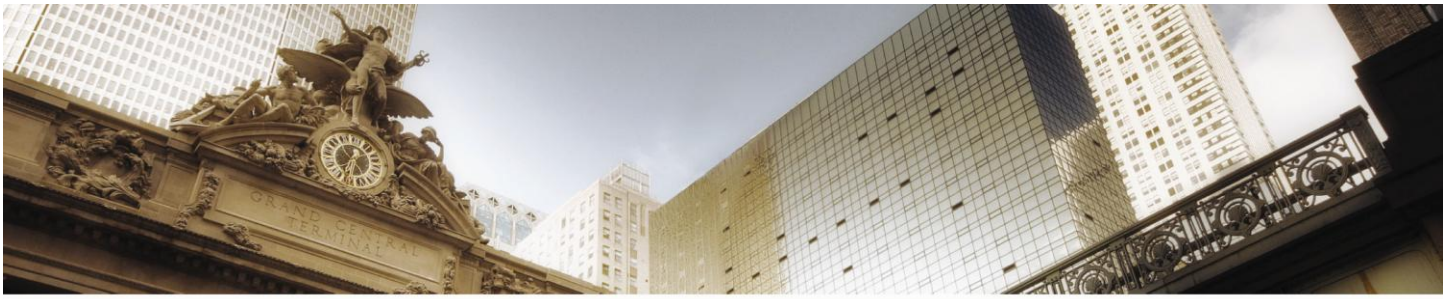

Client Memo

REGULATION CROWDFUNDING:

Proposed Rules by the SEC to give effect to the Crowdfunding Provisions of Title III under the JOBS Act.

Proposed Regulation Crowdfunding implements Title III of the JOBS Act, and creates a regulatory framework for issuer disclosure and intermediary requirements that is geared toward investor protection.

The Secutiries and Exchange Commision (SEC), on October 23, 2013, released its long-awaited proposed rules, Regulation Crowdfuning [1] to implement the crowdfunding provisions of Title III of the Jumpstart our Business Startups Act (JOBS Act)[2].The proposed rules are open for public comment until February 3, 2014. The proposed rules set out the criteria for certain limited-value securities offerings through Internet portals, to purchasers who need not be accredited investors but who are subject to other prescribed limits on their ability to invest in securities sold under the new safe harbor. The proposed rules also create a new disclosure form, Form C, to be used by Issuers to meet prescribed disclosure requirements, and set out a framework and rules for the operation of Internet intermediary portals. On the same day, FINRA (Financial Industry Regulatory Authority) proposed its set of rules governing Internet portals.

The release of the proposed rules does not yet make offers and sales of securities to the general public through crowdfunding permissible, and the public should expect that it will be many months before final rules are issued due to the public comment period which expires on February 3, 2014, and the Commission's need to thereafter finalize rules. However, offers and sales to accredited investors may be conducted via an Internet intermediary in reliance upon other exemptions, please refer to my articles *A Seismic Shift in the Securities Laws: The Elimination of the Ban on the Use of General Solicitation or General Advertising in Certain Private Placements, and What It Means for Issuers, Accredited Investors* ("A Seismic Shift"), and *Crowdfunding* and *Crowdfunding – Clearing Away the Fog* for a full explanation of the

[1] The proposed rules can be found at http://www.sec.gov/rules/proposed/2013/33-9470.pdf

[2] Pub. L. No. 112-106, 126 Stat. 306 (2012).

circumstances under which such offers and sales can be conducted.

Requirements Pertaining to Issuers and Purchasers, and Offering Requirements and Limitations

Regulation Crowdfunding implements the Section 4(a)(6) exemption and Section 4A of the Securities Act of 1933 (Securities Act) and Sections 3(h) and 12(g)(6) of the Securities Exchange Act of 1934 (the "Exchange Act"), and in some cases goes beyond the strict terms of the JOBS Act. The regulations follow the general plans of Title III of the JOBS Act, imposing limits on the amount an issuer can raise, the amount an investor can invest, the disclosure that the issuer will be required to provide, the manner in which the funding portal will be qualified and operate. However, the SEC noted that it was cognizant of the balance it needs to strike between protecting investors and providing rules that are not unduly burdensome such that they stifle capital raising by startups and small businesses; nevertheless, the disclosure requirements and ongoing reporting requirements are of such a nature that they will require the assistance of third party professionals such as accountants and lawyers which may indeed inhibit the ability of cash-strapped early stage companies to use the exemption, particularly in light of the fact that crowdfunding-type offerings to accredited investors(as discussed in *Crowdfunding – Clearing Away the Fog*) come with no prescribed or ongoing reporting obligations apart from the ubiquitous concerns of the anti-fraud provisions of the Securities Law.

What type of issuers qualify for the exemption

The exemption will not apply to offers or sales of securities by any issuer that:

i. Is not organized under, and subject to, the laws of any state or territory of the United States or District of Columbia – hence foreign issuers may not take advantage of the exemption;
ii. Is required to file periodic reports pursuant to the Securities Exchange[3];
iii. Is an Investment Company as defined in Section 3 of the Investment Company Act of 1940[4] or is excluded from the definition of Investment Company under Sections 3(b) or 3(c) of that Act[5].
iv. Falls within the exclusion of " bad actors" specified in the proposed rules (as described below);
v. Has previously sold securities under the crowdfunding exemption and is not up to date with its required annual SEC filings nor provided any required periodic information updates to investors as required under the rules (described below) during the two years immediately preceding the filing of the offering statement – hence a two-year penalty for disclosure violations; or
vi. Has no specific business plan, or has indicated that its plan consists of engaging in a merger or acquisition with an unspecified company or companies, because such a plan is not in keeping with the spirit of crowdfunding which is the provide early stage funding for a new idea, and if the business plan

[3] See Sections 13 and Section 15(d) of the Exchange Act, 15 U.S.C. §§78m and 78o(d).

