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SEC Proposals For Securities Crowdfunding Under Title III of the JOBS Act

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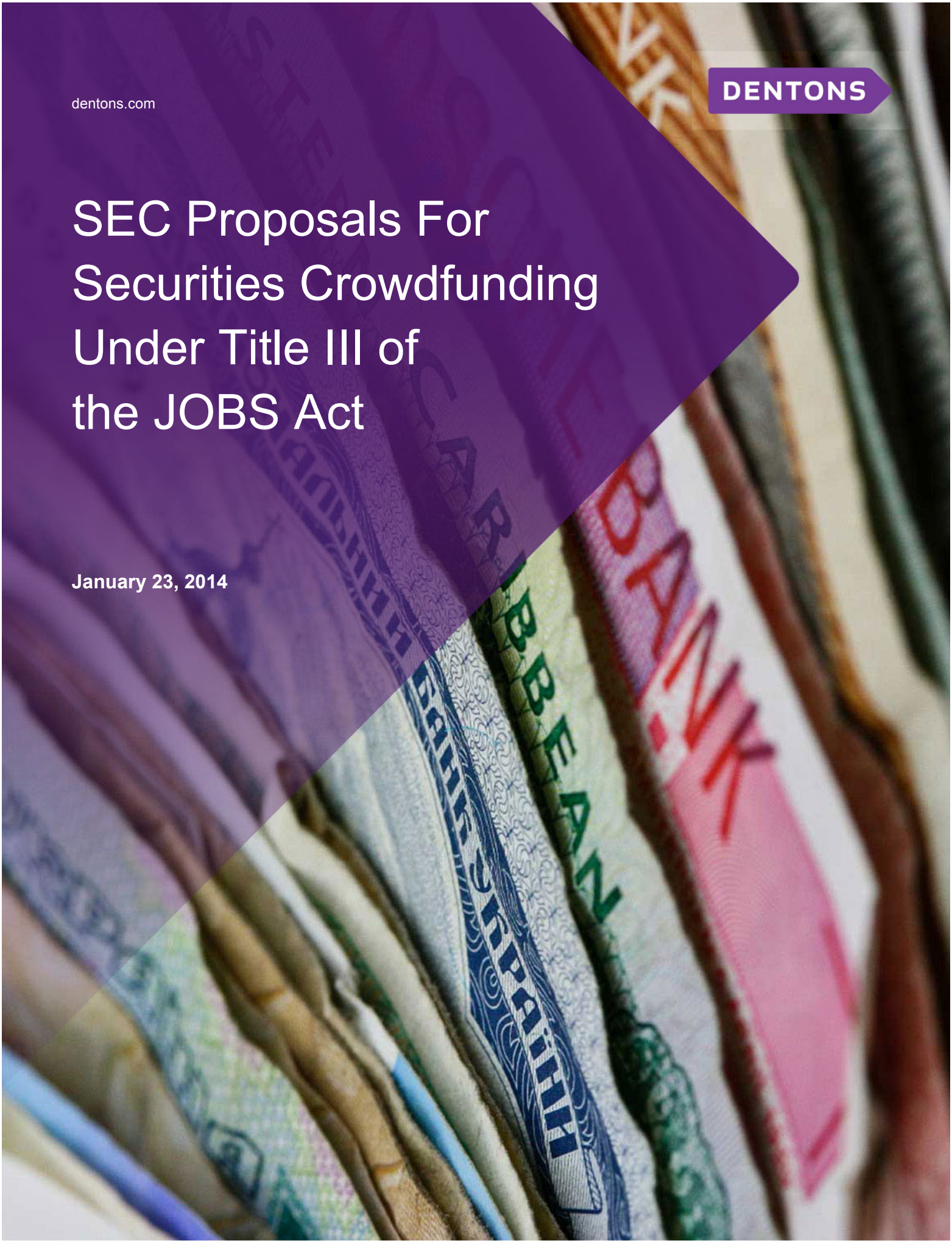

Introduction

The U.S. Securities and Exchange Commission (SEC) has proposed rules to implement the provisions of Title III of the Jumpstart Our Business Startups Act, or JOBS Act, that would allow startups and small businesses to raise capital through "securities-based crowdfunding." The proposed rules also provide a framework to regulate a new category of so-called “funding portal” intermediaries, in coordination with rules pertaining to funding portals proposed on the same day by the Financial Industry Regulatory Authority, Inc. (FINRA), the self-regulatory organization for broker-dealers and the new funding portals.[1] Crowdfunding issuers must use an intermediary that is either a registered broker-deal or a funding portal in order to issue crowdfunding securities to investors. The SEC has solicited public comment on its proposals, with the comment period currently set to expire on February 3, 2014, the same date the comment period on FINRA's related rules expires.

