibilities to the investor as described below.

Transfer restrictions

Securities will be freely tradable *after one year* from the date of purchase. During the first year resales are restricted to the issuer, an accredited investor, a sale as part of a registered offering or to a transfer to a family member or in connection with certain life events such as death or divorce.



There are no venture exchanges or other secondary sales marketplaces in the US.

Intermediary platform/portal regulation

Eligibility requirements

A 'platform' is defined as 'a program or application accessible via the Internet or other similar electronic communication medium through which a **registered broker** or a **registered funding portal** acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6) of the Securities Act'.

Directors, officers or partners of the intermediary may not have a financial interest in the issuer.

An intermediary may have a financial interest in an issuer on the platform if it receives the financial interest from the issuer as offering compensation; and the financial interest consists of securities of the same class and having the same terms as those sold in the offering.

Although non-US issuers may not rely on Regulation Crowdfunding, non-US crowdfunding platforms may operate a platform in the United States, subject to additional requirements:

- An information-sharing arrangement is in place between the SEC and the competent regulator in the jurisdiction under the laws of which the non-resident funding portal is organised or where it has its principal place of business.
- It designates an agent for service of process in the United States, and provides an opinion of counsel addressing the ability of the applicant to provide the SEC and the national securities association of which it is a member with prompt access to its books and records and to submit to onsite inspection and examination by the SEC and the national securities association.
- It consents that service of any civil action brought by, or notice of any proceeding before, the SEC or any national securities association of which it is a member, in connection its investment-related business, may be served to its main address or mailing address indicated on the form.

Intermediary responsibility to reduce the risk of fraud

Intermediaries must undertake to do the following:

- An intermediary must have a reasonable basis for believing that the issuer is in compliance with relevant regulations and has established means to keep accurate records of holders of the securities it offers. *An intermediary may reasonably rely on the issuer's representations*, in the absence of knowledge or other information that would suggest that the representations are not true.
- An intermediary must deny access to an issuer if it has a reasonable belief that the issuer or its offering would present a potential for fraud, or that the issuer or any of the issuer's officers or directors is disqualified as a 'bad actor'.
- Background check requirement – an intermediary must conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered by the intermediary, as well as on each of its officers, directors (or any person occupying a similar status or performing a similar function) and 20 per cent beneficial owners.



Intermediary account and information delivery requirements

An investor must create an account with the intermediary, and agree to electronic delivery of materials. The intermediary must deliver the offering statement and educational materials to investors and explain the following:

- the process for the offering;
- the types of securities sold through the platform and the associated risks;
- the restrictions on resale;
- the investment limitations;
- the limitations on an investor's right to cancel an investment commitment and the circumstances under which an issuer may cancel the commitment;
- the need to consider the appropriateness for the investor of an investment in a crowdfunded offering, that following the completion of the offering there may or may not be a continuing relationship between the issuer and the intermediary; and
- that under certain circumstances the issuer may cease its ongoing reporting.

Before permitting an investor to make an investment commitment on its platform, an intermediary must have a reasonable basis to believe that the investor satisfies the investment limitations, but the intermediary may rely upon a representation to that effect from the investor.

Intermediary management of failed offering

If an issuer does not complete an offering because the target amount to be raised is not reached or the issuer decides to terminate the offering, within five business days the intermediary must give or send to each investor who made an investment commitment, a notification disclosing the cancellation of the offering, the reason for the cancellation and the refund amount that the investor should expect to receive. The intermediary must also direct the refund of investor funds and prevent future commitments – it must block investors from making investment commitments with respect to that offering on its platform.

Intermediary prohibited actions

A funding portal cannot:

- offer investment advice or recommendations;
- solicit purchases, sales or offers to buy the securities displayed on its platform;
- compensate employees, agents or other persons for such solicitations based on the sale of securities displayed or referenced;
- hold, manage, possess or otherwise handle investor funds or securities.

Intermediary permitted activities

An intermediary may:

- Provide a communications channel for potential investors to communicate about the merits of an offering.
- Highlight issuers and offerings based on objective criteria, such as the type of security, geographic region, industry, etc. The funding portal cannot receive special or additional compensation for highlighting one or more issuers or offerings on its platform.



