Crowdfunding Intermediaries under the JOBS Act

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The JOBS Act

On April 5, 2012, President Obama signed the Jumpstart Our Business Startups (JOBS) Act into law. The Act had a number of provisions, but the most important and ground breaking of these were Titles II, III, and IV, which authorized various forms of crowdfunding. Title II authorized almost unlimited crowdfunding from accredited investors. Title III authorized limited crowdfunding from the public at large. Title IV authorized an overhaul and expansion of Regulation A, which operates as a mini-IPO option. Each of these crowdfunding options may be appealing to a different class or community of investors.

Title III is perhaps the most revolutionary. Also called "Regulation Crowdfunding," Title III permits companies to solicit and advertise the sale of securities to the public at large, something that was strictly prohibited prior to the JOBS Act. Under the Securities Act of 1933 and SEC Rule 502, general solicitation of securities to the public is forbidden unless those securities are registered with the Securities and Exchange Commission (SEC) (through the Regulation S process). The various exemptions promulgated by the SEC, most notably Regulation D, incorporated Rule 502's prohibition on general solicitation in almost all instances. Regulation Crowdfunding is the first time that an exemption has been enacted that is explicitly exempt from Rule 502, allowing general solicitation and advertising of private securities offerings.

A unique and essential feature of this new exemption is the requirement that Regulation Crowdfunding offerings be consummated through an intermediary. This can be a broker or a "funding platform." This language seems to contemplate online platforms in the mold of a Kickstarter or GoFundMe, where companies could post funding campaigns and individuals could make investments, subject to the offering and purchasing limitations found in the JOBS Act and subsequent SEC regulations. Indeed, experience has born this out. As of this writing 19 "funding portals" have registered with the Financial Industry Regulatory Authority (FINRA), the body empowered by the SEC to regulate broker-dealers and, following the passage of the JOBS Act, crowdfunding portals.

On October 30, 2015, the SEC adopted its final rules on Regulation Crowdfunding, to become effective in May of 2016. In their final rules, the SEC ordered that all funding portals be registered with the SEC and also with FINRA, which triggered a round of rulemaking by FINRA. FINRA's rules on funding portals were approved by the SEC in February of 2016. The SEC and FINRA rules together regulate the conduct of the new Regulation Crowdfunding funding portals.

The SEC Rules

Definition of a Funding Portal and Associated Person

The SEC Rules define a "funding portal" as:

> any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Securities Act Section 4(a)(6), that does not: (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the Commission, by rule, determines appropriate.

In other words, the Rules contemplate an entity that is purely a platform for companies and investors to use to interact directly with each other. These funding portals cannot engage in any of the activities of an investment advisor, underwriter, go-between, escrow agent, or even the activities of a traditional broker.

The Rules also apply to any person who is "associated with a funding portal," which means:

> any partner, officer, director or manager of a funding portal (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling or controlled by a funding portal, or any employee of a funding portal, other than persons whose functions are solely clerical or ministerial.

Conflicts of Interest

The SEC Rules prohibit high level employees of funding portals to have any financial interest in the companies they service. Specifically, the rules prohibit directors, officers, and partners (or other persons holding similar positions) from holding:

1. A financial interest in an issuer using its services
2. From receiving a financial interest in the issuer as compensation for services provided to, or for the benefit of, the issuer, in connection with the offer and sale of its securities

Financial interest here means "a direct or indirect ownership of, or economic interest in, any class of the issuer's securities."

The funding portal itself may have a financial interest in the issuer, provided, however, that certain conditions are met. Those conditions are that:

1. The intermediary receives the financial interest from the issuer as compensation for the services provided to, or for the benefit of, the issuer in connection with the offer or sale of such securities being offered or sold in reliance on Section 4(a)(6) through the intermediary's platform.
2. The financial interest consists of securities of the same class and having the same terms, conditions, and rights as the securities being offered or sold in reliance on Section 4(a)(6) through the intermediary's platform.

In short, the funding portal can only receive the financial interest in the issuer if it is in compensation for using the funding portal, and the securities they receive are no better or worse than those offered to the public.