Background

Crowdfunding involves the use of the Internet by individuals or organizations to find other people or organizations to fund their projects, often artistic or charitable endeavors as well as personal and business projects, typically in exchange for a future service, product or other benefit. A crowdfunding campaign typically has a target amount of funds to be raised and an identified use for those funds. Because the Internet is the venue for crowdfunding activities, those seeking funds can appeal to anyone using the Internet anywhere. Those who are interested in a crowdfunding campaign can in turn use the Internet to share information about the project with each other, generating the "wisdom of the crowd" to collectively identify and reward with a financial contribution those projects deemed most attractive, or to reject those projects deemed unworthy or a mere "sham."

To date, crowdfunding has not been used by businesses seeking to raise capital in exchange for securities of the business because doing so generally would trigger the application of the Securities Act of 1933, as amended (Securities Act), under which the offer and sale of securities is required to be registered with the SEC unless an exemption applies.

The JOBS Act provides such an exemption by adding new Section 4(a)(6) to the Securities Act to permit eligible issuers to conduct limited sales of securities without registration under the Securities Act through Internet-based crowdfunding activities intermediated by either a registered broker-dealer or a funding portal.[2] In addition, it exempts such issuers from state blue sky registration provisions (but not state anti-fraud provisions).

Although the JOBS Act is already law, its crowdfunding provisions may not be relied upon until the SEC, and FINRA with respect to funding portals, adopt final rules implementing securities-based crowdfunding. Until that time, which may be months or more following the expiration of the comment period on February 3, issuers and intermediaries may not conduct any securities-based crowdfunding activities.

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[1] FINRA's proposals for crowdfunding funding portals are available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/industry/p369763.pdf.

[2] In this paper, we generally refer to such activities as "securities-based crowdfunding." The SEC's proposals are also often described elsewhere as relating to "equity crowdfundng" in light of the view that such crowdfunding activities, once permitted, are likely to involve offers and sales of equity. We note, however, that the SEC's proposals are not limited to equity offerings and that the SEC specifically requests comment about whether the exemption should be limited to offers and sales of equity.

The SEC's proposals, as required, closely track the provisions of the JOBS Act, including new Section 4(a)(6). Under Section 4(a)(6):

- the amount raised by an issuer must not exceed $1 million in a 12-month period;
- an investor is limited in the amount he/she may invest in crowdfunding securities in any 12-month period across all issuers;
- transactions must be conducted through an intermediary that is registered either as a broker-dealer or a funding portal.

In addition, the crowdfunding provisions of the JOBS Act add:

- Section 4A to the Securities Act, which requires, among other things:
    - issuers and intermediaries relying on the crowdfunding exemption to provide certain information to the SEC, investors and potential investors; and
    - funding portals to register as such (or as a broker).
- Section 3(h) to the Securities Exchange Act of 1934, as amended (Exchange Act), which requires the SEC to adopt rules exempting funding portals from having to register as brokers or dealers pursuant to Exchange Act Section 15(a)(1); and
- Section 12(g)(6) to the Exchange Act, which requires the SEC to adopt rules exempting securities acquired pursuant to an offering made in reliance on the crowdfunding exemption from the registration requirements of Section 12(g).

Overview

Prior to issuing the proposing release, the SEC had previously solicited public input on each title of the JOBS Act, including Title III.[3] The proposing release references comments received through this pre-proposal solicitation. In the proposing release, the SEC acknowledged the need to balance the protection of ordinary investors from fraud against Congress' goal of reducing regulations on capital raising for startups and entrepreneurs. Many believe that securities-based crowdfunding may offer a potential solution to small businesses' funding problems. They point to the success of non-securities based crowdfunding activities through which individuals and organizations have reportedly raised approximately $2.7 billion in funding worldwide in 2012. However, even the strongest advocates of securities-based crowdfunding acknowledge the potentially substantial risks to investors. Investing in small businesses is inherently risky, as many new business ventures fail. Furthermore, small business investments tend to be highly illiquid since most such offerings are too small to support any active secondary trading market.

