

Equity Crowdfunding Under Federal Law: Intermediaries

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On October 23, 2013, the Securities and Exchange Commission released proposed rules for implementing the crowdfunding exemption from the Securities Act registration requirements that is set forth in the Jumpstart Our Business Startups Act (JOBS Act). The equity crowdfunding exemption, which reflects the popularity of rewards-based and donation crowdfunding on sites like Kickstarter and Indiegogo, would allow private companies to sell securities in small denominations to a broad range of investors over the Internet.

The proposed rules, which were due to be released at the end of last year, hew close to the statute and fill in the details of a fairly burdensome regulatory framework for both issuers and intermediaries, but do not go as far as some crowdfunding proponents had feared or as some investor protection advocates had hoped. The sheer size of the proposing release for the new rules (585 pages in the original PDF) should be enough to warn investors and issuers that equity crowdfunding is not “Kickstarter for stocks.” Heavy comments from both sides are expected during the 90-day comment period for the rules, and final rules are not expected to be in place until next summer at the earliest.

Until then, equity crowdfunding is not legal.

This alert focuses on the rules as applied to crowdfunding intermediaries, which are designed to provide a platform for the offering and sale of crowdfunding securities and mediate transactions and information flow among issuers and investors.

An alert focused on the proposed rules as applied to issuers can be found by [clicking here](#).

Business Issues

Three central business issues emerge for intermediaries from the proposed rules: (1) funding portals vs. brokers, (2) compensation restrictions and (3) compliance obligations.

Funding Portals vs. Brokers

The proposed rules delineate the specific services that intermediaries would be able to provide. “Funding portals,” a special class of brokers that may only act as crowdfunding intermediaries, would be permitted to provide more limited services, while registered brokers would be permitted to provide more extensive services. Funding portals, even if they do not receive a commission, are still brokers under federal law, but the JOBS Act gives them an exemption from registering as brokers – though they must register as funding portals.

Funding portals would be limited to:

- Providing a searchable platform through which issuers could sell and investors could purchase crowdfunding securities,
- Facilitating the offer and sale process,
- Providing certain educational materials and between-investor communications functionality, and
- Advising issuers on the structure and content of offerings.

Registered brokers (but not funding portals) would be permitted to deliver additional services, including:

- Providing investment advice,

- Engaging in solicitation,
- Handling investor funds and securities, and
- Potentially facilitating secondary market transactions.

The rules contemplate and would permit the provision of services from funding portals to registered brokers (*i.e.*, information technology services) and from registered brokers to funding portals (*i.e.*, recommending securities listed on a funding portal's platform).

Compensation Restrictions

Intermediaries would be prohibited from receiving securities of an issuer as compensation for hosting a crowdfunding offering. The JOBS Act requires an intermediary to prohibit its directors, officers or partners from having any financial interest in the issuer using its services. The proposed rules would extend this prohibition to cover the intermediary itself and define "financial interest" in this context to mean an interest in any class of the issuer's securities. Intermediaries would, however, be able to receive a cash commission based on the success of the offering, including the amount raised.

The SEC has stated by way of clarification that funding portals would be permitted to receive commissions, so long as the portal fully discloses how it will be compensated when a prospective investor opens an account with the funding portal.

The proposed rules would prohibit intermediaries from paying for certain types of referrals, namely the provision of an investor's personally identifying information. Intermediaries would be able to provide compensation for other types of referrals, including the delivery of information regarding issuers or investors that are entities and the delivery of investors themselves (rather than their personally identifying information) to the intermediary's portal.

Compliance Obligations

The proposed burden of compliance, which is largely dictated by the underlying statute, appears to be substantial. It is already the case that broker-dealers must register with the SEC and become a member of a self-regulatory organization such as FINRA, the Financial Industry Regulatory Authority. Customer accounts at broker-dealers are insured by the Securities Investor Protection Corporation, SIPC.

Funding portals would also be required to register with the SEC and become a member of FINRA (which has separately proposed 50 pages of rules for FINRA membership of funding portals), but would be subject to a more streamlined registration process, and instead of SIPC, would be required to post a substantial fidelity bond to provide security to customers.

The proposed rules also impose a range of ongoing time- and resource-intensive post-registration compliance requirements. All intermediaries would be required to:

- Reasonably assess the eligibility and compliance of investors and issuers participating on their platform (and intervene when appropriate),
- Provide communications channels for investors to communicate with issuers and each other,
- Publish issuer information,
- Provide educational materials (which could be of the intermediary's own creation within certain guidelines),
- Provide informational disclosures with respect to offerings, and
- Provide certain types of communication to investors.

Intermediaries would also be subject to a variety of recordkeeping and funds transfer requirements and would be required to adopt and implement compliance programs regarding privacy, anti-money laundering and similar topics.

The Rules In More Detail

The proposed rules are quite detailed. Highlights are summarized below.

