

Client Alert

November 10, 2015

SEC Adopts JOBS Act Crowdfunding Rules

Congress enacted the JOBS Act in April of 2012 adding Sections 4(a)(6) and 4A to the Securities Act of 1933 (the “1933 Act”). Among other things, this legislation directed the SEC to adopt rules to exempt crowdfunding transactions from registration under the federal securities laws. The SEC released its proposed crowdfunding rules in October of 2013.

On October 30, 2015, the SEC adopted the final crowdfunding rules.

The crowdfunding rules contain limits on the amount of funds that companies can raise in a crowdfunding transaction and the amount an investor can invest in crowdfunding offerings. The rules also govern the manner in which such an offering must be conducted and set forth the reporting and disclosure obligations a company must comply with during and following a crowdfunding offering. In addition, these rules provide that a crowdfunding transaction must take place exclusively online through platforms operated by a **single** SEC registered intermediary, either a registered broker-dealer or a new type of SEC registrant called a “funding portal”.

The crowdfunding rules will become effective in May of 2016 (180 days after their publication in the Federal Register), except those applicable to the forms allowing funding portals to register with the SEC; these forms will be effective on January 29, 2016.

Background

Historically, the term “crowdfunding” has been used to describe fund raising activities that used the internet to raise money for charitable causes.

From a capital raising perspective, crowdfunding is viewed as a capital raising technique that will allow startups to inexpensively raise capital from a large group of investors. The investment opportunity would be available to all investors, not just those with a high net worth or net income, allowing the small investor to acquire shares in a company that one day might become a Fortune 100 company (e.g., Facebook) and reap the benefits of such an investment.

However, offers and sales of securities to the public generally require compliance with the registration requirements of the 1933 Act and state securities laws. As a consequence, crowdfunding has not been used to raise investment capital.

Some forms of capital-raising techniques are often mistakenly referred to as crowdfunding, but these techniques are not crowdfunding as these offerings are not usually available to small investors.

For example, an intermediary (usually a broker-dealer) may establish a web-based platform for companies to connect with “accredited investors” in unregistered securities offerings; these offerings are usually made under the exemption for private offerings under Rule 506 of Regulation D. But this is not crowdfunding, as the investors must be accredited investors—for individuals, a net worth in excess of \$1 million or net income in excess of \$200,000—and the companies seeking capital are not typically startups.

The JOBS Act provisions and the SEC crowdfunding rules are supposed to allow startups and small investors to take advantage of these capital raising opportunities. As can be seen from what follows, however, the JOBS Act provisions and crowdfunding rules establish what may be a cumbersome and potentially costly regulatory regime. Costs companies may incur in meeting requirements related to financial statements and costs related to preparing the required offering circular may deter companies from undertaking crowdfunding offerings. In addition, companies will have to pay a fee to an intermediary for its services.

Furthermore, companies that use the exemption will have to post their financial information on their websites in an annual report; the report will be available for all the world to see, including competitors. Because of the individual investor investment limitations, a company may add a significant number of shareholders. It may be costly and time consuming to manage all of these new shareholders. Companies will have to consider a variety of issues when it brings in a new group of investors that it may not have had to consider when it was closely held, such as will fiduciary duties that are owed to shareholders, the observance of more corporate formalities, the election of directors and the distribution of company information.

With a proposed limit of \$1 million on the amount that a company may raise in crowdfunding transactions in any 12-month period and the costs that may be incurred to complete a crowdfunding offering, the issue to be resolved is whether the benefits of raising capital through crowdfunding or acting as a crowdfunding intermediary would be great enough to justify the compliance costs and potential liability risks.

Crowdfunding Rules for Companies Seeking to Raise Capital

Offering and Investment Limits

The crowdfunding rules contain the following thresholds and limits:

- The aggregate amount of securities that may be sold by a company within a 12-month period in crowdfunding transactions may not exceed \$1 million.
- During any 12-month period, the aggregate amount of securities sold to any investor **by all companies in crowdfunding transactions** must not exceed the greater of:
 - (i) \$2,000 or 5% of either the annual income or net worth of such investor (and his spouse), if both the annual income **and** the net worth of the investor is less than \$100,000;

- (ii) 10% of either the annual income or net worth of such investor (and his spouse), if either the annual income **or** net worth of the investor is equal to or more than \$100,000; and
- (iii) a maximum aggregate amount of \$100,000 for all crowdfunding purchases in the 12-month period.