The principle concern of the SEC in adopting this rule was the potential conflicts of interest that could arise from a funding portal or one of its principle officers having an ownership or financial interest in an issuer using its services. The rule was loosened to allow funding portals themselves to take an interest out of a concern that this might be the only form of compensation some small issuers were capable of providing. This is consistent with standard practice in the technology sector, in particular, where securities are often offered as compensation. The SEC believed that this loosening of the Rule was acceptable because whatever minor conflict might be created by this would have to be disclosed as part of the normal disclosure process.

Bad Actor Disqualifications

Consistent with the Dodd-Frank law, the SEC Rules include a "bad actor" disqualification that is substantially the same as that found in Rules 262 of Regulation A and Rule 506 of Regulation D. Intermediaries are required to deny access to their platform to any issuer if the intermediary has a reasonable basis for believing that the issuer or its directors, officers, or beneficial owner of more than 20% of its stock, would be disqualified under this rule.

Under the bad actor rule, an issuer will lose its Regulation Crowdfunding exemption, and must be denied access to a funding platform, if a "covered person" including the issuer itself has experienced any of the following disqualifying events:

- Felony and misdemeanor convictions within the last five years in the case of issuers, their predecessors, and affiliated issuers, and 10 years in the case of other "covered persons" in connection with the purchase or sale of a security, involving the making of a false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, funding portal, or paid solicitor of purchasers of securities
- Injunctions and court orders within the last five years against engaging in or continuing conduct or practices in connection with the purchase or sale of securities, involving the making of any false filing with the Commission; or arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser, funding portal, or paid solicitor of purchasers of securities
- Certain final orders and bars of certain state and other federal regulators
- Commission cease and desist orders relating to violations of scienter-based antifraud provisions of the federal securities laws or Section 5 of the Securities Act

- Filing, or being named as an underwriter in, a registration statement or Regulation A offering statement that is the subject of a proceeding to determine whether a stop order or suspension should be issued, or as to which a stop order or suspension was issued within the last five years
- U.S. Postal Service false representation orders within the last five years
- For covered persons other than the issuer:
    - Being subject to a Commission order:
        - Revoking or suspending their registration as a broker, dealer, municipal securities dealer, investment adviser, or funding portal
        - Placing limitations on their activities as such
        - Barring them from association with any entity
        - Barring them from participating in an offering of penny stock
    - Being suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or "national securities association" for conduct inconsistent with just and equitable principles of trade

For the purpose of the bad actor disqualification, covered persons mean:

- The issuer and any predecessor of the issuer or affiliated issuer
- Directors, officers, general partners, or managing members of the issuer
- Beneficial owners of 20% or more of the issuer's outstanding voting equity securities (that we believe should be calculated based on the present right to vote for the election of directors, irrespective of the existence of control or significant influence)
- Any "promoter" connected with the issuer in any capacity at the time of such sale
- Compensated solicitors of investors
- General partners, directors, officers, or managing members of any such solicitor

Educational Materials

The SEC Rules also require funding portals to deliver certain educational materials to potential investors upon opening their account, and to make an updated version of those materials available on the website at all times. The SEC explicitly decided against requiring these disclosures to be made to or approved by the commission itself (as would be required in a public offering or Regulation A offering).

Minimum Disclosures

As a minimum, the educational materials must include:

- The process for the offer, purchase, and issuance of securities through the intermediary
- The risks associated with investing in securities offered and sold in reliance on Section 4(a)(6)
- The types of securities that may be offered on the intermediary's platform and the risks associated with each type of security, including the risk of having limited voting power as a result of dilution
- The restrictions on the resale of securities offered and sold in reliance on Section 4(a)(6)
- The types of information that an issuer is required to provide in annual reports, the frequency of the delivery of that information, and the possibility that the issuer's obligation to file annual reports may terminate in the future
- The limits on the amounts investors may invest, as set forth in Section 4(a)(6)(B)

- The circumstances in which the issuer may cancel an investment commitment
- The limitations on an investor's right to cancel an investment commitment
- The need for the investor to consider whether investing in a security offered and sold in reliance on Section 4(a)(6) is appropriate for him or her
- That following completion of an offering, there may or may not be any ongoing relationship between the issuer and intermediary

Additional Disclosures

Beyond these minimum requirements, the SEC specifically declined to adopt additional requirements as to format and substance, preferring instead to leave such determinations to the funding portals in light of their specific offerings and investors. In fact, the Commission explicitly allows intermediaries to provide additional educational disclosures tailored to the investors using their services.

