The JOBS Act: Crowdfunding
Agenda

We will address:

• The background that led to a call for an offering exemption for crowdfunding;
• The JOBS Act Title III provisions;
• The SEC’s proposed rules; and
• FINRA’s proposal.
Background
Crowdfunding

- Crowdfunding permits entrepreneurs to pool money from individuals who have a common interest and are willing to contribute to a venture.
- Crowdfunding may or may not involve the sale of securities.
- To the extent the effort involves the sale of securities then the offering must be registered or must rely on an exemption.
- Prior to the enactment of the JOBS Act, crowdfunding advocates had called on the SEC to consider implementing a new exemption from registration under the federal securities laws for crowdfunding efforts.
- For example, it was suggested that the SEC exempt crowdfunding offerings of up to $100,000, with a cap on individual investments not to exceed $100.
Crowdfunding

The “Crowd”

• An “all or none” offering.
• No limits on the number or sophistication of investors.
• Issuer information (including financial information) required.
• All offering activities must be conducted through an intermediary.
Title III of the JOBS Act
Crowdfunding

• Title III provides an exemption that could apply to crowdfunding offerings, to be implemented by SEC rules adopted within 270 days.

• The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption during the 12-month period preceding the date of the transaction, is not more than $1,000,000.

• The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the exemption during the 12-month period preceding the date of the transaction, does not exceed:
  • the greater of $2,000 or 5 percent of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than $100,000; or
  • 10 percent of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of $100,000, if either the annual income or net worth of the investor is equal to or more than $100,000.
Crowdfunding

- The transaction must be conducted through a broker or “funding portal.”
- Information will be filed and provided to investors regarding the issuer and offering, including financial information based on the target amount offered.
- The provision would prohibit issuers from advertising the terms of the exempt offering, other than to provide notices directing investors to the funding portal or broker, and would require disclosure of amounts paid to compensate solicitors promoting the offering through the channels of the broker or funding portal.
Crowdfunding

- Issuers relying on the exemption would need to file with the SEC and provide to investors, no less than annually, reports of the results of operations and financial statements.

- A purchaser in a crowdfunding offering could bring an action against an issuer for rescission in accordance with Section 12(b) and Section 13 of the Securities Act, as if liability were created under Section 12(a)(2) of the Securities Act, in the event that there are material misstatements or omissions in connection with the offering.

- Securities sold on an exempt basis under this provision would not be transferrable by the purchaser for a one-year period beginning on the date of purchase, except in certain limited circumstances.
Crowdfunding

- The exemption would only be available for domestic issuers that are not reporting companies under the Exchange Act and that are not investment companies, or as the SEC otherwise determines is appropriate.
- Bad actor disqualification provisions similar to those required under Regulation A would also be required for exempt crowdfunding offerings.
- Funding portals would not be subject to registration as a broker-dealer, but would be subject to an alternative regulatory regime, subject to SEC and SRO authority, to be determined by rulemaking by the SEC and SRO.
Crowdfunding

• A funding portal is defined as an intermediary for exempt crowdfunding offerings that does not:
  • offer investment advice or recommendations;
  • solicit purchases, sales, or offers to buy securities offered or displayed on its website or portal;
  • compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
  • hold, manage, possess, or otherwise handle investor funds or securities; or
  • engage in other activities as the SEC may determine by rulemaking.

• The provision preempts state securities laws by making exempt crowdfunding securities “covered securities,” however, some state enforcement authority and notice filing requirements would be retained.

• State regulation of funding portals would also be preempted, subject to limited enforcement and examination authority.
The SEC’s Proposed Rules
The SEC voted to release proposed rules on October 23, 2013, and these rules are subject to a 90-day comment period. As we will discuss, the SEC’s proposed rules track the statute closely.
Issuer Provisions
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 that are 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 Commission 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
  • Any issuer that has no specific business plan or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies.
Process

• An issuer may only engage in an offering through a registered broker-dealer or through a funding portal.

• The issuer can only use one intermediary
  • This seems to be based on practical considerations
  • Using one intermediary makes it easier to track the $1 million issuer offering limit for example

• The offering will be conducted online only so that the crowd has access to information. 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.
Restrictions on Advertising and Promotion

- An issuer cannot advertise a Section 4(a)(6) offering, except for 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;
  - 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 can communicate with potential crowdfunding investors if the communications occur through the platform, and it should be clear which communications are being made by the issuer.

