Client Alert

November 15, 2013

Standing out from the Crowd:

A Closer Look at the SEC's and FINRA's Proposed Crowdfunding Rules

In this alert, we provide a detailed overview of the proposed regulatory framework that will be applicable to crowdfunding offerings conducted pursuant to Title III of the JOBS Act in reliance on Section 4(a)(6) of the Securities Act. As we have noted in our prior initial observations related to the rules proposed by the Securities and Exchange Commission, or SEC, in late October 2013, implementing the Congressional mandate to formulate a framework for crowdfunded offerings, whether or not one intends to avail oneself of this new offering exemption, the tailored approach taken by the SEC and by FINRA in their proposed regulations merits a close look. Both the SEC and FINRA acknowledge that regulation of these offerings requires adapting disclosure-based principles and the existing approach to broker-dealer regulation and oversight to an entirely new public offering rubric. While drawing on these well-established principles, the SEC's and FINRA's proposed rules stand out because the proposed rules attempt to provide a scaled or "right-sized" approach. For example, the SEC's proposed rules would establish limited disclosure requirements for issuers that rely on crowdfunding, as well as limited ongoing reporting requirements for these issuers, although these issuers will not be SEC-reporting companies for the purposes of other SEC requirements. This is novel. Similarly, both the SEC's and FINRA's proposed rules relating to funding portals establish a pared-down regulatory framework that acknowledges the limited functions of a funding portal. We hope our discussion below provides a perspective as to whether the SEC and FINRA have struck the right balance in designing regulations that facilitate crowdfunding while promoting investor protection concerns.

PART ONE: ISSUER REQUIREMENTS

Eligible Issuers

The ability to engage in crowdfunding is not available to all issuers. The proposal excludes: issuers not organized under the laws of a state or territory of the United States or the District of Columbia; issuers already subject to Exchange Act reporting requirements; investment companies as defined in the Investment Company Act or companies that are excluded from the definition of "investment company" under Section 3(b) or 3(c) of the Investment Company Act; any issuer that has sold securities in reliance on Section 4(a)(6) if the issuer has not filed with the SEC and provided to investors, to the extent required, the ongoing annual reports required by Regulation Crowdfunding during the two years immediately preceding the filing of the required new offering statement; issuers subject to the "bad boy" disqualifiers in Section 302(d) of the JOBS Act and the proposed rules implementing that provision; and any issuer that is a development stage company that has no specific business plan or purpose, or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies. The SEC notes that there may be a higher risk of fraud in connection with "such blank" issuers.

Form of Offering

As contemplated by the proposed rules, an issuer would only be able to engage in an offering through a registered broker-dealer or through a funding portal, and can only use one intermediary for a particular offering or concurrent offerings made in reliance on the exemption. This restriction appears to be premised on the notion that a single intermediary will be more effective in policing compliance with the issuer offering limit, as we discuss below. A "platform" is defined as an Internet website or similar electronic medium through which a broker-dealer or a funding portal conducts a Section 4(a)(6) offering.

It is contemplated that the offering will be conducted online only, so that the "crowd" has access to information and there is a forum for an exchange of information among potential offering participants.

Disclosure Requirements

An issuer that elects to engage in a crowdfunding offering must comply with disclosure requirements, including: an initial disclosure about the offering on Form C; amendments to Form C to report material changes (Form C-A); periodic updates on the offering on Form C-U; and ongoing annual filings until a filing obligation is terminated. The annual filing must be made on Form C-AR and a termination notice on Form C-TR.

The Form C would be filed with SEC and the intermediary would post the filing or provide a link to the filing for investors. The Form C must include disclosures relating to the issuer's business, officers, directors, and control persons, use of proceeds, capital structure and financial results. In many respects, the Form C requirements resemble those for Form 1-A used in connection with Regulation A offerings, and it seems safe to assume that the SEC will refer to the Form C framework in formulating disclosure requirements for Section 3(b)(2) (or "Regulation A+") offerings.

