



Crowdfunding and the Exemption for Small Firms from Securities and Exchange Commission Registration Requirements

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April 5, 2012

Congressional Research Service

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www.crs.gov

R42060

Summary

Crowdfunding refers to the financing of an activity through the collective cooperation of people who pool their money or other resources, sometimes through a networking site on the Internet. Common goals of crowdfunding involve such activities as disaster relief, political campaigns, and investing. In the investment area, crowdfunding may involve relatively small individual monetary contributions from a group of investors in order to meet a specific goal. Crowdfunding in the investment area received increased attention in the 112th Congress, resulting with the passage of the Jumpstart Our Business Startups Act (JOBS Act), in exemption from some federal securities registration requirements for crowdfunding activities. The President signed the bill on April 5, 2012.

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Definition of Crowdfunding

Crowdfunding refers to the financing of an activity through the collective cooperation of people who pool their money or other resources, sometimes through a networking site on the Internet. Common goals of crowdfunding involve such activities as disaster relief, political campaigns, and investing. In the investment area, crowdfunding may involve relatively small individual monetary contributions from a group of investors in order to meet a specific goal. Crowdfunding in the investment area received increased attention in the 112th Congress, resulting with the passage of the Jumpstart Our Business Startups Act (JOBS Act), in exemption from some federal securities registration requirements for crowdfunding activities.

Federal Securities Law Registration Requirements

The Securities Act of 1933 makes it illegal to offer or sell securities¹ to the public unless they have been registered with the Securities and Exchange Commission (SEC or Commission).² Registration covers only the securities actually being offered and only for the purposes of the offering in the registration statement. The registration consists of two parts: the prospectus, which must be provided to every purchaser of the securities, and Part II, which contains information and exhibits which do not have to be provided to purchasers but which are available for inspection by the public at the Commission. Section 7 of the 1933 Act,³ referring to Schedule A,⁴ sets forth the information which must be contained in the registration statement. The schedule requires a great deal of information, such as the underwriters, the specific type of business, significant shareholders, debt and assets of the company, and opinions as to the legality of the issue. Section 10(a) of the 1933 Act specifies the information which the prospectus must contain.⁵ There are also numerous regulations issued by the Commission which provide further details about the registration process under the 1933 Act.⁶

Certain transactions and securities are exempted from the registration process. The exempted transactions include private placements, intrastate offerings, and small offerings.⁷ In addition, the Commission may by rules and regulations exempt any class of securities if it finds that such an

¹ The term “security” is defined very broadly in 15 U.S.C. §77b(1) as

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

² 15 U.S.C. §77e.

³ 15 U.S.C. §77g.

⁴ 15 U.S.C. §77aa.

⁵ 15 U.S.C. §77j(a).

⁶ *See, e.g.*, 17 C.F.R. Parts 230, 231, and 239.

⁷ 15 U.S.C. §77d.

exemption is in the public interest and the issue of securities does not exceed \$50 million.⁸ Among other exempted securities are government securities and short-term commercial paper, securities for which it is believed that other, adequate means of government regulation exist.⁹

Ongoing Disclosure Requirements

The Securities Exchange Act of 1934 is concerned with many different areas, one of which is the ongoing process of disclosure to the investing public through the filing of periodic and updated reports with the SEC.¹⁰ Any issuer which has a class of securities traded on a national securities exchange or has total assets exceeding \$10 million and a class of equity securities with at least 500 or 2,000 shareholders, depending upon whether the investors are considered accredited, must register under the 1934 Act with the Commission.¹¹ Every issuer required to register under the 1934 Act must file periodic and other reports with the SEC.¹² Section 12¹³ requires the filing of a detailed statement about the company when the company first registers under the 1934 Act. Section 13¹⁴ requires a registered company to file annual and quarterly reports with the SEC. These reports must contain essentially all material information, financial and otherwise, about the company which the investing public would need in making a decision about whether to invest in the company. The Commission has issued extensive regulations to specify information which these required reports must provide.¹⁵ Some exemptions from these reporting requirements are provided.¹⁶ Exemptions include securities of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for profit; securities issued by a mutual or cooperative organization supplying a commodity or service primarily for the benefit of its members and operating as a nonprofit; and securities issued by a registered investment company.

