SECURITIES REGULATION

Syllabus

Fall Semester 2016
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Room 9107; Office Hours – Tuesday & Wednesday, 12:00-1:00

Course Materials

Choi & Pritchard, Securities Regulation: Cases & Analysis (Foundation Press – 4th ed. 2015)
Choi & Pritchard, Securities Regulation – Statutory Supplement (Foundation Press 2016 ed.)

All assignments include the statutes and rules referred to in the Casebook

Assignment #

CORE CONCEPTS

Chapter 1 – Introduction

#1. Background

b. Regulatory Structure – Casebook pp 33-45

Chapter 2 – Materiality

#2. Introduction; Forward-Looking Information – Casebook pp. 47-49; Note on TSC Industries, Inc. v. Northway, Inc. (attached); Casebook pp. 49-57

#3. Objective Tests – Casebook pp. 57-76; also, for background before the Litwin case (p. 58), read over the Casebook’s discussion of securitization (pages 156-160)

#4. “Total Mix” – Casebook pp. 76-84

#5. Management Integrity – Casebook pp. 84-94
Assignment #

Chapter 3 – Definition of a Security

#6. Investment Contracts
   a. Casebook pp. 95-122
   b. Casebook pp. 122-142; Wis. Stat. § 551.102(28) (attached)

#7. Stock – Casebook pp. 142-147

#8. Notes – Casebook pp. 147-160

Chapter 4 – Disclosure & Accuracy

#9. 1934 Act Registration; Disclosure Timing – Casebook pp. 161-182

#10. Disclosure Accuracy; Selective Disclosure – Casebook pp. 182-196

SECURITIES ACT OF 1933 – REGISTRATION & EXEMPTION

Chapter 7 – Public Offerings

#11. Overview – Casebook pp. 393-411

#12. Pre-Filing Period – Casebook pp. 411-423

#13. Waiting Period – Casebook pp. 423-440

#14. Post-Effective Period – Casebook pp. 441-452

#15. Trading Practices; Shelf Registration – Casebook pp. 452-466

Chapter 9 – Offering Exemptions

#16. Private Offerings – pp. 549-559

#17. Reg D
   a. Casebook pp. 559-573
   b. Casebook pp. 573-588

#18. Regulation A+ – Casebook pp. 588-605


#20. Intrastate Offerings – Casebook pp. 612-627
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#21. Reg S – Casebook pp. 627-640

Chapter 10 – Secondary Offerings

#22. Statutory Concepts
   a. Statutory Underwriters – Casebook pp. 641-652
   b. Resales by Controlling Persons – Casebook pp. 652-657

#23. Rule 144 – Casebook pp. 658-669

#24. Rule 144A – Casebook pp. 669-676

CIVIL LIABILITY

Chapter 5 – Rule 10b-5 Antifraud

#25. Background – Casebook pp. 197-204

#26. Standing – Casebook pp. 205-227

#27. False & Misleading Statements – Casebook pp. 227-246

#28. Other Elements
   a. Scienter – Casebook pp. 246-265
   b. Reliance – Casebook pp. 265-284
   c. Loss Causation – Casebook pp. 284-289
   d. Damages – Casebook pp. 311-317

#29. Defendants – Casebook pp. 289-311

#30. Transnational Securities Fraud – Casebook pp. 317-327

Chapter 8 – Civil Liability under the 1933 Act

#31. Section 11
   a. Basic Elements – Casebook pp. 467-490
   b. Defenses – Casebook pp. 490-514
   c. Damages & Allocation of Liability – Casebook pp. 514-522
LEARNING OUTCOMES

Securities Regulation introduces students to the processes by which businesses obtain investment capital and the legal rules that govern them. The transactions we cover range from initial public offerings (IPOs) to new issues of stock by Fortune 100 companies to start-ups raising money from venture capitalists or from friends and family.

Students will gain a detailed familiarity with the federal Securities Act of 1933 and the rules adopted under it. Because the Act is substantially the same today as when first enacted, the applicable law has been kept up to date principally by means of the rules and administrative practices of the Securities & Exchange Commission. For that reason, the course offers students an opportunity to gain insight into the workings of administrative law in practice.

About half the course consists of problem sets based on a series of “motivating hypotheticals.” Students will therefore gain hands-on experience in analyzing problems and advising clients in a complex regulatory area.
NOTE ON TSC INDUSTRIES, INC. v. NORTHWAY, INC.

As the Casebook indicates, the test for materiality under Rule 14a-9 (as well as the other antifraud provisions of the federal securities laws) was established by the Supreme Court in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976). The case was a challenge to the acquisition of TSC by National Industries, Inc., on the ground that the proxy statement used to solicit shareholder approval of the acquisition was materially misleading. Relying on a statement in the Supreme Court’s earlier opinion in Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970), the Court of Appeals for the Seventh Circuit had held that the appropriate test for materiality was whether reasonable shareholder might consider the facts at issue important. Applying that standard, the Seventh Circuit held that the omitted facts were material as a matter of law.

Rejecting this test as unnecessarily low, the Supreme Court expressed concern that “management’s fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information – a result that is hardly conducive to informed decisionmaking.” In its place, the Court defined the appropriate standard as whether “there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” It elaborated:

It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.

