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What Is Title III Crowdfunding?



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Client

I have a small business and I need additional capital to expand. I heard about Crowdfunding. Can you explain what this is?

Lawyer

- Specifically investment crowdfunding
- New exemption 4(a)(6) of the Securities Act of 1933
- Use of online intermediary
- Issuers, investor and intermediaries

Issuers

Client

How much can I raise and how does it work?

Lawyer

- Limited to raising \$1M in a rolling 12-month period
- Will not be integrated with other offerings
- Must use one online intermediary
- Must be US entity
- Cannot be Investment Company or company relying on an exemption from the '40 Act
 - Cannot use SPV structure

Issuers

Client

Are there any restrictions or other requirements?

Lawyer

- Must have a business plan
- Cannot intend to merge with an unidentified company
- Cannot be public reporting company
- If conducted an offering pursuant to Regulation CF in the past must be compliant with ongoing reporting requirements
- Cannot be a Bad Actor
- 12(g) caps on stockholders don't apply as long as issuer is compliant with Regulation CF, does not have more than \$25M net assets and has engaged a transfer agent

Issuers

Client

What documents and disclosures do I have to make in this process?

Lawyer

- *Disclosure Requirement – Form C*
 - Name, legal status, address, website
 - Directors, officers, background, offices held
 - Identity of 20% beneficial holders of voting securities
 - Description of the business
 - Financial condition
 - Target offering amount, maximum amount, deadline
 - Description of the securities including prices and how determined
 - Use of proceeds
 - Risk factors
 - Ownership, capitalization, indebtedness
 - Offering mechanics
 - Related party transactions

Issuers

Client

What financial disclosure must I make?

Lawyer

- Disclosure Requirements – Financial Information
 - Up to \$100,000
 - GAAP financials for past two years or time in existence certified by CEO
 - Information from tax return filed for the most recently completed fiscal year
 - Over \$100,000 up to \$500,000
 - GAAP financials for past two years or time in existence certified by CEO and reviewed by public accounting firm
 - Over \$500,000 up to \$1,000,000
 - GAAP financials for past two years or time in existence certified by CEO and audited by public accounting firm
 - One time exemption for first time crowdfunding companies can provide reviewed financial statements rather than audited
- Formal consent from accountant/auditor not required

Issuers

Client

After I raise the money, what are my obligations?

Lawyer

- ***Disclosure Requirements – Ongoing Reporting***
 - Progress reports on the offering
 - Can rely on intermediary to provide progress reports to investors
 - Must the Form C-U at close of offering
 - File annual disclosure on Form C-AR
 - Use Form C as the base and update disclosure
 - Delete information about the offering
 - Does not require audited or reviewed financial statements
 - Must file until:
 - Issuer becomes public filer
 - Issuer has filed at least one Form C-AR and has fewer than 300 holders of record
 - Issuer has filed at least three Forms C-AR and has assets of \$10M or less
 - All Reg CF securities are purchased, repurchased or redeemed
 - Issuer liquidates or dissolves

Issuers

Client

Can I advertise this offering and, if so, how much can we say?

Lawyer

- Advertising Limitations
 - Statement that offering is being conducted, name of and link to intermediary
 - Terms of the offering
 - Factual information about the issuer including a brief description of the business
 - Similar to tombstone ads under Rule 134
 - Medium agnostic
 - Can pay for advertising but cannot be transaction based or receive personal identifying information (PII)
 - All compensation to promoters must be disclosed

Investors

Client

Who can invest and are there any limitations?

Lawyer

- No accreditation restrictions
- Investment Limitations
 - If net worth or annual income is less than \$100,000, can invest the greater of \$2,000 or 5% of such net worth or income annually in all crowdfunding investments
 - If net worth and annual income is \$100,000 or greater, can invest 10% of net worth or annual income (whichever is lesser) up \$100,000 annually
 - Can combine with spouse
- Issuers and intermediaries can rely on investor attestations of net worth, annual income and annual investment amounts

Investors

Client

Is there an exit strategy for investors?

Lawyer

- Resale – restricted for one year except:
 - To the issuer
 - To an accredited investor
 - As part of a registered offering
 - To a member of the family in connection with death, divorce or similar event

Intermediaries

Client

What is an intermediary and why must I use one?

Lawyer

- Must be registered broker-dealer or crowdfunding platform
- Must Register with FINRA
- Must provide communication channel between investors and issuer and amongst investors
- Must provide educational materials for potential investors
- Must get affirmation acknowledgements that issuers understand risks
- May curate prospective issuers
- Must have a reasonable basis to believe that an issuer is compliant with Reg CF
- May receive cash and/or equity compensation from issuers for services provided

Intermediaries

Client

What are the duties of the Intermediary?

Lawyer

- Must provide notices to investors
- Must give investors right to cancel transaction up to 48 hours prior to the offering deadline
- Can compensate third parties for advertising as long as they do not receive any PII and the compensation is not based on the purchase or sale of the security offered
- “Issuer” liability based on facts and circumstances
- Broker-dealers and funding portals can fee split

Intermediaries

Lawyer

- Funding Portals
 - Register with SEC and FINRA
 - Cannot custody funds
 - Must engage qualified third-party to custody funds and conduct transaction
 - Cannot provide investment advice – recommend one issuer over another
 - Can provide objective search criteria and highlights of issuers
 - Can advise issuers on deal structure and documentation
 - May be foreign entity
 - No fidelity bond, anti-money laundering (AML), know your customer (KYC) or Bank Secrecy Act (BSA) requirements
 - Must adhere to same privacy rules as broker-dealers

Practical Considerations

Client

What other considerations should I be concerned with?

Lawyer

- Who will use this exemption, if anyone?
- Will Reg CF issuers be able to get future financing?
- Can concurrent offerings be conducted?
- What are the legal costs?
- What are the accounting costs?
- Is it practical to be a funding portal?
- How much volume is possible?
- Who will invest in these deals?
- What about fraud? Failure?

Practical Considerations

Client

What are the costs for doing this? It seems to me I have to pay the Intermediary, someone to receive and hold funds, broker, advertisements, accountants and lawyers. That does not leave me with much . What is your estimate?

Lawyer

My estimate of the total cost for a \$1,000,000 raise is from \$50,000 to \$75,000.

Practical Considerations

Client

So let me summarize:

General solicitation -	Yes, through a funding portal.
Investor limitations -	Amount that may be sold to an investor based on investor net worth, with an annual limit of \$100,000 for all crowdfunding investments.
Dollar offering limit -	\$1 million.
Bad actor disqualification -	Yes. Section 302(d) of JOBS Act requires SEC to include disqualification provision by rule.
SEC filings -	Yes, pursuant to Section 4A(b). Form C proposed.
State preemption -	Yes. Notice filing and fee permitted only by (1) the state where the issuer has its principal place of business and (2) the state (if any) in which purchasers of 50% or more of the offering are residents.

Practical Considerations

Restricted securities post-sale - Yes. Securities may not be sold for one year after date of purchase except (1) to the issuer or an accredited investor, (2) to a family member or in case of certain events like death or divorce, (3) in a registered offering or (4) as otherwise permitted by SEC.

Disclosure requirement - Financial and other disclosures required by Section 4A(b)(1).