Basic issuer information would be required including name, form of entity, jurisdiction of formation, formation date, address, website, and number of employees, as well as the intermediary's SEC file number and FINRA CRD number and fees being paid to the intermediary. The form also must specify a specific use or range of possible uses for the proceeds of the offering, as well as the factors impacting the selection by the issuer of each such use. The form also must include a business description. The proposed rules do not specify a format for the business description; however, it is likely that market participants will base the format on the description used in SEC-registered offerings. For officers and directors, the issuer would be required to provide each individual's name, positions held with the issuer and duration in those positions, and business experience during the last three years. For principal stockholders, the issuer would be required to identify each shareholder who owns 20 percent or more of the issuer's outstanding voting equity securities (calculated as of the most recent practicable date). The form would also require a description of capital stock; a description of any special voting rights or investor rights; a description of indebtedness; a description of related party transactions for transactions that involve amounts in excess of five percent of the amount raised by the issuer in crowdfunded offerings in the trailing 12-month period including in the proposed deal; a description of all exempt offerings undertaken during the preceding three years; and a description of how the offered securities are valued. The form also would be required to include a discussion of the risks associated with an investment in the securities and with participation in a crowdfunded offering, as well as the restrictions on transfer of the securities.

The proposed rule takes a "phased" approach to disclosures regarding financial results. As proposed, an issuer would include a description of its historical results of operation, liquidity and capital resources, and its financing needs along the lines of a traditional "Management's Discussion and Analysis" (or MD&A) section. The issuer would be required to include financial statements prepared in accordance with GAAP, including a balance sheet, income statement, statement of cash flows, and statement of changes in owners' equity. The requirements as to certification of the financial statements would differ based on the aggregate amount (A) offered in the current offering, and (B) raised by the issuer in crowdfunded offerings in the prior 12 months as follows: if the aggregate offering amount is $100,000 or less, the issuer would only need to provide tax returns (with personal information

such as Social Security numbers redacted) for the most recently completed year and financial statements that are certified by the issuer's principal executive officer as true and complete in all material respects on a form proposed by the SEC; if the aggregate offering amount is greater than $100,000 but not more than $500,000, the issuer would need to provide financial statements that have been reviewed by an independent public accountant, using the independence standards set forth in Rule 2-01 of Regulation S-X. The review would need to be based on the American Institute of Certified Public Accountants (AICPA) standards. This may permit companies to use a broader range of accounting professionals. A copy of the independent public accountant's review report would be included in the disclosures to the SEC, the intermediary and potential investors. If the aggregate offering amount is more than $500,000, the issuer would be required to provide financial statements that have been audited by an independent public accountant (again, using the Regulation S-X independence standards). The audit could be conducted either using the AICPA standards or the standards of the Public Company Accounting Oversight Board (PCAOB). A copy of the audit report would need to be included in the disclosures to the SEC, the intermediary and potential investors. An issuer that received an adverse audit opinion or a disclaimer of opinion would be disqualified from engaging in a Section 4(a)(6) offering.

As discussed above, an issuer would be required to amend its Form C disclosures using Form C-A for any updates or material changes. The materiality determination is left up to the issuer based on the customary guidance that the SEC considers a material change to be a change that would affect an investor's investment decision. The issuer must identify on Form C-A whether the amendment is filed to disclose a material change. Investor reconfirmations must be obtained following the occurrence of a material change. An issuer also is required to file progress updates with the SEC on a Form C-U. Updates are required five days after any of the following milestones: commitments for 50% of the deal are received; commitments for the full deal are received; subscriptions in excess of the initial offering amount will be accepted; or the issuer closes the offering. Once an issuer completes a crowdfunded offering, it becomes subject to limited ongoing filing requirements. Annually, within 120 days of the end of the issuer's fiscal year, the issuer must prepare and file an annual report on

Form C-AR. The annual report should update information included in the Form C. This reporting obligation continues until the issuer becomes an SEC reporting company, all securities sold in crowdfunded offerings are redeemed or repurchased by a third party, or the issuer liquidates or dissolves.

Offering Amount and Offering Mechanics

In connection with a proposed offering, the proposed rules contemplate that the issuer would include in its disclosures a discussion of the target or maximum amount to be raised, and a discussion of the subscription or offering process that must disclose that investors can cancel their investment up to 48 hours prior to the deadline identified in the offering materials, but if an investor does not cancel the investment, then their funds will be released to the issuer upon closing. The intermediary will notify investors when the target offering amount has been met, and if the target offering amount is not met, then no securities will be sold and all funds will be returned to investors. If the target offering amount is met prior to the deadline identified in the offering materials, the issuer must provide five days' advance notice before closing the offering early. If an investor does not reconfirm the investment commitment after a material change is made to the offering and disclosed on Form C-A, the investment will be cancelled and the issuer must return the funds to the investor.

