

# **CROWDFUNDING 2.0: THE JOBS ACT GAME CHANGER**

Presented by the  
American Bar Association  
Forum on the Entertainment and Sports Industries,  
Section of Intellectual Property Law,  
Business Law Section Federal Regulation of Securities Committee and  
Center for Professional Development



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# Crowdfunding 2.0: The JOBS Act Game Changer

Tuesday, May 28, 2013 | 1:00 PM Eastern

Sponsored by the Forum on the Entertainment & Sports, Business Law Section, Business Law Section Federal Regulation of Securities Committee, Section of Intellectual Property Law and the ABA Center for Professional Development

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## Crowdfunding 2.0: The JOBS Act Game Changer

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## Crowdfunding 2.0: The JOBS Act Game Changer

President Obama signed the Jumpstart Our Business Startups (JOBS) Act into law on April 5, 2012.

## What is CF?

- Background on the JOBS Act and Section III- Crowd Funding
- How does CF fit within exemptions from registration?

## How does CF work?

### Features of the new law

- Non-accredited investors
- Limits on amount raised
- Limits on amounts investors can invest
- Use of an intermediary

## How does CF work?

- Minimums - Can't use funds until target amount is reached.
- Issuer disclosure requirements
- Notices of the offering
- Finders
- Easing of state law requirements

## What are the problems with CF?

- Is the \$1 million cap sufficient?
- What are the potential problems with a large number of strangers in a deal?
- What are the risks of fraud and how can they be handled, what will the states' role be in that process?

## What are the opportunities that CF presents?

- What are the new opportunities for investors and offerors?
- What is the potential size of the CF investor pool?
- Will CF contribute to the growth of domestic jobs?
- How will CF be more or less transparent than offerings under other exemptions?



## What are the opportunities that CF presents?

- What are the possibilities for the use of social media?
- How can social media play a role in investors' due diligence?
- How will social media be used by offerors to direct investors to the portal?
- What should the SEC should allow?

## Portals

- What is a portal?
- How does CF look from a portal's perspective?
- What are the implications/impact of online standardization of evaluating offerors, vetting potential investors, educating investors, administrating offerings, transactions with investors, etc.
- What is the role of FINRA?

## Predictions for CF

- Is CF dead on arrival?
- Some commentators describe CF as the bridge to nowhere. They assert that the SEC regs will be so restrictive that only lawyers will benefit.
- Other commentators see CF as the democratization of capital formation and assert that the JOBS Act may prove to be the most significant change in securities laws since the Securities Acts of '33, '34.
- How useful will CF be in reality?

# QUESTIONS

# ????



## Jumpstart Our Business Startups Act

### FINRA Requests Comment on Proposed Regulation of Crowdfunding Activities

Comment Period Expires: August 31, 2012

#### Executive Summary

The Jumpstart Our Business Startups Act (JOBS Act)<sup>1</sup>—a new law aimed at increasing American job creation and economic growth—contains key provisions relating to securities offered or sold through “crowdfunding.”<sup>2</sup> Under the new law, intermediaries performing crowdfunding on behalf of issuers must register with the Securities and Exchange Commission (SEC) as a “funding portal” or broker and must register with an applicable self-regulatory organization (SRO). FINRA is soliciting public comment on the appropriate scope of FINRA rules that should apply to member firms engaging in crowdfunding activities, either as funding portals or as brokers.

Questions regarding this *Notice* should be directed to:

- ▶ Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; or
- ▶ Adam H. Arkel, Associate General Counsel, OGC, at (202) 728-6961.

#### July 2012

##### Notice Type

- ▶ Request for Comment

##### Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

##### Key Topics

- ▶ Crowdfunding
- ▶ Funding Portals
- ▶ JOBS Act

##### Referenced Rules & Notices

- ▶ NTM 03-73

## Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by August 31, 2012.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to [pubcom@finra.org](mailto:pubcom@finra.org); or
- ▶ Mailing comments in hard copy to:  
Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW  
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

**Important Notes:** The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.<sup>3</sup>

Before becoming effective, a proposed rule change must be authorized for filing with the SEC by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).<sup>4</sup>

## Background & Discussion

The crowdfunding provisions of the JOBS Act provide an exemption from registration under the Securities Act of 1933 (Securities Act) for securities offered by issuers in amounts of up to \$1 million over a 12-month period provided that the amount raised from any single investor adheres to strict limits (ranging from \$2,000 to \$100,000) based on the investor's annual income or net worth.<sup>5</sup> The crowdfunding exemption establishes specific eligibility and sales practice standards for issuers and intermediaries that engage in crowdfunding.<sup>6</sup> Intermediaries that seek to engage in crowdfunding must be registered as a broker or a funding portal, a newly created entity.

The regulatory scheme established by Congress expressly contemplates a role for an organization such as FINRA by mandating that each registered funding portal be a member of an applicable SRO.<sup>7</sup> However, Congress limited a national securities association's examination and enforcement authority over such registered funding portals to its rules "written specifically for registered funding portals."<sup>8</sup>

### Registered Funding Portal Rules

While the scope of any FINRA rules written specifically for registered funding portals will be influenced by, and should not be duplicative of, any crowdfunding rules adopted by the SEC, we have had conversations with SEC staff suggesting that FINRA should consider adopting its own crowdfunding rules. To assist in developing its crowdfunding rules, FINRA solicits comment on the specific rules that FINRA should adopt for registered funding portals that become FINRA members.

In writing rules specifically for registered funding portals, FINRA would seek to ensure that the capital-raising objectives of the JOBS Act are advanced in a manner consistent with investor protection. Commenters are encouraged to identify the types of requirements that should apply to registered funding portals, taking into account the relatively limited scope of activities by a registered funding portal permitted under the JOBS Act.<sup>9</sup> Comments are particularly requested about possible rules concerning supervision, advertising, anti-money laundering, fraud and manipulation, and just and equitable principles of trade.

### Application of FINRA Rules to Crowdfunding Activities by Broker-Dealers

FINRA also solicits comment on the application of existing FINRA rules to crowdfunding activities of *broker-dealers*. Unlike the rules applicable to *registered funding portals*, the JOBS Act does not limit the FINRA rules applicable to registered broker-dealers engaging in crowdfunding activities. Nevertheless, FINRA invites comments from broker-dealers regarding the application of existing FINRA rules to broker-dealers' crowdfunding activities and whether such rules should be relaxed to address a broker-dealer's crowdfunding activities, taking into account, among other things, the extent to which a broker-dealer may be able to isolate its crowdfunding business, or otherwise places limitations on its activities akin to those for registered funding portals. FINRA requests information from broker-dealers that may engage in crowdfunding concerning the organizational structure through which this activity would occur within the firm (*e.g.*, through the broker-dealer entity or a separately identified department). FINRA also requests comment on whether engaging in crowdfunding might present special conflicts or concerns for a broker-dealer, such as might arise if a registered representative were to recommend that a customer visit the firm's crowdfunding site.

## Endnotes

1. Pub. L. No. 112-106, 126 Stat. 306 (2012).
2. See Title III of the JOBS Act. Crowdfunding generally refers to the use of the Internet by small businesses to raise capital through limited investments from a large number of investors.
3. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. See [NTM 03-73](#) (November 2003) (NASD Announces Online Availability of Comments) for more information.
4. See SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. See SEA Section 19(b)(3) and SEA Rule 19b-4.
5. Specifically, an issuer relying on the crowdfunding exemption created by the JOBS Act may not raise from an investor an aggregate amount that exceeds: (i) the greater of \$2,000 or 5 percent of the investor's annual income or net worth (for investors whose annual income or net worth is less than \$100,000); or (ii) 10 percent of the investor's annual income or net worth, not to exceed \$100,000 (for investors whose annual income or net worth is \$100,000 or more). See Securities Act Section 4(6). These aggregate amounts limit an investor's total crowdfunding purchases from all issuers in a 12-month period.
6. See generally Securities Act Section 4A and SEA Section 3(a)(80).
7. See SEA Section 4A(a)(2). The term "self-regulatory organization" is defined under SEA Section 3(a)(26) to include a registered securities association (e.g., FINRA). SEA Section 3(h)(2) provides in part that for purposes of SEA Section 15(b)(8) the term "broker or dealer" includes a funding portal and the term "registered broker or dealer" includes a registered funding portal. SEA Section 15(b)(8) generally requires a broker or dealer to be a member of a registered securities association.
8. See SEA Section 3(h)(2).
9. For example, among other things, a funding portal may not: offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; compensate employees, agents or other persons for such solicitation or sales; or hold, manage, possess or otherwise handle customer funds or securities. See SEA Section 3(a)(80).







## NEWS RELEASE

**For Release:** January 10, 2013  
**Contacts:** [George Smaragdis \(202\) 728-8988](#)  
[Nancy Condon \(202\) 728-8379](#)

### **FINRA Issues Voluntary Interim Form for Crowdfunding Portals**

WASHINGTON — The Financial Industry Regulatory Authority (FINRA) today issued a voluntary *Interim Form for Funding Portals* designed for prospective crowdfunding portals under the JOBS Act. Those intending to become a funding portal may voluntarily submit information regarding their business on the interim form. The information received will help FINRA develop rules specific to crowdfunding portals.

FINRA and the SEC are engaging in an open dialogue about the rules that should apply to funding portals. Once the SEC and FINRA have adopted funding portal rules, FINRA will issue a final funding portal application for FINRA regulation. In applying for membership, crowdfunding portals will not be bound by the responses provided on the Interim Form.

"FINRA is committed to ensuring that the capital-raising objectives of the JOBS Act are advanced in a manner consistent with Congressional intent and investor protection. Crowdfunding portals that file this form will provide FINRA with important information regarding portal business models, which will inform our rulemaking," said Thomas Selman, Executive Vice President, Regulatory Policy.

The Interim Form asks prospective funding portals to provide information including:

- ownership;
- funding;
- management; and
- business model and relationships.

FINRA is also asking prospective funding portals to supplement the information in the interim form with any additional information or documents that they believe would be helpful. FINRA will treat information that prospective portals file on the interim form as confidential.

Last year, FINRA solicited [comments](#) on the specific rules it should adopt for registered funding portals that become FINRA members. FINRA has also asked for comment on the application of existing rules to broker-dealers engaging in crowdfunding activities.

FINRA is the largest non-governmental regulator for all securities firms doing business in the United States. FINRA is dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. FINRA touches virtually every aspect of the securities business – from registering and educating all industry participants to examining securities firms, writing and enforcing rules and the federal securities laws, informing and educating the investing public, providing trade reporting and other industry utilities, and administering the largest dispute resolution forum for investors and registered firms. For more information, please visit our website at [www.finra.org](http://www.finra.org).



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## **Crowdfunding Portals**

FINRA invites prospective crowdfunding portals to voluntarily file an interim funding portal form.

If you intend to act as a funding portal under the JOBS Act, you may voluntarily submit this form to inform us about your future funding portal business. Your filing will help us to develop rules that reflect the funding portal community and its business. FINRA will treat the information that you file on the interim form as confidential.

Note: Filing of this interim form will not entitle you to FINRA membership. We will make membership available to funding portals after the SEC adopts funding portal rules and approves FINRA's funding portal rules.

Once funding portal rules are in place, FINRA will issue a final funding portal application that will be necessary for you to file to become a FINRA member. In applying for membership, you will not be bound by the responses you provided on this interim funding portal form.

In addition to the information we request on the interim form, you may provide any additional information or documents that you believe would be helpful.

- [Interim Form for Funding Portals](#) (Word 117 KB)

### **Submitting the IFFP**

Please submit the completed interim funding portal form to [fundingportals@finra.org](mailto:fundingportals@finra.org).

If you have any questions, please contact FINRA at (212) 858-4000 and select option 5.



## Interim Form for Funding Portals

If you intend to act as a funding portal under the JOBS Act, you may voluntarily submit this form to inform us about your future funding portal business. Your voluntary submission of the requested information will help FINRA better understand the funding portal community and help us develop rules specific to funding portals. FINRA will accord confidential treatment to the information that you submit.

Although a further filing will be needed before FINRA will be able to grant you membership, we intend to prepopulate for you a future funding portal membership form with the information that you submit on this form. FINRA membership will be made available after the SEC has adopted funding portal registration and other rules, and has approved FINRA’s funding portal rules.

Please feel free to supplement the information that we request on this form with any additional information that you believe would be helpful.

Please submit the form to: [fundingportals@finra.org](mailto:fundingportals@finra.org). If you have any questions, please contact us at (212) 858-4000 and select “option 5.”

### Contact Information

Please provide us a contact person whom we can ask follow-up questions.

#### Contact person

First name	<input type="text" value="Click here to enter text."/>
Last name	<input type="text" value="Click here to enter text."/>
Email address	<input type="text" value="Click here to enter text."/>
Phone number	<input type="text" value="Click here to enter text."/>
Fax number	<input type="text" value="Click here to enter text."/>

#### Mailing address

Company name	<input type="text" value="Click here to enter text."/>
Street address, line 1	<input type="text" value="Click here to enter text."/>
Street address, line 2	<input type="text" value="Click here to enter text."/>
City	<input type="text" value="Click here to enter text."/>
State	<input type="text" value="Click here to enter text."/>
Country	<input type="text" value="Click here to enter text."/>
Postal code	<input type="text" value="Click here to enter text."/>

## Information About Your Business

### I. General Information

- a. Full Name of Funding Portal (“FP”)

Click here to enter text.

- b. Any Other Name(s) Under Which Business Is or Will Be Conducted

Click here to enter text.

- c. Business Address

Click here to enter text.

- d. All Website Addresses Where Business Is or Will Be Conducted

Click here to enter text.

- e. Legal Status of FP (*e.g.*, Corporation, Limited Liability Company (“LLC”), Partnership, Sole Proprietorship or Other)

Click here to enter text.

- f. State/Country of Formation

Click here to enter text.

- g. Date of Formation

Click here to enter text.

### II. Ownership

- a. Please use the schedule below to identify the *direct* owners of the FP. Please include, as applicable:

- i. any shareholder that directly owns 5 percent or more of a class of a voting security of the FP, unless the FP is a public reporting company (that is, subject to Sections 12 or 15(d) of the Securities Exchange Act of 1934 (the “Act”));
- ii. all general partners and those limited and special partners that have the right to receive upon dissolution, or have contributed, 5 percent or more of the partnership’s capital;
- iii. any trust, and each trustee, that directly owns 5 percent or more of a class of voting security of the FP, or has the right to receive upon dissolution, or has contributed, 5 percent or more of the FP’s capital; and
- iv. all members of an FP that is a LLC that have the right to receive upon dissolution, or have contributed, 5 percent or more of the LLC’s capital.

b. Please use the schedule below to identify the *indirect* owners of the FP. Regarding each direct owner provided in response to the above question, please complete the schedule below as follows:

- i. in the case of an owner that is a corporation, each of its shareholders that beneficially owns, has the right to vote, or has the power to sell or direct the sale of, 25 percent or more of a class of a voting security of that corporation; (Note: For purposes of this schedule, a person beneficially owns any securities (i) owned by his/her child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, sharing the same residence; or (ii) that he/she has the right to acquire, within 60 days, through the exercise of any option, warrant or right to purchase the security);
- ii. in the case of an owner that is a partnership, all general partners and those limited and special partners that have the right to receive upon dissolution, or have contributed, 25 percent or more of the partnership’s capital;
- iii. in the case of an owner that is a trust, the trust and each trustee; and
- iv. in the case of an owner that is an LLC , (i) those members that have the right to receive upon dissolution, or have contributed, 25 percent or more of the LLC’s capital, and (ii) if managed by elected managers, all elected managers.

(Note: Continue up the chain of ownership listing all 25 percent owners at each level. Once a public reporting company (a company subject to Sections 12 or 15(d) of the Act) is reached, no further ownership information up the chain is required.)

Full Legal Name	Domestic or Foreign Entity or Individual	Entity in Which Interest Owned	Percentage of Interest in Entity Owned	CRD number, SSN or Tax ID
Click here to enter text.	Choose an item.	Click here to enter text.	Click here to enter text.	Click here to enter text.
Click here to enter text.	Choose an item.	Click here to enter text.	Click here to enter text.	Click here to enter text.
Click here to enter text.	Choose an item.	Click here to enter text.	Click here to enter text.	Click here to enter text.
Click here to enter text.	Choose an item.	Click here to enter text.	Click here to enter text.	Click here to enter text.
Click here to enter text.	Choose an item.	Click here to enter text.	Click here to enter text.	Click here to enter text.

(If additional space is needed, please submit a separate document as an additional attachment containing the information and identifying the question to which the information pertains.)

- c. Identify (i) all subsidiaries of the FP and (ii) any affiliated entities with which the FP will engage in a business relationship in connection with its funding portal activities. Please identify any of these entities that are broker-dealers.

Click here to enter text.

**III. Funding**

- a. Source of Funding

Please identify below all contributions of equity capital or debt financing made to the FP's business.

Date	Name of Source	Recipient	Amount	Type (Equity or Debt)
Click here to enter text.	Click here to enter text.	Click here to enter text.	Click here to enter text.	Choose an item.
Click here to enter text.	Click here to enter text.	Click here to enter text.	Click here to enter text.	Choose an item.
Click here to enter text.	Click here to enter text.	Click here to enter text.	Click here to enter text.	Choose an item.
Click here to enter text.	Click here to enter text.	Click here to enter text.	Click here to enter text.	Choose an item.
Click here to enter text.	Click here to enter text.	Click here to enter text.	Click here to enter text.	Choose an item.

(If additional space is needed, please submit a separate document as an additional attachment containing the information and identifying the question to which the information pertains.)

**IV. Management and Disclosure**

- a. Please identify by name, title and, if applicable, CRD number, each person associated with the FP who is or will be engaged in the management, direction or supervision of the FP's business.

Click here to enter text.

- b. Statutory Disqualifications

Is the FP or any person identified in response to questions II.a. or IV.a. subject to statutory disqualification pursuant to [Section 3\(a\)\(39\) of the Act](#)? (FINRA notes that we may expand this question to include additional persons in the future funding portal membership form.)

Yes  No

[If 'Yes' indicated above] As applicable to the FP and each person, identify the nature of the disqualifying event, provide CRD number (if applicable) and describe the anticipated role with the FP.

Click here to enter text.

- c. Other Disclosure History (FINRA notes that we may expand this question to include additional persons and events in the future funding portal membership form.)  
Is or has the FP or any person identified in response to questions II.a. or IV.a. been the subject of the following (or is any of the following otherwise true with respect to the FP or such person(s) identified): (i) any permanent or temporary adverse action by a state or federal authority, or a self-regulatory organization, with respect to a registration or licensing determination regarding the FP or any person identified in response to questions II.a. or IV.a.; (ii) a pending, adjudicated or settled regulatory action or investigation by the SEC, the CFTC, a federal, state or foreign regulatory agency, or a self-regulatory organization; (iii) an adjudicated or settled investment-related private civil action for damages or an injunction; (iv) a criminal action (other than a minor traffic violation) that is pending, adjudicated, or that has resulted in a guilty or no contest plea; (v) the FP or any person identified in response to questions II.a. or IV.a. is subject to unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements; (vi) any person identified in response to questions II.a. or IV.a. was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule or an industry standard of conduct; or (vii) a state or federal authority or self-regulatory organization has imposed a remedial action, such as special training, continuing education requirements, or heightened supervision, on any person identified in response to questions II.a. or IV.a..

Yes  No

[If 'Yes' indicated above] As applicable to the FP and each person identified, provide CRD number (if applicable), the person's role with the FP and a description of the event(s).

Click here to enter text.

## V. Business Relationships, Business Model and Compensation

- a. Certain Business Relationships

Please describe all business and contractual relationships the FP will maintain, as applicable, with the following:

- i. Escrow agents, transfer agents, and custodians of investor funds and securities
- ii. Securities brokers and dealers
- iii. Recordkeeping

Click here to enter text.