[4] 15 U.S.C. §80a-3.

[5] 15 U.S.C. §§80a-3(b) or 80a-3(c).

is too vague or does not specify a plan other than to merge with an unidentified company then there is no idea stated with enough specificity upon which to make an investment decision.

The rules state that an "issuer" includes all entities controlled by or under common control with the issuer, and all predecessor entities. In its commentary the Commission references the definition of "control" found in Securities Act Rule 405[6], being the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through voting securities, by contract, or otherwise.

"Bad Actor" Disqualification. An issuer may not rely on the exemption if it or an enumerated related party has engaged in any of a long list of actions[7] that triggers the bad actor disqualification. The disqualification criteria captures a broad range of entities including not only the issuer and any affiliated issuer but also any director, officer, general partner or managing member of the issuer; any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities based on voting power; any promoter connected with the issuer in any capacity at the time of such sale; any person that has been or will be paid (directly or indirectly) remuneration for solicitation of purchasers in connection with such sale of securities; or any general partner, director, officer or managing member of any such solicitor. However, events related to an affiliate prior to the time the affiliation with the issuer arose will not be disqualifying as long as the issuer and the relevant affiliate did not control the issuer and the two were not under common control of a third party.

[6] 17 CFR 230.405.

[7] Regulation Crowdfunding § 227.503. If any of the entities listed above has engaged in any of the following activities that occurred after the effective date of the rule (hence not retroactive) then the issuer may not rely on the exemption:

- Has been convicted of a felony or misdemeanor, or is the subject of an order judgment or decree of a court related to the sale of a security, false statements before the Commission or arising out of the conduct of a broker dealer, within 5 or 10 years (depending on which entity is involved from the list above) prior to the filing of the information for the exemption; or
- Is the subject of a final order of a state securities commission, state or federal bank supervisory authority, insurance commission, the CFTC or credit union administrator that bars the person from association with an entity that is regulated by such commission, authority or agency, or engaging in the business of securities, insurance or banking or credit union; or
- Is the subject of an order of the SEC suspending or revoking a person's registration as a broker dealer or bars a person from being associated with any entity offering any penny stock; or
- Is subject to an order of the SEC to cease and desist from committing or causing a violation of Section 5 of the Securities Act, or any scienter-based anti-fraud provision of the securities laws (such as Securities Act Section 17(a)(1)m, Exchange Act Section 10(b) and Rule 10b-5, and Section 206(1) of the Investment Advisors Act; or
- Has been suspended or expelled from membership of a registered national securities exchange; or
- Has filed or was the named underwriter in any registration statement or Regulation A offering statement that was the subject of a refusal order, stop order, or order suspending the Regulation A exemption ; or
- Is the subject of a US Postal Service false representation order.

Provided, however, that the exemption will not be lost if the conviction, order, judgment, decree, suspension or expulsion occurred before the effective date of the final rule, if the issuer can show good cause and the Commission determines that the exemption should not be denied, or the relevant court or body that entered the relevant order etc. advises in writing that disqualification from the exemption need not arise, or if the issuer establishes after exercising reasonable care that it did not know and could not have known of the disqualification.

What type of Securities May be Offered

The proposed rules do not limit the type of security that may be offered in reliance on the Section 4(a)(6) crowdfunding exemption, hence either debt or equity may be offered and sold. In its Commentary the Commission explains its view that debt securities issued pursuant to the Section 4(a)(6) crowdfundng exemption would be able to rely on the exemption from applicability of the Trust Indenture Act of 1939 ("Trust Indenture Act")[8] pursuant to the exemption found in the Trust Indenture Act for transactions exempt from Securities Act registration pursuant to Section 4 thereof [9].

Limitation on Capital Raised

An issuer relying on the crowdfunding exemption is limited to raising no more than an aggregate $1,000,000 in any rolling 12-month period. The SEC has a mandate to update this figure at least every 5 years for inflation.

Calculating the Limit Amount. The proposing release clarifies that, for purposes of calculating the $1,000,000 limit in a rolling 12-month period, capital raised in another Section 4(a)(6) exempt crowdfunding transaction would count, but securities raised by means of any other exempt offering (such as Regulation D) would not be counted against the $1 million limit, and further states that a 4(a)(6) offering should not be integrated with another exempt offering provided that the other offerings comply with the relevant applicable exemption that is being relied upon. However, if the issuer was conducting a concurrent exempt offering for which general solicitation or advertising is not permitted, then the issuer must "be satisfied" that the purchasers in that offering were not solicited by means of the crowdfunding offering being made in reliance upon the Section 4(a)(6) exemption – consequently conducting these types of offerings concurrently could be fraught with danger from a regulatory compliance perspective. Similarly, any concurrent exempt offering for which general solicitation or advertising is used (i.e. under Rule 506(c)) could not include an advertisement of the terms of the 4(a)(6) offering if such an ad would not be permitted under Section 4(a)(6) or Regulation Crowdfunding.

The release goes on to state that funds raised through methods that do not involve the offer or sale of securities such as donations from a perk-based crowdfunding platform, contributions from friends and family, gifts, grants and loans, would also not count toward the $1 million limit.

Defining the Issuer for purposes of calculating the limit. For purposes of determining which securities offerings to include in the calculation, all offerings by entities that are controlled by or under common control with the issuer must be aggregated. Additionally, securities issued by any predecessor of the issuer would count, to eliminate the possibility that an issuer would restructure in an attempt to circumvent the limit.

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[8] 15 U.S.C. 77aaa *et seq*.

[9] 15 U.S.C. 77ddd(b). It is also notable that Trust Indenture Act Section 304(a)(8) [15 U.S.C. 777ddd(a)(8)] and Rule 4a-1 [17 CFR 260.4a-1] also provide an exemption to issue up to $5 million of debt securities in any 12-month period without an indenture.