426 U.S. at 449.

Prior to the merger that was the basis for the proxy solicitation, National had acquired 34 percent of TSC’s stock, an ownership interest that was fully disclosed in in the proxy statement, along with the fact that no other person held more than 10 percent. The proxy statement also disclosed the five of TSC’s ten directors were National’s nominees, and it identified each’s affiliation with National. Among the omitted facts that the Seventh Circuit had held to be material as a matter of law were (1) that Stanley Yarmuth, National’s president and chief executive officer, was also chairman of the TSC board, and that Charles Simonelli, National’s executive vice president, was chairman of the TSC executive committee; and (2) that in filing reports required by the SEC, both TSC and National had indicated that National “may be deemed to be a ‘parent’ of TSC.” Under the definition of materiality set forth by the Supreme Court, do you believe that these omissions are material?
(28) “Security” means a note; stock; treasury stock; security future; bond; debenture; evidence of indebtedness; limited partnership interest; life settlement investment or similar agreement; certificate of interest or participation in a 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; put, call, straddle, option, or privilege on a security, certificate of deposit, or group or index of securities, including an interest therein or based on the value thereof; put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency; or, in general, an interest or instrument commonly known as a “security”; or a 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. The term:

(a) Includes both a certificated and an uncertificated security.

(b) Does not include an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed or variable sum of money either in a lump sum or periodically for life or other specified period.

(c) Does not include an interest in a contributory or noncontributory pension or welfare plan subject to the Employee Retirement Income Security Act of 1974 or in a governmental benefit plan qualified for federal income tax purposes under the Internal Revenue Code or trust or fund managed by the investment board.

(d) Subject to the exception in par. (e), includes all of the following:

1. An investment in a common enterprise with the expectation of profits to be derived through the essential managerial efforts of someone other than the investor. For purposes of this subdivision, a “common enterprise” is an enterprise in which the fortunes of the investor are tied to the efficacy of the efforts of those seeking the investment or a third party.

2. Any investment by which an offeree furnishes initial value to an offeror, and a portion of this initial value is subjected to the risks of the enterprise, and the furnishing of the initial value is induced by the offeror’s promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind over and above the initial value will accrue to the offeree as a result of the operation of the enterprise, and the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

(e) Includes as an “investment contract,” among other contracts, an interest in a limited liability partnership and in a limited liability company; except an interest, or class or series thereof, in a limited liability partnership or limited liability company is not an "investment contract" if any of the following apply:
1. Each holder of an interest, or class or series thereof, is actively engaged in the management of the limited liability partnership or limited liability company. However, evidence that partners or members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability partnership or limited liability company, or the right to participate in management, shall not establish, without more, that all partners or members are actively engaged in the management of the limited liability partnership or limited liability company.

2. Each holder of an interest, or class or series thereof, is authorized under applicable law or under the partnership, operating, or other governing agreement or document to act for and bind the limited liability partnership or limited liability company and the total number of holders of all interests in the limited liability partnership or limited liability company does not exceed 15.

(f) Does not include a time share created and marketed in accordance with ch. 707 if the requirements under s. 707.11 are satisfied.

(g) Does not include a membership interest in a domestic mutual holding company, as provided under s. 644.22.

(h) Does not include as an “investment contract” any contract excluded by rule adopted or order issued under this chapter.
§ 509. Civil Liability.

(b) [Liability of seller to purchaser.] A person is liable to the purchaser if the person sells a security in violation of Section 301 or, by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the purchaser not knowing the untruth or omission and the seller not sustaining the burden of proof that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission. An action under this subsection is governed by the following:

(1) The purchaser may maintain an action to recover the consideration paid for the security, less the amount of any income received on the security, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys’ fees determined by the court, upon the tender of the security, or for actual damages as provided in paragraph (3).

(2) The tender referred to in paragraph (1) may be made any time before entry of judgment. Tender requires only notice in a record of ownership of the security and willingness to exchange the security for the amount specified. A purchaser that no longer owns the security may recover actual damages as provided in paragraph (3).

(3) Actual damages in an action arising under this subsection are the amount that would be recoverable upon a tender less the value of the security when the purchaser disposed of it, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys’ fees determined by the court.

(g) [Joint and several liability.] The following persons are liable jointly and severally with and to the same extent as persons liable under subsections (b) through (f):
(1) a person that directly or indirectly controls a person liable under subsections (b) through (f), unless the controlling person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;

(2) an individual who is a managing partner, executive officer, or director of a person liable under subsections (b) through (f), including an individual having a similar status or performing similar functions, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;

(3) an individual who is an employee of or associated with a person liable under subsections (b) through (f) and who materially aids the conduct giving rise to the liability, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist; and

(4) a person that is a broker-dealer, agent, investment adviser, or investment adviser representative that materially aids the conduct giving rise to the liability under subsections (b) through (f), unless the person sustains the burden of proof that the person did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which liability is alleged to exist.

(h) [Right of contribution.] A person liable under this section has a right of contribution as in cases of contract against any other person liable under this section for the same conduct.

OFFICIAL COMMENTS

3. As with Section 12(a)(2) of the Securities Act of 1933, Section 509(b) contains a type of privity requirement in that the purchaser is required to bring an action against the seller. Section 509(b) is broader than Section 12(a)(2) in that it will reach all sales in

4. Unlike the current standards on implied rights of action under Rule 10b-5, neither causation nor reliance has been held to be an element of a private cause of action under the precursor to Section 509(b). See Gerhard W. Gohler, IRA v. Wood, 919 P.2d 561 (Utah 1996); Ritch v. Robinson-Humphrey Co., 748 So. 2d 861 (Ala. 1999); Kaufman v. I-Stat Corp., 754 A.2d 1188 (N.J. 2000).