In addition to those risks, state securities regulators and others have commented that small business investments may pose higher risks of fraud, self-dealing and overreaching by controlling shareholders. The JOBS Act and the SEC's proposed rules attempt to address such risks by: (i) establishing issuer eligibility requirements that prohibit certain issuers from engaging in securities-based crowdfunding under the new exemption; (ii) requiring issuers to make specific disclosures to potential investors and the SEC in

[3] The public comments received by the SEC on Title III, referred to in this paper as "Title III comments," are available on its website at http://www.sec.gov/comments/jobs-title-iii/jobs-title-iii.shtml.

prescribed ways; (iii) strictly limiting the amount a single investor can invest within a 12-month period in securities-based crowdfunding offerings, as noted above and explained further below; and (iv) requiring a single funding portal or registered broker-dealer to act in the dual role of gatekeeper and facilitator between potential investors and the issuer. Under the SEC's proposed rules, the intermediary would be required to perform functions and implement procedures designed to protect investors. For example, the intermediary must provide an online communication platform for the issuer to make required disclosures and for the crowd to share information about potential investments.

Proposed Rules

Issuer Sale and Investor Purchase Limits

The SEC's proposals implement the requirements in Section 4(a)(6) that strictly limit the amounts of securities an eligible issuer can sell to investors in any 12-month period. The limitations are as follows:

- The aggregate amount an eligible issuer may sell to all investors during the prior 12-month period may not exceed $1,000,000.[4]

This limitation is independent of any money raised pursuant to other exemptions, such as Regulation D.

- The aggregate amount an investor may invest in all crowdfunding offerings (whether made by one or more issuers) during the prior 12-month period may not exceed:
    - The greater of $2,000 or 5% of the investor's annual income or net worth, if the investor's annual income or net worth is less than $100,000; and
    - 10% of the investor's annual income or net worth, if the investor's annual income or net worth is $100,000 or more, provided that no investor may invest more than $100,000 regardless of annual income or net worth.

The proposed rules would require a natural person's annual income or net worth to be calculated in accordance with the rules for determining accredited investor status.[5]

Securities-based crowdfunding transactions must be conducted exclusively over the Internet through either a broker-dealer or a funding portal intermediary. Each issuer would be required to use only one intermediary so that the intermediary, among other things, can help ensure that neither the issuer nor any investor is exceeding the applicable aggregate issuer sale and investor purchase limits.

Resale Restrictions

While securities-based crowdfunding transactions involve public offers and sales exempt from registration under the Securities Act, securities sold in a crowdfunding transaction would be subject to transfer restrictions that would prohibit an investor from reselling such securities for one year, except when transferred:

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[4] The SEC is required to adjust this amount for inflation at least every five years.

[5] *See* Securities Act Rule 501(a)(5) (net worth) and Securities Act Rule 501(a)(6) (income). The calculation of net worth would exclude the value of the investor's primary residence.

- to the issuer of the securities;
- to an accredited investor;
- as part of an offering registered with the SEC; or
- to a family member of the investor or trust for the benefit of a family member.

Requirements for Issuers

Issuer Eligibility

To rely on the exemption provided under Section 4(a)(6), the issuer must be a company incorporated in or organized under the laws of a U.S. state or territory. Certain entities are prohibited from engaging in securities-based crowdfunding offerings under Section 4(a)(6) as follows:

- all foreign issuers, including Canadian issuers;
- issuers already subject to SEC reporting requirements;
- investment companies registered or required to be registered under the Investment Company Act of 1940;
- "blank-check" companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company; and
- companies that have failed to comply with the annual reporting and disclosure requirements in the final rules adopted by the SEC.

Financial Statement Requirements

An issuer offering or selling securities in reliance on Section 4(a)(6) must prepare comprehensive disclosure about itself and the offering. The issuer must file this disclosure with the SEC via EDGAR on Form C and make it available on the intermediary's platform for review or download by potential investors at least 21 days before any securities may be sold.

The financial statements required of an issuer would depend on the amount the issuer is seeking to raise in the crowdfunding transaction, as follows:

- if targeting $100,000 or less, tax returns (portions of which may be redacted under the proposed rules) for the most recent year and financial statements certified by the issuer's principal executive officer;
- if targeting $100,000–$500,000, the financial statements must be reviewed by an independent public accountant;[6]
- if targeting more than $500,000, audited financial statements must be provided.

All financial statements must be prepared in accordance with GAAP and include a balance sheet, income statement, statement of cash flows, and changes in owners' equity for two years (or since inception if less than two years).

