SEC Adopts Long-Awaited Crowdfunding Rules

By Joel T. Shaw and Helen Sterling Coburn

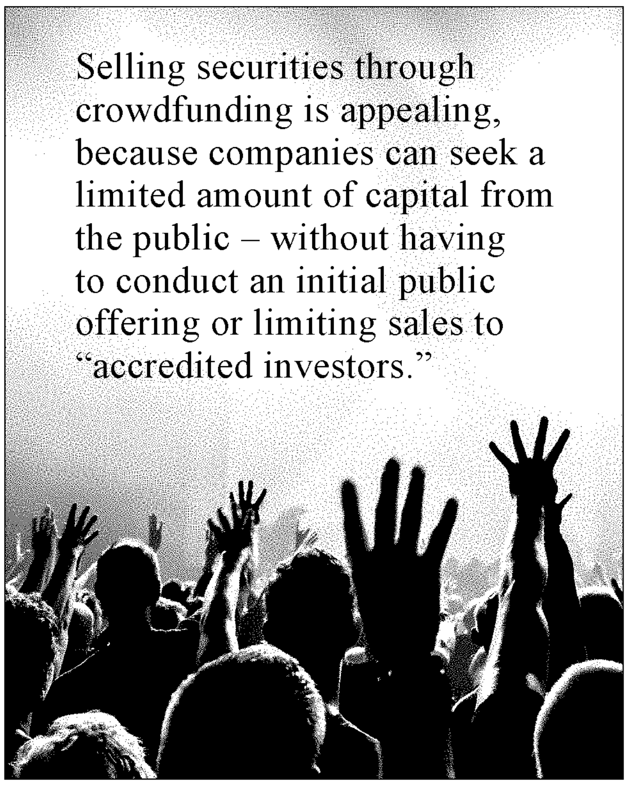
Facilitating investment in small business was a critical component of the Jumpstart Our Business Startups Act of 2012. Among the various aspects of the law, a new federal exemption for "crowdfunding" generated the most excitement in the entrepreneurial community and the most controversy among securities regulators.

Rules recently finalized by the Securities and Exchange Commission (SEC), formally legalizing crowdfunding under the new exemption, will take effect May 16, 2016. The new "Regulation Crowdfunding" rules are an attempt to strike a delicate balance between the spirit of the legislation and investor protection considerations.

Crowdfunding, Generally

The type of crowdfunding that is regulated by Regulation Crowdfunding should be distinguished from other types of crowdfunding, such as Kickstarter, Indiegogo, or GoFundME. With the former, companies raise capital by selling securities to the public (implicating securities laws); with the latter, by contrast, companies raise funds by soliciting cash contributions in exchange for a product, gift, or even a written acknowledgment of the contribution.

Under applicable federal and state laws, every offer and sale of securities must be either registered or qualify for an applicable exemption from registration. Selling securities through crowdfunding is appealing, because companies are enabled to broadly distribute offering materials and to seek a limited amount of capital from the public – without having to go through the rigorous process of conducting an initial public offering or limiting sales to "accredited investors."



Regulation Crowdfunding – The Basics

Regulation Crowdfunding (Section 4(a)(6) of the Securities Act of 1933, as amended) provides both a new federal exemption and limited state law preemption for crowdfunded securities offerings.

Companies. Section 4(a)(6) permits a company to raise a maximum of $1 million through crowdfunded offerings in a 12-month period. Capital raised during the same timeframe through other means is not counted in determining the aggregate amount sold. Regulation Crowdfunding does not limit the type of securities that may be offered – i.e., debt, equity, and hybrid securities may be sold. Companies subject to "bad actor" disqualification under existing SEC rules are prohibited from relying upon Section 4(a)(6).

Investors. Individual investments in all crowdfunded offerings by an investor in a 12-month period are limited to: (a) the greater of $2,000 or 5 percent of annual income or net worth, if the investor's annual income or net worth is less than $100,000; or (b) 10 percent of annual income or net worth (not to exceed $100,000), if the investor's annual income or net worth is $100,000 or more. There are no limitations on the type of investor who can participate in a crowdfunded offering.