5. The measure of damages in Section 509(b)(3) is that contemplated by Section 12 of the Securities of 1933. See 9 Louis Loss and Joel Seligman, Securities Regulations 4242-4246 (3d ed. 1992). . . . In providing for damages as an alternative to rescission, Section 509(b)(3) follows the 1956 Act and is an improvement upon many earlier state provisions, which conditioned the plaintiff’s right of recovery on his or her being in a position to make a good tender. A plaintiff is not given the right under this type of statutory formula to retain stock and also seek damages.
V. CROWDFUNDING

Crowdfunding has its roots outside of the formal capital markets, drive by the rise of the Internet. The Internet allowed groups of people to pool their money through websites, such as kickstarter.com, to fund various artistic and other creative endeavors. People typically contributed money without regard to investment return, for projects such as the development of a video game, the filming of a documentary, or the writing of a first novel. In return for their funding, project sponsors typically promised contributors copies of the completed video game, a digital download of the finished documentary, or first edition copies of their book.

When crowdfunding fundraisers offer contributors the prospect of financial returns from business activities then the fundraisers run the risk that this “equity model” of crowdfunding will be deemed an offer or sale of a security. One consequence for equity crowdfunding is the application of § 5 of the Securities Act and the gun-jumping rules. The securities law antifraud provisions would also apply.

To regulate equity crowdfunding, Congress enacted the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (the CROWDFUND Act) as part of the JOBS Act of 2012. Following Congress’ directive, the SEC promulgated Regulation Crowdfunding. The JOBS Act exempts equity crowdfunding from § 5 Securities Act § 4(a)(6). Unlike the § 4(a)(2) or Rule 506 exemptions from § 5, the JOBS Act does not restrict the types of investors who may participate in crowdfunding, so retail investors are included. The JOBS Act, however, does exclude certain issuers from crowdfunding including foreign issuers, Exchange Act reporting issuers, and investment companies. Securities Act § 4A(f). These exclusions are in keeping with the purpose of crowdfunding to facilitate capital formation by early stage companies.

A. AGGREGATE OFFERING LIMITS

The JOBS Act limits both the quantity that issuers can sell and investors can buy. An issuer can sell no more than an aggregate $1 million to all investors in a 12-month period in reliance on § 4(a)(6). Rule 100(a)(1) Regulation Crowdfunding. An issuer will often raise capital through different types of offerings that occur close in time. If an issuer raises capital through § 4(a)(6) crowdfunding, the amount sold will reduce the amount the issuer may raise for the next 12 months through another crowdfunding offering. Rule 100(a)(1). If an issuer raises capital through another type of exempt transaction, however, such as a Regulation D private placement, this separately raised capital
will not aggregate for purposes of the $1 million issuer sales limit. Rule 100(a)(1).

Section 4A(h) provides that the SEC must adjust the $1 million issuer aggregate sales limit at least every five years to account for inflation. The $1 million limit parallels the $1 million aggregate offering price limitation in Rule 504. This limit dampens the appeal of crowdfunding for most issuers, especially if they have an established business. Only smaller lesser-known companies—for example new Internet startups—are likely to take advantage of crowdfunding.

Given the high compliance costs that follow a crowdfunding offering, including ongoing reporting requirements, it is unclear why an issuer would want to incur such costs to raise only $1 million. Moreover, other types of exempt offerings, including Regulation D, do not carry those ongoing costs. It is possible that companies may value the “buzz” that the company will receive from a well-publicized crowdfunding offering. This “buzz” may help pave the way for an eventual initial public offering. It is also possible, however, that only those issuers unable to sell through a more traditional private placement will turn to crowdfunding. This selection effect could leave unsuspecting retail investors with higher risk and lower quality issuers utilizing crowdfunding. Moreover, the truly fly-by-night crowdfunding issuers may not care about the costs of ongoing reporting requirements if they do not expect to survive very long, which would give such issuers a cost advantage in choosing crowdfunding.

The SEC requires that the crowdfunding issuer must commit to a target offering amount and an offering deadline. Rule 201(g). Investors may worry that an issuer will not raise enough capital to follow through on its business plans. If a company needs $1 million to launch its product and the company raises only $700,000, investors may worry that the product will not launch and the company will use the $700,000 for other purposes. Addressing this fear, § 4A(a)(7) requires that an intermediary transmit offering proceeds from a crowdfunding offering only when the aggregate capital raised is equal to or exceeds the target offering amount. Investors can also cancel their commitment to invest up until 48 hours prior to the offering deadline identified in the issuer’s offering materials. Rule 304(a). If the issuer does not complete the offering, the intermediary must send each investor notice of the cancellation and refund the offering amount to each investor. Rule 304(d). An issuer that determines that it is unlikely to reach the target offering amount by the offering deadline can change the target amount, but the intermediary must notify investors who have made a commitment and inform the investors that the investor’s commitment will be cancelled unless the investor affirmatively re-commits to the offering. Rule 304(c).
B. INTEGRATION

An issuer that offers or sells securities through crowdfunding and another type of exempt transaction during the same or similar timeframe runs the risk of having the two offerings integrated absent an integration safe harbor, such as Rule 502(a) under Regulation D. Nonetheless, the SEC anticipated the possibility of concurrent crowdfunding offerings and other types of exempt offerings under certain circumstances: “For example, an issuer conducting a concurrent exempt offering for which general solicitation is not permitted will need to be satisfied that purchasers in that offering were not solicited by means of the offering made in reliance on Section 4(a)(6).” Sec. Act Rel. 33-9974, at p. 19.