[6] The definition of "independent" in this context is consistent with or the same as the definition provided in SEC Rule2-01 of Regulation S-X.

Where an issuer sets a target amount but is willing to accept more than that target, the issuer must disclose the maximum amount it will accept and provide disclosure about the intended use of the additional proceeds, the method of allocation of the above-target shares and other disclosures. Additionally, the financial statement requirement would be based on the maximum amount the issuer is willing to accept rather than the target amount. The SEC's proposing release provides the following example:

> [A]n issuer that sets a target offering amount of $80,000 and a maximum offering amount of $105,000 would be required to provide financial statements reviewed by an independent public accountant (rather than tax returns for the most recently completed fiscal year and financial statements certified by the principal executive officer).[7]

In addition to financial statements, the issuer must present a narrative discussion of its financial condition, which discussion is conceptually similar to the management's discussion and analysis required by Item 303 of Regulation S-K (MD&A) for registered offerings. While the SEC did not propose to prescribe the content or format of such information, it stated that the discussion here need not be as lengthy or detailed as an MD&A but should address the issuer's historical results of operations, liquidity and capital resources.[8]

Where an issuer is conducting a "follow-on" offering, the financial statements it must prepare are based on the aggregate amount offered by such issuer during the 12-month period prior to and including the target amount of the current offering. Thus, for example, if an issuer has made a prior offering with a target amount of $400,000 and such issuer seeks to conduct another crowdfunding offer with a target of $200,000, it must provide audited financial statements as the aggregate amount of the two offerings would exceed $500,000.[9]

ISSUER AND OFFERING DISCLOSURE REQUIREMENTS

Other required disclosures include:

- the issuer's name, legal status, physical address and website address;
- the names and three-year business experiences of directors and officers of the issuer, and the names of holders of 20% or more of the issuer's voting power;
- a description of the business and the business plan of the issuer;[10]
- a sufficiently detailed description of the intended use of the proceeds of the offering and the length of the period for which the proceeds are expected to satisfy the operational needs of the issuer;

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[7] Securities Act Release No. 9470 (Oct. 23, 2013) at 53, fn. 121.

[8] If an issuer has a prior operating history, the discussion should also focus on whether historical earnings and cash flows are representative of what investors should expect in the future. If the issuer does not have a prior operating history, the discussion should focus on financial milestones, liquidity and other operational challenges.

[9] *See* proposed Rule 201(t)(3) of Regulation Crowdfunding.

[10] Because issuers engaging in crowdfunding are likely to be small businesses at various early stages of development, the proposed rules recognize that such "business plans" may not be fully developed or highly specific. For that reason, the proposed rules do not require a business plan to include a formal document prepared by management or used for marketing purposes to solicit investors. Although some Title III commenters requested that the SEC formally specify the disclosures that an issuer must include in the description of a business, the SEC opted not to do so, preferring instead to provide flexibility to issuers in what information they disclose about their businesses.

- the target offering amount, the deadline to reach that amount, how oversubscribed offerings will be allocated, and regular updates regarding the progress of the issuer in meeting the amount;
- the price of the securities or the method for determining the price; and
- a description of the ownership and capital structure of the issuer, including:
    - the terms of the securities being offered and each other class of security of the issuer, including the number of securities being offered and/or outstanding, whether or not such securities have voting rights, any limitations on such voting rights, how the terms of the securities being offered may be modified and a summary of the differences between such securities and each other class of security of the issuer, and how the rights of the securities being offered may be materially limited, diluted or qualified by the rights of any other class of security of the issuer;
    - a description of how the exercise of any rights held by the principal shareholders of the issuer could affect the purchasers of the securities being offered;
    - how the securities being offered are being valued, and examples of methods for how such securities may be valued by the issuer in the future;
    - the risks to purchasers of the securities relating to minority ownership in the issuer and the risks associated with corporate actions, including additional issuances of securities, issuer repurchases of securities, a sale of the issuer or of assets of the issuer or transactions with related parties; and
    - a description of transfer restrictions with respect to the securities.

In addition to the above statutory disclosure requirements, the SEC also proposed that an issuer's disclosure materials must include the following:

- a discussion of the material factors that make an investment in the issuer speculative or risky;
- a description of certain related-party transactions;
- a description of the material terms of any indebtedness of the issuer, including the amount, interest rate, maturity date and any other material terms;
- disclosure of exempt offerings conducted by the issuer within the past three years;
- disclosure of the current number of employees of the issuer;
- disclosure of the amount of compensation paid to the intermediary for conducting the offering, including the amount of any referral or other fees associated with the offering;
- inclusion of certain legends in the offering statement; and
- disclosure of the name, SEC file number and Central Registration Depository number (as applicable) of the intermediary through which the offering is being conducted.