Registration And Membership Requirements

The proposed rules would require all intermediaries to register with the SEC. Broker-dealers already file the existing Form BD with the

SEC, while intermediaries registering as funding portals would be required to file the new Form Funding Portal.

The proposed new Form Funding Portal would ask for similar types of information as Form BD, although it would require less extensive disclosure. Like Form BD, Form Funding Portal would be available to the public with standard exceptions for certain personally identifiable and similar information.

Funding portals would have to post a \$100,000 fidelity bond as a condition of registration to help protect investors and issuers for the loss of funds, but would not be subject to any net capital requirements.

The registration of a funding portal would be effective as of the later of 30 calendar days after the date that the SEC receives the registration or the date FINRA approves the funding portal. All intermediaries would be required to register with FINRA.

Eligibility Determinations

The proposed rules would require an intermediary to assess the eligibility of both issuers and investors to participate in a given offering. The intermediary would be required to have a reasonable basis for believing that an issuer is in compliance with the crowdfunding regulatory framework and has established some means to keep accurate records of holders of the securities they offer. In making this assessment, the intermediary would be permitted to reasonably rely on the representations of the issuer, absent knowledge or another indication that the representations were not true.

An intermediary would be required to deny access to an issuer or a particular offering if the intermediary were to believe that providing access would present a potential for fraud or if the intermediary were to have a reasonable basis to believe that the issuer or certain covered persons of the issuer would be disqualified from issuing or participating in the issuance of crowdfunding securities under “bad actor” disqualification provisions that are substantially similar to the recently adopted disqualification provisions under Rule 506(d) of Regulation D.

An intermediary would be required to reasonably determine that each investor is in compliance with applicable investment limitations. The proposed rules would permit an intermediary to rely on an investor’s representations concerning compliance with such limitations unless it has reason to question the reliability of such representations and would require an intermediary to account for all other crowdfunding investments made by an investor through the intermediary, as well as other information or facts within its possession, in making that determination.

Before accepting an investment commitment, an intermediary also would be required to obtain certain specified representations from an investor regarding the investor’s review of the intermediary’s educational materials and the investor’s understanding of the risk involved in the investment.

Communications To, With And Among Investors

The proposed rules would require intermediaries to conduct and facilitate the delivery of educational materials, transactional information and information regarding each offering to investors. To permit such delivery, and as a prerequisite to accepting an investment commitment, intermediaries would be required to oblige investors to open an account with the intermediary and consent to the electronic delivery of materials.

At account opening, an intermediary would have to inform investors of the manner in which the intermediary will be compensated in connection with crowdfunding offerings and that any person who promotes an issuer’s offering for compensation, or is a founder or an employee of an issuer that engages in promotional activities on behalf of the issuer on the intermediary’s platform, must disclose that interest in all communications on the platform.

Intermediaries would also be required to electronically deliver to investors educational materials in plain language designed to effectively communicate the following information:

- The process for the offer, purchase and issuance of securities through the intermediary,
- The types of securities that may be offered on the intermediary’s platforms and the risks associated with each type of security, including the risk of dilution,
- The restrictions on the resale of crowdfunding securities,

- The types of information that issuers are required to provide in annual reports, the frequency of the delivery of that information and the possibility that an issuer's obligation to file annual reports may terminate,
- The limitations on the amount that investors can invest,
- The circumstances in which an issuer may cancel an investment commitment,
- The limitations on an investor's right to cancel an investment commitment,
- The need for investors to consider whether investing in a crowdfunding security is appropriate for such investor, and
- A statement that, following the completion of an offering, there may or may not be any ongoing relationship between the issuer and the intermediary.

Intermediaries would be required to make publicly available on the intermediary's platform at least 21 days prior to the first day on which crowdfunding securities are sold to an investor the information provided by the issuer to the intermediary pursuant to the crowdfunding rules regarding issuer disclosure. That information would have to remain publicly available on the intermediary's platform until the offering is completed or canceled and be viewable even by persons who have not established an account with the intermediary.

Intermediaries would be required to provide communications channels through which investors could communicate with one another and with representatives of issuers about offerings. An intermediary that is a funding portal would be prohibited from participating in communications in these channels, with the exception of establishing communications guidelines or removing abusive or potentially fraudulent communications. These communications channels would be required to be publicly available to view, but participation would be restricted to those persons who have opened accounts with the intermediary.

Maintenance, Transmission And Return Of Investor Funds

The proposed rules would require prompt deposit and transfer instructions and other communications by intermediaries with respect to investment funds.

Funding portals would be required to direct investors to deposit investment funds with a bank that has agreed in writing either to hold the funds in escrow or to establish a bank account for the exclusive benefit of investors and the issuer. The intermediary would be required to subsequently direct transmission of funds to the issuer upon the closing of the offering or to the investor upon the cancellation of an investment commitment.