C. INVESTORS

In addition to the aggregate offering amount limit, the JOBS Act also limits the aggregate amount that may be sold to any particular investor across all issuers in reliance on Section 4(a)(6) during a 12-month period. In Regulation Crowdfunding, the SEC specified the limit for any particular investor as: “(1) The greater of: $2,000 or 5 percent of the lesser of the investor’s annual income or net worth if either the investor’s annual income or net worth is less than $100,000; or (2) 10 percent of the lesser of the investor’s annual income or net worth, not to exceed an amount sold of $100,000, if both the investor’s annual income and net worth are equal to or more than $100,000.” Rule 100(a)(2). For example, if an investor has an annual income of $125,000 and a net worth of $50,000 then the limit would equal $2,500 (5% of $50,000, the lesser of the two thresholds). Notably, the individual investor’s limit is aggregated during any 12-month period for all issuers using the § 4(a)(6) crowdfunding exemption. In establishing the limits for any particular investor, the SEC recognized that the “startups and small business that we expect will rely on the crowdfunding exemption are likely to experience a higher failure rate than more seasoned companies” and that the limits will “potentially limit investment losses in crowdfunding offerings for investors who may be less able to bear the risk of loss.” Sec. Act Rel. 33-9974, at p. 26.

The computation of the annual income and net worth of an investor is the same as accredited investor status under Rule 501 of Regulation D. Rule 100(a)(2), Instruction 1. For example, in determining the net worth of a natural person, the person’s primary residence is not included as an asset. Spouses are also allowed to calculate their net worth or annual income jointly. When computed jointly, the aggregate investment of the spouses may not exceed the limit that would apply to an individual investor with the same income and net worth level. To illustrate, if two spouses utilize joint calculation and have a joint income of $1.2 million and joint net worth of $2 million, then they would be limited to investing $100,000 (the same investment
cap as for individuals) in any 12-month period across all § 4(a)(6) crowdfunding offerings. Issuers may rely on crowdfunding intermediaries to determine that the aggregate amount of securities purchased by any particular investor through crowdfunding does not exceed the investment limit unless the issuer knows that the investor has exceeded the investor limits or would exceed the investor limits by purchasing securities in the issuer’s offering. Rule 100(a)(2), Instruction 3. To account for inflation, § 4A(h) of the Securities Act provides that the SEC must adjust the individual investment dollar limits periodically along with the limits for accredited investor status.

D. INTERMEDIARIES

Given the low investment limits, retail investors are likely to dominate the crowdfunding market. Retail investors purchasing securities from relatively unknown startup companies face risky investment choices without the information or sophistication to make informed decisions. Worst case scenario, retail investors will face a sea of fraudsters. Congress’s solution to this dilemma was to employ third party intermediaries to act as gatekeepers to ensure compliance with the crowdfunding regulations. The starting point for a crowdfunding offering is for an issuer and a crowdfunding intermediary to connect.

The SEC imposes a number of requirements on intermediaries. First, an intermediary must either register with the Commission as a broker under § 15(b) of the Exchange Act or as a “funding portal” under Rule 400 of Regulation Crowdfunding. Rule 300(a)(1). In addition, the intermediary must be a member of a national securities association registered under § 15A of the Exchange Act (FINRA). Rule 300(a)(2).

Brokers that register with the Commission under § 15(b) of the Exchange Act are subject to extensive regulation. These include requirements governing the conduct of the brokers, such as the duty of fair dealing, duty of best execution, suitability, and various restrictions on trading. Registered brokers also must meet certain financial requirements, including minimum net capital requirements, requirements dealing with the use of customer funds, and the keeping of books and records. Finally, registered brokers are subject to examinations and inspections by the SEC and FINRA.

Crowdfunding intermediaries wanting to register as a “funding portal” face a number of requirements specific to them. Funding portals are not allowed to: (i) Offer investment advice or recommendations; (ii) Solicit purchases, sales or offers to buy the securities displayed on its platform; (iii) Compensate employees, agents, or other persons for such solicitations or based on the sale of securities displayed or referenced on its platform; or (iv) Hold, manage, possess, or otherwise handle investor
funds or securities. Rule 300(c)(2). Funding portals must register with the Commission using Form Funding Portal and become a member of FINRA. Rule 400. Note that while the SEC uses the word “broker” in its definition of a funding portal, funding portals that are registered pursuant to Rule 400 of Regulation Crowdfunding are exempt from the broker registration requirements of § 15(a)(1) of the Exchange Act. Consequently, they do not need to register under § 15(b) of the Exchange Act as a broker with the Commission. Rule 401.

The SEC provides a list of permitted activities for funding portals in Rule 402(b), including providing search functions and communication channels to investors, compensating third parties for referrals of persons to the funding portal in certain circumstances, and advertising the funding portal. Rule 402(b). A registered funding portal must also implement written policies and procedures “reasonably designed to achieve compliance with the federal securities laws and the rules and regulations thereunder relating to its business as a funding portal.” Rule 403(a). Funding portals, like brokers, have record-keeping requirements and are subject to examinations and inspections by the SEC and FINRA. Rules 403(c) and 404.