Investment Limits

The statute prescribes limits on the amount that can be invested by an individual in crowdfunded offerings in any 12-month period. The SEC has interpreted the statute to provide for an investment limit such that: if both an investor's annual income and its net worth are less than $100,000, then the investor would be subject to an investment limit that is the greater of: a $2,000 limit; or 5 percent of annual income or net worth. If either the investor's annual income or net worth exceeds $100,000, then the investor would be subject to an investment limit that is the greater of: 10 percent of annual income or net worth, but in no event more than $100,000. As we discuss later, the issuer can rely on the intermediary's calculation of the investment limit.

Status of Securities

Securities sold in a crowdfunded offering pursuant to the exemption would be subject to transfer restrictions; the securities could not be transferred by a purchaser for one year from the date of purchase, except for transfers to: the issuer; an accredited investor; a family member of the purchaser, or in estate type transfers; and third parties in an SEC-registered offering. The statute exempts securities sold in Section 4(a)(6) offerings from the Exchange Act "holder of record" count for the purposes of determining if registration of a class of equity securities is required under Section 12(g). The proposing release notes that an issuer will be required to establish a means for tracking its shareholders. This may require an early-stage company to engage the services of a transfer agent or other similar service provider in order to monitor its security holders.

Integration

Under the proposed rules, an offering made pursuant to the Section 4(a)(6) exemption will not be integrated with another exempt offering that precedes the crowdfunded offering, or that takes place concurrently or subsequently. The issuer must ensure that it has satisfied all of the conditions for the exemption that it is claiming for each such offering. If the issuer is conducting a Rule 506(c) offering (using general solicitation), it must ensure that the Rule 506(c) offerees were not solicited by means of the communications used for the crowdfunded offering. In practice, this may prove difficult.

Restrictions on Advertising and Promotion

The proposed rules contemplate that an issuer would not be permitted to advertise a Section 4(a)(6)-exempt offering, except by releasing an offering notice that contains only the following information: a statement that the issuer is conducting an offering, the name of the intermediary and a link to the intermediary's offering page; the amount of securities offered, the nature of the securities, the price of the securities, and the closing date for the offering; and the name, address, phone number and website of the issuer, the e-mail address of a representative of the issuer, and a brief factual description of the issuer's business. The issuer would be able to communicate with potential crowdfunding investors if the communications occur through the platform; however, it should be clear to potential investors which portal communications are being made by the issuer or on the issuer's behalf.

It is contemplated that the issuer would be able to continue to engage in regular business communications so long as it does not disclose information about the offering, except as permitted in an offering notice.

Promoter Compensation

As proposed, the rules would provide that an issuer cannot compensate a person for advertising or promoting a Section 4(a)(6) offering other than through the intermediary's platform unless the promotion is limited to distributing permitted notices. An issuer would be able to compensate a person for promoting the offering through the intermediary's platform if the issuer takes reasonable steps to ensure that such person discloses past and prospective compensation from the issuer. This applies to intermediaries, but also to employees or others acting on the issuer's behalf that are advertising or promoting the offering through the portal.

PART TWO: INTERMEDIARIES

Title III of the JOBS Act provides that a crowdfunded offering must be made through an intermediary that is either a registered broker-dealer or a funding portal. The intermediary is intended to function as a gatekeeper and, in this role, protect investors from fraud. The SEC's proposed rules establish a regulatory framework for these intermediaries. As discussed below, in the case of funding portals, the regulatory framework is a scaled back version of the framework applicable to broker-dealers. The proposed rules extend in significant ways the duties of intermediaries in crowdfunded offerings.

We discuss the proposed rules in the sequence of an offering, and then provide an overview of the registration, compliance and other requirements applicable to intermediaries.

Conducting a Crowdfunded Offering

Single Intermediary

The proposed rules would require that an offering be made only through one intermediary. The release notes that use of a single intermediary "fosters the creation of a crowd" and also makes it easier for the intermediary to monitor the issuer's compliance with the investment limitation. Offerings must be conducted online only through an intermediary's platform, which is defined to mean an Internet website or other similar electronic medium through which a registered broker or registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6). The proposing release notes that offerings made through electronic means permit the engagement of participants in the offering.