Limitations on Amount Invested by a Particular Purchaser

The proposed rule limits the aggregate amount of securities sold in reliance on the crowdfunding exemption to any individual investor – natural person or entity, regardless of whether such person is an accredited investor or institutional investor – during the 12-month period preceding the current transaction, to the greater of:

i. $2,000 or 5% of the investor's annual net worth, whichever is greater, if *both* the investor's annual income and net worth are *less than* $100,000; and

ii. 10% of the investor's annual income *or* net worth, whichever is greater, with an absolute cap of $100,000, if *either* annual income *or* net worth of the investors is $100,000 or more.

The proposed rule specifies that the calculations for an individual's income and net worth would follow the calculation guidelines used to determine accredited investor status[10], and that income and net worth calculations may be a joint calculation for spouses even though the JOBS Act is silent on the point. Issuers may rely on the efforts that an intermediary is required to take, described below, to ensure that an investor has not exceeded the limits, provided that the issuer does not have actual knowledge that the purchaser would exceed the limits as a result of purchasing the securities. Two specific items upon which the SEC requested public comments are the use of joint annual income or joint net worth for purposes of calculating the limit, and whether there should be different limits for accredited investors and institutional investors. As discussed in my article *Crowdfunding, Clearing Away the Fog*, an accredited investor crowdfunding market has already developed based on pre-existing exemptions and safe harbors; it is questionable whether specific crowdfunding regulations that apply to this investor base are necessary or indeed whether they would be counterproductive by creating parallel sets of regulations that may not be consistent with each other, unless the Commission devises a clear safe harbor that would allow for general solicitation and general advertising without triggering the accredited investor verification procedures currently prescribed by Rule 506(c) (as described in my article *A Seismic Shift*).

Use of Intermediary Portal

The Commission's commentary to the proposed rules focused on the concept that a central tenet of crowdfunding is to enable the crowd to share information and evaluate a business idea. The commentary makes it clear that the Commission's view is that, in order to best accomplish the purposes of the statute, all offers and

[10] The definition of the term "accredited investor" is set forth in Rule 501(a) of Regulation D [17 CFR 230.501(a)] and includes any person who comes within one of the definition's enumerated categories of persons, or whom the issuer "reasonably believes" comes within any of the enumerated categories, at the time of the sale of the securities to that person. For natural persons, Rule 501(a) defines an accredited investor as a person: (1) whose individual net worth, or joint net worth with that person's spouse, exceeds $1 million, excluding the value of the person's primary residence (the "net worth test"); or (2) who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year (the "income test"). Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1577 (July 21, 2010) (the "Dodd-Frank Act"), the SEC is mandated to review the definition of accredited investor every four years, and it has begun the current review process by soliciting public comment on the definition in its Release No. 33-9416 (July 10, 2013).

sales pursuant to the exemption should take place via an Internet platform or similar electronic medium that may develop in the future (such as mobile device applications), and additionally that an offer should be conducted on only one such platform, even though the JOBS Act does not prescribe either specifically. The Commission's reasoning is that to fulfill the fundamental characteristic of being widely available to the public, Internet or electronic media are ideal, and that having an offer limited to the use of one platform would concentrate the "collective wisdom of the members of the crowd" in one place, accessible to all.

The Commission has requested public comment on the definition of platform which it proposes to be "an Internet website or other similar electronic medium through which a registered broker dealer or a registered funding portal acts as an intermediary in a transaction involving the offer or sale of securities in reliance on Section 4(a)(6)."

Additionally, the commission has asked for public input on whether it should allow intermediaries to restrict who can access their platforms, for example by invitation only or to certain categories of investors.

The proposed rules allow for back-office and administrative operations to take place elsewhere other than on their platforms, and describes those activities as including such things as document maintenance, preparation of notices and confirmations, preparing internal policies and procedures, defining information technology security requirements, and preparing information for regulatory filing.

The particular detailed requirements regarding the intermediary's obligations and responsibilities, compensation limitations, and the proposed FINRA rules, are discussed below.

Purchaser's Right to Cancel the Commitment

Purchasers have the right to cancel an investment until 48 hours prior to the deadline identified in the issuer's offering materials. If there is a material change to the terms of the offering or the disclosure information provided by the issuer, the intermediary must notify investors of the changes and also inform them that their investment commitment will be automatically cancelled if they do not reconfirm the commitment within five business days of receipt of the notice; if no reconfirmation is received, the intermediary must cancel the commitment, notify the investor of the action, and return or direct the return of the investor's funds.

The Internet intermediary must notify investors when the target amount is met, and if the issuer reaches the target amount prior to the deadline then it may end the offering early upon five business days notice provided that that offer has minimally been open for 21 days from the date the disclosure information was first made available on the platform. If the aggregate commitments fall short of the offering target by the deadline, the offering will be cancelled and all funds must be returned to investors.

Issuer Disclosure Requirements

The proposed rules prescribe extensive disclosure obligations by an issuer, and anticipate a narrative description of its financial condition including its historical results of operations, liquidity and capital resources, or if there

is not operational history then a description of financial milestones and operational liquidity and other challenges. The detailed requirements are broad enough in scope that they begin to resemble the disclosure found in a public offering, particularly when the ubiquitous anti-fraud provisions of the Securities Laws are juxtaposed upon them, and indeed the Commission's commentary likens the disclosure to what would be found in the MD&A (management's discussion and analysis of financial condition and results of operations) section of a prospectus but notes that, because issuers would tend to be smaller and have less operating history, they would not expect the discussion to be quite as lengthy or detailed as the MD&A of an Exchange Act reporting company. The commission specifically declined to set a format for the disclosure, in favor of laying out broad principles.