With respect to the limits on investors, the SEC illustrates such rules as provided below:

Investor Annual Income	Investor Net Worth	Calculation	Investment Limit <i>(across all offerings)</i>
\$30,000	\$105,000	Greater of \$2,000 or 5% of \$30,000 (\$1,500)	\$2,000
\$150,000	\$80,000	Greater of \$2,000 or 5% of \$80,000 (\$4,000)	\$4,000
\$150,000	\$100,000	10% of \$100,000 (\$10,000)	\$10,000
\$200,000	\$900,000	10% of \$200,000 (\$20,000)	\$20,000
\$1,200,000	\$2,000,000	10% of \$1.2 million (\$120,000), subject to \$100,000 cap	\$100,000

The investor purchase limits are calculated on all crowdfunding purchases made by an investor during any 12-month period. Thus, an investor’s purchases **in all crowdfunding transactions during such period must be aggregated** (and not just from the offering in which the investor is participating). A company may rely on the efforts of an intermediary to ensure that an investor does not exceed these aggregate purchase amounts.

The net worth and annual income tests will to be calculated using the accredited investor tests contained in Rule 501 of Regulation D. Before accepting any investment commitment, an intermediary must have a reasonable basis to believe that the investor satisfies the investment requirements under the crowdfunding rules, including the investment limits set forth above. The intermediary may rely on the investor’s representations that the investor so qualifies unless the intermediary has reason to believe otherwise (see **“Investor Qualifications”**).

Intermediaries

Under the crowdfunding rules, a crowdfunding transaction must take place exclusively online through platforms operated by a **single** SEC registered intermediary, either a registered broker-dealer or a new type of SEC registrant called a “funding portal” (see **“Intermediaries—Funding Portal”**). An intermediary must be a member of FINRA or any other applicable national securities association registered under Section 15A of the Securities Exchange Act of 1934 (the “Exchange Act”).

Disqualified Companies

The crowdfunding exemption will not be available to: (i) Exchange Act reporting companies, (ii) companies organized outside the United States, (iii) investment companies (and certain funds excluded from the Investment Company Act definition of investment company), (iv) companies that are not in compliance with the annual reporting requirements of the crowdfunding rules during the two-years immediately preceding the filing of an offering statement, (v) companies

that are development stage companies without a business plan or those whose business plan is to enter into business combination transactions with unidentified targets, and (vi) companies subject to the bad actor disqualification provisions of the crowdfunding rules.

“Bad Actor” Disqualification

A company may not conduct a crowdfunding offering if it has run afoul of any of the “bad actor” disqualifications under Rule 503 of the crowdfunding rules. Even if a company is not so disqualified, a description of any matters that would have prevented the company from relying on the crowdfunding exemption due to a disqualification under the crowdfunding “bad actor” rules that occurred before May of 2016 (180 days after their publication in the Federal Register) must be included in the company’s offering circular.

These bad actor disqualification provisions are substantially similar to the ones adopted for Rule 506 of Regulation D (for a discussion of these rules, see <http://www.hinshawlaw.com/newsroom-publications-alerts-524.html>).

Integration

A crowdfunding offering will not be integrated with other exempt offerings that precede the crowdfunding offering, or that take place concurrently or subsequently. The company must satisfy all of the conditions for the exemption that it is claiming for each such offering. If the company is conducting a Rule 506(c) offering (using general solicitation), it must ensure that the Rule 506(c) offerees are not solicited by means of the communications used for the crowdfunding offering.

State Blue Sky Laws

Under the final rules, registration requirements under state securities laws will be preempted for securities issued in crowdfunding offerings that comply with the crowdfunding requirements. Some states, including Illinois, have adopted rules to permit purely intrastate crowdfunding offerings.

Restrictions on Resales

Crowdfunding securities may not be transferred by the purchaser for one year after the date of purchase, except when transferred:

- to the company that issued the securities;
- to accredited investors (as defined in Rule 501 of Regulation D);
- as part of an offering registered with the SEC; or
- to a family member of the purchaser or the equivalent, or in connection with certain events (e.g., death or divorce).

It is important to note that this restriction applies not only to the original purchaser, but to any holder of such shares during the one-year period.

