

# Getting Ready for Crowdfunding

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A Legal Guide to Understanding Federal Equity Crowdfunding Regulations



## Notice

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## Overview

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Many entrepreneurs, especially in the technology sector, start their business with some expectation that their idea will capture the attention of venture capitalists who will, in turn, make an investment that will catapult their company's success. In reality, venture capitalists fund less than 1% of startups and small businesses. The vast majority of entrepreneurs rely on their personal savings, credit cards, and friends and family to launch their companies. Congress' response to the reality that small businesses have fairly limited access to the capital markets was to pass the Jumpstart Our Business Startups (JOBS) Act in 2012 to, among other things, permit equity crowdfunding. The U.S. Securities and Exchange Commission (SEC) issued Regulation Crowdfunding, the set of rules and regulations for equity crowdfunding in 2015. Regulation Crowdfunding rules go into effect on **May 16, 2016**.

### What Is Crowdfunding?

Crowdfunding is the practice of funding a project or venture by raising monetary contributions from a large number of people primarily over the Internet. There are two main types of crowdfunding: rewards-based crowdfunding and equity crowdfunding.

Rewards-based crowdfunding allows entrepreneurs to pre-sell a product or service or to launch a business concept without incurring debt or selling equity. Supporters receive rewards, such as discounts off the product or service once it is released, in exchange for supporting the project now. Platforms such as Kickstarter and Indiegogo are frequently used for rewards-based crowdfunding initiatives.

Equity crowdfunding allows entrepreneurs to sell small amounts of stock or other equity in their companies to raise capital. Prior to the passage of the JOBS Act, equity crowdfunding was not permitted under federal securities laws unless done through specific exemptions, such as in cases where the offer was restricted to residents of just one state. Regulation Crowdfunding removes these types of geographic restrictions and allows businesses to sell securities across state lines without the requirement of a burdensome registration process but only if the rules of Regulation Crowdfunding are followed.

### Is Crowdfunding Exempt from Securities Laws?

Yes, equity crowdfunding when conducted in compliance with the rules under Regulation Crowdfunding is exempt from registration under federal securities laws. Meeting all of the requirements under the federal regulations is important because without them, a business would need to register its stock with the SEC – a very time-consuming and expensive process – or risk being prosecuted for selling unregistered securities.



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Because states can also regulate sales of securities occurring within their borders, the JOBS Act specifies that states may require notice filings of an offering under Regulation Crowdfunding but may not impose any filing fees as a requirement to such filings, except for those states where the issuer has its principal place of business or at least 50% of the purchasers reside. However, registration is only one aspect of securities laws compliance. The SEC and individual states always retain the right to investigate and prosecute fraudulent securities activities. Overstating expectations about projected revenue or failing to disclose events that could have an adverse impact on a business can leave investors feeling misled so, no matter what, businesses always need to be careful of what information they release to investors and when in order to avoid accusations of fraud or misconduct.

### **What Is the Process for Beginning a Crowdfunding Campaign?**

Before beginning any equity crowdfunding campaign, you will want to assemble your team of advisors to assist you in planning. Consider seeking the advice of a small business counselor to help with understanding your capital needs and updating any business plan that you have. You may also want to speak with your accountant as you will need to disclose financial statements to potential investors. In addition, if your entity is formed as an S-corporation, you will want to make sure that the offering you undertake does not jeopardize your S-election status in terms of the number of investors that buy shares and the type of stock that you sell. You may also want to consult with legal counsel to help with planning the structure and documentation for the offering and to make sure that all of your corporate governance documents are in good order.

Once you know the size and structure of your offering, you will need to select an intermediary to conduct the crowdfunding offerings. An intermediary is either a federally registered broker or a funding portal registered with the SEC. The intermediary will be responsible for conducting the crowdfunding campaign through a portal or other platform over the Internet. Only one intermediary can be used at a time for any crowdfunding campaign that a business undertakes.

The remainder of this booklet examines the key aspects of how a crowdfunding campaign under Regulation Crowdfunding works so that you can work with your team of advisors on launching your campaign.



## Eligibility

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Equity crowdfunding is available to a variety of businesses. However, there are some basic requirements that a company needs to meet in order to engage in a crowdfunding offering under Regulation Crowdfunding.

