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SEC to Consider Crowdfunding Changes?

It has been almost 10 years since the SEC finalized rules for investment crowdfunding (Reg CF) for non-accredited investors as mandated by the *Jumpstart Our Business Startups Act*. We have summarized the SEC's Small Business Capital Formation Advisory Committee's (SBCFAC) recent meeting on Reg CF and recommendation on updating Reg CF's audit requirements to reduce Reg CF costs and expand access to early-stage capital raising. The Appendix includes an overview of other small offering exemptions.

Reg CF Growth

Reg CF eased securities regulations to allow startups and small businesses to raise capital from a large number of people via SEC-registered crowdfunding platforms with less regulatory burden compared to traditional securities offerings. At its inception in May 2016, Reg CF enabled a company to raise a maximum of \$1 million during any 12-month period from an unlimited number of investors. In April 2017, the maximum limit was statutorily adjusted for inflation to \$1.07 million and the cap further expanded to \$5 million in March 2021.

Highlights from a [research study](#) commissioned by the SEC's Office of the Advocate for Small Business Capital Formation:

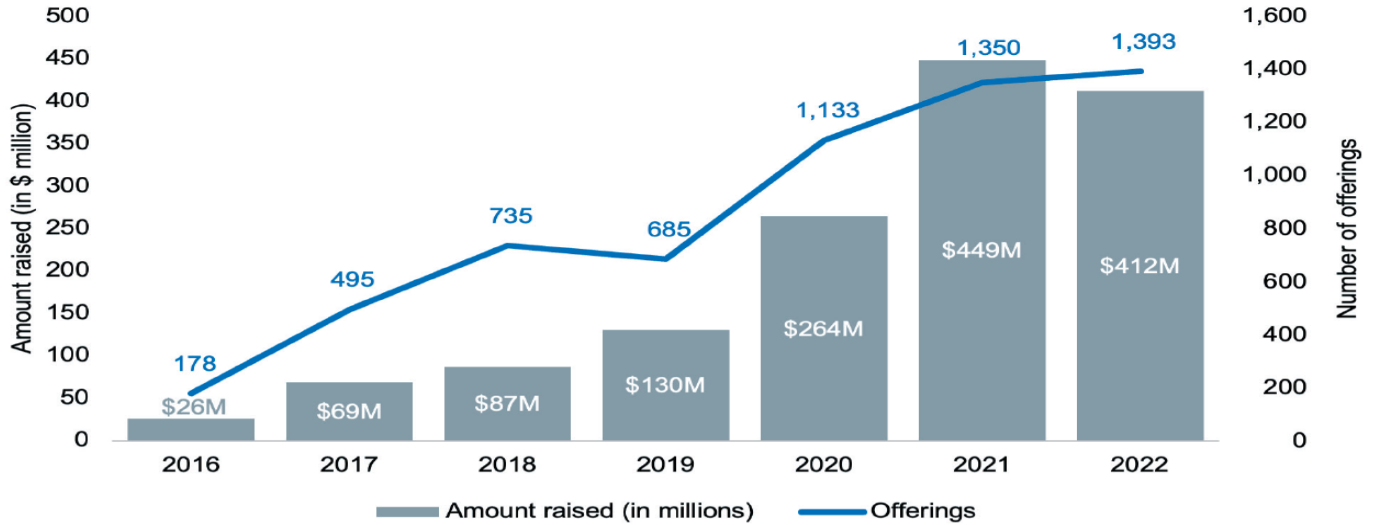
- Reg CF outcomes are strongly correlated with firm survival rates, future funding received, and business performance.
- Successfully raising capital from Reg CF is associated with a 9% decline in the startup failure rate and increases the chance of receiving future funding by 2%.
- The amount raised from Reg CF has a strong positive association with employee size and net income the fiscal year following the offering year.

While Reg CF provides a platform for initial fundraising, it does not guarantee long-term financial sustainability and growth.

Capital Raised

The use of Reg CF has grown consistently from its inception in 2016 through December 31, 2022. During this period, \$1.4 billion in funding was raised in almost 6,000 offerings. The number of offerings more than doubled during the COVID-19 pandemic. The amount raised in 2022 fell slightly due to the rising interest rate environment, but the falloff was less than the drop in the overall venture capital market.