Promotional Activities

The proposed rules would prohibit an issuer from compensating, or committing to compensate, directly or indirectly, any person to promote the issuer's offering through communication channels provided by the intermediary unless the issuer takes reasonable steps to ensure that the person clearly discloses the receipt (both past and prospective) of compensation each time the person makes a promotional communication. These rules would apply to any person acting on behalf of the issuer, regardless of whether they are compensated or receive compensation specifically to promote the offering. For example, a founder or an employee of the issuer that promotes the offering through the intermediary's communications channels would be required to disclose, with each posting, that he is acting on the issuer's behalf in promoting the offering.

Financial Interest in Issuer

An intermediary would be required to prohibit its directors, officers or partners (or others having a similar status or performing a similar function) from having any financial interest in an issuer using its services. The proposed rules extend the prohibition to the issuer itself. The proposed rules also would specifically prohibit an intermediary from receiving a financial interest in the issuer as compensation for services provided to, or for the benefit of, the issuer, in connection with the offer and sale of its securities. A "financial interest" in an issuer means a direct or indirect ownership of, or economic interest in, any class of the issuer's securities.

Measures to Reduce Risk of Fraud

Under the proposed rules, an intermediary must have a reasonable basis for believing that the issuer is in compliance with relevant regulations and has established means to keep accurate records of holders of the securities it offers. An intermediary must deny access to an issuer if it believes the issuer or its offering would present a potential for fraud. An issuer would have an independent obligation to comply with the requirements in Section 4A(b) and Regulation Crowdfunding. An intermediary could reasonably rely on the issuer's representations, absent knowledge or other information that would suggest that the representations are not true.

An intermediary would be required to deny access to its platform to an issuer if the intermediary has a reasonable belief that the issuer, or any of its directors, officers or 20% beneficial owners is subject to a disqualification under the proposed rules or if the intermediary believes that the issuer or the offering presents the potential for fraud or otherwise raised investor protection concerns. An intermediary must conduct a background and securities enforcement regulatory history check on each issuer whose securities are to be offered by the intermediary, as well as on each of its officers, directors (or any person occupying a similar status or performing a similar function) and 20% beneficial owners.

Account Opening

Under the proposed rules, an investor that seeks to invest in a crowdfunded offering must open an account with the intermediary and consent to electronic delivery of materials, and the intermediary would be required to deliver educational materials to the investor. The proposed rules contemplate that all materials be provided electronically or by sending an email with links to information posted on the intermediary's website.

Educational Materials

An intermediary would be required to deliver (or make available) at account opening educational materials in plain English. Any revised materials must be made available to all investors before accepting any additional investment commitments or effecting any further crowdfunded transactions. The materials must discuss: the process for the offering; the risks associated with investing in the securities; the types of securities sold through the platform and the associated risks; restrictions on resale; the types of information that an issuer is required to provide in annual reports; the frequency of the delivery of that information; the limitations on the amount investors may invest; the circumstances under which an issuer may cancel an investment commitment; the limitation on the investor's right to cancel an investment commitment; the need for an investor to consider the appropriateness of an investment; and that there may be no ongoing relationship between the investor and the intermediary. The proposed rules do not require a specified format for the materials.

An intermediary also would be required to inform investors that disclosure is required regarding any past or prospective compensation paid to a promoter. An intermediary also must disclose the compensation it will receive in connection with crowdfunded offerings.

Issuer Information

The proposed rules contemplate that an intermediary must make available to the SEC and potential investors not later than 21 days prior to the first day on which securities are sold to any investor any information provided by the issuer under proposed Rules 201 and 203(a). The proposed rules would require that: an intermediary make this information publicly available on the intermediary's platform, in a manner that reasonably permits a person accessing the platform to save, download or store the information; this information be made publicly available on the intermediary's platform for a minimum of 21 days before any securities are sold in the offering during which time the intermediary may accept investment commitments; and this information, including any additional information provided by the issuer, remain publicly available on the intermediary's platform until the offer and sale is completed or cancelled. An intermediary cannot require any person to establish an account with the intermediary in order to receive this information.

Investor Qualifications

Section 4A(a)(8) imposes an obligation on intermediaries to make sure no investor exceeds the statutory investment limitations. The proposed rules would implement this requirement by providing that, before permitting an investor to make an investment commitment on its platform, an intermediary must have a reasonable basis to believe that the investor satisfies the investment limitations under Section 4(a)(6)(B) and Regulation Crowdfunding. The proposed rules would allow reasonable reliance on an investor's representation to this effect.