As noted above, all mandated disclosures would be made on the intermediary's website for access by investors and also via the SEC's EDGAR filing system using new Form C. According to the SEC, the benefit of proposed Form C is that it would provide key offering information in a standardized format, while also giving the issuers a degree of flexibility in the presentation of other required information.

The SEC is not required to comment on or to qualify (as with Regulation A offering statements) or declare effective (as with Securities Act registration statements) an issuer's disclosures made on Form C or otherwise on the intermediary's website. All issuer disclosures, however, whether included in Form C or on the intermediary's website, are subject to the anti-fraud provisions of the federal securities laws. Moreover, issuers should expect the SEC staff to review issuer crowdfunding disclosures as it monitors the use of the final crowdfunding rules and performs its enforcement functions.

Investment Process and Related Disclosures

As noted above, issuers must disclose the target offering amount, the deadline to reach that amount, how oversubscribed offerings will be allocated, and regular updates regarding the progress of the issuer in meeting the amount. As the offering is being conducted, issuers must allow investors with expressed interest in the offering to exit the offering as follows:

- issuers must provide investors with the unconditional right to cancel their investment commitments until 48 hours prior to the offering deadline identified in the issuer's offering materials — after that deadline passes, an investor would only be able to cancel an investment commitment following notice of a material change to the offering, including determination of the final price of the securities offered; and
- if an investor does not affirmatively reconfirm an investment commitment within five business days of receipt of notice of a material change to the terms of the offering, the investment would be cancelled and the intermediary would be required, within five business days, to direct the return of committed funds.

If an issuer reaches its target offering amount prior to the expiration of a specified offering deadline, the issuer may close the offering early provided that:

- the offering was open for at least 21 days;
- the intermediary provides notice about the new offering deadline at least five business days prior to the new offing deadline;
- investors are given an opportunity to reconsider their investment decision and cancel their commitment until 48 hours priors to the new deadline; and
- at the time of the new offering deadline, the issuer continues to meet or exceed the target offering amount.

The proposals provide that, if an offering is not completed because the target offering amount is not reached or the issuer otherwise terminates the offering, the intermediary must provide notice of the termination, including the reasons, direct the refund of investor funds and prohibit investors from making further investments in the terminated offer.

Ongoing Disclosure Requirements

The proposed rules would require all issuers that have sold securities in a crowdfunding offering to file with the SEC via EDGAR, and post on its website, an annual report on Form C-AR disclosing its financial condition and results of operations and other information similar to that required about the issuer in Form C. The issuer must file the report within 120 days of the issuer's fiscal year end.

The annual report must also include financial statements of the issuer, with the standard of the financial statements based upon the highest standard previously provided by the issuer for a crowdfunding offering. If the issuer has completed only one securities-based crowdfunding offering, the financial statements required in the annual report would be of the same standard included in the disclosure for such offering based on the target amount or, if applicable, the maximum amount the issuer was willing to accept in that offering.

In cases where an issuer has made multiple securities based-crowdfunding offerings, which individually would require different levels of financial statements, the issuer would be required to provide financial statements that meet the highest standard previously provided. The SEC's proposing release includes the following example:

> [I]f an issuer had previously completed an offering with a $200,000 target and an offering with a $700,000 target, the issuer would be required to provide audited financial statements rather than reviewed financial statements. This would be the case even if the $200,000 offering was conducted more recently than the $700,000 offering.[11]

The SEC's view is that the annual report accessible by all investors in the issuer should contain financial statements at least as rigorous as those provided to any investors in a prior crowdfunding offering. This view dovetails with the SEC's proposal that an issuer aggregate the target amounts of all prior crowdfunding offers in determining the standard of financial statements required for a follow-on crowdfunding offering and ensures that issuers cannot avoid, for example, disclosing audited financial statements by conducting multiple small offerings that in aggregate exceed $500,000. In addition, as a result of this proposal, initial investors that may not have been provided with audited financial statements of the issuer for its first crowdfunding offering would be able to access audited financial statements should the issuer trigger the requirement to disclose them in materials for a follow-on offering in which the initial investor did not participate.

The SEC's proposing release also invites crowdfunding issuers to voluntarily provide financial statements in their annual reports that meet a higher standard than the standard required in their disclosures for crowdfunding offerings.