Regulation Crowdfunding Offering & Amounts Raised by Year

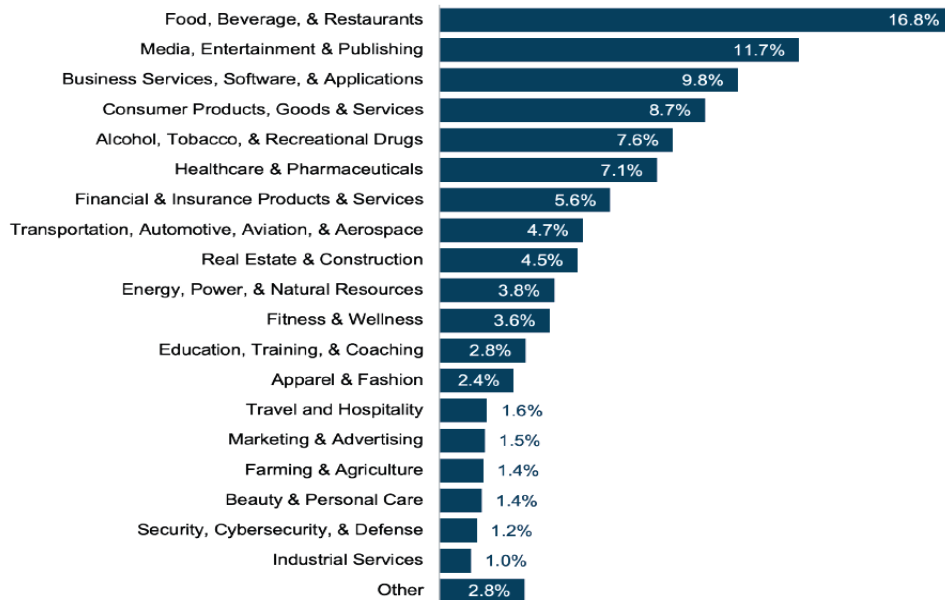


Source: www.sec.gov/files/oasb-women-minority-businesses-crowdfunding-report.pdf

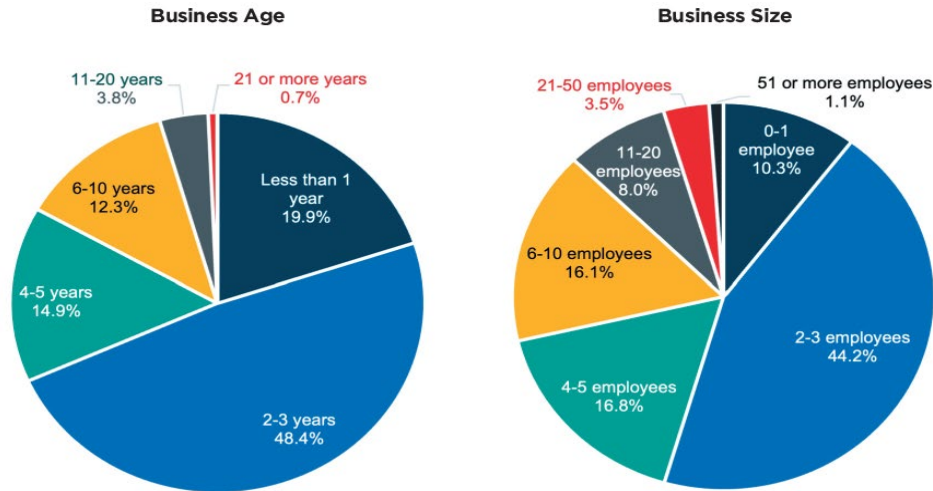
Who’s Raising Capital?

Reg CF is used by micro to small enterprises across a variety of industries for growth funding. Almost half of the firms seeking funding have been established in business for two to three years and 20% for less than one year.

Industry Distribution



Business Age & Size



Source: www.sec.gov/files/oasb-women-minority-businesses-crowdfunding-report.pdf

Secondary Market

A secondary trading market for crowdfunding securities is generally nonexistent even after transfer restrictions are lifted (see investor requirements in [Appendix A](#)). The lack of secondary market liquidity is consistent with the illiquidity of other startup securities. Feedback from intermediaries in a [2019 SEC report](#) noted “that challenges in supporting a secondary market for Reg CF securities would be similar to those faced by current public markets, and that in order for any such secondary market to thrive, it would require sufficient trading volume (ideally supported by market makers), quality third-party research, analysis, and content, and continued access to current information about issuers in the market.”