Intermediaries. Crowdfunding transactions must be conducted exclusively through an "intermediary" registered with the SEC and the Financial Industry Regulatory Authority as either a broker-dealer or a "funding portal." Intermediaries will use an online platform to connect companies with prospective investors (on an unsolicited basis), make available disclosure documents, provide communication channels, and otherwise coordinate transactions. Intermediaries also will be responsible for qualifying investors and taking certain steps to monitor for signs of offering fraud.

Advertising. Despite the public nature of crowdfunding, advertising is prohibited in an offering in reliance upon the Section 4(a)(6). Instead, Regulation

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Crowdfunding allows companies to publish a notice reflecting the terms of a proposed offering, which is similar to a so-called "tombstone ad" under existing SEC rules.

Transfers. For a period of one year after purchase, all transfers of securities purchased in a crowdfunded offering under Section 4(a)(6) are restricted, except: redemptions by the company; transfers to an accredited investor; sales as part of an SEC registered offering; and transfers to a member of the purchaser's family (or to a trust for the benefit of a family member) or in connection with death, divorce, or a similar circumstance.

Disclosure and Reporting

A company undertaking a crowdfunded offering under Section 4(a)(6) is required to file a disclosure document with the SEC, which includes, among other things, information concerning the company's business plan, management, intended use of proceeds, capital structure, and risk factors. Companies are also subject to varying GAAP compliant financial disclosure requirements, depending on the amount offered and sold pursuant to Section 4(a)(6) during the preceding 12 months. Finally, the company must also provide a narrative analysis of its financial condition, including, to the extent material, a discussion of liquidity, capital resources, and historical results of operations.

An annual report (containing information required in Regulation Crowdfunding) must be filed with the SEC and posted on the company's website within 120 days after fiscal year end.

With Regulation Crowdfunding finalized, crowdfunding pursuant to Section 4(a)(6) will soon take its place among Regulation D, Rule 506(c), Regulation A+, and various state crowdfunding laws. The question of its ultimate utility for early-stage companies is still open, given the relatively small cap on investment and the risk of companies "crowding" their cap tables with a large number of small investors. Nevertheless, it is a thoughtful attempt to facilitate the capital raising process while balancing investor protection concerns.

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is "reasonable" in these cases.

In contrast, S corporations may try to limit compensation paid to shareholder employees (due to payroll tax planning purposes) and distribute nearly all cash out via dividends. In these cases, the IRS is in the opposite position – claiming that S corporations have not paid sufficient "reasonable" compensation for services rendered by shareholder employees (as the IRS will receive the same income tax on the corporation's income that flows through to S corporation shareholders, but will not receive payroll tax on the dividend payments, as those employment taxes are only paid on wages).

The United States Court of Appeals for the First Circuit has looked to the following factors in determining whether compensation paid was "reasonable": (1) What an arm's-length owner would pay the same employee for work performed; (2) General performance of the company, including return on equity; (3) Comparability of compensation with pay for similar jobs at like companies and with others within the same company, especially non-owner employees; (4) Employee role(s) in the company; and (5) Whether compensation was legitimately rewarding past underpayment. *Haffner's Service Stations, Inc. v. C.I.R.* (1st Cir. 2003). These are highly facts- and circumstances-based determinations, and no single fact pattern will apply in all cases. Therefore, it is important for both C and S corporations to be able to support compensation paid as "reasonable" considering the factors listed above.

In light of the potential risks of IRS recharacterization of compensation paid as either "unreasonably" high, or "unreasonably" low, individuals starting or operating a small business should take care to minimize the risk of an IRS recharacterization before it arises. Documentation of compensation decisions in board minutes or in employment agreements, after benchmarking, is a good first step for a start-up or small business. Any benefits provided by the business or year-end bonuses should also be documented to properly support compensation decisions. If not all shareholder employees are providing the same services (i.e., if they have different roles in the company), they should not all be paid the same salary. Doing so looks to the IRS like a "disguised" dividend.

In addition, it may be prudent for a C corporation to pay some dividends, such that not all income is "comped out." Similarly, shareholders of S corporations who provide services to the company should be paid some compensation in the form of wages, in addition to receiving dividends.

As is often the case, a little forethought and advance planning can go a long way towards avoiding the stress and considerable expense of a dispute with the IRS.

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