The issuer will be required to file the information with the Commission on EDGAR (the Electronic Data Gathering, Analysis, and Retrieval System)[11] using a new form, Form C, and also provide the information to the Internet intermediary and to investors, the latter two requirements being met by providing the intermediary with a copy of the all filed Form C's, and referring investors (via email or a posting on its website) to the information on the intermediary's platform; no physical copy need be delivered. The scope and nature of the disclosure is such that issuers may require legal assistance to comply with it, particularly in light of the potential two-year penalty from relying on the crowdfunding exemption if certain information disclosure requirements are not met.

Offering Disclosure Specifics. The disclosure requirements include:

- Identifying information about the issuer including its name, legal status and organization type, physical address and website.
- Identifying information about its officers (president, vice president, secretary, treasurer, chief financial officer and controller) and directors, including each person's principal occupation and employment record, and whether they are an employee of the issuer.
- The name of each person who is the beneficial owner of 20% or more of the outstanding voting securities of the issuer.
- The description of the business plan -- in its commentary the Commission specifically states that the plan does not have to take any prescribed form; rather it should encompass a wide range of project descriptions, articulated ideas and business models in keeping with the fact that issuers may be in various stages of development and in different industries.

[11] An issuer that does not already have EDGAR filing codes, and to which the Commission has not previously assigned a user identification number, called a "Central Index Key (CIK)" code, would need to obtain the codes by filing electronically a Form ID [17 CFR 239.63; 249.446; 269.7 and 274.402] at https://www.filermanagement.edgarfiling.sec.gov. The applicant also would be required to submit a notarized authenticating document as a Portable Document Format (PDF) attachment to the electronic filing. The authenticating document would need to be manually signed by the applicant over the applicant's typed signature, include the information contained in the Form ID and confirm the authenticity of the Form ID. *See* 17 CFR 232.10(b)(2).

- Current number of employees.
- A discussion of material risk factors.
- A description of the securities being offered.
- The target offering amount, the deadline to reach the target amount, and statement that the offering will be canceled and funds returned if the offering target amount is not reached. Additionally, if applicable, the issuer must describe whether it will accept investments in excess of the target offering amount, and if so how the oversubscription will be allocated among investors.
- Use of proceeds, and if there are a range a possible uses of proceeds then each must be identified with a description of the factors that might impact upon one use prevailing over another.
- The description of the process to complete the transaction and cancel an investment, which are prescribed by the rules, see below.
- The offering price or method for determining the price[12].
- Description of the ownership and capital structure of the issuer including the terms of the securities being offered, each other class of security of the issuer, description of voting rights and any restrictions on voting rights of any securities, how the terms of the securities being offered maybe modified, and how the securities being offered may be materially limited, diluted or qualified by the rights of other classes of securities (note the proposed rules do not ban dilution practices).
- The description of how the securities being offered are valued.
- Risks to purchasers of the securities who will be minority owners including risks associated with corporate actions such as the issuance of more securities, issuer repurchase, and the sale of the issuer or the assets of the issuer.
- Description of transfer restrictions (see below).
- Information related to the Internet intermediary, including the name, Commission file number and Central Registration Depository (CRD) number if applicable, the amount of compensation the intermediary will receive for conducting the offer, including any referral or other fees.
- Description of material terms of any indebtedness of the issuer.

[12] Some commenters suggested to the Commission that it require issues to set a fixed offer price and prohibit dynamic pricing (i.e. pricing per share that increases with the passage of time) because dynamic pricing schemes may apply pressure on the investment decision, but the Commission noted that the JOBS Act contemplated flexible pricing and that ability of an investor to cancel its commitment deals with these concerns.

- Description of all exempt offerings conducted within the last three years including the date, exemption relied upon, type of security, amount and use of proceeds.

- Description of related party transactions within the preceding 12 months that exceeded 5% of the aggregate amount of the capital being raised by the issuer in reliance upon the crowdfunding exemption. Related parties include beneficial owners of 20% or more of the outstanding voting securities, any promoter or incorporator of the issuer if it was incorporated within the last three years, and in each case immediate family members or related parties (parent, child, siblings, in-laws, and domestic partners).

- Description of the financial condition of the issuer, including historical results of operations, liquidity and capital resources. For issuers with no prior operating history, the description should include a discussion of financial milestones and operational, liquidity and other challenges. For issuers with an operating history, the discussion should address whether historical earnings and cash flow are representative of what the issuer expects in the future. Also discuss how the proceeds will impact liquidity, and describe other available sources of capital to the business including lines of credit and contributions from shareholders.

- Third-party verification of financial statements (balance sheet, income statement, statement of cash flows and statement of changes in owners' equity) prepared in accordance with US generally accepted accounting principles (GAAP) covering the shorter of the two most recently completed fiscal years or since corporate inception. The Commission noted that financial statements prepared in accordance with GAAP are generally self-scaling to the size and complexity of the issuer, which would intrinsically reduce the burden of preparing financial statements for early stage companies. The type of verification is tiered based on the aggregate size of sales under the crowdfunding exemption for the preceding 12-month period -- actual sales are key, unsuccessful offerings are not aggregated, and conversely amounts raised above an offering target are included. An issuer must disclose, for offerings that, together with all other crowdfunding sales under the exemption in the preceding 12 months, are

    - less than $100,000, income tax returns for the most recently completed year, if any, and financial statements of the issuer, certified by the principal executive officer to be true and complete in all material respects;

    - more than $100,000 and up to $500,000, financial statements reviewed by an independent public accountant ("independence" being determined by applying the criteria set forth in Rule 2-01 of Regulation S-X[13]) using the Statements on Standards for Accounting and Review Services

[13] 17 CFR 210.2-01. Rule 2-01 of Regulation S-X is designed to ensure that auditors are qualified and independent both in fact and in appearance. The rule sets restrictions on financial, employment and business relationships between and accountant and a client and restrictions on an accountant providing certain non-audit services to a client.