Advertising

The final rules limit the ability of companies, as well as others acting on their behalf, to advertise crowdfunding offerings. However, companies may provide very limited notices that direct investors to the intermediary's platform (the "Offering Notice"). This notice may include no more than the following:

- a statement that the company is conducting a crowdfunding offering, the name of the intermediary and a link directing the potential investor to the intermediary's platform;
- the terms of the offering, including the type of securities, offering price and closing date; and
- information about the legal identify and business location of the company, which must be limited to the name of the company, the address, the phone number and website of the company, the e-mail address of a representative of the company and a brief factual description of the business of the company.

These notices are similar to the "tombstone ads" permitted under Rule 134 of the 1933 Act.

A company may communicate with investors and potential investors about the terms of the offering through communication channels provided by the intermediary on the intermediary's platform (see "**Communication Channels**"). The company must identify itself as the entity making the communications. Persons acting on behalf of the company must identify their affiliation with the company in all communications made on the platform.

A founder or employee of the company that engages in promotional activities on the company's behalf through the intermediary's platform must disclose in each posting that he is engaging in such activities on the company's behalf.

A company may continue to engage in regular business communications so long as it does not disclose information about the offering, except as permitted in an Offering Notice. However, the final rules do not contain an express safe harbor for regularly released business information.

Compensation

A company may compensate or commit to compensate, directly or indirectly, a person to promote its crowdfunding offering through communication channels provided by an intermediary on its platform. The company, however, must ensure that such person clearly discloses the receipt, past or prospective, of such compensation and ensure that such disclosure is made each time a promotional communication is made.

A company may compensate the intermediary for its participation in the crowdfunding offering, so long as that compensation does not include a financial interest in the company. An intermediary must advise all investors, who open accounts with it, of the manner in which it will be compensated in connection with a crowdfunding offering.

An intermediary may not have a financial interest in a company that is offering or selling securities through the intermediary's platform unless:

- (1) the intermediary receives the financial interest from the company as compensation for the services provided to, or for the benefit of, the company in connection with the offer or sale of the securities being offered or sold in reliance on the crowdfunding exemption on the intermediary's platform; and
- (2) the financial interest consists of securities of the same class and having the same terms, conditions and rights as the securities being offered or sold on the platform.

An intermediary may compensate a third party for directing (but not soliciting) companies or potential investors to the intermediary's platform. If the compensation is not paid to a registered broker or dealer, the compensation must not be based on the purchase or sale of a security offered under the crowdfunding rules.

An intermediary is prohibited from compensating any person for providing an intermediary with personally identifiable information (e.g., name, social security number) of any investor or potential investor.

Types of Securities Offered

The final rules do not limit the types of securities that may be offered in a crowdfunding transaction. A company offering debt securities must determine whether it needs to comply with the Trust Indenture Act of 1939 (the "Trust Indenture Act"). The final rules do not include a specific exemption from Trust Indenture Act requirements for crowdfunding transactions.

Exemption from Section 12(g)

Holders of securities offered pursuant to the crowdfunding exemption do not count toward the threshold number of holders that would require a company to register with the SEC under Section 12(g) of the Exchange Act if the company is current in its annual reporting obligations, retains the services of a registered transfer agent and has less than \$25 million in total assets at the end of its most recently completed fiscal year. A company will have to develop procedures to keep track of such shareholders.

Offering Circular Disclosure Requirements

A company that offers crowdfunding securities must electronically file an offering circular on Form C with the SEC. A company will have to secure SEC access codes in order to file this form. The intermediary must provide a link to the offering circular to investors.

The company must provide to investors and the intermediary, offering materials which contain the following information:

- the name, legal status, physical address, website address of the company and the number of its employees;