Issuers that trigger the ongoing reporting requirements would be required to file annual reports until:

- the issuer becomes a reporting company under the Exchange Act (other than as a result of triggering the registration thresholds in Section 12(g) under the Exchange Act);
- the issuer or another party repurchases all of the securities issued in the crowdfunding offering; or
- the issuer liquidates or dissolves its business in accordance with state law.

Advertising Restrictions

Section 4(a)(6) prohibits issuers from advertising their offerings outside of the intermediary's communication channels except for certain limited notices that direct investors to the intermediary. Under

[11] Securities Act Release No. 9470 (Oct. 23, 2013) at 95, fn. 226.

the SEC's proposed rules, the only offline, or non-intermediary, website advertising that issuers may conduct would be to publish a tombstone-like notice advertising the "terms of offering", provided that the notice also includes the name of the intermediary facilitating the offering and a reference to the intermediary's platform where additional information about the issuer and the offering may be found. "Terms of offering" would be limited to:

- the amount of securities offered;
- the nature of the securities;
- the price of the securities; and
- the closing date of the offering.

Limited factual information about the issuer, including its name, business address, website address and other basic identifying information would also be permitted in the notice. The SEC proposes that issuers could publish these tombstone-like notices on social media sites or in newspapers and other offline venues. Permitting advertising outside of the intermediary's communication channels or platform could be crucial to the success of securities-based crowdfunding, as the strongest interest in many small businesses and startups may be found locally where the issuer's business and management team are located or where its products and services are sold.

The SEC noted that several Title III commentators were concerned that a prohibition on broader advertising would prevent startups from reaching their desired funding goals, but also noted that the JOBS Act itself specifically restricts the ability of issuers to advertise the terms of offering.

Record Keeping

The proposed rules would require an issuer to establish a means to keep accurate and complete records of the securities it sells to investors. However, the SEC did not propose a particular form or method of recordkeeping of securities. In particular, the SEC did not propose to require that an issuer use a transfer agent or any other third party agent.

Requirements for Intermediaries

The proposed rules would require a crowdfunding transaction to be conducted online through a broker or funding portal. A funding portal is a new category of broker required to register with the SEC and FINRA and is defined as a person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others solely pursuant to Section 4(a)(6). The intermediary requirement is intended to ensure that:

- all relevant information regarding the offering will be available to the crowd in a single, regulated, online location — the intermediary's website — enabling the "wisdom of the crowd" to form and grow; and
- the investor protection provisions of the rules, including issuer disclosure requirements, prescribed offering procedures, issuer offer limits and investor investment limits are implemented and monitored by such intermediaries.

Communication Channels

The proposed rules would require an intermediary to provide on its platform channels through which investors could communicate with one another and with representatives of the issuers about offerings made on the intermediary's portal. While the JOBS Act does not require such a feature, the SEC agreed with Title III commenters who suggested that such a feature would be an integral component of crowdfunding. Under the proposed rules, some of the requirements of the communication channels would be as follows:

- while the general public must be able to view communications on the channel, only persons that have accounts with the intermediary would need to be able to post comments on the channel;
- intermediaries would be responsible to track the origins of any abusive or potentially fraudulent comments made on the channels; and
- any person posting a comment would have to declare if he/she is a founder or employer of the issuer, or is engaging in a promotional or otherwise compensatory activities on behalf of the issuer.

Registration and SRO Membership

The proposed rules would require intermediaries to:

- register with the SEC as a funding portal pursuant to Securities Act Section 4A(a)(1) or as a broker under Exchange Act Section 15(b);
- be subject to examination enforcement and other rulemaking authority of the SEC; and
- register with FINRA.

The SEC would permit non-U.S. based funding portals to register as funding portals provided that an information sharing agreement exists between the SEC and the "competent regulator" in the non-resident funding portal's home country. In addition, the non-resident funding portal would be required to submit to service of process in the United States and to on-site inspection of its books and records by the SEC.

Ban on Financial Interests

The SEC's proposals would require an intermediary to prohibit an intermediary and its directors, officers or partners from having any financial interest in an issuer using its services.

Some Title III commentators believed that allowing an intermediary to have a financial interest in an issuer would constructively align the funding portal's interest with those of potential investors, and that full disclosure of any such interest would be sufficient to address any concerns. The SEC disagreed with this approach, stating its concern with potential conflicts of interest, including the possibility that an interested intermediary might have an incentive to ensure the success of its own investment in the issuer to the disadvantage of ordinary investors.