- b. Please describe the FP's business model (*e.g.*, the types of securities to be presented to investors, any limitations on the types of issuers, how issuers will be presented to investors).

Click here to enter text.

- c. Please describe the forms and sources of compensation that the FP and persons associated with the FP expect to receive (*e.g.*, transaction-based, referral-based, flat fee, from issuers, from investors).

Click here to enter text.

- d. Do you plan to use any pre-dispute arbitration agreements?

Yes  No

- e. Please describe how the FP addresses the requirements for funding portals under the JOBS Act. In particular, please describe how the FP would (i) address investor education; (ii) take measures to reduce the risk of fraud with respect to funding portal transactions; (iii) ensure adherence to the aggregate selling limits; and (iv) protect the privacy of information collected from investors.

Click here to enter text.





## Jumpstart Our Business Startups Act Makes Significant Changes to Capital Formation, Disclosure and Registration Requirements

The Jumpstart Our Business Startups Act, or JOBS Act, was signed by President Obama on April 5, 2012.<sup>1</sup> The JOBS Act makes significant changes to the capital formation, disclosure and registration requirements applicable to many public companies. In particular, the JOBS Act:

- Creates a new class of public company, called an “emerging growth company”, which is any company that has total annual gross revenues of less than \$1 billion, and exempts these companies from certain of the disclosure, audit, proxy and other requirements applicable to other public companies;
- Increases the holders of record thresholds that trigger registration and public company reporting requirements with the Securities and Exchange Commission under the Securities Exchange Act of 1934; and
- Facilitates private placements of securities by:
  - amending Section 4 of the Securities Act of 1933 to add a new type of transaction exemption from SEC registration requirements for securities sold by “crowdfunding”;
  - amending Section 3 of the Securities Act to add a new class of security exempt from most provisions of the Securities Act, including registration with the SEC, provided that, among other things, the aggregate offering amount of all securities offered and sold within a 12-month period in reliance on the new exemption does not exceed \$50 million; and
  - permitting general advertising and general solicitation in connection with offerings conducted in accordance with Rule 506 under Regulation D or Rule 144A promulgated under the Securities Act, provided that the only purchasers in such offerings are accredited investors in Regulation D offerings or qualified institutional buyers, known as QIBs, in Rule 144A offerings.

The JOBS Act became effective on April 5, 2012 when it was signed by President Obama, although certain provisions, particularly those dealing with crowdfunding and registration under the Exchange Act, require the SEC to write implementing rules, generally in a very short time frame.

### EMERGING GROWTH COMPANIES

#### DEFINITION

The JOBS Act amends Section 2(a) of the Securities Act and Section 3(a) of the Exchange Act to define an “emerging growth company” as an issuer that had total annual gross revenues of less than \$1 billion during its most recently completed fiscal year. The \$1 billion threshold is to be indexed for inflation every five years by the SEC to reflect the change in the consumer price index.

An issuer remains an emerging growth company until the earliest of:

- The last day of the fiscal year during which it had total annual gross revenues of \$1 billion or more;
- The last day of the fiscal year following the fifth anniversary of its initial public offering date;
- The date on which it has, during the previous three-year period, issued more than \$1 billion in non-convertible debt; or
- The date on which it is deemed to be a “large accelerated filer”.<sup>2</sup>

For this purpose, the “initial public offering date” is defined as the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act.

An issuer is not an emerging growth company if the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act occurred on or before December 8, 2011. The effect of this is to create two classes of public companies among those that have less than \$1 billion in total annual gross revenues based on when they first publicly sold common equity securities. Those that did so on or prior to December 8, 2011 are required to comply with all existing SEC requirements, while those that did so after December 8, 2011 are able to choose to instead comply with the reduced requirements for emerging growth companies described below.

#### EXEMPTIONS FROM EXISTING REQUIREMENTS

The JOBS Act exempts emerging growth companies from numerous requirements under the federal securities laws including:

**Say-On-Pay.** Section 14A(e) of the Exchange Act has been amended to exempt emerging growth companies from the “say-on-pay”, “say-on-pay-frequency” and “say-on-golden parachute” requirements that were enacted as part of the Dodd-Frank Wall Street Reform and Consumer

Protection Act. After cessation of emerging growth company status, if an issuer was an emerging growth company for less than two years after its initial public offering date, it must hold a say-on-pay vote no later than the end of the three-year period beginning on the date it is no longer an emerging growth company. Any other company that has ceased to be an emerging growth company must hold a say-on-pay vote no later than the end of the one-year period beginning on the date it is no longer an emerging growth company. In addition, following cessation of emerging growth company status, a company will become subject to the say-on-pay-frequency and say-on-golden parachute provisions of Rule 14a-21 promulgated under the Exchange Act.

**Pay-versus-Performance.** Section 14(i) of the Exchange Act has been amended to exempt emerging growth companies from the pay-versus-performance requirements that were enacted as part of the Dodd-Frank Act. The SEC has not yet finalized the regulations implementing the pay-versus-performance requirements of the Dodd-Frank Act.

**CEO Pay Ratio Disclosure.** Section 953(b)(1) of the Dodd-Frank Act has been amended to exempt emerging growth companies from the requirement to compare CEO compensation to the median of the annual total compensation of all employees of the issuer other than the CEO. The SEC has not yet finalized the regulations implementing the pay ratio disclosure requirements of the Dodd-Frank Act.

**Compensation Disclosures.** Emerging growth companies may comply with the less burdensome executive compensation disclosure requirements applicable to any issuer with a market value of less than \$75 million of outstanding voting and nonvoting common equity held by nonaffiliates. Currently these provisions are set forth in Item 402(l) through (r) of Regulation S-K as applicable to smaller reporting companies.

**Financial Statement Requirements.** Section 7 of the Securities Act has been revised to require

that two years, rather than three years, of audited financial statements be included in any registration statement filed with the SEC by an emerging growth company. Similarly, an emerging growth company need only present its Management's Discussion and Analysis of Financial Condition and Results of Operations for each period for which financial statements are presented rather than the periods required by Item 303 of Regulation S-K. Furthermore, an emerging growth company need not present selected financial data for any period prior to the earliest audited period presented in connection with its initial public offering. In addition, an emerging growth company need not comply with any new or revised financial accounting standard until such date that a company that is not an "issuer", as defined in Section 2 of the Sarbanes-Oxley Act of 2002 (generally, a nonpublic company), is required to comply with such new or revised accounting standard. Similar changes were also made to Section 13(a) of the Exchange Act.

#### **Internal Control over Financial Reporting.**

Section 404(b) of Sarbanes-Oxley has been amended to exempt emerging growth companies from the requirement to obtain an attestation report on internal control over financial reporting from the issuer's registered public accounting firm. Currently, this requirement is only applicable to "accelerated filers" and "large accelerated filers" as defined in Rule 12b-2 promulgated under the Exchange Act.

**PCAOB Rules.** The Public Company Accounting Oversight Board must exclude emerging growth companies from any rules it might adopt addressing mandatory audit firm rotation or requiring a supplement to the auditor's report in which the auditor would provide additional information about the audit and the financial statements of the issuer (a so-called auditor discussion and analysis). No PCAOB rules adopted after the date of enactment of the JOBS Act will apply to an emerging growth company unless the SEC determines that the application of

such rules is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition and capital formation.

#### **OTHER AMENDMENTS TO SECURITIES ACT**

**Section 2(a)(3) and Research Reports.** The definitions of "sale," "sell," "offer to sell," "offer for sale" and "offer" in Section 2(a)(3) have been amended to exclude the publication or distribution by a broker or dealer of a research report about an emerging growth company that is the subject of a proposed public offering of its common equity pursuant to a registration statement that the issuer proposes to file or has filed or that is effective, even if the broker or dealer is participating or will participate in the registered offering. For this purpose, a "research report" is defined as a written, electronic or oral communication that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of a security or an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.

**Section 5 and Testing the Waters.** Section 5 of the Securities Act has been amended to provide that an emerging growth company or any person authorized to act on behalf of an emerging growth company may engage in oral or written communications with potential investors that are qualified institutional buyers, as defined in Rule 144A, or institutions that are accredited investors, as defined in Rule 501 promulgated under the Securities Act, to "test the waters" by determining whether such investors might have an interest in a contemplated securities offering, either prior to or following the date of filing of a registration statement with respect to such securities with the SEC.

**Section 6 and Confidential Filing of Registration Statements.** Section 6 of the Securities Act has been amended to provide that any emerging growth company, prior to its initial public offering date, may confidentially submit to

the SEC a draft registration statement for confidential nonpublic review by the SEC staff prior to public filing, provided that the initial confidential submission and all amendments thereto are publicly filed not later than 21 days before the date on which the issuer conducts a road show. For this purpose, a “road show” is used as defined in Rule 433(h)(4) promulgated under the Securities Act and means an offer (other than a statutory prospectus, or portion thereof, filed as part of a registration statement) that contains a presentation regarding an offering by one or more members of the issuer’s management and includes discussion of one or more of the issuer, such management and the securities being offered.

#### OTHER AMENDMENTS TO EXCHANGE ACT

##### **Section 15D and Securities Analyst**

**Communications.** Section 15D of the Exchange Act has been amended to provide that neither the SEC nor any registered national securities association may adopt or maintain any rule or regulation in connection with an initial public offering of the common equity of an emerging growth company that:

- Restricts, based on functional role, which associated persons of a broker, dealer or member of a national securities exchange may arrange for communications between a securities analyst and a potential investor; or
- Restricts a securities analyst from participating in any communications with the management of an emerging growth company that is also attended by any other associated person of a broker, dealer or member of a national securities association whose functional role is other than as a securities analyst.

##### **Section 11(A)(c) and SEC Study on Decimalization of Trading Prices for**

**Emerging Growth Companies.** Section 11A(c) of the Exchange Act has been amended to require the SEC to conduct a study examining the transition to trading and quoting securities in

one-cent increments, known as decimalization, including the impact decimalization has had on the number of initial public offerings since its implementation relative to the period prior to its implementation and the impact on liquidity for small and middle capitalization company securities. The SEC is to also examine whether there is sufficient economic incentive to support trading operations in these securities in one-cent increments. The study must be submitted to Congress by early July 2012. If the SEC determines that securities of emerging growth companies should be quoted and traded using a minimum increment of greater than one cent, the SEC may, by rule no later than early October 2012, designate a minimum increment for the securities of emerging growth companies that is greater than one cent, but less than ten cents, for use in all quoting and trading of securities on any exchange or other execution venue.

#### POST-OFFERING COMMUNICATIONS BY BROKERS AND DEALERS

A provision in the JOBS Act provides that neither the SEC nor any registered national securities association may adopt or maintain any rule or regulation prohibiting any broker, dealer or member of a national securities association from publishing or distributing any research report or making a public appearance, with respect to the securities of an emerging growth company. This applies within any prescribed time period following the initial public offering date of the emerging growth company and within any prescribed period of time prior to the expiration date of any agreement between the broker, dealer or member of a national securities association and the emerging growth company or its shareholders that restricts or prohibits the sale of securities held by the emerging growth company or its shareholders after the initial public offering date.

#### OPT-IN COMPLIANCE

An emerging growth company may choose to forgo compliance with any or all of the provisions

applicable to emerging growth companies made by the JOBS Act and instead comply with the requirements that apply to an issuer that is not an emerging growth company. With respect to the extension of time for complying with new or revised financial accounting standards discussed above, if an emerging growth company chooses to comply with such standards to the same extent that a nonemerging growth company is required to comply with such standards, the emerging growth company:

- Must make such choice at the time the company is first required to file a registration statement, periodic report or other report with the SEC under Section 13 of the Exchange Act and notify the SEC of such choice;
- May not select some standards to comply with in such manner and not others, but must comply with all such standards to the same extent that a nonemerging growth company is required to comply with such standards; and
- Must continue to comply with such standards to the same extent that a nonemerging growth company is required to comply with such standards for as long as the company remains an emerging growth company.

#### SEC RULEMAKING

The emerging growth company provisions of the JOBS Act are effective immediately and do not require any SEC rulemaking prior to implementation. However several provisions do conflict with existing SEC rules, so we expect that the SEC will revise its rules to bring them in line with the changes made with respect to emerging growth companies.

#### REVIEW OF REGULATION S-K

The SEC is required to conduct a review of Regulation S-K to comprehensively analyze the current registration requirements of this regulation and determine how these requirements can be updated to modernize and simplify the registration process and reduce the costs and other burdens associated with these

requirements for issuers that are emerging growth companies. The SEC must report its findings to Congress by early October 2012, and must include the specific recommendations of the SEC on how to streamline the registration process in order to make it more efficient and less burdensome for the SEC and for prospective issuers that are emerging growth companies.

## REGISTRATION AND DEREGISTRATION UNDER THE SECURITIES EXCHANGE ACT OF 1934

### INCREASE IN HOLDERS OF RECORD THRESHOLDS FOR REGISTRATION AND DEREGISTRATION

The JOBS Act has increased the threshold for the registration requirements of Section 12(g) of the Exchange Act. The Exchange Act registration requirements contained in Section 12(g)(1)(A) of the Exchange Act have been revised to require a company to register with the SEC within 120 days after the last day of its first fiscal year on which the issuer has total assets exceeding \$10 million and has a class of equity security (other than an exempted security) held of record by either 2,000 persons in total or 500 persons who are not accredited investors (as such term is defined by the SEC).

In addition, Section 12(g)(1)(B) of the Exchange Act has been revised to require registration under the Exchange Act by an issuer that is a bank or bank holding company, not later than 120 days after the last day of its first fiscal year ending after April 5, 2012, on which the issuer has total assets exceeding \$10 million and a class of equity security (other than an exempted security) held of record by 2,000 or more persons. With respect to bank and bank holding companies, Section 12(g)(4) and Section 15(d) of the Exchange Act have been amended to permit termination of registration when the issuer has fewer than 1,200 holders of record. The SEC is to issue final regulations no later than early April 2013 to implement these changes.

## Holders of Record

Section 12(g)(5) of the Exchange Act has been amended to provide that to determine whether an issuer must register a security under the Exchange Act, the definition of “held of record” will exclude securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act. The SEC is directed to revise the definition of “held of record” in Rule 12g5-1 promulgated under the Exchange Act to implement this amendment. The SEC must also adopt safe harbor provisions that issuers can follow when determining whether holders received the securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of Section 5 of the Securities Act.

In addition, the SEC is to examine its authority to enforce Rule 12g5-1 to determine if new enforcement tools are needed to enforce the anti-evasion provision contained in subsection (b)(3) of the rule and is to, no later than early August 2012, transmit its recommendations to Congress.

Finally, as noted below, the JOBS Act adds new Section 12(g)(6) to the Exchange Act to require the SEC by rule to exempt, conditionally or unconditionally, securities acquired pursuant to an offering made under new Section 4(6) of the Securities Act from the provisions of Section 12(g) of the Exchange Act.

## CROWDFUNDING

### DEFINITION

Although the JOBS Act created a new exemption from the registration requirements of the Securities Act designed to ease SEC or statutory requirements as they apply to crowdfunding, the JOBS Act does not contain a definition of crowdfunding. A common definition is that it is a method of raising capital in small amounts from a large group of people using the internet and social media.<sup>3</sup> By not defining crowdfunding

and not limiting how funds can be raised, the new exemption can apply to a broader range of capital raising than just through the internet or social media.

### NEW SECTION 4(6) OF THE SECURITIES ACT

The JOBS Act amends Section 4 of the Securities Act by adding new paragraph (6) to exempt from the registration requirements of Section 5 transactions involving the offer or sale of securities by an issuer (including all entities controlled by or under common control with the issuer) provided that:

- The aggregate amount of securities sold by the issuer to all investors during the 12-month period, including any amount sold in reliance on the new exemption, preceding the date of the transaction is not more than \$1 million;
- The aggregate amount of securities sold to any investor by an issuer, including any amount sold in reliance on the new exemption, during the 12-month period preceding the date of such transaction does not exceed the greater of \$2,000 and 5 percent of such investor’s annual income or net worth, if either the annual income or net worth is less than \$100,000, or 10 percent of such investor’s annual income or net worth, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000;
- The transaction is conducted through a broker or funding portal, defined below, that complies with the requirements of new Section 4A(a); and
- The issuer complies with the requirements of new Section 4A(b).

Dollar amounts in new Section 4(6) discussed above and new Section 4A(b) discussed below are to be indexed for inflation no less frequently than every five years to reflect the change in the consumer price index. The income and net worth tests in new Section 4(6) are to be calculated in accordance with any rules of the SEC adopted for this purpose.

#### NEW SECTION 4A(a) OF THE SECURITIES ACT AND REQUIREMENTS APPLICABLE TO INTERMEDIARIES

Under new Section 4A(a), a person acting as an intermediary in a transaction exempt under new Section 4(6) must:

- Register with the SEC as a broker or a funding portal;
- Register with any applicable self-regulatory organization;
- Provide such disclosures, including disclosures relating to risks and other investor education materials, as the SEC by rule determines appropriate;
- Ensure that each investor:
  - reviews investor education information in accordance with standards established by the SEC by rule;
  - positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and
  - answers questions demonstrating an understanding of the level of risk generally applicable to investments in startups, emerging businesses and small issuers, the risk of illiquidity, and such other matters as the SEC by rule determines appropriate;
- Take measures to reduce the risk of fraud with respect to these transactions, as established by the SEC by rule, including obtaining a background check and securities enforcement regulatory history check on each officer, director and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person;
- Make available to the SEC and to potential investors, not later than 21 days prior to the first day on which securities are sold to any investor (or such other period as the SEC may establish), any information provided by the issuer pursuant to new Section 4A(b), as described below;

- Ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest, as the SEC by rule determines appropriate;
- Make such efforts as the SEC by rule determines appropriate to ensure that no investor in a 12-month period has purchased securities offered pursuant to new Section 4(6) that, in the aggregate, from all issuers, exceed the investment limits in that section;
- Take such steps to protect the privacy of information collected from investors as the SEC by rule determines appropriate;
- Not compensate promoters, finders or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor;
- Prohibit its directors, officers or partners from having any financial interest in an issuer using its services; and
- Meet such other requirements as the SEC by rule may prescribe for the protection of investors and in the public interest.

The SEC is to make, or cause to be made, available to the state securities commissioners, by the relevant broker or funding portal, the information described above, and such other information as the SEC by rule determines appropriate.

#### NEW SECTION 4A(b) OF THE SECURITIES ACT AND REQUIREMENTS APPLICABLE TO ISSUERS

Under new Section 4A(b), an issuer that offers or sells securities in a transaction exempt under new Section 4(6) must:

- File with the SEC and provide to investors and the relevant broker or funding portal and make available to potential investors:
  - the name, legal status, physical address and website address of the issuer;



- the names of the directors and officers and each person holding more than 20 percent of the shares of the issuer;
- a description of the business of the issuer and the anticipated business plan of the issuer;
- a description of the financial condition of the issuer, including, for offerings that have, together with all other offerings of the issuer under new Section 4(6) within the preceding 12-month period, aggregate target offering amounts of (i) \$100,000 or less, the income tax returns filed by the issuer for the most recently completed fiscal year and financial statements of the issuer, which are to be certified by the principal executive officer of the issuer to be true and complete in all material respects, (ii) more than \$100,000, but not more than \$500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the SEC by rule for such purpose; and (iii) more than \$500,000 (or such other amount as the SEC by rule may establish), audited financial statements;
- a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
- the target offering amount, the deadline to reach the target offering amount and regular updates regarding the progress of the issuer in meeting the target offering amount;
- the price to the public of the securities or the method for determining the price, provided that, prior to sale, each investor is provided in writing the final price and all required disclosures, with a reasonable opportunity to rescind the commitment to purchase the securities;
- a description of the ownership and capital structure of the issuer, including (i) the terms of the securities being offered and each other class of equity security of the issuer, including how such terms may be modified, and a summary of the differences between such securities, including 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, (ii) how the exercise of the rights held by the principal shareholders of the issuer could negatively impact the purchasers of the securities being offered, (iii) the name and ownership level of each existing shareholder who owns more than 20 percent of any class of the securities of the issuer, (iv) 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, including during subsequent corporate transactions and (v) the risks to purchasers of the securities related to minority ownership in the issuer, the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related persons; and
- such other information as the SEC by rule may prescribe for the protection of investors and in the public interest;
- Not advertise the terms of the offering, except for notices that direct investors to the funding portal or the broker;
- Not compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal without taking such steps as the SEC by rule requires to ensure that such person clearly discloses the past or prospective receipt of such compensation, upon each instance of such promotional communication;
- File with the SEC not less frequently than annually, and provide to investors, reports of the results of operations and financial statements of the issuer, as the SEC by rule determines appropriate, subject to such

- exceptions and termination dates as the SEC by rule may establish; and
- Comply with such other requirements as the SEC by rule may prescribe for the protection of investors and in the public interest.