("SSARS") issued by the accounting and review services committee of the American Institute of Certified Public Accountants ("AICPA"), including a copy of the accountants review report;

- more than $500,000, financial statements audited by an independent public accountant using auditing standards issued by either the AICPA or the Public Company Accounting Oversight Board ("PCAOB"), including a copy of the audit report.

In all cases the issuer must include a discussion of any material changes in the financial condition during the time subsequent to the date for which the financial statements are provided and the offering date.

- Any matter that would have required disqualification under the bad actor provisions if it occurred on or after the effective date of the rules, unless the issuer establishes that it did not know of, and in the exercise of reasonable care could not have known of, the existence of the undisclosed matter.

Updating Offering Disclosure. In addition to the initial filing, the Form C must be updated during the time when the offering has not yet been terminated if there have been any material[14] changes, additions or updates to the information, including but not limited to a material change to the financial condition or the intended use of proceeds, and determination of the final price if the issuer previously only disclosed a method for determining the final price. Additionally, progress updates on meeting the target financing amount must be filed on Form C within five days of when the commitments reach fifty percent of the target amount and one-hundred percent of the target offering amount, and if the issuer accepts proceeds in excess of the target offering amount, it must file a final Form C-U to disclose the total amount of securities sold in the offering.

Ongoing reporting requirements under the crowdfunding rules, and exemption from triggering certain Exchange Act reporting requirements. Issuers that have successfully sold securities in reliance on the crowdfunding exemption must file with the SEC on EDGAR, and post to its website (no physical delivery requirement to its security-holders is required), a Form C-AR annual report of results of operations, and financial statements, in each case in line with the disclosure requirements noted above for the offering. The annual reporting obligation continues after the offering until either the issuer becomes an Exchange Act reporting company pursuant Sections 13(a) of 15(d) of the Exchange Act[15], or another party repurchases all of the outstanding securities that were sold in reliance on the crowdfunding exemption, or the issuer otherwise liquidates its assets or dissolves its business. To terminate its annual reporting obligation for any of the reasons noted above, the issuer will need to file a Form C-TR with the SEC.

Section 303 of the JOBS Act amended Exchange Act Section 12(g) to provide that "the Commission shall, by rule, exempt, conditionally or unconditionally, securities acquired pursuant to an offering made under [S]ection 4[(a)](6) of the Securities Act of 1933 from the provisions of this subsection." As amended by the JOBS Act,

[14] An item is "material" if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether or not to purchase the securities. *Basic Inc. v. Levinson*, 485 U.S. 224 (quoting *TSC Indus., Inc. v. Northway, Inc*., 426 U.S. 438 (1976).

[15] 15 U.S.C. 78m(a)) or 15(d) (15 U.S.C. 78*o*(d).

Section 12(g) requires, among other things, that an issuer with total assets exceeding $10,000,000 and a class of securities held of record by either 2,000 persons, or 500 persons who are not accredited investors, register such class of securities with the Commission. The Commission's view is that to be consistent with the intent of the JOBS Act, securities issued pursuant to the crowdfunding exemption be permanently excluded from the record holder count. Consequently, proposed Rule 12g-6 provides that securities issued pursuant to an offering made under Section 4(a)(6) would be permanently exempted from the record holder count under Section 12(g). An issuer seeking to exclude a person from the record holder count would have the responsibility to demonstrate that the securities held by the person were initially issued in an offering made under Section 4(a)(6).

Advertising the Offering

Issuers relying on the crowdfunding exemption may not engage in general solicitation or general advertising, and are limited to advertising that directs investors to the intermediary's Internet platform and certain very basic information similar to "tombstone ads" permitted under Securities Act Rule 134[16] such as:

- Issuer's identifying information -- name, the legal identity and business location of the issuer such as address and website address, and email contact details;
- The fact that it is conducting an offering;
- The name of the intermediary and its website address;
- Basic identifying terms of the offering such as the nature and amount of securities being offered, the price, and the closing date.

Issuers are not restricted in how or where to place the ads, for example in newspapers or on social media sites. The proposed rules, however, allow the issuer to communicate with investors about the terms of the offering through the communication channels provided by the Internet intermediary on the intermediary's platform, provided that the issuer identifies itself as the issuer in all such communications.

Additionally, the proposed rules do not restrict an issuer's ability to communicate other information that does not refer to the terms of the offering. The Commission specifically cited the practice under Securities Act Rule 169[17] permitting non-Exchange Act reporting issuers engaged in an IPO to continue to publish, subject to certain exclusions, regularly released factual business information that is intended for use by persons other than in their capacity as investors or potential investors, and will enable the business to continue to advertise its products or services.

Persons Promoting the Offering -- Compensation and Disclosure

The proposed rules would prohibit an issuer from compensating, or committing to compensate, directly or indirectly through a third party, any person to promote the issuer's offering through communication channels

[16] 17 CFR 230.134.

[17] 17 CFR 230.169.

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. Disclosure of the promoter relationship addresses a need to alert the investing public about a potential bias or self-interest in these types of communications. Together, the proposed disclosure rule, combined with the application of the Exchange Act provisions that require any party who receives transaction-based compensation to register as a broker[18], and Securities Act Section 17(b) which also requires disclosure of past, present and prospective compensation related to promotion activities[19], and the proposed rules under Regulation Crowdfunding setting forth the intermediary's responsibilities with respect to the disclosure (discussed below), create a regulatory framework that must be navigated with great care.

Minimum Offering Period

The proposed rules require that the offering materials are accessible on the intermediary platform a minimum of 21 days before any securities can be sold, even if the target amount is met before the deadline, which effectively creates a minimum 21-day offering period.