Investor's Acknowledgment of Risks

Section 4A(a)(4) requires an intermediary to ensure that each investor reviews the educational materials; positively affirms that the investor understands that he or she is risking the loss of the entire investment and that the investor could bear such a loss; and answer questions demonstrating an understanding of the level of risk

involved in startups. As discussed above, educational materials must be provided at account opening. Proposed rules also require that an intermediary, each time before accepting an investment commitment, obtain from the investor a representation that the investor has reviewed the intermediary's educational materials, understands that the entire investment may be lost and can bear the risk of loss. The intermediary also must ensure each time before accepting an investment commitment that each investor answers questions demonstrating the investor's understanding that there are restrictions on the investor's ability to cancel an investment commitment and obtain a return of his or her investment, that it may be difficult for the investor to resell the securities, and that the investor should not invest any funds in a crowdfunding offering unless s/he can afford to lose the entire amount of his or her investment.

Communication Channels

The proposed rules would require an intermediary to provide, on its platform, channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary's platform, subject to certain conditions. This is intended to provide a centralized and transparent means for members of the public to share their views and to communicate with the issuer. The intermediary cannot participate in the communications. It can set rules regarding the postings or remove postings that use offensive language.

Communications should be available for public viewing, but the intermediary would only be able to permit those persons who have opened accounts with it to post comments. With each post, a person must disclose whether such person is a promoter or affiliate of the issuer and whether it has been or will be compensated. The intermediary must keep records of these communications.

Notice of Investment Commitment

An intermediary, upon receipt of an investment commitment from an investor, would be required to promptly give or send to the investor a notification disclosing the dollar amount of the commitment, the price of the securities (if known), the name of the issuer, and the date and time by which the investor may cancel the investment commitment. Notification would be required to be provided by email or other electronic media and to be documented in accordance with applicable recordkeeping rules.

Maintenance and Transmission of Funds

Securities Act Section 4A(a)(7) requires that an intermediary "ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount." The proposed rules would require an intermediary that is a registered broker to comply with established requirements in Exchange Act Rule 15c2-4 for the maintenance and transmission of investor funds. Investor funds must be held in escrow until the specified contingency occurs (i.e., the targeted amount or the minimum amount is raised), and then the funds would be promptly transmitted to a bank, which has agreed in writing to hold such funds in escrow for the investors and to transmit or return such funds directly to the issuer or to investors, as the case may be. Proceeds are to be transmitted to the issuer only if the target offering amount is met or exceeded.

Because a funding portal cannot receive or handle any funds, it would be required to direct investors to transmit money or other consideration directly to a qualified third party (a bank) that serves as an escrow agent. A funding portal would be required to promptly direct transmission of funds from the qualified third party to the issuer when the aggregate amount of investment commitments from all investors is equal to or greater than the target amount of the offering and the cancellation period for each investor has expired, but no earlier than 21 days after the date on which the intermediary makes publicly available on its platform the information required to be

provided about the issuer and the offering. A funding portal also would have to direct the return of funds to an investor when an investment commitment has been cancelled or the offering is terminated or cancelled.

Confirmation of Transaction

At or before the completion of a transaction, the intermediary would be required to give or send each investor a notification, like a confirmation, disclosing the transaction date; the type of security; the price and number of securities purchased; the number of securities sold by the issuer in the transaction; the price at which the securities were sold; certain specified terms of the security (for example, if it is a debt or callable security); and the source and amount of any remuneration received or to be received by the intermediary in connection with the transaction, whether from the issuer or other persons. This notification must be by email or other electronic media and subject to recordkeeping rules.

Completion of Offerings, Cancellations and Reconfirmations

Investors would have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline identified in the issuer's offering materials. Thereafter, an investor would not be able to cancel any investment commitments made within the final 48 hours (except in the event of a material change to the offering, as discussed below). Pursuant to the proposed rules, if an issuer reaches the target offering amount prior to the deadline identified in its offering materials, it may close the offering once the target offering amount is reached, provided that the offering will have remained open for a minimum of 21 days; the intermediary provides notice about the new offering deadline at least five days prior to the new offering deadline; investors are given the opportunity to reconsider their investment decision and to cancel their investment commitment until 48 hours prior to the new offering deadline; and at the time of the new offering deadline, the issuer continues to meet or exceed the target offering amount.