The SEC is to make, or cause to be made, available to the state securities commissioners, by the relevant broker or funding portal, the information described above and such other information as the SEC by rule determines appropriate.

#### LIABILITY FOR MISSTATEMENTS AND OMISSIONS

Under new Section 4A(c), a person who purchases a security in an offering pursuant to the exemption provided by new Section 4(6) may bring an action against an issuer to recover the consideration paid for such security, with interest thereon, less the amount of any income received, if the issuer makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading. Similar to the liability provisions in Section 12(a)(2) of the Securities Act, a purchaser may only recover if the purchaser did not know of such untruth or omission and the issuer is not able to show that it did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.

For purposes of the new liability provision, an issuer includes any person who is a director or partner of the issuer and the principal executive officer, principal financial officer, and controller or principal accounting officer of an issuer and any person who offers or sells the security in a transaction exempted by new Section 4(6).

#### RESTRICTIONS ON RESALE

If securities are issued in a transaction described in new Section 4(6), a purchaser may not transfer such securities during the one-year period beginning on the date of purchase, except to:

- The issuer;

- An accredited investor;
- As part of an offering registered with the SEC; or
- A member of the family of the purchaser, or in connection with the death or divorce of the purchaser or similar circumstances, as determined by the SEC.

The SEC by rule may also establish other limitations on resales of securities purchased in transactions subject to new Section 4(6).

#### LIMITS ON AVAILABILITY OF NEW EXEMPTION

New Section 4(6) is not available for transactions involving the offer or sale of securities by any issuer that:

- Is not organized under and subject to the laws of a state or territory of the United States or the District of Columbia;
- Is required to file reports with the SEC pursuant to Section 13 or Section 15(d) of the Exchange Act;
- Is an investment company; or
- The SEC by rule or regulation excludes.

#### FUNDING PORTAL REGULATION

Section 3 of the Exchange Act has been revised to add subsection (h) requiring the SEC to adopt rules exempting, conditionally or unconditionally, a registered funding portal from the requirement to register as a broker or dealer, provided that such funding portal:

- Remains subject to the examination, enforcement and other rulemaking authority of the SEC;
- Is a member of a registered national securities association; and
- Is subject to such other requirements as the SEC determines appropriate.

New Section 3(h) defines “funding portal” to mean any person acting as an intermediary in a transaction involving the offer and sale of securities for the account of others solely

pursuant to new Section 4(6) of the Securities Act that does not:

- Offer investment advice or recommendations;
- Solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal;
- Compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- Hold, manage, possess or otherwise handle investor funds or securities; or
- Engage in such other activities as the SEC by rule determines.

In addition, the revisions allow a national securities association to examine a registered funding portal and enforce against a registered funding portal rules of the national securities association written specifically for registered funding portals.

No later than the end of 2012, the SEC is to issue rules to carry out funding portal regulation.

#### NON-EXCLUSIVE EXEMPTION

The exemption from registration provided by new Section 4(6) is not exclusive and does not prevent an issuer from relying on another exemption from registration in connection with the sales of other securities.

#### SEC RULEMAKING

No later than the end of 2012 the SEC is to issue such rules as may be necessary or appropriate for the protection of investors to carry out new Section 4(6) and new Section 4A of the Securities Act.

#### DISQUALIFICATION

No later than the end of 2012, the SEC by rule is to establish disqualification provisions under which an issuer is not eligible to offer securities pursuant to new Section 4(6) and a broker or funding portal is not eligible to effect or participate in transactions pursuant to new

Section 4(6). These disqualification provisions are to be substantially similar to the disqualification provisions of Rule 262 of Regulation A promulgated under the Securities Act. They should disqualify any offer or sale of securities by a person who:

- Is subject to a final order of a state securities commission, a state authority that supervises or examines banks, savings associations or credit unions, a state insurance commission, an appropriate federal banking agency or the National Credit Union Administration that (i) bars the person from association with an entity regulated by such commission, authority or agency, engaging in the business of securities, insurance or banking, or engaging in savings association or credit union activities; or (ii) that constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct within the 10-year period ending on the date of the filing of the offer or sale; or
- Has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security involving the making of any false filing with the SEC.

#### EXEMPTION FROM SECTION 12(G) OF THE EXCHANGE ACT

The JOBS Act adds new Section 12(g)(6) to the Exchange Act, which requires the SEC to exempt by rule, either conditionally or unconditionally from the registration requirements of Section 12(g) of the Exchange Act discussed above, securities acquired pursuant to an offering made under new Section 4(6) of the Securities Act.

#### PREEMPTION OF STATE LAW

Section 18(b)(4) of the Securities Act has been revised to include securities issued in new Section 4(6) offerings as covered securities. This prohibits states from requiring their registration or qualification.

Section 18(c)(1) of the Securities Act has been revised to clarify state jurisdiction over unlawful conduct of funding portals and issuers as it relates to fraud or deceit or unlawful conduct by a broker, dealer, funding portal or issuer in connection with a transaction under new Section 4(6).

Section 18(c)(2) has been revised to prohibit any filing or fee being required with respect to any security that is a covered security pursuant to Section 18(b)(4)(B), or that will be a covered security upon completion of the transaction, except for the requirements of the securities commission of the state of the principal place of business of the issuer, or any state in which purchasers of 50 percent or more of the aggregate amount of the issue reside.

Section 15(i) of the Exchange Act has been amended to prohibit any state or political subdivision thereof from enforcing any law, rule, regulation or other administrative action against a registered funding portal with respect to its business as a registered funding portal. This provision does not apply to the examination or enforcement of any law, rule, regulation or administrative action of a state or political subdivision thereof in which the principal place of business of a registered funding portal is located, provided that such law, rule, regulation or administrative action is not in addition to or different from the requirements for registered funding portals established by the SEC.

## SMALL COMPANY CAPITAL FORMATION

### NEW SMALL OFFERING EXEMPTION

Section 3(b) of the Securities Act has been amended by adding Section 3(b)(2) requiring the SEC to adopt rules and regulations adding to the securities exempted by Section 3 from the application of the Securities Act securities issued in accordance with the following terms and conditions:

- The aggregate offering amount of all securities offered and sold within the prior 12-month

period in reliance on the new exemption is not to exceed \$50 million;

- The securities may be offered and sold publicly;
- The securities will not be restricted securities;
- The civil liability provision in Section 12(a)(2) of the Securities Act will apply to any person offering or selling such securities;
- The issuer may solicit interest in the offering prior to filing any offering statement, on such terms and conditions as the SEC may prescribe in the public interest or for the protection of investors;
- The SEC is to require the issuer to file audited financial statements with the SEC annually; and
- Such other terms, conditions or requirements as the SEC may determine necessary in the public interest and for the protection of investors, which may include:
  - a requirement that the issuer prepare and electronically file with the SEC and distribute to prospective investors an offering statement, and any related documents, in such form and with such content as prescribed by the SEC, including audited financial statements, a description of the issuer’s business operations, its financial condition, its corporate governance principles, its use of investor funds and other appropriate matters; and
  - disqualification provisions under which the exemption will not be available to the issuer or its predecessors, affiliates, officers, directors, underwriters or other related persons, which are to be substantially similar to the disqualification provisions discussed above under “Crowdfunding”.

### SECURITIES TO BE ISSUED IN RELIANCE ON NEW EXEMPTION

The only securities that may be exempted under Section 3(b)(2) are equity securities, debt securities and debt securities convertible into or

exchangeable for equity interests, including any guarantees of such securities.

#### FILING PERIODIC DISCLOSURES WITH THE SEC

Upon any terms and conditions as the SEC determines necessary in the public interest and for the protection of investors, the SEC by rule or regulation may require an issuer of a class of securities exempted under new Section 3(b)(2) to make available to investors and file with the SEC periodic disclosures regarding the issuer, its business operations, its financial condition, its corporate governance principles, its use of investor funds and other appropriate matters and also may provide for the suspension and termination of such a requirement with respect to that issuer.

#### SEC REVIEW OF DOLLAR LIMITATION

Every two years the SEC is to review the offering amount limitation (initially \$50 million) and increase such amount as the SEC determines appropriate. If the SEC determines not to increase the dollar amount, it must report to Congress on its reasons for not increasing the amount.

#### PREEMPTION OF STATE LAW

Section 18(b)(4) of the Securities Act has also been revised to include securities issued in new Section 3(b)(2) offerings as covered securities and therefore prohibits states from requiring their registration or qualification, provided that the security is offered or sold on a national securities exchange or is offered or sold to qualified purchasers.

#### COMPTROLLER GENERAL STUDY

The Comptroller General is to conduct a study on the impact of state laws regulating securities offerings on offerings made under Regulation A. The study is to be presented to Congress no later than early July 2012.

## PRIVATE OFFERING EXEMPTIONS

#### REVISIONS TO REGULATION D TO PERMIT GENERAL SOLICITATION

No later than early July 2012, the SEC must revise Rule 506 of Regulation D promulgated under the Securities Act to provide that the prohibition against general solicitation or general advertising will not apply to offers and sales of securities made pursuant to Rule 506 if all purchasers of the securities are accredited investors. The SEC must also revise Rule 506 to require the issuer to take reasonable steps to verify that purchasers of the securities are accredited investors, using methods to be determined by the SEC.

#### REVISIONS TO RULE 144A TO PERMIT GENERAL SOLICITATION

No later than early July 2012, the SEC must revise Rule 144A(d)(1) to provide that securities sold under Rule 144A may be offered to persons other than QIBs, including by means of general solicitation or general advertising if the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe are QIBs.

#### AMENDMENT TO SECTION 4

Section 4 of the Securities Act has been revised to provide that offers and sales exempt under Rule 506 are not to be deemed public offerings under the federal securities laws as a result of general advertising or general solicitation.

Section 4 has been further revised to provide that, with respect to securities sold in compliance with Rule 506 of Regulation D, no person must register as a broker or dealer solely because:

- That person maintains a platform or mechanism that permits the offer, sale purchase or negotiation of or with respect to securities, or permits general solicitations, general advertisements or similar or related activities by issuers of such securities, whether online, in person or through any other means;

- That person or any person associated with that person co-invests in such securities; or
- That person or any person associated with that person provides ancillary services with respect to such securities.

The exemption from registration as a broker or dealer only applies if the person and each person associated with the person:

- Does not receive any compensation in connection with the purchase or sale of such security;
- Does not have possession of customer funds or securities in connection with the purchase or sale of such security; and
- Is not subject to a statutory disqualification described in the Securities Act.

For purposes of this provision, ancillary services means:

- The provision of due diligence services in connection with the offer, sale, purchase or negotiation of such security, so long as such services do not include, for separate compensation, investment advice or recommendations to issuers or investors; or
- The provision of standardized documents to the issuer and investors, so long as such person or entity does not negotiate the terms of the issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service.

## SEC OUTREACH

The SEC must provide online information and conduct outreach to inform small- and medium-size businesses, women-owned businesses, veteran-owned businesses and minority-owned businesses of the changes made by the JOBS Act.

## PRACTICAL CONSIDERATIONS

### EMERGING GROWTH COMPANIES

Emerging growth companies are permitted to both “test the waters” to determine whether certain investors might have an interest in a contemplated securities offering and to submit registration statements confidentially to the SEC for nonpublic review. However, confidential registration statements must be filed publicly at least 21 days before the date on which the issuer conducts a road show that constitutes an offering of securities. Because “testing the waters” is inconsistent with the new public filing deadlines for confidential submissions, issuers will not be able to do both at the same time. In practice, issuers will need to choose when and whether they want to test the waters and whether they want to submit a registration statement for confidential review by the SEC staff. It does not appear that persons who are not affiliated with the issuer but who are acting on behalf of the issuer are subject to the same limitations. As a result, investment bankers, for example, may be able to test the waters without issuer participation at the same time that an issuer has submitted a registration statement confidentially. However, before testing the water, issuers and persons acting on their behalf should make sure that their activities will be in compliance with then-current SEC guidance.

Rather than complying with the exemptions available to an emerging growth company, such a company can instead choose to comply with any or all of the requirements, other than financial accounting standards, applicable to nonemerging growth companies. With regard to financial accounting standards only, an emerging growth company must elect whether it wants to comply with the provisions applicable to nonemerging growth companies at the time it files its first report or registration statement with the SEC and notify the SEC of the election. It then cannot change its election for so long as it remains an emerging growth company. With regard to all

other provisions, it would appear that an emerging growth company can elect at any time whether to comply with some or all of the exemptions available to emerging growth companies and can change its election as many times as it desires. Emerging growth companies should discuss the available exemptions matter with all of its advisors to determine whether there are any adverse consequences, such as negative perception in the market place, to be considered.

An emerging growth company can elect to comply with the financial accounting standards applicable to all other public companies or the financial accounting standards in effect at the time it becomes a public company. Consequently, investors must carefully review the financial statements of an emerging growth company to determine what financial standards the company has elected to use and will have to determine on their own whether the financial statements have been prepared on a comparable basis with those of any other public company. In addition, it is unclear whether it will be obvious to investors which accounting standards are being used.

For an emerging growth company that went public after December 8, 2011, or that has already filed a registration statement with the SEC, the deadline may have passed for electing which set of financial accounting standards it will comply with as an emerging growth company. If the emerging growth company would like to change its standards, it should immediately begin a dialogue with the SEC staff to determine if this is possible and, if so, the method to make such election.

#### CROWDFUNDING

The new liability provisions and related defenses that can be raised by participants in crowdfunding offerings are similar to those contained in Section 12(a)(2) for registered offerings. Accordingly, participants in crowdfunding offerings should consider performing similar types of due diligence as they

would do if participating in an offering registered with the SEC in order to best avail themselves of the defenses provided by new Section 4A(c) of the Securities Act.

Based on the restrictions placed on crowdfunding by new Section 4A of the Securities Act, the new exemption may not be as appealing to potential issuers as initially hoped. However, depending on the rules ultimately adopted by the SEC in connection with the new small offering exemption, that new exemption may result in a much more appealing option to potential issuers as the maximum amount that can be raised is \$50 million and the securities are freely tradeable when purchased.

Securities purchased pursuant to the new crowdfunding exemption contained in new Section 4(6) of the Securities Act are not to be counted in determining whether the shareholder of record threshold is tripped for purposes of registration under Section 12(g) of the Exchange Act. However, it is unclear whether this result changes when a crowdfunding purchaser transfers those shares. It will be important for issuers engaging in crowdfunding offerings to monitor SEC rulemaking and interpretations in this regard to determine whether records must be maintained to track securities sold in crowdfunding offerings separately from securities sold in other offerings and securities initially sold in crowdfunding offerings that have been subsequently transferred. Similar tracking concerns and monitoring of SEC rulemaking are present in connection with securities sold in employee compensation plans exempted from the registration requirements of the Securities Act.

#### SMALL OFFERING EXEMPTION

All companies, including public companies, should monitor the SEC rulemaking process regarding the new small offering exemption as it may be a very efficient and cost effective way to raise up to \$50 million in the aggregate in any

12-month period through the sale of unrestricted debt or equity securities.

#### GENERAL SOLICITATION

Issuers engaging in private offerings in reliance on Rule 506 of Regulation D or Rule 144A will be able to engage in general solicitations and general advertising in connection with their offerings provided that the purchasers are either accredited investors or QIBs, as applicable. This could result in a significant change in practice for many issuers. However, until the SEC actually changes its rules, general solicitations and general advertising are still prohibited in connection with offerings made in reliance on Rule 506 of Regulation D or Rule 144A.

The SEC is directed to identify methods that issuers can use to verify the status of purchasers in offerings made pursuant to Rule 506 of Regulation D. All issuers should monitor this rulemaking process to determine whether changes will need to be made to existing verification procedures to comply with SEC rules. It is extremely important to implement SEC-compliant procedures to verify that all purchasers are qualified, as even one nonqualified purchaser will call the exemption into question.

#### EXCHANGE ACT REGISTRATION

As described in more detail above, the new requirement to register under the Exchange Act set forth in Section 12(g)(1)(A) is triggered when an issuer with \$10 million in assets has a class of equity security held of record by either 2,000 persons in total or 500 persons who are not accredited investors. Under these revised thresholds, an issuer will need to maintain records that specify whether or not its holders of record are accredited investors. At a minimum, it should obtain representations from investors at the time of initial investment, such as through a subscription agreement or shareholders agreement, and a commitment from the investor to update the issuer if its status changes or upon

request of the issuer. In addition, any transfer of securities could be conditioned upon the transferee making the same commitments.

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**Endnotes**

<sup>1</sup> Available at <http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606enr/pdf/BILLS-112hr3606enr.pdf>.

<sup>2</sup> Rule 12b-2 promulgated under the Exchange Act defines a “large accelerated filer” as a company that has: (i) an aggregate worldwide market value of the voting and nonvoting common equity by its nonaffiliates of \$700 million or more, (ii) been subject to the reporting requirements of the Exchange Act for at least 12 months, and (iii) filed at least one annual report pursuant to the requirements of the Exchange Act.

<sup>3</sup> See, e.g., [www.techopedia.com](http://www.techopedia.com).

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ROCKETHUB

IMPLEMENTATION OF CROWDFUNDING

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BUILDING ON TITLE III OF THE JOBS ACT

WHITEPAPER 2.0

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## **Introduction**

In the months since the publication of RocketHub’s initial whitepaper, RocketHub has received numerous requests to comment on crowdfunding practices and the implementation of the JOBS Act. This whitepaper elaborates on opinions expressed in RocketHub’s first whitepaper, “Regulation Of Crowdfunding: Building On The Jumpstart Our Business Startups Act” (publicly available at <http://www.sec.gov/comments/jobstitle-iii/jobstitleiii-39.pdf>), and addresses additional topics.

Understanding the spirit of the Act and its intent to revitalize the US economy, encourage job creation, and foster domestic innovation, we discuss:

- Investor protection rules and suggested practices;
- Security purchase mechanics; and
- Potential Portal practices.

## **Key Industry Drivers**

Crowdfunding has thrived under the perks-based system because it provides a low-cost fundraising method. In part, this is due to the lack of upfront expenses. This low barrier to entry has encouraged many individuals to attempt crowdfunding campaigns, without risking the negative financial impact of an unsuccessful raise. While adopting investor protections, the Commission must also consider the perspective of the issuer, and understand that providing additional documents, or submitting to robust background checks will result in considerable upfront expenses being born by the issuer. When that figure becomes financially unattractive, many viable businesses will opt out of attempting a crowdfunding campaign, defeating the legislative intent of the JOBS Act.