Whether an intermediary is a broker or funding portal, a crowdfunding offering must be conducted only through a single intermediary. Rule 100(a)(3). According to the SEC, “in order for a crowd to effectively share information, we believe it would be most beneficial to have one meeting place for the crowd to obtain and share information, thus avoiding dilution or dispersement of the ‘crowd.’” Sec. Act Rel. 33-9974, at p. 31. The SEC also imposed an “online-only” requirement, requiring that crowdfunding transaction take place over the Internet or another similar electronic medium that is accessible to the public. The SEC believed that the online-only requirement “enables the public to access offering information and share information publicly in a way that will allow members of the crowd to share their views on whether to participate in the offering and fund the business or idea.” Sec. Act Rel. 33-9974, at pp. 31-32.

Intermediaries in a crowdfunding offering face limits on their financial interests. First, affiliates of an issuer, “may not have a financial interest in an issuer that is offering or selling securities” in a crowdfunding offering through the intermediary’s platform. Rule 300(b). Second, the intermediary itself is prohibited from having a financial interest in an issuer except for interests received as compensation for services in a crowdfunding. Those interests must have the same terms as those being offered. Rule 300(b)(1), (2).

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1 The SEC also defines an “associated person of a funding portal or person associated with a funding portal” as “any person directly or indirectly controlling or controlled by such funding portal, or any employee of a funding portal.” Rule 300(c)(1). The SEC then includes, where relevant, persons associated with a registered broker or registered funding portal in its definition of an “intermediary.” Rule 300(c)(3).
The SEC relies on the intermediary in a crowdfunding transaction to screen issuers. The intermediary must, among other things, have a reasonable basis for believing that the issuer complies with the crowdfunding disclosure requirements. Rule 301(a). The intermediary must also have a reasonable basis for believing that the issuer has established means to keep accurate records of the holders of its securities offered and sold through the intermediary’s platform. Rule 301(b). The intermediary must deny access to its platform to an issuer if the intermediary has a reasonable basis for believing that the issuer or any of its officers, directors, or beneficial owners of 20 percent or more of the issuer’s outstanding voting equity securities is subject to disqualification under Rule 503 of Regulation Crowdfunding. The intermediary must conduct a background check as well as check the securities enforcement regulatory history of those individuals. Rule 301(c)(1). The intermediary must deny access to its platform if the intermediary has a reasonable basis for believing that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection. Rule 301(c)(2).

Intermediaries must provide investors with certain disclosures, including among other things, the issuer’s required crowdfunding disclosures (discussed below) and the intermediary’s compensation in crowdfunding offerings. Rule 302(d). The intermediary must provide investors with certain educational materials. Rule 302(a)(2), (b). In a provision unique to crowdfunding, the intermediary must also engage in investor screening. Before accepting a commitment from an investor, the intermediary must have a reasonable basis for believing that the investor satisfies the investment limitations established by § 4(a)(6)(B). Rule 303(b). In satisfying that obligation, the intermediary may rely upon the investor’s representations concerning those requirements unless the intermediary has reason to question the reliability of the representation. Rule 303(b)(2). The intermediary must also obtain from the investor a representation that the investor has reviewed the educational materials and understanding that “his or her investment may be lost, and is in a financial condition to bear the loss of the investment” and a completed questionnaire by the investor demonstrating the investor’s understanding that the investor may face restrictions on the investor’s ability to cancel an investment commitment, that the investor may have difficulty reselling the securities, and that crowdfunding transactions have risk. Rule 303(b)(2).

A key part of the SEC’s vision for crowdfunding is the sharing of information by investors through an intermediary’s crowdfunding platform. Accordingly, the SEC requires an intermediary to provide “communication channels” on its platform for investors to interact with one another and with issuer representatives regarding offerings on the intermediary’s platform. Rule 303(c). The SEC also requires intermediaries to provide notices of investment commitments to
investors, Rule 303(d), maintain and transmit investor funds in a particular manner, Rule 303(e), and send confirmation of transactions to investors, Rule 303(f). Intermediaries are prohibited from compensating any person for identifying investors or potential investors in a crowdfunding transaction. Rule 305.

Crowdfunding poses a dilemma for securities regulators. The goal is to increase capital market access for small and unknown startups that otherwise would have difficulty raising capital. The downside of facilitating capital raising for these companies is that crowdfunding also invites fraudsters and con artists eager to bilk unsophisticated investors of their money. Issuers self-select themselves into the crowdfunding market because they are unable to raise capital from institutional investors through more traditional means. Will harnessing securities market intermediaries as gatekeepers to provide disclosures, conduct investor tests, and background checks adequately offset the increased risk of fraud posed by those issuers?

E. DISCLOSURE

Section 4A(a)(6) requires the issuer to file the information specified in § 4A(b) no later than 21 days prior to the first day that securities are sold to investors through crowdfunding. Through rulemaking, the SEC has delineated the disclosure required in Rule 201 of Regulation Crowdfunding. In particular, the issuer must file a mandatory disclosure document, the Offering Statement (filed on Form C), with the SEC and with the issuer’s selected intermediary. Regulation Crowdfunding provides for both updating disclosures on the progress of an offering (Form C-U) as well as ongoing reporting in an annual report after sales take place (Form C-AR).