Measures to Reduce Risk of Fraud

To reduce the risk of fraud, the SEC would require intermediaries to:

- obtain a background check, including any regulatory enforcement actions, on each officer, director and holder of 20% voting power of the issuer;

- have a "reasonable basis" for believing that an issuer is in compliance with the applicable disclosure requirements and a means to keep accurate records of its securityholders consistent with the crowdfunding rules; and
- deny access to its services if it believes the issuer or the offering presents a potential for fraud.

The proposed rules would require an intermediary to deny an issuer access to its services not only when it has information that provides the basis for the issuer's disqualification under the rules, but also when the intermediary merely believes the *potential* for fraud exists. The proposed rules would, however, permit an intermediary to reasonably rely on the representations of the issuer regarding its compliance with the applicable crowdfunding rules, provided the intermediary has no knowledge or indication that such representations are not true.

Numerous Title III commenters requested guidance on the acceptable scope of the background and securities enforcement regulatory history checks, or the appropriate actions an intermediary should take with respect to information uncovered during such checks. The SEC, however, did not propose specific procedures for intermediaries to follow, in part to control costs faced by the intermediaries. Instead, the SEC decided to allow each intermediary to use its own experience and judgment, with the view that each intermediary's concern for the reputational integrity of its own platform would result in systems and processes that effectively reduce the risk of fraud.

Providing Investors With Educational Materials

The proposed rules would require intermediaries to deliver to investors educational materials that are in plain language and designed to effectively communicate specified information, such as the types of securities available for purchase on the platform and the risks associated with them. For example, some of these materials would need to explain:

- the risks associated with investing in crowdfunding securities;
- the restrictions on the resale of crowdfunding securities;
- the types of information that an issuer is required to provide in annual reports and the possibility that the issuer’s obligation to file annual reports with the SEC may terminate in the future;
- the limitations on the amounts investors may invest in crowdfunding transactions; and
- the circumstances in which the issuer may cancel an investor's crowdfunding investment commitment.

In addition, before an investor makes an investment commitment, an intermediary would be required to obtain a representation that the investor has reviewed the educational materials and understands the investment risks.

Compliance With Investment Limitations

In accordance with the JOBS Act, the proposed rules would require intermediaries to ensure that the issuer and investors do not exceed the rolling 12-month issuer sale and investor purchase limits.

With respect to the individual investor purchase limits, many Title III commentators stated that it would be difficult for an intermediary to monitor individual investor investment limits because an investor may not

always use the same intermediary or the same user account when making multiple issuer crowdfunding investments. In response to these pre-proposal comments, the SEC's proposals would permit an intermediary to rely on an investor's representations concerning adherence to the investment limitation requirements. Similarly, to make it easier for intermediaries to ensure that issuers are in compliance with the 12-month/$1 million aggregate offering limit, issuers would be required to post all their crowdfunding offerings with only one intermediary on one portal.

Maintenance and Transmission of Funds

Under the proposed rules, intermediaries that are funding portals would not be permitted to hold, manage, possess or otherwise handle any investor funds. Funding portals would be permitted only to direct investors to transmit money to a "qualified third party" that had agreed in writing to hold the funds in escrow for the benefit of the investor and the issuer. When the target offering amount has been met and the cancellation period for each investor has expired, the funding portal would direct the qualified third party to transmit the funds to the issuer. If the issuer does not meet the target offering amount or otherwise terminates the offering, or an investor cancels his/her commitment, the funding portal must direct the qualified third party to return the funds to the investor.

Prohibitions on Funding Portals

Funding portals would be subject to a number of restrictions under the Exchange Act that do not apply to brokers. The proposed rules would prohibit funding portals from:

- offering investment advice or recommendations;
- soliciting purchases, sales or offers to buy securities displayed on its platform;
- compensating employees, agents or other persons for such solicitation, or based on the sale of securities displayed on its platform; or
- holding, managing, possessing or otherwise handling investor funds or securities.

In light of these prohibitions, and based on Title III commenter requests for "bright line rules" on how intermediaries could more clearly avoid non-compliance with certain of these prohibitions, the SEC proposed a conditional, non-exclusive safe harbor identifying certain limited activities that would not run afoul of these prohibitions, including:

- limiting offerings made on or through the funding portal’s platform based on eligibility requirements;
- highlighting and displaying crowdfunding 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.