Crowdfunding Portals (a “funding portal” as defined in Section 304 of the JOBS Act) are able to operate efficiently because they are web-based. The Commission must also recognize that funding Portals differ from large brokerage houses in that they may or may not have any direct contact with issuers or investors off-line. Therefore, required disclosure documents, including but not limited to company financial statements, business plans, financial projections, issuer background check results, etc., must be easily deliverable via digital delivery methods in a standardized format.

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## IMPLEMENTATION OF INVESTOR RISK REDUCTION

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### Sources of Investor Risk

When investing in a company via a crowdfunding Portal, investors face three broad categories of risk:

1. Underperformance of the issuer's endeavor;
2. Misrepresentation or fraud by the issuer; and
3. Investor misunderstanding of the nature and risks of the investment.

While issuer fraud is the least likely risk to investors, the media has fixated on the possibility that criminals may create fraudulent issuances, and attempt to bilk the new investor class. We believe the risk of loss due to underperformance of a legitimate start-up or small business far outweighs the likelihood of loss due to fraud or omission.

The JOBS Act specifically addresses methods for reducing these risks to investors. They include:

1. Annual investment limits on the dollar amount investors are permitted to commit;
2. Investor education;
3. Mandated issuer disclosures; and
4. Issuer background checks.

While some commentators have called for additional anti-fraud protections, we believe these will generally add to the upfront expense of crowdfunding and will not provide sufficient benefits. The costs of these measures would largely be borne by legitimate issuers, not by the few disreputable individuals the regulation would be targeted to exclude. Instead we advocate that risk reduction rely on the power of the Internet to inform and provide feedback.

### Annual Investment Limits

The JOBS Act reduces investor risk, by limiting the amount that an investor may put at risk. This type of limitation, on an individual's decision on how much to invest in an enterprise, is, at the very least, paternalistic, and not the type of restriction that we believe should guide future regulation of the crowdfunding industry.

The Act imposes the restriction in two ways, as a limit on sales by an issuer to an investor, and then again as an aggregate limit (with the same dollar cap) on an investor's purchases from all crowdfunding issuers. As a practical matter, these standards raise substantial difficulties and may not be possible to achieve absent reliance on investor representations. As a legal requirement, we expect that Portals will need to show that each investor is unique, and that each investor is investing within the investor's permitted limit.

*Portals must be able to establish that each investor using the Portal is unique.* Otherwise, an investor could set up multiple accounts to fund one or more issuers on the Portal.<sup>1</sup> Were an investor able to establish multiple accounts with a single crowdfunding Portal, either intentionally or accidentally, the investor could circumvent the Portal's efforts to enforce annual investment caps. Therefore, when registering with the Portal, we believe each investor should be required to supply the following information:

1. Full legal name
2. Social Security Number (SSN)
3. Date of birth
4. Full mailing address

The Portal can crosscheck this data against public and/or private databases to confirm the individual's identity. Access to these databases often comes at a cost per inquiry, which may be passed along to the user as a registration fee, or covered by the Portal, and reclaimed as an increased fee to a successful issuer. Given the economics of crowdfunding, this cost eventually decreases the net proceeds raised by the issuer, impacting both issuer and investor pool.

While these methods should enable Portal operators to monitor account compliance on their Portal, these methods do not address an investor who seeks to open accounts on multiple Portals. We do not believe that Portals can, or should, be asked to police this aspect of investor behavior.<sup>2</sup>

The risk of requiring Portals to cross-check accounts with other Portals<sup>3</sup> greatly outweighs any benefits. Those risks include:

- Information exposure in transit:
  - Bad actors may intercept data in transit. If exposed, it would be impossible to ascertain how far the sensitive information has spread. The increased transmission rate of this data between Portals may significantly increase the risk of identity theft;
- Information exposure in storage:
  - Each platform will have different security standards and protocols. If bad actors are able to penetrate the security measures of one Portal, the data of all connected funding Portals could be compromised;
- Privacy concerns, including encouraging intrusive behavior from funding Portals; and
- Competiveness and anti-trust concerns that may arise where competitors are regularly required to share data.

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<sup>1</sup> The risk of one investor setting up multiple accounts to fund a single issuer may be more apparent than real, however, as an investor with interest and sufficient funds could contact an issuer directly and make a legal, private investment utilizing other securities laws means.

<sup>2</sup> It is unclear how prevalent this behavior would be.

<sup>3</sup> The SEC would need to define the universe of Portals, the personal data to be cross-checked and the method and protocol of communication.

In order to effectively and securely share information directly between platforms, the Commission would have to establish a new open standard for data interoperability. The IJIS Institute 2009 report for the U.S. Department of Justice on data interoperability states that there is “no question that governance issues are the most challenging part of implementing data interoperability, especially if the data needs to be shared across both jurisdictional and discipline boundaries. The critical first step is to put in place a governance group of agency decision makers, as they will have the necessary ‘clout’ to achieve the desired results... This stage of the process can be frustrating and time consuming, but it must be completed effectively.”<sup>4</sup> Creating a new open standard to share information would be an exceptionally costly process that would burden funding Portals, Self Regulatory Organization (SROs), and the Commission, as all parties would have to be involved in the governance and technology development process.

However, if the Commission were to mandate that funding Portals send information into a central database, either the SRO or the Commission itself would be tasked with the responsibility of developing and maintaining a cloud based repository to store this confidential information.

Neither FINRA nor the Commission currently has systems in place to undertake this responsibility. Therefore significant development costs would be required to establish this secure central database. Furthermore, maintenance of a large central database is exceptionally costly due to constant security concerns, and skilled staffing requirements. These expenses will drive up transactional costs. The Commission should recognize that providing this level of investor activity oversight would be unnecessary, costly, and overly complex. As a result, Portals must only be required to police their own platforms, and must be permitted to rely on representations from the investor. The Portal cannot be held liable for intentional deceptions by an investor.

We believe the only practical solution is investor self-certification. The investor should affirm that it is investing within the applicable limits, and face liability if the investor is seeking to violate the law.

***Portals must establish an investor’s permitted investment limit.***

The JOBS Act sets two tiers of potential investment by investors. If an investor’s annual income or net worth is less than \$100,000, the investor may invest the greater of \$2,000 or 5% of such amount each year. If the investor’s annual income or net worth is \$100,000 or more, the investor may invest up to 10% of the investor’s annual income or net worth up to a maximum of \$100,000. This requirement imposes significant additional challenges for Portals. Keep in mind that crowdfunding relies on a large number of small investors. Therefore, Portals must be able to uniquely identify each investor and establish an appropriate account for each investor at a low-cost. Otherwise, too much of the investor’s or issuer’s funds will go towards administration and legal compliance.

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<sup>4</sup> [http://www.ijis.org/docs/Guide\\_Info\\_Sharing\\_Data%20Interoperability\\_Local\\_Comm\\_Ctrs\\_FINAL.pdf](http://www.ijis.org/docs/Guide_Info_Sharing_Data%20Interoperability_Local_Comm_Ctrs_FINAL.pdf)



As a practical matter, there are only a few ways to confirm an investor's annual income and none of them are low-cost or quick. While the Internal Revenue Service's Income Verification Express Service would allow Portals to compare an investor's stated income with official records, it does not allow for instantaneous or easily processed/interpreted results. Results are "generally" delivered within two business days, and could be cost prohibitive.<sup>5</sup> Furthermore, crowdfunding offerings are inherently time sensitive. Any delay in investor account approval could cost the investor the opportunity to participate in the offering. Since we believe most individual investors are likely to participate in a crowdfunding offering because they have a connection with a specific issuer, and not as a result of seeking asset diversification through exposure to crowdfunding, a delay or difficulty in opening an account is likely to cause them not to participate in crowdfunding at all. One compliance method that has been suggested is to require a Portal to review an issuer's Form W-2 or pay stubs. Requiring an investor to submit copies of original documents, however, again raises privacy concerns and would require that someone at the Portal manually confirm the information, which significantly increases time and costs to the Portal (and thus to the issuer). This also raises the specter of investors falsifying documents, or Portals misinterpreting the results of submitted documents.

Establishing an investor's net worth is not currently practical. There is no third-party resource that Portals have access to which would permit them to accurately judge an investor's net worth. Portals could ask investors to provide documentation of assets and liabilities, but again, this process would impose significant administrative costs on the Portal; costs that are disproportionate to the amounts generally expected to be invested through crowdfunding. It is a mistake to regulate a crowdfunding account, which is likely to be small and be used for only a few investments, in the same manner as a brokerage account that may be orders of magnitude larger.

To resolve these issues, we believe that Portals should be able to rely on self-certification by investors. Portals can ask investors to submit information electronically, have the investor affirm the accuracy of the statement and then calculate the appropriate investment limit. Disclosure of the reason behind these limits (i.e., the risk of losing the investment) will help investors understand the reason to stay within the limits.

The risk of not being able to rely on self-certification is that Portals may simply find it impractical to allow investor accounts where the investor seeks to invest more than \$2,000. This *de facto* limitation would defeat Congress's intent in passing the JOBS Act.

### **Investor Education**

The JOBS Act provides a mechanism for low-cost, small dollar capital raises. These raises will permit participation by investors seeking to invest small amounts, which allows issuers to engage a new class of investor. Some of these investors will be unfamiliar with the mechanics of investing in ventures of this type. Therefore, the

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<sup>5</sup> <http://www.irs.gov/Individuals/Income-Verification-Express-Service>.

educational materials provided by the funding Portal are critical in protecting and informing investors.

### *Disclosure by Portals*

Under Section 302(b) of the JOBS Act, Portals are required to, “provide such disclosures, including disclosures related to risks and other investor education materials as the Commission shall, . . . determine appropriate.”

In addition, the JOBS Act specifically requires Portals to:

- (4) ensure that each investor—
  - (A) reviews investor-education information, in accordance with standards established by the Commission, by rule;
  - (B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and
  - (C) answers questions demonstrating
    - (i) an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers;
    - (ii) an understanding of the risk of illiquidity; and
    - (iii) an understanding of such other matters as the Commission determines appropriate, by rule;

To implement these requirements, investors should be made aware of the following information before making an investment:

1. 100% of the funds invested are at risk because the business may fail;
2. Even if the business is “successful,” the investor may never get any money back because either:
  - a. The business never becomes successful enough, or
  - b. If investor payout (or other structure) is not guaranteed, management may decide there are better uses for the funds;
3. The investor may not have any say in how the business is run; and
4. The investor may not be able to sell his/her stake in the business either because
  - a. No one wants to buy, or
  - b. It may be difficult to find a willing purchaser, or
  - c. It may be difficult to transfer.

Investors should be required to acknowledge these risks before “clicking through” to make an investment. To take advantage of the web-based nature of funding Portals, the Commission should allow for both time tested, and new delivery methods for educational content. Those methods could include, but are not be limited to text, audio, pictures, video, and live seminars. All efforts should also be made to maximize engagement while presenting the educational content, and minimize the volume of required lessons. RocketHub intends to use interactive text and images, time tracking, click tracking, and live webinars to make the material easy to understand and retain.

In order to meet the Acts' standard of "ensure," at the close of an educational module, perspective investors should be required to answer questions that demonstrate their understanding of the risks involved. Any questions that are specifically required by the Commission should be presented in plain English. The Commission should provide guidance on what "ensure" requires in this context.

### *Disclosure by Issuers*

The Act also requires an issuer to disclose information to prospective investors regarding the company's financial condition and performance. This is an important investor protection, as it provides the investor with information about the company that is generally unavailable to the public. As a practical matter, we expect that much of the required disclosure will be provided by the issuer through the Portal and in a format mandated by the Portal.

Crowdfunding will attract many smaller issuers who do not have experience with capital markets or the specifics of the JOBS Act. These issuers may not have legal representation. As a result, they will look to the Portals for guidance in preparing certain required disclosures.

This makes sense, and has some positive impacts as the Portal will want standardized disclosure relating to pricing, offering periods, and withdrawal rights. Additionally, Portals will want to limit the variety of corporate forms and will want to require issuers to prepare a package of shareholder rights. This will provide greater comfort to investors by providing uniformity allowing comparability as well as aiding in transparency of disclosure.

Issuers are, however, subject to liability for misstatements and omissions. This liability can keep issuers honest, but it can also deter issuers from seeking to raise funds in the first place. Issuers with limited capital raising experience may be scared off by the threat of securities litigation. As a result, the Commission, in implementing these rules, must provide standards, including a safe harbor, that are attainable by inexperienced and unrepresented issuers and that results in plain English disclosure of general risks to investors. No risk disclosure can cover every possible risk, and requiring issuers to draft complex and highly specific risk disclosure will add significant cost to fundraising. Given the nature of start-ups and small businesses, investors need to appreciate that all such ventures are high-risk, and that they will have limited ability to control the issuer or to exit the investment. Requiring a specific analysis of why a particular business may not succeed misses the forest for the trees.

The Act also requires disclosure of specified financial information. While we feel the triggering dollar thresholds are too low and the cost of preparation of this information is too high, the requirements have the advantage of being easily understood.

## SEC.302(b)/SEC4A.(b)(1)(D) – FINANCIAL CONDITION OF ISSUER

(D) a description of the financial condition of the issuer, including, for offerings that, together with all other offerings of the issuer under section 4(6) within the preceding 12-month period, have, in the aggregate, target offering amounts of—

(i) \$100,000 or less—

(I) the income tax returns filed by the issuer for the most recently completed year (if any); and

(II) financial statements of the issuer, which shall be certified by the principal executive officer of the issuer to be true and complete in all material respects;

(ii) more than \$100,000, but not more than \$500,000, financial statements reviewed by a public accountant who is independent of the issuer, using professional standards and procedures for such review or standards and procedures established by the Commission, by rule, for such purpose; and

(iii) more than \$500,000 (or such other amount as the Commission may establish by rule), audited financial statements;

RocketHub recommends the Commission permits issuers to digitally enter the data from their original documents, instead of submitting digital scans. This will protect the issuers from accidental disclosure of confidential information, and will allow investors to view the information in a structured and consistent manner. For example, if each issuer were to upload their version of a financial statement, the responsibility of learning to understand each format would fall to the investor. Standardized formats for financial projections, financial statements, and business plans will allow investors to quickly compare issuances and more readily evaluate investment opportunities.

### **Issuer Background Checks**

The Act specifically requires issuers to undergo background and securities enforcement regulatory history checks. But, it also allows for the Commission to add additional requirements as it sees fit.

## SEC.302(b)/SEC4A.(a)(5) – ISSUER BACKGROUND CHECKS

(5) take such measures to reduce the risk of fraud with respect to such transactions, as established by the Commission, by rule, including obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such person;

As a matter of policy, any and all required background checks should follow guidelines outlined by the Fair Credit Reporting Act (FCRA)<sup>6</sup> and the Equal Employment Opportunity Commission (EEOC).<sup>7</sup> Furthermore, the Commission must clearly define whether, or under what circumstances, the results of such checks need to be made public or should prevent an issuer from utilizing crowdfunding. The Commission's guidance should encompass the results of improved and more comprehensive databases in the future. At a minimum the Commission must offer answers to the following questions:

1. Which databases, if any, must be queried for records in the issuer's name?
2. If a record is found, what specific infraction or information will require exclusion?
3. If a record is found, but exclusion is not required, what specific information must be disclosed to prospective investors?

RocketHub encourages the Commission to note that accessing 3<sup>rd</sup> party databases comes at a cost, which in most instances will be passed on to the users in some fashion (both investor and issuer). In order to uphold the spirit of the Act, it is imperative to keep friction-based costs such as these as low as possible.

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<sup>6</sup> <http://www.ftc.gov/os/statutes/031224fcra.pdf>

<sup>7</sup> <http://www.eeoc.gov/>

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## SECURITIES PURCHASE MECHANICS

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### **The Continuing Role of the Crowdfunding Portal**

Once an issuer has provided appropriate disclosure, lawfully attracted investors, and priced the sale of securities, a new set of challenges arise. These challenges originate in the restrictions placed on crowdfunding Portals and the potential obstacles they place on the Portal's ability to play a ministerial role in aiding issuers.

As most crowdfunding issuers will have little experience with securities sales, it will benefit the issuers and the investors if the Portal assists the issuer in:

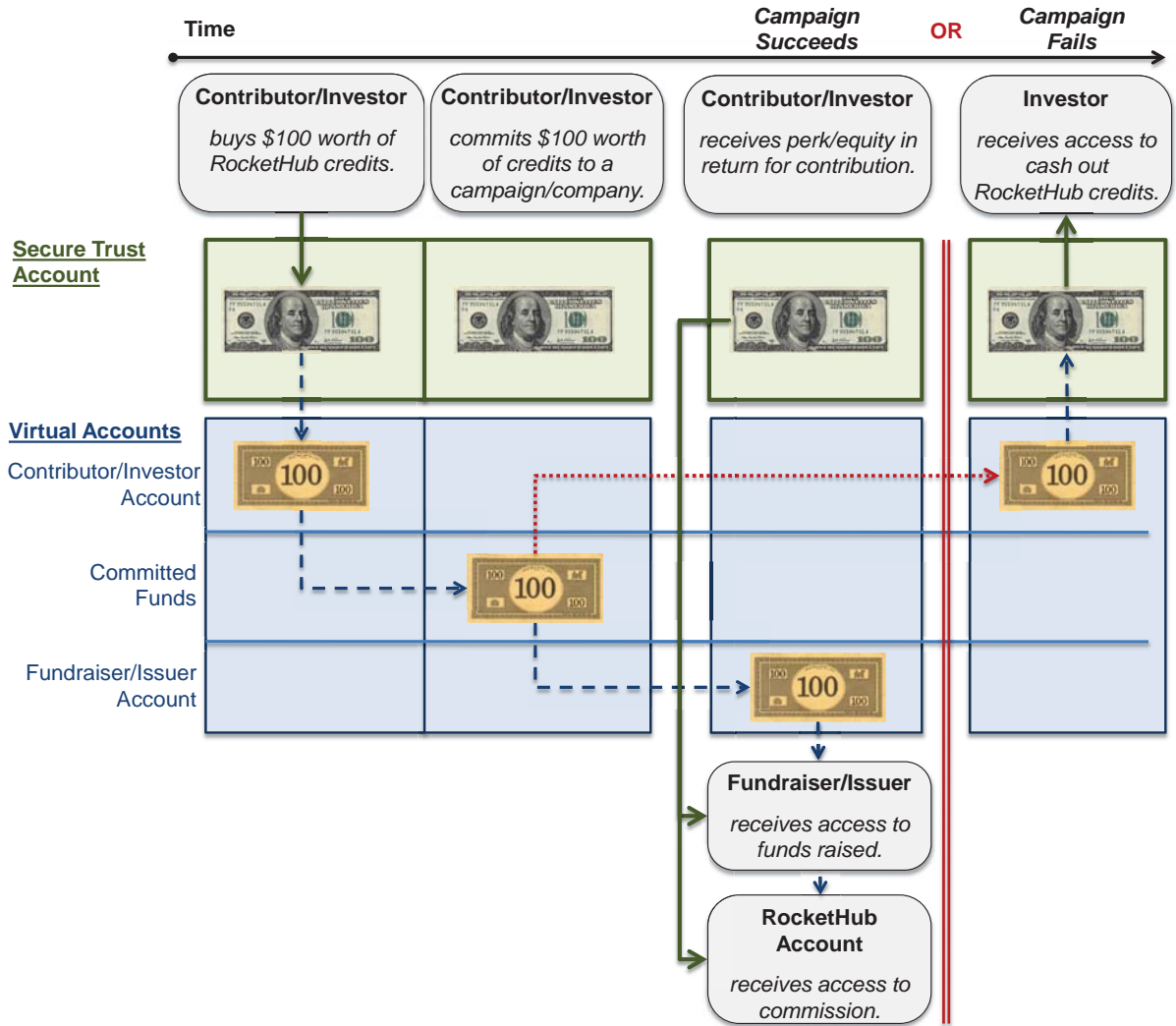
- Collecting and transferring funds from investor accounts to the issuer;
- Keeping a record of investors, amounts invested and securities purchased for the issuer; and
- Transferring evidence of investment, such as a stock certificate, to the investor.