- The issuer can 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

• 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 may 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.
Disclosure Requirements

• An issuer that elects to engage in a crowdfunding offering must comply with various disclosure requirements including:
  • An initial disclosure about the offering on Form C;
  • Amendments to Form C to describe updates or material changes (Form C-A);
  • Periodic updates on the offering on Form C-U;
  • 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.
Form C Disclosure Requirements

• 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, operations, officers, directors, control persons, use of proceeds, capital structure, financial results, etc.
• Form C is a novel concept in that it represents an approach to phased disclosure for a company that is “non-reporting”.
• Basic issuer information will be required including name, form of entity, jurisdiction of formation, date of formation, address, website, number of employees, as well as the intermediary’s SEC file number and FINRA CRD number and fees being paid to the intermediary.
Form C Disclosure Requirements

• Officers and directors: each individual’s name, positions held with the issuer and duration in those positions, and business experience during the last three years

• Principal stockholders: names of each shareholder who owns 20% or more of the issuer’s outstanding voting equity securities (calculated as of the most recent practicable date)

• Use of proceeds: a specific use or range of possible uses and the factors impacting the selection of each such use

• Business description: a business plan or description
Form C Disclosure Requirements

• Offering amount and offering mechanics: the target or maximum amount raised; a discussion of the subscription or offering process that must include the following information:
  • 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; and
  • 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.
Form C Disclosure Requirements

• Capital structure: 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; a description of how the offered securities are valued

• Legends/risks: the issuer must include legends addressing the risks associated with such an offering, as well as the restrictions on transfer of the securities

• Ongoing reporting: information about the issuer’s reporting obligations and where information can be found
Form C Disclosure Requirements

• Financial information
  • MD&A: an issuer must include a description of its historical results of operation, liquidity and capital resources, and its financing needs
  • Financial statements: 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 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
Form C Disclosure Requirements

be based on the American Institute of Certified Public Accountants (AICPA) standards. A copy of the independent public accountant’s review report would be included in the disclosures to the SEC, the intermediary, and potential investors; and

• 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 Public Company Accounting Oversight Board (PCAOB) standards. 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.
Required Amendments on Form C-A

- An issuer may amend its Form C disclosures using Form C-A
- The SEC requires that the issuer file an amendment in order to disclose material changes. Materiality is left to the issuer to determine 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, and investor reconfirmations must be obtained following the occurrence of a material change
Ongoing Reporting Requirements

• Progress updates: an issuer is required to file progress updates with the SEC on a Form C-U. Updates are required five days after any of the following: 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.

• Annual reports: 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.

• Terminating ongoing reporting requirements: the 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.
Other General Provisions
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% 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% 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

• The securities sold in a crowdfunded offering are subject to transfer restrictions; the securities cannot 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.
Exchange Act Threshold

• The statute exempts securities sold in Section 4(a)(6) offerings from the Exchange Act holder of record count under Section 12(g).

• The issuer would have the responsibility for tracking or monitoring the holders of its securities and ensuring that it is accurately “counting” its holders of record.

• The SEC acknowledges that it may be costly for an early stage company to engage the services of a transfer agent; however, it does not propose other alternatives.
Integration

- An offering made pursuant to Section 4(a)(6) 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 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.
Intermediary Provisions
Funding Portals

• A funding portal is an intermediary registered with the SEC as a funding portal and that is a FINRA member firm.

• A funding portal must limit the scope of its activities. It cannot offer investment advice or make recommendations; solicit purchases, sales or offers to buy securities offered through its platform; receive or pay its employees transaction-based compensation; receive or hold investor funds or securities; or engage in any other SEC prohibited activity.

• A funding portal cannot, and its directors, officers and partners cannot, have a financial interest in any issuer that uses the funding portal’s services.
Funding Portals

SEC registration:

• A funding portal registers with the SEC by filing a form (Form Funding Portal)

• Registration becomes effective on the later of: 30 days after the date the registration is received by the SEC, or the date that the funding portal is approved for FINRA membership

• As a condition of registration, the funding portal must have and maintain a fidelity bond that:
  • Has a minimum coverage of $100,000;
  • Covers any associated person of the funding portal unless excepted in the FINRA rules; and
  • Meets any other applicable requirements.

• A funding portal is subject to examination and inspection by the SEC and FINRA.
Non-U.S. Funding Portals

• A non-U.S. entity may register as a funding portal
• Conditions:
  • There must be an information sharing arrangement in place between the SEC and the foreign jurisdiction where the entity is domiciled
  • The entity must complete a Schedule C to Form Funding Portal that provides
    • Information regarding a U.S. agent for service of process
    • An opinion of counsel addressing the applicant’s ability to provide the SEC and the national securities association of which it is a member with prompt access to its books and records and submit to
    • Onsite SEC inspection
  • Consent to service of any civil action relating to its funding portal business
Duties of an Intermediary

• An intermediary has substantial obligations in respect of its crowdfunding activities.
• Mitigating fraud: In order to minimize the incidence of fraud, an intermediary:
  • Must establish a reasonable belief that the issuer is in compliance with relevant regulations (it can rely on issuer representations absent knowledge that the representations are not accurate);
  • Must have a reasonable belief the issuer has a means of tracking beneficial holders of its securities;
  • Must deny access to any issuer that is, or that has a director, officer or control person that is, a bad actor;
  • Must conduct certain background checks; and
  • Upon becoming aware of a disqualifying event, must remove the issuer from its platform.
Duties of an Intermediary

• Monitoring investor limits: the intermediary must ensure no investor exceeds applicable limits; an intermediary may rely on investor representations regarding its annual income and net worth made within the last 12 months

