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Crowdfunding: Narrative and Financial Disclosures

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Disclosure obligations imposed on public companies by the Securities and Exchange Commission (SEC) have been criticized as too lengthy, too prolix and not sufficiently helpful for making investment decisions.[1] In 2012, Congress passed the Jumpstart Our Business Startups (JOBS) Act[2] to relieve small businesses of various disclosure obligations and other requirements when raising capital. Emerging growth companies (ECGs) are relieved from some normal disclosure requirements in initial public offerings (IPOs) under the Securities Act of 1933 (Securities Act) and are not necessarily required to become registered and reporting companies under the Securities Exchange Act of 1934 (Exchange Act) after making an offering of their securities.[3]

In April, the SEC adopted amendments to Regulation A and other rules to implement Section 401 of the JOBS Act and provide an exemption from registration for offerings up to $50 million.[4] These rules created Tier 1 offerings of up to $20 million annually, including no more than $6 million on behalf of selling securities holders, and Tier 2 offerings of up to $50 million annually, including no more than $15 million on behalf of selling shareholders.[5]

In addition, the JOBS Act established a framework for small businesses to raise funds through crowdfunding by way of an exemption from registration in Section 4(a)(6) of the Securities Act, and instructed the SEC to pass rules to facilitate use of the Internet to raise capital through small contributions from individuals. After a lengthy rulemaking process, the crowdfunding rules were passed by the SEC in November 2015.[6] Crowdfunding uses the Internet to raise capital for a wide range of projects, typically seeking small contributions from a large number of individuals.

The crowdfunding rules are lengthy and complex; the crowdfunding release occupies 293 pages of the Federal Register. It covers the issuers eligible to utilize crowdfunding, the procedures they must follow, and the qualifications for selling intermediaries—brokers or crowdfunding portals—through which crowdfunding offerings must be made. This column will focus on the disclosures issuers engaging in crowdfunding are required to make, both when first accessing the capital market and then on an annual basis. In fashioning the crowdfunding rules, the SEC had an opportunity to construct a simplified disclosure system for small companies. The

rules are comprehensive and interesting as an experiment with simplified disclosure.

DIsclosures

The crowdfunding rules permit a company to raise a maximum aggregate amount of $1 million through crowdfunding offerings over a 12-month period. Due to the risky nature of these offerings, there are limits on the amounts individual investors can invest in the aggregate for all crowdfunding offerings. If an investor's annual income or net worth is less than $100,000, the maximum he or she can invest is the greater of $2,000 or 5 percent of the lesser of annual income or net worth. If both annual income and net worth are equal to or more than $100,000, the maximum allowed investment is 10 percent of the lesser of annual income or net worth. Further, the aggregate amount of securities sold to any investor through all crowdfunding offerings may not exceed $100,000.[7] Commissioner Michael Piwowar dissented from the adoption of the crowdfunding rules on the ground that non-accredited investors should be able to use their own judgment on how much to invest and these limits could stifle crowdfunding offerings.[8]

The JOBS Act added Section 4A(b)(1) to the Securities Act setting forth the specific disclosures that an issuer offering or selling securities in reliance on the crowdfunding exemption must make. The SEC implemented the statute in Rule 201 of Regulation Crowdfunding[9] requiring an issuer to disclose: its name and legal status, including the jurisdiction in which it was organized and the date it was organized; its physical and web site addresses; the names of its directors and officers, their length of service with the issuer and their business experience over the past three years; and the name and ownership level of any shareholder who owns more than 20 percent of any class of the issuer's voting securities.

Rule 201(d) requires an issuer to disclose information about its business and business plan. Since the SEC anticipates that issuers utilizing crowdfunding will have businesses in various stages of development, the SEC did not specify the types of information an issuer needs to disclose in its description of its business, but rather, decided on a flexible approach. The issuer is also required, in Rule 201(i) to provide a reasonably detailed description of the purpose of the offering and the intended use of proceeds.