- the names of the directors and officers (and any persons occupying a similar status or performing a similar function) and background information on such persons, and each person holding more than 20% of the shares of the company;
- a description of the business of the company and its anticipated business plan;
- information about the material factors that make an investment speculative or risky;
- the target offering amount, the deadline to reach the target amount, regular updates regarding the progress of the company in meeting the target offering amount, and whether the company will accept capital in excess of the target amount; and if so, the maximum amount that the company will accept and how over-subscriptions will be allocated;
- if the sum of the investment proceeds does not equal or exceed the target offering amount by the stated deadline, a statement that no securities will be sold and that the proceeds will be returned;
- the price to the public of the securities or the method for determining the price, provided that, prior to any sale, each investor is provided in writing the final price and all required disclosures;
- a reasonably detailed description of the intended use of the proceeds;
- information advising investors that: (i) they can cancel their subscription until 48 hours prior to the specified deadlines; (ii) the intermediary will advise investors when the target offering amount has been met; (iii) if the company reaches the target amount prior to the deadline, it may close the offering early (provided it gives the requisite notice); and (iv) if the investor does not cancel the investment before the 48-hour period, the funds will be released to the company if the offering closes;
- a statement advising investors that if an investor does not reconfirm the investment commitment after a material change to the offering, the investor's funds will be returned;
- detailed information about related-party transactions;
- a description of the financial condition of the company, including to the extent material, the company's results of operations, liquidity and capital resources;
- for offerings that, together with all other offerings of the company under the crowdfunding provisions within the preceding 12-month period, have, in the aggregate, the target offering amounts set forth below, the company must also provide the following:
 - *if the offering is for \$100,000 or less*: the amount of total income, taxable income and total tax or equivalent line items, as reported on the federal tax forms filed by the company for the most recently completed year (if any), certified by the principal executive officer of the company, and the financial statements of the company, also certified by the principal executive officer. If

financial statements of the company are available and have either been reviewed or audited by an independent public accountant, then, these financial statements must be provided in lieu of the materials described in the preceding sentence.

- if the offering is for more than \$100,000 and less than \$500,000: financial statements of the company reviewed by an independent public accountant. If financial statements of the company are available that have been audited by an independent public accountant, the company must provide those in lieu of the reviewed statements.
 - if the offering is for more than \$500,000: financial statements of the company audited by an independent public accountant. For companies that are first-time issuers, the financial statements need only be reviewed by an independent public accountant. If audited statements are available, those must be provided instead.
- financial statements must be prepared in accordance with U.S. GAAP. Financial statement audits must be conducted in accordance either with American Institute of Certified Public Accountants (“AICPA”) standards (“U.S. GAAS”) or Public Company Accounting Oversight Board (“PCAOB”) standards. A signed audit report must accompany audited financial statements.
 - during the first 120 days of the company’s fiscal year, a company may conduct a crowdfunding offering using financial statements for the two fiscal years prior to the most recently completed fiscal year if the financial statements for the most recently completed fiscal year are not otherwise available.
 - the name and the SEC file number of the intermediary;
 - the amount of compensation to be paid to the intermediary including any referral or other fees and any direct or indirect interest held by the intermediary in the company;
 - a description of the material terms of any indebtedness;
 - a detailed description of all exempt offerings made within the last three years;
 - a description of the ownership and capital structure of the company, including:
 - (i) terms of the securities of the company being offered and each other class of security of the company, 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 company;
 - (ii) how the exercise of the rights held by the principal shareholders of the company could negatively impact the purchasers of the securities being offered;

- (iii) how the securities being offered are being valued and examples of methods for how such securities may be valued by the company in the future, including during subsequent corporate actions;
 - (iv) the risks to purchasers of the securities relating to minority ownership in the company, the risks associated with corporate actions, including additional issuances of shares, a sale of the company or of assets of the company, or transactions with related parties; and
 - (v) a description of the transfer restrictions on the securities (see "**Restrictions on Resale**" for a discussion of these restrictions).
- a description of any matters that would have prevented the company from relying on the crowdfunding exemption due to a disqualification under the crowdfunding “bad actor” rules that occurred before May of 2016 (180 days after their publication in the Federal Register);
 - where on the company’s website investors will be able to find the company’s annual report, and the date by which such report will be available on the company’s website;
 - whether the company or any of its predecessors previously failed to comply with the ongoing reporting requirements set forth in the crowdfunding rules; and
 - any material information necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading.

Amendment of Offering Circular

A company will be required to amend its Form C disclosures by filing a Form C/A that will contain updates or material changes with respect to offerings that have not been completed or terminated. Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to purchase the securities. The company must identify on Form C/A whether the amendment is filed to disclose a material change. The amendment would have to be provided to investors and each intermediary. Investor reconfirmations must be obtained following the disclosure of a material change (see “**Completion of Offerings, Cancellations, Reconfirmations and Material Changes**”).