1. OFFERING STATEMENT AND PROGRESS UPDATES

Form C requires identification of the issuer (including its physical and website addresses), Rule 201(a), as well as the location of the issuer’s annual report on the issuer’s website, Rule 201(w). The Offering Statement provides information on the control and capital structure of the issuer. Issuers must disclose, among other things, the names of directors and officers, along with their positions, each person’s principal occupation and employment, and their business experience during the past three years. Rule 201(b). Issuers must disclose the names of shareholders with more than 20 percent beneficial ownership of the outstanding voting equity, Rule 201(c), describe the material terms of the issuer’s indebtedness, Rule 201(p), and describe the ownership and capital structure of the issuer, Rule 201(m).

Offering Statement disclosures also cover the issuer’s business and plans. The issuer must describe its business and anticipated business plan, Rule 201(d), disclose the current number of employees, Rule 201(e), and discuss the material factors that make an investment
in the issuer speculative or risky, Rule 201(f). The issuer must also provide a discussion of its financial condition, including “to the extent material, liquidity, capital resources and historical results of operations.” Rule 201(s). The issuer must provide certain financial statements depending on the size of the target offering. For a target offering amount of more than $1 million, for example, the issuer must provide financial statements audited by an independent public accountant. Rule 201(t).

The SEC excludes issuers that lack a specific business plan or plan to engage in mergers or acquisitions with unidentified companies. Rule 100(b)(6). In excluding such issuers, the SEC focused on the information sharing among investors that it hoped would occur in crowdfunding. In the SEC’s view, this information sharing may not occur if investors are not provided with “sufficient information about a particular proposed project or business to allow investors to make an informed investment decision.” Sec. Act Rel. 33-9974, at p. 40.

The Offering Statement includes transaction-specific information including the target offering amount and the offering deadline to reach that target, Rule 201(g), whether the issuer will accept investments in excess of the target amount, Rule 201(h), the purpose of the offering and intended use of proceeds, Rule 201(i), a description of the process for an investor to complete the transaction or cancel an investment commitment (including the investor’s right to cancel an investment commitment until 48 hours prior to the deadline for the offering), Rule 201(j), the price of the securities (or method to determine the price – investors must be provided the final price in writing prior to sale), Rule 201(l). Issuers must disclose the terms of the securities being offered, including voting rights, how the exercise of rights by the principal shareholders could harm the crowdfunding investors, how the offered securities are being valued, and the risks to investors from minority ownership in the issuer and the risks associated with corporate actions such as additional issuances of securities or transactions between the issuer and related parties. Issuers must also disclose restrictions on the transferability of the securities. Rule 201(m).

Issuers must provide updates on their progress in meeting the target offering amount. Rule 201(v). The issuer must also notify investors that if they do not reconfirm their investment commitment after a material change is made to the offering, they will have their investment commitment cancelled and their funds returned. Rule 201(k). The Offering Statement also provides for disclosure regarding the issuer’s selected intermediary, including the intermediary’s financial interest in the transaction and in the issuer. Rules 201(n), (o).

The Offering Statement provides disclosure of certain past transactions of the issuer. This includes a description of exempt offerings within the past three years. Rule 201(q). Issuers must also
describe certain transactions in which a related party had a direct or indirect material interest including: any director or officer of the issuer, any beneficial owner of 20 percent or more of the issuer’s outstanding voting equity securities, and any promoter of the issuer if the issuer was organized within the past three years, and certain family members of the foregoing persons. Rule 201(r). The Offering Statement also requires the disclosure of certain bad acts by the issuer, including any matters that would have triggered disqualification under Rule 503(a) prior to the adoption of the crowdfunding rules, Rule 201(u), and whether the issuer failed in the past to comply with the Regulation Crowdfunding ongoing reporting requirements described below, Rule 201(x). Finally, the Offering Statement includes the usual catch-all provision that requires the issuer 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.” Rule 201(y).

Crowdfunding offerings may take more time to complete than traditional public offerings. Regulation Crowdfunding provides no time limit for offerings, but the issuer must specify a deadline in the Offering Statement. Issuers must also file with the SEC and provide to investors and the relevant intermediary a Form C: Progress Update (Form C-U) to disclose the issuer’s progress in meeting its target within five business days of the issuer reaching the 50 percent and 100 percent amount. Rule 203(a)(3)(i). If the issuer decides to accept proceeds in excess of the target offering amount, the issuer must also file with the SEC and provide to investors and the relevant intermediary, no later than five business days after the offering deadline, a final Form C-U to disclose the total amount of securities sold. Rule 203(a)(3)(ii). Other than the filing of a Form C-U indicating the total amount sold, the issuer does not need to file a Form C-U if the relevant intermediary provides frequent updates on the issuer’s progress to its target or its platform. Rule 203(a)(3)(iii).

2. ONGOING REPORTING

An issuer that has offered and sold securities through crowdfunding under § 4(a)(6) must file with the SEC and post on the issuer’s website “an annual report along with the financial statements of the issuer certified by the principal executive officer.” Rule 202(a), 203(b). The issuer must file the annual report on Form C: Annual Report (Form C-AR). If the issuer has available “financial statements that have either been reviewed or audited by a public accountant that is independent of the issuer” then the certification by the principal executive officer is not required, but those financial statements must be provided. The annual report must update many of the items in the Offering Statement described above. To ensure compliance with ongoing reporting, the SEC excludes issuers from a new crowdfunding offering if
the issuer has failed to provide required ongoing annual reports during the prior two years.