Transfer Restrictions

Securities purchased pursuant to the crowdfunding exemption would be freely tradable after one year from the date of purchase. Within one year of the date of purchase the securities may be transferred in the following limited circumstances:

- To the issuer of the securities;
- To an accredited investor;
- As part of an offering registered with the Commission; or
- To a family member of the purchaser or the equivalent[20], or in connection with certain events, including death or divorce of the purchaser, or other similar circumstances, in the discretion of the Commission.

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[18] The receipt of transaction-based compensation in connection with the offer and sale of a security could cause a person to be a broker required to register with us under Exchange Act Section 15(a)(1) [15 U.S.C. 78*o*(a)(1)].

[19] 15 U.S.C. 77q. Section 17(b) provides that "[i]t shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof."

[20] The Commission proposes to define the phrase "member of the family of the purchaser or the equivalent" to mean a "child, stepchild, grandchild, parent, stepparent, grandparent, spouse or spousal equivalent, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of the purchaser, and shall include adoptive relationships." This definition tracks the definition of "immediate family" in Exchange Act Rule 16a-1(e). 17 CFR 240.16a-1(e).

Safe Harbor for Insignificant Deviations

The proposed rules include a safe harbor for insignificant deviations from a term, condition or requirement of Regulation Crowdfunding provided that the issuer can show:

- The failure to comply was insignificant with respect to the offering as a whole;
- The issuer made a good faith and reasonable attempt to comply with all applicable terms, conditions and requirements of Regulation Crowdfunding; and
- The issuer did not know of the failure to comply, where the failure to comply with a term, condition or requirement was the result of the failure of the intermediary to comply with the requirements of Section 4A(a) and the related rules, or such failure by the intermediary occurred solely in offerings other than the issuer's offering.

The Commission retains the right, however, to bring enforcement actions for failure to comply with all applicable terms, conditions and requirements, so in order to reap the benefits of this safe harbor, issuers are relying on the Commission being magnanimous in its enforcement efforts.

Blue sky law application to securities offered under Regulation Crowdfunding

Significantly, the JOBS Act amends Section 18(b)(4) of the Securities Act to classify securities sold under the new crowdfunding safe harbor as covered securities for which pre-emption applies, so securities sold pursuant to Regulation Crowdfunding will be exempt from state blue sky registration, documentation and offering requirements. However, both the state of the issuer's principal place of business and the state in which the purchasers of 50 percent or more of the aggregate amount of the securities reside are permitted to require notice filings and fees for crowdfunded offerings, and some of these requirements apply prior to the commencement of an offering so care must be given to review blue sky law requirements. Additionally, states are not limited in their authority to take anti-fraud enforcement action against any broker, dealer, crowdfunding issuer or funding portal using the exemption.

Requirements Pertaining to Crowdfunding Intermediaries

Who can Operate an Internet Intermediary Site

In accordance with Section 4(a)(6) of the JOBS Act, the proposed rules require that crowdfunding offerings under the regulations be conducted through a broker registered with the SEC under Section 15(b) of the Exchange Act, or if not a broker then through an intermediary that is a registered "funding portal" which is also registered with FINRA (or another national securities association registered with the SEC under the Exchange Act, but today FINRA is the only such organization). As discussed above, the Commission has prescribed that intermediaries function via an Internet platform or other electronic medium. The proposed rules set forth criteria for qualification to operate an intermediary platform. The Commission noted that funding

portals would not be required to register as an exchange under Exchange Act Section 3(a)(1) or as an alternative trading system.

Excluded persons: The crowdfunding intermediary itself, as well as its directors, officers or partners, any person directly or indirectly controlling or controlled by the portal, or any employee (excluding employee who are purely clerical or ministerial) may not have a financial interest – direct or indirect ownership of, or economic interest in, any class of the securities -- in any issuer offering securities on the platform.

Excluded activities: An intermediary that registers as a funding portal, and is not a registered broker, is restricted in the services it can provide. It may not:

- Offer investment advice or recommendations;
- Solicit purchases, sales or offers to buy the securities displayed on its platform;
- Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its platform; or
- Hold, manage, possess, or otherwise handle investor funds or securities. Given that an intermediary that is merely a registered funding portal cannot hold funds, it will either need to be affiliated with a registered broker which is allowed to hold investor funds or contract with a third party to manage funds.

Foreign funding portals

Although only US issuers may offer and sell securities pursuant to Regulation Crowdfunding, the proposed rules would allow non-US resident entities to register as funding portals if there is an information sharing arrangement in place between the SEC and the competent regulator where the non-US resident portal is organized or has it principal place of business, such arrangement being deemed to provide the Commission and FINRA (or any other registered national securities association) with appropriate tools for supervising such entities. The portal must obtain a written consent of an agent in the US for service of process for a lawsuit, and must obtain an opinion of counsel as to certain matters.

Responsibilities of the Intermediary Funding Portal

Reducing the risk of fraud The proposed rules set forth a set of affirmative duties of the intermediary that are aimed at reducing the risk of fraud. The Intermediary must have a reasonable basis to believe a crowdfunding issuer is in compliance with crowdfuding regulations, and has set up a means to keep accurate records of the holders of its securities (for example, use of a direct registration system, legends on certificates or use of a registered transfer agent, although none of these are required). However, the intermediary may rely upon representation of the issuer in this regard unless it has reason to question the reliability of such representations.

The intermediary has the duty to minimally conduct a background and securities enforcement regulatory history check on each issuer, officer, director or beneficial owner of 20 percent or more of the issuer's outstanding voting securities to determine if any such person falls within the "bad actor" disqualification described above. The intermediary must deny access to the platform to an issuer if it has a reasonable basis for believing that the "bad actor" disqualification is triggered or that there otherwise is a potential risk of fraud, or if it is unable to adequately or effectively assess the risk of fraud.

Additionally, if any such disqualification triggers come to light after an offering is launched on the platform, the intermediary must remove the offering and return (or in the case of funding portals, which are not allowed to hold investor funds, direct the return of) any funds committed by investors up to that point in time.

