Securities Regulation Daily Wrap Up, STRATEGIC PERSPECTIVES—Crowdfunding experiment begins: Ballard Spahr's Debbie Klis looks ahead, (May 16, 2016)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

Legal experts, like Ballard Spahr LLP's Debbie A. Klis, are looking ahead to how clients might best use the SEC's Regulation Crowdfunding. Securities-based crowdfunding formally launched today with its goal of opening investments in early stage companies to virtually all investors, not just to institutions, angels or other accredited investors. With the final rules in place, the legal bar to federally-authorized securities-based crowdfunding has lifted.

Final crowdfunding rules. The Commission voted last Halloween eve to adopt final rules implementing a crowd-sourced capital raising regime that some may consider to be the emotional heart of the Jumpstart Our Business Startups (JOBS) Act (Commissioners' statements: White, Aguilar, Stein, Piwowar). The JOBS Act, enacted in April 2012, was an attempt by the Administration and Congress to lift a U.S. economy still held back by the effects of the 2008 financial crisis.

SEC Chair Mary Jo White recently explained how crowdfunding fits into the Commission's exempt transactions framework. "There is significant interest and excitement in the United States about the use of securities-based crowdfunding, which we hope will give small businesses another tool for raising capital and building vibrant markets," said White. "Companies have many options for raising money to fund their businesses, and those seeking capital will ultimately be in the best position to decide whether crowdfunding or another capital-raising option will work best for them."

The commissioners' own references to Halloween at their meeting to adopt Regulation Crowdfunding suggested the question of whether the final crowdfunding rules are more treat or trick? Now, with more than half a year to evaluate a complex set of rules that initially defied the often rapid-fire issuance of law firm memos, early stage companies, new entities called funding portals, and perhaps some investors are ready to engage in a securities-based crowdfunding experiment.

Raising capital from the crowd. Attorney Klis explained that JOBS Act Titles II, III, and IV—general advertising and solicitation, crowdfunding, and Regulation A, respectively—are the primary capital raising titles in the Act and that, while each has its advantages and disadvantages, Title II's amendments to Regulation D could be an alternative to securities-based crowdfunding for many companies. "Rule 506 may be superior because there are fewer rules and companies can raise as much as needed."

Klis said it was unclear exactly which companies would get into securities-based crowdfunding, but she noted that many real estate firms contemplating offerings are unlikely to use crowdfunding unless they are small firms due to the limits on how much capital can be raised. Under Regulation Crowdfunding, a company is limited to offering an aggregate amount of securities no higher than $1 million in a 12-month period. Klis also said the final crowdfunding rules would not permit a firm to skirt the rules by using multiple entities.

Legislation introduced in Congress earlier this year could provide some relief in terms of how much money companies can raise via crowdfunding. The Fix Crowdfunding Act (H.R. 4855), introduced by Rep. Patrick McHenry (R-NC), would increase the aggregate securities limit from $1 million to $5 million. Klis said this could significantly improve the crowdfunding option. But she also noted that under the crowdfunding rules, even accredited investors are limited to investing no more than $100,000 in a 12-month period.

The gatekeepers. Crowdfunding, as envisioned by Congress and the SEC, puts a lot of pressure on intermediaries, registered brokers or registered funding portals, to serve as gatekeepers in order to control issuers' access to crowdfunding platforms and to provide a degree of investor protection. The Commission's final crowdfunding rules would apply the issuer liability provisions to intermediaries, subject to statutory defenses.

According to Klis, Regulation Crowdfunding places intermediaries in a "quasi-governmental" role. Klis distinguished intermediaries' active role in securities-based crowdfunding from the more passive role played by intermediaries in the non-securities crowdfunding space. She emphasized that securities-based crowdfunding intermediaries will not be able to simply "rep away" their duties and instead will need to have staff devoted to conducting due diligence on issuers.

Advertising. Regulation Crowdfunding does permit some limited forms of advertising by issuers and intermediaries, but the rules for issuers are quite restrictive. For example, Klis explained that a company engaging in securities-based crowdfunding could use familiar "tombstone" ads to convey only basic information about the proposed transaction.

But this is another area where Congress could step in to help crowdfunding issuers. Although not truly an advertising provision, the Fix Crowdfunding Act would allow issuers to solicit nonbinding indications of interest ahead of an offering. Klis said this provision would function much like the JOBS Act's test-the-waters provision for emerging growth companies.

Joining the crowd. One of the big questions leading up to the start of securities-based crowdfunding was who will give it a try? The answer is a bit clearer now that, as of 3 p.m. CDT today, 15 issuers have filed Forms C and eight funding portals have filed Forms Funding Portal on EDGAR.

Of the companies with Forms C on EDGAR, seven listed Wefunder Portal LLC as their portal, six named StartEngine Capital LLC as their portal, and one each named portals NextSeed US LLC and SI Portal, LLC. StartEngine said in a blog post it was ready for the start of securities-based crowdfunding, while NextSeed had announced its plans for similar offerings in April. Wefunder's website urged investors to end what it called "the monopoly of the rich." NextSeed billed itself as a place to invest in Texas companies. The companies associated with these portals run the gamut of ideas, from glowing plants to a social network for gamers.

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