The issuer must report on an ongoing basis until one of several events occur: 1) the issuer is required to file reports under § 13(a) or § 15(d) of the Exchange Act (i.e., the issuer becomes a public reporting company, Rule 202(b)(1); 2) the issuer has filed at least one annual report pursuant to Rule 202 and has fewer than 300 holders of record, Rule 202(b)(2); 3) the issuer has filed the required annual reports under Rule 202 for at least the three most recent years and has total assets that do not exceed $10 million, Rule 202(b)(3); 4) the issuer or another party repurchases all of the crowdfunding securities, Rule 202(b)(4); or 5) the issuer liquidates or dissolves its business in accordance with state law, Rule 202(b)(5).

Will the ongoing disclosure obligation discourage use of crowdfunding? A private company that raises capital through a private placement faces no ongoing disclosure obligations after the offering. If companies that can find sufficient interest to sell securities in a private placement avoid crowdfunding, what type of issuers will be left in the crowdfunding pool?

**F. LIMITS ON ISSUER COMMUNICATION**

Crowdfunding issuers, although subject to mandatory disclosure requirements, also face limits on their ability to communicate directly with investors. Issuers are prohibited from advertising a crowdfunding offering except for notices that direct investors to an intermediary’s platform. Rule 204. Such notices may include the terms of the offering, the amount of securities offered, the nature of the securities, the price of the securities, the closing date of the offering period, and factual information about the legal identity and business location of the issuer. The issuer and those acting on its behalf, who must identify their affiliation with the issuer, may also communicate with investors and potential investors about the terms of the offering through the intermediary on the intermediary’s platform, as long as an issuer identifies itself in those communications. Rule 204(c). Issuers can also compensate others to promote crowdfunding through channels in an intermediary’s platform as long as the compensation is disclosed. Rule 205.

**G. ANTIFRAUD LIABILITY**

Rule 10b–5 applies to crowdfunding, as it does to all transactions in connection with the purchase or sale of securities that use an instrumentality of interstate commerce. Congress also enacted a heightened private antifraud liability provisions specifically for crowdfunding to address concerns about the types of investors (retail) and issuers (smaller, lesser-known) that will participate in crowdfunding.
Crowdfunding antifraud liability closely follows § 12(a)(2) liability. Like § 12(a)(2), only those who purchase securities have standing to bring a private suit under § 4A(c). Section 4A(c) provides that a person who purchases securities in a § 4(a)(6) transaction may bring a private action against an “issuer,” but § 4A(c)(3) defines an issuer to include directors, CEOs, CFOs, and “any person who offers or sells the security in such offering.” Securities Act § 4A(c)(3). Thus, the list of defendants under § 4A(c) is a hybrid of the potential defendants under §§ 11 and 12(a)(2).

Like § 12(a)(2), § 4A(c) provides liability if an issuer makes “an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading” as part of an offering or sale of securities under § 4(a)(6). Also like § 12(a)(2), plaintiffs do not need to show scienter, reliance, or loss causation as part of their cause of action under § 4A(c). Finally, § 4A(c) provides similar remedies to § 12(a)(2). Purchasers receive rescission as their remedy, adjusted for any income received, or damages if they no longer own the securities.

Several defenses are available to issuers. Purchasers that knew of the untruth or omission at the time of the offer or sale are barred. Section 4A(c)(2)(A). Section 4A(c)(1)(B) also provides that § 12(b)’s loss causation defense applies to the § 4A(c) private actions. Issuers also have a reasonable care defense. Section 4A(c)(2)(B). The statute of limitations in § 13 applies. Securities Act § 4A(c)(1)(B).

H. RESALES

As we saw in our discussion of § 4(a)(2) and Regulation D, investors who purchase securities through an exemption from § 5 are subject to resale limits. These privately-placed securities are referred to as “restricted” securities. On the one hand, the resale restrictions reduce the value of the securities to the investors. If they cannot resell, investors cannot convert these securities into cash and will demand an illiquidity discount. On the other hand, the resale restrictions help protect the public offering process. If investors can immediately resell freely after an exempt offering, issuers will have little reason to use public offerings.

Congress followed the path taken for other forms of exempt offerings by imposing resale restrictions on crowdfunding securities. Securities sold pursuant to § 4(a)(6) cannot be resold by the purchaser for one year. Section 4A(e). The SEC provides several exceptions from the restriction on resales, including sales back to the issuer, to accredited investors, sales through a registered public offering, and sales to family members. Rule 501(b).
The one-year legal limit on resale may not be the most important resales constraint. Only smaller, little-known issuers are likely to use crowdfunding. Moreover, issuers can raise only up to $1 million in a 12-month period. The volume of securities sold by a typical crowdfunding issuer generally will be insufficient to support a liquid trading market, even after the 1-year holding period expires, unless the issuer does repeated annual crowdfunding offerings. Without a liquid market, retail investors will have difficulty reselling their securities. They will have to hope that the issuer eventually does a registered public offering, thereby creating a liquid market.

I. “BAD ACTOR” DISQUALIFICATION

Rule 503 addresses disqualification of issuers, brokers, and funding portals. The disqualification sweeps broadly: “the issuer; any predecessor of the issuer; any affiliated issuer; any director, officer, general partner or managing member of the issuer; any beneficial owner of 20 percent or more of the issuer’s outstanding voting equity securities ... any promoter connected with the issuer in any capacity at the time of such sale, any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer, managing member of any such solicitor.” Rule 503(a). If disqualification under Rule 503 applies then the § 4(a)(6) exemption is not available. In other words, if any of the delineated entities or persons eligible for disqualification in fact is disqualified under Rule 503 then the entire crowdfunding offering loses its exemption from § 5.