Failure to disclose material information is actionable. For example, Section 18(a) of the Securities Exchange Act¹⁷ grants an express private right of action to investors who have been injured by reliance upon material misstatements or omissions of facts in reports which have been filed with the SEC. Section 10(b) of the 1934 Act,¹⁸ the general antifraud provision, and Rule 10b-5,¹⁹ issued by the SEC to carry out the statutory fraud prohibition, provide for a cause of action for

⁸ 15 U.S.C. §77c(b). *See also* SEC Regulation A at 17 C.F.R. §§230.251 *et seq.* The cap was raised from \$5 million to \$50 million by Section 401(a) of the JOBS Act.

⁹ 15 U.S.C. §77c.

¹⁰ 15 U.S.C. §78m.

¹¹ 15 U.S.C. §78l. As stated earlier, the 1933 Act requires the registration of a particular *offering* of securities. The 1934 Act requires the registration of a *class* of securities. The statutory requirements for ongoing disclosure pre-passage of the JOBS Act were levied upon any issuer with a class of securities traded on a national securities exchange or with total assets exceeding \$1 million and 500 or 750 shareholders, depending upon certain criteria.

¹² 15 U.S.C. §§78l, 78m, and 78n.

¹³ 15 U.S.C. §78l.

¹⁴ 15 U.S.C. §78m.

¹⁵ *See, e.g.*, 17 C.F.R. Parts 240, 241, and 249.

¹⁶ 15 U.S.C. §78l.

¹⁷ 15 U.S.C. §78r(a).

¹⁸ 15 U.S.C. §78j(b).

¹⁹ 17 C.F.R. §250.10b-5.

injuries which have been caused by omissions, misrepresentations, or manipulations of material facts in statements other than those filed in documents with the SEC.

Congressional Interest in Exempting Crowdfunding from SEC Registration

Several bills concerning crowdfunding or other kinds of relaxing of SEC registration requirements were introduced in the 112th Congress. They included H.R. 1070, the Small Company Capital Formation Act; H.R. 2930, the Entrepreneur Access to Capital Act; H.R. 3606, the Jumpstart Our Business Startups Act (JOBS Act); S. 1544, the Small Company Capital Formation Act; S. 1791, the Democratizing Access to Capital Act; and S. 1970, the Capital Raising Online While Deterring Fraud and Unethical Nondisclosure Act (CROWDFUND Act).

On March 8, 2012, the House passed H.R. 3606, the JOBS Act. H.R. 3606, as passed by the House, combined H.R. 2930, H.R. 2940, H.R. 1070, H.R. 2167, H.R. 3606, and H.R. 4088. On March 22, 2012, the Senate passed the House version of the JOBS Act, with amendments relating to the crowdfunding exemption. The House on March 27, 2012, signed off on the Senate version. The President signed the bill on April 5, 2012.

Title III of the JOBS Act concerns crowdfunding. Section 302(a) provides an additional exemption from registration under the Securities Act of 1933 for crowdfunding transactions. To qualify for the exemption, restrictions are placed on the amount of money raised by the issuer: (1) the aggregate amount of securities sold to all investors by the issuer during a 12-month period cannot exceed \$1 million; (2) the aggregate amount sold to any investor during a 12-month period cannot exceed the greater of \$2,000 or 5% of the annual income or net worth of the investor if either the annual income or the net worth of the investor is less than \$100,000 or, if the investor's annual income or net worth is more than \$100,000, the greater of 10% of the annual income or net worth of the investor, not to exceed a maximum aggregate amount sold of \$100,000; (3) the transaction must be sold through a broker or funding portal;²⁰ and (4) the issuer must comply with various notification and filing requirements, discussed below.

Section 302(b) sets out additional requirements for meeting the crowdfunding exemption. For example, a person acting as an intermediary in a crowdfunding transaction must (1) register with the SEC as a broker or as a funding portal; (2) register with the appropriate self-regulatory organization; (3) provide disclosures concerning risks and other investor education materials; (4) ensure that each investor reviews the education information, affirm that the investor understands the risk involved and can bear the loss, and affirm that the investor answers questions demonstrating understanding of risks involved with startups and small issuers; (5) take measures to reduce the risk of fraud, including obtaining background and securities enforcement regulatory checks on officers, directors, and persons holding more than 20% of the outstanding equity of every issuer whose securities are offered by the person; and (6) prohibit its directors, officers, or partners from having any financial interest in an issuer using its services.

²⁰ A "funding portal" is defined as any person acting as an intermediary in a crowdfunding transaction but not offering investment advice or recommendations; soliciting purchases, sales, or offers to buy the securities offered or displayed on its website or portal; compensating employees, agents, or others for solicitation; holding, managing, possessing, or handling investor funds or securities; or engaging in any other activities prohibited by the SEC.