Maintaining Accuracy

Rule 302(b)(2) does, however, require that all disclosures be accurate, and intermediaries are required to update their disclosures, particularly those on their website, to keep them current.

Investor Representations

Intermediaries are also required to obtain a representation from investors that they have reviewed the revised disclosures before accepting new investments from the investor.

Communication Channels & Promoters

Rule 303(c) requires intermediaries to create and maintain, on their platform, "communication channels," which are defined as "channels through which investors can communicate with one another and with representatives of the issuer about offerings made available on the intermediary's platform." These channels must be publicly available, but commenting must be open only to persons who have opened an account. The intermediary must also require that "promoters" comply with advertising requirements (see below).

Communications between issuers and investors must occur through the intermediary, and these platforms may serve as a conduit for such communication. Outside communication between investors is permitted, but communications between issuers and investors outside the platform is not. If the intermediary is a funding portal, it may not participate in the communication channel.

Promoters

The Rules generally permit the use of promoters to promote an offering through the funding portal. A promoter is any person who is compensated, either directly or indirectly, to promote an issuer's security offering through communication channels offered by the intermediary. Issuers must comply with two requirements in order to use a promoter:

- First, if they are compensating the promoter, the issuer must take reasonable steps to ensure that the promoter clearly discloses in each communication that they are being compensated for their promotion of the issuance.
- Second, if the promoter is a founder, director, manager, or employee of the issuer or any person who undertakes promotional activities for the issuer, then that too must be disclosed in each posting.

Intermediaries have two responsibilities related to these required disclosures. Under Rule 302(c), intermediaries are required to alert investors at the time they create their account that promoters are required to make the above disclosures. Under Rule 302(c)(4), intermediaries must also require person's posting comments through the intermediary's communication channels to make the required disclosures. Thus, even though it is the issuers and promoters who must make these disclosures, the intermediary must alert investors about the disclosure when they sign up and also alert promoters to the requirement before they make their promotions.

Investor Qualifications

The JOBS Act imposes certain limits on how many securities an investor can purchase in a given 12-month period. The Act places some of the responsibility for policing this limit on intermediaries.

Investor Limits

According to the SEC Rules, intermediaries must have a "reasonable basis for believing that the investor satisfies the investment limits" before accepting an investment commitment through its platform. This Rule allows the intermediary to rely on investor representations rather than undertaking an investigation unless they have a reasonable basis for questioning those representations.

The Commission did not require, but does permit, issuers to undertake additional measures to ensure compliance. Some options the Commission noted, include:

> using a centralized data repository, to the extent that one is created; requiring verification of income or net worth electronically by uploading financial documents; or creating a tool for investors to use, such as a questionnaire, to assemble the underlying data.

Indeed, the Commission singled out the now common practice of creating a centralized data repository for special praise in the final rules signaling that this practice is probably a good idea.

Acknowledgement of Risk

The SEC Rules also require that the intermediary obtain representations from the investor demonstrating that the investor:

- Has reviewed the intermediary's educational materials
- Understands that the entire amount of his or her investment may be lost
- Is in a financial condition to bear the loss of the investment

The Rules also require that intermediaries solicit answers to questions demonstrating the investor's understanding that:

- There are restrictions on the investor's ability to cancel an investment commitment and obtain a return of his or her investment.
- It may be difficult for the investor to resell the securities.
- The investor should not invest any funds in a crowdfunding offering unless he or she can afford to lose the entire amount of his or her investment.

The format of these representations and questions is left to the discretion of the intermediary and the intermediary is free to solicit additional representations if desirable; however, it must be reasonably designed to demonstrate receipt and understanding of the information. Furthermore, the intermediary may not pre-select answers for the investor, suggesting that popular auto-fill features that populate forms from user profile information should not be used to complete this part of the investment transaction.

The Rules also clearly state that these representations must be solicited for each investment. This means that an intermediary cannot simply solicit and obtain representations and questionnaire answers when the investor first creates his or her profile and use those throughout. The representations and questionnaires must be obtained each time the investor wishes to make an investment through the platform.

Third Parties

The Rules prohibit intermediaries from compensating promoters, finders, or lead generators for providing personal information on potential investors. The rule is broad and applies to any person who provides personal information about potential investors.

The Rule does permit intermediaries to advertise their services and hire a third party to direct potential investors to the platform in the form of referrals.