Rule 503 then proceeds to provide a laundry list of events that lead to disqualification. One path to disqualification focuses on activities (a) in connection with the purchase or sale of any security, (b) involving the making of any false filing with the Commission, or (c) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, funding portal or paid solicitor of investors (collectively termed “securities related activities”). Disqualification occurs if the person was convicted of any securities related activities, or is subject to any court order, judgment or decree that restrains or enjoins such person from engaging or continuing to engage in any conduct or practice involving securities related activities.

Disqualification also occurs if a person is subject to a certain final orders of various regulators including state securities commissions, banking regulators, the Commodity Futures Trading Commission, and the National Credit Union Administration. The final order must bar the person from, among other things, associating with an entity regulated by the particular institution or engaging in the business of securities, insurance, or banking. The final order must be
based on a violation of any law or regulation that “prohibits fraudulent, manipulative or deceptive conduct entered within ten years before such filing of the offering statement.”

Disqualification also results from SEC administrative proceedings. A person is disqualified if he or she is subject to an administrative order that suspends or revokes such person’s registration as a broker, dealer, municipal securities dealer, investment adviser or funding portal, places limitation on the activities, functions or operations of such person, or bars the person from being associated with any entity or from participating in the offering of any penny stock. Persons are also disqualified if they are subject to any administrative order to cease and desist from committing or causing a violation or future violation of § 5 of the Securities Act or any scienter-based anti-fraud provision of the federal securities laws. Disqualification can also result from disciplinary actions from a self-regulatory organization if a person is suspended or expelled from membership in, or suspended or barred from association with a member, of an SRO for conduct inconsistent with “just and equitable principles of trade.” Disqualification can also occur if a person has filed as a registrant or issuer or was an underwriter in any registration statement or Regulation A offering statement that was the subject of an SEC refusal order, stop order, or order suspending the Regulation A exemption or is the subject of an investigation or proceeding to determine whether such an order should be issued; or is subject to certain U.S. Postal Service false representation orders. The SEC can waive disqualification upon “a showing of good cause,” Rule 503(b)(2), but we expect the SEC to use this waiver authority sparingly.

J. INSIGNIFICANT DEVIATIONS

As with Rule 508 of Regulation D, the SEC provides forgiveness for minor deviations from Regulation Crowdfunding’s requirements. Rule 502 of Regulation Crowdfunding provides that: “A failure to comply ... will not result in the loss of the exemption” if the issuer can demonstrate several conditions: 1) the failure to comply was “insignificant with respect to the offering as a whole,” 2) the issuer made a “good faith and reasonable attempt to comply, and 3) the issuer “did not know of such failure where the failure ... was the result of the failure of the intermediary to comply with the requirements of section 4A(a) of the Securities Act and the related rules, or such failure by the intermediary occurred solely in offerings other than in the issuer’s offering.” Note that § 4A(a) deals with requirements imposed on intermediaries in a crowdfunding offering. As with Rule 508 of Regulation D, the forgiveness under Rule 502 of Regulation Crowdfunding does not preclude the SEC from bringing an enforcement action. Forgiveness under Rule 502 of Regulation Crowdfunding only protects against private liability for violations of § 5 that might occur due to the loss of the crowdfunding exemption.
K. PUBLIC COMPANY STATUS

We saw in Chapter 4 that private companies seeking to raise capital through exempt offerings must worry about inadvertently becoming a public company. The JOBS Act of 2012 greatly alleviated the risk of becoming a creeping public company by: 1) increasing the threshold number of shareholders of record of a class of equity to become a public company from 500 to 2,000 (or 500 non-accredited investors); and 2) excluding employees from the shareholders of record tally if they receive equity securities through exempt transactions pursuant to an employee compensation plan.

Crowdfunding poses a heightened risk to startups of becoming a public company. The startup must worry that crowdfunding will attract a relative large number of retail investors, each purchasing a relatively small number of shares, which will trigger public company status if the total assets of a startup company are above $10 million. To avoid public company status, it is much better to have one institutional investor purchase 200,000 shares than to have 2,000 retail investors each purchase 100 shares. The fear of accidentally triggering public company status could chill the use of crowdfunding by startups. Addressing this concern, Rule 12g-6 of the Exchange Act provides that holders of securities purchased in a crowdfunding transaction are not counted toward the number of shareholders of record threshold of § 12(g) of the Exchange Act for public company status if: 1) the issuer is current in its annual crowdfunding reporting obligation; 2) the issuer retains the services of a registered transfer agent pursuant to § 17A of the Exchange Act; and 3) the issuer has less than $25 million in assets as of the end of its last fiscal year.

HYPOTHETICAL EIGHTEEN

Redeye, Inc. is a startup company based in New York City that manufactures highly caffeinated energy drinks. Jeff, the CEO, founder, and sole shareholder of Redeye, hopes to break out of the Northeast region and market Redeye’s energy drinks on the West Coast in direct competition with Trendy, Inc. Redeye is a low budget operation and Jeff calculates that Redeye needs only $500,000 to launch a social media campaign to raise its awareness on the West Coast. What are the pros and cons of crowdfunding for Redeye? What alternatives methods of raising capital would you suggest to Jeff?