An issuer offering or selling securities pursuant to the crowdfunding exemption has certain requirements, among which are filing with the SEC and providing and making available to investors, potential investors, and the appropriate broker or funding portal such information as the name, legal status, physical address, and website address of the issuer; the names of the directors, officers, and every 20% shareholder of the issuer; a description of the business and the anticipated business plan of the issuer; a description of the financial plan of the issuer, including, for offerings of \$100,000 or less, income tax returns for the most recent year and certified financial statements; for offerings from \$100,000-\$500,000, financial statements reviewed by a public accountant; audited financial statements for offerings over \$500,000; a description of the stated purpose and intended use of the proceeds of the offering; the targeted offering amount and its deadline; the price to the public of the securities or the method for determining the price; and a description of the ownership and capital structure of the issuer. An issuer is prohibited from advertising the terms of the offering, except for notices which direct investors to the funding portal or broker, nor may an issuer pay any person to promote its offerings without observing SEC rules concerning the disclosures of the compensation. In addition, the issuer must file at least annually with the SEC and provide to investors results of the operations and financial statements.

A person who purchases a security sold in a crowdfunding transaction is specifically authorized to bring a court action against the issuer for any material misstatements or omissions relating to the transaction.

The SEC must make available or require the relevant broker or funding portal to make available to the states all of the information which the issuer must file with the SEC, described above.

Securities issued in a crowdfunding transaction are prohibited from being transferred by the purchaser for one year unless the securities are transferred to the issuer, to an accredited investor,²¹ as part of an offering registered with the SEC, or to a member of the family of the purchaser or in connection with the death or divorce of the purchaser.

Section 302(d) sets out various circumstances which will bar an issuer from using the crowdfunding exemption, such as conviction of a violation relating to the buying and selling of securities.

Section 303 requires the SEC to exempt by rule securities acquired in a crowdfunding transaction from the shareholder cap determining whether an issuer must register under the Securities Exchange Act.

Section 304 requires the SEC by rule to exempt a registered funding portal from the requirement to register as a broker or dealer, provided that the funding portal remains subject to the examination, enforcement, and other rulemaking authority of the SEC; is a member of a

²¹ Under SEC Regulation D (17 C.F.R. sections 230.501 *et seq.*), an accredited investor is defined as any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person: any bank or savings and loan association; any registered broker or dealer; any registered investment company; any licensed Small Business Investment Company; any employee plan established and maintained by a state or its political subdivisions, if the plan has assets over \$5 million; any licensed or registered employee benefit plan with assets over \$5 million; any private business development company; any IRS 501(c)(3) with assets over \$5 million; certain officers of the issuer of the securities being sold; an individual whose net worth exceeds \$1 million; a person whose individual income exceeded \$200,000 in the past two years or \$300,000 with that person's spouse and who has a reasonable expectation of reaching the same income level in the current year; and any trust with assets exceeding \$5 million. 17 C.F.R. §230.501(a).

registered national securities association; and is subject to other requirements which the SEC deems appropriate.

Section 305 sets out the relationship of the federal crowdfunding registration exemption to state law. For example, the federal exemption shall have no impact or limitation upon other state authority to take enforcement action involving such misconduct as fraud or deceit concerning an issuer, funding portal, or any other person using the exemption. No filing fee is allowed on crowdfunded securities except for the securities commission of the state of the principal place of business of the issuer or any state in which 50% or more of the aggregate amount of the issue are residents.

The JOBS Act is a significant piece of legislation. In addition to crowdfunding, the JOBS Act relaxes SEC registration and oversight requirements in other areas. For example, Title I exempts an “emerging growth company,” defined as an entity having annual revenues of less than \$1 billion, from certain registration requirements for a period up to five years. Title IV raises the SEC Regulation A²² cap for registration exemption for small issues from \$5 million to \$50 million.

The JOBS Act received a great deal of bipartisan support; yet, there was also considerable opposition. Supporters of the JOBS Act believe that it will, by exempting certain small and medium-size publicly traded companies from various SEC registration requirements, create many new jobs in the United States. Opponents of the legislation believe that it will create few, if any, new jobs and that it will make easier the defrauding of investors. The actual effect of the legislation upon the economy will become more clear as it is implemented.

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²² 17 C.F.R §§230.251 *et seq.*

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