



CLIENT ALERT

Introduction

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups Act (the "Act") into law. The Act introduces several historic reforms to facilitate capital formation, including the creation of a new exception under Section 4 of the Securities Act of 1933 (the "Securities Act") permitting crowdfunding transactions. Crowdfunding is the offering of unregistered securities through a registered internet intermediary website or broker to raise small amounts of money (up to \$1,000,000) from a large pool of investors. Prior to enactment, entrepreneurs, new ventures and charities had proven with great success that the internet and social media can be used to raise money from hundreds or thousands of contributors in exchange for either rewards, a gift or the completed product once manufactured. The reforms will now allow securities to be sold so that contributors may become shareholders.

Crowdfunding Intermediaries: Funding Portals & Brokers

Crowdfunding transactions may only be conducted through either a broker or funding portal registered with the Securities & Exchange Commission ("SEC") and probably the Financial Industry Regulatory Authority as well. A funding portal is a new form of registered entity whose rules and regulations are currently being drafted. As a law firm, we are cooperating and participating in the process. Unlike a broker, a funding portal is restricted from offering investment advice or recommendations to investors. Its members may not solicit purchases, sales or offer to buy securities offered by the portal. Funding portals are strictly prohibited from paying its agents or employees any compensation based on the sale of securities offered on its portal or website. The SEC is currently drafting the new rules and regulations that will define the registration process, legal obligations and liabilities of a funding portal.

The crowdfunding intermediaries will have certain obligations to protect investors. For example, the Act requires a crowdfunding intermediary to:

- Ensure that investors review certain educational material and acknowledge that the investor both understand the risks inherent in a crowdfunding investment and can sustain the risks of loss;
- Ensure that investors demonstrate an understanding of the risks associated with investing in new ventures and small business;
- Implement measures to reduce the risks of fraud;

- Implement measure to ensure that the proceeds of an offering are only released to the issuer when the target offering amount is reached or exceeded;
- Comply with applicable privacy rights and protections of information requirements;
- Ensure that investors do not purchase an amount of crowdfunding securities during a 12 month period in excess of the statutory limit; and
- Prohibit its directors, officers or partners from participating in a crowdfunding offering or having any financial interest in a company that uses its services.

Offerings Limitations & Requirements

The Act limits both the aggregate value of securities that an issuer may offer through a crowdfunding intermediary and the amount that an individual can invest. An issuer may sell up to an aggregate of \$1,000,000 of its securities during any 12 month period. Investors with an annual income or net worth of less than \$100,000 will only be permitted to invest the greater of \$2,000 or 5% of their annual income or net worth in any 12 month period. Investors with an annual income or net worth greater than \$100,000 will be permitted to invest the greater of \$100,000 or 10% of their annual income or net worth. Investors are limited to investing \$100,000 in crowdfunding issues in a 12 month period.

Investors who purchase securities in a crowdfunding transaction are restricted from transferring those securities for a period of one year. This restriction is subject to certain exceptions, including transfers: (i) to the issuer; (ii) to an accredited investor; (iii) pursuant to an offering registered with the SEC; (iv) or to the investor's family members.

The option of raising capital through a crowdfunding offering is only available to domestic issuers that are neither reporting companies under the Securities Exchange Act of 1934 nor investment companies. The SEC will further provide rules disqualifying certain "bad actor" from participating, including persons with criminal convictions or court injunction in connection with the purchase or sale securities.

Issuer Responsibilities

Equal access to and disclosure of material information is a core principal of federal and state securities regulations. It is essential for investors to have the necessary information to appreciate the potential risks and rewards of an investment. The Act requires issuers to provide investors with a description of the following:

- Company: the issuer and its members, including the name, legal status, physical address, the names of the directors and officers holding more than 20 percent of the shares of the issuer.
- Offering: the anticipated business plan of the issuer, the target offering amount, the deadline to reach the target offering amount and the price to the public of the securities.
- Structure: the ownership and capital structure of the issuer, including terms of the securities of the issuer being offered.
- Valuation: how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future, including during subsequent corporate actions; and
- Risks: the risks to purchasers of the securities relating to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties.

The intermediary crowdfunding portals are also required to make available to the SEC and to potential investors any information provided by the issuer no later than 21 days prior to the first day on which securities are sold to any investor.

The extent to which an issuer must disclose its financial statements varies depending on the aggregate amount offered, including any prior offerings in the preceding 12 months period. For crowdfunding offerings with an aggregate offering amount up to \$100,000, the issuer must disclose its most recently filed income tax returns and its financial statements certified by the issuer's principal executive officer. For offerings that exceed \$100,000 during the 12 month period but are less than \$500,000, the issuer must provide financial statements reviewed by an independent public accountant. If an aggregate offering amount exceeding \$500,000, the issuer must provide audited financial statements.

Crowdfunding Rules & Regulations

The Act requires the SEC to draft the rules regulating crowdfunding within 270 days from the date of its enactment, namely January 1, 2013. The rules will further define the role of intermediaries in crowdfunding transactions, obligations of issuers and the rights of investors. On April 21, 2012, EG&S was privileged to be the only law firm to participate in a formative meeting with the SEC along with several leading intermediary sites to discuss the substance of the new regulations. The SEC is currently accepting comments from members of the public in advance of its publication of the draft regulations.

Ellenoff Grossman & Schole LLP

Ellenoff Grossman & Schole LLP was the premier sponsor at Deal Flow Media's Crowdfunding Conference on April 19th, in New York City. Douglas S. Ellenoff, a member of the Firm, opened the conference with his keynote address focusing on the outlook of the crowdfunding market. Sarah E. Williams, also a member of the Firm, moderated the panel: *Understanding Policy Issues vs. Securities Rules if you're in the Crowdfunding Business.*

The Firm is actively engaged with clients in fashioning what level of regulatory review and monitoring is appropriate by the SEC and FINRA in balancing the interests of the program with investor protection. EG&S has established a Crowdfunding Group comprised of the following members:

Douglas S. Ellenoff
Barry I. Grossman
Adam Mimeles
David Selengut
Sarah Williams

Joan Adler
George Georgiades
Svetlana Lebedev
Matthew Bernstein

To learn more about crowdfunding and the recent reforms in capital formation, we invite you to join our Resource Center or contact our members.

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For more information on EG&S' Resource Center, please visit:
<http://www.egsllp.com/resource-center-list.html>

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