Responsibility to deliver educational materials, compensation and other information to investors An investor must open an account with the intermediary and consent to the electronic delivery of materials before it may be allowed to make an investment commitment. The intermediary is required to provide information about the platform, the intermediary and the offering process to the investor in an electronic message such as an email, or via a link to the information on the intermediary's website or the issuer's website. The educational materials must describe in plain language:

- The process for the offer, purchase and issuance of securities through the intermediary and the risks of purchasing securities offered and sold via crowdfunding;
- The type of security and the risks associated with the security, including potential dilution;
- The restrictions on the resale of securities offered and sold;
- The limitations on the amounts investors may invest and on the investor's ability to cancel an investment;
- The circumstances in which the issuer may cancel an investment commitment; and
- That following the completion of the offering there may or may not be an ongoing relationship between the issuer and the intermediary.

The intermediary is required to keep the most up-to-date version of all educational materials on its platform at all times.

The intermediary must inform investors that all promoters – persons who promote an issuer's offering for compensation or who is a founder or employee that engages in promotional activities for an issuer on the platform – must disclose the compensation it is receiving. The intermediary also must disclose the manner in which it is compensated.

Responsibility to deliver transaction and issuer-related information The intermediary must make available, for a minimum of 21 days prior to the sale of securities, all the materials discussed in "Issuer Disclosure Requirements" above, in a manner that may be saved, downloaded or otherwise stored by an investor, and must continue to make the information available including any updates until the offer is completed or cancelled. An investor need not open an account to have access to these materials.

The intermediary must, upon receipt of an investment commitment, send the investor a notification disclosing the dollar amount of the investment, the price of the securities if known, the name of the issuer and the date by which the investor can cancel the investment commitment.

Responsibility to verify investor qualification The proposed rules require the intermediary to have a reasonable basis for believing that the investor falls within the investment limits prescribed by the rules, as described above. The proposed rules allow the intermediary to rely on an investor's representation concerning compliance with the investment limitation unless it has reason to question the reliability of the representation.

The intermediary must also receive an affirmative representation from each investor that it has reviewed the educational material, understands that its entire investment may be lost and that s/he is able to bear the loss of the investment, as well as a completed questionnaire demonstrating that the investor understands that it is restricted in its ability to cancel an investment commitment, and that it is subject to resale restrictions that may make it difficult to sell the investment.

Communication infrastructure The intermediary must provide a mechanism on its platform to facilitate communication among investors and between investors and the issuer. If the intermediary is merely a registered funding portal and not a registered broker, it must not participate in the communications other than to establish guidelines and remove abusive or potentially fraudulent communications, and it must permit public access to the discussions, but must limit the ability to post comments to persons who have opened an account, the theory being that accountability will reduce the risk of fraudulent or abusive postings. The proposed rules also require any person posting a comment to clearly and prominently disclose with each posting whether s/he if a founder or employee engaged in promotional activities on behalf of the issuer.

Maintenance of investor funds and investor notices An intermediary that is a registered broker can accept investor funds, and must comply with applicable requirements under the Exchange Act and FINRA.

An intermediary that is a registered funding portal, not a registered broker, must direct investors to transmit money directly to a qualified third-party that has agreed in writing to hold the funds for the benefit of the persons ultimately entitled to receive them. The person entitled to receive the funds will be the issuer if the aggregate commitments equal or exceed the target amount of the offering after the cancellation period has elapsed (which in all cases must be at least 21 days after the first date that the issuer's disclosure information had become publicly available on its platform), or will be the investor when an investment commitment has been canceled either if the investor cancels up to 48 hours of the deadline or the commitment is automatically cancelled for failure to obtain from an investor effective reconfirmation of a commitment upon a material change to the offering or disclosure information, or if the total commitments fall short of the target amount by the deadline.

At or before an offering is completed, an intermediary must send each investor a notification disclosing the date of the transaction, the type of security it is purchasing, identifying information for the security including price, number of securities purchased and the total number of securities sold by the issuer, and the price(s) at which they were sold. If the security is a debt security, the notice must also state the interest rate and the yield to maturity calculated from price paid and maturity date. If callable, the first day that the security can be called by the issuer must be disclosed.

If an offering is not completed for any reason, within five business days after the deadline the intermediary must send a notice of cancellation with the reason, direct the refund of investor funds and prevent any investor from making investment commitments with respect to the cancelled offering.

Compensation Limitations and Disclosure

Although not prescribed by the JOBS Act, the proposed rules require that the intermediary disclose to an investor opening an account, the source and amount of any remuneration that it will receive from the issuer or persons other than the issuer.

The proposed rules prohibit an intermediary from compensating promoters, finders or lead generators for providing the funding portal with the personal identifying information – information that can be used to distinguish or trace an individual's identity – of any potential investor. The Commission sites as examples a person's name, social security number, date or place of birth, mother's maiden name, or employment, educational, medical or financial information. The rules permit, however, the compensation of a third party for directing issuers or potential investors to the intermediary's platform, so long as the third party does not provide personally identifiable information and the compensation is not based on the purchase or sale of a security unless the third party is a registered broker or dealer, as only registered brokers or dealers may receive transaction-based compensation. Thus, flat fees are acceptable.

Limited Discretionary Control Over Issuer's Access to the Platform, and Presentation of Issuers on the Platform

In its commentary the Commission noted that it anticipates the desire of funding portals to limit the scope of their businesses by, for example, specializing in offerings by issuers in certain industries or geographic locations. In some circumstances, these limitations could be viewed as providing investment advice. To accommodate reasonable limitations, the proposed safe harbor would permit a funding portal to apply objective criteria to limit the offerings on its platform, without being deemed to be providing investment advice. The criteria would be required to be designed to result in a broad selection of issuers (otherwise the platform could be deemed to be giving an implicit endorsement to the issuers) and be applied consistently to all potential issuers so as not to recommend or implicitly endorse one issuer or offering over others, and the criteria must be clearly displayed on the funding portal's platform. Some examples of criteria include type of security such as common or preferred stock or debt, geographic location or business or industry segment, but it cannot deny access to the platform based on the advisability of investing in the issuer or the securities.