- ❖ The company must be a domestic entity (i.e., formed as a business entity in any State or territory of the United States or in the District of Columbia).
- ❖ If the company has raised money through Regulation Crowdfunding before, the business must be in compliance with all annual reporting requirements.
- ❖ The company must have been formed with a specific business plan and not simply for engaging in a merger or acquisition with another business.
- ❖ The company cannot be a reporting company under the Securities Exchange Act of 1934.
- ❖ The company cannot be an investment company under the Investment Company Act of 1940.
- ❖ Neither the company nor any director, officer, owner holding at least 20% of the business, or solicitor can be the subject of any disqualifying events, including conviction of any felony or misdemeanor involving the sale of securities or be subject to a order or court degree prohibiting that person from engaging in securities transactions.

While none of these requirements is particularly onerous or difficult, care should be taken with respect to the last bullet point as founders may not have a complete grasp of the backgrounds and histories of people that they invite to join the board or be an investor and may, by failing to ask, become associated with someone who is the subject of a disqualifying event. A good practice is to use what is called a “bad actor” questionnaire when hiring new officers, recruiting new board members or taking on new investors so that founders do not unknowingly bring people into the organization that create eligibility problems.



## Selecting an Intermediary

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Crowdfunding campaigns offered under Regulation Crowdfunding must be conducted through an intermediary. An intermediary can be either a federally registered broker or a funding portal registered with the SEC. Funding portals may not offer investment advice or recommendations.

The primary roles of an intermediary are to:

- ❖ Reduce the risk of fraud to investors;
- ❖ Make information available to investors about crowdfunding campaigns made available on their funding portal or platform;
- ❖ Provide investors with educational materials about the risk of loss of their investments;
- ❖ Provide a communications channel on its portal or platform so that interested investors can communicate with each other and with the representatives of the company making the crowdfunding offering;
- ❖ Notify the company of any investor commitments received for the crowdfunding offering;
- ❖ Direct the collection funds from the investors and transmittal of funds to the company once the crowdfunding offering is closed; and
- ❖ Provide investors with confirmation of the closing of the offering.

An intermediary is only able to share information and conduct crowdfunding transactions for investors who have or establish an account with that intermediary. In addition, because funding portals cannot offer investment advice, they may not promote particular crowdfunding campaigns. Instead, funding portals are allowed to highlight crowdfunding campaigns based only upon objective criteria, such as the locations or industry type of live campaigns and the progress to date of reaching target campaign amounts, so long as the criteria is consistently applied to all campaigns on the funding portal's platform.

Selecting an intermediary is an important decision because a company making a crowdfunding offering cannot conduct its offering(s) using more than one intermediary. For instance, let's say that a company wants to raise capital to develop a cool new product and also to purchase a building for locating its headquarters. If that company decides to raise \$200,000 to accomplish both of those goals, it could try to do so by making a single crowdfunding offering for the entire amount of \$200,000. However, it could also consider splitting up the goals into two separate offerings, hoping to attract support for its cool new

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product from investors who like investing in technology or are potential consumers of the product and separate support for buying the real estate from investors who may be located in the town/city where the property is located or like investing in real estate. Regardless of the strategy employed, only one intermediary may be used by that company for all crowdfunding offerings that it has open at the same time.

When selecting an intermediary, consider the following:

- ◇ **Pricing.** It is too early yet to have a good understanding of the types of fees that intermediaries will charge businesses for hosting crowdfunding campaigns. Comparison-shopping is advisable until the market matures enough that fees across intermediaries normalize.
- ◇ **Registration.** Do not assume that funding portals found on the Internet have the proper registration. Funding portals operating outside of the U.S. must be registered with the SEC.
- ◇ **Number of Investor Accounts.** Crowdfunding relies upon lots of people making smaller investments rather than a few individuals making large investments. Therefore access to large numbers of potential investors to view your campaign is important.
- ◇ **Specialization.** Does the intermediary handle crowdfunding campaigns across a wide array of industries or has it become known for crowdfunding campaigns of a certain type? For instance, if an intermediary, through its marketing efforts or otherwise, has a large concentration of investors from New England and you are a local business located in New Hampshire, having access to investors with local ties may be an important part of your strategy for reaching your crowdfunding goal.
- ◇ **Broker vs. Funding Portal.** Funding portals cannot give investment advice to investors. Is there a complexity to your business strategy that might be better served by having a broker available to work with investors to understand your business plan and therefore make your crowdfunding campaign more interesting to those investors?