Progress Reports

A company will have to file with the SEC on Form C-U regular updates on the progress of its offering, such as when one-half or the whole target amount has been reached, and provide such updates to investors and each intermediary. A final Form C-U must be filed within five business days after the offering deadline. If the company will except proceeds in excess of the offering amount, it must file a final Form C-U to disclose the total sold within five business days after the completion of the offering.

Annual Reporting Requirements

A company that completes a crowdfunding offering will have to file with the SEC an annual report on Form C-AR and make the report available to investors by posting it on its website. The Form C-AR must be filed within 120 days of the end of the fiscal year. The annual report requires disclosure of information similar to that required in the offering statement filed on Form C, including the financial disclosure requirements applicable to the initial offering statement. The financial statements must be certified by the principal executive officer as being true and complete in all material respects. If the financial statements have been reviewed or audited by an independent public accountant, this certification is not needed.

Termination of Reporting

An company must file with the SEC a Form C-TR to terminate its reporting obligations within five business days of the date on which it becomes eligible to do so. A company can terminate its ongoing reporting requirements upon the earliest to occur of the following:

- the company is required to file reports under the Exchange Act;
- the company has filed at least one annual report and has fewer than 300 holders of record;
- the company has filed at least three annual reports and has total assets that do not exceed \$10 million;
- the company or another party purchases or repurchases all of the securities issued pursuant to the crowdfunding exemption, including any payment in full of debt securities or any complete redemption of redeemable securities; or
- the company liquidates or dissolves in accordance with state law.

Intermediaries--General

General

Under the crowdfunding rules, a crowdfunding transaction must take place exclusively online through platforms operated by a **single** SEC registered intermediary, either a registered broker-dealer or a new type of SEC registrant called a “funding portal” (see “**Intermediaries—Funding Portal**”). An intermediary must be a member of FINRA or any other applicable national securities association registered under Section 15A of the Exchange Act.

Financial Interests

An intermediary (and any of its directors, officers or partners, or any person occupying similar status or performing similar functions) may not possess or receive any direct or indirect ownership of, or economic interest in, any class of securities that a company offers through the intermediary’s platform.

An intermediary may not have a financial interest in a company that is offering or selling securities through the intermediary’s platform unless:

- (1) the intermediary receives the financial interest from the company as compensation for the services provided to, or for the benefit of, the company in connection with the offer or sale of the securities being offered or sold in reliance on the crowdfunding exemption on the intermediary's platform; and
- (2) the financial interest consists of securities of the same class and having the same terms, conditions and rights as the securities being offered or sold on the platform.

Compensation

A company may compensate the intermediary for its participation in the crowdfunding offering. An intermediary must advise all investors, who open accounts with it, of the manner in which it will be compensated in connection with a crowdfunding offering.

An intermediary may compensate a third party for directing (but not soliciting) companies or potential investors to the intermediary's platform. If the compensation is not paid to a registered broker or dealer, the compensation must not be based on the purchase or sale of a security offered under the crowdfunding rules.

An intermediary would be prohibited from compensating any person for providing an intermediary with personally identifiable information (e.g., name, social security number) of any investor or potential investor.

Broker-dealer intermediaries may pay transaction-based compensation to appropriately registered persons (but not funding portals) for the referral of companies and/or investors.

Disqualification

An intermediary that is subject to a "statutory disqualification" under the Exchange Act is prohibited from participating in crowdfunding transactions, absent relief from the SEC.

Company Access and Information

An intermediary must not grant a company access to the intermediary's platform if, at any time, the intermediary has a reasonable belief that:

- the company is not eligible to rely on the crowdfunding exemption;
- the company lacks an established means to keep accurate records of holders of the offered securities;
- the company is subject to "bad actor" disqualifications under the crowdfunding rules; or
- the offering presents the potential for fraud or otherwise raises concerns regarding investor protection.

With respect to the "bad actor" disqualification rules, an intermediary must conduct a background and securities enforcement regulatory history check on each company whose

securities are to be offered by the intermediary, as well as on each of the company's officers, directors (or any person occupying a similar status or performing a similar function) and 20% owners.

The rules contain bad actor disqualification provisions similar to those recently adopted for Rule 506 of Regulation D (for a discussion of these rules, see <http://www.hinshawlaw.com/newsroom-publications-alerts-524.html>).

The intermediary will have to make publicly available on the intermediary's platform all of the company's required disclosures at least 21 days before any securities are sold and until the crowdfunding offer has been completed or cancelled.