In its adopting release, the SEC gave examples of the kind of disclosure that might be necessary to give investors sufficient information to evaluate the investment. For example, an issuer may intend to use the proceeds to acquire assets or businesses, compensate the intermediary or the issuer's own employees or hire new employees. If so, the issuer might consider disclosing how the proceeds will be used for salaries or bonuses and how many employees it plans to hire. If the issuer will accept proceeds in excess of the target offering amount, it needs to provide a detailed description of the purpose, method for allocating oversubscriptions and intended use of any excess proceeds.[10]

The issuer must disclose the target offering amount and the deadline for reaching that amount. If the issuer is willing to accept funds in excess of the target amount, it must disclose the maximum it will accept, and how shares in oversubscribed offerings will be allocated.[11] The procedures for cancelling an offering until 48 hours prior to the deadline for accepting offers must be spelled out and if a material change is made in the offering, the investor must reconfirm his or her investment commitment.[12] Under Rule

201(l) an issuer must disclose the offering price of the securities, or alternatively, the method for determining the price. In addition, there must be clear disclosure of the number of securities being offered and those outstanding, the voting rights of such securities, and restrictions on the transfer of securities.[13]

A variety of additional disclosures also are required by Rule 201. Disclosure of the compensation to be paid to the intermediary may be disclosed either as a dollar amount or a percentage of the offering. The issuer must disclose the location on its website where investors will be able to find its annual report and the date it will be made available, and whether the issuer or its predecessors have failed to comply with ongoing reporting requirements. Also, the SEC added a requirement to disclose any material information necessary in order to make the statements made, in light of the circumstances under which they were made not misleading.[14] This formulation is standard in Rule 10b-5 under the Exchange Act and other anti-fraud provisions in the securities laws.

The current number of employees must be disclosed in order to give investors a sense of the size of the issuer. Risk factor disclosure also is required by Rule 201(f). The SEC did not, however, provide examples of or standards for the disclosure of why or how the investment is speculative or risky because the SEC believed the risk factor disclosure should be tailored to the issuer's business and the offering. A description of the material terms of any indebtedness is required.[15] Issuers must provide disclosures about any exempt offering that they conducted within the past three years pursuant to Rule 201(q).

As might be expected, there is required disclosure of related party transactions, but these are limited to those transactions in excess of 5 percent of the aggregate amount of capital raised by the issuer in reliance on Section 4(a)(6) during the preceding 12-month period, inclusive of the amount the issuer seeks to raise in its current offering. Such transactions are defined as "any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships."[16] The following persons who had a direct or indirect material interest are captured by the related party transactions rule: any director or officer of the issuer; any person who is, as of the most recent practicable date, the beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities; if the issuer was incorporated within the past three years, any promoter of the issuer; or any member of the family of any of the foregoing.[17]

Issuers taking advantage of the crowdfunding rule are subject to a disclosure similar to the Management Discussion and Analysis (MD&A) to which public companies are generally subject. Rule 201(s) clarified that the issuer's description of its financial condition must include, to the extent material, a discussion of liquidity, capital resources and historical results of operations. Also, the issuer must discuss, for each period for which financial statements are provided, any material changes or trends known to management in the financial condition and results of operations subsequent to that period. While these discussions need not be as lengthy or detailed as the traditional MD&A, the issuer should take into account the proceeds of the offering, any other sources of capital, and how these proceeds will affect the issuer's liquidity and the viability of its business.[18]

Financial Disclosures

The financial disclosures required of issuers taking advantage of the Section 4(a)(6) exemption for crowdfunding offerings are based on the amounts offered and sold within the preceding 12 months. For issuers offering $100,000 or less disclosure of the amount of total income, taxable income and total tax as reflected in the issuer's federal income tax returns must be certified by the principal executive officer as true and complete. Although the proposed rules would have required submission of a redacted tax return, the SEC was persuaded that this could pose potential violations of applicable privacy rules. If financial statements are available that have been either reviewed or audited by a public accountant who is independent of the issuer, the issuer must provide those and need not provide the information on income tax returns.[19]

If an issuer is offering more than $100,000 but not more than $500,000, or the issuer is offering more than $500,000 but not more than $1 million and is relying on the crowdfunding exemption for the first time, the issuer must provide financial statements reviewed by a public accountant that is independent of the issuer. If audited financial statements are available, however, they must be provided. Issuers that have previously sold securities in reliance on the crowdfunding exemption must provide audited financial statements by an accountant independent of the issuer.[20]

All issuers relying on the crowdfunding exemption must file with the SEC and provide to investors and their intermediary a complete set of their financial statements, including balance sheets, statements of comprehensive income, statements of cash flows, statements of changes in stockholders' equity and notes to the financial statements. Statements that are not audited must be labelled as non-audited.[21] Further, all financial statements must be prepared in accordance with U.S. GAAP and will be considered "public business entities" as defined by the FASB.[22]

The SEC exempted securities sold in a crowdfunding offering from the provisions of Section 12(g) of the Exchange Act, so even if the offering and secondary sales result in crowdfunded securities being owned by more than 500 non-accredited investors, issuers will not become subject to the annual and periodic reporting provisions applicable to other public companies.[23] Instead, the SEC's final crowdfunding rule provides for ongoing reporting requirements for issuers which take advantage of the exemption.[24]