There may be other factors to consider as well. It is still too early to predict how intermediaries will differentiate themselves in the market and to establish themselves as preferred and reputable vendors of crowdfunding services. Careful evaluation of any intermediary is recommended.



# Terms of the Offering

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The terms that a company offers to investors as part of a crowdfunding campaign or offering will vary depending on the maturity of the business, its capital needs and how the crowdfunding offering fits with the company's overall funding strategy. The crowdfunding offering of an existing company that is already generating revenue but is looking for capital for expanding its product or service offerings may be structured very differently from a technology startup that is raising capital to cover operating expenses to create a minimum viable product (MVP) and then plans to raise venture capital investment. Regardless of the exact terms, all crowdfunding offerings need to address the following terms in the offering documents:

## Target Offering Amount and Deadline

Under Regulation Crowdfunding, an offering must identify the target dollar amount to be raised and the deadline to reach this target amount. Companies, whether alone or with their affiliates, may not raise more than \$1 million through equity crowdfunding in any 12-month period. Once a target dollar amount is set, failure to meet or exceed the target dollar amount by the offering deadline will result in the termination of the offering and all investment commitments will be cancelled and committed funds returned to investors. For this reason, a company is going to want to be realistic about its ability to raise funds over whatever deadline it chooses.

It is possible to accept investments in excess of the target dollar amount disclosed to investors. However, in order to do so, the business must disclose upfront whether it plans to accept over-subscriptions and the maximum dollar amount that it will accept. The company will also need to disclose how over-subscriptions will be allocated among interested investors who come along after the target dollar amount is reached, such as on a *pro rata* or a first come-first served basis.

## What Type of Security Is Being Sold

If the company is a corporation, it will likely be selling stock. If the company is a limited liability company (LLC), it will likely be selling membership interests or units. However, it is possible to create classes of stocks and membership interests to allow for, among other things, voting rights, dividend and liquidation preferences and anti-dilution rights.

A company may be inclined to issue the same type of security as the founders have to crowdfunding investors. This is, by far, the simplest approach. However, consideration should be given to the practical effects of having a large number of investors with small percentages of voting power. While founders might not ever be in jeopardy of losing voting control, there can be burdens associated with a large voting class of security holders exists. For examples, holding shareholder meetings (and giving notice for such meetings) or in acting by written consent in lieu of a meeting if a company's bylaws or operating

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agreement require action by unanimous consent may present logistical challenges that delay management's ability to take action on certain business initiatives.

Some companies may want to consider offering a liquidation preference to crowdfunding investors as an incentive for making their investment. A liquidation preference could allow the crowdfunding investors to receive their original investments back first following the sale or dissolution of the company before the founders received any money. However, for a company with existing investors, this type of preference would need to be appropriately balanced against the rights of existing investors to receive their original investment plus any accrued dividends (if any).

As you can see, the structuring of the type of security offered through a crowdfunding offering must be carefully considered in light of a company's existing capital structure and the charter documents that address both capital structure and governance. If your entity is formed as an S-corporation, this is especially important, as you will want to make sure that you not jeopardize your S-election status in terms of the number of investors and the type of stock that you sell.

## Pricing

Regulation Crowdfunding requires that a company not only disclose the price per share of the securities offered for sale but also a description of how those securities were valued and examples of methods of how such securities may be valued in the future. For this reason, pricing of crowdfunded securities should be considered in light of past funding by the company as well as anticipated future funding.

## Restrictions on Transfer

Regulation Crowdfunding requires a one-year holding period on all crowdfunded securities before they can be transferred. (See [Restrictions on Resale](#) for more information.) If a large number of investors is anticipated in a crowdfunding offering, a company may wish to consider imposing further restrictions on the transfer of its securities so as to avoid the administrative burden of having to record small transfers of securities on its books or records. In addition, if a company has existing investors, there may already be restrictions on transfer in place for securities held by those investors. Common transfer restrictions include a right of first refusal or drag along rights imposed by majority shareholders.

A right of first refusal allows an existing investor to find a purchaser for his/her securities in a company and then gives that company the right to repurchase those securities on the sale terms as the investor negotiated with the new purchaser. In many cases, if the company declines to exercise its option, the option to purchase is then passed on to the other investors in the company. If neither the company nor the other existing investors



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elects to purchase any of the offered securities, the investor is free to go forward with the sale to the new purchaser.