Given the web-based nature of crowdfunding Portals, issuers and investors will expect that these services be provided for a low-cost and delivered electronically. Portals will naturally be in the best position to provide these services, as they will have collected the information in connection with the securities sale.

While Portals could allow issuers to transfer the information over to a third-party provider, or perform these tasks themselves, we believe that allowing the Portal to provide these services will reduce cost to the issuer and investor, while also improving transparency and decreasing investor risk.

### **Processing of Investor Funds**

In its first whitepaper, RocketHub offers a brief overview of its accounting methodologies, and policies pertaining to the processing of users' funds. RocketHub operates on a virtual currency system that allows contributors to purchase RocketHub credits. Those credits are then allocated to support a particular campaign. RocketHub does not handle user funds. When credits are purchased, user funds are maintained in a segregated account throughout the life of those credits. All user activity is registered through movement of virtual currency. RocketHub's ledger states how many credits of virtual currency each user has purchased, or has available, and how they have committed those credits. If a user has a balance of uncommitted credits, they are entitled to a full refund of the value of those credits. Figure 1 is a visual representation of the flow of money on RocketHub's platform.



**Figure 1**

RocketHub suggests extending this methodology to the equity crowdfunding model established under the JOBS Act. Throughout the life of a campaign, funds are maintained in a segregated trust account to prevent the “co-mingling” of RocketHub funds with user funds. They remain untouched until the campaign ends, at which point the investor is either committed, or receives a credit to his/her account balance with the option to withdraw funds. RocketHub believes this system provides full oversight on flow of funds while providing a high-level of security for the issuer, investor, and Portal. Furthermore, the investor has the flexibility to allocate funds as they see fit, and withdraw funds when they deem necessary.

This system is a prime example of the proper handling of capital, in a manner compliant with the JOBS Act, and concerns reflected by the Commission during recent discussions. RocketHub’s proposed system has tax compliance, OFAC, AML, Anti-Terror, Anti-Narcotics compliance, as well as money handling compliance as broken down below.

### Tax Compliance

All individuals receiving funds from RocketHub’s platform will be required to fill out (and digitally sign) digital versions of tax forms as part of their self-registration with RocketHub. For RocketHub’s US based users, a W-9 (Request for Taxpayer Identification Number and Certification) will be required. For Non-US entities, RocketHub will require a declaration from the entities stating that they are not a “US Person” as per the Internal Revenue Services (the “IRS”) definitions.

### OFAC, AML, Anti-Terror, Anti-Narcotics Compliance

Before a payout is made to a user, RocketHub will automatically crosscheck payee identities against lists of restricted individuals and entities. This will occur before each and every payout cycle. RocketHub leverages a 3<sup>rd</sup> party database that is updated weekly with the latest information as published by the US Treasury Department's Office of Foreign Assets Control<sup>8</sup> (OFAC) in its SDN (Specially Designated Nationals) List.<sup>9</sup>

### Money Handling Compliance

RocketHub has a single bank account used to fund all payments to all payees. In partnership with a major bank and a PCI<sup>10</sup> compliant 3<sup>rd</sup> party, RocketHub has relinquished control of the account to the unaffiliated 3<sup>rd</sup> party. RocketHub is an owner of the account in writing only, but has no formal rights or ability to access the funds directly. RocketHub has outsourced the mechanics of the pay-out process while maintaining complete control over payment frequency, payment methods, and cost to payees. This system allows RocketHub to reduce costs well below those associated with traditional escrow accounts, pass the savings on to the user, and maintain the same level of protection in handling funds associated with traditional escrow accounts.

RocketHub believes this accounting methodology should be permitted under the new JOBS Act regulation – as it provides significant cost savings to Portals and users, increased transparency in money-flow, as well as sophisticated reporting to government agencies.

## **Holding and Transferring Securities**

The JOBS act does not explicitly cover the practical issuance, and transfer of securities at the end of a successful crowdfunding campaign, however per SEC.304(b)/Sec3(a)(80)(D), Portals are restricted from certain activities.

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<sup>8</sup> <http://www.treasury.gov/ofac/>

<sup>9</sup> <http://www.treasury.gov/sdn>

<sup>10</sup> The Payment Card Industry Security Standards Council was founded in 2006 by American Express, Discover Financial Services, JCB International, MasterCard Worldwide, and Visa.  
<https://www.pcisecuritystandards.org/>



## SEC.304(b)/SEC3(a)(80)(D) – FUNDING PORTALS

(80) FUNDING PORTAL.—The term ‘funding portal’ means any 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(6) of the Securities Act of 1933 (15 U.S.C.77d(6)), that does not—

**(D) hold, manage, possess, or otherwise handle investor funds or securities;**

We believe Portals can comply with these limitations, while assisting issuers in allocating and transferring their securities to investors.

Investors have three choices when holding their securities:

1. Physical certificate
2. “Street name” registration
3. “Direct” registration

Physical certificates are simply that. A piece of paper that is the actual security. Ownership is evidenced by possession. That is the most basic method of allowing investors evidence of their ownership. The issuer and investors should retain the right to prepare and distribute physical certificates, however we believe that the time and cost involved, as well as the resulting lack of standardization (and lack of expertise that most issuers would have in this task), will make this an undesirable option for most issuers, and that most investors would prefer to have the convenience of an electronic system hosted by the Portal.

Under street name registration, the security is registered in the name of the brokerage firm on the books of the issuer; the brokerage firm holds the security in book-entry form. RocketHub believes that street name registration, when handled by Portals would be highly effective and low cost. However, this form of registration is currently only available to broker/dealers as this registration would require Portals to hold securities.

Portals should be able to facilitate issuance via a Direct Registration System (DRS). Under a DRS, the security is registered in the investor’s name on the issuer’s books, and the Portal tracks the security for the investor as a book-entry. Since the issuer controls this system, RocketHub believes this method allows the Portal to facilitate the registration and transfer of securities, without holding, managing, or possessing the securities. RocketHub believes the Commission should provide guidance on this issue.

The DRS will allow Portals to assist issuers with management of investor contact information, and by forwarding or posting on its website any correspondence from the issuer to the investor, including the annual reports discussed in SEC.302(b)/SEC4A.(b)(4). This also allows for oversight when the issuer is disseminating pertinent information to the investors.

The DRS will simplify transfer restriction enforcement under SEC.302(b)/SEC4A.(e)(1). Since the Portal holds a record of securities owned by investors, upon request by the issuer the Portal is able to print and provide paper certificates with transfer restrictions clearly visible.

RocketHub requests that statements of ownership, periodic account statements, dividends, annual reports, proxies, and other mailings are allowed to be distributed in digital format, either directly from the issuer, or from the Portal at the issuer's request. Furthermore, the issuer should be allowed to deposit the dividends owed to an investor into the investor's account with the Portal. Doing so will allow issuers to avoid many of the administrative tasks associated with issuing communication and dividend payments to large investor pools.

It is important to note, the Portal should be restricted to recording securities purchased on the Portal, or securities transferred from one Portal to another. Portals should not be permitted to act as a full-fledged brokerage firm or transfer agent, as that would violate SEC.304(b)/SEC3(a)(80).

The Commission should recognize that crowdfunding platforms are capable of providing additional services that are necessary and beneficial to issuers and investors. Portals should be permitted to assist issuers with ministerial corporate duties and by keeping corporate stock ledgers. The Commission should consider the efficiencies of having the Portal provide those services, and should not restrict the Portal as a service provider.

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## POTENTIAL PORTAL PRACTICES

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### Portal Participation in Offerings

The Act specifically bars the principals of a funding Portal from establishing a financial interest in the success of the issuance, but the Act does not address the possibility of the Portal itself investing in the campaign.

#### SEC.302(b)/SEC4A.(a)(11) – INTERMEDIARY’S FINANCIAL INTEREST IN ISSUER

(11) prohibit its directors, officers, or partners (or any person occupying a similar status or performing a similar function) from having any financial interest in issuer using its services...

The issue of Portal participation in offerings becomes complex because the Portal’s action of investing in a particular offering could be viewed as an endorsement constituting investment advice. Additionally, this raises a possible abuse by the Portal, where it would not invest unless the issuer provides specific deal terms or favored treatment for the Portal.

This practice also risks accelerating commitment of investor capital, by advancing offerings to the 100% mark without true market commitment by crowdfunding investors, if the Portal is investing in the crowdfunded offering instead of pursuant to another exemption. This creates an artificial acceleration of the money supply on the Portal system at the expense of investor protection, by short-circuiting the investor protection provided by a large number of investors having adequate time to discuss the investment opportunity. In the situation of crowd-funded debt-based products, which RocketHub believes to be one of the riskiest forms of capital available, Portals would in effect be turned into banks that are padding their own capital expenditures with outside investor capital by leveraging the JOBS Act regulation framework. This behavior should not be permitted.

If the Commission permits Portals to participate in offerings, this participation should only be allowed after the campaign reaches 100% of its funding target. The Portal may only participate by investing between the funding target, and the funding cap. Thereby the campaign will have achieved success by crowd action, without the influence of the Portal.

The Portal could also take equity in the issuer as part of its commission. While this scenario avoids the “acceleration” risk, it may raise disclosure risks if the Portal’s equity is not issued on the same terms as crowdfunding investors. The Portal should disclose whether its fees will be paid with equity, the dilutive impact of such payment on investors and any special rights the Portal will receive, before investors make an investment

decision. The Commission should clarify that the receipt of equity as payment of a Portal's commission is not "investment advice," while also requiring disclosure of any transaction between the Portal and the issuer.

### **Selective Offerings**

Crowdfunding is community based. Entrepreneurs reach out to members of their family and their web-based connections to crowdfund projects. It is this pre-existing connection to an entrepreneur or project that RocketHub believes will drive most participation in crowdfunding. One issue that may arise is where an entrepreneur does not want to offer interests to people outside of a select group (such as family members, neighbors or participants in an on-line community). RocketHub believes that Portals can provide this service in compliance with applicable laws. Portals should be able to offer entrepreneurs the ability to "hide" their offering from the public. Only invitees from the issuer would have the opportunity to invest. This would allow an entrepreneur to use the Portal's mechanisms and compliance, while retaining control over their offering. These offerings would have a more difficult time reaching their goals, as their promotion would, of necessity, be more limited. A Portal's decision whether or not to offer this service, should be in the Portal's discretion.

Conversely, a Portal should not distinguish between investors in any offering openly promoted on the Portal's website. This type of practice could enmesh a Portal in discriminatory behavior and cause the Portal to be viewed as partial with respect to certain offerings.

Additionally, crowdfunding issuers should be able to insert a "call" right in their constituent documents, which would allow the issuer to repurchase all, or a portion, of shares issued. This mechanism may be a needed safety valve for issuers who find that they cannot work with certain of their new investors. Any such right would need to be appropriately disclosed to investors.

### **Credit Card Payment vs. Secure Funding Method**

Credit cards are debt vehicles. Payments via credit card are effectively high interest, short-term loans. While payment via credit card may be convenient, it exposes the investor, issuer, and Portal to unnecessary risks and the possibility of substantial complications. Credit cards are notoriously vulnerable to fraudulent transactions, and additional complications could include:

1. Investor default on credit card debt; and
2. Investor chargebacks

If an investor were to purchase securities with a credit card, then default on the debt, ownership of the securities may potentially be transferred to the credit card company. Furthermore, credit card companies allow cardholders to dispute charges (i.e. issue chargebacks) up to six months after a transaction is completed, with as little justification

as the charge is “not recognized” by the cardholder. This would allow for an investor to rescind payment for securities well after the securities had been issued. Banks often issue credit card chargebacks without truly investigating the merits behind the claim. These factors expose the investor, the issuer and the Portal to unnecessary risk.

Many other payment systems exist that are more suitable than credit cards to the requirements of crowdfunding Portals. ACH is an example of one of them. The Automated Clearing House network (ACH) provides a secure payment method. ACH provides a transaction system with real liquid capital, from actual bank accounts, owned by bank verified individuals. Furthermore, ACH rules and regulations prevent any financial institution from issuing an ACH transaction towards an account without prior authorization from the account holder, and ACH already has an established electronic authorization system in place. ACH’s chargeback policy still protect consumers from debits that occur without permission, but it also protects businesses from “buyer’s remorse” as long as the business can provide proper documentation of the debit authorization.

If the Commission permits Portals and issuers to accept credit card payments, the Commission should provide clear guidance on how Portals and issuers should handle disallowed or fraudulent charges.

### **Portal Sponsored Grants/Contests**

The Act specifically prohibits Portals from offering investment advice. As such Portals should clearly refrain from issuing reports or performing analyses concerning securities. Portals that hold contests providing prizes or proclaiming winners are in effect performing an analysis. If the Portal compensates any of the judges, we believe the Portal is providing prohibited investment advice. Therefore, a Portal should not be allowed to host the crowdfunding campaign of any business that has participated in a contest/competition organized by, or associated with, that Portal.

RocketHub believes that contests hosted by Portals will lead to:

1. Confusion by investors;
2. Interpretation of the company’s status as “winner”, “finalist”, “entrant” or “non-winner”, as investment advice; and
3. Abusive practices by Portals and issuers that deceive investors into believing that the endorsed campaign is less risky or an appropriate investment.

When the investment advice has been organized and solicited by the platform, a clear conflict of interest arises. On the other hand, third-party advertisers should be permitted to sponsor contests on the Portal. These third-party advertisers are not “Portals” under the JOBS Act and should not be regulated as such. We do not believe the same risks of confusion of the Portal’s role are present in contests sponsored by unaffiliated third-parties.

The Commissioners should keep the spirit of the legislation in mind when clarifying this topic, and consider what crowdfunding is today when crafting these regulations. RocketHub believes that in order for crowdfunding to flourish, funding Portals must be allowed to:

- Feature trending campaigns, as all currently existing crowdfunding platforms do on their homepages, blogs, newsletters and other promotional material;
- Present a list of all, or a subsection of, campaigns; and
- Order that list of campaigns based on specific objective metrics, including
  1. Percentage funded;
  2. Total dollars raised;
  3. Time remaining;
  4. Date launched; and
  5. Activity.

A disclaimer stating that a campaign’s status as “featured” should not be construed as investment advice, or any indication as to the likelihood of future investment performance, should allow for both automated, and discretionary featured placement.

### **White Label Equity-Based Crowdfunding Platforms**

Some entrepreneurs have indicated that they intend to operate a “parent” funding Portal, which allows other sites to operate under its umbrella, (leveraging the parent’s systems, architecture, design, infrastructure, etc.). If subordinate Portals are allowed to operate under the umbrella of a registered Portal, either the management team of the parent Portal must be liable for the operations of the subsidiary Portals, or those subordinate Portals must fully register with the SEC and FINRA as independent Portals. The logic applies also to the licensing of any “turn-key” Portal solution. The Commission must make it clear that the operators of each funding Portal must comply with all pertinent SEC and FINRA regulations.

### **Investment Target and Investment Cap**

As SEC.302(b)/SEC4A.(a)(7) specifically allows for issuers to raise funds “greater than a target offering amount,” the issuer must also establish an offering cap at campaign inception. This will protect the issuer by limiting over subscription. RocketHub does not believe there should be a limit on the spread between a cap and a target offering amount. While this would allow for a campaign where an issuer has a target offering amount of \$1,000 and a cap of \$1,000,000, RocketHub sees no issue as long as there is a clear and transparent communication path for both investors and issuers to understand the risks associated with such a large spread between investment target and cap. Additionally, the issuer must abide by the disclosure requirements mandated by the investment cap.

## SEC.302(B)/SEC4A.(A)(7) – INVESTMENT TARGET AND INVESTMENT CAP

(7) ensure that all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, and allow all investors to cancel their commitments to invest...

As part of its Portal, RocketHub plans to offer a new countdown mechanism. Once an offering reaches its cap amount, the “count down” to the offering deadline will be paused, awaiting the expiration of the last investor’s rescission period. During the pause, RocketHub will continue accepting “investment pledges” and placing those who invest during the pause on a “wait list.” If during the pause, a pending investor exercises his/her right to cancel his/her investment, investors will be added from the wait list, until the cap is reached again, and the pause will continue. If the entire wait list is exhausted, without reaching the cap the “count down” will resume. Due to the retail nature of the investors, RocketHub believes it is not necessary to follow the practice of counting only working days; RocketHub believes that if terms are set at the beginning of the offering, the rescission period should last no longer than 24 hours.

### **Substantial Compliance**

The SEC should implement “substantial compliance” rules that protect issuers and Portals, even if the issuer failed to comply with the exemption in certain insignificant ways. The Regulation D exemption includes several provisions that protect the issuer if it reasonably believed the requirements of the rule were met, even if they actually were not. If this language is not included, a small infraction, or an infraction that has no true effect on the quality of the offering could invalidate the entire offering.

The SEC should include language to protect the issuer and the issuance from involuntary, innocent and immaterial violations.

### **Pilot Program**

RocketHub recognizes that the Commission is responsible for regulating an emerging market. As such, there is limited information available to generate effective regulatory policies. While RocketHub has made its data freely available to the Commission’s economist department, it believes there are further steps that can be taken to test the infrastructure, security, and cost of full compliance through the proposed framework.

A pilot program would initiate equity crowdfunding, including the data collection and filing process, on a small scale to get feedback on whether the regulation is likely to work as expected in a “real world” situation. RocketHub believes that by administering crowd-funded offerings by a small group of issuers to the retail-investor public the Commission will effectively simulate the offering process including security registration, offering logistics, and identity verification. This will give the Commission an

opportunity to make revisions to their regulatory framework to ensure that the right data will be collected and the data collection methods will work, the securities registrations procedures work, and investors and issuers are protected. Furthermore, the pilot program would also provide the SRO with necessary data for their own regulatory programs. RocketHub believes that by neglecting pilot testing the regulatory framework, the Commission runs the risk of writing out an inefficient and potentially ineffective regulatory framework. A pilot program will allow both the Commission and SRO to identify topics that require additional regulation before the floodgates are opened to numerous Portals many of whom are first-time entrants into the crowdfunding space.

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Thank you for your attention. If you have any questions regarding the contents of this paper, or would like to contact us, you may do so at:

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## **Crowdfunding -- the Law and the Reality**

### **Are We Ready for Prime Time?**

**Emerson R. Marks, Jr.  
Bennett J. Fidlow  
Kirk T. Schroder**

**Schroder Fidlow, PLC  
[www.schroderfidlow.com](http://www.schroderfidlow.com)**

**May 28, 2013**

Crowdfunding is a financing structure where small financial contributions are made to a venture or a cause seeking to raise capital without the contribution being classified as an investment or a tax-deductible donation. In crowdfunding a contributor is giving financial support because he or she wants to help a particular cause or venture and by doing so, may or may not get some small token of appreciation in return (but nothing else). This concept took hold on the Internet as websites like Kickstarter and IndieGoGo have become places where someone can post on the host website a request for support of their cause or venture while people who are inclined to make small monetary gifts can browse such posts and decide whether or not to make a contribution. In many instances, it has been a successful method for those seeking venture capital on a relatively small scale to use the power of the Internet to ask for financial support on a mass scale without having to comply with securities laws and charity tax laws. This has been especially popular in the entertainment industry where film and television producers who otherwise do not have the means to comply with securities laws can simply ask people to give money (with no expectation of any return) to their film or television project without having to treat them as investors in the project under securities laws. Recent well-known examples are the independent film projects *Veronica Mars* and Zack Braff's *Wish I Was Here*, which together raised over \$8 million.