An annual report must be filed with the SEC and posted on the issuer's web site no later than 120 days after the end of the fiscal year covered by the report. The financial statements in the annual report need not be audited but can be certified by the principal executive officer of the issuer to be true and complete in all material respects. If audited reports are available, however, they must be provided and the certification is not necessary. The general content of the annual report in addition to the financial statements should be the same as the information required in an offering statement. Although the disclosure costs should be less than the costs of preparing the initial offering statement, annual updates are important because securities sold in a crowdfunding offering will be freely tradeable after a year.[25]

Regulation A

Some of the narrative and financial statement disclosure set forth in the crowdfunding rules is consistent with the requirements for Tier 1 and Tier 2 offerings under revised Regulation A. For example, the offering documents for a Tier 1 Regulation A offering need not include audited financial statements.[26] But the expanded exemption for Regulation A offerings was built upon an existing framework for such exempt offerings, whereas the crowdfunding exemption is entirely new and the SEC was required to think through an appropriate simplified narrative and financial statement disclosure scheme for very small offerings using the Internet as a delivery vehicle.

Some of the differences between the Regulation A rules and the crowdfunding rules seem arbitrary. For example, in Regulation A offerings, issuers can "test the waters,"[27] while advance advertising about crowdfunded offerings is much more limited.[28] On the other hand, funding portals can advertise their existence and identify one or more issuers or offerings available, with certain restrictions.[29]

The liability provisions for offerings under Regulation A, as expanded, and crowdfunding are essentially the same. Since these are not registered offerings, the strict liability provisions of Section 11 of the Securities Act are inapplicable. However, under Section 3(b)(2)(D) of the Securities Act, Section 12(a)(2) of the Securities Act applies to any person offering or selling securities exempt under Regulation A. Similarly, under Section 4A(c) of the Securities Act a person who purchases a security in a crowdfunding transaction from an issuer which makes untrue or misleading statements of material facts may institute an action "as if" the liability were created under Section 12(a)(2). Since these small, unregistered offerings are likely to be speculative and risky, these liability provisions are likely to be tested by disappointed investors.

Now that the disclosure provisions of Regulation A and the crowdfunding rules have been formulated, issuers making an IPO have a wide array of choices as to the kind of offering to make. Further, the SEC has been forced by the JOBS Act to construct three new disclosure templates for small business offerings. How market practices will evolve as these exemptions are utilized will be interesting, and hopefully closely monitored by the SEC and others.

Endnotes:

1. See Keith F. Higgins, Dir., Div. of Corp. Fin., SEC, Disclosure Effectiveness: Remarks Before the American Bar Association Business Law Section Spring Meeting (April 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370541479332.

2. Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified in scattered sections of 15 U.S.C.).

3. JOBS Act §§101-104.

4. Amendments for Small and Additional Securities Exemptions Under the Securities Act (Regulation A), Securities Act Rel. No. 9741, 80 Fed. Reg. 21805 (Apr. 20, 2015) [hereinafter Reg A Release].

5. Id. at 21807.

6. Crowdfunding, Securities Act Rel. No. 9974, 80 Fed. Reg. 71387 (Nov. 16, 2015) [hereinafter Crowdfunding Release].

7. Id. at 71390.

8. Michael S. Piwowar, Commissioner, SEC, Dissenting Statement at Open Meeting on Crowdfunding and Small Business Capital Formation (Oct. 30, 2015), http://www.sec.gov.news/stat4ement/piwowar-regulation-crowdfunding-147-504.html. Since the SEC's rules implement the statutory provisions of the JOBS Act, Securities Act §4(a)(6), 15 U.S.C. §77d(a)(6), this objection is really an objection to the JOBS Act itself.

9. 17 C.F.R. §227.201.

10. Crowdfunding Release, supra note 6, at 71401.

11. Id.

12. Id. at 71402.

13. Id. at 71403.

14. Id. at 71404.

15. Id. at 71405.

16. Rule 201(r), Crowdfunding Release, 80 Fed. Reg. at 71539.

17. Id.

18. Id. at 71407.

19. Id. at 71412.

20. Id.

21. Id.

22. Id. at 71414.

23. Id. at 71476.

24. 17 C.F.R. § 227.202.

25. Crowdfunding Release, supra note 6, at 71420.

26. Reg A Release, supra note 4, at 21832.

27. Id. at 21841.

28. Crowdfunding Release, supra note 6, at 71420.

29. Id. at 71468.

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