A drag along right compels minority shareholders to sell their holdings in the event that a buyer comes along and wants to purchase or acquire a 100% interest in the company. The minority shareholders must sell their interests on the same terms as those negotiated between the majority shareholders and the buyer.

Whether a company already has restrictions in place on the transfer of its securities or decides to impose new restrictions on crowdfunded securities, these restrictions must be decided upon in advance of the offering and disclosed to potential investors as part of the offering terms.



## Investor Requirements

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Investors are limited in the amount that they can invest in crowdfunding offerings in any 12-month period. An investor with *either* annual income or net worth of *less than* \$100,000 is limited to annually investing \$2,000, or 5% of the investor's annual income/net worth, whichever is greater. An investor with both annual income and net worth exceeding \$100,000 is limited to annually investing a maximum of 10% of the investor's annual income/net worth, subject to an investment cap of \$100,000. So for example, an investor with annual income of \$50,000 a year and \$105,000 in net worth would be subject to an investment limit of \$2,500. Warren Buffett, having a net worth of over \$66 billion, would be subject to the maximum investment cap of \$100,000 in any 12-month period. Regulation Crowdfunding adopts the net worth test used with certain other federal securities exemptions, meaning that an investor's primary residence cannot be included as an asset when calculating net worth. Given these investment caps, a successful crowdfunding campaign seeking a large amount of capital could require 100+ investors.

Intermediaries are primarily responsible for verifying investor qualifications to participate in crowdfunding offerings. In addition to confirming the maximum amount that an investor may invest, intermediaries must also obtain from each investor:

- ❖ Certification that the investor has reviewed the intermediary's educational materials, understands that there is a high risk of loss of the investment and is in a financial condition to bear the loss of the investment; and
- ❖ A questionnaire completed by the investor demonstrating the investor's understanding that there are restrictions on the investor's ability to cancel participation in a crowdfunding offering, that the crowdfunded securities may be difficult for the investor to sell and that investment in crowdfunded securities should not be made unless the investor can afford to lose the entire amount of his or her investment.



# Disclosure Requirements

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In order to engage in a crowdfunding offering, there are a number of disclosures that must be made to both investors and the intermediary. These disclosures will also need to be filed with the SEC. The required disclosures include:

- ❖ **Basic Company Information** – Includes name; entity type; physical address; website; names of directors and officers with description of their business experience over the past 3 years and the number of years in which each person has held their position with the company; names of any owners holding 20% or more of the voting securities of the company; and, the current number of employees.
  - ❖ **Offering Details** – Includes the target offering amount and deadline (including details about over-subscriptions); a description of the purpose and intended use of the crowdfunding proceeds; a discussion of the material factors that make an investment in the issuer risky; the pricing of the crowdfunded securities; and, the method for determining the price.
  - ❖ **Process for Making/Cancelling an Investment Commitment** – Includes a description of the process to complete the transaction or cancel an investment commitment. This process must address the following:
    - ◇ Investors may cancel an investment commitment until 48 hours prior to the deadline for closing the crowdfunding campaign.
    - ◇ The intermediary must notify investors when the target offering amount has been met.
    - ◇ If a company reaches its target offering amount early, then it may close the campaign early if it provides at least 5 business days notice to investors and the SEC.
    - ◇ If an investor does not cancel an investment commitment before the 48-hour period prior to the closing deadline, their funds will be released upon the closing of the offering.
    - ◇ If the company makes a material change to its disclosure materials, an investor must reconfirm his or her commitment or the investment commitment will be cancelled and the investor's money returned.
  - ❖ **Ownership and Capital Structure** – Includes a description of the crowdfunded securities and each other class of security of the company, including voting rights and how the crowdfunded securities may be diluted or limited in the future, disclosure of any options held by principal shareholders; and, a description of how
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the crowd-funded securities are being valued as well as methods of how they may be valued in the future. Any material debt of the company must also be disclosed, including principal owed, interest rate and maturity date.