But what if those relatively small "gifts" could be treated as "investments"? Could there be a balance between protecting people making small monetary investments with the hope of getting a return without requiring those seeking such investments to comply with securities regulatory requirements that up to now have been impractical for these types of investments? Answering

those questions is what the “Crowdfund Act,” Title III of the Jumpstart Our Business Startups Act (“JOBS Act”), signed into law by President Obama on April 5, 2012 now attempts to do. The Act is designed to extend crowdfunding into the world of investment financing by allowing businesses (“issuers”) to sell equity securities to an unlimited number of purchasers over the Internet (so long as they meet minimum qualifications set forth in the Act and in SEC regulations). The Act appears to be a boon for small businesses and individuals seeking capital.

Although the Act was signed into law over a year ago, it requires that the SEC issue detailed regulations in order for it to take effect, and the SEC has not taken this required action and is now well past the drop-dead date of January 1, 2013 set by the Act. Given the pressures on the SEC to complete Dodd Frank regulations and remove solicitation requirements from private offerings under Rule 506, it is likely the promulgation of these regulations will take more time.

To complicate matters, there is strong opposition to the Act from very influential people (whose resistance may well be a major reason for the delay thus far), including prominent regulators such as the North American Securities Administrators Association (state regulators), former SEC regulators, consumer and investor advocates, labor unions, and academics. (See Organizations and Individuals Critical of Anti-investor Provisions in the House JOBS Act and Companion Senate Bills, <http://www.consumerfed.org/news/473>). Securities law Professor John Coffee went so far as to dub the Crowdfund Act the “boiler room legalization act.”

**<http://www.sfgate.com/business/article/Financial-regulations-gutted-in-new-bill-3407178.php#ixzz2TmiNNLXg>** Thus it is fair to say that there is a potential tug of war between small businesses eager to go forward with crowdfunding and regulators and their allies who are strongly opposed to the concept as conceived, perhaps even to the concept at all.

Further, the Act, as it reads now, is itself problematic, imposing regulatory and compliance costs that are arguably too high for those seeking investors and are of modest means. Here are the essential features of the new law and some of the unanswered issues to be addressed going forward.

## **Provisions of the Act**

### **Requirements for Investors**

The Act adds a new exemption from the registration requirements of the Securities Act of 1933, namely Section 4(6). The new exemption is subject to the following conditions:

- The aggregate amount sold to “all investors” by that issuer may not exceed \$1 million in any 12-month period.

Comment: Whether “all” really means “all” in counting up the \$1 million limit is unclear. Would the statute count offerings to accredited investors under other exemptions, such Regulation D or Section 4(6)? That would be counterproductive, since such investors would be in a completely different situation and there would be no reason to limit their numbers. The thinking is that the Act might be construed by the SEC to mean just crowdfunded investors, but it doesn’t say so. As it stands now,

any issuer hoping to raise private capital in the near future should calculate the numbers very conservatively.

- Any single investor is limited in the amount they may invest in crowdfunding securities in any 12-month period as follows:
  - If either the annual income or the net worth of the investor is less than \$100,000, the investor is limited to the greater of \$2,000 or 5% of their annual income or net worth, as applicable.
  - If either the annual income or net worth of the investor is \$100,000 or more, the investor is limited to 10% of their annual income or net worth, as applicable, to a maximum of \$100,000.

Comment: Ensuring that the investor does not go over the personal investment limit with respect to a specific issuer's investment falls on the issuer, but ensuring that the investor does not go over the overall limit with respect to all issuers in a given year falls on the funding portal. This places significant due diligence responsibilities on both the issuer and the portal, adding to the cost of the offering. Query what the effect on the issuer will be if the portal fails to do proper due diligence or if the investor fails to provide accurate information?

- The transaction must be made through a broker or a "funding portal," which is a newly conceived entity created under the Securities Exchange Act to facilitate crowdfunding offers. These intermediaries will be primarily responsible for implementing and overseeing the new and fairly rigorous due diligence and education, information gathering, and reporting requirements under the Act, as we discuss below.

### **Requirements for Intermediaries (funding portals)**

All intermediaries facilitating the crowdfunding transactions on behalf of the issuers must be either brokers or funding portals, and most will likely be funding portals. We suspect that the low amounts of capital involved and the rather time consuming burdens imposed on portals will make the portal role unattractive to most registered brokers. Funding portals are exempt from broker registration, but must register as funding portals in what (we presume) will be a more simplified registration process. The statute imposes a number of requirements on funding portals.

- Register with the SEC;
- Register with a self-regulatory organization ("SRO"); FINRA (the former NASD) currently being the only SRO available;

Comment: FINRA has solicited comments from its brokers about possible rules concerning supervision, advertising, anti-money laundering, fraud and manipulation, and just and equitable principles of trade, all traditional areas of brokerage regulation. FINRA RN 12-34 (July 2012). FINRA's query was directed to brokers, the only parties with whom it has a regulatory relationship, so it may be difficult to assess the interests of non-broker players, who at this point are largely unknown. FINRA raises the possibility of special rules for brokers which are funding portals, as distinct from non-broker portals. If brokerage firms do become involved as funding portals, a number of

conflicts potentially emerge, for instance, in the broker's recommending crowd-funded securities for which it is acting as portal.

- Provide SEC-mandated disclosures and investor education materials;
- Ensure that investors (i) review the educational materials and (ii) affirm their understanding of the risks of investment loss, illiquidity, etc.;

*Comment:* Just how the funding portal is to accomplish this is a large and largely unanswered question, as is how the portal's work will be monitored by an already overworked SEC.

- Take measures to "reduce the risk of fraud" regarding each officer, director and person holding more than 20% of the outstanding equity of every issuer. In other words, the funding portal is being tasked to perform due diligence on every significant individual connected to the issuer. This could include personal background checks such as criminal history, credit history, prior bankruptcies, prior work history, and securities enforcement regulatory history checks.

Comment: The fear of fraud is a primary and a legitimate issue among securities regulators. However, some commentators have pointed out, the real risk in small company finance is business failure and investment risk, not outright fraud. Heightened measures against fraud in this context may only end up burdening legitimate issuers and do little to reduce fraud. RocketHub Whitepaper, "Implementation Of Crowdfunding" (Oct. 2012). We believe that crowdfunding carries its own inherent antifraud provision since the permissible investment amounts are sharply limited, which reduces the amount an investor might lose from fraud.

This requirement places a significant amount of responsibility and possibly liability on the funding portal. Moreover, issuer due diligence can be time consuming and expensive. The funding portal will typically be just a third party service provider, without the connection to the actual offering that a broker or underwriter would have in a typical securities offering. This is yet another potentially costly requirement that the issuer will be forced to bear.

- Ensure that investors and the SEC receive required issuer disclosures at least 21 days before any sales take place;
- Ensure that the issuer obtains control of the offering proceeds only when it has reached the target offering amount, and ensure investors' right to cancel their commitment before that time, per SEC regulations;
- Ensure that investors do not exceed the investment limits imposed on them; and
- Protect the privacy of information collected from investors.

Comment: It is anticipated that the SEC regulations will fill in a lot of detail concerning how the funding portals are to meet all of these requirements. A significant concern is the added cost and potential liability that these requirements create and, should the portal fail in its duties, how that will affect the issuer & the offer.

In addition, the Act places several prohibitions on funding portals, which may not:

- Offer investment advice or recommendations;

- Solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
- Compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- Hold, manage, possess, or otherwise handle investor funds or securities;
- Pay promoters, finders, or lead generators for finding investor leads.

Comment: Of course, simply posting a crowdfunding offering is a solicitation, but portals are otherwise expected to convey an aura of objectivity and hence of authority, not to be compromised by partisan salesmanship or interested principal trading. These requirements will sharply limit the extent to which portals will be able to market the various offerings on their site, perhaps more than crowdfunding enthusiasts realize. So how will portals and their employees be paid and will they be able to enter into customary revenue sharing partnerships as is currently customary? There may be something of a rude awakening when the regulations come out.

- Compensate employees, agents, or other persons for such solicitations or based on the sale of securities compensate promoters, finders, or lead generators;

### **Requirements for Issuers**

An issuer must be incorporated under the laws of a state. It may not be an “investment company” under the Investment Company Act of 1940, nor an SEC-reporting company under the Exchange Act. All issuers are required to:

- ♦ Provide the SEC, investors and the intermediary with the following information:
  - Name, legal status, web address and physical address.
  - Names of officers, directors and 20% shareholders.
  - Description of business and anticipated business plan.
  - Description of financial condition AND:
    - If raising \$100,000 or less, tax returns and financial statements certified by principal executive officer.
    - If raising \$100,000-\$500,000, reviewed financial statements.
    - If raising \$500,000 or more, audited financial statements.
  - Description of intended use of proceeds of offering.
  - Target for the offering amount, deadline to reach that amount, and regular updates regarding progress toward the target.
  - Price of the securities or the method for determining that price, giving the investor the right to rescind his/her commitment after the price has been determined).
  - Description of ownership and capital structure of the issuer, including:

- Terms of the securities offered and of each other class of securities of the issuer (and the differences between them), including how those terms might be limited, diluted or qualified by the rights of other classes of security.
  - A description of how the exercise of rights of controlling shareholders could affect the rights of crowdfunding shareholders.
  - Identification of holdings of 20% security holders.
  - How securities offered are valued and how they may be valued in the future, including during future corporate actions.
  - Risks of minority ownership, risks associated with future corporate actions, including additional issuances of shares, sale of issuer's assets and related party transactions.
- ♦ Not advertise the terms of the offering, except for notices that direct investors to the broker or funding portal.

Comment: Crowdfunding is all about getting the word out, both on the website and elsewhere, such as via social media sites. The SEC will need to accommodate the Act to this economic and social reality or whether.

- ♦ Not compensate anyone for promoting its offerings without disclosing that compensation.
- ♦ File annual reports of results of operations and financial statements in accordance with Commission rules.
- ♦ Comply with other Commission investor protection requirements.

Comment: Much of the information required by these provisions of the Act is technical and will require skilled professionals to provide it (e.g., share valuation, share rights and dilutions thereof, share pricing (different matter than valuation), and auditing of financial statements). All of this imposes more costs on unseasoned and possibly financially strapped issuers.

### **Liability**

Issuing companies face statutory liability similar to that found elsewhere in the Securities Act for untrue statements of a material fact and or omissions of material fact, with an allowed defense for lack of knowledge. Damages are rescission of the purchase price plus interest.

### **State Law**

The SEC will make issuer information available to state regulatory authorities. The states are pre-empted from requiring registration of Section 4(6) offerings, but there is no restriction on their ability to take enforcement action with respect to fraud or deceit by issuers, brokers or funding portals. States may impose filing fees, but in contrast to filings made of preempted "covered securities" under Rule 506, the only states which may do so are the principal place of business of the issuer or and the state of residence of more than half the purchasers of the

crowdfunded offering. A funding portal's home state may regulate the portal, but cannot impose rules that are different or additional to what is required under the Act.

### **Resale Restrictions**

Securities sold under Section 4(6) are restricted for one year and during that time can only be resold:

- Back to the issuer.
- To an "accredited investor."
- In a registered offering of securities.
- To a family member or on death or divorce.

### **Regulations**

As we have discussed, there is much the SEC will need to be doing to further define and refine these rules. We have indicated a few areas particularly calling for regulations, but it is fair to say that, if the Act as we have it is going to work, it will need, at the least, substantial massaging at the administrative agency level.

In the meantime, the SEC has made clear in public announcements that it will not tolerate jumping the gun by issuing companies before its regulations are issued, so we continue to caution clients to avoid soliciting funds in the crowdfunding market until the regulations are issued and approved.

### **Some Practical Issues To Consider**

The costs for a small company in complying with the duties imposed on it by the Act – either directly on the issuer or indirectly on the funding portal, which will be passing its costs along to the issuer - are considerable. Presumably at least part of the compliance costs incurred by funding portals will have to be borne up front by the issuers. It cannot be anticipated that funding portals would be willing to bear these costs and charge them against something like an offering spread, as in a registered offering. Indeed, the restrictions set out in the Act prohibit payments to the portals based on the success or amount of the offerings. Given the low amount that can be raised (currently \$1 million per issuer per year), it may be doubted whether the crowdfunding law, as written, is really ready for prime time. Small companies seeking to keep costs down – and facing considerable reporting costs down the road by reason of this Act – may well be unable to make use of this statute.

The role of the funding portals will be considerable and uncertain, since they will be newly created. Moreover, the actual players will themselves be uncertain, given the likelihood that the portals will mostly not be established brokerage firms, but rather entities lacking retail securities experience and expertise. We may possibly expect negative impacts on shareholder relations by entities unused to communicating with large numbers of investors. Moreover, the services traditionally played by underwriters in conditioning and stabilizing markets will not be available,



which may possibly increase investment risk, although the relative illiquidity of these investments and their small size will tend to mitigate that risk.

There are also corporate governance costs to the issuers that may arise in the crowdfunded arena. Issuers may well end up with hundreds, even thousands, of unsophisticated stockholders with unrealistic expectations who will need to be managed. This could increase communications costs and executive time and effort and add to the risk of shareholder suits and attendant litigation costs.

Moreover, if an issuer intends to raise funds from more sophisticated investors down the road or to do business with established companies (such as film distributors) in the exploitation of the finished product that was financed through a crowdfunding offering, such parties might well draw back for fear of being entangled in a mass of unsophisticated and demanding shareholders. This might also chill future rounds of financing, perhaps block or frustrate future acquisitions, sales, or mergers requiring a shareholder vote. The costs of soliciting shareholder votes in even routine corporate governance matters might be inordinately high.

### **Conclusion**

The Crowdfund Act is a step in the right direction in addressing the crowdfunding phenomenon in a investment context with the intent to strike the right balance between investment regulation for these types of investments and a healthy measure of streamlining so that such regulation is not too burdensome. Of course, we will not know if that will happen until the SEC issues regulations and then perhaps even not then. The Crowdfund Act could possibly be the huge boon to the economy and for small businesses that it has been made out to be. If it can be made to work, it will allow small businesses and similar venture to raise limited amounts of capital in potentially broad public markets without costly full registration. But it remains to be seen whether the SEC will be able to modify the present scheme and whether the market participants will be able to spread and limit the costs and the risks in a manner that will make this financial model work.

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## **Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act**

On April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law. The Act requires the Commission to adopt rules to implement a new exemption that will allow crowdfunding. Until then, we are reminding issuers that any offers or sales of securities purporting to rely on the crowdfunding exemption would be unlawful under the federal securities laws.

<http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm>

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Modified: 04/23/2012



Mr. Chairman and Members of the Committee:

Thank you for this opportunity to provide testimony on the implementation of the JOBS Act and the proper elimination of government barriers to small business capital formation.

My name is Alon Hillel-Tuch. I am a co-founder and CFO of RocketHub. RocketHub is an established crowdfunding website, having provided a platform for the launch of over 8,000 campaigns and raised over \$2 million to support entrepreneurs and small businesses. These successful campaigns have provided funding to businesses of all types, from a local bakery to a start-up developer of medical devices to enabling the financing of a film production.

Crowdfunding is the application of new technology to an old idea. People have always sought support in their community to help raise money for new businesses. The advent of web-based social networking allows people to expand their community to their on-line friends and to benefit from the lower costs of a web-based platform.

Thanks to Title III of the JOBS Act, crowdfunding in the U.S. will soon expand to permit the sale of stock by these entrepreneurs to their supporters. We at RocketHub, look forward to this development, and we intend to register as a crowdfunding portal as provided in the JOBS Act.

While I believe that the JOBS Act will benefit small businesses in the U.S., I also believe that its impact can be improved through the proper use of the Securities and Exchange Commission's discretion in rule making, and through certain amendments to the Act.

In the JOBS Act, Congress provided that issuers utilizing crowdfunding platforms must provide investors with certain information, including audited financial statements where the issuer seeks to raise more than \$500,000, or such other amount as the Commission may establish. I believe this \$500,000 threshold is too low, and that audited financial statements should not be required unless the issuer seeks to raise \$1 million. Crowdfunding typically attracts start-up companies and small businesses. *Audited* historical financial statements of these types of companies, which may have little or no operations, do not provide investors with more meaningful information as compared to unaudited financial statements, yet they impose a significant cost on the entrepreneur. Making this change could save small businesses tens of thousands of dollars while opening up the opportunity for them to take full advantage of the crowdfunding platform.

A second area where the Commission should exercise its discretion in rule-making is by minimizing up-front expenses to entrepreneurs and small businesses that seek to crowdfund. Crowdfunding platforms usually charge fees for successful projects. This allows small businesses to access crowdfunding at minimal initial cost. If they attract support for their project, then they have the funds to pay fees. If their idea does not attract support, their costs are minimal, no supporter is charged, and the entrepreneur can come back in the future with a new idea. In implementing the JOBS Act, the Commission should be careful to preserve this fee structure. Platforms should be able to charge fees on successful projects, while not imposing costs on projects that do not attract funding. This fee structure will allow more small companies to use crowdfunding, while reducing their risk if they are unable to attract financing.

One area that Congress should address to improve the JOBS Act is to raise the crowdfunding exemption to \$5 million from \$1 million. The higher amount will allow more small businesses who need capital to utilize the cost-effective crowdfunding method. Currently, a company that seeks more than \$1 million is unable to use crowdfunding and must rely on traditional venture capital and angel investors, credit card debt, or small business loans. These sources may not be available to all businesses, especially start-ups, women and minority led businesses, and those traditional small businesses that fall outside of the high-tech model. Raising this limit would allow crowdfunding to more effectively compete as a source of funds with venture capital and banks, giving small businesses more options and driving down financing costs.

Crowdfunding can be an important economic tool to help small businesses grow and drive job creation. I believe that by: raising the aggregate limit for crowdfunding to \$5 million; limiting the costs associated with audited financials to raises above \$1 million; and aligning the interests of companies, investors and platforms with a success fee structure, we can increase the economic benefit provided by crowdfunding.

These reforms will increase the number and type of companies that choose to raise capital through crowdfunding. By expanding the role of crowdfunding in small business finance, we also expand the opportunities and benefits to crowdfunding investors. These small investors will have the ability to participate in the growth and success of a wider range of companies, including companies in their communities.

I'm very excited by the opportunities provided by crowdfunding, and I again thank the committee for the opportunity to speak with you here today.

If time is available I would like to address the following points and common questions regarding crowdfunding.

**Q: Won't crowdfunding lead to a lot of fraud by issuers?**

**A:** Every securities market and/or offering has the potential for fraud, but crowdfunding structures help minimize that risk. Crowdfunding is highly transparent, and there is substantial feedback from other community participants. The crowd helps police players and keeps them honest. Portals provide a clear and central location for communication by potential investors to analyze and share their views on offerings. The web based structure also allows portals and regulators to provide risk disclosure and investor education. In addition, we expect portal operators will undertake a gatekeeping role in authenticating issuer identity and requiring minimum standards for issuers.

**Q: What potential does Title III of the JOBS Act have to create new domestic jobs?**

**A:** As shown in the July, 2010 Kaufman Foundation report ("The Importance of Startups in Job Creation and Job Destruction"), startups are the job creation engine in the American economy. Without startups there is no net job growth. Access to capital for small business is a challenge; small businesses have relied on financing from community members as well as sources such as credit card debt, loans, and angel investors. Debt structures often come at a high cost and burden to entrepreneurs, who may lack regular cash flow, during the growth stages of their companies. Furthermore, traditional sources of capital have strict guidelines to the nature of the businesses

they support, excluding a wide range of domestic businesses. Crowdfunding is especially important for women and minority owned businesses that may not have traditional access to funding sources. By using a web-based platform, crowdfunding drives down the cost to companies of raising capital and allows companies to reach out to their natural investor base.