Anti-Money Laundering (AML) Statute and Privacy Requirements

Although funding portals are exempt from broker registration, they would be required to comply with certain AML provisions as if they were a broker, particularly the requirements of the Bank Secrecy Act (BSA) to assist in the detection, prevention and reporting or prosecution of money laundering, terrorist financing or other types of illegal financing. While the SEC believes a funding portal's BSA activities would be limited due to their limited activities, funding portals would, like brokers, be required to establish and maintain an effective AML program and a customer identification program, and to monitor and report on suspicious activity at the individual customer level and comply with requests of information from Financial Crimes Enforcement Network.

Funding portals would also be subject to the same privacy rules applicable to brokers. Specifically, funding portals would be required to comply with Regulation S-P (Privacy of Consumer Financial Information and Safeguarding Personal Information), Regulation S-AM (Limitations on Affiliate Marketing), and Regulation S-ID (Identity Theft Red Flags).

Exchange Act Section 12(g)

Pursuant to the JOBS Act, holders of securities sold in a crowdfunding transaction would not count towards the security holder thresholds under Section 12(g) of the Exchange Act. Section 12(g) requires companies to register with the SEC when their equity securities are held of record by 2,000 persons or 500 persons who are not accredited investors. Crowdfunding transactions contemplate that an issuer may sell securities directly to a large number of individual investors each of whom might be counted as a holder of record. Investors in public companies often hold their securities through a broker, bank or other nominee, in which case the nominee (or other entity) rather than the investor is counted as a record holder. Accordingly, the exemption of Section 4(a)(6) securities from the Section 12(g) threshold effectively avoids the imposition of a smaller investor limitation on securities-based crowdfunding transactions compared generally to transactions by public companies.

What We Might Expect

The SEC's proposals to allow securities-based crowdfunding transactions are in many ways strictly limited by the provisions in the JOBS Act itself. While market participants continue to express significant interest in securities-based crowdfunding transactions, the costs to issuers under the proposed rules may outweigh the benefits, in particular since even the smallest, earliest-stage companies would need to prepare the extensive disclosures required by Form C, including financial statements the standard of which will depend on the maximum amount an issuer will seek to raise during a 12-month period. Under these proposed financial statement requirements, issuers seeking to raise more than $500,000 in any 12-month period would need to file audited financial statements, which can be costly to prepare, particularly where the issuer has an ongoing reporting obligation, in which case it generally would need to continue to provide audited financial statements along with other extensive annual disclosures, including disclosure about its financial condition and results of operations and information concerning the identity and background of management.

Furthermore, issuers must comply with advertising and other offering communication restrictions, including the requirement that almost all offering communications be limited to the intermediary's platform for the offering. Offline advertising is permitted only where the issuer limits the information in the advertisement to that of the type typically seen in today's tombstone ads. The advertising and communication limitations therefore could impose real hurdles to a small business that wants to advertise the offering locally using physical advertisements. Issuers that violate these requirements can face significant issues, including potential violations of Section 5 of the Securities Act.

Finally, issuers that sell securities in a crowdfunding transaction must implement processes to help ensure they maintain accurate security holder and other records. As to crowdfunding securityholders, while they are not counted towards the registration thresholds under Exchange Act Section 12(g), they may be so diverse and numerous that an issuer may find significant challenges in communicating with them, including addressing questions or requests for business updates. In addition, having a large number of small investors may complicate the issuer's capitalization table and balance sheet in ways that may ultimately impede the issuer's ability to raise further capital.

Nevertheless, the smallest, earliest stage companies may focus on the potential of securities-based crowdfunding transactions where friends and family or banks cannot provide needed financing. Issuers that are aware of and consider ways to address the potential challenges of having a large and diverse base of securityholders, that carefully consider the services provided by intermediaries and select the "right one" for its offering and business, and that prepare carefully and efficiently for the initial and ongoing disclosure requirements may find significant benefits under the new offering exemption once it becomes effective.

Requests for Comments

The SEC makes approximately 300 specific requests for comment covering all aspects of the proposed rules. The SEC seeks comment on general questions, such as whether the proposed disclosure requirements are appropriate, as well as comments on numerous specific questions. The period for comments ends on February 3, 2014. Comments received to date are generally supportive of the SEC's proposal and are enthusiastic about the capital raising potential and investor opportunities stemming from the crowdfunding concept.

You can find the full text of the proposal at http://www.sec.gov/rules/proposed/2013/33-9470.pdf.

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