Intermediaries that are registered brokers would be permitted to receive funds directly, to be deposited promptly in a separate bank account and transmitted or returned upon the closing of the offering or cancellation of the investment commitment. The proposed rules would require that intermediaries provide electronic confirmation of transactions executed containing the details of the transactions and information regarding the compensation received from the intermediary in connection with the transactions.

Intermediaries would be required to provide investors with the opportunity to cancel their investment commitments until 48 hours prior to the deadline identified in an issuer's offering materials.

Intermediaries would not be able to close an offering until the target amount of investment commitments from all investors is greater than the target amount of the offering, the cancellation period for each investor has expired, and at least 21 days have passed since the date on which the intermediary makes publicly available on its platform the information required to be provided by the issuer regarding the offering.

If there is a material change to the terms of the offering or information provided by the issuer regarding the offering, an intermediary would be required to notify potential investors of that change and that the investors' commitments will be canceled absent investor reconfirmation of such commitment within 5 business days of receipt of the notice. Intermediaries would also be required to notify investors about unsuccessful or terminated offerings within 5 business days thereof.

Compensation Arrangements

As noted above, the proposed rules would prohibit intermediaries from compensating any person for providing them with personally identifiable information (information that can be used to distinguish or trace an individual's identity) of any investor or potential investor. Intermediaries would be able to provide compensation to a third party for directing issuers or potential investors to the intermediary's platform as long as no personally identifiable information of any investor is provided and as long as the compensation, unless it is

provided to another intermediary, is not based on the purchase or sale of a crowdfunding security. As discussed above, intermediaries would also not be able to receive securities of the issuer as compensation for providing services in connection with the offering of crowdfunding securities.

Funding Portal Permitted Activities

Unlike a broker-dealer, a funding portal would not be able to offer investment advice or recommendations, solicit purchases, sales or offers to buy the securities offered or displayed on its platform, provide compensation for such solicitation, or handle investor funds or securities. The proposed rules provide a nonexclusive, conditional safe harbor specifying a funding portal would generally be able to engage in the following activities:

- Apply objective criteria to limit offerings, highlight offerings and permit investors to search or categorize offerings. Such objective criteria generally would include the type of securities being offered, the geographic location or industry/business segment of the issuer, and when applicable, the number or amount of investment commitments made, progress in meeting the issuer's target offering amount or the maximum or minimum investment amount. Such criteria would not include the portal's assessment of the advisability of investing in the offering and the funding portal would not be able to accept additional compensation to highlight an offering.
- Advise an issuer about the structure or content of the issuer's offering, including assisting the issuer in preparing the offering documentation.
- Advertise the existence of the funding portal and identify one or more issuers or offerings on the portal on the basis of objective criteria in such advertisement. Funding portals would not be able to accept payment for highlighting a particular issuer or offering in an advertisement.
- Accept, on behalf of an issuer, investment commitments for crowdfunding securities of that issuer on the funding portal's platform.
- Direct investors where to transmit funds or remit payment in connection with purchases of crowdfunding securities.
- Direct a bank to release proceeds to an issuer upon completion of a crowdfunding offering or return proceeds to investors in the event of that an investment commitment or an offering is canceled.
- Compensate third parties for referring a person to the funding portal, so long as the third party does not provide the funding portal with personally identifiable information of a potential investor and the compensation arrangement is not in violation of other rules.
- Provide compensation to or receive compensation from a registered broker-dealer for services rendered in connection with the offer or sale of crowdfunding securities pursuant to a written agreement.
- Comply with legal requirements, such as providing communications channels by which investors can communicate with one another and with representatives of an issuer and denying access to its platform to, or cancel the offering of an issuer that the funding portal believes may present the potential for fraud or raise investor protection concerns.

Compliance Requirements

The proposed rules would impose a variety of compliance requirements on funding portals, with more extensive requirements applicable to registered brokers by virtue of existing law. Funding portals would be required to:

- Implement written policies and procedures reasonably designed to achieve compliance with federal securities laws and regulations relating to their business,
- Comply with certain anti-money laundering provisions such as establishing and maintaining an effective anti-money laundering program, establishing and maintaining a customer identification program, monitoring for and filing reports of suspicious activity and complying with requests for information from the Financial Crimes Enforcement Network,
- Verify customer identities and run queries of customers against lists of known or suspected terrorist organizations, and
- Submit to SEC examination and inspection and would be subject to certain recordkeeping and preservation requirements.

The proposed rules would subject funding portals to the same privacy rules applicable to brokers, which include required notification of privacy policies and practices, permitting customers to block certain affiliates from soliciting based on eligible information, and developing and implementing an identity theft prevention program.

All intermediaries would also be subject to certain bad actor disqualification provisions (which are slightly different from the disqualification provisions applicable to issuers), which would disqualify intermediaries from effecting or participating in transactions based upon certain criminal convictions, injunctions related to unlawful trading activity, suspensions or expulsions from regulatory organizations and similar events with respect to the intermediary or its related persons.

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