**Q: How will crowdfunding investors receive liquidity in their investment positions?**

**A:** As with any private placement we expect that investors in crowdfunded projects seek long term alignment with the issuers. We do not believe this industry is conducive to rapid trading, we believe the industry consists of smaller investors that are looking to participate in long term opportunities they are familiar with and understand.

**Q: Why is crowdfunding good for investors?**

**A:** Before the JOBS Act the ability of small investors to participate or invest in private businesses has been limited. The JOBS Act now enables small investors to provide support to capital seeking entrepreneurs. Crowdfunding portals and regulators are able to drive standardized and understandable terms across offerings. This allows crowdfunding investors to become educated and aware of the offering terms and risks. Investors in crowdfunding offerings are able to clearly see the terms and success of an offering, and are able to directly communicate with the issuer and other investors.





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**Via Electronic Submission**

March 20, 2013

U.S. Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549-1090

**Re: Request for Public Comments on SEC Regulatory Initiatives under the JOBS Act Title III - Crowdfunding**

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee") of the Business Law Section (the "Section") of the American Bar Association (the "ABA") with respect to the rules the Securities and Exchange Commission (the "Commission") is required to adopt pursuant to the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"). This letter is submitted in response to the Commission's request for public comments relating to the JOBS Act rulemaking.<sup>1</sup>

The comments expressed in this letter represent the views of the Committee, and have also been prepared in conjunction with, and reviewed and approved by, the Middle Market and Small Business Committee, the Private Equity and Venture Capital Committee, and the State Regulation of Securities Committee of the Section. The comments expressed in this letter have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, these comments do not represent the official position of the Section.

The Committee thanks the Commission for this opportunity to comment on the rulemaking the Commission is required or authorized to undertake in connection with the JOBS Act. In accordance with the Commission's efforts to organize the submission of comments relating to each major initiative under the JOBS Act, the Committee expects to submit a number of comment letters, each addressing one of the rulemaking categories identified by the Commission. This letter comments on the provisions set forth in Title III of the JOBS Act relating to crowdfunding (Title III). Because this letter is being submitted prior to the Commission's issuance of proposed rules, our comments are intended to highlight matters we believe the Commission should consider in formulating its proposed rules pursuant to Title III or in providing guidance pursuant with respect thereto.

<sup>1</sup> <http://sec.gov/spotlight/jobsactcomments.shtml>

### **Summary of Our Comments**

Our comments with respect to Title III which, among other things, adds new Sections 4(6)<sup>2</sup> and 4A to the Securities Act of 1933 (the “Securities Act”) and amends Sections 3 and 12(g) of the Securities Exchange Act of 1934 (the “Exchange Act”), are as follows:

1. The Commission is not required in its rulemaking to combine amounts raised by an issuer in crowdfunding transactions within any 12-month period with amounts raised by the issuer in transactions not involving crowdfunding during that period, and it should not do so.
2. The Commission should clarify the maximum amount permitted to be invested by each investor in a crowdfunding transaction.
3. The Commission should clarify the ability of an issuer to engage in crowdfunding transactions before, concurrently with or following certain other exempt transactions.
4. The Commission should consider the creation of standardized disclosure templates that can be used by crowdfunding issuers.
5. The Commission should work with FINRA to evaluate the benefits of creating a central database to facilitate compliance with investor maximum purchase limitations.
6. The Commission should develop a standard set of investor education materials that could be used to satisfy the investor education requirements of Title III.
7. The Commission should permit issuers and intermediaries in crowdfunding transactions to rely in good faith on investor representations as to the investor’s net worth and annual income without requiring additional verification.
8. The Commission should consider increasing the target amounts that would require an issuer in a crowdfunding transaction to prepare audited financial statements.
9. The Commission should require an issuer that has engaged in a crowdfunding transaction to provide reviewed or audited financial statements in its annual report only if the total assets of the issuer at the last day of its fiscal year exceed specified amounts.
10. The Commission should permit issuers to raise funds in excess of the target offering amounts subject to specified conditions.

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<sup>2</sup> We note that Title III refers to Section 4(6) of the Securities Act. Although we assume that the intended reference was to Section 4(a)(6) in light of the other modifications to Section 4 of the Securities Act mandated by Title II of the JOBS Act, we will refer in this letter to Section 4(6) to be consistent with the statutory language.

11. The Section 4(6) disqualification provisions should be consistent with the disqualification provisions applicable to other Securities Act exemptive safe harbors.
12. The Commission should specify what compensation models would be acceptable for a crowdfunding intermediary that is not registered as a broker or dealer under the Exchange Act.
13. The Commission should provide guidance as to what activities may be undertaken by a crowdfunding intermediary that do not constitute “investment advice”, as well as with respect to the activities in which a funding portal may engage or not engage without registration as a broker, dealer or investment adviser.
14. The Commission, together with FINRA, should consider which rules currently applicable to registered broker-dealers should also be applicable to funding portals and, correspondingly, which rules should not.
15. The Commission should clarify that a crowdfunding intermediary will not be required to register as an exchange or alternative trading system.

In addition to the foregoing comments, we expect to also submit comments to the Commission relating to its rulemaking to implement Section 303 of the JOBS Act to exempt securities acquired pursuant to crowdfunding offerings from the scope of Section 12(g) of the Exchange Act.

### **Background**

Title III of the JOBS Act added Section 4(6) to the Securities Act to provide an exemption from the registration provisions of the Securities Act for crowdfunding transactions involving the offering of securities, and added Section 4A to the Securities Act to set forth the requirements for issuers and intermediaries, liability provisions, and certain other matters relating to crowdfunding. In addition, Title III amended various provisions of the Exchange Act in connection with the crowdfunding provisions. The JOBS Act requires the Commission to adopt a number of rules implementing crowdfunding, including the following:

1. Rules to carry out Section 4(6) and Section 4A of the Securities Act, pursuant to Section 302(c) of the JOBS Act;
2. Rules to provide for disqualifications of issuers, brokers or funding portals pursuant to Section 302(d) of the JOBS Act;
3. Rules to exempt, conditionally or unconditionally, the requirement for a registered funding portal to register as a broker or dealer under Section 15(a)(1) of the Exchange Act, pursuant to Section 304(a) of the JOBS Act; and

4. Rules to exempt, conditionally or unconditionally, securities acquired in crowdfunding transactions from the scope of Section 12(g) of the Exchange Act, pursuant to Section 303 (b) of the JOBS Act.

In addition, Title III authorizes the Commission to adopt such additional rules as may be appropriate to implement the crowdfunding provisions.

The purpose of this comment letter is to present the views of the Committee to the Commission in order to assist the Commission in connection with the formulation of its proposed rulemaking under Title III.

### Discussion

1. The Commission is not required in its rulemaking to combine amounts raised by an issuer in crowdfunding transactions within any 12-month period with amounts raised by the issuer in transactions not involving crowdfunding during that period, and it should not do so.

Section 4(6) provides a transactional exemption from registration under the Securities Act for crowdfunding, subject to certain limitations. Section 4(6)(A) provides that “the aggregate amount sold to all investors by the issuer, *including* any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than \$1,000,000” (emphasis added).

Although the statutory language is not entirely clear, and could be read to provide for the aggregation of amounts raised in Section 4-exempt transactions that do not involve crowdfunding, we believe it is properly read to include as the limitation on the amount that can be raised in a crowdfunding transaction only those amounts raised by the issuer in other crowdfunding transactions during the preceding 12-month period. This reading is consistent with the language describing the aggregate limits on the amounts that can be invested by an individual investor under Section 4(6)(B), which provides in pertinent part that “the aggregate amount sold to any investor by an issuer, *including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed...*” (italics added). It is also consistent with the issuer disclosure requirement in Section 4A(b)(1)(D) of the Securities Act, which requires an issuer to describe “the financial condition of the issuer, including, for offerings that, *together with all other offerings of the issuer under section 4(6) within the preceding 12-month period...*” (italics added). This reading is also consistent with the statutory approach, and the Commission’s rulemaking, taken for other exempt offerings with dollar limitations, and it is reasonable to assume that Congress had these precedents in mind. Moreover, the specific aggregation identified in the statutory provision is limited to any crowdfunding offering within the preceding 12

months, further supporting the statutory reading that amounts raised in offerings that do not rely on the crowdfunding exemption are not required to be aggregated with amounts raised in crowdfunding transactions.

In addition, the policy considerations underlying the crowdfunding exemption support this reading of Congress' intent. Were any different interpretation applied to this section (that is, to read the statutory language limiting the "aggregate amount sold to all investors by the issuer" to refer to all sales pursuant to Section 4 of the Securities Act, the benefits of the crowdfunding exemption could be significantly undermined, as illustrated by the following examples:

- a. Initial or follow-on investments in the issuer by the founder or founders of the issuer in exchange for securities of the issuer pursuant to the exemption under Section 4(a)(2) of the Securities Act would need to be subtracted from the maximum amount that could be raised in crowdfunding transactions within a given 12-month period. In the event the founders' investments were significant, the issuer may be limited or even precluded from raising capital by means of crowdfunding.
- b. Capital raised in Section 4(a)(2)-exempt transactions from persons or entities other than founders also would decrease the amount an issuer could raise through crowdfunding. To illustrate, a start-up issuer may have capital needs in excess of \$1,000,000 in a 12-month period. If such an issuer raised \$1,000,000 or more in prior Section 4(a)(2)-exempt transactions during this period - for example, via early-stage venture capital investments - and later were to determine that it needs to raise additional capital in order to pay its employees or to maintain or expand its business operations, such an interpretation would prevent the issuer from raising any additional funds by means of crowdfunding.

We believe that the above results would be inconsistent with the basic premise of crowdfunding: to facilitate small business capital formation, especially early-stage capital, and thereby to promote job creation. Accordingly, we recommend that the Commission, in its proposed rules, clarify that the \$1,000,000 calculation refers solely to the aggregation of amounts raised in transactions pursuant to Section 4(6).<sup>3</sup>

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<sup>3</sup> We believe that the need for this clarification is also important because Section 4(6) includes, within the scope of offers or sales by an issuer, offers or sales by all entities controlled by or under common control with an issuer. If the controlling person of an issuer seeking to raise funds in a crowdfunding transaction also controls an entity that had sold securities pursuant to Section 4(a)(2) within the prior 12 months (even if the only purchaser of such securities was the controlling person), then the sales by the other entity could - absent this clarification - decrease the amount that the issuer could sell in a crowdfunding transaction, because both entities would be under common control. It seems to us that this result is not what the statute intended.

2. The Commission should clarify the maximum amount permitted to be invested by each investor in a crowdfunding transaction.

Section 4(6)(B) also sets forth limits with respect to the aggregate amount of securities that may be sold to any investor in reliance on the exemption within a 12-month period. There are two tests, one with a lower limit and the other with a higher limit. The lower-limit test provides that the investment by any investor may not exceed the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000. The higher-limit test provides that the investment by any investor may not exceed the greater of 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000. Simply stated, these tests are logically inconsistent. For example, an investor with an annual income of less than \$100,000, and with a net worth greater than \$100,000, would fall within both categories. As a result, it is unclear from the statute how Congress intended such an investor to be treated.

We recommend that the Commission address this inconsistency in its proposed rules to implement Section 4(6). The Commission could do so most easily by including in its proposed rules either the lower-limit test or the higher-limit test, and by providing that the alternative test applies to investors who do not fall within the scope of the category of investors covered by the specified test. Should it believe that it has the statutory authority to do so, the Commission could also fashion a test along the lines of the statutory provision, by proposing standards that address what appears to be the Congressional intent to limit the maximum investment for all investors, and to impose lesser limits for less affluent investors. For example, the lower-limit test might apply only if an investor's annual income and net worth were both below a specified amount (*i.e.*, either annual income or net worth were below \$100,000, and neither the investor's annual income nor the investor's net worth exceeded the specified amount). This formulation would, therefore, enable a retired investor who may have little current annual income, but a significantly higher net worth, to invest at the higher level. However the Commission chooses to address this matter in its proposed rulemaking, it is important that the Commission resolve the inconsistencies inherent in the two standards set forth in the statute.

Finally, on a separate but related point, it is unclear to us which measure (annual income or net worth) serves as the basis for the statutory investment limits. For example, if an investor has an annual income of \$40,000 and net worth of \$80,000, does the 5% test apply to the annual income or the net worth? Both with respect to the lower-limit test and the higher-limit test, the statute is unclear. We believe that the Commission should seek to eliminate this ambiguity in its proposed rules. It can do this by proposing within each category that either the

lower or the higher of annual income or net worth would serve as the benchmark for the application of the 5% or 10% test (as applicable).

3. The Commission should clarify the ability of an issuer to engage in crowdfunding transactions before, concurrently with or following certain other exempt transactions.

One of the concerns we have with respect to crowdfunding offerings is that individual investors may have neither the financial sophistication nor (in view of the limitations on the amount of individual investments) a sufficient economic incentive to conduct their own due diligence with respect to an issuer, or to negotiate or influence the terms of a crowdfunding offering and ancillary arrangements designed to protect investor rights. As a consequence, we believe that the investor protections available in crowdfunding transactions may be substantially less than those that may be demanded by accredited investors in proposed Rule 506(c) transactions. For example, we believe it would be more likely that accredited investors in Rule 506(c) transactions (assuming this rule is adopted substantially as proposed) will recognize the need for, and engage in, some degree of due diligence and would insist on certain protections. These protections may take various forms, including (but not necessarily limited to) the terms of the securities being offered to investors, the rights of the investors reflected in those terms, the ancillary agreements that may be entered into with investors (such as investors' rights agreements, voting agreements, and right of first refusal and co-sale agreements), and also in the conditions precedent to the consummation of the offering. Accredited investors are more likely, in our experience, to require that an issuer's management (or at least key personnel), as a condition to the investment, enter into employment agreements containing noncompetition and other provisions, to protect those investors from the risk that key personnel will resign and thus leave the issuer without suitable management expertise or management structure.

Although it is unlikely that investors in crowdfunding transactions will insist on receiving the full range of protections that larger and more sophisticated investors might require as a condition to investment, there could, in our view, be a significant benefit to crowdfunding investors were the Commission to permit crowdfunding transactions to occur concurrently with Rule 506(c) transactions utilizing general solicitation. Crowdfunding transactions conducted concurrently (or shortly after) Rule 506(c) transactions may provide greater assurance to the crowdfunding investors as to the corporate and organizational integrity of the issuer, based on the due diligence we believe normally would be performed by accredited investors in connection with the Rule 506(c) transaction. In addition, crowdfunding investors may indirectly benefit from the involvement of another investor group in monitoring the development of the business and the effectiveness of management performance, and the protections that may result from the ability of the other investor group to intercede if the business or management fails to perform as contemplated. Although, as we have noted,

crowdfunding investors are not likely to receive directly all of the protections accredited investors may obtain from the issuer in a private offering context, they may be able to benefit, if even indirectly, from the conditions and procedures that accredited investors may impose or undertake with respect to their investments.

Currently (that is, until the Commission adopts rules implementing the elimination of the current prohibition on general solicitation and general advertising in connection with certain Rule 506 transactions), an issuer's ability to conduct a side-by-side Rule 506 offering with an offering that is publicized (such as registered public offerings) requires an analysis of how investors in the private offering were solicited.<sup>4</sup> The elimination of the general solicitation and general advertising restrictions in connection with a proposed Rule 506(c) transaction should to a large extent obviate the need for this analysis in the context of Rule 506(c) offerings. However, unlike a Rule 506(c) offering, which will not be subject to any significant limitations on the offering process other than the issuer's obligation to take reasonable steps to verify an investor's status as an accredited investor, Title III imposes significantly more conditions on the conduct of crowdfunding offerings. In order that an issuer's Rule 506(c) offering shortly prior to or concurrently with a proposed crowdfunding transaction not be integrated with the crowdfunding transaction or viewed as being inconsistent with the statutory requirements applicable to the crowdfunding transaction, we recommend that the Commission's proposed rules reflect the following considerations:

- a. A Rule 506(c) transaction may be conducted by an issuer without any limitations beyond those set forth in Rule 506(c), provided that the Rule 506(c) transaction is completed not less than 30 days prior to the commencement of a crowdfunding transaction by that issuer.
- b. A Rule 506(c) transaction by an issuer may be conducted less than 30 days prior to the commencement of a crowdfunding transaction by that issuer, or concurrently with a crowdfunding transaction by that issuer, provided that the manner in which the Rule 506(c) offering is conducted is consistent with the manner in which the crowdfunding transaction is required to be conducted. We believe that this requirement could, for example, provide that advertising with respect to the Rule 506(c) transaction state explicitly that the Rule 506(c) offering is being made only to accredited investors. In addition, the Commission should require that any Rule 506(c) advertising following the commencement of the crowdfunding offering direct persons who are not accredited investors to the funding portal or broker in accordance with the provisions of Section 4A(b)(2) of the Securities Act and the Commission's rules thereunder.

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<sup>4</sup> See, for example, the interpretive positions outlined in Section II.C. of the Commission's proposing release entitled "Revisions of Limited Offering Exemptions in Regulation D", Release No. 33-8828 ( August 3, 2007), available at <http://www.sec.gov/rules/proposed/2007/33-8828.pdf>.



Beyond the scope of crowdfunding transactions conducted prior to or concurrently with Rule 506(c) transactions, we suggest that the Commission explicitly state that a securities offering by an issuer pursuant to an exemption from registration under the Securities Act that has been completed prior to the commencement of a crowdfunding transaction will not be affected by any subsequent crowdfunding transaction.<sup>5</sup> In its proposed rulemaking (or the Commission's release with respect thereto), it may be helpful for the Commission to address whether an issuer's ability to engage in a crowdfunding transaction will be affected by any prior exempt offering.<sup>6</sup>

4. The Commission should consider the creation of standardized disclosure templates that could be used by crowdfunding issuers.

It is clear that, in enacting Section 4(6), Congress intended to provide a simplified means for small issuers to raise limited amounts of capital. However, many small private companies are unfamiliar with the capital-raising process, and the issuer disclosure requirements set forth in Section 4A(b)(1) may appear to them to be intimidating and overly complex. We believe it would be very helpful to such issuers, and entirely consistent with the Congressional intent, if the Commission were to create a disclosure template that would allow issuers to complete certain fields by inserting the required information. Such a template could also provide drop-down screens or other methods to explain to issuers what is meant by certain terms or intended to be included in certain fields, especially the fields providing for a description of the ownership and capital structure of the issuer.<sup>7</sup> For example, not all issuers would necessarily know what information is contemplated to be provided in discussing the terms of the securities being offered, 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. Explanations of such concepts would be useful, and a series of simple questions to which the issuer could respond would help to avoid unnecessary confusion. Were the template to ask an issuer whether the issuer has any class of security other than a single class of common stock, and the issuer were to answer "no", then the template might direct the issuer to sections other than the class-by-class comparisons.<sup>8</sup>

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<sup>5</sup> See, by analogy, Securities Act Rule 152 relating to a completed private offering followed by a registered public offering.

<sup>6</sup> Under any circumstances, in our view, securities offerings that are distinct from each other based upon the five-factor test referred to in the Note to Securities Act Rule 502(a) should not be integrated under any circumstances.

<sup>7</sup> We note that the North American Securities Administrators Association (NASAA), in conjunction with the American Bar Association, has developed the Small Company Offering Registration ("SCOR") program, which includes a simplified "question and answer" registration form that companies can use as the disclosure document for investors in connection with a Rule 504 offering.

<sup>8</sup> As part of the standardized form, the Commission may want to consider, though, whether issuers should (assuming this to be the case) be required to disclose as a risk factor that the issuer may in the future issue securities having terms that may materially limit, dilute or qualify the rights of the holders of the securities

Whether or not the Commission is able to create such templates by the time the Commission's crowdfunding rules become effective, the Commission should state in its rulemaking that the disclosures required to be made by issuers should be clear and concise and need not, except to the extent material to investors, include any information beyond the scope of the disclosures mandated by the Commission's rules.