Exit Outcomes

Startup investing is a long-term commitment. Similar to venture capital and angel investments, returns on equity from crowdfunding generally materialize through an initial public offering (IPO) or acquisition by another entity. Not all startups achieve a successful exit, with the vast majority of early-stage companies failing to yield any returns for their investors. For the limited number of businesses that do exit, industry reports note that this typically takes five to 10 years after inception.

The research study notes that since Reg CF started, 14 IPOs and 71 acquisitions of businesses have conducted a Reg CF offering. As of March 10, 2024, 25.5% of businesses that participated in Reg CF before 1Q 2021 are no longer operating.¹ The failure rate breaks down to 19% for businesses funded via Reg CF versus 40% for those that fail to get funding via Reg CF.

¹A business is classified as no longer operating if it meets at least one of the following criteria: (1) no functional website or application, (2) website or social media page mentions business closure or cease of operations, (3) no sign of online (website, social media) activity since March 2023, or (4) Crunchbase and Pitchbook reports that it is “out of business.”

SBCFAC Recommendations

Reg CF

The SBCFAC discussed the costs of a Reg CF offering, which include legal, accounting, advertising, and portal fees. The annual cost of a review or audit can range from \$3,000 to \$10,000, depending on the complexity and level of reporting required (noted below). For smaller offerings above \$124,000, independent public accounting fees for a review of two years of financial statements can be a substantial percentage of proceeds and a significant deterrent to entrepreneurs. The SBCFAC felt raising the limit for a review requirement could attract more companies seeking funding without a substantial increase in risk to potential investors. The committee approved a recommendation to raise the cap for certified financial statements to \$250,000. This will be formally submitted to the SEC for consideration in the next quarter.

The minimum level of financial disclosure required by the company depends on the amount of money being raised or raised by the company in the prior 12 months:

\$124,000 or less – Financial statements and specific line items from income tax returns, both of which are certified by the company’s principal executive officer, unless financial statements *reviewed* or audited by an independent public accountant and the accountant’s review or audit report are otherwise available.

\$124,000.01 to \$618,000 – Financial statements *reviewed* by an independent public accountant and the accountant’s review report unless financial statements audited by an independent public accountant and the accountant’s audit report are otherwise available.

\$618,000.01 to \$1.235 million – If first-time crowdfunding and audited financial statements are not available, then financial statements *reviewed* by an independent public accountant and the accountant’s review report; otherwise, financial statements audited by an independent public accountant and the accountant’s audit report.

More than \$1.235 million (up to the maximum aggregate of \$5 million) – Financial statements *audited* by an independent public accountant and the accountant’s audit report.

Accredited Investor Definition

On May 1, 2024, the SBCFAC submitted recommendations on the accredited investor definition:

- The SEC should leave the current financial thresholds in place and not adjust such financial thresholds for inflation (either retroactively or going forward).
- For individuals who do not meet the wealth and income thresholds, there should be a way to qualify as accredited by satisfactorily completing an educational program, which would then allow such person to invest up to 5% in total of the greater of their income or net worth over a 12-month rolling period. While the committee defers to the SEC to further develop and implement these criteria, the SEC is encouraged to consider the analogous framework used in Regulation Crowdfunding.

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- The SEC should look at ways to ensure that certain information is made available that identifies key investment risks of this asset class in a clear and concise manner:
 - Risk of total investment loss
 - Limited liquidity
 - Loss of investment (absent fraud) does not give an investor a legal claim against the company

Current Accredited Investor Requirements

- 1) Earned income of more than \$200,000 (or \$300,000 together with a spouse) in each of the last two years and reasonably expects to earn the same for the current year
- 2) Has a net worth exceeding \$1 million, either individually or together with a spouse (excluding the value of a primary residence)
- 3) Is a “knowledgeable employee” of a private fund
- 4) Is a financial professional who has Series 7, Series 65, or Series 82 financial securities licenses

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Appendix A – Reg CF Overview

Investor Requirements

Reg CF limits how much non-accredited investors can invest. (There is no limit for an accredited investor.) A non-accredited investor cannot exceed either of these limits over a 12-month period:

- If *either* the annual income or net worth is less than \$124,000, the greater of \$2,500 or 5% of the greater of the annual income or net worth
- If *both* the annual income and net worth are at least \$124,000, 10% of the lesser of annual income or net worth, whichever is greater, not to exceed \$124,000

Examples of Investor Limits			
Annual Income	Net Worth	Calculation	Investment Limit
\$30,000	\$40,000	Greater of \$2,500 or 5% of \$40,000 (\$2,000)	\$2,500
\$150,000	\$80,000	Greater of \$2,500 or 5% of \$150,000 (\$7,500)	\$7,500
\$150,000	\$124,000	10% of \$150,000 (\$15,000)	\$15,000
\$124,000	\$900,000	10% of \$900,000 (\$90,000)	\$90,000

Investors are restricted from reselling shares for the first year unless the shares are transferred:

- To the company that issued the securities
- To an accredited investor
- To a family member
- Due to death or divorce or other similar circumstance
- To a trust controlled by the investor or a trust created for the benefit of a family member
- As part of an offering registered with the SEC

Issuer Requirements

Certain companies would not be eligible to use the exemption, including:

- Non-U.S. companies
- Exchange Act reporting companies
- Certain investment companies
- Companies that have failed to comply with the annual reporting requirements during the two years immediately preceding the filing of the offering statement
- Companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies

Issuer Disclosure Requirement

Companies relying on Reg CF to conduct an offering must file certain information with the SEC on Form C and provide certain information to investors, including:

- The security price or method for determining the price, the target offering amount, the deadline to reach the target offering amount, and whether the company will accept investments in excess of the target offering amount
- A discussion of the company's financial condition
- A description of the business and the use of proceeds from the offering
- Information about officers and directors as well as owners of 20% or more of the company
- Certain related-party transactions

Financial Statements

The minimum level of financial disclosure required by the company depends on the amount of money being raised or raised by the company in the prior 12 months:

- **\$124,000 or less** – Financial statements and specific line items from income tax returns *certified by the company's principal executive officer* unless financial statements reviewed or audited by an independent public accountant and the accountant's review or audit report are available.
- **\$124,000.01 to \$618,000** – Financial statements *reviewed* by an independent public accountant and the accountant's review report unless financial statements audited by an independent public accountant and the accountant's audit report are otherwise available.
- **\$618,000.01 to \$1.235 million** – If first time crowdfunding and audited financial statements are not available, then financial statements *reviewed* by an independent public accountant and the accountant's review report; otherwise, financial statements audited by an independent public accountant and the accountant's audit report.
- **More than \$1.235 million (up to the maximum aggregate of \$5 million)** – Financial statements *audited* by an independent public accountant and the accountant's audit report.

Companies relying on the crowdfunding exemption would be required to file an annual report with the SEC and provide it to investors.

Issuers offering securities under the crowdfunding rules will be considered “public business entities” as defined by FASB and, therefore, ineligible to rely on any alternative accounting or reporting standards for nonpublic business entities. The SEC retains the authority to determine whether such issuers would be permitted to rely on the nonpublic business entity standards. The final rules do not allow Reg CF issuers to use the alternatives available to nonpublic business entities under U.S. GAAP in the preparation of their financial statements.

Appendix B – Comparison of Small-Issue Exemption

	Reg A – Tier 1	Reg A – Tier 2	Reg CF
Dollar limit (12-month period)	\$20 million	\$75 million	\$5 million
Audited financial statements	No, unless prepared for other purposes	Yes – can use either U.S. GAAS or PCAOB standards	Review/audit depending on offering size. Can use either U.S. GAAS or PCAOB standards
Individual investor limits	None	Non-accredited investors are subject to investment limits based on the greater of annual income and net worth, unless securities will be listed on a national securities exchange	No investment limits for accredited investors. Non-accredited investors are subject to investment limits based on the greater of annual income and net worth
“Testing the waters”	Yes – solicitation materials to be filed with first offering statement 48 hours prior to first sale		Permitted before Form C is filed
Resale restrictions	No	No	12-month resale limitations
Offering statement	Yes. SEC qualification and state approval	Yes. SEC approval	SEC filing required. Must be conducted on an internet platform through a registered intermediary
State security law pre-emption	No	Yes	Yes