In short, intermediaries cannot pay for the personal information of potential investors, but may advertise or hire someone to direct potential investors to the platform.

Offering Proceeds & Handling of Investor Funds

Intermediaries are prohibited from transmitting collected funds to the issuer until and unless the minimum aggregate amount is raised. Similar to a Kickstarter campaign or a traditional public offering, this requirement imposes a floor that must be reached before any funds can be acquired by the issuer.

If the intermediary is a registered broker-dealer, the Securities Exchange Act rules apply. In particular, Rule 15c2-4 would cover the maintenance of funds, meaning that the funds would have to be held in a segregated account or deposited into an escrow account.

Special rules apply to funding portals in regards to the collection of offering proceeds. Funding portals are not permitted to collect or hold the offering proceeds, so they must direct those funds to a "qualified third party," which must be a bank, as defined under Section 3(a)(6) of the Securities Exchange Act, a credit union insured by the National Credit Union Administration, or a broker-dealer that carries such accounts. The Bank, Credit Union, or broker-deal must agree to either serve as the escrow agent for the transaction (that seems the more likely scenario) or open a bank account for the exclusive benefit of the investors and issuer.

FINRA Rules

In addition to registering with the SEC, The JOBS Act requires a funding portal seeking to host crowdfunding campaigns for issuers in reliance on the JOBS Act's crowdfunding exemption to become a member of a national securities association. Currently, FINRA, formerly the National Association of Securities Dealers, is the only such association.

A different regulatory scheme, FINRA Rule 4518, governs registered broker/dealer members of FINRA that Act as intermediaries in transactions pursuant to the crowdfunding exemption. Regulatory Notice 16-07, also issued on January 29, 2016, addresses this rule framework as applied to broker/dealers.

The Funding Portal Rules found their basis largely in existing FINRA Rules for broker dealers and on the SEC's definition of funding portals. At nearly 350 pages, the draft rules FINRA filed for SEC approval in October 2013 included requirements that funding portals undertake due diligence on issuers and offerings, provide educational materials to investors, enforce income-based limits on the amount investors may invest, and provide initial and ongoing offering data to the SEC. The proposed rules also would have required portals to have written anti-money laundering programs and fidelity bond coverages, though these two requirements were dropped in the final rule proposal published in October 2015. The seven final rules—that became effective on January 29, 2016—and the subject matter addressed in each are:

Rule 100. General Standards

Rule 110. Funding Portal Application

Rule 200. Funding Portal Conduct

Rule 300. Funding Portal Compliance

Rule 800. Investigations and Sanctions

Rule 900. Code of Procedure

Rule 1200. Arbitration and Mediation

When the Funding Portal Rules became effective on January 29, 2016, FINRA issued Regulatory Notice 16-06, which included the forms required to register as a crowdfunding portal with FINRA. The forms are Form FP-NMA (New Member Application), Form FP-CMA (Continuing Member Application), Funding Portal Rule 300(c) Form, and Form FP-Statement of Revenue. It was on May 16, 2016, that Title III equity and debt crowdfunding campaigns opened for the first time to investors.

Funding Portal Rule 100 (General Standards)

Funding Portal Rule 100, similar to the FINRA Rule 0100 series applicable to FINRA's broker/dealer members, sets out definitions and basic standards applicable to the Rules. It provides that anyone "associated" with a funding portal member has the same duties and obligations as the funding portal member itself and is subject to the FINRA By-Laws and the Funding Portal Rules.

Funding Portal Rule 110 (Funding Portal Application Process)

Funding Portal Rule 110 is based on the NASD Rule 1010 series and governs the membership application process (MAP) for funding portals (referred to as "FP Applicants"). The stated objective of the application process is to permit FINRA to determine whether an applicant is capable of complying with federal securities laws and FINRA's funding portal rules.