Investor Accounts and Disclosure Requirements

An intermediary will not be able to accept an investment commitment from an investor until the investor opens an account with the intermediary and the investor consents to the electronic delivery of materials.

The intermediary would have an ongoing duty to provide the investor with the following:

Educational Materials. Upon the opening of an account, the intermediary will have to deliver the investor the following information: (i) the process for the offer, purchase and issuance of the securities, (ii) the risks associated with the securities being sold in a crowdfunding transaction, (iii) the types of securities being sold and the risks associated with each type of security, and (iv) the resale restrictions imposed on the securities in a crowdfunding offering.

In addition, the intermediary must disclose (i) the type of information required in the reports to be filed by selling companies, the frequency of delivery of such reports and the possibility that the obligation to file such reporting may terminate, (ii) the limitations on the amount an investor may invest and the investor's ability to cancel the investment, (iii) the need for the investor to consider whether the investment is appropriate, and (iv) the possibility that the company and intermediary may have an ongoing relationship.

An intermediary must make the most current version of its educational material available on its platform at all times and, if at any time, the intermediary makes a material revision to its educational materials, it must make the revised educational materials available to all investors before accepting any additional investment commitments or effecting any further transactions in securities offered and sold in reliance on the crowdfunding exemption.

Company Information. An intermediary must make available to the SEC and potential investors, not later than 21 days prior to the first day on which securities are sold to any investor, any information required to be provided by the company under the crowdfunding rules. This information must be publicly available on the intermediary's platform. It must be presented in a manner that reasonably permits a person accessing the platform to save, download or otherwise store the information.

This information, and any additional information provided by the company, must remain publicly available on the intermediary's platform until the offer and sale is completed or

cancelled. An intermediary cannot require any person to establish an account with the intermediary in order to receive this information.

Notice of Investment Commitment. Upon receipt of an investment commitment, the intermediary will have to promptly notify the investor of: (i) the dollar amount of the investment commitment; (ii) the price of the securities, if known; (iii) the name of the company; and (iv) the cancellation deadline for the investment commitment.

Confirmation of a Transaction. At or before the completion of a transaction, the intermediary will have to send to each investor a notification confirming information related to the securities purchased by the investor. This information will include, among other things: (i) the date of the transaction; (ii) the type of security; (iii) the price and number of securities purchased; and (iv) the source and amount of compensation to be received by the intermediary.

Promoters. Intermediaries will have to advise investors of any person promoting the company's offering for compensation or who is a founder or an employee of the company that promotes the company on the intermediary's platform. It must disclose in all communications on the intermediary's platform that the promoter, founder or employee is: (i) receiving compensation; and (ii) engaging in promotional activities on behalf of the company.

Disclosure of Compensation. When establishing an account, the intermediary will have to disclose the manner in which it is compensated in connection with crowdfunding offerings.

Investor Qualification

Before accepting any investment commitment, an intermediary must have a reasonable basis to believe that the investor satisfies the investment limitations discussed above (see "**Offering and Investment Limits**"). The intermediary may rely on the investor's representations that the investor so qualifies unless the intermediary has reason to believe otherwise.

The intermediary will have to obtain from the investor a representation that the investor has reviewed the intermediary's educational materials, understands that the entire investment may be lost and is capable of bearing the risk of loss in the investment.

The investor will also have to complete a questionnaire affirming the investor's understanding that: (i) there are restrictions on the investor's ability to cancel or obtain a return of the investment; (ii) it may be difficult to resell the acquired securities; (iii) the investment involves risks; and (iv) the investor should not invest unless the investor can afford to lose the entire investment.

Communication Channels

The communication channels on an intermediary's platform must allow investors and potential investors to communicate with one another and with representatives of the company, provided that the intermediary must:

- permit public access to view the communication channels;

- restrict posting on the communication channels to only those that have accounts with the intermediary; and
- require all persons posting comments in the communication channels to disclose whether he or she is a founder, employee of the company engaging in promotional activities on behalf of the company or is otherwise compensated to promote the company's offering.

If the intermediary is a funding portal, it may not participate in such communications other than to establish guidelines for communication and remove abusive or potentially fraudulent communications.