- ❖ **Risks to Purchasers** – Includes a description of risks to purchasers relating to minority ownership in the company and the risks associated with future company action if the company issues additional securities or sells the business.
- ❖ **Restrictions on Transfer** – Includes a description of the restrictions on transfer, including the one-year holding period required under Regulation Crowdfunding.
- ❖ **Intermediary’s Financial Interest in the Offering** – Includes the identity of the intermediary; and, the amount of compensation to be paid to the intermediary or any other arrangement between the intermediary and the company.
- ❖ **Past Offerings** – Includes a description of any exempt offerings conducted within the past 3 years, including the date of the offering, the type of securities exemption relied upon, the type of securities, the amount of securities sold and the use of proceeds.
- ❖ **Financial Condition** – Includes a discussion of the company’s financial condition, including liquidity, capital resources and historical results of operation. If the company has no prior operating history, the discussion should identify financial milestones and operational, liquidity and other challenges that the company anticipates.
- ❖ **Updates and Reporting** – Includes periodic updates on the progress of the crowdfunding campaign, where on the company’s website investors will be able to fund the company’s annual report and whether the company has ever failed to comply with its ongoing reporting requirements under Regulation Crowdfunding.



# Financial Statements

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Financial statements must also be included with the disclosures required under Regulation Crowdfunding. The type of financial statements required depends upon the amount of money being raised through the crowdfunding campaign.

- ❖ **Offerings raising \$100,000 or less.** The company must disclose the amount of total income, taxable income and total tax, as reported on the federal income tax returns filed by the company for the most recently completed year *and* provide management prepared financial statements, both of which must be certified as being true by the principal executive officer of the company. However, if the company has either reviewed or audited financial statements by an independent public accountant, the company must provide those reviewed or audited statements instead of the tax return and management prepared information.
- ❖ **Offerings raising more than \$100,000 but no more than \$500,000.** The company must disclose reviewed financial statements from an independent public accountant. However, if the company has audited financial statements, the audited financial statements must be disclosed instead of the reviewed financial statements.
- ❖ **Offerings raising more than \$500,000.** The company must disclose audited financial statements. However, if the company is raising less than \$1,000,000, and this is its first crowdfunding offering, it may provide reviewed financial statements instead.

Financial statements must include balance sheets, statements of income, statements of cash flows, statements of changes in stockholders' equity and notes to the financial statements. They must cover the two most recently completed fiscal years of the company or the period since formation (if shorter). All financial statements must be prepared in accordance with U.S. GAAP.



## Ongoing Reporting

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Once the crowdfunding offering is closed, the company has an ongoing obligation to make annual reports to the SEC and its investors. Reporting to the SEC must be done on SEC Form C (available on the SEC website). The annual report to investors must be posted on the company's website. The annual report must include updated disclosures about the company's location, number of employees, risk factors that may make the investment risky, changes in capital structure, current indebtedness, any additional exempt offerings, related party transactions and whether the company remains in compliance with the reporting requirements under Regulation Crowdfunding.

Financial statements will need to be included with the annual report. If a company has undertaken to have reviewed or audited financial statements prepared since the closing of its crowdfunding offering, it must provide the reviewed or audited statements.

Annual reporting must continue until one of the following occurs:

- ❖ The company becomes a reporting company under the Securities Exchange Act;
- ❖ The company has filed at least one annual report under Regulation Crowdfunding and has fewer than 300 shareholders;
- ❖ The company has filed annual reports under Regulation Crowdfunding for at least 3 years and has total assets of less than \$10 million;
- ❖ The company repurchases all of the crowdfunded securities from investors; or
- ❖ The company liquidates or dissolves its business.



# Filing Requirements

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There are a number of filing requirements for offerings under Regulation Crowdfunding. All filings must be made electronically through the SEC's EDGAR filing system. Attachments must be in PDF format.

- ❖ **Form C: Offering Statement** – This is the form that companies must file with the SEC and provide to investors and the intermediary *prior to* sale of crowd-funded securities. Form C must be accompanied by an attachment that contains all the disclosure information required under Regulation Crowdfunding. The SEC has an optional Question and Answer Format for an Offering Statement that a company may use for its disclosures.
- ❖ **Form C: Amendment** – Any material changes, additions or updates to the company's business or the crowdfunding offering must be disclosed to investors and the intermediary and filed with the SEC on this form. If the amendment reflects a material change, addition or update, the company must check the box indicating that investors must reconfirm their investment commitments. Failure to reconfirm within 5 business days by an investor results in cancellation of his or her investment commitment.
- ❖ **Form C: Progress Update** – This form is used to disclose progress in meeting the target offering amount in a crowdfunding campaign. An update form is required to be filed no later than 5 business days after a company reaches 50% of its target amount and after reaching 100% of its target amount. Progress updates do not have to be filed if the intermediary makes publicly available on its platform frequent updates regarding the progress of a company in meeting its target offering amount. However, a final update report must be filed with the SEC to disclose the total amount of securities sold by no later than 5 business days after the offering closes.
- ❖ **Form C: Annual Report** – Annual reports must be filed on this form with the SEC by no later than 120 days after the end of the fiscal year covered by the report.
- ❖ **Form C: Termination** – If a company is eligible to terminate its reporting obligations with the SEC, the company must file this form within 5 business days of becoming eligible to terminate its reporting obligations.