If there is a material change to the terms of the offering, or the information provided by the issuer regarding the offering, the proposed rules would require the intermediary to give or send to any potential investors who have made investment commitments notice of the material change, stating that the investor's investment commitment will be cancelled unless the investor reconfirms his or her commitment within five business days of receipt of the notice. If the investor fails to reconfirm his or her investment within those five business days, the proposed rules would require an intermediary, within five business days thereafter to provide or send the investor a notification disclosing that the investment commitment was cancelled, the reason for the cancellation and the refund amount that the investor should expect to receive, and direct the refund of investor funds.

Finally, if an issuer does not complete an offering because the target is not reached or the issuer decides to terminate the offering the proposed rules would require an intermediary within five business days to give or send to each investor who made an investment commitment a notification disclosing the cancellation of the offering, the reason for the cancellation, and the refund amount that the investor should expect to receive; direct the refund of investor funds; and prevent investors from making investment commitments with respect to that offering on its platform.

Intermediary Registration and Other Requirements

Registration and SRO Membership

An intermediary must be a registered broker-dealer or a funding portal under Securities Act Section 4A(a)(1) and proposed Rule 400 of Regulation Crowdfunding. A funding portal must register with the SEC either as a broker or a funding portal. Facilitating crowdfunded transactions alone would not require an intermediary to register as an exchange or as an alternative trading system. However, if the intermediary facilitates a secondary market in securities issued in a crowdfunded offering, the intermediary would be required to register as an exchange or as an

alternative trading system. As a result, a funding portal could not effect secondary market transactions in securities. A funding portal also must be a member of a registered national securities association, which is expressly identified as being FINRA.

Additional Requirements on Funding Portals

Securities Act Section 4A(a)(1) requires that an intermediary facilitating a transaction register with the SEC as a broker or a funding portal. The SEC proposes to establish a streamlined registration process under which a funding portal would register with the SEC by filing a form with information consistent with, but less extensive than, the information required for broker-dealers on Form BD. A funding portal would register by completing a Form Funding Portal, which includes information concerning the funding portal's principal place of business, its legal organization and its disciplinary history, if any; business activities, including the types of compensation the funding portal has received and disclosure of its disciplinary history, if any; FINRA membership with any other registered national securities association; and the funding portal's website address(es) or other means of access. A funding portal's registration would become effective the later of (1) 30 calendar days after the date that the registration is received by the SEC; or (2) the date the funding portal is approved for membership in FINRA. In order to promote transparency, all such Forms Funding Portal will be available publicly.

A funding portal must file an amendment to the Form Funding Portal within 30 days of any of the information in the original form becoming inaccurate for any reason. The proposed rules would require a funding portal to promptly file a withdrawal of registration on Form Funding Portal upon ceasing to operate as a funding portal. The withdrawal would be effective on the later of 30 days after receipt by the SEC after the funding portal is no longer operational within such longer period of time as to which the funding portal consents or within such period of time as to which the SEC, by order, may determine as necessary or appropriate in the public interest or for the protection of investors.

A funding portal can operate multiple website addresses under a single funding portal registration provided that the funding portal discloses on the Form Funding Portal all the website and names under which it does business.

Non-U.S. Funding Portals

Entities domiciled or organized outside of the United States ("non-U.S. entities") would be able to act as funding portals; however, they would be subject to additional requirements. There must be an information sharing arrangement in place between the SEC and the competent regulator in the jurisdiction under the laws of which the non-U.S. entity is organized or where it has its principal place of business. In addition, a non-U.S. entity would be required to complete a Schedule C to Form Funding Portal. This schedule would require information about the applicant's arrangements to have an agent for service of process in the United States, as well as an opinion of counsel addressing the ability of the applicant to provide the SEC and the national securities association of which it is a member with prompt access to its books and records and to submit to onsite inspection and examination by the SEC and the national securities association. The funding portal also would be required to consent that service of any civil action brought by, or notice of any proceeding before, the SEC or any national securities association of which it is a member, in connection with the funding portal's investment-related business, may be given by registered or certified mail to the funding portal's contact person at the main address or mailing address indicated on the form.