Additionally, the platform may highlight an offering on the funding's portal as long as the criteria in this instance is also designed to highlight a broad spectrum of issuers, is applied consistently and is displayed prominently. The criteria may include the same criteria noted above as well as some transaction or security based criteria such as the number or amount of investment commitments, maximum offering amount or minimum investment, progress in meeting the target offering amount, but not on advisability of investing.

The platform may also provide tools for searching, sorting or categorizing offerings.

The registered funding portal may receive compensation from a registered broker or dealer for services provided by the portal, and conversely may compensate a broker or dealer for providing services that it is

unable to provide due to its position as not being a registered broker or dealer, in connection with the offer and sale of securities. The parties would need a written agreement and the compensation must otherwise be allowed under the rules and comply with the rules of any registered national securities association of which the portal is required to be a member (i.e. FINRA).

The proposed rules set forth detailed criteria for a funding portal's record keeping requirements and compliance policies and procedures, and allow the portal to contract with a third party to manage those tasks but the portal nevertheless remains statutorily responsible.

Registering as a Funding Portal

Intermediaries who are not registered brokers may perform the functions of an intermediary if they register as a funding portal. The Commission's commentary noted that its intention was to establish a streamlined registration process under which a funding portal would register with the Commission by filing a form with information requirements that are consistent with, but less extensive than, the information required for broker-dealers. Under the proposed rules, 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 would receive; control affiliates of the funding portal and disclosure of their disciplinary history, if any; FINRA membership or membership with any other registered national securities association; and the funding portal's website address(es) or other means of access.

The funding portal's registration would become effective the later of: (1) 30 calendar days after the date that the registration is received by the Commission, and (2) the date the funding portal is approved for membership in FINRA or any other registered national securities association. This approach is intended to help ensure that a funding portal is subject to regulation by the Commission and FINRA or any other national securities association before it can engage in business with the public. The rules also provide for the mechanism for one portal to succeed to the business of another portal, and to discontinue its operations.

Since a registered funding portal is subject to less regulation and oversight than a registered broker, 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 – a type of insurance that protects its holders against certain types of losses, including those related to malfeasance of its officers and employees and the effect of such malfeasance on the holder's capital -- 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, as set forth by FINRA or any other registered national securities association of which it is a member. The Commission believes a fidelity bond affords a level of protection to investors if a portal violates the prohibition on holding investor funds and then goes out of business, because funding portals will not be required to maintain minimum capital requirements, and because funding portals would not be members of the Securities Investors Protection Corporation (SIPC) which protects investors' funds up to $500,000. The

$100,000 figure is in line with the minimum amount of coverage that brokers are required to have under FINRA rules.

Exemption from registration as a broker under the Exchange Act The proposed rules clearly state that a registered funding portal will be exempt from registering as a broker under Section 15(a)(1) of the Exchange Act in connection with its activities as a funding portal, but the rules require that the funding portal permit the examination and inspection by representatives of the Commission and national securities association of which it is a member, of all of its business and operations that relate to its activities as a funding portal, including its premises, systems, platforms and records. Funding portals would also be subject to compliance with Chapter X of the Exchange Act including the anti-money laundering provisions.

Application of State Blue Sky Laws to Funding Portals The JOBS Act also provides that states may only enforce state laws, rules or regulations against a registered funding portal if the portal's principal place of business in that state, and the laws, rules or regulations are not in addition to or different from the requirements for funding portal registration established by the SEC.

FINRA Proposed Rules

FINRA proposed rules to govern registered crowdfunding portals[21] simultaneously with the release by the SEC of proposed Regulation Crowdfunding. .Compared to other broker-dealer members, FINRA has reduced the standards for being approved as a funding portal and has established a quicker turnaround time – 60 days – for approval decisions. FINRA rules also require a fidelity bond. The rules set forth standards of conduct for communications with the public, and exempt the portal from responsibility for communications on its website that are provided by an issuer. The proposed rules also contain compliance procedures, and requirements regarding anti-money laundering efforts and independent testing requirements regarding the Bank Secrecy Act.

The proposed rules set forth the parameters for FINRA investigations and sanctions, circumstances giving rise to disqualification, and the appeals process. FINRA also has the right to make certain information public.

Crowdfunding in its purest sense is meant to provide access to funds for start-up and early stage businesses. Proposed Regulation Crowdfunding implementing the JOBS Act Title III legislative mandate, attempts to create the framework for this market that balances the need for investor protection. Additionally, the rules governing the crowdfunding intermediary place substantial responsibilities on the intermediary and require the intermediary to either be, or be affiliated with, a registered broker in order to receive transaction-based compensation, all in the context of offerings by an issuer that are limited to $1 million in a 12-month period. It is difficult to predict whether issuer's will be financially able to take on the burdens of offering securities under the safe harbor, and whether a vibrant portal industry will develop when the offerings are relatively small and

[21] The FINRA rules can be found at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p370743.pdf

the compensation is limited, particularly when compared with the "accredited investor crowdfunding" market which is not subject to such restrictions and is active and growing, as described in my article *Crowdfunding – Clearing Away the Fog*.

If you have any questions regarding the content of this article, please contact **Noreen Weiss Adler** at nweissadler@bartonesq.com or +1-917-751-6039. Additionally, please note that the proposed rules are open for public comment until February 3, 2014; consequently, please contact Noreen Weiss Adler if you would like assistance preparing a comment letter to the SEC on any aspect of the proposed rules.

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