5. The Commission should work with FINRA to evaluate the benefits of creating a central database to facilitate compliance with investor maximum purchase limitations.

Pursuant to Section 4A(a)(8), intermediaries are required to make such efforts as the Commission determines appropriate, by rule, to ensure that no investor in a 12-month period has purchased securities offered pursuant to Section 4(6) in excess of the limit set forth in Section 4(6)(B).<sup>9</sup> In order to facilitate compliance with this requirement, the Commission should consider, in collaboration with FINRA, creating a central database that intermediaries can use to report 4(6) offerings, including the names of issuers, a description of the securities sold in the offering, the names of investors and the amounts such investors have invested in each such offering. Because investors will likely not want the specifics of their investments to be publicly available, we recommend that this information only be made available to intermediaries, and subject to such further controls as the Commission deems appropriate. Were the Commission and FINRA to develop such a database, we believe that it would facilitate greatly compliance by covered intermediaries regarding the monitoring of individual investments, and could also assist the Commission (as well as FINRA) in connection with its data-gathering and enforcement programs.<sup>10</sup>

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being offered. The Commission also may want to suggest certain standardized risk factors, which issuers would be able to include, exclude or modify to the extent appropriate.

<sup>9</sup> Section 4(6)(B) sets forth the aggregate amount that may be sold to any investor *by an issuer* – we note that the such section does not specify the aggregate amount of securities that may be sold to any investor by all issuers within the relevant 12-month period. Accordingly, we read the reference in Section 4A(a)(8) as requiring intermediaries to take steps to confirm that an investor in a specific crowdfunding transaction has not, in the preceding 12-month period, purchased securities in other crowdfunding transactions that exceeded the investor limitations applicable to purchases of securities from each issuer in such other transactions. We do not read the provision as imposing a substantive limitation on investments extending beyond the scope of the limitation set forth in Section 4(6)(B).

<sup>10</sup> The Commission may also determine that intermediaries are entitled to rely on self-certification from investors as to their compliance with the investor maximum purchase limitations, as discussed in Item 7 of this comment letter.

6. The Commission should develop a standard set of investor education materials that could be used to satisfy the investor education requirements of Title III.

One of the principal benefits of the crowdfunding rules may be the opportunity they provide to disseminate investor education materials widely to retail investors. Section 4A(a)(3) requires intermediaries to provide investors with disclosure relating to risks and other investor education materials, as the Commission determines appropriate. We believe it would be very helpful if the Commission were to create a standardized set of basic investor education materials that could be used by intermediaries to satisfy this requirement. Among other things, the use of a standardized set of materials would help to assure that investors are provided with information regarding their rights as investors and their remedies should the investors believe that an issuer has acted fraudulently or otherwise in violations of the securities laws, a matter that many issuers may not be willing to highlight. Issuers and intermediaries should be free to supplement this information as appropriate (assuming issuers otherwise fulfill the mandatory disclosure obligations established by the Commission in implementing Section 4A(b)), but a standardized set of investor education disclosures would assure that investors receive straightforward, clear and helpful information that will assist them in formulating investment decisions. The information could also provide a link ([www.investor.gov](http://www.investor.gov)) and contact information to the Commission's Office of Investor Education and Advocacy, as well as information regarding possible enforcement recourse in the event that fraud or irregularity are suspected. We see this as accretive: the more investors learn about intelligent investing, the more likely they are to be informed investors going forward, and to share their information with others.

7. The Commission should permit issuers and intermediaries in crowdfunding transactions to rely in good faith on investor representations as to the investor's net worth and annual income without requiring additional verification.

Pursuant to Title III, all investors will be able to invest up to the greater of \$2,000 or 5% of the investor's annual income or net worth in crowdfunding transactions during a 12-month period. In order to invest at higher levels, however, investors in crowdfunding transactions will be required to represent that they have annual income or net worth in excess of \$100,000. We are aware that the investment limitations that Congress imposed on purchases by investors in crowdfunding transactions could be evaded were investors to misrepresent their net worth or annual income to issuers or intermediaries. However, we are concerned that any requirement that issuers or intermediaries undertake a verification process would be both costly and burdensome, especially because a single crowdfunding transaction may attract hundreds or even thousands of potential investors. Verification with respect to income may require a review of tax records, and verification of net worth may require analysis of the value of particular assets

owned by investors, as well as a review of the investor's liabilities, which may be very complicated.<sup>11</sup> In many cases, the costs of verification may be disproportionate relative to the amount of funds being raised. Finally, requiring investors in crowdfunding transactions to provide personal financial information may create privacy concerns and dissuade investors from participation in crowdfunding transactions.

Based upon the above considerations, we believe the Commission should permit issuers and intermediaries in crowdfunding transactions to rely in good faith on investor representations as to the investor's net worth and annual income without requiring additional verification (unless otherwise on notice that a particular potential investor may not be eligible). We also suggest that the Commission consider proposing that issuers include a statement in any offering circular or related document (such as an investor questionnaire or subscription agreement) advising investors that any misrepresentation by an investor with respect to the investor's annual income or net worth could cause the issuer to sell securities in excess of the individual limits established by statute. This statement could also note that the Commission has the authority to initiate administrative proceedings or seek other remedies against investors who fraudulently misrepresent their annual income or net worth.

Finally, we suggest that the Commission include in the proposed rule a provision to the effect that an issuer will not lose the Section 4(6) exemption with respect to a crowdfunding transaction if it reasonably believes that the aggregate amount sold to investors in the transaction does not exceed the maximum amounts set forth in clauses (A) and (B) of Section 4(6).<sup>12</sup> Because time will tell whether investor misrepresentation proves to be a significant problem, we recommend that, whatever standard the Commission may propose and may adopt, the Commission should monitor compliance with this requirement following the effectiveness of the final crowdfunding rules in order to determine whether there appear to be significant violations of the statutory investment limitations and, if appropriate, to consider additional rulemaking to reduce the risk of any such violations in future periods.

8. The Commission should consider increasing the target amounts that would require an issuer in a crowdfunding transaction to prepare audited financial statements.

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<sup>11</sup> Consider, for example, how an issuer or intermediary would be able independently to determine whether an investor's estimate of the value of home furnishings or collectibles is accurate. Although we understand that third party companies may be able to provide verification services, we do not believe the Commission's proposed rulemaking should impose obligations in anticipation that such service companies will develop, or if they do, that they will be able to provide such services in a reliable, cost-efficient manner to crowdfunding issuers and/or intermediaries.

<sup>12</sup> A reasonable belief standard would be consistent with the determination of "accredited investor" status in Rule 506 offerings, and eligible "qualified institutional buyers" in Rule 144A transactions.

The JOBS Act provides that every issuer that offers or sells securities that (together with all other offerings of the issuer under Section 4(6) within the preceding 12-month period) have a target offering amounts of more than \$500,000 is required to prepare, file with the Commission and provide to investors audited financial statements. The JOBS Act, however, specifically authorizes the Commission to change the threshold triggering an obligation to provide audited financial statements. Although we appreciate that an audit report would provide additional integrity to an issuer's financial statements, we are concerned that the additional costs associated with an audit may discourage some issuers from undertaking a crowdfunding offering at or above the \$500,000 level. Because the Commission has the express authority to revise the \$500,000 threshold, we recommend that the Commission consider a higher trigger level for the audited financial statement requirement amount (such as \$750,000), or identify additional criteria (such as revenue levels) that would require an issuer to provide audited financial statements, and invite public comment as to the appropriateness of such levels or criteria.<sup>13</sup>

Because amounts raised in a crowdfunding transaction are required to be aggregated with amounts raised in crowdfunding transactions conducted by the same issuer within the preceding 12-month period for the purpose of calculating whether a review or audit of the issuer's financial statements is required, we are concerned that the audit requirement could be triggered by a small offering that follows prior offerings within the preceding 12-month period. For example, were the applicable audit trigger level set at \$500,000, and an issuer were to seek to raise \$100,000 after having raised \$400,000, the issuer would be obligated to engage an auditor to conduct an audit of its financial statements in connection with the planned crowdfunding offering. We note that, in this example, the prior investors would have already made their investment decisions without the benefit of having audited financial statements. Moreover, the costs of the audit could represent a significant percentage of the additional amounts to be raised. Issuers in this situation would be required either to incur the cost of an audit or, in order to avoid the audit, to defer the offering until the passage of time would not require audited financial statements, or to seek capital by some other route.

In view of the Commission's express statutory authority with respect to the audit requirement, we recommend that an issuer not be required to provide audited financial statements in connection with a crowdfunding transaction if (i) the target offering amount in the crowdfunding transaction is not greater than \$100,000 (notwithstanding any other crowdfunding transactions conducted by the issuer within the preceding 12-month period), and (ii) the issuer has not conducted a crowdfunding transaction within six months prior to the commencement of the proposed crowdfunding transaction. The latter requirement would minimize the

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<sup>13</sup> We note that this provision, as well as other provisions of Title III, refers to a "target offering amount." As discussed in Item 10 below, we believe that issuers should be permitted to raise amounts of capital in excess of the target offering amount, subject to their compliance with certain additional disclosure obligations.

risk that issuers will seek to avail themselves of the exemption in clause (i) by arranging a series of crowdfunding transactions. We note that if audited financial statements are not required, an issuer would nonetheless be required to provide reviewed financial statements for offerings that, together with all other crowdfunding transactions by the issuer within the preceding 12-month period, have, in the aggregate, target offering amounts of more than \$100,000.

9. The Commission should require an issuer that has engaged in a crowdfunding transaction to provide reviewed or audited financial statements in its annual report only if the total assets of the issuer at the last day of its fiscal year exceed specified amounts.

We believe that the Commission's rules regarding annual reporting by issuers that have engaged in crowdfunding transactions should require issuers to provide reviewed or audited financial statements only if the total assets of the issuer at the last day of its fiscal year exceed specified amounts. For example, financial statements reviewed by an independent accounting firm may be required only if total assets on such date exceed \$300,000 and audited financial statements should be required only if total assets exceed \$750,000. We suggest these tests based, in part, on the fact that public reporting pursuant to Section 12(g) of the Exchange Act is based on a total assets test, and the same Commission rules or staff guidance regarding Section 12(g) could apply equally to this situation.<sup>14</sup> We believe that a requirement based upon other standards, such as revenues or income, may result in developmental stage companies with considerable assets but limited or no revenues or income not being subject to the review or auditing requirements, and that a requirement based upon whether the issuer was required to provide reviewed or audited financial statements in connection with a prior crowdfunding transaction may subject the issuer to excessive costs in proportion to its current assets if its current asset levels have declined by reason of expenditures. In short, we believe that an asset test offers a reasonable predicate for balancing the relative costs to very small, early-stage issuers vs. informational benefits to crowdfunding investors (recognizing, of course, that equity securities issued in "crowdfunding" transactions are carved out of the Section 12(g) record holder calculation).<sup>15</sup>

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<sup>14</sup> See, e.g., Exchange Act Rule 12g5-2 (defining "total assets").

<sup>15</sup> In addition, the Commission should also consider specifying criteria for determining when issuers that have conducted an offering exempt under the crowdfunding provisions will no longer be required to prepare an annual report. Similar to Section 15(d) of the Exchange Act, that obligation could terminate after a specified period of time if the securities of the class issued in the crowdfunding transaction are held by less than a specified number of holders of record as of the beginning of a fiscal year.

10. The Commission should permit issuers to raise funds in excess of the target offering amounts subject to specified conditions.

In determining whether a review or an audit by an independent public accountant is required, and in connection with certain disclosures issuers are required to make in connection with crowdfunding transactions, Title III refers to target offering amounts. Although Title III suggests that the target offering amount is not an absolute cap on the amount an issuer can raise in a crowdfunding transaction<sup>16</sup>, the statute does not provide clarity as to the obligations imposed on an issuer that seeks to accept investments in excess of the target offering amount. We suggest that the Commission's proposed rules permit issuers to raise funds in a crowdfunding offering in excess of the target offering amount, subject to the following conditions:

- a. An issuer seeking to raise amounts in excess of the target offering amount must disclose:
  - i. The maximum amount that it will raise in the crowdfunding transaction.
  - ii. The total amount of securities that will be issued should the target offering amount be raised and the total amount of securities that will be issued should the maximum amount be raised.
  - iii. The anticipated use of proceeds should the target offering amount be raised and the anticipated use of proceeds should the maximum amount be raised.
- b. If the maximum amount exceeds the target offering amount, the issuer would be required to provide the financial statements (certified, reviewed or audited) that would have been required had the target offering amount been stated to be equal to the maximum amount.<sup>17</sup>

11. The Section 4(6) disqualification provisions should be consistent with the disqualification provisions applicable to other Securities Act exemptive safe harbors.

Section 302(d) of the JOBS Act requires the Commission to adopt disqualification rules applicable to crowdfunding transactions that are "substantially similar" to

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<sup>16</sup> Subsection (a)(7) of Section 4A provides that "all offering proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to *or greater* than a target offering amount..." (italics added)

<sup>17</sup> Also, in our view, the calculation of amounts raised in crowdfunding transactions during the preceding 12-month period should equal the aggregate of the amounts actually raised rather than the target offering amounts.

those set forth in Rule 262 under the Securities Act. Because the Commission is currently engaged in rulemaking required under the Dodd-Frank Act to implement disqualification provisions under Rule 506 of Regulation D, we believe it would be appropriate for the Commission to adopt a uniform disqualification standard applicable to Rule 506 transactions, Regulation A transactions and crowdfunding transactions pursuant to Section 4(6). Uniformity will avoid unnecessary complexity and therefore facilitate compliance by issuers and persons acting on their behalf. Because of the potential breadth of the disqualification provisions, the Commission may also want to create, or work with FINRA to create, a central database of persons and entities that are disqualified under these rules.

12. The Commission should specify what compensation models would be acceptable for a crowdfunding intermediary that is not registered as a broker or dealer under the Exchange Act.

New Section 4A(a) of the Securities Act requires that any person acting as an intermediary in a crowdfunding transaction register with the Commission, either as (i) a broker or (ii) a funding portal (as defined in Section 3(a)(80) of the Exchange Act). Pursuant to Section 3(a)(80), the term “funding portal” means any person acting as an intermediary in a crowdfunding transaction that does not “(A) offer investment advice or recommendations; (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal; (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (D) hold, manage, possess, or otherwise handle investor funds or securities; or (E) engage in such other activities as the Commission, by rule, determines appropriate.”

Although Title III clearly prohibits a funding portal from compensating its employees, agents or other persons for solicitation activities in respect of purchases or sales of the securities being offered in crowdfunding transactions based on “such solicitation or based on the sale of securities displayed or referenced on its website or portal”, there is no provision relating to the means by which the funding portal itself may be compensated. We believe the Commission should seek public comment regarding the compensation of funding portals and provide appropriate guidance as to the types of compensation models that may be implemented by a funding portal without triggering a requirement that the funding portal also register as a broker or dealer under the Exchange Act.

In particular, we note that the staff of the Commission has maintained in other contexts that the receipt of so-called “transaction-based compensation” is the hallmark of broker-dealer activity, and that an entity receiving such compensation should normally be registered as a broker or dealer absent an available exemption. In view of this position, several important questions should, in our view, be addressed in the Commission’s rulemaking. For example, if a funding portal



were to receive a fee from the issuer that is success-based or that represents a percentage of the amount raised by the issuer in a crowdfunding transaction, would the funding portal be required to register as a broker or dealer under Section 15(a) of the Exchange Act? Is a funding portal entitled to charge only a flat fee that is paid regardless of whether the crowdfunding transaction is ultimately consummated and regardless of the amount that is actually raised in the offering? If the latter limitation is imposed, the cost to the crowdfunding issuer may be too high to risk utilizing the funding portal's services and would appear to defeat the Congressional purpose in establishing this new category of intermediary.

13. The Commission should provide guidance as to what activities may be undertaken by a crowdfunding intermediary that do not constitute "investment advice", as well as with respect to the activities in which a funding portal may engage or not engage without registration as a broker, dealer or investment adviser.

As noted above, there are significant limitations on the activities in which a crowdfunding intermediary may engage if it is registered solely as a funding portal. We believe the Commission should provide guidance as to those activities in which a funding portal is able to engage without registration as a broker, dealer or investment adviser. In this regard, the proposed rules should provide guidance as to which activities would not constitute "investment advice" as used in Exchange Act Section 3(a)(80), and clarify that the reference to "investment advice" refers to investment advice regarding the securities to be offered in the crowdfunding transaction. In addition, we are concerned that the limitation as to the provision of "investment advice" could be interpreted to prohibit a prospective crowdfunding intermediary that is registered as an investment adviser with the Commission or applicable state regulatory authority from registering as a funding portal under Section 4A, and we therefore request further clarification with respect to this issue as well.

We also believe the Commission's proposed rules should permit a registered broker-dealer to establish a separate subsidiary or affiliate (including a separate unit, department or division within the broker-dealer itself) that may engage in crowdfunding activities on the same basis as funding portals that are not affiliated with a broker-dealer (*i.e.*, subject to the same requirements and limited obligations applicable to funding portals). The absence of such capability could put registered broker-dealers at a competitive disadvantage relative to funding portals.

14. The Commission, together with FINRA, should consider which rules currently applicable to registered broker-dealers should also be applicable to funding portals and, correspondingly, which rules should not.

Funding portals exempted from the requirement to register as a broker or dealer pursuant to Section 304(a) of Title III are, among other things, required to become

members of a national securities association registered under Section 15A of the Exchange Act. We are aware that FINRA, as the only such national securities association so registered, is already in discussions with the Commission regarding the registration and regulation of funding portals and has been actively considering which of its rules would apply to registered funding portals as well as to broker-dealers that engage in crowdfunding activities.<sup>18</sup>

We expect to provide detailed comments regarding the application of FINRA's rules to crowdfunding intermediaries once FINRA is further along in its process. However, we note that, at a minimum, such proposed rulemaking should address the application of (or exemption from) rules regarding recordkeeping, privacy, suitability, capital, fidelity bond requirements, personnel licensing requirements, anti-money laundering, reporting, due diligence, continuing education requirements, arbitration and dispute resolution, "know your customer" requirements, the account opening process, standards for communications with the public and the use of material nonpublic information. We believe the provision of more specific comments on these and other rules is premature at the present time, but look forward to submitting them in the future once the Commission and/or FINRA solicits further input.

15. The Commission should clarify that a crowdfunding intermediary will not be required to register as an exchange or alternative trading system.

The activities of a crowdfunding intermediary may be deemed to bring together purchasers and sellers of securities within the meaning of Section 3(a)(1) of the Exchange Act, and, absent further clarification or exemption, could require such intermediary to register with the Commission as an exchange or alternative trading system.

Although Rule 3b-16 under the Exchange Act describes certain activities that fall outside the definition of "exchange", we believe further clarification regarding the parameters of a crowdfunding intermediary's permitted activities in this context is necessary. Without such clarification or exemptive relief, these requirements would likely thwart the intent of Title III.

The Committee appreciates the opportunity to submit these comments. Members of the Committee are available to meet and discuss these matters with the Commission and its staff and

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<sup>18</sup> See FINRA Regulatory Notice 12-34 (July 2012). FINRA's Board of Governors has also recently approved the issuance by FINRA of an interim form that would seek to elicit certain information from prospective funding portals intending to apply for membership with FINRA in accordance with the JOBS Act. See Letter from Richard Ketchum regarding the FINRA Board of Governors Meeting dated December 7, 2012 at <http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P197425>.

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to respond to any questions.

Very truly yours,

/s/ Catherine T. Dixon

Catherine T. Dixon

Chair, Federal Regulation of Securities Committee

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