Fidelity Bond

The proposed rules would require, as a condition of registration, that a funding portal have in place, and thereafter maintain for the duration of such registration a fidelity bond that (1) has a minimum coverage of $100,000; (2) covers any associated person of the funding portal unless otherwise excepted in the rules set forth by FINRA or any other registered national securities association of which it is a member; and (3) meets any other

applicable requirements set forth by FINRA or any other national securities association of which it is a member. Given that funding portals are not broker-dealers and are not SIPC members, the fidelity bond helps insure against the loss of investor funds that might occur.

Intermediary Payments to Third Parties

The proposed rules would broadly prohibit an intermediary from compensating any person for providing it with the personally identifiable information of any investor or potential investor. The proposed rules would, however, permit an intermediary to compensate a person for directing issuers or potential investors to the intermediary's platform if the person does not provide the intermediary with the personally identifiable information of any potential investor, and the compensation, unless it is paid to a registered broker or dealer, is not based, directly or indirectly, on the purchase or sale of a security offered in reliance on Section 4(a)(6) on or through the intermediary's platform.

The proposed rules would not permit a funding portal to compensate third parties by commission or other transaction-based compensation unless that third party is a registered broker-dealer and subject to an established regulatory and oversight regime.

Under the proposed rules, an intermediary could pay a person a flat fixed fee to direct other persons to the intermediary's platform through, for example, hyperlinks or search term results, if the intermediary received no personally identifiable information. It would be acceptable under the proposed rules, therefore, for an intermediary to make payments to advertise its existence, provided that in doing so, it does not pay for the personally identifiable information of investors or potential investors.

Funding Portal Activities

The JOBS Act limits the permitted activities of a funding portal. A funding portal cannot: offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities offered or displayed on its platform or portal; compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform or portal; hold, manage, possess or otherwise handle investor funds or securities; or engage in such other activities as the SEC may determine. The proposed rules relating to intermediaries also apply to associated persons of the intermediary. We discuss below certain safe harbors for activities of a funding portal.

Exemptions from Broker-Dealer Registration and Safe Harbors

But for the exemption from registration for funding portals that Congress directed in the JOBS Act, a funding portal would be required to register as a broker under the Exchange Act. The SEC's proposed rules would exempt an intermediary that is registered as a funding portal from the requirement to register as a broker-dealer under the Exchange Act, although a funding portal would remain subject to the full range of the SEC's examination and enforcement authority. Notwithstanding the exemption from broker registration for purposes of Chapter X of Title 31 of the Code of Federal Regulations a funding portal would be deemed "required to be registered" as a broker with the SEC under the Exchange Act thereby requiring funding portals to comply with Chapter X, including certain AML provisions thereunder.

The proposed rules provide a non-exclusive, conditional safe harbor for funding portals that engage in certain limited activities. The activities relate to:

- Limiting offerings made on or through the funding portal's platform based on eligibility requirements;
- Highlighting and displaying offerings on the platform;

- Providing communication channels for potential investors and issuers;
- Providing search functions on the platform;
- Advising issuers on the structure or content of offerings;
- Compensating others for referring persons to the funding portal and for other services; and
- Advertising the funding portal's existence.

In addition, the proposed rules would clarify that, consistent with the other provisions of Regulation Crowdfunding, funding portals may deny access to issuers in certain circumstances, accept investment commitments and direct the transmission of funds in connection with offerings conducted on their platforms.

We discuss the intended scope of each of these safe harbors below:

***Limiting Offerings*:** a funding portal can limit the offerings on its platforms (for example, by limiting the offerings to issuers in certain industries, geographies, etc.) without being deemed to be providing investment advice. The criteria would be required to be reasonably designed to result in a broad selection of issuers offering securities through the funding portal's platform and be applied consistently to all potential issuers and offerings. Criteria must be displayed on the funding portal's site.

Highlighting Issuers and Offerings: a funding portal may highlight a particular offering made through its portal based on objective criteria, such as the type of security, geographic region, industry, etc. Criteria must be objective and cannot be based on investment advice or implicitly endorse an issuer or an offering.

Providing Search Functions: the funding portal platform may incorporate search tools that will facilitate the user's experience.

Providing Communication Channels: as noted above, a funding portal should provide a channel for potential investors to communicate about the merits of an offering.

Advising Issuers: a funding portal may advise an issuer on the structure or content of its proposed offering and prepare offering documentation.

Paying for Referrals: as discussed above, a funding portal may pay for referrals, subject to various limitations.