Disposition of Investor Funds

An intermediary that is a registered broker would have to comply with Rule 15c2-4 of the Exchange Act when handling investor funds. Under these rules, investor funds must be held in escrow until the specified contingency occurs (i.e., the targeted amount or the minimum amount is raised). The funds would then be promptly transmitted to a bank, which has agreed in writing to hold such funds in escrow for the investors and to transmit or return such funds directly to the company or to investors, as the case may be. Proceeds are to be transmitted to the company only if the target offering amount is met or exceeded and the offering closes.

If an intermediary is a funding portal, it must instruct investors to send their funds to a qualified third-party (a broker or dealer, bank or credit union) that will hold the funds in escrow. If the company reaches its target amount by the offering deadline and closes the offering, the funding portal will direct the third-party to transmit the funds to the company. If the investor cancels its investment commitment or the company fails to complete the offering, the funding portal will instruct the third-party to return the funds to the investors.

If there is a material change to the offering or the information provided by the company, the intermediary must take the actions described in “**Completion of Offerings, Cancellations, Reconfirmations and Material Changes**”.

Completion of Offerings, Cancellations, Reconfirmations and Material Changes

Investors will have an unconditional right to cancel an investment commitment for any reason until 48 hours prior to the deadline set forth in the company's crowdfunding materials. Thereafter, an investor will not be able to cancel any investment commitments made within the final 48 hours (except in the event of a material change to the offering).

If a company reaches the target offering amount prior to the announced deadline, it may close the offering early if at the time of the new offering deadline, the company continues to meet or exceed the target offering amount. To effectuate this, the offering will have to have remained open for a minimum of 21 days. In addition, the intermediary must provide notice to investors about the new offering deadline at least five business days prior to the new offering deadline. An investor must be given the opportunity to reconsider the investment and to cancel the investment until 48 hours prior to the new offering deadline.

If there is a material change in the offering or the information provided by the company, the intermediary must communicate the material change to any investor who made an investment commitment. The intermediary must also indicate that the investor's investment will be cancelled unless the investor reconfirms his or her commitment within five business days of receipt of the notice. If the investor fails to reconfirm the investment, the intermediary will then provide or send the investor a notification disclosing that the commitment has been cancelled, the reason for the cancellation and the refund that the investor should expect to receive. The intermediary would also direct the party holding the offering proceeds to refund the investor's funds.

If material changes to the offering or to the information provided by the company regarding the offering occur within five business days of the maximum number of days that an offering is to remain open, the offering must be extended to allow for a period of five business days for the investor to reconfirm his or her investment.

If there is a material change, the company must file an amendment on Form C/A with the SEC and the intermediary (see "**Amendment of Offering Circular**").

Finally, if a company does not complete an offering because the target is not reached or the company decides to terminate the offering, the intermediary must, within five business days, give or send to each investor who made an investment commitment a notification disclosing the cancellation of the offering, the reason for the cancellation, and the refund amount that the investor should expect to receive. The intermediary must direct the party holding the offering proceeds to refund the investors' funds. The intermediary must also prevent investors from making investment commitments with respect to that offering on its platform.

Intermediaries--Funding Portals

General

Under the crowdfunding rules, a crowdfunding transaction must take place exclusively online through platforms operated by **a single** SEC registered intermediary, either a registered broker-dealer or a new type of SEC registrant called a "funding portal." An intermediary must be a member of FINRA or any other applicable national securities association registered under Section 15A of the 1934 Act.

A funding portal is defined as any person acting as an intermediary in a crowdfunding transaction 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; or
- hold, manage, possess or otherwise handle investor funds or securities.

SEC Registration

A funding portal must register with the SEC by filing a Form Funding Portal, which includes information concerning the funding portal's principal place of business; its legal organization; its disciplinary history, if any; its business activities, including the types of compensation the funding portal has received; FINRA membership and membership with any other registered national securities association; and the funding portal's website address(es) or other means of access.

A funding portal's registration will become effective the later of (a) 30 calendar days after the date that the registration is received by the SEC; or (b) the date the funding portal is approved for membership in FINRA. All such filings will be publicly available.

A funding portal must file an amendment to the Form Funding Portal within 30 days if any of the information in the original form becomes inaccurate for any reason. A funding portal will have to promptly file a withdrawal of registration on Form Funding Portal upon ceasing to operate as a funding portal. The withdrawal will be effective on the later of (i) 30 days after receipt by the SEC; (ii) after the funding portal is no longer operational; or (iii) within such longer period of time as to which the funding portal consents which the SEC, by order may determine as necessary or appropriate in the public interest or for the protection of investors.