Because states can also regulate sales of securities occurring within their borders, the JOBS Act specifies that states may require notice filings of an offering under Regulation Crowdfunding but may not impose any filing fees as a requirement to such filings, except for those states where the company has its principal place of business or at least 50% of the crowdfunding purchasers reside. Companies therefore need to stay informed on the filing requirements in each state where an investor resides and make appropriate filings accordingly.

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# Advertising

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Letting the world know that your company has a crowdfunding campaign will be critically important to the campaign's success. However, Regulation Crowdfunding does set limits on what companies can communicate to potential investors.

Companies may issue notices or announcements of a crowdfunding campaign as long as those notices meet the following requirements:

- ❖ The notice may contain the basic terms of the offering (e.g., type of securities being sold, target offering amount, pricing);
- ❖ The notice must identify the name of the intermediary through which the offering is being made and contain a link to the intermediary's platform; and
- ❖ The notice must contain the name of the company, its address, phone number and website, the email address of a company representative, and a brief description of the business.

Any form of advertisement beyond the general notice discussed above is not permitted.

Because of this restriction on advertising, companies must be very careful about communications made to potential investors. Any inquiries received directly by company representatives should be directed to the intermediary platform hosting the company's offering materials and investors should be encouraged to post their questions on the platform. By failing to use the platform and responding to individual inquiries by email or other means, a company could be deemed to be advertising to or soliciting a particular investor in violation of Regulation Crowdfunding and risk enforcement action by the SEC. When responding to an investor question on the intermediary platform, company representatives must identify themselves as being affiliated with the company on all communications.



## Summary of Process

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Prior to Go Live

- **Prepare Disclosures & File Form C with SEC**
- **Release Crowdfunding Announcement to Public**

During Campaign

- **Amendments:** If material changes to the company or the offering occur, file Form C: Amendment to advise SEC and investors of changes within 5 business days of change occurring
- **Receive regular updates as to commitments and cancellations from intermediary**
- **Progress Updates:** Either regular updating through crowdfunding platform or filing Form C: Progress Update within 5 business days of reaching 50% goal

Campaign Close

- **48-Hours Before Offering Deadline:** All investment commitments are non-cancellable
- **Closing:** Intermediary facilitates transfer of funds to company; company issues securities to investors; file Form C: Progress Update within 5 business days

Post-Closing

- **120 Days After Year End:** File Form C: Annual Report with SEC and post on company website
  - **Reporting Termination Event Occurs:** File Form C: Termination with SEC within 5 business days
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## Promoter Compensation

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A company engaging in a crowdfunding offering may compensate someone to promote its campaign through the communication channels provided on an intermediary's platform. This can be a person specifically hired to promote the offering or an employee who is undertaking the promotional activities on behalf of the company. If such a promoter is engaged, the company must take reasonable steps to make sure that any communications made by that promoter clearly discloses that he or she has or may receive compensation as a result of such promotional activities. All activities of the promoter must be done through the intermediary's platform and no other form of advertising or promotion by the promoter is permitted.



## Restrictions on Resale

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Regulation Crowdfunding requires that anyone purchasing crowdfunded securities hold those securities for at least one year before they can be sold or transferred unless the crowdfunded securities are transferred:

- ❖ Back to the company that issued the securities;
- ❖ To an accredited investor;
- ❖ As part of a registered offering with the SEC;
- ❖ To a member of the family of the purchaser;
- ❖ To a trust created for the benefit of the purchaser or his/her family; or
- ❖ In connection with the death or divorce of the purchaser.

