



# Show me the money: Equity crowdfunding under Regulation CF

by Jeffrey O'Brien

## TIPS

- 1. Websites such as Kickstarter** allow for contributions, but they do not entitle the giver to profits resulting from the enterprise.
- 2. Securities purchased in a Regulation CF offering** may not be resold for a year. Holders of the securities would not count toward the threshold requiring a company to register with the SEC.
- 3. Companies that conduct Regulation CF offerings** must file certain information with the SEC and make it available to investors and to the intermediary that is used to facilitate the offering.
- 4. Regulation CF transactions** must be conducted through an SEC-registered intermediary, which will be either a broker-dealer or a funding portal.
- 5. The intermediaries will conduct offerings through online platforms,** are required to provide investors with educational materials outlining the risks of investing and must take measures to reduce fraud risks.

**Obtaining equity capital** is perhaps the most complicated and costly legal issue involved with starting and growing a business. Since the 1930s, businesses have had to comply with strict requirements in both federal and state securities laws, particularly with respect to smaller investors. These difficulties ultimately led to the passage of equity crowdfunding laws.

The 2012 JOBS Act allowed businesses to tap large and small investors alike with the promise of ownership in the business and loosened the solicitation rules for larger investors to allow businesses to cast a wider net for funds with the goal of simplifying the fundraising process. Three years later, the Securities and Exchange Commission (SEC) enacted Regulation CF. In March 2021, the SEC finalized amendments to Regulation CF to expand the amount(s) which could be raised via the exemption.

### What is a “security”

A key issue in raising money is whether or not what is being sold is a “security.” With websites such as Kickstarter, businesses offer rewards in exchange for a contribution with the clear understanding that the contribution does not entitle the person to any profits in the enterprise. Legally speaking, a “security” means any note, stock, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement.” In other words, you do not have to be selling shares of stock to be engaged in the sales of a “security” under the law.

### Registration vs exemption

The sale of securities became heavily regulated when, in the aftermath of the 1929 stock market crash and in the midst of the Great Depression, Congress enacted the Securities Act of 1933. This Act created the SEC as the federal regulatory agency having jurisdiction and oversight over the

raising of investment capital. Under the Act, a company seeking to raise funds, defined in the Act as the “issuer,” must either register its offering with the SEC (i.e., a “public offering”) or qualify for one of several exemptions. Most small private company offerings are made under exemptions set forth in Regulation D, particularly Rules 504, 506(b) and 506(c).

### JOBS Act & “equity crowdfunding”

In response to the success of rewards-based crowdfunding and demand from the startup community to streamline businesses’ ability to raise capital, Congress passed the JOBS Act in 2012.

The centerpiece of the 2012 Jumpstart Our Business Startups Act (the “JOBS Act”) was the creation of an exemption to permit securities-based or equities-based crowdfunding without registering the offerings with the SEC. Until the JOBS Act and the promulgation of Regulation CF, crowdfunding was not a legal means of raising equity capital.

A company issuing securities in reliance on Regulation CF can raise a maximum aggregate amount of \$5 million in a 12-month period. Investors are permitted to invest, during any 12-month period, up to \$2,200, or 5 percent of their annual income or net worth, whichever is greater, if both their annual incomes and net worth are less than \$107,000. Investors may invest up to 10 percent of their annual income or net worth, whichever is greater, if either is equal to or more than \$107,000.

Securities that are purchased in a Regulation CF offering may not be resold for a year and holders of the securities would not count toward the threshold that requires a company to register with the SEC under Exchange Act Section 12(g).

Companies that conduct Regulation CF offerings must file certain information with the SEC via Form

C and make it available to investors and to the intermediary that is used to facilitate the offering. The offering document must include information about officers, directors and holders of more than 20 percent of the issuer's securities. The disclosure would include a business description, the offering terms, a description of the use of the proceeds from the offering and the price of the securities being offered.

The Form C disclosure includes certain related-party transactions, a description of the financial condition of the company and its financial statements. Companies would be required to update the offering document to include material changes and to provide updates about the progress in reaching the targeted offering amount. Crowdfunding issuers also must file annual reports with the SEC and provide annual reports to investors.

Regulation CF's financial disclosure requirements differ based upon the amount of the offering:

- For offerings less than \$250,000, the issuer must provide financial statements and certain information from the issuer's federal income tax returns, both certified by the principal executive officer. If, however, financial statements of the issuer are available that have either been reviewed or audited by a public accountant that is independent of the issuer, the issuer must provide those financial statements instead and will not need to include the information reported on the federal income tax returns or the certification of the principal executive officer.
- For offerings from \$250,000 but not more than \$1,070,000,

financial statements must be reviewed by a public accountant that is independent of the issuer. If, however, financial statements of the issuer are available that have been audited by a public accountant that is independent of the issuer, the issuer must provide those financial statements instead and will not need to include the reviewed financial statements.

- For offerings of more than \$1,070,000, financial statements must be audited by a public accountant that is independent of the issuer.

Regulation CF transactions must be conducted through an SEC-registered intermediary, which will be either a broker-dealer or a funding portal. The intermediaries will conduct the offerings through online platforms. Intermediaries will be required to provide investors with educational materials that outline the risks of investing. They also must take measures to reduce the risk of fraud.

Funding portals may not offer investment advice or make recommendations. They may not solicit purchases, sales or offers to buy securities offered or displayed on their websites. The proposed rules impose restrictions on compensating people for solicitations and prohibit the funding portals from holding, possessing or handling investor funds or securities. The proposal includes a safe harbor under which funding portals can engage in certain activities consistent with these restrictions.



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