- Advise issuers about the structure or content of its proposed offering and prepare offering documentation.
- Pay for referrals, subject to various limitations.
- Have compensation arrangements with registered broker-dealers: may enter into arrangements with a broker-dealer pursuant to which they could compensate one another provided such arrangements are not prohibited by the national securities association of which the funding portal is a member.
- Advertise its services as well as offerings that are available through its platform, subject to compliance with various requirements.
- Limit offerings on its platforms (ie, certain industries, geographies, etc) without being deemed to be providing investment advice. The criteria would be required to be reasonably designed to result in a broad selection of issuers offering securities through the funding portal's platform and be applied consistently to all potential issuers and offerings. Criteria must be displayed on the funding portal's site.

Intermediary registration

An intermediary must be:

- a broker-dealer registered with the SEC under section 15(b) of the United States Securities Exchange Act of 1934 ('Exchange Act'); or
- a funding portal registered with the SEC; and also
- a member of a national securities association registered under section 15A of the Exchange Act, which is the Financial Industry Regulatory Authority (FINRA).

The funding portal registration process is streamlined, and is easier than for a registered broker-dealer ('Form Funding Portal'), and registration will be effective the later of: (1) 30 calendar days after the date that the registration is received by the SEC; and (2) the date the funding portal is approved for membership in FINRA. No fidelity bond is required.

A portal may operate multiple website addresses.

Trends in retail crowdfunding, crowd lending and future outlook

The use of Regulation Crowdfunding has increased each year since its adoption in May 2016, as demonstrated by SEC filings with approximately US\$33.2m raised in 2017 versus approximately US\$43.7m in 2018. The issuances are dominated by equity securities (36.6 per cent in 2017), followed by debt (26.3 per cent in 2017) and SAFEs⁴ (22.4 per cent in 2017). Peer-to-peer lending is not a separate regulated category, and that segment of the crowdfunding market has been stable, with

⁴ A 'SAFE' refers to a 'Simple Agreement for Future Equity', a mechanism of seed funding. A SAFE is neither equity nor debt. In return for its investment, the investor receives a right to receive company stock at a future date, usually the Series A preferred stock funding round. It is designed to alleviate the problem posed by needing a valuation at the seed stage in order to issue equity, and to avoid the cashflow pressure caused by issuing convertible notes, which carry interest charges and have a maturity date.

US\$7.9m raised through 109.6 thousand loans in 2017, US\$8.1m raised through 110.6 thousand loans in 2018.

The median income of investors in this segment is US\$90,000, far below the requisite US\$200,000 required to qualify as an accredited investor, indicating that the investments are appealing to a different demographic of investor who, formerly, had no access to this type of investment.

Not surprisingly, the dominant industries attracting crowdfunded investment are technology companies (over 40 per cent of all issuances), followed by life sciences and real estate.

Regulation Crowdfunding seems to be providing access to capital for startup enterprises, and has created investment opportunities to a new class of investor. However, the industry faces some challenges. The regulation is onerous, causing legal and accounting fees to be high relative to the limited amount of money that can be raised – those tensions may stifle growth in this segment. Given the limited amount of money that can be raised, it seems destined to be used for seed funding, which by its nature will keep the dollar size of the segment small compared to the multi-trillion dollar Regulation D market for sales of securities to accredited investors, but there is no indication of any endemic fraud or contemplation of any regulatory rollback that would stifle growth. Additionally, Regulation CF offerings are frequently used merely as marketing, to create buzz for a product or company.

A nod to ‘accredited investor crowdfunding’

As discussed above, Regulation Crowdfunding allows offers and sales to anyone, but with strict limits on the amount that can be raised and the amount that each investor can invest, whereas another safe harbour, Regulation D, places no such limits on the amount raised or invested as long as sales are made only to accredited investors. The primary rules of Regulation D, 506(b) and 506(c), both allow such sales to be made online via electronic platforms, but offering procedures are a bit different because one rule, rule 506(b), prohibits the use of general solicitation or general advertising (GSGA) and allows the market practice of self-certification of accredited status, while another rule, rule 506(c), permits GSGA with additional burdens on the issuer to take reasonable steps to verify that the investor is indeed accredited. Issuers of rule 506(c) offerings can advertise freely and allow unfettered access to websites, whereas rule 506(b) offerings have procedures in place for investors to pre-qualify as accredited before they can see any offering materials of any issuer listed on the website. Regardless, because the electronic platforms are freely available, and one does not need a broker-dealer or personal contact to get access to the private deals listed on these sites, offerings under both these rules are viewed as a kind of crowdfunding for high net worth individuals.

Deals under rules 506(b) and (c) have been growing steadily since the rules became effective in 2013. Given the freedom to raise large sums under these rules, they are providing more access to capital from investors previously unable to access these types of deals, and are routinely used for cutting-edge offerings such as tokens.