Once this one-year period has lapsed, a purchaser may transfer their securities to anyone unless the securities are otherwise contractually limited. The SEC currently plans to conduct a study of the secondary market that develops for crowdfunded securities over the next three years to determine what additional regulations may be required for the resale of crowdfunded securities.



## Penalties

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The rules and requirements under Regulation Crowdfunding were intended to strike a balance between providing businesses with greater access to capital and protecting investors from fraudulent investment scams. The SEC takes its job of protecting the public from investment fraud and frequently brings enforcement actions against those who violate federal securities laws.

Common violations that may lead to SEC investigations include:

- ❖ Misrepresentation or omission of important information about securities;
- ❖ Stealing customers' funds or securities;
- ❖ Selling unregistered securities.

Failing to observe all of the requirements under Regulation Crowdfunding, including failing to make accurate disclosures to investors, can result in loss of the exemption from registration. In essence, it results in the company having sold unregistered securities. Should the SEC bring an enforcement action against a company selling unregistered securities, remedies sought by the SEC would likely include: a court order, called an injunction, that prohibits any further acts or practices that violate the law or SEC rules, civil monetary penalties, or the return of illegal profits from the sale of the securities. The SEC could also seek to have a court bar or suspend an individual from serving as a corporate officer or director of any company in the future. A person who violates the court's order may be found in contempt and can be subject to additional fines or imprisonment.

Not all failures to comply with the requirements of Regulation Crowdfunding may result in SEC action. Insignificant deviations from the regulations that were made by a company in good faith and in a reasonable attempt to comply will not invalidate the crowdfunding exemption upon which the company sold its securities. There is no specific test for determining what is material and what is insignificant so a company should be vigilant in following the requirements of Regulation Crowdfunding to the best of its ability.



## Glossary of Terms

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**Accredited Investor** – Term used for a sophisticated investor that meets a certain income or net worth test under federal securities laws. Accredited investors can be individuals, businesses or trusts. For an individual, an accredited investor must have an annual income of at least \$200,000 (or \$300,000 if investing jointly with a spouse) in each of the last two years and expect to reasonably maintain the same level of income, or have net worth in excess of \$1,000,000. For a business or trust, an accredited investor must have assets in excess of \$5,000,000.

**Capital Structure** – A mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. The capital structure is how a business finances its overall operations and growth by using different sources of funds.

**Charter Documents** – The set of legal documents that provides for the creation and governance of an entity. For a corporation, this will include the Articles of Incorporation and bylaws. For a limited liability company, this will include the Certificate of Formation and operating agreement.

**Dividend** – A portion of a corporation's profits paid to shareholders of some or all classes of stock based upon *pro rata* ownership among the shareholders.

**Equity** – A stock or any other security representing an ownership interest in a company.

**Funding Portal** – A crowdfunding intermediary that **does not**: (i) offer investment advice or recommendations; (ii) solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal; (iii) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (iv) hold, manage, possess, or otherwise handle investor funds or securities; or (v) engage in such other activities as the SEC, by rule, determines appropriate.

**GAAP or 'Generally Accepted Accounting Principles'** – The common set of accounting principles, standards and procedures that companies use to compile their financial statements.

**Intermediary** – Either a federally registered broker or a funding portal registered with the SEC for the purposes of facilitating crowdfunding transaction pursuant to Regulation Crowdfunding.

**Issuer** – A company that is selling its stock or other securities to investors.

**Net Worth** – The amount by which an individual's or a company's assets exceeds its liabilities.



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***Offering*** - The sale of securities by a company.

***SEC*** - The acronym for the U.S. Securities and Exchange Commission.

***Security*** - A legal instrument that represents an ownership position, a creditor relationship or a future right to ownership of a company. Securities are generally divided into two classes: debt and equity. Debt securities include such instruments as convertible promissory notes. Equity securities include stock, membership units and stock options.

***Subscription*** - A legal commitment by an investor to purchase soon-to-be issued securities being offered by a company.



## About Millyard Tech Law

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Millyard Tech Law is a boutique law firm that serves as legal counsel to entrepreneurs and companies in the business of innovation. We work with companies across a broad spectrum of industries that are looking to bring innovation to their business sector. This ranges from assisting clients with formation, capital raising and day-to-day commercial transactions to working with clients to develop creative solutions to business and legal issues that arise in the course of sourcing, financing and closing complex strategic transactions.

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