Compensation Arrangements with Registered Broker-Dealers: a funding portal may enter into arrangements with a broker-dealer pursuant to which they could compensate one another provided such arrangements are not prohibited by the national securities association of which the funding portal is a member.

Advertising: a funding portal could advertise its services as well as offerings that are available through its portal, subject to compliance with various requirements.

Compliance Policies and Procedures

A funding portal would be required to implement written policies and procedures designed to achieve compliance with applicable regulations. As noted above, a funding portal will be required to comply with certain AML requirements, including establishing and maintaining an effective AML program, a customer identification

program, monitoring for and filing reports of suspicious activities, and complying with information requests from the Financial Crimes Enforcement Network, or FinCEN. The proposed rules also would subject funding portals to the same privacy rules (Regulation S-P, Regulation S-AM, and Regulation S-ID) applicable to broker-dealers.

A funding portal will be subject to the SEC's examination and inspection authority. Also, a funding portal would be subject to recordkeeping requirements in order to ensure that there is an audit trail for all crowdfunding transactions and communications.

Intermediary Disqualification ("Bad Actor") Provisions

The proposed rules would include bad actor provisions, which employ the definition of "statutory disqualification" under Section 3(a)(39) (applicable to broker-dealers), which is broader than the disqualification rules proposed for issuers. The proposed rules would prohibit any person subject to a statutory disqualification from acting as, or being, an associated person of an intermediary unless permitted to do so by an SEC rule or order.

FINRA Proposal

As discussed above, intermediaries must be registered with FINRA. On the same day that the SEC published the proposing release, FINRA published Regulatory Notice 13-34 that includes a set of seven proposed rules (Rules 100, 110, 200, 300, 800, 900 and 1200), referred to as Funding Portal Rules. The comment period closes February 3, 2014. The proposed rules reflect an attempt to streamline regulatory requirements in light of the limited scope of activities of a funding portal, while maintaining investor protection provisions. Below is a brief description of the proposed rules.

Rule 100: Funding portals and their associated persons would be subject to FINRA's bylaws.

Rule 110: The rule would outline the membership application process (MAP), which is based on the NASD's Rule 1010 Series but is abridged. FINRA must make a decision on membership within 60 days of the filing of a membership application (Form FP-NMA). Rule 110 would establish five standards for membership: (a) ability to comply with all applicable laws and regulations of the SEC and FINRA; (b) contractual arrangements sufficient to initiate operations; (c) supervisory systems that are sufficient; (d) evidence of direct and indirect funding; and (e) a recordkeeping system. Rule 110 also would permit membership interviews to take place by video, streamline the appeals process and narrow the events involving a change of control of the member that require FINRA approval. Rule 110 also sets out a fidelity bond requirement.

Rule 200 addresses portal conduct. Rule 200(a) would require funding portals to observe high standards of commercial honor and just and equitable principles of trade. Rule 200(b) would prohibit a portal from effecting any transaction in, or inducing the purchase or sale of, any security by means of, or by aiding or abetting, any manipulative or fraudulent device. Proposed Rule 200(c) tracks FINRA Rule 2210 on advertising and requires that funding portal communications be fair and balanced, and would prohibit the use of false and misleading statements and statements that predict future performance.

Rule 300 addresses compliance. Funding portals would be required to: establish written policies and procedures and supervisory systems reasonably designed to achieve compliance with all applicable rules; implement an AML program, although the independent testing requirements have been reduced (compared to those for broker-dealers) to once every two years; timely report to FINRA the occurrence of a disqualifying effort affecting the member or an associated person; and report current contact information.

Rule 800 addresses investigations and sanctions and would provide that information about funding portals and associated persons provided to FINRA, including information about disqualifying events, will be made public.

Rule 900 addresses codes of procedure, including the process for eligibility proceedings for a person to remain associated with a portal despite the existence of a statutory disqualification.

Rule 1200 addresses arbitration procedures for customer and industry disputes.

Conclusion

Crowdfunding has attracted a great deal of attention, largely because of its appeal as a capital raising alternative for new or small ventures. The SEC and FINRA have proposed very detailed rules to implement the Section 4(a)(6) exemption, which must necessarily remain true to the specific requirements contemplated in Title III of the JOBS Act. As the SEC and FINRA move forward to put in place final rules, they will need to strike a difficult balance between preserving necessary investor protections will developing a regulatory framework for these offerings that would make these types of offerings cost-effective and viable.

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