Funding Portal Safe Harbors

Because funding portals are limited to acting as intermediaries in crowdfunding transactions, they cannot effect secondary market transactions in securities issued in reliance on the crowdfunding exemption. The crowdfunding rules, however, provide a non-exclusive safe harbor for funding portals that engage in limited activities that may otherwise trigger a violation of these prohibited activities.

A funding portal is exempt from the broker registration requirements of Section 15(a)(1) of the 1934 Act and may, among other things:

- (i) limit offerings made on or through the funding portal's platform, (ii) highlight certain offerings, or (iii) provide search functions, in each case based on objective eligibility requirements;
- provide communication channels for potential investors and companies subject to restrictions;
- advise companies on the structure of offerings and content of disclosures, including assisting in the preparation of the offering documents;
- compensate others for referring persons to the funding portal as discussed above in "**Compensation**"; and
- advertise the funding portal's existence, including identifying available offerings on the basis of objective criteria.

Fidelity Bond

The proposed rules required a funding portal must procure a fidelity bond. This requirement was not included in the final rules.

Anti-Money Laundering

Funding portals must comply with anti-money laundering and Bank Secrecy Act rules.

Nonresident Funding Portals

Funding portals incorporated or organized under the laws of a jurisdiction outside the United States (“nonresident funding portals”) may register with the SEC. The SEC must retain comparable authority over the nonresident funding portal in the nonresident funding portal’s foreign jurisdiction.

FINRA Membership

The JOBS Act and the crowdfunding rules require funding portals to become members of FINRA. FINRA has proposed rules that would apply to funding portal members.

To become a FINRA member, a funding portal would have to file with FINRA an application on Form FP-NMA.

FINRA will approve the application if it determines that the applicant meets the five standards for membership contained in the proposed FINRA rules (set forth below).

FINRA will also establish a system which would make certain information about funding portal members publicly available.

Standards for FINRA Funding Portal Membership. In order to demonstrate that it can meet the FINRA funding portal membership rules, an applicant must show that it:

- is capable of complying with applicable federal securities laws, rules and regulations and FINRA rules;
- has established all contractual or other arrangements to initiate and conduct its business activities;
- has a supervisory system reasonably designed to achieve compliance with applicable federal securities laws, rules and regulations and FINRA rules;
- has established and disclosed all sources of funding; and
- has a sufficient recordkeeping system.

FINRA Conduct Rules. The proposed FINRA rules would impose conduct standards on funding portal members.

Disqualification. Funding portal members would be subject to disqualification procedures similar to those applicable to broker-dealers and their associated persons.

Conclusion

The theory underlying crowdfunding is that it is a capital raising technique that will allow startups to inexpensively raise capital from a large group of investors. The investment opportunity would be available to all investors, not just those with a high net worth or net income, allowing the small investor to acquire shares on a company that one day might become a Fortune 100 company (e.g., Facebook) and reap the benefits of such an investment.

The JOBS Act provisions and the SEC crowdfunding rules are supposed to allow startups and small investors to take advantage of these capital raising opportunities. As can be seen from what follows, however, the JOBS Act provisions and crowdfunding rules establish what may be a cumbersome and potentially costly regulatory regime. Costs companies may incur in meeting requirements related to financial statements and costs related to preparing the required offering circular may deter companies from undertaking crowdfunding offerings. In addition, companies will have to pay a fee to an intermediary for its services.

Furthermore, companies that use the exemption will have to post their financial information on their websites in an annual report; the report will be available for all the world to see, including competitors. Because of the individual investor investment limitations, a company may add a significant number of shareholders. It may be costly and time consuming to manage all of these new shareholders. Companies will have to consider a variety of issues when it brings in a new group of investors that it may not have had to consider when it was closely held, such as will fiduciary duties that are owed to shareholders, the observance of more corporate formalities, the election of directors and the distribution of company information.

With a proposed limit of \$1 million on the amount that a company may raise in crowdfunding transactions in any 12-month period and the costs that may be incurred to complete a crowdfunding offering, the issue to be resolved is whether the benefits of raising capital through crowdfunding or acting as a crowdfunding intermediary would be great enough to justify the compliance costs and potential liability risks.

For further information on this issue, please contact Tim Sullivan, Mike Morehead or your regular Hinshaw attorney.

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