Highlights of the process include:

- Submission of a form application—the Form FP-NMA (Funding Portal-New Member Application)
- Disclosure that an applicant or associated person is subject to statutory disqualifications under Section 3(a)(39) of the Exchange Act
- Payment of a $2700 application fee
- A membership interview, including a product demonstration focused on the anticipated user experience for both investors and issuers on the applicant's portal website once it goes live

Rule 110 sets out five standards for determining whether to grant or deny an application. These standards are consolidated and streamlined from the 14 standards in NASD Rule 1014(a) that apply to broker/dealer applications:

- The applicant is capable of complying with applicable federal securities laws and Funding Portal Rules.
- The applicant has contractual and business relationships with banks, escrow agents, transfer agents, technology service providers, and others needed to initiate funding portal operations once approved.
- The applicant has a supervisory system reasonable designed to achieve compliance with applicable law and regulation.
- The applicant has fully disclosed and documented all direct and indirect sources of funding.
- The applicant has a recordkeeping system that is compliant with federal state, and SRO recordkeeping requirements.

Within 60 days after the filing of a completed application, FINRA's Department of Member Regulation will issue a written decision on the application. This 60-day time period reflects the narrowed scope of funding portals' activity relative to that of broker/dealers, for whom new member application decisions take up to 180 days.

Funding Portal Rule 200 (Funding Portal Conduct)

Funding Portal Rules 200(a), 200(b), and 200(c) have their foundations in FINRA Rules 2010, 2020, and 2210 the standards of conduct, antifraud, and public communications rules applicable to broker/dealers, respectively. Unsurprisingly, then, the portal rules adopt the same principles-based approach to regulation found in the FINRA Rules.

Standards of Commercial Honor and Principles of Trade: Funding Portal Rule 200(a) states, in its entirety that "A funding portal member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

Use of Manipulative, Deceptive, or Other Fraudulent Devices: Funding Portal Rule 200(b) prohibits funding portal members from "effect[ing] any transaction in, or induc[ing] the purchase or sale of, any security by means of, or by aiding or abetting any manipulative, deceptive or other fraudulent device or contrivance."

Communications with the Public: Funding Portal Rule 200(c) applies to every electronic or other written communication by a portal member to one or more investors. By its terms, the rule prohibits:

- Any false, exaggerated, unwarranted, promissory, or misleading statement or claim
- The omission of any material fact that would cause the communication to be misleading
- Any statement or implication that FINRA endorses or guarantees the funding portal's business practices
- Any prediction or projection of performance or implication that past performance will recur

Issuer communications made on the portal are specifically excepted from these content standards, unless the portal member knows or has reason to know that an issuer's statement is false or misleading.

Funding Portal Rule 300 (Supervision and Disclosures)

Funding Portal Rule 300(a) requires a supervisory system that is reasonably designed to achieve compliance with applicable securities law and regulations. That system must include written supervisory procedures, designation of a person with authority to carry out supervisory responsibilities, and assessment of the qualifications of all supervisors to carry out their responsibilities.

Funding Portal Rules 300(c), (d), (e), and (f) require portal members to report to FINRA:

- Any disclosure events of the member or its associated persons
- Its gross revenues prepared in accordance with U.S. Generally Accepted Accounting Principles
- Contact information for the portal and its associated persons

Disclosure events include:

- Being named as a defendant in any regulatory proceeding or in securities or insurance-related civil litigation
- Being the subject of a written allegation of fraud, misuse, or misappropriation of funds
- Being disciplined by any securities, insurance, or financial regulatory body
- Being indicted or convicted of any felony and certain misdemeanors

Funding Portal Rule 800 (Investigations and Sanctions)

Funding Portal Rule 800 extends FINRA's investigative authority to and generally makes the FINRA Rule 8000 series applicable to registered funding portals. As a result, portal members are subject to FINRA's Rule 8210 authority to obtain discovery from members.

Funding Portal Rule 900 (Procedure for Eligibility Proceedings)

Funding Portal Rule 900 subjects funding portal members to the FINRA Rule 9000 Series, which outlines the process for resolving eligibility of a member or associated person that becomes subject to statutory disqualification.

Funding Portal Rule 1200 (Arbitration and Mediation)

Finally, Funding Portal Rule 1200 incorporates the procedures outlined in the FINRA Rule 12000, 13000, and 14000 series pertaining to, respectively, arbitration of customer disputes, arbitration of industry disputes, and mediation.

Related Content

For additional information on Crowdfunding, see the following practice notes:

- Comparing Crowdfunding Instruments: Common Stock, Preferred Stock, Convertible Notes and SAFEs
- Regulation A Plus
- A Summary of Crowdfunding under the JOBS Act
- A Comparison of the JOBS Act Crowdfunding Regulations (and When to Use Them)