• Discussion forum: an intermediary must provide a venue for discussions between investors and between investors and the issuer
Educational Materials

- An intermediary must deliver to investors at the time of account opening certain plain English educational materials that explain:
  - The offering process;
  - The risks associated with participating in, and investing in securities sold in, a crowdfunded offering;
  - The types of securities sold through the platform;
  - The risks associated with such securities;
  - Suitability considerations;
  - The issuer’s disclosure and reporting requirements;
  - Investment limitations; and
  - The circumstances under which the investor may withdraw its commitment to participate or the issuer may cancel the offering. An investor can cancel its commitment for any reason until 48 hours prior to the deadline specified in the issuer’s offering document.
Investor’s Acknowledgment of Risks

• An intermediary must ensure that each investor understands the risks of an investment. We noted an intermediary’s obligation to furnish educational materials. In addition, an intermediary also must:
  • Obtain an affirmation that the investor understands the educational materials
  • Each time before accepting an investor purchase commitment obtain a representation from the investor that the investor has read and understood the furnished materials and ensure that the investor has answered questions that demonstrate an understanding of the offering, the investment and the associated risks
Intermediary Requirements

- An intermediary is subject to requirements relating to the handling of funds. If it is a broker-dealer, it must comply with the 15c2-4 rules. If it is an intermediary, it must use the services of a bank.
- An intermediary must provide investors with a confirmation-like document.
- As discussed earlier, investors have an unconditional right to cancel their investment commitment for any reason until 48 hours prior to the issuer’s announced deadline. Changes in the offering require or trigger certain reconfirmation obligations.
Safe Harbors for Funding Portals

• The proposed rules provide for certain safe harbor activities, which, if conducted by a funding portal would not, on their own, require broker-dealer registration. These include
  • 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
Secondary Market Activities

• An intermediary would not need to register as a securities exchange or as an alternative trading system (ATS) solely as a result of facilitating crowdfunded offerings.
• A funding portal cannot effect secondary market transactions.
• However, if an intermediary facilitates secondary market trading in securities issued in a Section 4(a)(6) offering, then it would may be required to register as an exchange or ATS if it meets the criteria set forth in Exchange Act Rule 3b-16.
FINRA’s Proposed Rules
Funding Portals

FINRA Regulations:

• 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 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.
Funding Portals

FINRA Regulations:

- Rule 100: Funding portals and their associated persons are subject to FINRA’s bylaws
- Rule 110: Outlines the membership application process (MAP), which is based on the NASD’s Rule 1010 Series but abridged. FINRA must make a decision on membership within 60 days of the filing of a membership application (Form FP-NMA)
- Rule 110 establishes five standards for membership: (a) ability to comply with all applicable laws and regulations of the Securities & Exchange Commission 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.
Funding Portals

FINRA Regulations:

- Rule 110 also permits membership interviews to take place by video, streamlines the appeals process, and narrows the events involving a change of control of the member that requires FINRA approval.
- Fidelity Bond: Rule 110 also sets out the fidelity bond requirement.
- Rule 200 addresses portal conduct.
- Rule 200(a) requires funding portals to observe high standards of commercial honor and just and equitable principles of trade.
Funding Portals

FINRA Regulations:

- Rule 200(b) prohibits 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.
- Rule 200(c) tracks FINRA Rule 2210 on advertising and requires that funding portal communications be fair and balanced, and prohibits the use of false and misleading statements and statements that predict future performance.
Funding Portals

FINRA Regulations:

- Rule 300 addresses compliance. Funding portals must:
- 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.
Funding Portals

FINRA Regulations:

• Rule 800 addresses investigations and sanctions and provides 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.
# Intermediary Comparison

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<th>Broker-Dealer</th>
<th>Funding Portal</th>
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<tr>
<td><strong>Regulatory Environment</strong></td>
<td>Well-established SEC and FINRA rules regarding registration and ongoing obligations</td>
<td>A new, “broker-dealer” like framework; subject to both SEC and FINRA oversight</td>
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<td><strong>Conduct of Business</strong></td>
<td>Handling customer funds and securities, making recommendations, compensating for sales of securities, etc.</td>
<td>Activities of a funding portal are quite circumscribed. Transaction-based compensation is prohibited. Owning a financial interest in issuers is prohibited. Certain “referral” arrangements with broker-dealers may be permissible.</td>
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<td><strong>Costs</strong></td>
<td>Significant registration costs, as well as ongoing compliance costs</td>
<td>Although both the SEC framework and the FINRA framework applicable to funding portals is scaled back (by comparison to the regulation of broker-dealers), funding portals are subject to registration, compliance requirements, and inspection and oversight by both agencies. In addition, funding portals have substantial obligations to issuers and investors and also must comply with AML and privacy regulations.</td>
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<td><strong>Availability of Crowdfunding Exemption</strong></td>
<td>Available for issuers using broker-dealer’s platform.</td>
<td>Available for issuers using funding portal’s platform.</td>
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